PRESS RELEASE

ESAs highlight main risks for the EU financial system

The Joint Committee of the European Supervisory Authorities (EBA, EIOPA and ESMA - ESAs) published today its Autumn 2017 Report on risks and vulnerabilities in the European Union's financial system. The Report highlights the risks to the stability of the European financial sector in an uncertain political and economic environment, not least in light of the UK's withdrawal from the EU. It also highlights persistent valuation risk with an uncertain outlook for yields and argues that financial institutions continue to face profitability challenges in spite of recent improvements. Rapid developments in the area of FinTech are raising new opportunities, but also challenges for financial institutions and final users. The Report also presents regulatory and supervisory initiatives to monitor and mitigate the risks identified.

The UK's withdrawal from the EU

Uncertainties around the terms of the United Kingdom (UK)'s withdrawal from the EU have the potential to expose the EU27 and the UK to economic instability and to weaken market confidence, in particular if negotiations end in a disorderly fashion. Such a situation could cause disruptions to the legal framework for financial services and the continuity of financial contracts between parties in the EU27 and the UK. As passport arrangements enabling the EU and UK-domiciled financial entities to operate in each other's jurisdictions will expire, business continuity planning is essential.

Valuation risks in the context of an uncertain outlook for yields

The low interest rate environment persists, and search for yield continues, with EU equity and real estate prices at high levels, but not necessarily supported by economic fundamentals. Indications for a reversal in interest rates and risk premia have emerged, as some EU sovereign and low risk corporate yields started to increase. The Report cautions that abrupt increases in yields could affect the profitability and solvency position of financial institutions, generate substantive portfolio reallocation, and spill over into wider asset markets, potentially leading to mark-to-market losses in investment positions and reducing the net wealth of households. In the insurance sector, some negative implications on assets in light of Solvency II could be overcompensated by positive implications on liabilities.

Low profitability of financial institutions

Persistent low profitability of banks and insurers remains a major challenge, albeit some recent improvements have been observed. Returns of EU banks remain, on average, below estimates for the cost of equity, while recent strong increases in trading income may not prove sustainable. Continued high levels of non-performing loans and the need to adapt business models, including substantial investment needs to technological infrastructures, aggravate profitability challenges. In parallel, overcapacity persists in many banking markets. Attaining adequate profitability is not least important to attract investors to instruments eligible for loss absorbing capacity that many banks still need to build up. The Report, moreover, shows that a combination of low yields, low economic growth and low asset quality in some countries continues to affect EU insurers, as both life- and non-life insurers are exposed to interest-rate sensitive assets and business models may encompass interest-rate sensitive product lines.

Rapid developments in FinTech

The rapid growth of FinTech increasingly affects the financial sector. It drives business model changes at financial institutions, attracts new market entrants, and creates opportunities to increase cost efficiency, improve service quality and broaden the access to financial services. The ESAs are assessing the impact of FinTech on financial institutions' business models and their strategic response as well as on supervision and regulation. They have identified data privacy issues, potential client discrimination, vulnerability to cyber-crime and associated legal issues among key risks to consumers and financial institutions. In addition, they are providing recommendations and advice on issues such as outsourcing to cloud services providers and robo-advice. The Report points out that recent regulatory and supervisory monitoring also covers the use of consumer data and of "Big Data" analytics by financial institutions.

Notes for Editors

- The Joint Committee is a forum for cooperation that was established on 1 January 2011, with the goal of strengthening cooperation between the European Banking Authority (EBA), European Securities and Markets Authority (ESMA) and European Insurance and Occupational Pensions Authority (EIOPA), collectively known as the three European Supervisory Authorities (ESAs).

- Through the Joint Committee, the three ESAs cooperate regularly and closely to ensure consistency in their practices. In particular, the Joint Committee works in the areas of supervision of financial conglomerates, accounting and auditing, micro-prudential analyses of cross-sectoral developments, risks and vulnerabilities for financial stability, retail investment products and measures combating money laundering. In addition, the Joint Committee also plays an important role in the exchange of information with the European Systemic Risk Board (ESRB).