DIRECTORATE GENERAL MACROPRUDENTIAL POLICY AND FINANCIAL STABILITY

MACROPRUDENTIAL POLICIES AND FINANCIAL STABILITY CONTACT GROUP

FRANKFURT AM MAIN, WEDNESDAY 27 SEPTEMBER 2017

MEETING SUMMARY

1) Introductory presentation by the ECB

ECB staff presented the ECB's views on the risks and vulnerabilities for euro area financial stability as published in the May 2017 ECB Financial Stability Review (see Table 1). According to the MFCG members, repricing in global markets remains the primary risk to euro area financial stability. Most MFCG members are however more concerned about public and private debt sustainability than about adverse feedback loops between weak bank profitability and low nominal growth.

Table 1

Key risks to euro area financial stability

	Current level (colour) and recent change (arrow)*
pronounced systemic risk	
medium-level systemic risk	
potential systemic risk	
Repricing in global fixed income markets – triggered by changing market expectations about economic policies – leading to spillovers to financial conditions	medium-level, →
Adverse feedback loop between weak bank profitability and low nominal growth, amid structural challenges in the euro area banking sector	medium-level, →
Public and private debt sustainability concerns amid a potential repricing in bond markets and political uncertainty in some countries	medium-level, ↑
Liquidity risks in the non-bank financial sector with potential spillovers to the broader financial system	potential, →

Source: ECB Financial Stability Review May 2017

* The colour indicates the cumulated level of risk, which is a combination of the probability of materialisation and an estimate of the likely systemic impact of the identified risk over the next 24 months, based on the judgement of the ECB's staff. The arrows indicate whether the risk has increased since the previous FSR.

2) Market developments since the February 2017 MFCG meeting

Members discussed the financial stability outlook shaped by the low level of volatility in financial markets. Members considered that the current low volatility regime is in part driven by fundamental factors, such as a low level of economic surprises, low earnings volatility, low default rates, and low overall financial system leverage. Quantitative easing policies by key global central banks were also seen as impacting price discovery mechanisms, with volatility dampening effects. With regard to the financial stability implications of the low volatility environment, which does not seem to reflect current political and geopolitical risks, it could rather contribute to a higher risk appetite and allow for more risk taking . The low volatility environment was also seen as fertile ground for high asset valuations and members discussed comparisons and differences with previous bubble episodes. A correction in financial markets would affect in particular interest-rate sensitive assets. Members also discussed potential triggers for a correction in financial markets. Members regarded investors' behaviour as complacent. While some degree of policy normalisation is widely expected, there is no visible forward-looking behaviour in investor positioning consistent with that expectation.

3) The aftermath of recent bank resolutions/liquidations

Members discussed the implications of the resolution and the liquidations of banks in Spain and Italy, events which had occurred since the February 2017 MFCG meeting.

It was important to note that the resolution/liquidation actions did not have a systemic impact, but members argued that the different approaches were seen as confusing. Some members nonetheless saw these bank failures as an incentive for others to hold more capital and fast-track their capital-augmenting plans. However, members also commented that in spite of the absence of contagion the gap between the funding costs of small non-systemic versus large systemic banks has widened. This shift was seen as permanent and a reflection of the higher likelihood of resolution actions being taken against smaller institutions. Members also discussed the outlook for bank M&A in Europe. Most members saw limited scope for cross-border M&A activity and, in the absence of further incentives for cross-border deals, expect M&A to be limited to local institutions.

4) Brexit – state of financial services sector preparations

Following up on the ECB's message[1] on the need for proper and timely planning by financial institutions to reduce the risks of a cliff-edge effect, especially if no transitional agreement would be reached, members discussed the state of preparations for Brexit in different sectors of the financial services industry and remaining challenges. Many members highlighted the difficulties in navigating complex issues without a clear roadmap. This notwithstanding, most members did not see Brexit as a major systemic risk for the euro area as they were not overly concerned about the risk of the euro area being excluded from access to wholesale financial services. They agreed, however, that the impact is likely to be mainly reflected in the cost of financial services. The main concerns for global banks relate to the cost and capital implications of a potential loss of passporting for banking and investment services within the EU. Also for the insurance and asset management sectors, members saw limited material dangers of cliff-edge disruptions, and preparations are focusing on continuity of services to customers. Issues around the clearing of euro-denominated derivatives were seen as being at the centre of the Brexit debate and as also having an impact on other areas of financial services. Brexit is expected to have an impact on the market for CCP cleared derivatives in the EU. Members had different views on the additional margins related to a potential relocation of euro-denominated derivatives and, in order to mitigate operational risks, highlighted the need for a transition period, especially for existing exposures.

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[1] See May 2017 Financial Stability Review, Box 1: "Preparing for Brexit to secure the smooth provision of financial services to the euro area economy."