EUROPEAN CENTRAL BANK

EUROSYSTEM

May 2021

Financial Stability Review

JVI webinar:
Global and European Financial Stability Risks

27 May 2021

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Financial stability vulnerabilities remain elevated

A clustering of vulnerabilities

Rise in US yields as market exuberance extends

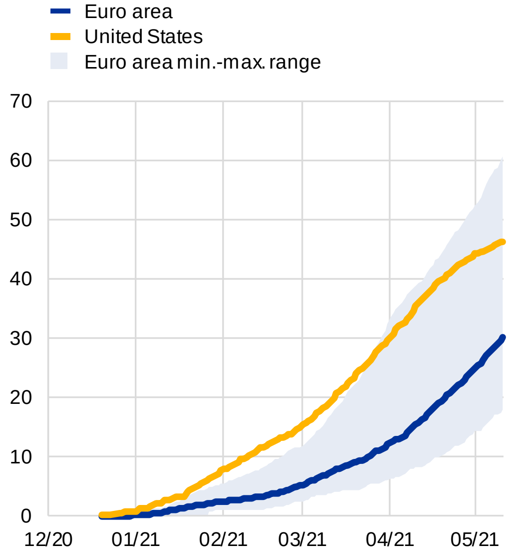
Improved optimism on banks, although with reservations

Material climate-related risks

Third wave delays the economic recovery, particularly for some sectors

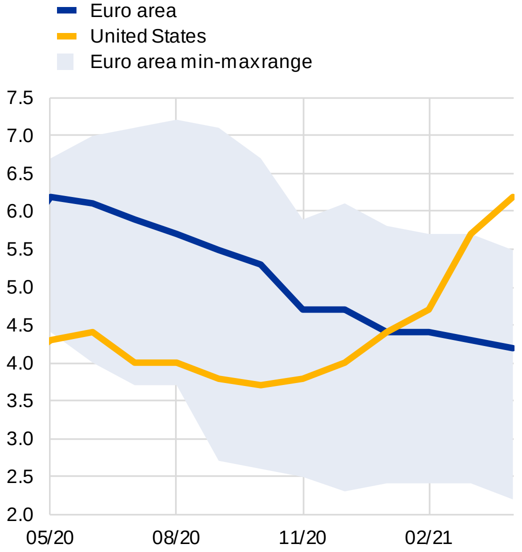
- The third wave has delayed the euro area economic recovery, but vaccinations are now catching up
- Costs of lockdown, and policy support reliance, increasingly concentrated in some sectors/countries

Vaccination rates (first dose)
1 Dec. 2020-11 May 2021, percentage of population



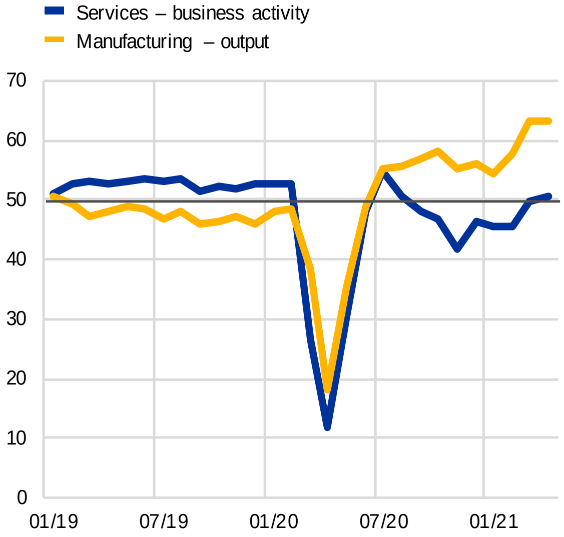
Sources: ourworldindata.org and ECB calculations.

2021 real GDP growth forecasts
May 2020-Apr. 2021, percentage change per annum



Sources: Consensus Economics and ECB calculations.

Euro area PMIs by sector
Jan. 2019-Apr. 2021; 50 = no change on previous month

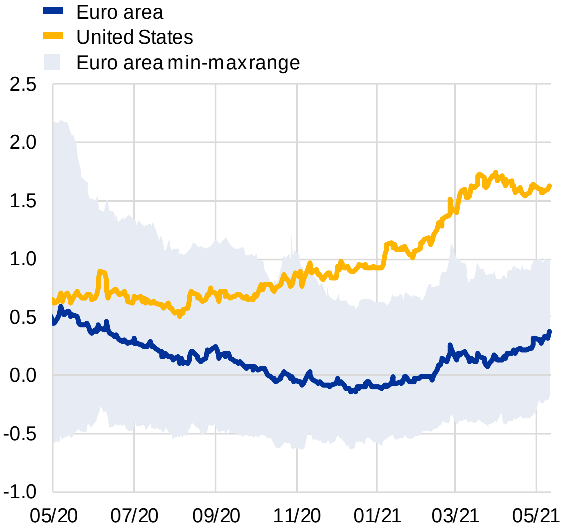


Sources: IHS Markit and ECB calculations.

