EUROPEAN CENTRAL BANK

EUROSYSTEM

November 2021

Financial Stability Review

Webinar on Global and European Financial Stability Risks

Joint Vienna Institute

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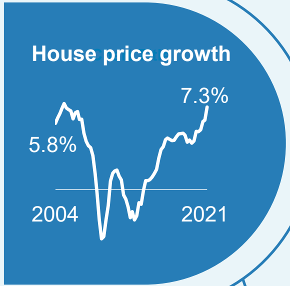
Paul Hiebert

Head of Systemic Risk and Financial Institutions Division

Near-term tail risks fall, but high debt and buoyant housing markets are of concern

- Solidifying economic recovery
- Rapid expansion in housing markets
- Solvency risks among vulnerable firms
- Elevated sovereign indebtedness

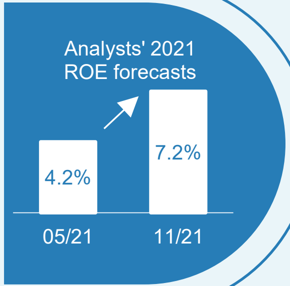


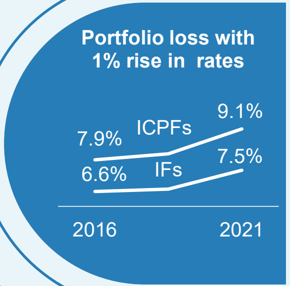
Stretched asset valuations at risk of disorderly correction

- Low real yields incentivise risk-taking
- Increased leverage
- Growing sensitivity to a rise in rates
- Stretched valuations in some markets

Improved bank profitability, but structural challenges remain

- Slower asset quality deterioration
- Muted corporate lending
- Rising share of negative deposit rates
- Slightly lower capital ratios





Non-banks vulnerable to renewed corporate stress, liquidity and duration risks

- Continued credit risk-taking
- Inflation concerns among fund investors
- Low liquid asset holdings in funds
- Improved financial conditions for insurers

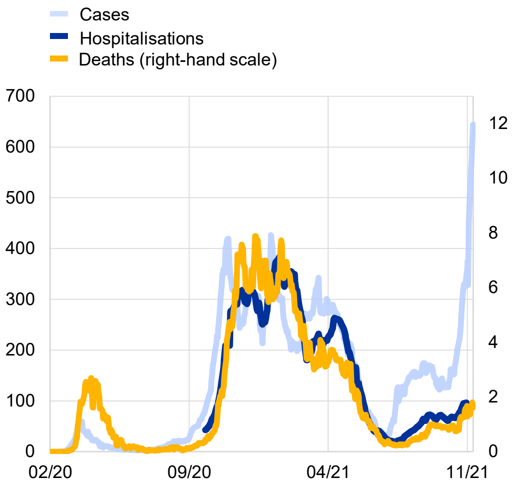
As the recovery progresses, policies shift focus from short-term support to mitigating risks from higher medium-term financial stability vulnerabilities, in particular emerging cyclical and real estate risks.

From the structural perspective, strengthening the regulatory framework for banks and the macroprudential approach for non-banks remains key.

1. Macro-financial and credit environment

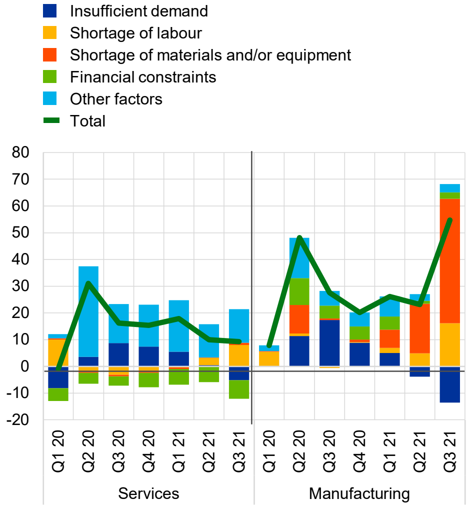
Improved economic outlook, though economic reopening comes with challenges

New COVID-19 cases versus COVID-19 related deaths and hospitalisations
(17 Feb. 2020- 9 Nov. 2021, persons per million, EA median)



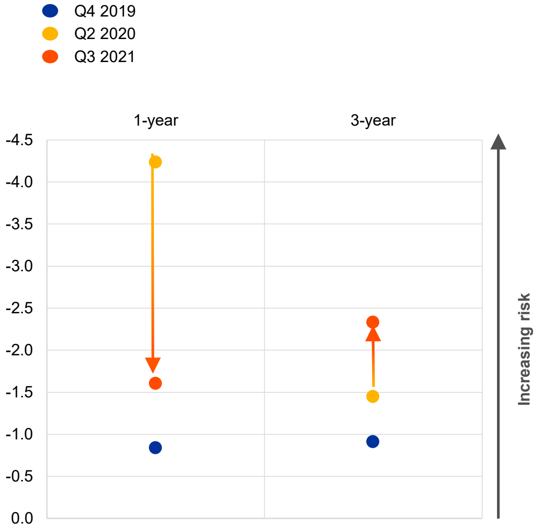
Sources: Our world in data.

Production limits in the services and manufacturing sectors
(percentage of respondents, point deviation from long-term average)



Sources: European Commission, ECB.

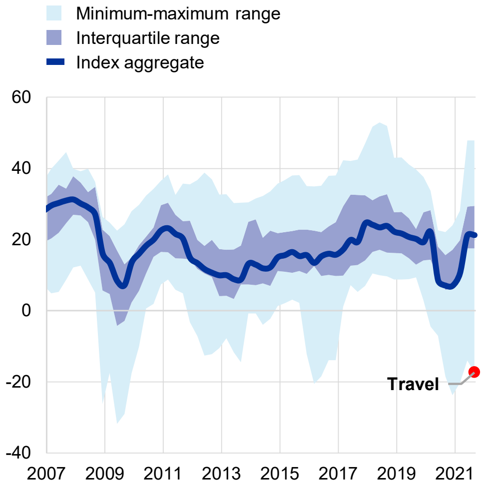
Near and medium-term growth-at-risk estimates for the euro area at different horizons
(percentages)



Sources: ECB, ECB and ECB calculations.

