EUROPEAN CENTRAL BANK

EUROSYSTEM

November 2020

Financial Stability Review

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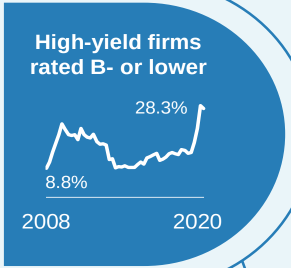
JVI Webinar: ***Key Global and European Risks to Financial Stability***

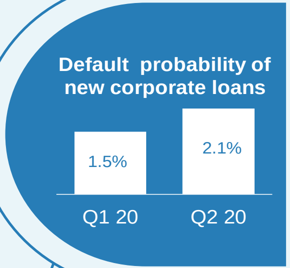
Wednesday, December 2, 2020

Financial stability vulnerabilities have increased

Growing vulnerability of asset prices to correction

- Elevated negative rating outlooks
- Large debt issuance increases leverage
- Growing equity sector dispersion
- Stretched valuations in some asset classes



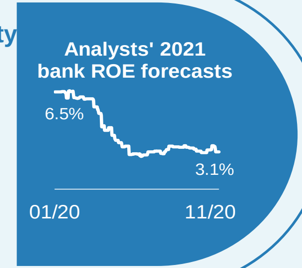


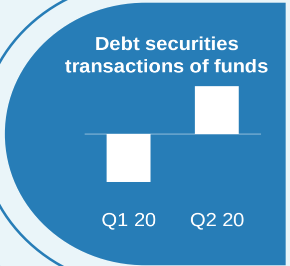
Rising debt servicing challenges for firms, households and sovereigns

- Possible sovereign risk reassessment
- Risk of sovereign-corporate nexus
- Worsening labour market conditions
- Risk of property market correction

Further weakening of bank profitability amid higher credit losses

- Low market valuations
- Increasing credit risk
- Rising sovereign exposure
- Improved funding conditions





Increasing credit and liquidity risk of non-banks amid renewed risk-taking

- Renewed fund inflows
- Increased exposure to corporate credit risk
- Decline in cash and liquid asset holdings
- Profitability challenges for insurers

The outlook is dominated by the pandemic, although extensive policy support has helped lessen the impact significantly.

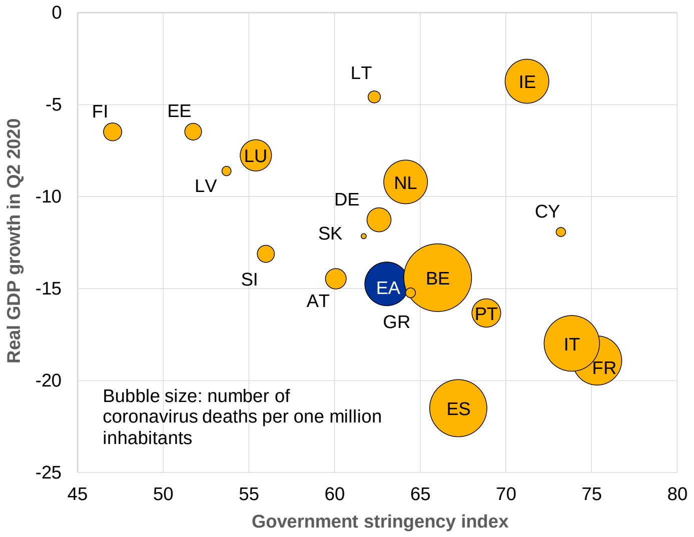
There is a need to carefully manage the exit from the comprehensive fiscal policy package to avoid cliff edges…

… including ensuring bank capital buffers remain usable to limit deleveraging, while developing an effective macroprudential framework for non-banks.

Economic fragmentation risk

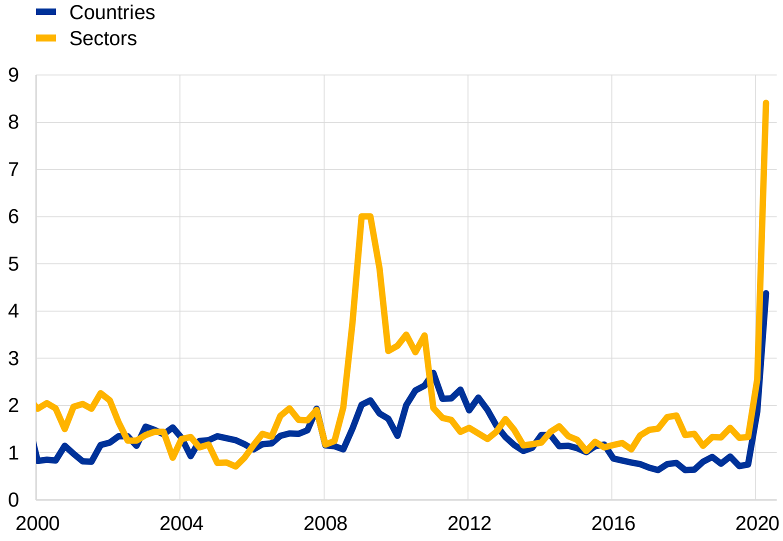
- Some signs of recovery, but it all depends on path of infections and government action.
- Economic recovery from pandemic lows has been highly dispersed across sectors and countries

Real GDP growth rates and government stringency index
Index, annual percentage changes



Sources: Eurostat, Oxford University, JHU

Dispersion of value-added growth across euro area countries and sectors
Q1 2000 – Q2 2020, percentage points

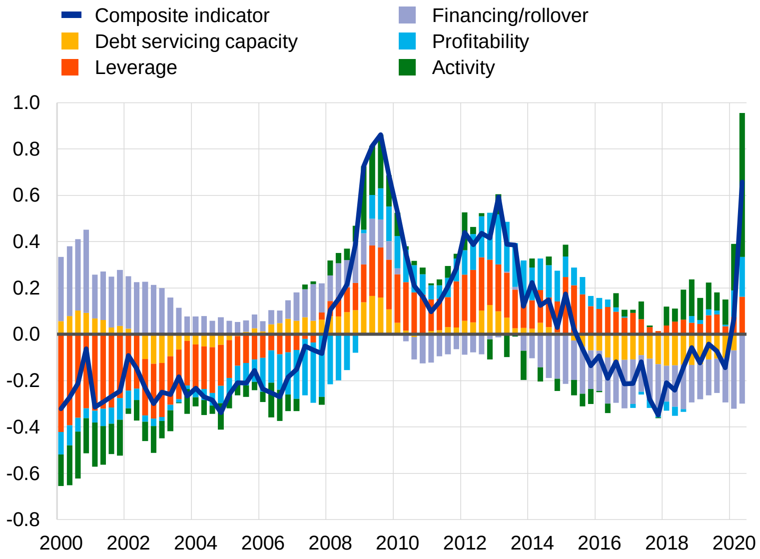


Sources: Eurostat and ECB calculations.