Financial markets exhibit robust risk sentiment as US yields rise

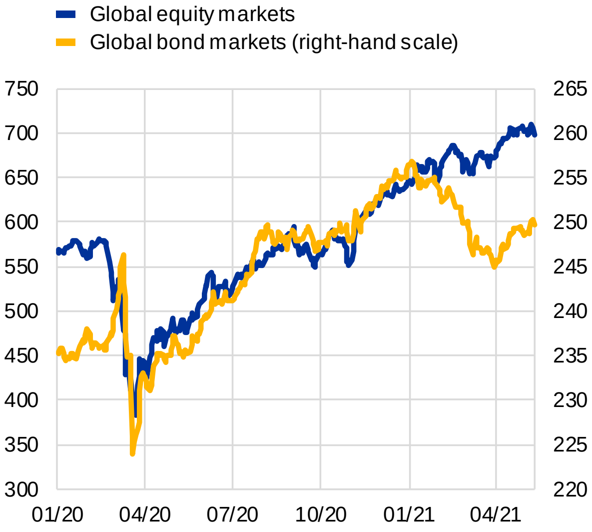
- As US interest rates rose and global bond markets sold off, equity markets saw a renewed rally
- Some market segments continue to show signs of elevated valuations and may be at risk of a correction
- Further rise in risk-free interest rates risks tightening financial conditions

10-year benchmark government bond yields
1 May 2020-11 May 2021, percentages



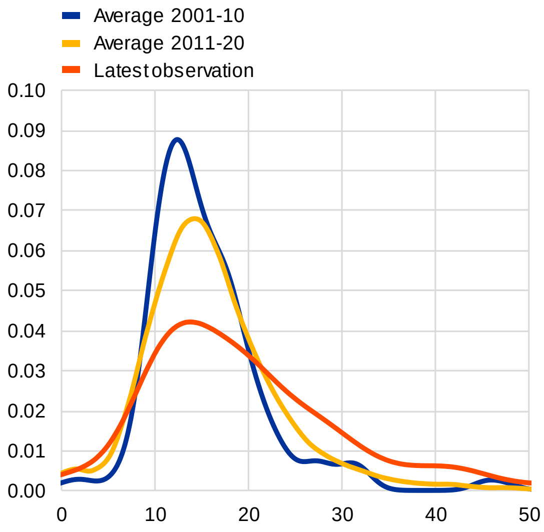
Sources: Bloomberg Finance L.P., Reuters, ECB and ECB calculations.

Global equity and bond market price developments
1 Jan. 2020-11 May 2021, indices



Sources: Bloomberg Finance L.P.

EURO STOXX forward price/earnings ratio
Jan. 2000-May 2021; density

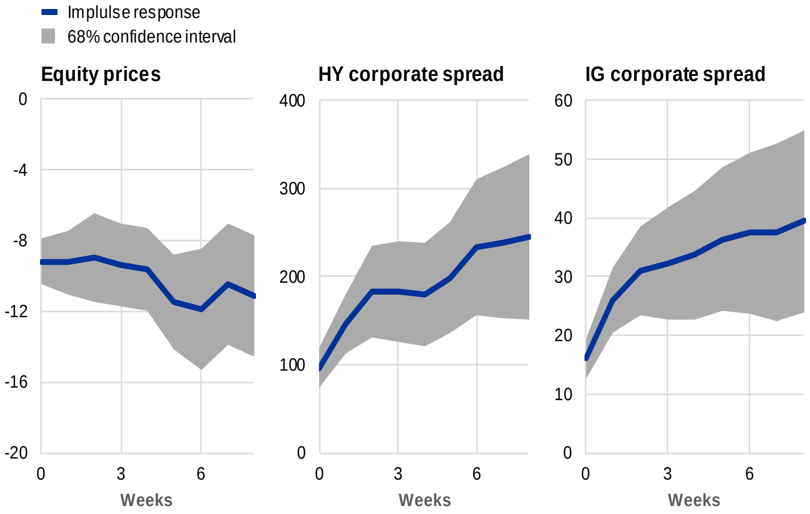


Sources: Refinitiv and ECB calculations.

A further sharp and sustained rise in rates could prompt valuation adjustments

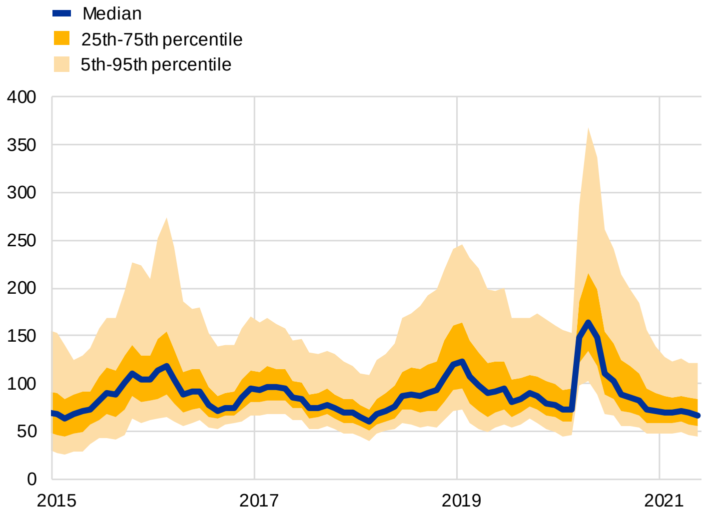
- Spillovers to euro area markets from a potential US monetary policy tightening shock could be substantial
- Ongoing search-for-yield has pushed corporate bond spreads to multi-year lows, susceptible to correction

Effect of a US monetary policy tightening shock
percentage changes (left panel), basis points (middle and right panel)



Sources: Refinitiv and ECB calculations

Range of euro area non-financial investment grade corporate bond spreads
Jan. 2015-May 2021; basis points

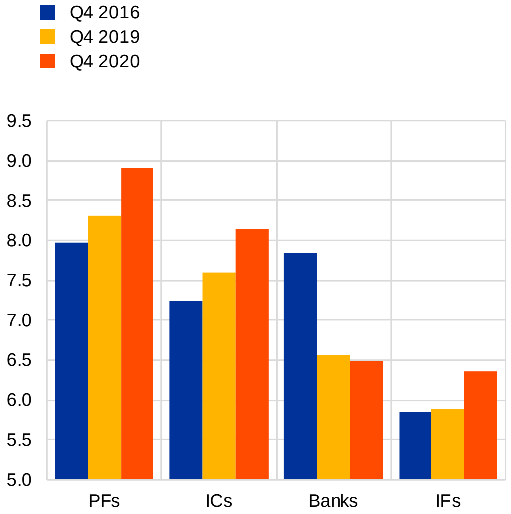


Sources: IHS Markit and ECB calculations.