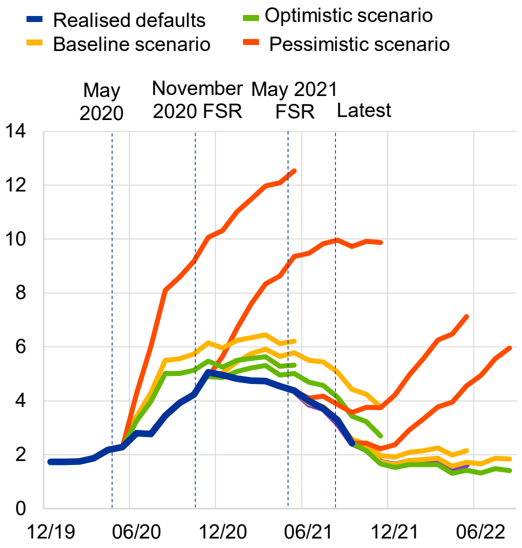
Corporate solvency risks lower than feared previously, though some areas of concern

Earnings per share across EUROSTOXX sectors
(Q1 2007-Q3 2021, per share)



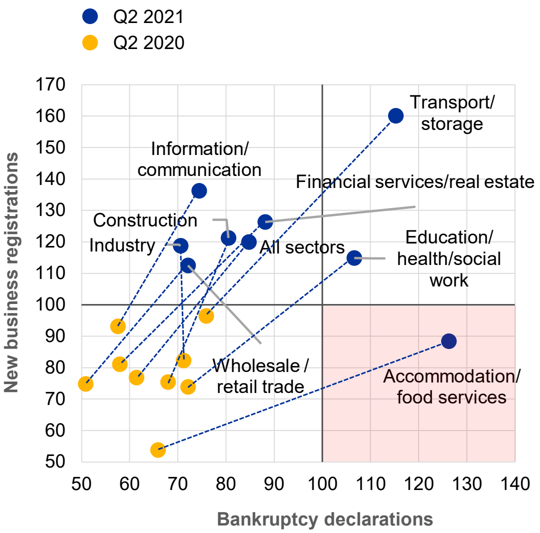
Sources: ECB calculations, Bloomberg Finance L.P.

European speculative-grade 12-month trailing default rates
(percentages)



Source: Moody's Analytics.

Bankruptcy declarations and new business registrations
(Index; 2015=100)

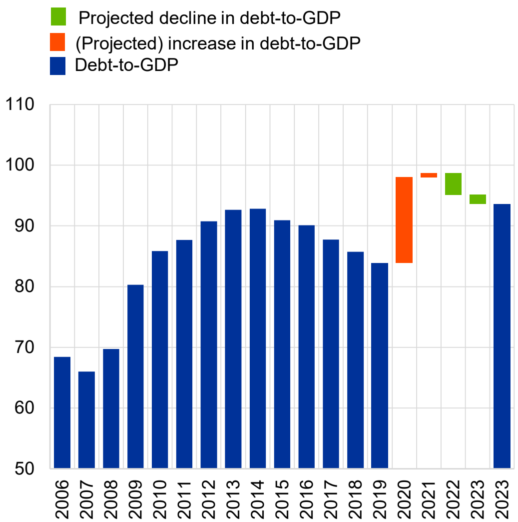


Source: Eurostat, ECB.

Sovereign debt dynamics benefit from low funding costs

General government debt-to-GDP ratios

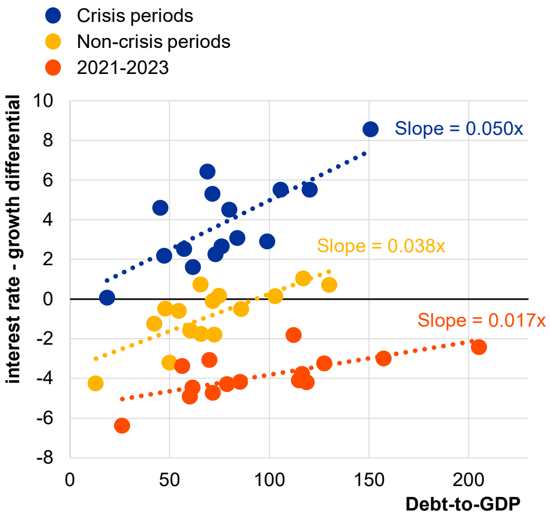
(2006 – 2023, percentage of GDP)



Sources: ECB and ECB staff calculations.

Interest rate-growth differentials versus debt-to-GDP

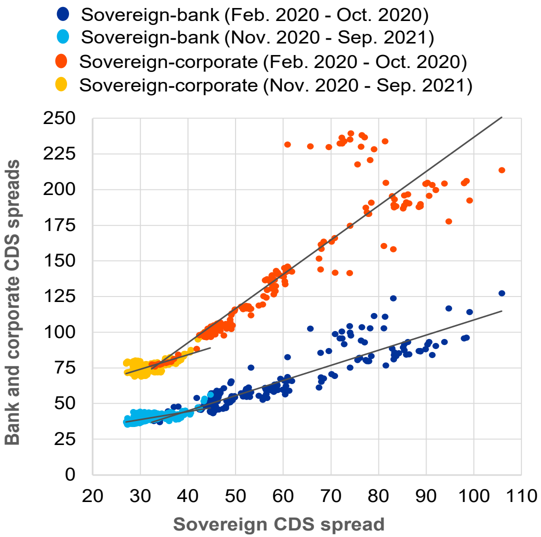
(percentage and percentage of GDP)



Sources: ECB calculations, Eurostat.
Note: crisis periods refer to 2008, 2009 and 2011-13.