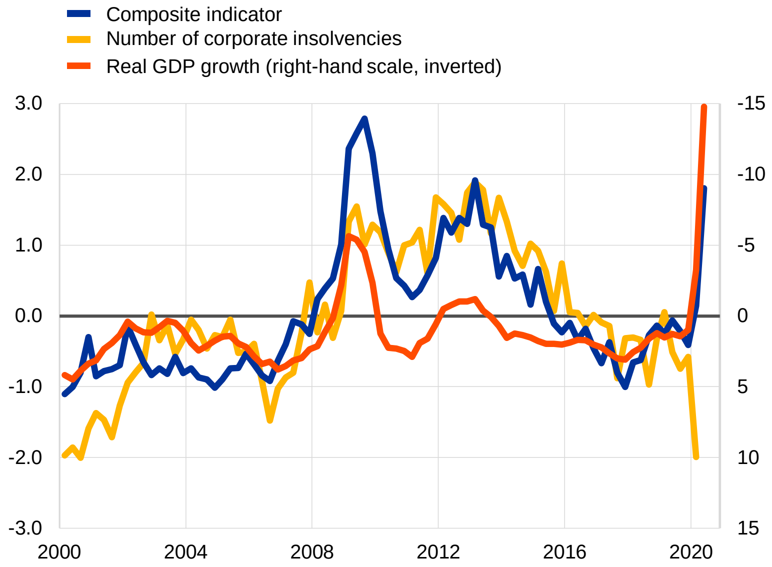
Corporate vulnerabilities: Underlying versus manifest

- Financial health of firms has deteriorated strongly, but is supported by policy measures
- Absent policy support or with a disappointing recovery, corporate bankruptcies could rise

Composite indicator of corporate vulnerabilities and underlying driving factors
Q1 2000-Q2 2020, z-scores



Composite indicator, number of corporate insolvencies in the euro area and real GDP growth over time
Q2 2000-Q2 2020, z-scores, percentages

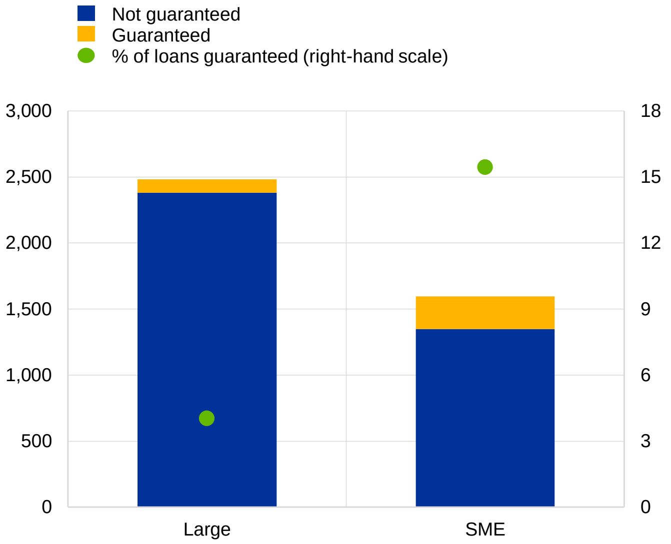


Sources: Eurostat, IHS Markit, ECB and ECB calculations

Crucial government support amid uneven pandemic impacts

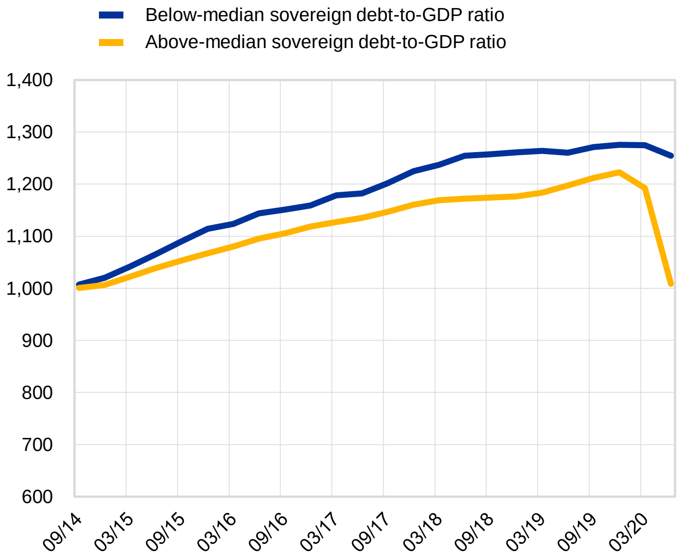
- SMEs have relied more on government guaranteed loans than larger companies
- Corporate earnings particularly weak in countries with high levels of sovereign debt

Reliance on government-guaranteed loans by firm size
DE, IT, FR, ES; Q2 2020; € billion (left scale), % (right scale)



Sources: Anacredit, FINREP and national sources.

Non-financial firm profits by sovereign indebtedness
2014-20, € billions



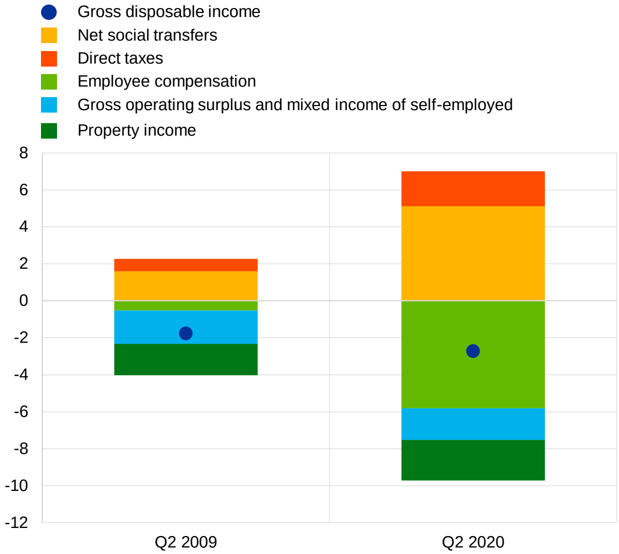
Sources: European Commission and ECB calculations.

Household sector also cushioned by government support schemes

- Social transfers and temporary relief in tax burdens helped to maintain household's disposable income…
- … but consumer confidence remains below its long run average

Household gross disposable income and contributing components

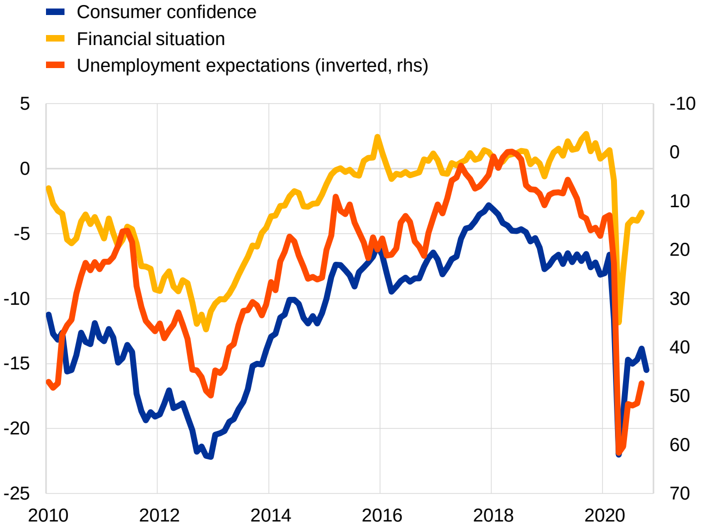
Q2 2009, Q2 2020, annual percentage changes



Sources: Eurostat, ECB and ECB staff calculations.