Non-bank FIs have continued to increase duration, liquidity and credit risk

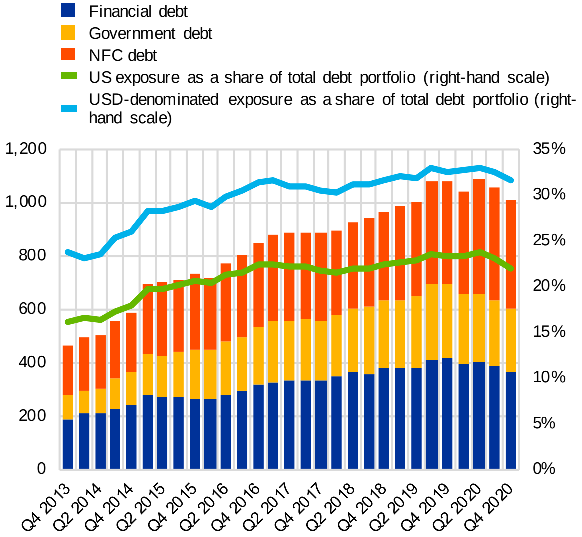
- Non-bank FIs have become more sensitive to a yield shock, given increased bond portfolio duration, and exposed to US markets
- Non-banks continue to have large exposures to corporates with weak fundamentals

Duration of bond portfolios across financial institutions
2016-2020, years



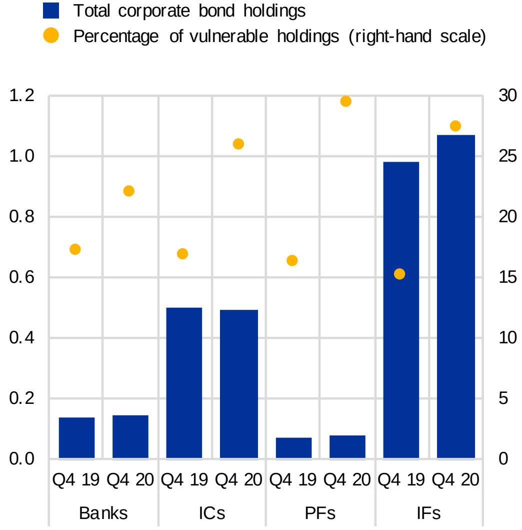
Sources: ECB (SHSS) and ECB calculations.

Total US and USD debt exposure of euro area investment funds
Q4 2013-Q4 2020, € billions, percentages



Sources: ECB (SHSS) and ECB calculations.

Non-financial corporate bond holdings of euro area financial sectors
Q4 2019, Q4 2020; € billion, percentages

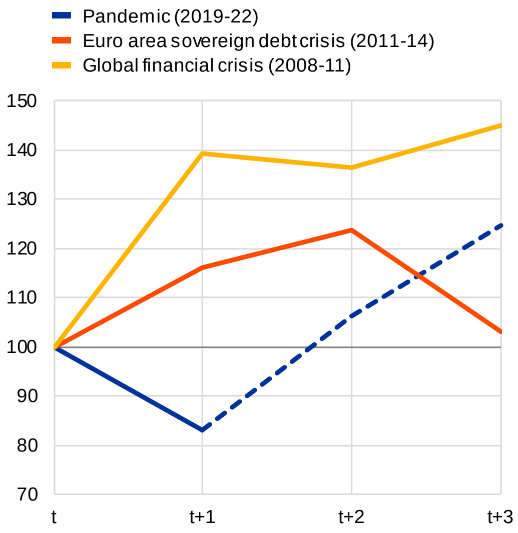


Sources: ECB (SHSS) and ECB calculations.

Large corporate solvency challenges ahead

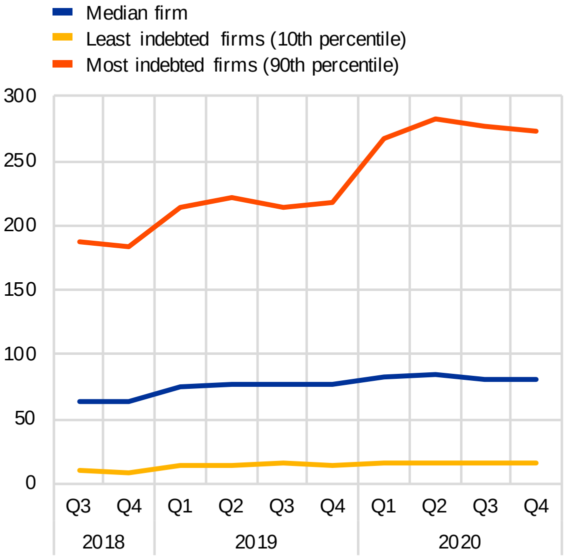
- Corporate insolvencies expected to rise amid uncertainty
- Reliance on debt has increased among a tail of already vulnerable firms amid growing roll-over risks
- Corporate stress may spill over to other parts of the economy

Development of corporate insolvencies during different crisis episodes
Indices



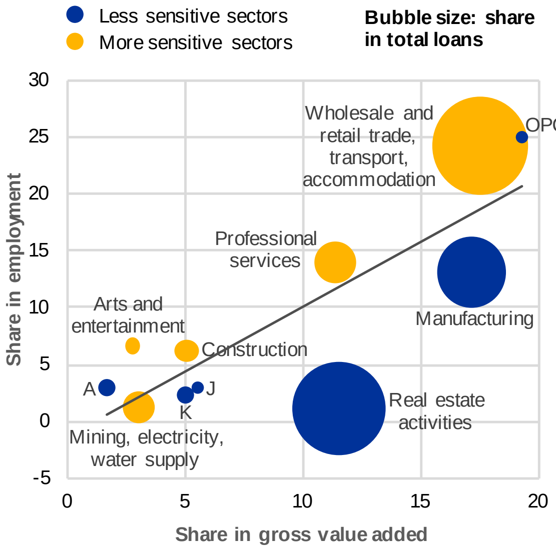
Sources: Allianz Euler Hermes and ECB calculations.

