EUROPEAN CENTRAL BANK

EUROSYSTEM

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Challenges to financial stability increase amid downside risks to the economic outlook

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- Materialisation of downside risks to economic growth could spark greater financial market volatility
- Persistent downside risks to growth reinforce the need to strengthen balance sheets of highly indebted firms and governments
- Bank profitability prospects subdued given slow progress in addressing structural issues

"If downside risks to the growth outlook were to materialise, risks to financial stability may arise," said Luis de Guindos, Vice-President of the ECB. "The growth outlook is central to all the main risks to financial stability."

Uncertainty about global economic growth prospects has contributed to bouts of high volatility in financial markets. Weaker than expected growth and a possible escalation of trade tensions could trigger further falls in asset prices, the FSR warns.

Repricing risks appear particularly high in riskier segments of the corporate sector. The global leveraged loan sector, which has grown significantly in recent years, is susceptible to weaker corporate earnings. The FSR sets out how this sector could pose risks to financial stability, particularly given uncertainties about ultimate exposures to the riskiest parts of collateralised loan obligations.

Should downside risks to growth materialise, financing costs for vulnerable sovereigns are likely to increase which may unearth debt sustainability concerns. In addition to the high level of debt and large fiscal deficits, some countries could face rollover risks if market participants were to reassess sovereign risk.

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Bank profitability is expected to remain low in the euro area. ECB estimates point to an aggregate return on equity of around 6% over the next 2-3 years. A large share of euro area banks will not be able to meet the expected returns required by investors (of around 8-10%). That said, euro area banks' capital adequacy remains strong, implying widespread resilience to plausible adverse scenarios. Notwithstanding this near-term resilience, the FSR highlights that any change in the credit rating outlook could lead to higher medium-term funding costs for banks. In order to return to sustainable profitability, euro area banks need to tackle a number of structural challenges – such as low cost-efficiency, limited revenue diversification and still high stocks of legacy assets in some countries.

The FSR also reports on continued high risk-taking in the non-bank and fund sector. There are signs that more funds are increasing their leverage and their exposure to higher-yielding assets with commensurately higher credit risk. A renewed sudden repricing of financial assets could trigger large outflows and possibly result in forced asset sales by investment funds, thereby amplifying stress in less liquid markets.

This issue of the FSR contains three special features, including one that looks at the financial stability challenges stemming from climate change, amongst other things reflecting on the measurement of risks from physical manifestations of climate change as well as transition risks on the way towards meeting internationally agreed climate objectives.

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