Consumer confidence and households' expectations for unemployment and their financial situation over the next year

Percentage balances

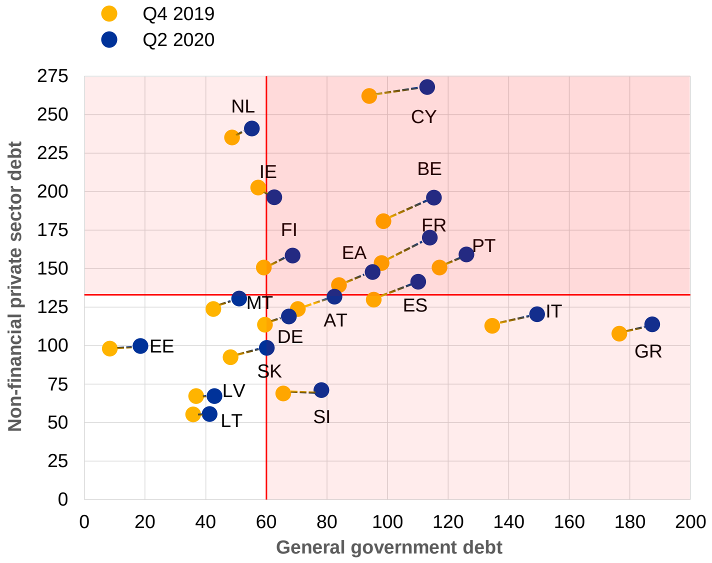


Sources: ECB, European Commission and ECB calculations.

Medium term risk from potential sovereign-corporate-bank nexus

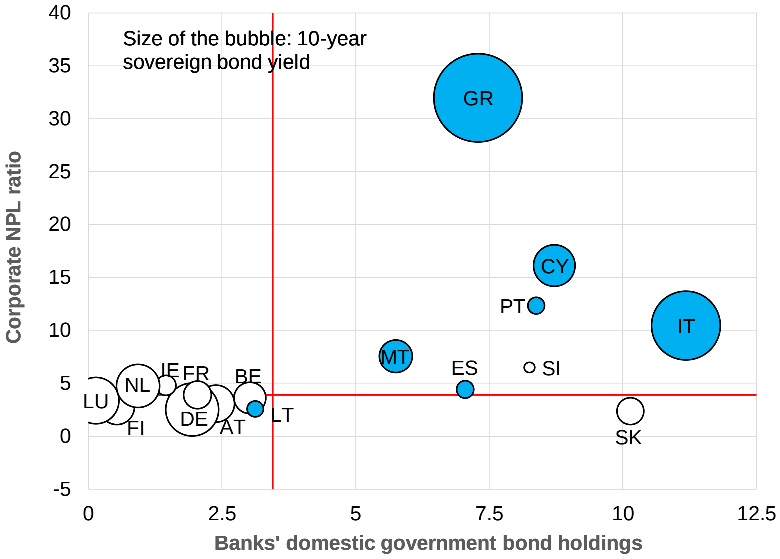
- Debt sustainability concerns are on the rise, even if mitigated in the near-term by low interest rates, favourable financing conditions and large-scale supranational support

Indebtedness of the general government and non-financial private sector across the euro area
Q4 2019 vs. Q2 2020, percentages of GDP



Sources: ECB and ECB calculations.

Banks' domestic government bond holdings and corporate NPL ratios across the euro area
percentage of total assets, percentages of total corporate loans

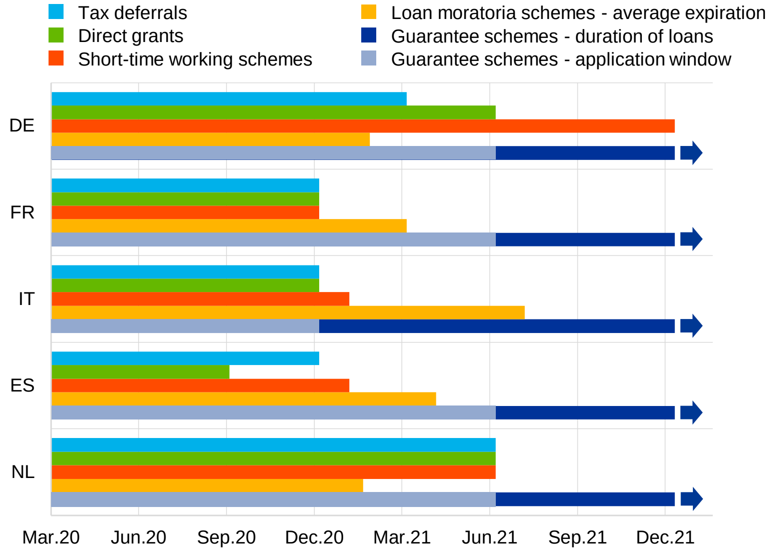


Sources: ECB (BSI statistics and supervisory statistics), Bloomberg and Reuters.

Risks in reducing policy support too early … or too late

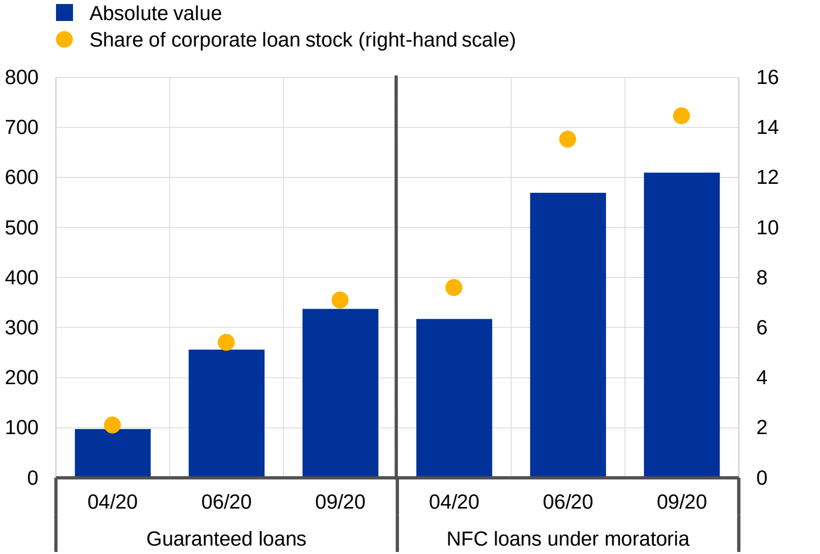
- Euro area non-financial firms and households are cushioned by various government support measures
- But risks arise either from a premature end to measures or from prolonged support

Timeline of the phasing-out of different policies
Dates



Sources: National authorities and EBA notifications.
Notes: Cut-off date: 10 November 2020. Guaranteed loans mature at the latest in: mid-2031 in DE, mid-2027 in FR and NL, end-2030 in IT, mid-2029 in ES.

Euro area banks' corporate loan books affected by guarantees and moratoria
€ billions, percentages

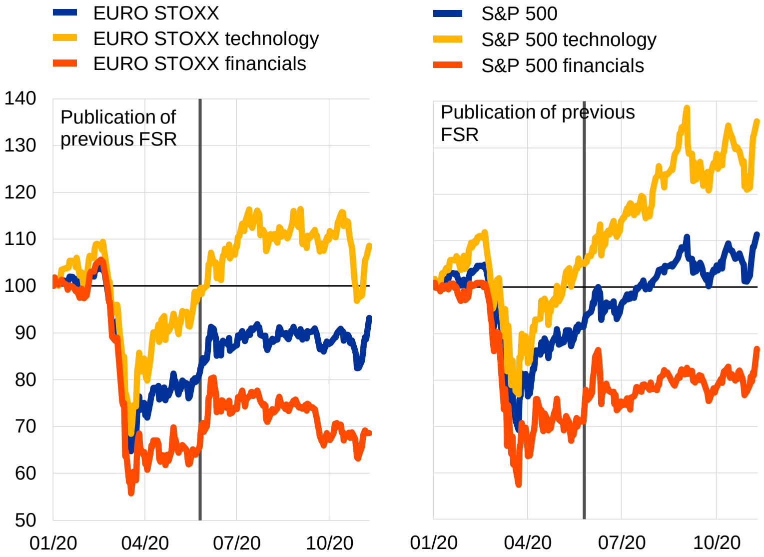


Sources: EBA, national authorities and ECB calculations.

