EUROPEAN CENTRAL BANK

EUROSYSTEM

PRESS RELEASE

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Global risk repricing endangers financial stability

- The euro area financial system has shown resilience and systemic stress has remained relatively low
- Risks of global asset market corrections have intensified, partially due to political uncertainty and expected US policy changes
- Vulnerabilities remain significant for euro area banks due to structural factors and despite the steepening of the yield curve

The euro area financial system has shown resilience in the face of repeated bouts of financial market turbulence over the past six months according to the latest Financial Stability Review of the European Central Bank. However, risks to euro area financial stability related to possible global asset market corrections have intensified.

Compared with the previous assessment, the review sees the possibility of further asset price changes, triggered by political events in advanced economies, amid existing vulnerabilities in emerging markets.

The financial stability implications for the euro area stemming from changes in US economic policies are highly uncertain at this point in time. The euro area economy may be directly impacted via trade channels and by possible spillover effects from higher interest and inflation rate expectations in the US.

Vulnerabilities remain significant for euro area banks. Profitability prospects overall remain low across the euro area in a subdued economic growth environment. Banking sector structural challenges stem from high stocks of non-performing loans (NPLs), high operating costs and excess capacity, with different incidence across countries.

In recent weeks, banks' stock prices have recovered somewhat, as investors' fears of ever-tighter bank regulation have been receding and increases in euro area bond yields have contributed to a steepening of yield curves. If sustained, steeper yield curves may provide some support for euro area banks' profitability prospects, although these are currently at low levels.

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Risks extend also to the real economy. In particular, concerns about debt sustainability might re-emerge despite relatively benign financial market conditions. Higher political uncertainty may lead to more domestically focused, growth-hindering policy agendas. This, in turn, could delay much needed fiscal and structural reforms and could in a worst-case scenario reignite pressures on more vulnerable sovereigns.

Risks to euro area financial stability also stem from the non-bank financial sector. Investment funds, in particular, have grown rapidly in recent years. The more important role played by investment funds needs to be met with a commensurate increase in monitoring. Many of these funds are exposed to liquidity mismatches. This characteristic increases the potential for the investment fund sector to amplify market-wide shocks due to its high interconnectedness with credit institutions.

The ECB has singled out four systemic risks to financial stability over the next two years:

- Global risk repricing leading to financial contagion, triggered by heightened political uncertainty in advanced economies and continued fragilities in emerging markets
- Adverse feedback loop between weak bank profitability and low nominal growth, amid challenges in addressing high levels of non-performing loans in some countries
- Re-emerging sovereign and non-financial private sector debt sustainability concerns in a low nominal growth environment, if political uncertainty leads to stalling reforms at the national and European levels
- Prospective stress in the investment fund sector amplifying liquidity risks and spillovers to the broader financial system

The review also contains three special features. The first special feature develops a framework to guide the design and calibration of macroprudential leverage limits for alternative investment funds. The second discusses impediments to the functioning of a market for NPL sales; it highlights indicators of market failure and distinguishes between supply and demand factors that impede market functioning. The third examines the financial stability implications of greater reliance by banks on fee and commission income.

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