Debt-to-equity ratios across euro area non-financial corporations
Q3 2018-Q4 2020, percentages



Sources: S&P Global Market Intelligence and ECB calculations.

Share of sectors in gross value added, employment and total loans
Q4 2020, percentages



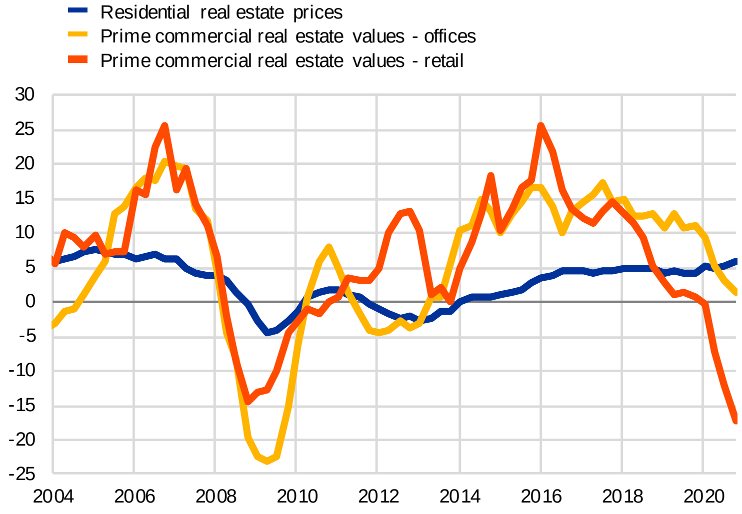
Sources: Eurostat, ECB and ECB calculations.

Residential property markets remain robust, contrasting CRE

- Residential real estate remains strong, especially in some countries, supported by strong household income
- Commercial real estate has, however, come under severe pressure

Euro area residential and commercial property price developments

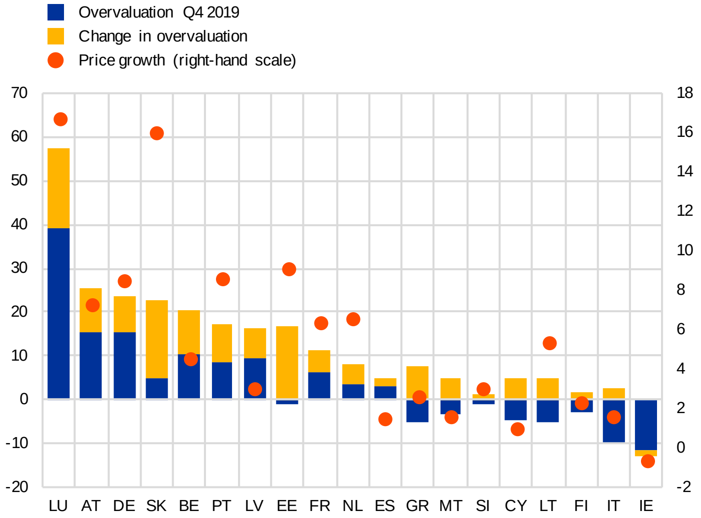
Q1 2004-Q4 2020; percentage change per annum



Sources: Jones Lang LaSalle, ECB and ECB calculations.

Change in overvaluation and price growth since the end of 2019

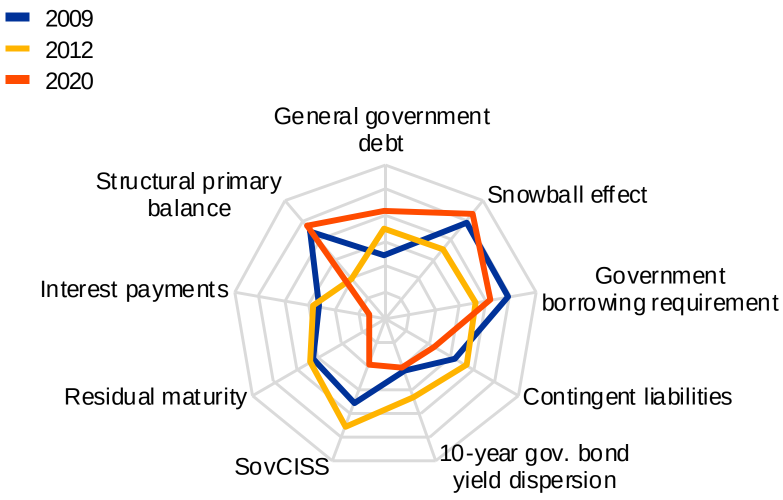
Q4 2019-Q4 2020; percentages



Sources: ECB and ECB calculations.