Striking recovery in financial markets

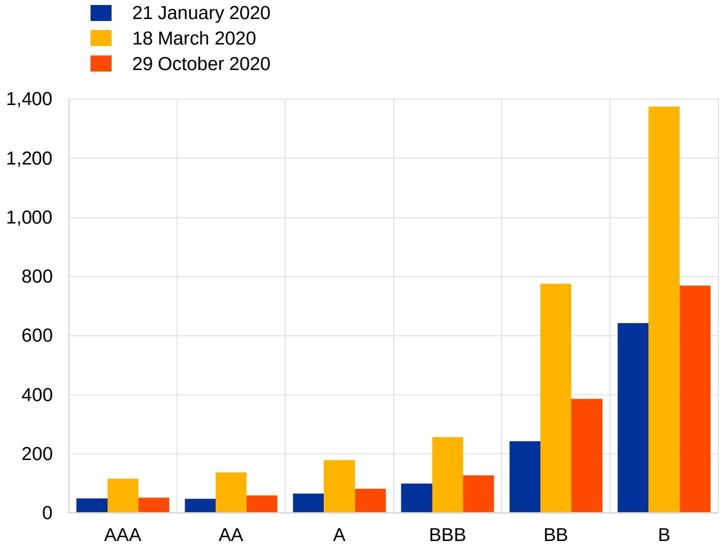
- Equity market response strong, albeit with some segmentation
- Corporate spreads have declined to near pre-Covid levels

Development of the EURO STOXX and S&P 500 stock indices and selected sectoral constituents
indices, 1 January 2020 = 100



Sources: Bloomberg Finance L.P and ECB calculations.

Corporate bond spread per rating category
basis points and ratings

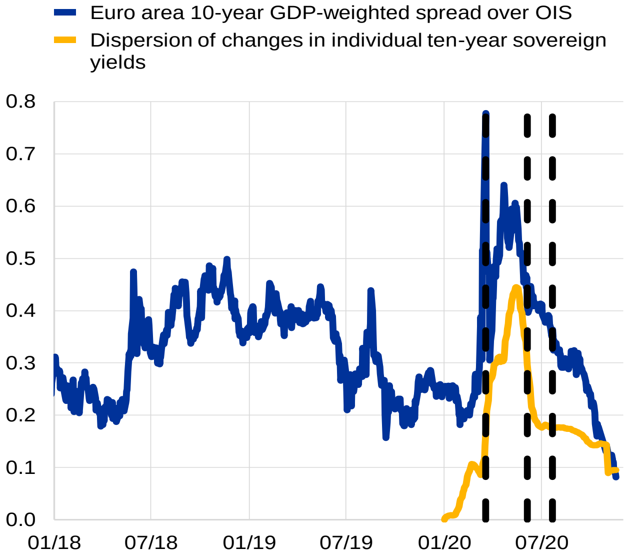


Source: IHS Markit, Merrill Lynch and ECB calculations.

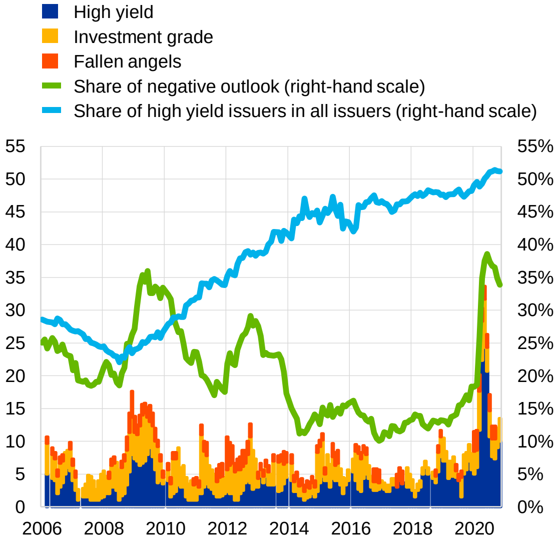
Quiescent bond markets and deteriorating corporate credit quality

- Sovereign bond market fragmentation pressures have eased
- Corporate credit quality has deteriorated and negative rating outlooks stand at historically high levels

Sovereign bond yields over overnight index swap rate and dispersion of sovereign yields
Percentage



Credit rating downgrades, negative credit rating outlook and share of high yield issuers
Number and percentage

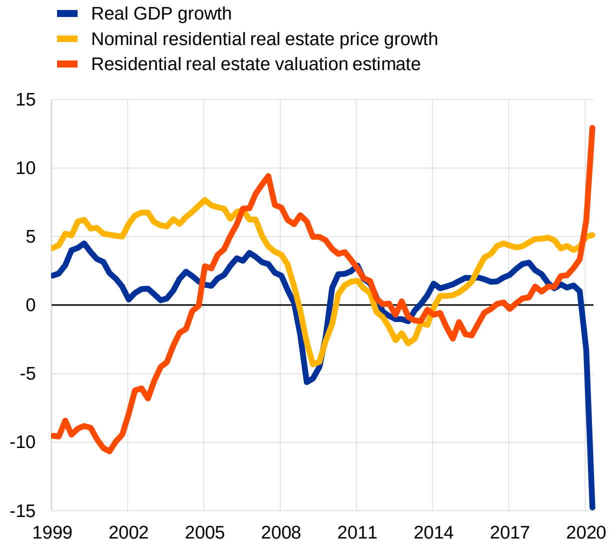


Sources: Refinitiv, Bloomberg
Notes: The dashed vertical lines denote the announcement of the PEPP on 18 March 2020, the expansion of the PEPP on 4 June 2020 and the announcement of the EU recovery fund on 21 July 2020.

A tale of two property markets

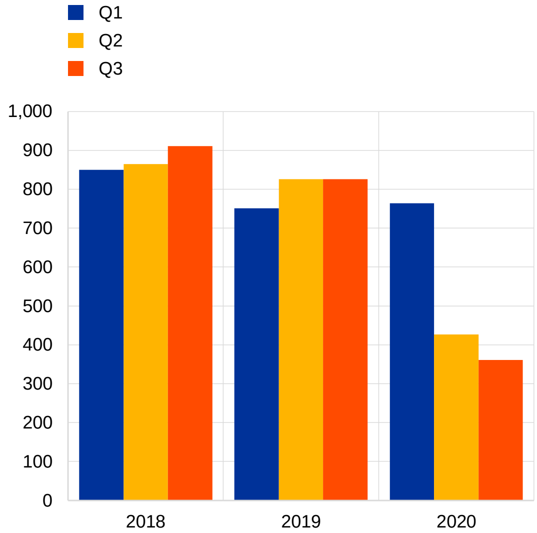
- Contrasting commercial and residential property market developments
- Liquidity has been low and valuation metrics suggest that price corrections are likely

Real GDP growth, nominal RRE price growth and RRE valuation estimates
annual percentage changes, percentages



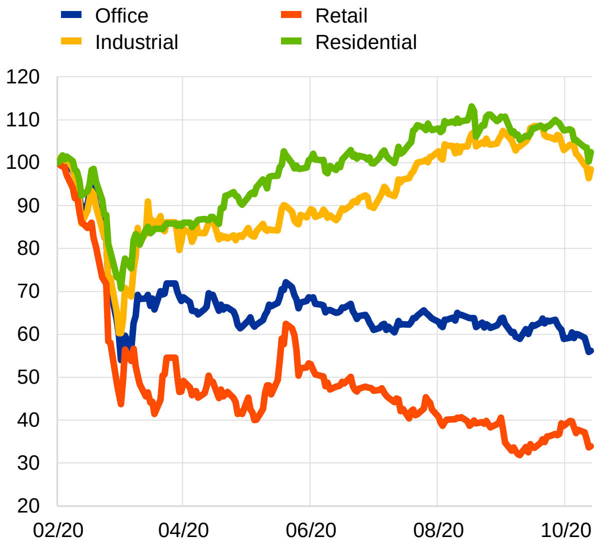
Source: ECB and ECB calculations.

