EUROPEAN CENTRAL BANK

EUROSYSTEM

PRESS RELEASE

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Risk of further bond market repricing persists but financial market stress is contained

- Repricing risks in fixed income markets remain significant
- Market pressure on euro area banks has receded amid persisting structural vulnerabilities
- Continued political uncertainty and potentially higher bond yields could trigger renewed debt sustainability concerns
- Brexit not expected to pose significant financial stability risk to euro area

Systemic stress indicators for the euro area have remained low over the past six months, according to the latest Financial Stability Review of the European Central Bank. The risk of a rapid repricing in global fixed income markets nevertheless remains. In the euro area, this could materialise via spillovers from higher yields in other advanced economies, in particular the United States. As investors continue to extend the duration of their fixed income portfolios, they are exposed to increased market risk.

Significant vulnerabilities also remain for euro area banks. Market pressure on euro area banks waned over the past six months, with banks' stock prices, in particular, increasing sharply. Low interest rates, however, continue to challenge banks' profitability. In some regions, profitability prospects are still dampened by large stocks of non-performing loans (NPLs). A number of structural challenges also weigh on profitability prospects in several banking sectors, including overcapacity, a limited degree of income diversification and cost-inefficiencies.

The risk that debt sustainability concerns may re-emerge has been revised upwards since the last Financial Stability Review published in November 2016. The ongoing economic recovery over the past six months has supported the outlook for the sustainability of euro area sovereign debt. A prolonged period of (geo)political uncertainty could, however, hamper economic growth and lead to higher risk premia. This would increase funding costs and could trigger debt sustainability concerns in some countries.

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Risks stemming from elevated debt levels are also present for the non-financial private sector, given the high levels of indebtedness of the euro area non-financial corporate sector, both by historical and international standards.

Risks to euro area financial stability also stem from the non-bank financial sector. Investment funds have grown rapidly in recent years and have the potential to amplify financial stability risks. These vulnerabilities are closely linked to the risk of an abrupt repricing in bond markets.

In this environment, the Review singles out four main risks to financial stability in the euro area over the next two years:

pronounced systemic risk
medium-level systemic risk
potential systemic risk

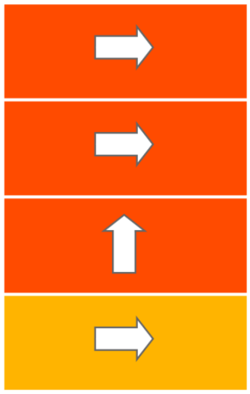
Current level (colour) and recent change (arrow)*

1. Repricing in global fixed income markets – triggered by changing market expectations about economic policies – leading to spillovers to financial conditions

2. Adverse feedback loop between weak bank profitability and low nominal growth, amid structural challenges in the euro area banking sector

3. Public and private debt sustainability concerns amid a potential repricing in bond markets and political uncertainty in some countries

4. Liquidity risks in the non-bank financial sector with potential spillovers to the broader financial system



* 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.

The Review also contains three special features. The first special feature examines the decoupling observed recently between financial market conditions and economic policy uncertainty. The second presents an approach to identifying excessive household credit developments that relies on a concept of equilibrium debt based on fundamental economic factors. The third highlights the potential role and benefits of several co-investment strategies for addressing NPLs involving the private and the public sector.

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Notes:

- The Financial Stability Review May 2017 can be accessed via the ECB website.

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