Benign financing conditions mitigate near-term sovereign debt sustainability risks

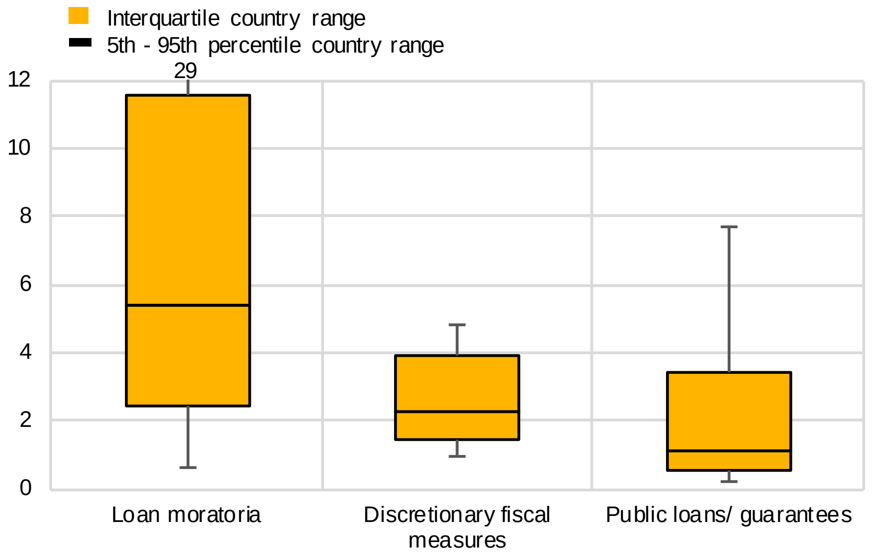
Selected fiscal vulnerability indicators during different crisis episodes, z-scores



Centre of the cobweb indicates lower risk

Sources: Eurostat, ECB and ECB calculations.

Size of fiscal support measures (take-ups) across euro area countries Q4 2020, percentages of GDP

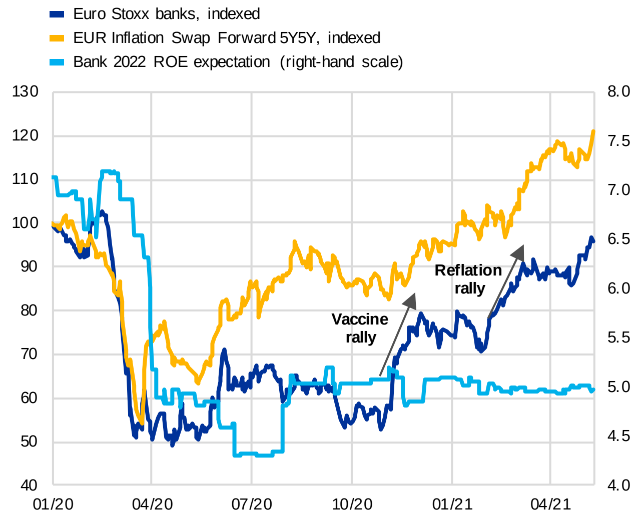


Sources: ESRB.
Notes: discretionary fiscal measures include direct grants as well as tax measures.

Improved market sentiment vis-à-vis euro area banks despite poor profitability

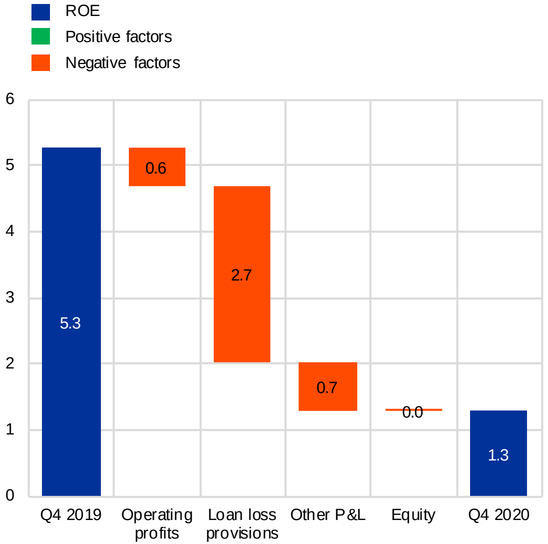
- Euro area bank stock prices have recovered from low levels, but market analyst ROE forecasts are unchanged
- Loan losses provisions have been the factor weighing on recent profits, heavily concentrated in some countries

Euro area bank stock prices, analysts' ROE expectations and inflation expectations
2 Jan. 2020-11 May 2021, percentages, index



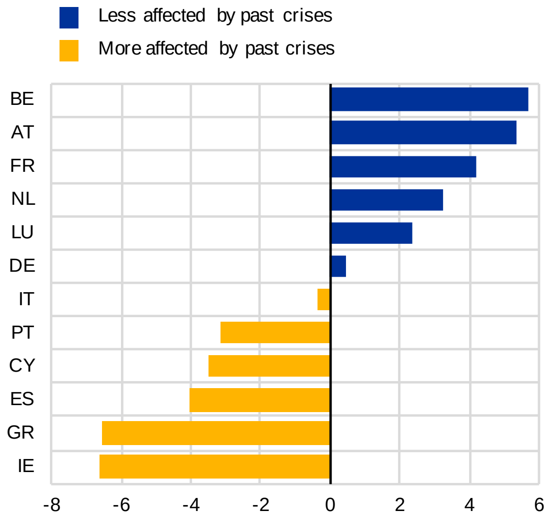
Sources: Bloomberg Finance L.P. and ECB calculations.

Euro area banks' ROE and factors contributing to its change
Q4 2019, Q4 2020, percentage points



Sources: ECB supervisory data and ECB calculations.

