Luis de Guindos: Key vulnerabilities for euro area financial stability

Remarks by Mr Luis de Guindos, Vice-President of the European Central Bank, at the meeting of the Financial Stability Contact Group, Frankfurt am Main, 2 October 2019.

* * *

- Let me start by thanking you all for participating in this meeting of the Financial Stability Contact Group. These meetings are a key feature of the ECB's market intelligence gathering activities.
- The financial stability environment has certainly remained challenging since this group last met in March. The global economic outlook has worsened since then, and political and policy uncertainty has increased in a number of areas.
- Taking this into account, we continue to see four key vulnerabilities for euro area financial stability: (i) first, a risk of mispricing of some financial assets; (ii) second, high public and private sector indebtedness in several countries; (iii) third, in view of banks' subdued profitability outlook, we see a risk of hampered bank intermediation capacity; and (iv) fourth, vulnerabilities stemming from increased risk taking in the non-bank financial sector. We see the likelihood of these vulnerabilities unravelling in a disorderly manner over the next 18–24 months as remaining largely unchanged. This is because the now widely expected "lower-for-longer" interest rate environment mitigates many of the possible triggers for corrections over the short to medium term.
- Let me expand a little on these vulnerabilities:
- Repeated downward revisions to the economic outlook and accommodative monetary policy actions on both sides of the Atlantic have put downward pressure on global bond yields across the whole maturity spectrum. For the first time in history, large parts of the yield curve for many euro area sovereign bonds, in particular those issued by governments with high credit ratings, have entered negative territory.
- It is often said that low or negative interest rates inflate asset prices as investors search for yield and take on more credit and duration risk. Equity and corporate bond prices, for instance, have appreciated across the globe over the past decade as yields have followed a path of long-term decline. Abrupt corrections, especially in equity markets and markets for lower-rated bonds remain a risk, particularly in the face of high economic and political uncertainty.
- Low funding costs can encourage firms to increase their leverage, which might intensify vulnerabilities in the event of an economic downturn. This risk has increased as the economic outlook has worsened and the share of triple-B ratings has grown.
- Concerning the second vulnerability, in several countries debt in the public and/or non-financial private sectors is lingering at levels that are high by historical and international standards. This leaves public and private finances exposed to the risk of a sudden change in market sentiment or deteriorating macroeconomic conditions.
- Third, parts of the banking sector continue to exhibit weak performance. Banks have improved their capital positions and profitability since the euro area crisis, and the stock of non-performing loans continues to decline at a moderate pace. But further improvements are needed in parts of the banking sector if banks are to achieve sustainable rates of return. In particular, overcapacity and cost inefficiencies weigh on many banks' long-term profitability prospects. The better performance of some banks within the euro area, and in jurisdictions facing similar economic and financial conditions, illustrates the importance of addressing structural issues.
- The current interest rate environment has various implications for the resilience of the banking sector. Banks have benefited, and will continue to benefit, from the lower credit risk for borrowers, and from the higher asset valuations associated with lower interest rates and

better macroeconomic outcomes. This has helped support bank profitability across the euro area since the deposit facility rate turned negative in 2014. However, the negative interest rate policy also entails costs for banks, and these could increase the longer negative rates are in place, the lower policy rates are set and the larger the amount of excess liquidity held by banks.

- These vulnerabilities could crystallize if economic growth is much weaker than expected, or if weak growth persists for longer than expected. We thus welcome the measures taken by the banking sector in recent years to improve resilience, and support efforts to further strengthen resilience while conditions are benign.
- There are also vulnerabilities in the non-bank financial sector, which has significantly expanded its role in financing the real economy in the euro area. Total assets held by non-banks have almost doubled over the last ten years, growing from €23 trillion in 2008 to €42 trillion in 2018, while the size of the banking sector stagnated over this period. Non-banks currently account for around 55% of the euro area financial sector. While a larger non-bank financial sector has the benefit of helping to diversify the funding sources available to the real economy, it may also entail rising risk taking in the current market environment.
- We are closely monitoring two developments in this context: first, non-bank financing activity is growing, in particular in higher credit risk corporate financing, where indebtedness is already higher. Second, as institutional investors are searching for yield, they may amplify the cyclical underpricing of risk, potentially also taking on more leverage and liquidity risk.
- In the euro area investment fund sector, we have observed increasing liquidity risk for some time. This reflects a falling share of holdings of liquid government bonds and a fall in cash holdings across the sector. We have recently witnessed cases in which funds holding considerable amounts of illiquid assets (Woodford, H2O and GAM – all UCITS funds) faced severe difficulties in dealing with large-scale outflows. These cases had no systemic repercussions – partly because the outflow triggers were idiosyncratic and partly because the market environment was benign.
- In a more broad-based market downturn, though, we would be concerned that a repricing of financial assets could trigger sudden and large redemptions from these funds, possibly resulting in forced asset sales, which could amplify stress in less liquid markets. This would have wider implications in the form of impaired market liquidity and possible spillovers to the real economy.
- While leverage in the euro area fund sector is low on average, there are also pockets of high leverage among some types of alternative funds, and these need to be monitored closely. Even if leverage of UCITS funds is not excessive, it can still add to the procyclical selling of assets if a fund tries to keep its leverage constant during periods of stress.
- I hope that gives you a good perspective on our current assessment of financial stability risks. I look forward to hearing your own views on these and other vulnerabilities for the euro area financial system.