



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 25 FEBRUARY 2016, 09:00-13.30 CET

MEETING SUMMARY

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

Members discussed the evolution of risks to euro area financial stability since the publication of the November 2015 Financial Stability Review (FSR). Their ranking of key risks was consistent with that published in the November FSR. Concerns among members regarding euro area banks' profitability had increased since the last meeting in September, a reflection of the deterioration in the global nominal growth outlook and related turbulence in bank equity and subordinated debt markets that occurred during the intervening period. Nonetheless, they still considered risks surrounding euro area banks' profitability as secondary to the threat of an abrupt reversal of global risk premia. The majority of members believed global risk premia would rise further this year and that financial asset price movements would be amplified by low secondary market liquidity. The liquidation of assets by sovereign wealth funds and declines in FX reserves of emerging market economies was seen by most as likely triggers for market dislocations. Most members also believed political uncertainty could become a trigger for financial instability. While members still regarded the level of public sector debt in certain countries to be beyond comfortable levels, they did not consider the level of non-financial private sector debt a risk to financial stability.

2. Key developments in global financial market movements and their financial stability implications?

Preceding a general discussion, introductory presentations were given on:

- i. What is driving global financial asset price movements? (Citi)
- ii. Risks to global commodity traders and their implications for global bank. (Bank of America Merrill Lynch)

Members expressed concern that the mood in global financial markets had become more cautious at the beginning of the year. Participants concurred that there was growing concern in global financial markets that threatened the global economic recovery. Elevated downside risks to the nominal growth outlook were seen as the key driver of the deterioration in global risk appetite during late January and early February. In particular, members noted challenges facing emerging market economies (in particular China) and the energy sector and concern that the global economy could start to follow the market.

The presentation on large commodity traders highlighted their rapid growth and significant fragilities in their business models (heavily reliant on short-term bank funding and quite vulnerable to rising risk premia or global interest rates due to low margins) and criticised the low risk weighting of banks' exposures to them.

3. Deterioration in market sentiment towards euro area banks: panic overdone?

Preceding a general discussion, introductory presentations were given on:

- i. Market concerns regarding euro area banks: what's real and exaggerated? (Goldman Sachs)
- ii. Regulatory changes and funding conditions for euro area banks.(Autonomous)
- iii. The impact of negative rates on bank profitability. (Morgan Stanley)

The majority of MFCG members felt the deterioration in market sentiment towards euro area banks reflected concerns regarding profitability (rather than solvency). Members noted that weak revenues, remaining concerns with respect to credit quality and a general reluctance to offset headwinds through cost cutting was placing significant pressure on earnings and dampening risk appetite for bank securities. Most members felt the challenges facing euro area banks are more structural than cyclical.

Heightened volatility in bank equity and subordinated debt markets was seen by some as a manifestation of four key pressure points: the high stock of non-performing loans in some major banking sectors; significant business model risk for some large euro area banks; regulatory uncertainty was seen by most members as an impediment to banks' long-term strategic planning and was deterring investment in bank securities and; slow progress on Banking Union.

4. Challenges facing the pension funds industry and their broader ramifications.

Preceding a general discussion, introductory presentations were given on:

- i. Results of EIOPA stress test on the European pension funds industry. (EIOPA)
- ii. Pension funds' response to industry challenges. (APG)

The current environment was seen as challenging for pension funds largely for two reasons. First, low rates and compressed risk premia are depressing future returns and stressing solvency ratios. While such an environment could be conducive to increased risk-taking, market experts did not see evidence of such behaviour taking place on a large scale. One member noted that regulations in certain countries prohibited an increase in risk profiles when solvency ratios are depressed. Second, lower market liquidity was impacting pension funds' ability to trade large exposures. Several solutions to current challenges were noted: apply buy and hold strategies to more assets, consider peer to peer lending and alternative trading venues, trade longer lock-ups for better terms, vertical integration, extend product universe, exploit counter-cyclical tilts with respect to asset allocation.