



EUROPEAN CENTRAL BANK

EUROSYSTEM

DIRECTORATE GENERAL - MACROPRUDENTIAL POLICY AND FINANCIAL STABILITY

FINANCIAL STABILITY SURVEILLANCE DIVISION

MACROPRUDENTIAL POLICIES AND FINANCIAL STABILITY CONTACT GROUP





FRANKFURT AM MAIN, THURSDAY 10 SEPTEMBER 2015, 09:00-13.30 CET

MEETING SUMMARY

1. Update of key risks to euro area financial stability.

Members discussed the evolution of key risks to euro area financial stability since the publication of the May 2015 Financial Stability Review (see Table below). According to the views of the MFCG, an abrupt reversal of compressed global risk premia amplified by low secondary market liquidity remains the primary risk to euro area financial stability. The majority of members observed signs of overvaluation across euro area bond markets and all agreed that low secondary market liquidity would amplify price movements, should an adjustment occur. In contrast, they did not find broad based evidence of stretched valuations in euro area equity markets, although some concerns were raised regarding elevated price-to-earnings ratios in other markets, particularly the US and China. Members noted the improvement in euro area banks' profitability this year but still expressed concern that banks faced significant challenges going forward, largely owing to the environment of low nominal growth and regulatory uncertainty. Regarding Greece, MFCG members agreed that contagion to other euro area countries had been limited. However, most members felt that stretched public and private sector balance sheets in certain euro area countries would be a drag for economic recovery and should be monitored closely with respect to financial stability. On net, members felt the migration of traditional banking sector activities to the shadow banking sector, while on the positive side diversifying companies funding structures, could create challenging issues for euro area financial stability.

Table 1: Key risks to euro area financial stability

	Current level (colour) and recent change (arrow)*
1. Abrupt reversal of compressed global risk premia amplified by low secondary market liquidity	
2. Weak profitability prospects for banks and insurers in a low nominal growth environment, amid slow progress in resolving problem assets	
3. Rise of debt sustainability concerns in the sovereign and corporate sectors amid low nominal growth	
4. Prospective stress and contagion effects in a rapidly growing shadow banking sector	

Source: May 2015 Financial Stability Review

2. How are investors coping in the challenging macrofinancial environment?

Preceding a general discussion, introductory presentations were given on:

- i. Emerging market weaknesses and their implications for euro area financial stability (RBS).
- ii. Implications of diverging monetary policy cycles and risks to emerging market growth for asset allocation decisions and risk exposures (Blackrock).

The MFCG discussed possible spillover effects of correcting imbalances in emerging market economies to euro area financial stability. While most members were concerned about growing challenges in emerging markets, some were puzzled as regards the significant impact events in China exerted on global financial markets, in particular euro area equity markets, given limited direct trade and financial links to the country. The group also reviewed the role of monetary and market liquidity for risk taking incentives of asset managers. Concerns were expressed regarding a growing correlation of global asset price movements, which some members felt was reflective of an extended period of extraordinarily low levels of volatility. It was noted that in such an environment, there is only one (risk-on) trade. There was a broad based consensus among members that low secondary market liquidity was amplifying price movements in global bond markets.

3. Growing role for Central Counterparties (CCPs): Weighing the benefits and risks

Preceding a general discussion, introductory presentations were given on:

- i. Key risks facing CCPs and how they are managed (LCH.Clearnet).
- ii. Euro area banks' exposures to CCPs (HSBC).

In the general discussion members agreed that the role of CCPs in the financial system had increased considerably in the aftermath of the global financial crisis and the introduction of regulation mandating the clearing of standardised derivatives. Members stressed different risk mitigating contributions of CCPs as well as the degree to which the increased concentration of financial system activities in these regulated entities could negatively affect financial stability. While some members raised concerns regarding the lack of a clear recovery and resolution framework for CCPs, others felt that risks to CCPs were well managed by the entities.

4. Tackling remaining challenges in the euro area banking sector

Preceding a general discussion, introductory presentations were given on:

- i. Bank restructuring and consolidation: have banks turned a corner as regards legacy assets and what still needs to be done (Bank of America Merrill Lynch).
- ii. Bank business models adapt to regulatory change (Goldman Sachs).

Participants acknowledged the improvement in euro area banks profitability and efforts to reduce the stock of non-performing assets. Members discussed lessons to be learned from past experiences of successful non-performing loan resolution in Europe, which could be important for those countries where more effort will still be required. The discussion then focused on the significance of regulation and supervision for the consolidation process of the European banking sector. Some members expected larger institutions, designated as globally systemically important institutions, to reduce in size as additional capital charges reduced economies of scale and weighed on profitability, while smaller institutions would further consolidate.