Banks' ROE across countries
Q4 2020, percentages

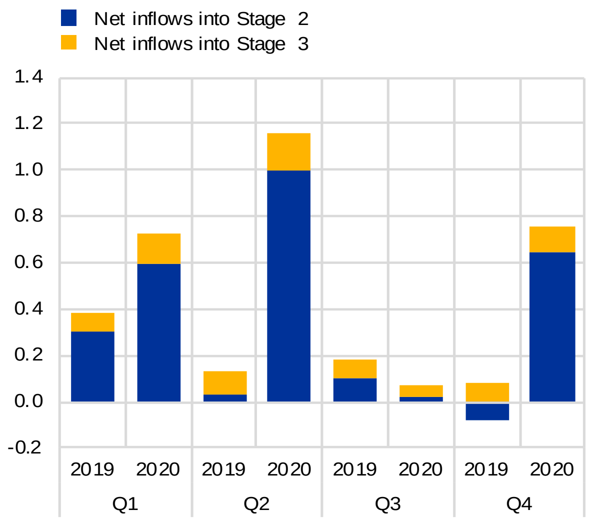


Sources: ECB supervisory data and ECB calculations.

Outlook depends on evolution of loan losses and avoiding a lending contraction

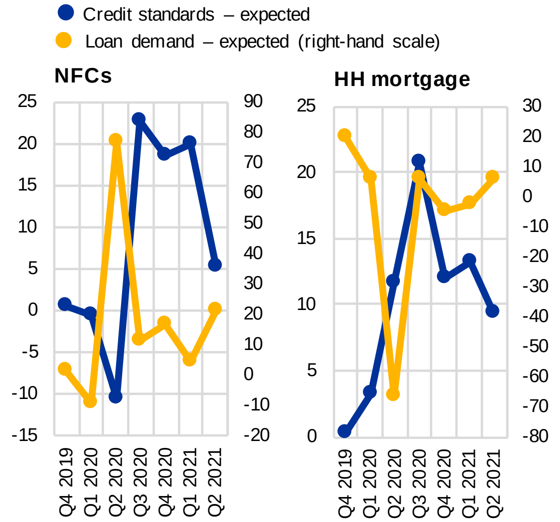
- Forward-looking indicators suggest loan losses beginning to materialise, focussed on stage 2
- Recent tightening of lending standards and uncertain demand may weigh on future loan income

Net inflows into Stage 2 and 3 assets
Q1 2019-Q4 2020, percentage of total loans



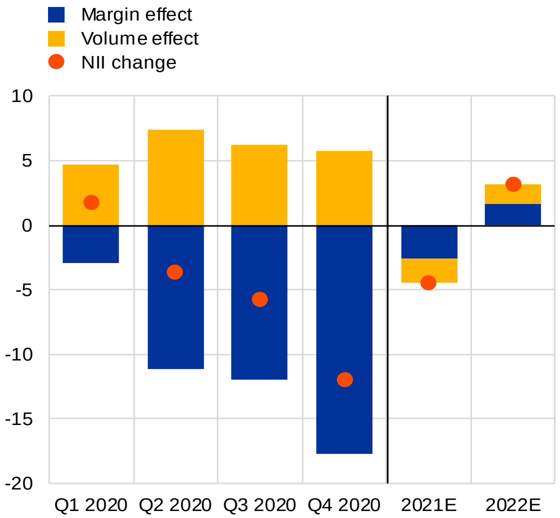
Sources: ECB supervisory data and ECB calculations.

Changes in bank lending standards for corporate and mortgage loans
Net percentages of banks reporting



Sources: ECB and ECB calculations.

Annual changes in net interest income and contributing factors
Percentage changes; ppt contributions



Sources: ECB supervisory data and ECB calculations.

Growing balance sheet vulnerabilities in non-financial sectors

Further weakening of bank profitability amid high credit risk exposure

Further increasing duration, liquidity and credit risks of non-banks

TARGETED POLICIES SHOULD CONTINUE TO SUPPORT THE RECOVERY AMID PANDEMIC RELATED UNCERTAINTY AND THE POTENTIAL FOR CREDIT RISK MATERIALISATION

Targeted and tailored economic policies to support viable borrowers

Improve credit risk management and use of capital buffers

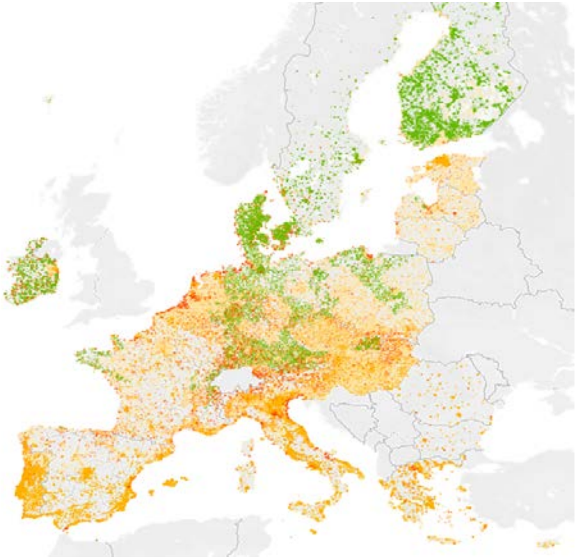
Effective NPL solutions

Macroprudential approach for non-banks and other regulatory actions

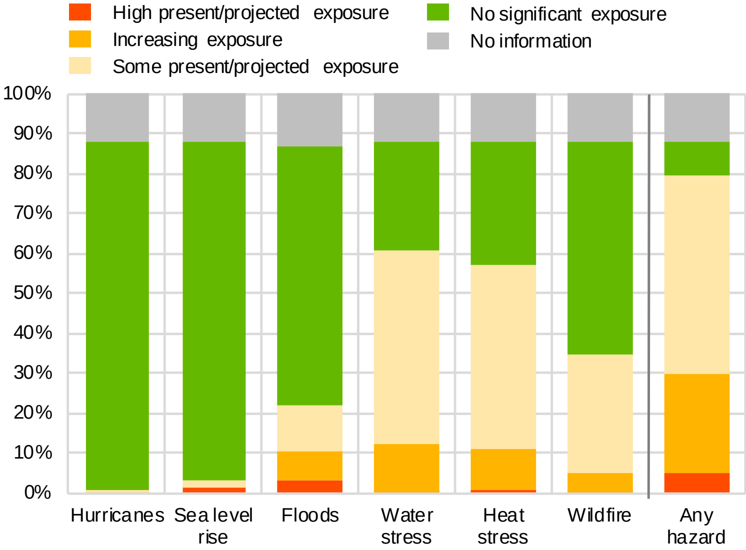
Risks to financial stability from physical climate risk drivers