CRE transactions in the euro area
Number of transactions



Sources: RCA and ECB calculation.

Sectoral REIT price indices
index, 17 February 2020 =100

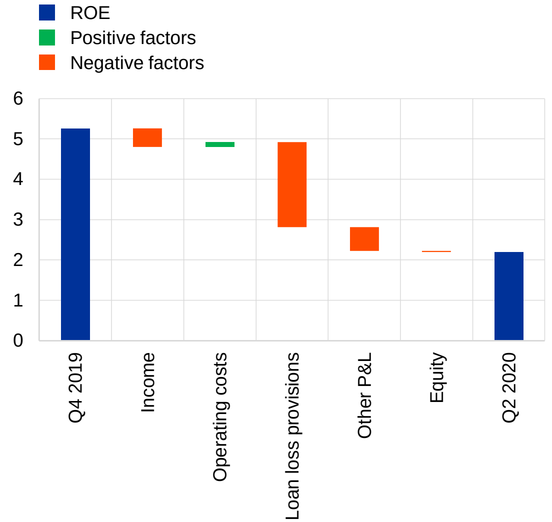


Source: Bloomberg Finance L.P..

Banks resilient so far, but profitability remains low

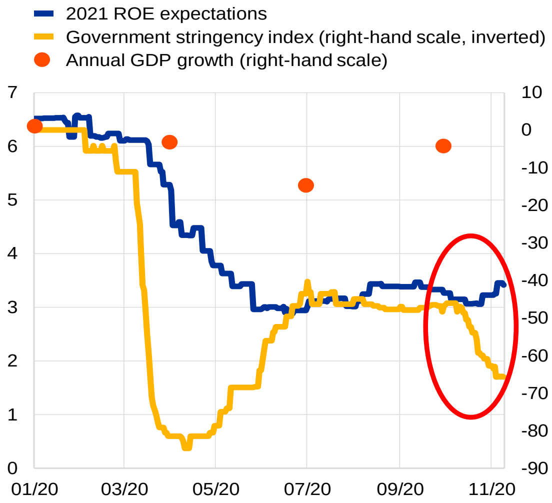
- Bank profitability declined substantially in the first half of 2020 and recovery is expected to be slow
- Lower interest income for banks from ongoing margin compression

Euro area banks' ROE and drivers of change in ROE
Q4 2019, Q2 2020, percentages, percentage points



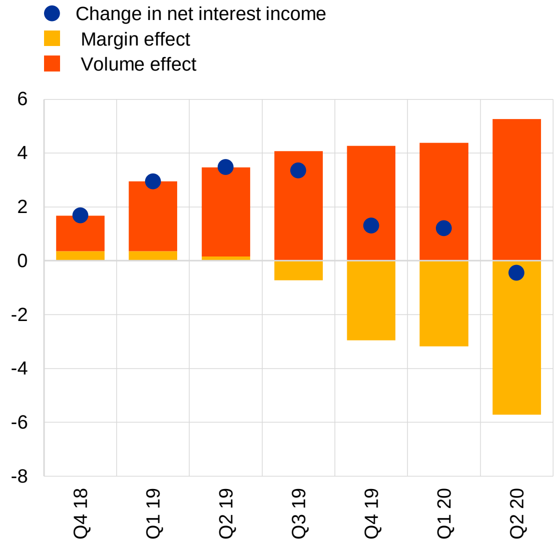
Sources: ECB (supervisory data) and ECB calculations.
Note: figures are on a trailing four-quarter basis..

Government stringency index, real GDP growth and 2021 ROE forecasts
31 Dec. 2019-09 Nov. 2020, percentages



Sources: : Bloomberg Finance L.P., Oxford COVID-19 Government Response Tracker, ECB and ECB calculations.

Drivers of change in euro area banks' net interest income
Q4 2018 – Q2 2020, percentage changes and percentage point contributions

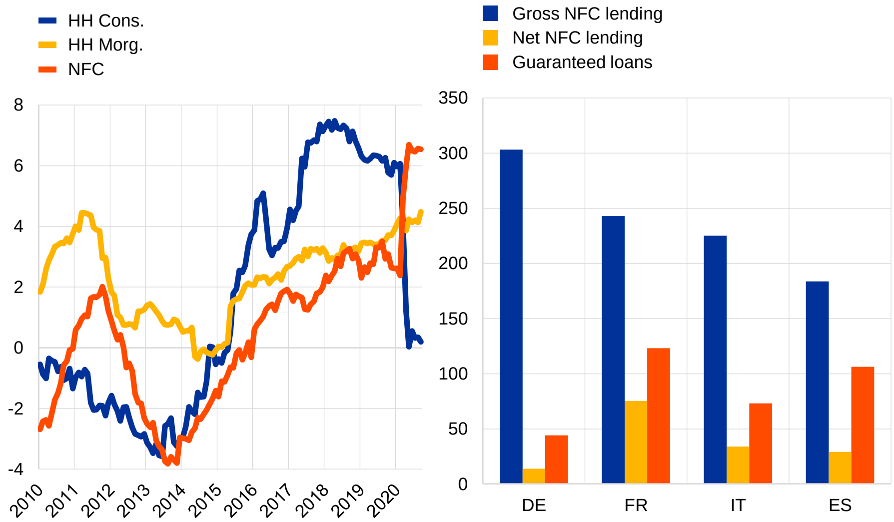


Sources: ECB (supervisory data) and ECB calculations.
Note: figures are on a trailing four-quarter basis.