Sovereign, bank and non-financial corporate CDS spreads

(Basis points)

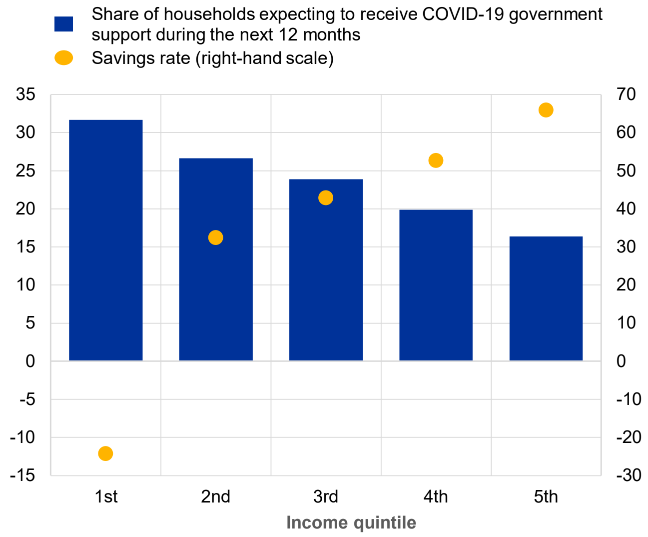


Sources: IHS Markit, ECB and ECB calculations.

Households resilient, but pockets of vulnerabilities as housing market powers ahead

HH savings and pandemic support across income quintiles

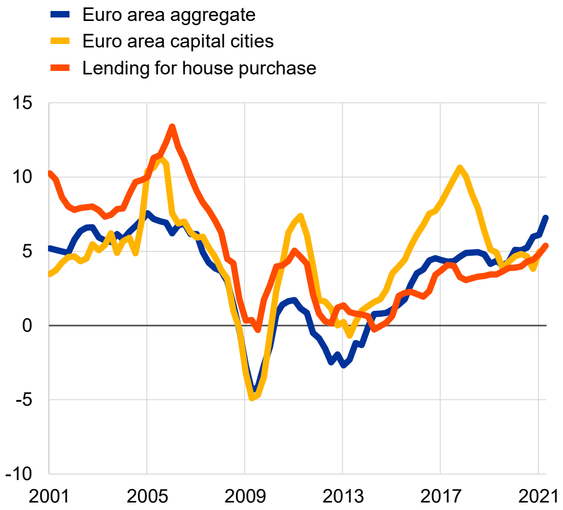
(Q2 2021)



Sources: ECB, CES and ECB calculations.
Note: savings are shown as percentages of gross disposable income.

Growth of RRE prices in capitals and at aggregate level and mortgage lending

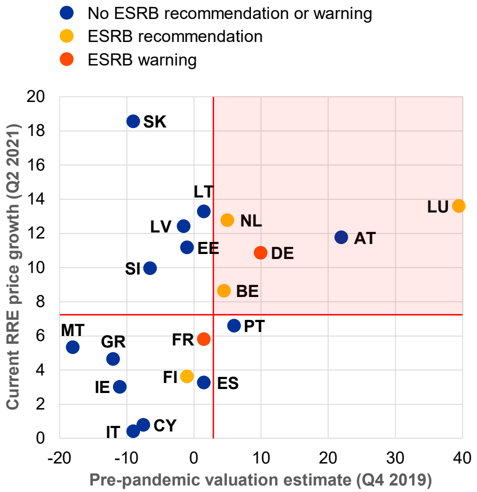
(Q1 2001-Q2 2021; annual % change)



Sources: ECB and ECB calculations.

RRE price growth and overvaluation across countries

(Q2 2021, Q4 2019; percentages)

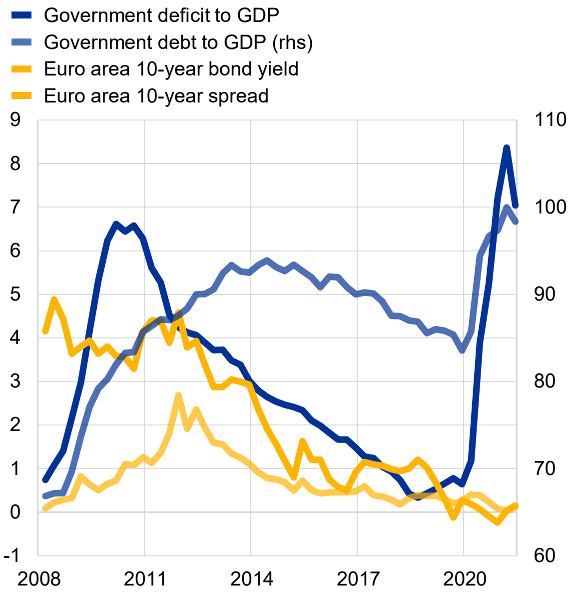


Source: ECB and ECB calculations.
Note: Red (yellow) dots indicate countries that received an ESRB warning (recommendation); lines EA aggregate.

2. Financial markets

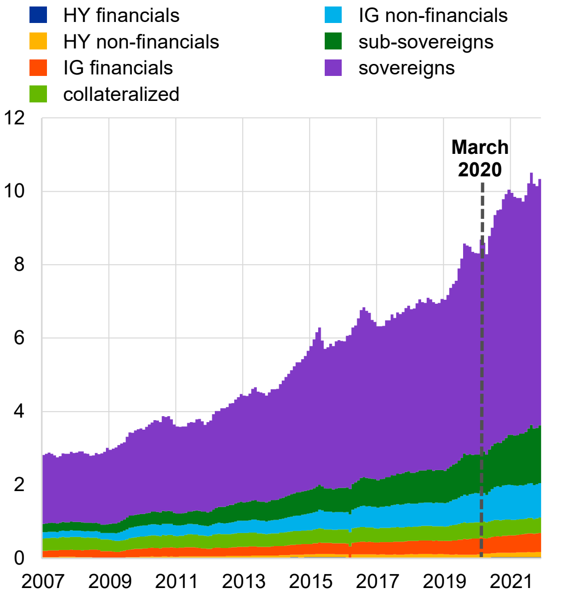
Pandemic scars of debt and duration contribute to long-term vulnerabilities

Debt increased, but spreads & yields didn't
(euro area debt/deficit vs. GDP, GDP weighted spreads and yields)