- `Physical risks appear to be somewhat concentrated in some sectors, geographical regions and individual banks

Corporate exposure to physical risk drivers
Firm max. risk level



Share of EA banks' credit exposures to firms by firm physical risk level
Percentages

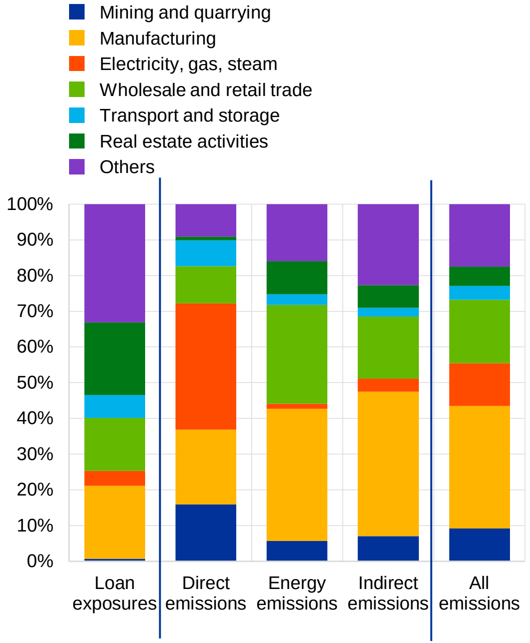


Sources: Four Twenty Seven, ECB AnaCredit and ECB calculations.

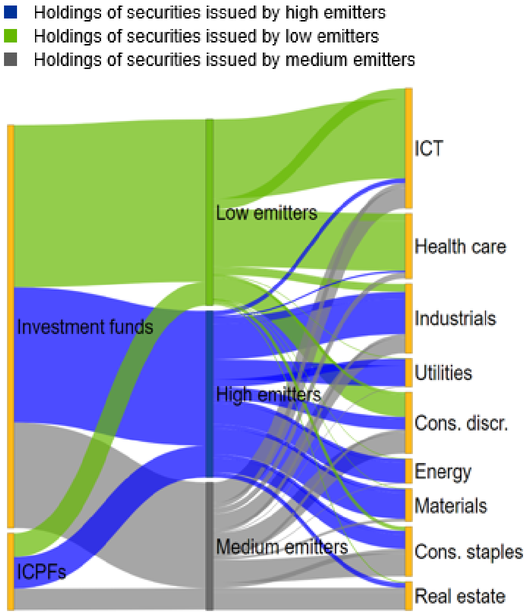
Risks to financial stability from transition climate risk drivers

- Bank exposures to manufacturing sector are significant and associated with high scope 3 emissions.
- Non-bank financial institutions hold 30% of their portfolios in securities of high-emitting NFCs.

Banks' loan exposures and share of corporate emissions by sector



Non-banks' exposure to transition risk via equity and debt securities

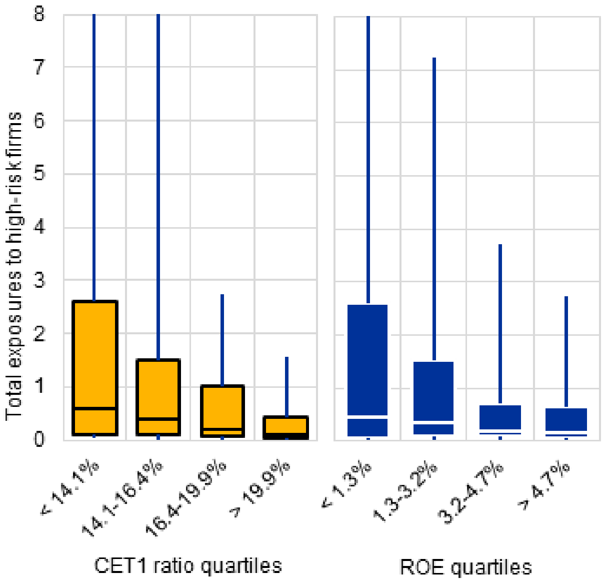


Sources: AnaCredit, Urgentem, ECB.

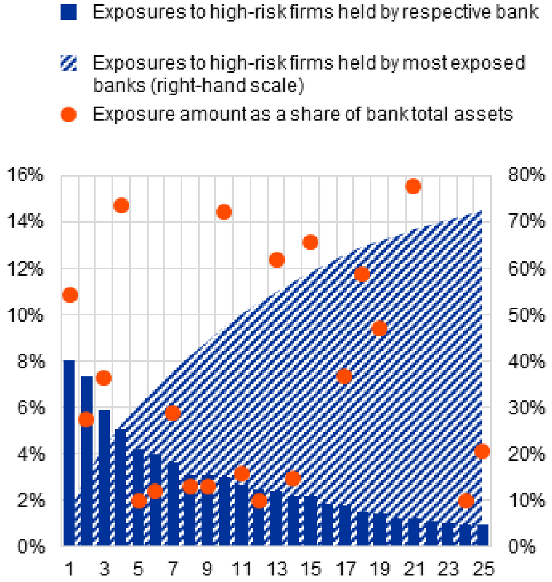
Concentrated bank exposures to physical risk

- Physical risks concentrated in few banks and interacting with other vulnerabilities of the banking sector.
- More than 70% of the banking system credit exposures high-risk firms are held by 25 banks.