The future path for lending will depend on expiry or extension of state guarantees

- Lending to NFCs in 2020 was strongly driven by loan guarantees
- Going forward credit standards are expected to tighten amid higher credit risk

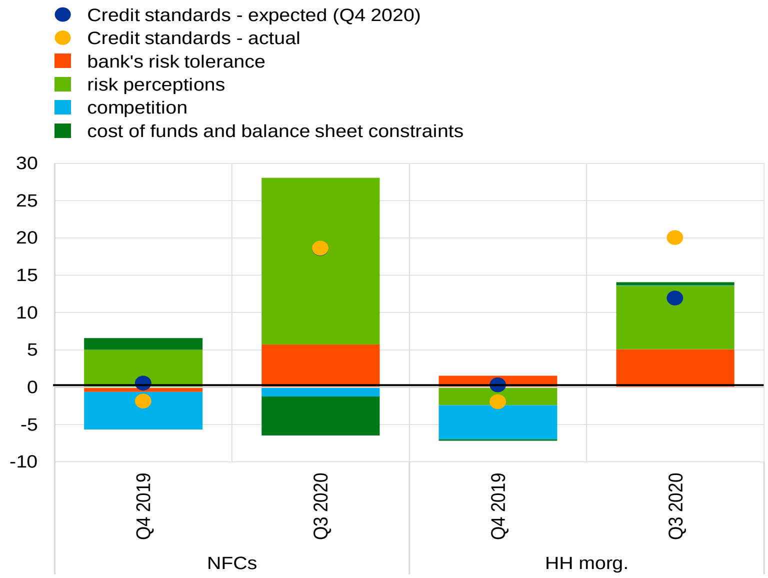
Lending growth to households and NFCs as well as NFC lending flows vs. loan guarantees
Jan. 2010-Sep. 2020, annual growth rates; Apr.-Sep. 2020, € billions



Source: ECB MFI balance sheet statistics, Kreditanstalt für Wiederaufbau (DE), Fédération Bancaire Française (FR), Ministero dello Sviluppo Economico e Mediocredito Centrale and Associazione Bancaria Italiana (IT), Ministerio de Asuntos Economicos y Transformación Digital (ES)

Note: State guaranteed loans granted until end-October.

Changes in credit standards for loans to NFCs and households for house purchases
Q4 2019, Q3 2020, net percentages of banks reporting a tightening of credit standards and contributing factors



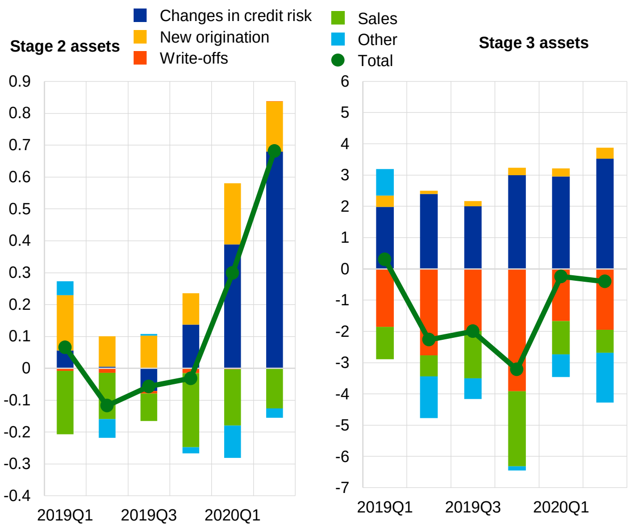
Sources: ECB Bank Lending Survey and ECB calculations

Credit risk has increased since the start of the pandemic

- Increase in provision inflows into stage 2 assets. But euro area banks provisioned less than US banks and less than implied by history, this may partly reflect policy support.

In- and outflows of impairments to Stage 2 and Stage 3 class

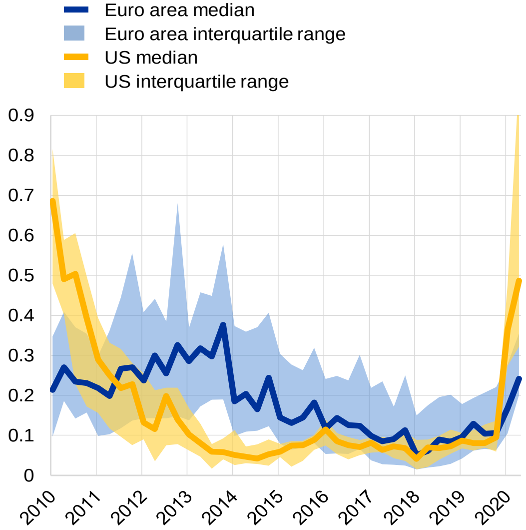
2019 Q1 – 2020 Q2, % of total assets in respective asset stage



Sources: ECB supervisory data and ECB calculations.

Loan loss provisioning of euro area and US listed banks

Q1 2010-Q2 2020, percentage of total loans

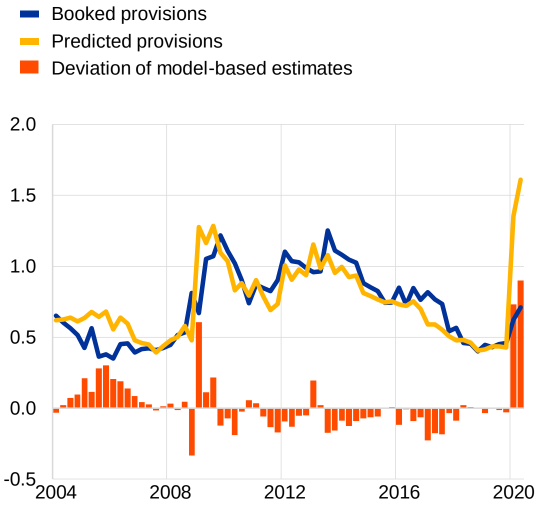


Sources: Bloomberg Finance L.P. and ECB calculations.

Notes: Based on a sample of 20 listed euro area banks and 17 listed US banks.

Actual and model-implied provisions of euro area banks

Q1 2004 – Q2 2020, percentages of total loans

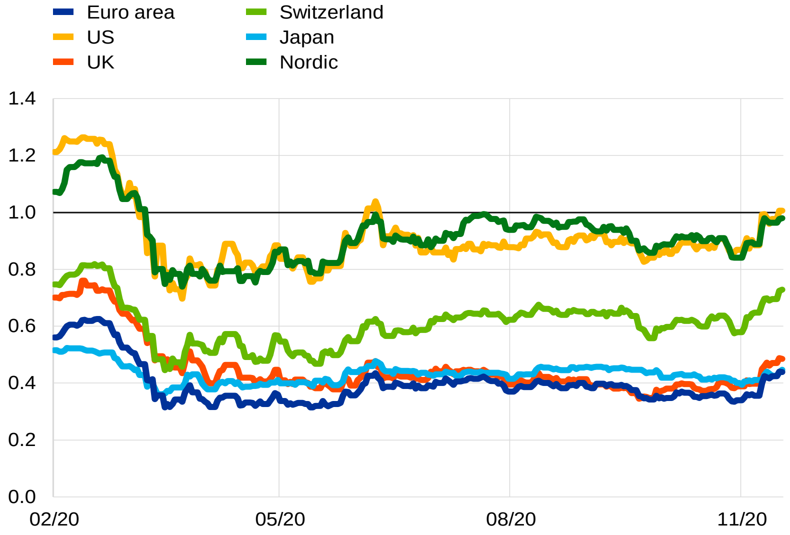


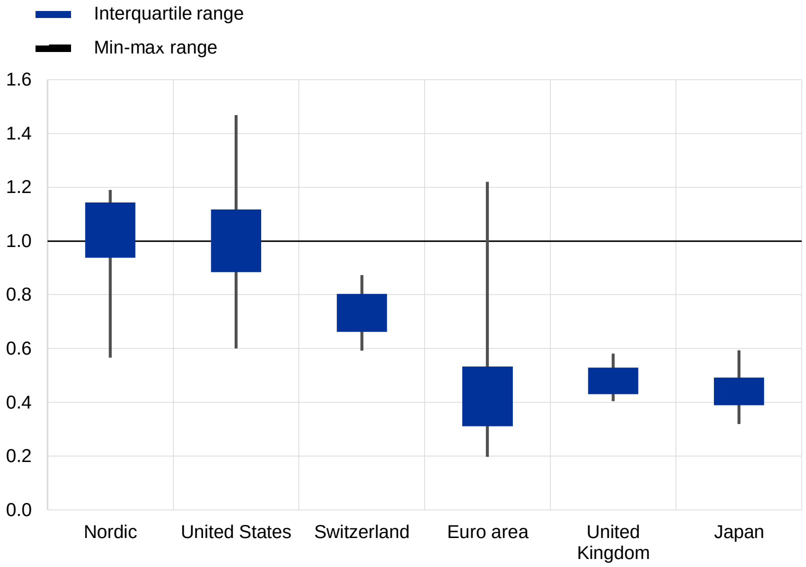
Sources: ECB supervisory data and ECB calculations.