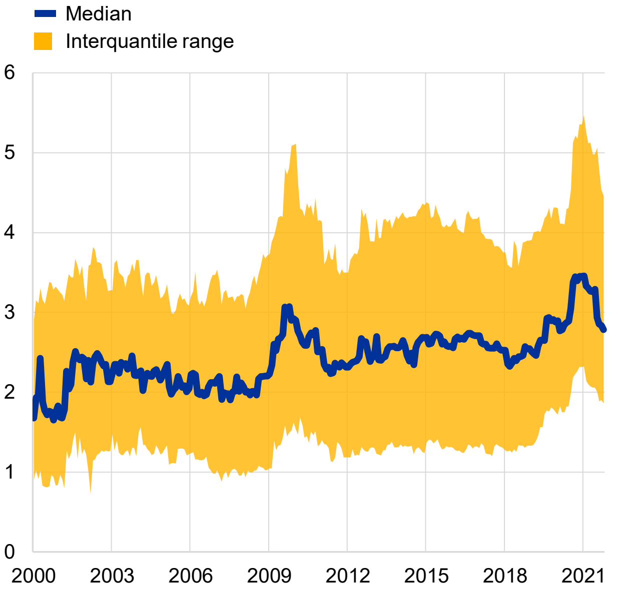
Source: Statistical Data Warehouse.

Duration increased
(EUR billion per basis point, euro area fixed income products)



Source: iBoxx, ECB calculations.

Corporate leverage increased
(debt/EBITDA, EURO STOXX)



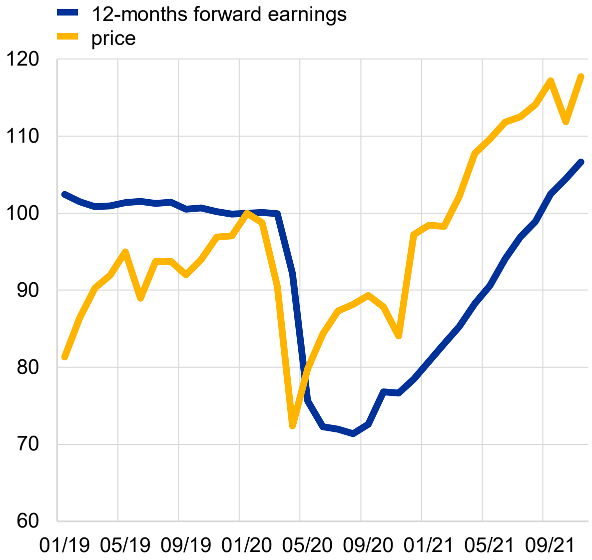
Sources: Bloomberg, ECB calculations

Stretched valuations in financial markets

Earnings uncertainty remains elevated
(EURO STOXX earnings expectations)

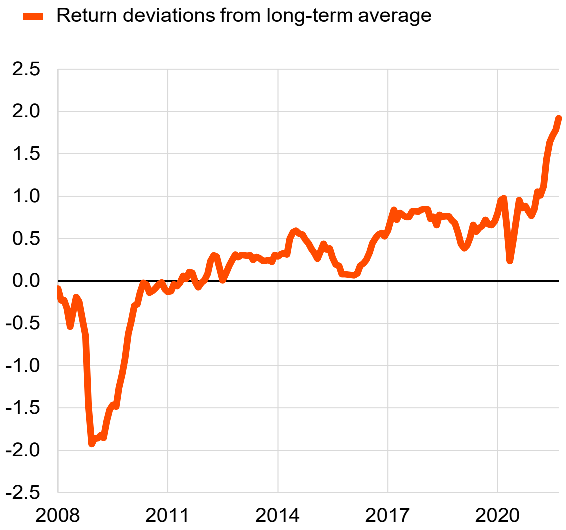
Source: Refinitiv Datastream.

Some valuations seem stretched
(EURO STOXX price and forward earnings, Jan.20 = 100)



Source: Refinitiv Datastream.

Deviation of a basket of global financial assets from historic average
(Jan. 2008-Nov. 2021, number of standard deviations)



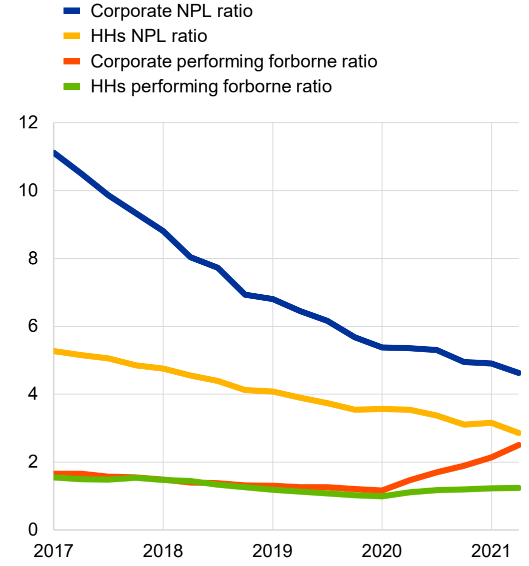
Sources: Refinitiv, Bloomberg Finance L.P., ECB and ECB calculations.

3. Euro area banking sector

Asset quality performed better than anticipated – so far

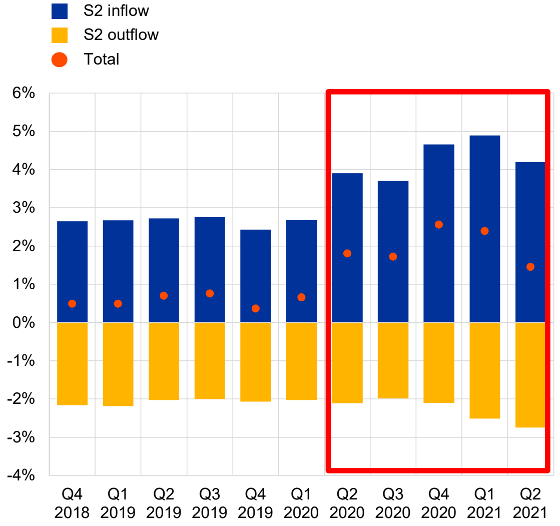
Indicators of bank asset quality for the euro area

