Key takeaways from the ECB’s new Financial Stability Review

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The ECB FSR

• Extensive.

• Rich in analyses that support the illustration of well described results.

• Really like the boxes and special features.

**ECB main take away:** Euro area financial stability outlook remains fragile

- High valuations and low market liquidity make markets vulnerable to negative surprises
- Resilience of corporates, sovereigns and households is being tested by higher interest rates
- Euro area banks resilient to stress, although liquidity and asset quality concerns are surfacing
My discussion

• ECB FRS main conclusions: The Euro area financial stability remains fragile.

• The results I will focus on:
  • Weak macro-financial prospects remain a challenge.
  • Banking sector stresses in the US and Switzerland had limited spillover to large euro area banks, financial markets and sovereigns.
  • Low liquid asset holdings remain a source of risk for forced asset sales in adverse market conditions.

• My comments:
  A. What else have we learned from the March 2023 turmoil that could be interesting to look at more closely?
  B. Holdings of high yield securities.
The banking turmoil in March 2023

SVB ➔ ➔ ➔ ➔ ➔ ➔ Credit Swiss

- Changes in banks regulations in the US/lack of international harmonization in the implementation of the existing rules.

- Things that fell through the cracks:
  - Explosive asset growth and lack of data.
  - Large reliance on uninsured deposits and very specific customer base.
  - Inadequate management and/or poor understanding of interest rate risk.
  - Lack of “adequate” corporate governance.

- The final nail in the coffin:
  - Twitter and social media!

- One of the world’s systemically important lenders, had very serious mismanagement problems in the recent past but still it had almost made it through.

- SVB event ➔ Credit Suisse was shook to its core
  - Credit Suisse was eventually sold to UBS.
  - Write-down of Credit Suisse's AT1 securities. (FINMA, the Swiss supervisor, not the resolution authority, was involved).
A. What more have we learned from these episodes that may be relevant to further highlight?

My main focus:

1. Social media effects on financial markets.
2. Are we measuring interconnectedness/spillover effects well enough?

Additional points:

• Mega-mergers.
• Hidden interest rate risks.
Social media effects on financial markets (I)

- A quick search on google scholar of the words “social media effects on financial markets” produces 17,000 results for 2023 alone! To many papers to read overnight!
- So I asked AI (CHAT GPT) to summarize the main results!

1. Positive results:
   - Information Dissemination and Market Efficiency: It may reduce information asymmetry.

2. Negative results:
   - Market Volatility and Sentiment Analysis: Link to increased market volatility.
   - Herding Behaviour and Social Contagion: Can lead to exaggerated market movements and speculative bubbles.
   - Market Manipulation and Rumour Spread: False information, rumours, and pump-and-dump schemes could lead to significant price distortions.

3. Not clear results:
   - Trading Strategies and Investor Sentiment: Use of social media data to develop trading strategies
   - Investor Attention and Stock Returns: Increased social media attention can lead to higher trading volumes and subsequent price movements. However, the impact on long-term returns is still a subject of debate.

Important: Research is ongoing and we should read the actual papers!
Social media effects on financial markets (II)

• This is a new and growing field in financial research.
  • Little is known about the actual effects that the widespread use of social media may have on financial stability.
  • Social media and digitalisation may contribute to faster and more wide-spread deposits runs than ever before.

• We can’t limit people’s freedom, but we need to make sure that the information flow we can control is concise, transparent and verifiable.

• We also need preparedness to step in quickly, if necessary, with clear and accurate communication to be able to break a potentially vicious circle of information.

• Improving financial literacy may also help.
Are we measuring interconnectedness/spillover effects well enough?

• In the EU, asset management companies and their investment funds are often part of a bank holding company.
  • Distress in the banking system may spill over to the mutual fund sector via ownership links.

• Source: Bagattini et al., ECBWP 2023 and Reuters.
Are we measuring interconnectedness/spillover effects well enough?

- In the EU, asset management companies and their investment funds are often part of a bank holding company.
  - Not clear whether this poses a clear issue for financial stability but we will know only with more analyses.

- More concretely: Real Estate Funds
  - ECB FSR: “Flows to real estate funds have been slowing steadily, raising the risk of liquidity events among euro area real estate funds, especially in those countries where open-ended real estate funds dominate.”
    - If the situation further deteriorates, could this become a source of stress for the banks in the same holding companies?

- Many funds have their ultimate parent in countries outside the EU
  - Further suggests the need for harmonization in the implementation of the existing rules across jurisdictions.
Additional comments

1. Mega-mergers.
   • Consolidation in the banking industry can have positive effects, but at what costs and in which conditions?
     • The UBS-CS merger have made the already quite concentrated Swiss banking system more concentrated.

2. Hidden interest rate risks could be a concern also for EU banks especially not the very large ones.
   • Regulation is not a substitute to adequate risk management, asset quality and sound business strategies.
   • Hedging does not make risk disappear.
     • Is risk transferred to less regulated entities?
B. If someone is selling HY securities who is buying?

- The FSR provides substantial evidence that NBFI are decreasing their exposure to HY securities, but who is buying these securities?

- Box 6, Chart A.b shows that the outstanding amount of HY bonds has even increased a little between 2021 and 2022.
Conclusions

• The ECB FSR provides important insights.

• Recent events have provided substantial food for thoughts.

• I am sure we won’t wait long to see more analyses done to understand whether new potential risks pose a real threat to the stability of the Euro area financial system.