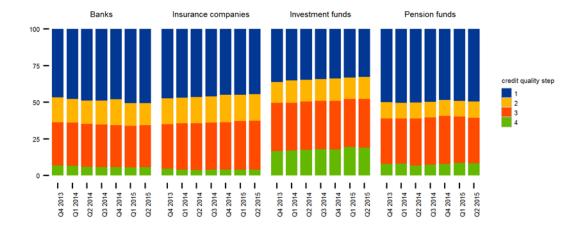
Box 7Debt securities holdings of the financial sector in the current low-yield environment

The protracted low-yield environment in the wake of the global financial crisis and the dearth of assets perceived as risk-free have challenged financial institutions' investment strategies. As risk/return strategies adapt to this environment, increased risk-taking is likely. From a financial stability standpoint, such risk-taking is meaningful to the extent that an agglomeration of exposures within key sectors could leave the financial system more vulnerable to an abrupt reversal of risk premia. Debt securities markets, including traditionally conservative segments, are one area where it is possible that investors have substantially increased their exposure to credit and interest rate risk in an effort to achieve higher returns.

Chart AInvestment funds and insurers have shifted their holdings from higher- to lower-rated debt securities on average, but banks have not

Share in nominal debt securities holdings by sector and rating category (Q4 2013 – Q2 2015; percentages)



Source: ECB and ECB calculations.

Notes: Credit quality steps are defined in accordance with the Eurosystem credit assessment framework (ECAF), which provides a harmonised rating scale classifying ratings into three credit quality steps. The first category includes securities rated from AAA to AA-, the second from A+ to A- and the third from BBB+ to BBB-. A fourth category is added which includes all rated securities with a rating below credit quality step three. The analysis is based on the nominal amounts of euro and foreign currency-denominated securities, including "alive" and "non-alive" securities. The investment fund sector excludes money market funds

One means of identifying the topography of increased risk-taking in the euro area financial sector is by looking at information on asset holdings. The ECB's securities holdings statistics (SHS)⁶² provide

The SHS data help to fill long-standing statistical gaps. SHS coverage in the period under review is, on average, equal to or higher than 90% of the value reported in benchmark statistics such as euro area national accounts or balance sheet item statistics. See "Who holds what? New information on securities holdings", *Economic Bulletin*, Issue 2, ECB, March 2015, pp. 72-84.

a wealth of information on the euro area in this regard as they contain data on individual securities held by resident investors, and cover all euro area countries and sectors. When used in combination with securities ratings, these data can help to address questions related to the changing composition of portfolios held by the financial sector – in particular, exposures to credit and interest rate risk by euro area banks (credit institutions), insurance companies, pension funds and non-money market investment funds.

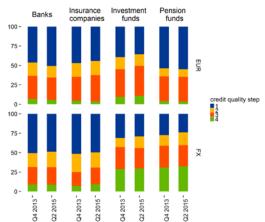
An important observation is the clear shift in asset allocation from higher- to lower-rated debt securities for the investment fund sector. A similar shift could be observed for the insurance sector, albeit less pronounced and with the relative amount of debt holdings "below credit quality" declining (see Chart A). The overall shifts in portfolio composition have largely been driven by an actual reduction in the holdings of higher-rated securities and an increase in lower-rated securities, rather than by a decline in the rating quality of securities held. While pension funds have kept their exposures largely constant, banks have shifted their allocation from lower- to higher-rated securities. The four broad rating categories referred to in Chart A correspond to the categories defined in the Eurosystem credit assessment framework.

Chart B

Higher share of lower-rated securities in foreign currency-denominated securities

Share in nominal debt securities holdings by sector, rating category and currency of denomination

(Q4 2013; Q2 2015; percentages)



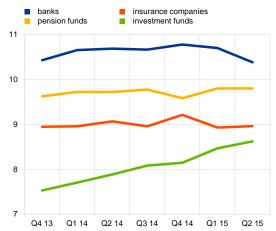
Source: ECB and ECB calculations. Note: See notes to Chart A.

Chart C

Increase in residual maturities in the investment fund sector

Weighted average residual maturity

(Q4 2013 - Q2 2015; years)



Source: ECB and ECB calculations.

Notes: All "alive", rated and non-rated euro and foreign currencydenominated debt securities are included. In order to estimate the average, residual maturities are weighted by the nominal amount held of each security by each sector over the total debt holdings of each sector.

The analysis is based on nominal amounts so as to eliminate potential valuation effects and focus on the actual change in portfolio composition. With the initial SHS data referring to holdings at the end of December 2013, the limited time span does not make it possible to identify definite trends. However, it does show how financial institutions have adjusted their portfolios of debt securities in the period between the fourth quarter of 2013 and the second quarter of 2015.

Robustness checks considered rating changes for the securities held throughout the period under consideration, as well as the ratings of securities that had left or newly entered the dataset. This information was used to assess the impact of rating changes on the results presented.

⁶⁵ See https://www.ecb.europa.eu/paym/coll/risk/ecaf/html/index.en.html

In addition, a structural difference can be seen in institutions' portfolio allocations for securities denominated in euro and securities denominated in foreign currencies (see Chart B). Investors appear to hold a higher share of the lowest-rated securities when these are issued in non-euro-denominated securities. This pattern in allocation is particularly pronounced for the investment and pension fund sectors which, coincidentally, are the two sectors with the highest relative exposure to foreign currency-denominated securities.

Since December 2013, average residual maturities have increased by almost one year for euro area investment funds' debt securities holdings (see Chart C). Other sectors have displayed much less variation in the remaining maturities, meaning that a definite trend cannot be identified. There has been an increase in remaining maturities for lower-rated securities across all sectors, with the exception of pension funds. On the other hand, governments and corporates have issued longer-term debt, thereby strengthening resilience to a reversal in rates (see Chart 1.17 in Section 1.2).

Overall, it appears that exposures to credit and interest rate risks have increased somewhat outside the core financial system, i.e. among investment funds and, to a lesser extent, insurers and pension funds. At first sight, this bodes well for the stability of the euro area financial system, as marginal risks are borne by investors and institutions that are potentially of less systemic relevance because they reside outside the banking sector. Nevertheless, the diagnosis lends support to concerns over the growing susceptibility of non-bank financial intermediation, in particular by investment funds, to an abrupt reversal in global risk premia.