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 9 FEBRUARY 2017

## MEETING SUMMARY

### 1) Introductory presentation by the ECB

John Fell, Deputy Director General DG Macroprudential policy and Financial Stability, presented the ECB's views on risks and vulnerabilities for euro area financial stability that were published in the November 2016 ECB Financial Stability Review (see Table 1). According to the views of MFCG members, global risk repricing remains the primary risk to euro area financial stability. Most MFCG members are however more concerned about the risk of re-emerging of debt sustainability concerns than about adverse feedback loops between weak bank profitability and low growth.

**Table 1**

Key risks to euro area financial stability

- pronounced systemic risk
- medium-level systemic risk
- potential systemic risk

| | **Current level (colour) and recent change (arrow)*** |
| --- | --- |
| Global risk repricing leading to financial contagion, triggered by heightened political uncertainty in advanced economies and continued fragilities in emerging markets | ↑ |
| Adverse feedback loop between weak bank profitability and low nominal growth, amid challenges in addressing high levels of non-performing loans in some countries | → |
| Re-emerging sovereign and non-financial private sector debt sustainability concerns in a low nominal growth environment, if political uncertainty leads to stalling reforms at the national and European levels | ↑ |
| Prospective stress in the investment fund sector amplifying liquidity risks and spillovers to the broader financial system | → |

Source: ECB Financial Stability Review November 2016
* 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 September 2016 MFCG

Members discussed the financial stability outlook shaped by developments in asset markets, the rise of populism, geopolitical risks, as well as low productivity. While most MFCG members regarded an imminent end of the low-for-long interest rate period as unlikely, many saw a risk that expectations about looser fiscal and tighter monetary policy in the US could lead to adverse spillovers to euro area financial conditions. Members also expressed concerns over the functioning of the repo market, potential fault lines in the global financial sector regulation consensus, and challenges for private savings in the current environment.

Members regarded the more positive market sentiment towards the European banking sector, partly driven by the steepening of the yield curve, with caution. In spite of the improvement in valuations, many members remain concerned about the outlook for bank profitability, as non-performing loans (NPLs) continue to weigh on banks in some euro area countries and political risks are perceived by members as being elevated. Many MFCG members agreed that tackling the overhang of NPLs needs to be prioritised, making comparisons with the situation in the US where banks have a finite timeline to write down assets.

## 3) The future of banking in Europe

Members discussed structural issues facing the banking sector, in particular the notion of Europe being "overbanked". Most MFCG members agreed that there is excess banking capacity in Europe and that this is one factor contributing to low profitability. Mergers and acquisitions were seen as the best opportunity to fund the clean-up of bank balance sheets and the cutting of costs, which would involve shrinking branch networks and headcount. MFCG members discussed existing obstacles to consolidation and many agreed that completing the Banking Union will foster consolidation of the euro area banking sector.

Members also discussed the impact of the completion of Basel III on European banks. This impact varies considerably depending on the region and business models, with Nordic banks and investment banks being viewed by some members as most adversely affected, although the overall impact was considered manageable over time. Many members agreed that reduced regulatory uncertainty (e.g. on final Basel III capital requirements) will contribute to lowering banks' cost of equity. MFCG members also discussed what a possible unwinding of financial regulation in the US would imply for the competitive landscape.

## 4) The rapid rise of exchange traded funds (ETFs) – a threat to financial stability?

The discussion on potential risks centred around ETFs as a price-discovery vehicle, the role of authorised participants, potential liquidity mismatches between ETFs and underlying assets, as well as the role of passive investing more generally in amplifying market risks and liquidity spirals. Views were mixed among MFCG members on potential systemic risks inherent in ETF structures and on possible vulnerabilities. While many MFCG members agreed that the rise in passive investment strategies makes the underlying markets more vulnerable to the risk of an abrupt repricing, some argued that this vulnerability is not related to ETF markets in particular. Concerning the role of ETFs more specifically, the majority of MFCG members regarded higher liquidity in secondary trading as a key advantage of ETFs but some expressed concern over liquidity risks in ETF structures that are dependent on the ability and willingness of authorised participants to transact in primary ETF markets during times of stress. Members also highlighted potential channels for contagion among the involved counterparties that are created by synthetic replication which is used in some ETF structures. Overall, while it was acknowledged that ETFs in the euro area still only hold a small part of the stock of bonds outstanding, some members pointed to the fact that the volume of bonds actually available for trading (free float) is much smaller.