



EUROPEAN CENTRAL BANK
EUROSYSTEM

PRESS RELEASE

24 May 2018

Financial stability conditions in euro area remain favourable but risk-taking in most financial markets intensified

- Improved economic conditions support financial stability environment
- Risk-taking in most financial markets gained momentum
- Bank profitability improved, but structural vulnerabilities remain

Systemic risk for the euro area has remained low over the past six months, the latest biannual Financial Stability Review of the European Central Bank finds. This was helped by better growth prospects, both outside and in the euro area.

However, vulnerabilities are building up in global financial markets. A surge in volatility in US stock markets in early February highlighted the current fragile market sentiment. Narrow risk premia and signs of increased risk-taking in most global financial markets require close attention. At this stage, no broad-based asset price misalignments can be observed across euro area financial and tangible assets. Yet, some pockets of stretched valuations are appearing, particularly for lower-rated bonds and in certain real estate markets.

The profitability of euro area banks improved on the back of a better cyclical situation. The level of profitability is, however, still weak, reflecting persisting structural challenges. Larger capital buffers have made banks more resilient and banks have not stepped up their risk-taking to boost their revenue.

The euro area sovereign sector has also become more resilient thanks to the improved macroeconomic outlook, helping keep financing costs low in some countries. Headline fiscal balances and indebtedness of euro area countries are expected to improve over the coming years, supported by the advantageous cyclical conditions. However, a deteriorating growth environment or a loosening of the fiscal stance in

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high-debt countries could impact the fiscal outlook and, by extension, market sentiment towards some euro area sovereign issuers.

The Review also highlights risks building up in the investment fund sector. Aiming to boost returns, funds have extended the maturity and increased the credit risk of their portfolios. At the same time, they have drawn down their liquidity buffers. Together, these developments make investment funds more prone to amplifying any repricing in global financial markets.

The Review singles out four main risks to financial stability in the euro area over the next two years. The first risk relates to spillovers from a disruptive repricing of risk premia in global financial markets. The second risk relates to a potential hampering of the ability of banks to intermediate amid weak financial performance compounded by structural challenges. The third risk relates to public and private debt sustainability concerns amid historically high debt levels. Finally, the fourth risk relates to liquidity risks that could emerge in the non-bank financial sector, with contagion to the broader system. All four of these risks are intertwined and any one of them could trigger the others.

The Review also contains three special features. The first special feature presents a new composite financial stability risk index (FSRI) aimed at predicting large adverse shocks to the real economy in the near term. The second introduces a composite cyclical systemic risk indicator (CSRI) designed to signal risks of a financial crisis over the medium term. The third analyses the distribution of interest rate risk in the euro area economy using balance sheet data and information on derivative positions from significant credit institutions.

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