Low bank valuations

- Price-to-book ratios remain lower than global peers
- A relatively high degree of dispersion across euro area banks (albeit with downside skew)

Banks' price-to-book ratios
20 Feb.-17 Nov. 2020, percentage changes





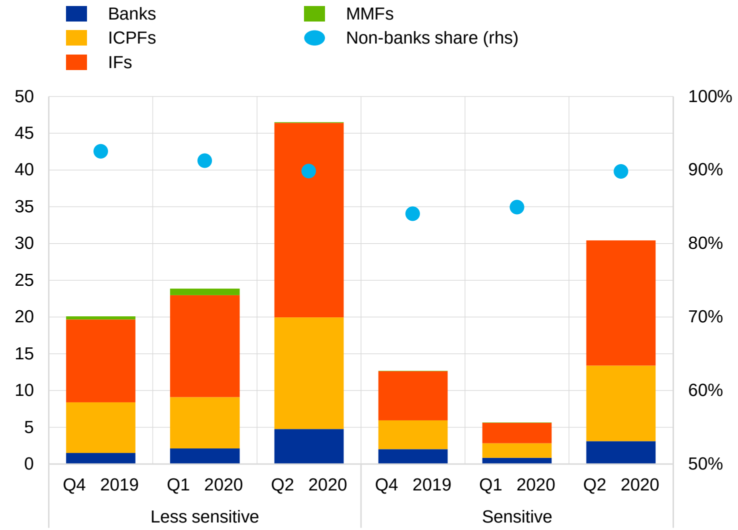
Sources: Sources: Bloomberg Finance L.P. and ECB calculations.

Notes: based on a sample of 59 listed banks. Right panel based on a sample of 59 banks

Non-bank financial intermediaries continue to increase risk-taking

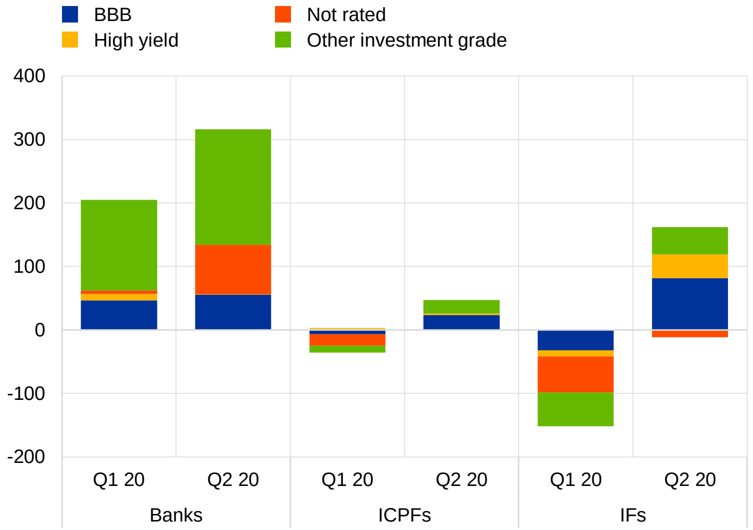
- The sector continued to provide significant financing for companies – also in pandemic-sensitive sectors
- The market turmoil in March led to pro-cyclical asset sales by non-banks

Euro area financial sector's net purchases of newly issued medium- to longer-term debt
Q4 2019 - Q2 2020, € billions



Sources: ECB securities holdings statistics and ECB calculations.
Notes: Net transactions in debt securities with original maturities of over one year. Sensitive sectors are expected to be affected especially hard by the coronavirus-related restrictions; these include mining, manufacturing, retail and wholesale trade, transport, hotels and restaurants, and arts and entertainment.

Euro area financial sectors' net transactions in debt securities by credit rating of the issuer
Q1 - Q2 2020, € billions

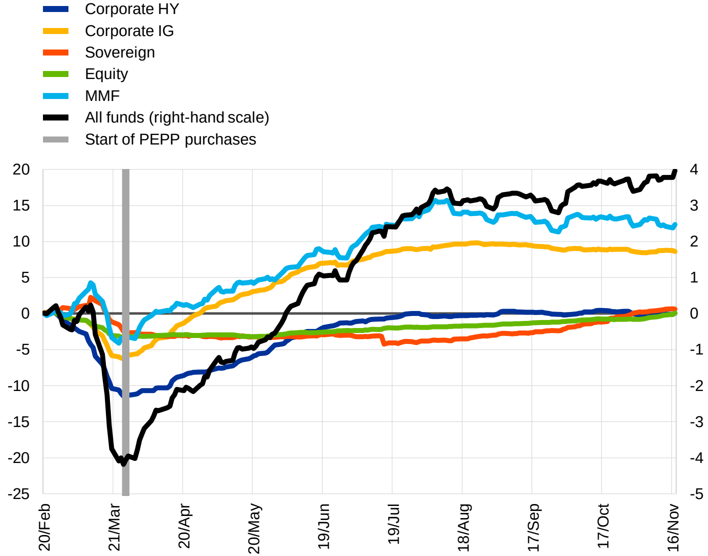


Sources: ECB securities holdings statistics and ECB calculations.

Continued (il)liquidity concerns in investment funds

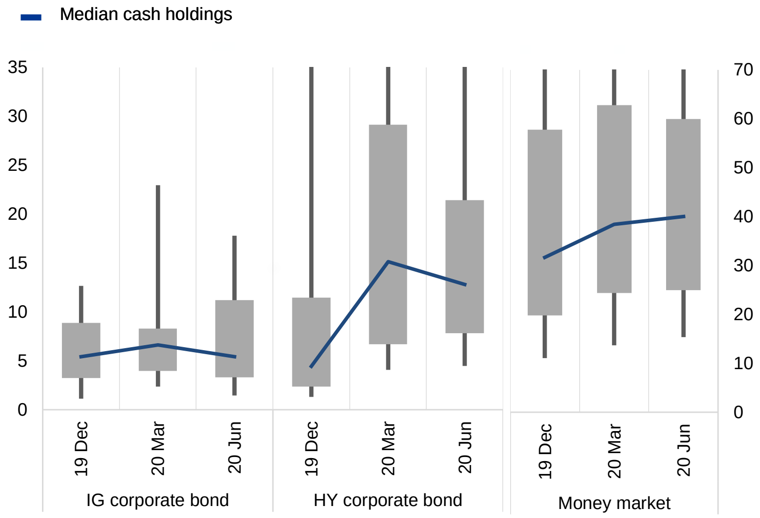
- Investment funds received significant inflows since start of PEPP purchases
- After temporary increase following the March turmoil, funds’ cash holdings reverted back to pre-crisis levels

Cumulative investment fund flows
percentage of AuM



Sources: EPFR Global and ECB calculations.
Note: Data refer to euro area-domiciled funds only.