Q1 2017 – Q2 2021, percentages



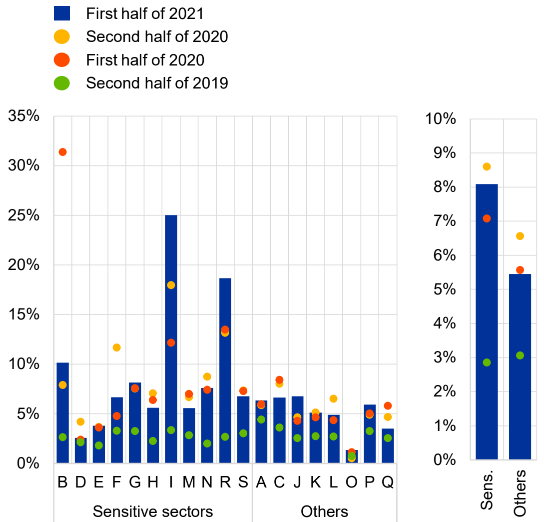
Loan inflows into and outflows from IFRS stage 2 assets class

(percentages of total loans)



Share of stage 1 loans transferred to stage 2 by economic sector

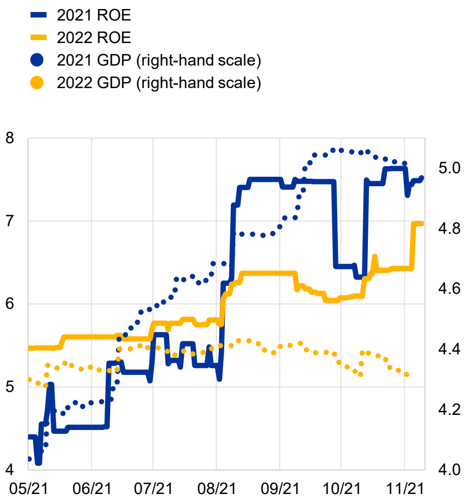
(percentages of stage 1 loans)



Sources: ECB supervisory data, AnaCredit and ECB calculations. Notes: Based on a balanced sample of 92 SIs.

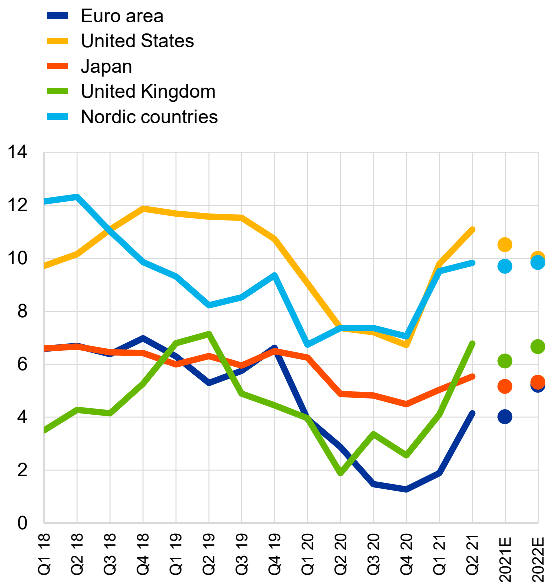
Profitability on recovery path towards pre-pandemic levels

Evolution of listed banks’ ROE and euro area GDP forecasts
(percentages)



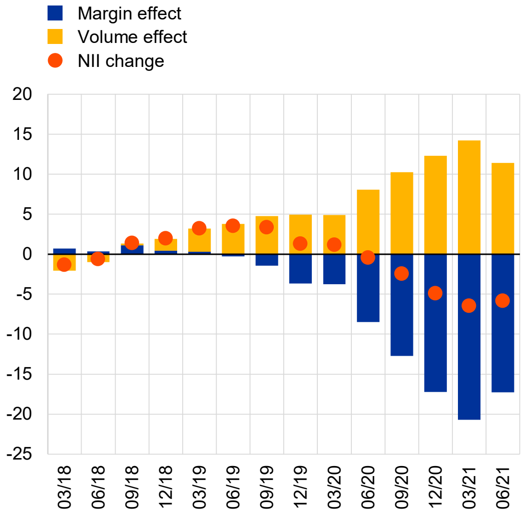
Sources: Bloomberg Finance L.P., Consensus Economics and ECB calculations.

Median bank ROE in major advanced economies
Q1 2018 – Q2 2021, percentages



Sources: Bloomberg Finance L.P. and ECB calculations.
Notes: “Nordic countries” refers to Denmark, Finland and Sweden.

Annual changes in net interest income and contributing factors
Percentages



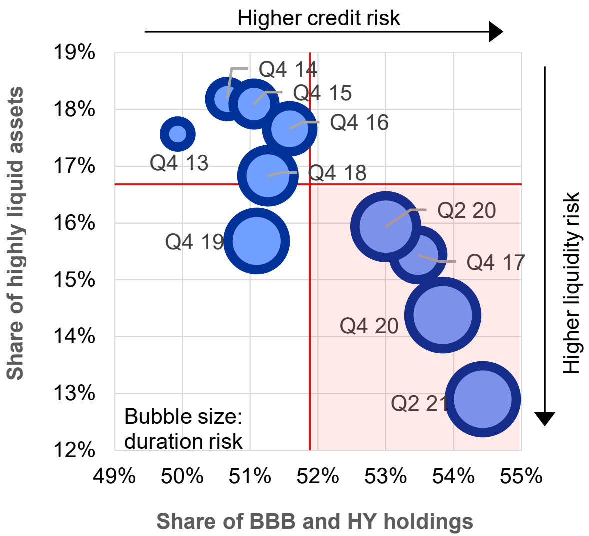
Sources: ECB supervisory data and ECB calculations.

