EUROPEAN CENTRAL BANK
EUROSYSTEM

Press release

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Euro area financial stability environment remains challenging

- Low interest rates support economic activity, but there can be side effects
- Signs of excessive risk-taking in some sectors require monitoring and targeted macroprudential action in some countries
- Banks have further increased resilience, but have made limited progress in improving profitability

Downside risks to global and euro area economic growth have increased and continue to create financial stability challenges, according to the November 2019 Financial Stability Review (FSR) of the European Central Bank (ECB). Low interest rates should support economic activity in the euro area, but may also encourage excessive risk-taking by some non-bank financial institutions and highly leveraged non-financial corporations, and in some real estate markets.

"While the low interest rate environment supports the overall economy, we also note an increase in risk-taking which could, in the medium term, create financial stability challenges", said Luis de Guindos, Vice-President of the ECB. "Authorities should use available tools to address the build-up of vulnerabilities where possible."

Non-banks, such as investment funds, insurance companies and pension funds, which play an increasingly important role in the financing of the real economy, have continued to take on more risk and have increased their exposure to riskier segments of the corporate and sovereign sectors. In the event of a sudden repricing of financial assets, growing credit and liquidity risk in some parts of the euro area non-bank financial sector – coupled with higher leverage in investment funds – may lead non-banks to respond in ways that cause stress to spread to the wider financial system.

Pockets of vulnerability also remain in the non-financial corporate sector and some property markets. Low funding costs appear to be encouraging more borrowing by riskier firms. At the same time, property markets in a number of euro area countries have continued to see rising prices. Authorities are using,

European Central Bank
Directorate General Communications, Global Media Relations Division
Sonnemannstrasse 20, 60314 Frankfurt am Main, Germany
Tel.: +49 69 1344 7455, e-mail: media@ecb.europa.eu, website: www.ecb.europa.eu

and should continue to use, targeted macroprudential measures, where available, to address the associated risks to financial stability.

Euro area banks' profitability prospects have deteriorated further, despite expectations of a modest but continued increase in net interest, fee and commission income. Return on equity of euro area banks is expected to face further pressure from both a weaker economic outlook and persistent cost inefficiencies and overcapacity. Even so, the banking sectors' solvency position remains robust with a Common Equity Tier 1 ratio of over 14%. And even under an adverse stress scenario, the aggregate solvency ratio is expected to remain above 11%.

This issue of the FSR contains two special features, including one that examines how and where consolidation could help banks to improve their profitability. It also includes eight boxes, including one which looks at the impact of cross-border transactions on real estate markets and one which considers the implications of misconduct costs for banks.

For media queries, please contact William Lelieveldt, tel.: +49 69 1344 7316.

European Central Bank
Directorate General Communications, Global Media Relations Division
Sonnemannstrasse 20, 60314 Frankfurt am Main, Germany
Tel.: +49 69 1344 7455, e-mail: media@ecb.europa.eu, website: www.ecb.europa.eu