EUROPEAN CENTRAL BANK

EUROSYSTEM

PRESS RELEASE

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Euro area systemic stress contained despite bouts of global financial market turbulence

- Europe's financial system showed resilience in face of rising vulnerabilities stemming from emerging market economies and financial market turbulence over the past six months
- Economic and financial vulnerabilities persist in the form of high legacy debt, both public and private, and a weak economic recovery
- Euro area banking sector repair continues amid challenges to profitability and, in some countries, high stocks of non-performing loans

The euro area financial system was able to absorb the strong turmoil around the turn of the year according to the latest Financial Stability Review of the European Central Bank (ECB). Bank, financial and sovereign stress all stood at low levels in early May. Notwithstanding this resilience, looking ahead the Review sees the risk of further financial stress, possibly triggered by vulnerabilities stemming from emerging markets and low commodity prices.

Global financial market tensions also extended to euro area banks. Volatility increased significantly in the first months of the year as investors grew increasingly concerned about banks' ability to generate sustainable profits in a low growth and interest rate environment. ECB monetary policy measures announced in March, coupled with better macroeconomic data, subsequently helped to restore market confidence.

Euro area financial institutions have made steady progress in strengthening their balance sheets and building up their resilience to adverse shocks in recent years. Despite this progress, both cyclical and structural challenges remain. Cyclical challenges relate to the subdued economic recovery, while structural challenges relate to high operating costs and a large stock of non-performing loans. In

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

particular, high unresolved stocks of non-performing exposures in some countries are dampening banks' lending capacity and their profitability.

Risks extend also to the real economy. In particular, concerns remain about euro area sovereign debt sustainability despite relatively benign financial market conditions. In particular, political risks have increased considerably in almost all euro area countries in recent years. Higher political uncertainty may further delay structural reforms and possibly exert renewed pressure on more vulnerable sovereigns.

There are also risks that stem from outside the traditional banking sector. Over the past few years assets managed by investment funds have expanded rapidly. Parts of the investment fund sector perform significant liquidity transformation and are also highly interconnected with other parts of the financial system. The Review also reports that investment funds have gradually increased their exposure to the riskier segments of the financial markets. Higher stress in parts of the investment fund sector has the potential to spread rapidly to other financial sectors owing to high interconnectedness.

The ECB has singled out four systemic risks to financial stability over the next two years:

- Further increase of risk premia and financial turmoil, triggered by emerging market stress and persistently low commodity prices
- Weak profitability prospects for banks and insurers, with banks' intermediation additionally constrained by unresolved problems in reducing non-performing loans
- Rising debt sustainability concerns in sovereign and non-financial private sectors amid heightened political uncertainty and low nominal growth
- Prospective stress in the investment fund sector amplified by liquidity risks and spillovers to the broader financial system

The Review also contains three special features. The first special feature presents the general case for setting macroprudential margins and haircuts on derivatives and securities financing transactions. The second examines systemic implications of the bail-in tool under the Bank Recovery and Resolution Directive. The third reviews recent trends in business model characteristics and discusses how they affect bank stability and performance.

For media queries, please contact Uta Harnischfeger, tel.: +49 69 1344 6321.

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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