4. Non-bank financial sector

Growing credit, liquidity and duration risk in non-bank financial intermediaries

BBB and high-yield holdings as well as highly liquid assets of investment funds

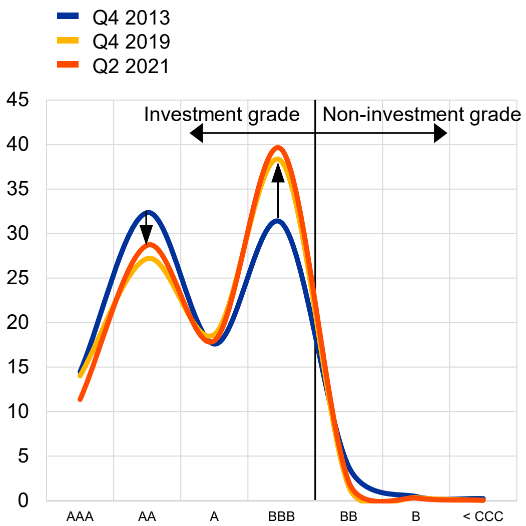
Percentages, years



Sources: Lipper, ECB SHSS and ECB calculations.

Distribution of insurance corporations' bond holdings by credit rating

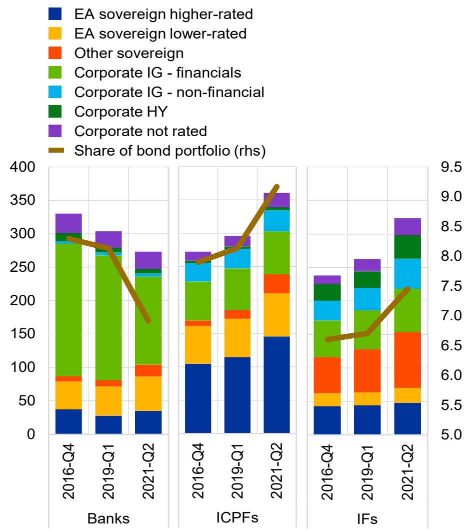
Percentages of bond portfolio



Sources: ECB SHSS and ECB calculations.

Bond portfolio valuation losses under a 1% rise in interest rates

Percentages of bond portfolio, € billions



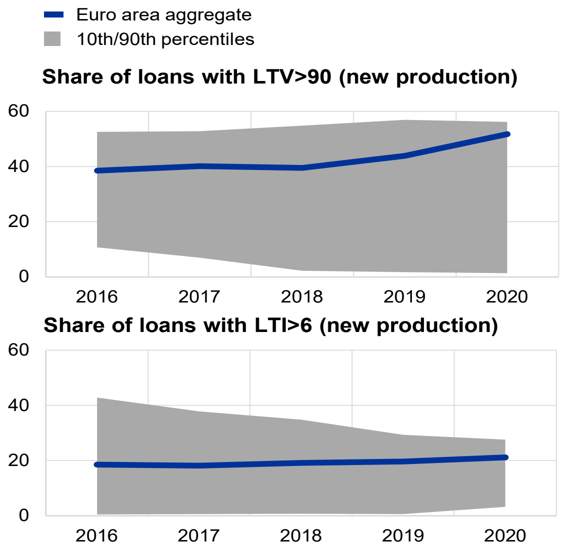
Sources: ECB SHSS and ECB calculations.

5. Policy issues

Medium-term vulnerabilities, most notably in residential real estate

Evolution of the share of high LTV and high LTI loans in new securitised mortgage loans for selected euro area countries

(2016-20, percentage of total new RRE loans used in securitisations)



European Datawarehouse GmbH (EDW) and ECB, ECB calculations.

Overview of macroprudential instruments in place to address RRE vulnerabilities in euro area countries

		Borrower-based measures						Capital measures	
	ESRB warning/ recommendation in September 2019	Loan-to-value limit	Debt-service-to-income limit	Debt-to-income limit	Maturity limit	Interest rate sensitivity test	Legally binding measures	Risk weight on IRB mortgages	Risk weight on STA mortgages
BE	Recommendation	●	●	●				●	
FI	Recommendation	●				●	✓		
LU	Recommendation	●					✓	●	●
NL	Recommendation	●	●		●		✓	●	
DE	Warning	No measures in place							
FR	Warning		●		●		✓		
AT		●	●		●				
CY		●	●				✓		
EE		●	●		●		✓	●	
IE		●		●			✓		●
LV		●	●	●	●		✓		
LT		●	●		●	●	✓		
MT		●	●		●		✓		●
PT		●	●		●				
SK		●	●	●	●	●	✓		
SI		●	●		●		✓		●

Source: ESRB and national notifications.

Two-pronged macroprudential policy for the euro area

Gradually shift policy emphasis to addressing medium-term vulnerabilities

- Consider **gradual adjustment of targeted macroprudential policy measures** to address RRE vulnerabilities.
- Consider **gradual increases in countercyclical capital buffers** where economic and banking sector outlook are favourable

Enhance the regulatory framework to ensure long-term resilience

- Ensure full, timely and consistent **implementation of final Basel III reforms** to address shortcomings in existing framework
- Develop a **holistic macroprudential approach for non-banks**, embedded in international coordination
- Enhance the resilience of **money market funds**

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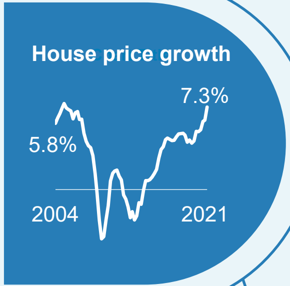

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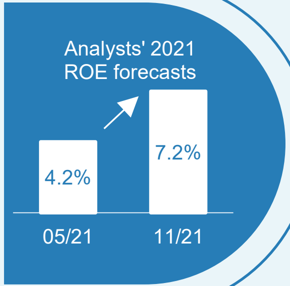

