EUROPEAN CENTRAL BANK

EUROSYSTEM

DIRECTORATE GENERAL MACROPRUDENTIAL POLICY AND FINANCIAL STABILITY

FINANCIAL STABILITY CONTACT GROUP

FRANKFURT AM MAIN, THURSDAY 4 OCTOBER 2018

MEETING SUMMARY

1) Introductory presentation by the ECB

ECB staff presented the ECB's analysis on the risks and vulnerabilities for euro area financial stability as published in the ECB's May 2018 Financial Stability Review.

Regarding these risks, Contact Group members were concerned most about the risk of repricing in global financial markets. They perceived risks to debt sustainability as having increased since the last meeting.

+ Positive developments	— Negative developments
Growing economy	Downside risks to growth
Limited contagion from volatility events	Emerging market concerns
Improving banking sector resilience	Rising political and policy uncertainty
	Continued intense risk-taking in financial markets

2) Market developments since the March 2018 meeting

Members discussed the financial stability outlook, including recent developments in Italy, emerging market risks, structural issues related to illiquidity, and the return of volatility. They agreed that the outcome of the Italian election and budget announcement in September had raised concerns about debt sustainability in Italy. While contagion to other euro area countries was seen as limited so far, members discussed risks that could lead to further repricing of Italian assets and potential spillovers to other euro area countries.

Regarding emerging market risks, members broadly agreed that the implications for financial stability in the euro area were contained at this juncture. While direct exposures of euro area banks to vulnerable emerging markets were small, some members argued that banks' losses could be higher than reflected in their direct exposures and that emerging market risks could also crystallise via non-banks.

Finally, members discussed potential implications of the reduction of central banks' asset purchases, including the possible reversal of crowding into risky assets.

3) Outlook for the European banking sector

Members discussed structural issues in the European banking sector, as well as political risk and recent events in Italy. Members said that Italian banks had increased their exposure to domestic sovereign debt in recent months. The importance of completing banking union was highlighted, given that the current fragmentation of the European banking system impeded cross-border consolidation. In this context, members also discussed progress of euro area banks in reducing their exposure to non-performing loans (NPLs). Some members argued that the turbulence in Italian sovereign debt markets will not affect Italian banks' progress in this area. Other members argued that NPL reduction targets will be very challenging for Italian banks. Members also discussed other political risks over the coming months, as well as continued low market-to-book valuations of European banks.

4) Vulnerabilities in the commercial real estate sector

The discussion on vulnerabilities in the commercial real estate sector revolved around potentially stretched valuations and the shift in funding sources in recent years amid expectations of rising interest rates. Some members argued that valuations are particularly stretched in the prime office segment. While the sector as a whole has reduced outstanding debt, debt is concentrated in a handful of countries. Inflows continue to be strong amid a shift of funding from banks to non-banks, although banks continue to be dominant. Some members expressed the view that the diversification of funding sources should make the sector more resilient. Members broadly agreed that rising interest rates could lead to outflows from the commercial real estate sector, though some members thought there was room for interest rates to rise to a certain degree before property yields were affected.