Interquartile range of liquid asset holdings of corporate bond and MMF funds
percentage of AuM, left-hand scale: IG and HY; right-hand scale: MMFs

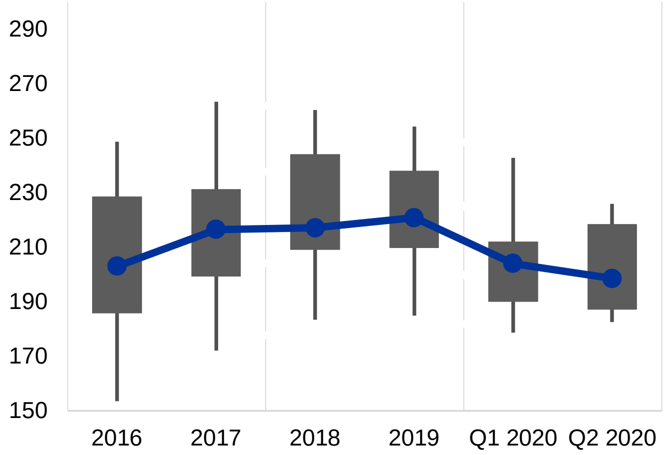


Sources: Refinitiv (Lipper) and ECB calculations.

Lower rates for longer may induce further risk-taking by insurers

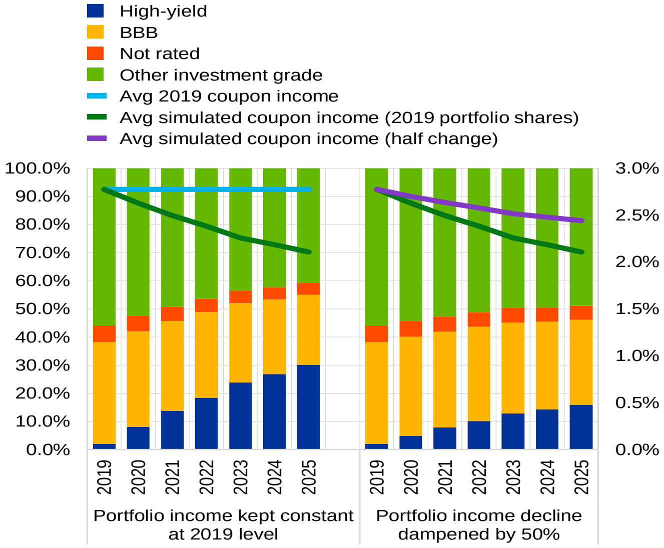
- Insurers' solvency ratios remained relative strong despite recent deterioration
- Pressures on profitability from low interest rates and higher claims could induce further risk-taking by insurers.

Solvency Capital Requirement ratios
percentages, 10th-90th percentile boxplots



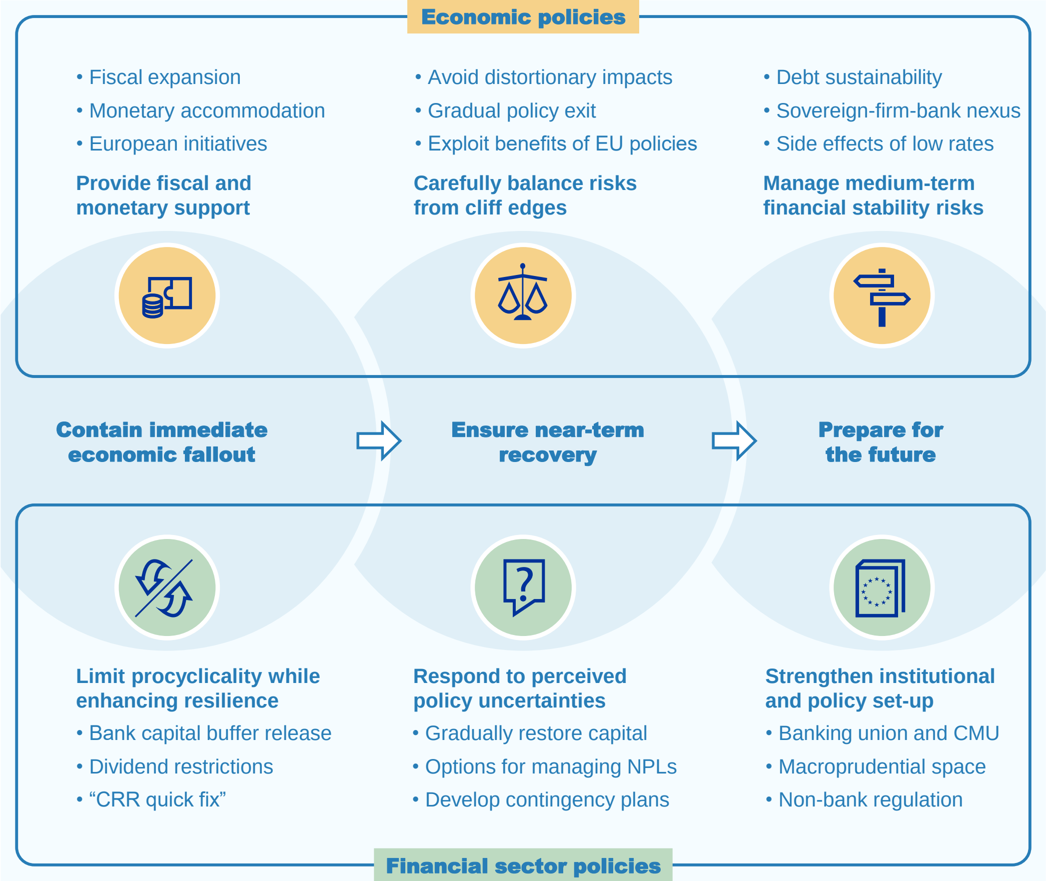
Sources: SNL and ECB calculations.

Projected debt portfolio shares by rating to avoid or dampen expected reduction of investment income
left-hand scale: percentage of debt portfolio, right-hand scale: percentage



Sources: ECB Securities Holdings Statistics by Sector, ECB insurance corporation balance sheet statistics and ECB calculations.

Policy Roadmap



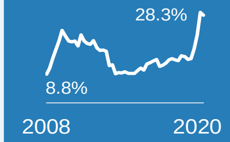
Sources: ECB.

Financial stability vulnerabilities have increased

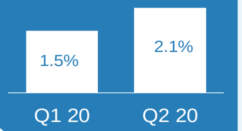
Growing vulnerability to asset price correction

- Elevated negative rating outlooks
- Increasing corporate leverage
- Rising asset price inflation
- Growing equity sector dispersion

High-yield firms rated B- or lower



Default probability of new corporate loans



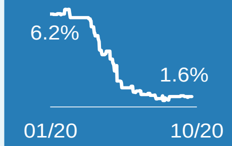
Rising debt servicing challenges of firms, households and sovereigns

- Reassessment of sovereign risk
- Rising corporate insolvencies
- Lower household incomes
- Risk of property market correction

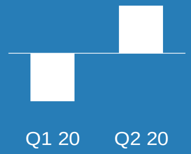
Further weakening of bank profitability amid higher credit losses

- Low market valuations
- Increasing latent credit risk
- Rising sovereign exposure
- Improved funding conditions

Analysts' 2020 bank ROE forecasts



Debt securities transactions of funds



Increasing credit and liquidity risk of non-banks amid renewed risk-taking

- Renewed fund inflows
- Increased exposure to corporate credit risk
- Decline in cash and liquid asset holdings
- Profitability challenges for insurers

The outlook is dominated by the pandemic, although extensive policy support has helped lessen the impact significantly.

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