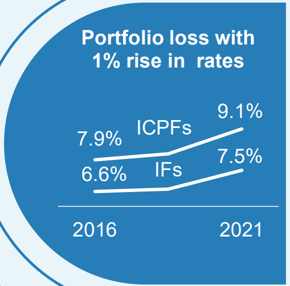

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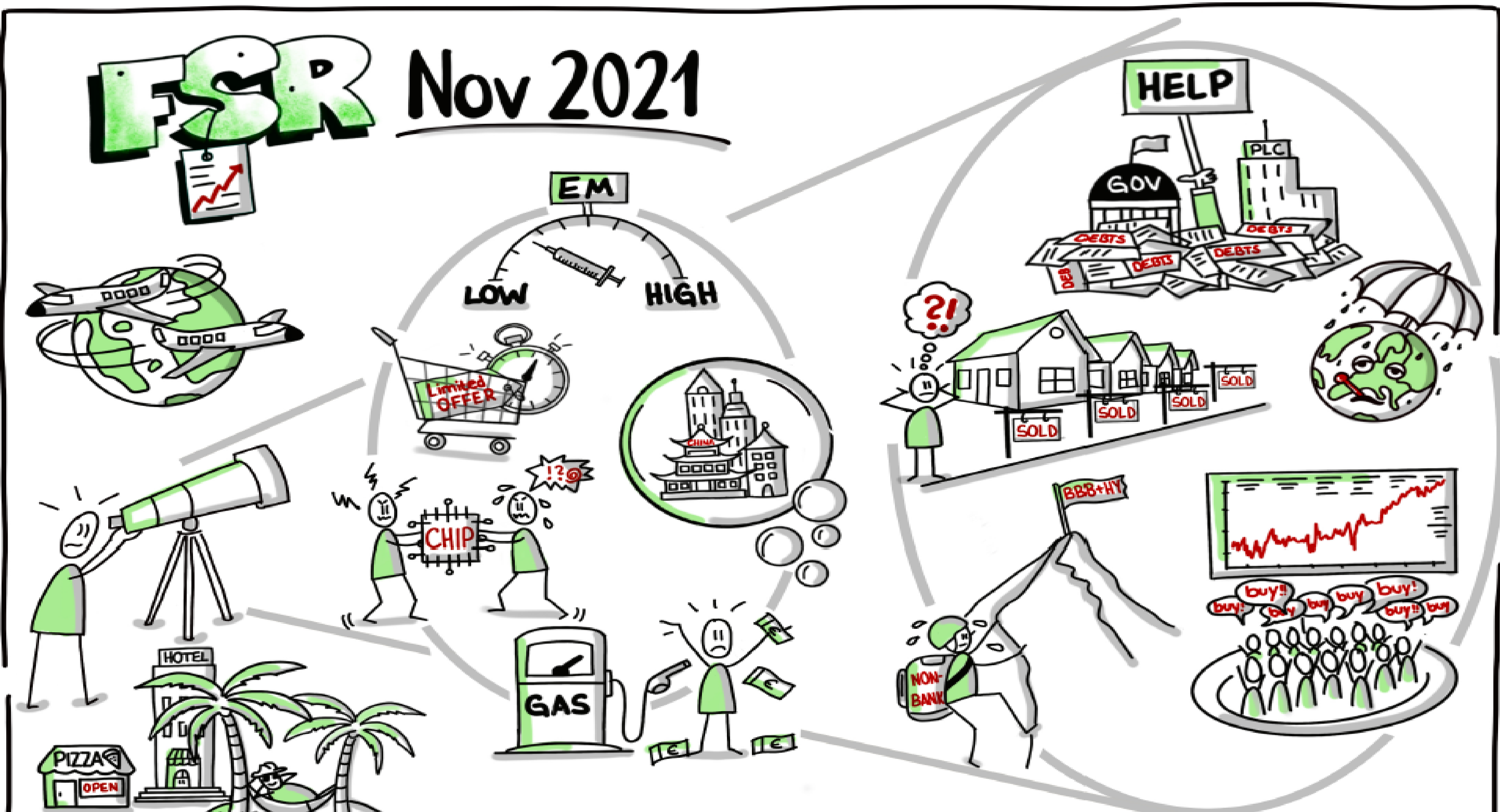


Illustrated by Inka Cordero Garcia, DGMF

Background slides

Boxes and Special Features

In addition to the Overview and five chapters on macro-financial developments and risk assessment:

Box 1 – Sensitivity of **sovereign debt** to an i-g shock

Box 2 – Assessing the strength of recent **RRE expansion**

Box 3 – **Asset price sensitivity** when corporate vulnerabilities are high

Box 4 – Expanding uses and functions of **stablecoins**

Box 5 – Recent **investment banking** strength in the euro area

Box 6 – ECB 2021 **Macroprudential stress test**

Box 7 – Impact of loan vs. **market-based credit supply** shocks on GDP

Box 8 – Financial stability in the ECBs new **monetary policy strategy**

Box 9 – Lessons learned from March 2020 **initial margin calls**

Special Feature A – Bank capital buffers and lending in the euro area

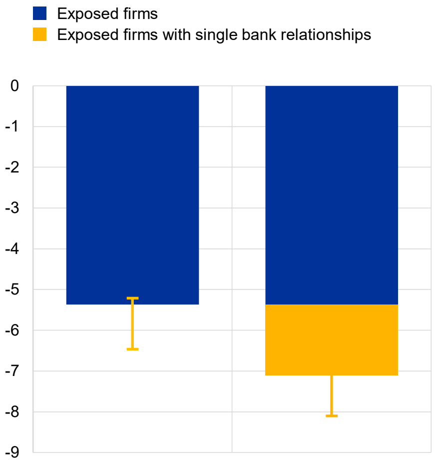
Special Feature B – Bank M&A in the euro area

Special Feature C – Non-performing corporate loan workout

Special Feature A: impeded buffer usability, but effective requirement releases

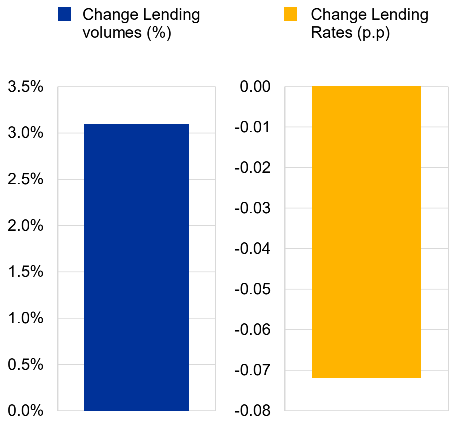
- Impeded buffer usability: banks close to the CBR at the COVID-19 outbreak tended to defend capital ratios, mostly through lower corporate credit supply
- Regulatory capital relief measures were effective in supporting credit supply (higher credit volume and lower interest rate) during the COVID-19 pandemic, in particular for banks close to the CBR

