EUROPEAN CENTRAL BANK

EUROSYSTEM

PRESS RELEASE

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Euro area financial stability environment has become more challenging

- Possibility of broader stress in emerging markets, rising debt sustainability concerns and trade tensions pose challenges
- Bank resilience improved, but structural vulnerabilities continue to restrain profitability
- Liquidity concerns are growing amid increased risk-taking by investment funds

The euro area financial stability environment has become more challenging since May, the latest Financial Stability Review (FSR) of the European Central Bank (ECB) says. On the positive side, a growing economy and improved banking sector resilience have continued to support the financial stability environment in the euro area. Furthermore, a series of volatility events have not spread to the broader global financial system. At the same time, downside risks to the global growth outlook have become more pronounced since May relating to a resurgence in protectionism and stress in emerging markets. Vulnerabilities in financial markets continue to build up amid pockets of high valuations and compressed global risk premia. In the euro area, political and policy uncertainty, related to market concerns about public spending plans have increased over the review period. In addition, the possibility of a cliff-edge Brexit could pose a risk to financial stability.

With a maturing global business and financial cycle, a number of market indicators appear to signal downside risks to global asset prices. A snapback of term premia on global benchmark bonds, in particular, could materialise and possibly spill over to the euro area. Meanwhile, the prospect of renewed stress in emerging market economies tested the resilience of the global financial system. Over the summer months Argentina and Turkey witnessed significant increases in bond spreads, falling stock prices and large currency depreciations. Higher US interest rates or rising trade tensions could spark further stress in emerging market economies, the FSR warns.

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Within the euro area, market concerns about budgetary plans in Italy have risen since May. Losses observed in Italian financial markets over the past six months have however not meaningfully spilled over to other euro area countries.

The profitability of euro area significant banks remained broadly stable in the first half of 2018. However, the average return on equity (at around 7%) still falls short of banks' cost of capital. Structural vulnerabilities including overcapacity in certain domestic banking markets and high operating costs continue to dampen bank profitability. At the same time, reductions in non-performing loans (NPLs) continued apace. As a result, banks' NPL ratios have nearly halved since 2014.

Banks' solvency positions remain solid. The recent European Banking Authority (EBA) stress test confirmed that the capitalisation of euro area banks is sufficient to weather a severe adverse scenario. Additional sensitivity analyses to account for recent developments not specifically catered for in the test lead to an additional capital depletion of around 30 to 70 basis points on top of the overall Common Equity Tier 1 ratio depletion of 380 basis points in the adverse scenario of the EBA stress test.

The FSR also highlights risks building up outside the banking sector – notably in the investment fund sector. Over the past ten years the total assets of euro area investment funds have more than doubled to €13.8 trillion in June 2018, with the size of the non-bank financial sector approaching half that of the euro area banking sector. Growing exposures to illiquid and risky assets make the funds vulnerable to potential shocks in global financial markets.

The Review also contains three special features. The first special feature examines how banks can reach sustainable levels of profitability. The second examines the implications for financial stability of a resurgence of trade tariffs. The third discusses the rapid growth in exchange-traded funds and their potential for transmitting and amplifying risks within the financial system.

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