Distribution of banks' exposures to firms located in areas of high or increasing physical risk, by level of capital and profitability



Concentration of exposures to firms located in areas of high or increasing physical risk in the banking system

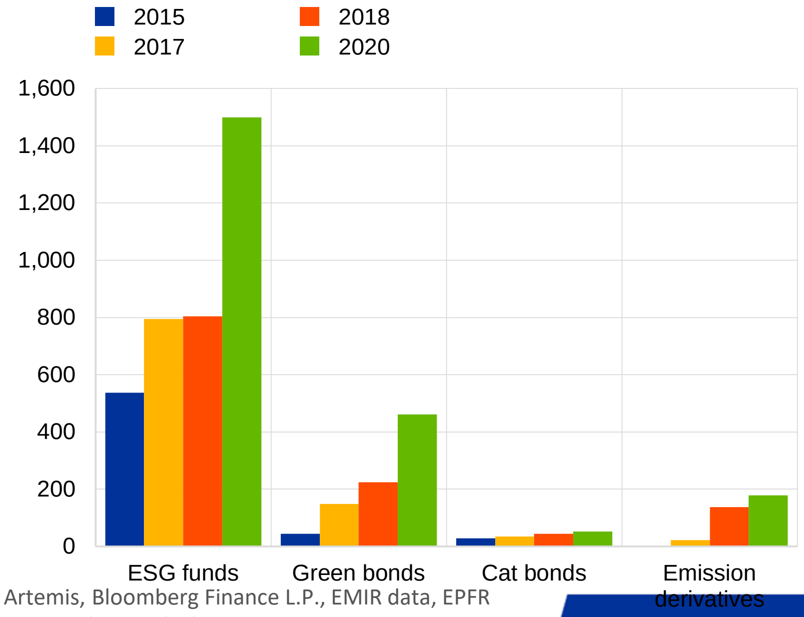


Sources: AnaCredit, Four Twenty Seven, ECB calculations.

Rapidly expanding green financial markets

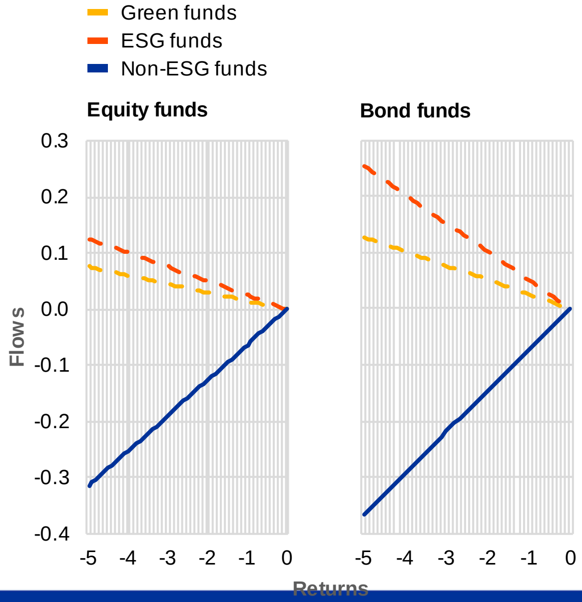
- Instruments of sustainable finance growing strongly and investors in ESG and green funds appear less sensitive to past negative performance
- But the risk of greenwashing remains high due to the lack of consistent disclosures, taxonomy alignment and consistent standards for green bonds and ESG investment funds.

Market growth in 'green' financial instruments
(in EUR billion)



Sources: Artemis, Bloomberg Finance L.P., EMIR data, EPFR Global, Lipper and ECB calculations.

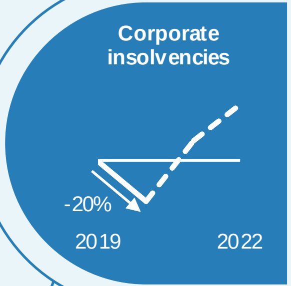
Flow sensitivities to past negative returns of green, ESG and non-ESG corporate bond and equity funds



Sharply higher rates may reveal risk asset vulnerabilities

- Pressure on risk compensation
- Increased equity market leverage
- Elevated bond market duration risk
- Tight credit market pricing

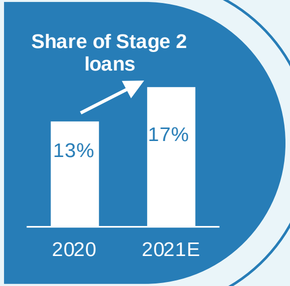
Growing balance sheet challenges in the non-financial sector

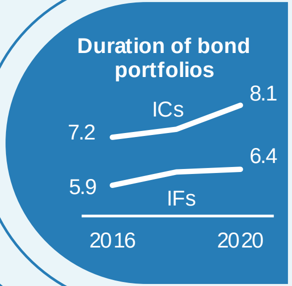


- Rising sectoral risk concentration
- Growing corporate solvency issues
- Risk of property market correction
- Materialisation of contingent liabilities

Weaker bank profitability amid high credit risk exposure

- Deterioration in asset quality
- Continued margin decline
- Lower corporate loan demand
- Stable funding conditions





Further increases in credit, liquidity and duration risks for non-banks

- Rotation from bond to equity funds
- Rising global rates could trigger outflows
- Low liquidity buffers could lead to asset sales
- Positive capitalisation effects for insurers

The outlook continues to be dominated by the pandemic, with the risks being concentrated in some sectors and countries with pre-existing vulnerabilities.

Well-targeted policy measures are still warranted to support the economy, while the use of available capital buffers, enhanced credit risk management and effective NPL solutions can protect the recovery and medium term growth.