Estimated reduction in borrowing capacity for firms exposed to CBR-constrained banks
(percentages)

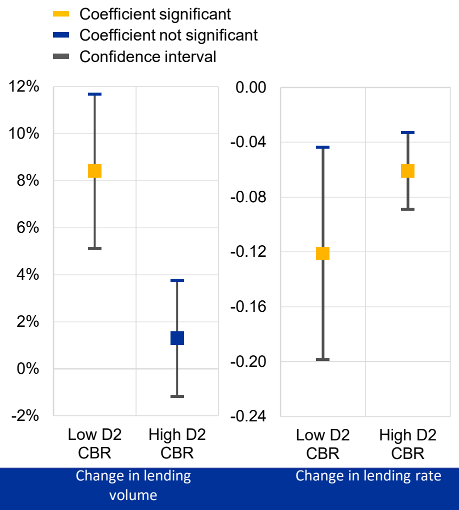


Sources: Sources: ECB AnaCredit data, ECB supervisory data and ECB calculations

Estimated effects of capital relief measures on bank lending
(%, percentages)



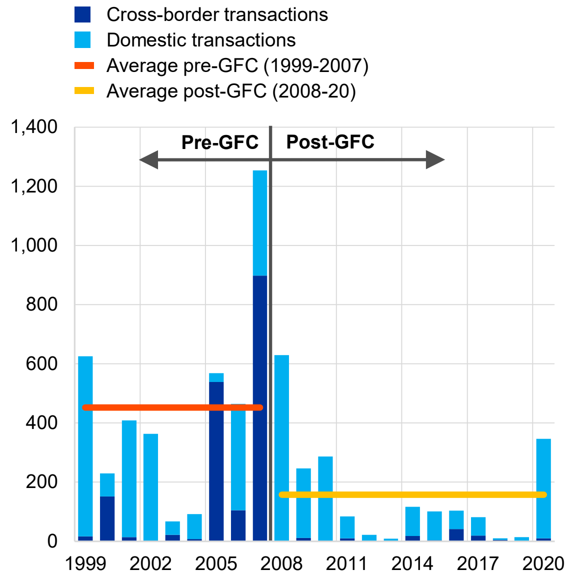
Estimated effects of the capital relief measures for banks with different distances from the CBR
(%, percentages)



Special Feature B: Drivers and performance of bank M&A

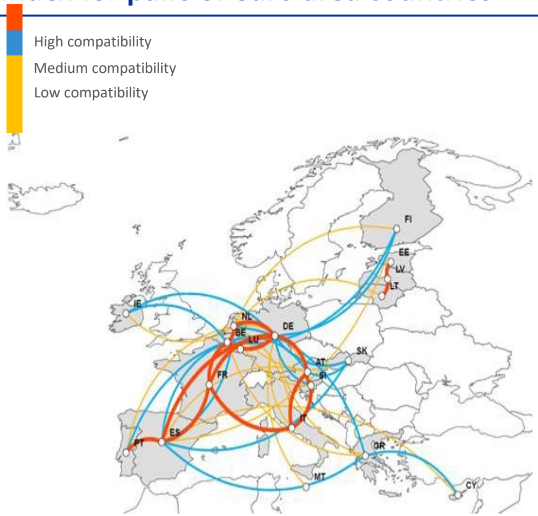
- Bank M&A activity has been weak and largely domestic since 2008 despite low profitability
- Cross-border M&A transactions more likely to occur between neighbouring countries
- M&A transactions led to an average improvement in ROE, particularly so in cross-border deals and where the target was showing cost inefficiencies

Total assets of target banks in M&A transactions (EUR billions)



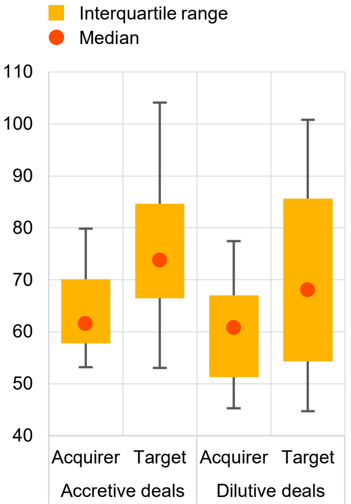
Sources: Dealogic, Orbis BankFocus, Refinitiv, ECB calculations.

Model-implied bank M&A compatibility index for pairs of euro area countries



Note: M&A compatibility index estimated using gravity equations including financial and trade linkages, based on a sample of bank M&A over 2014-20.

Distribution of cost/income ratio by merger outcome (percentage)

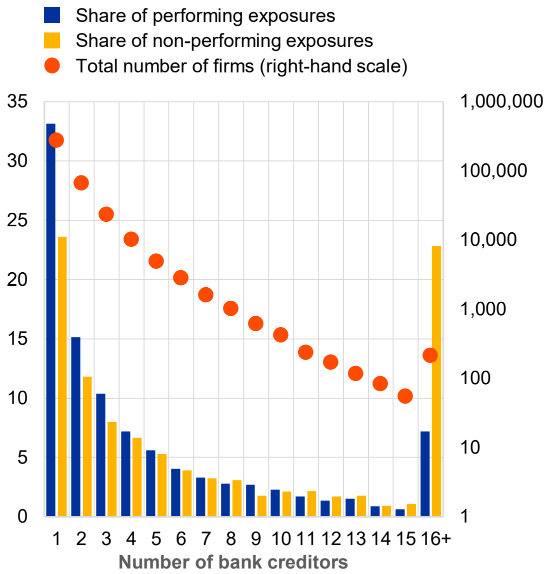


Note: accretive/dilutive deals: transactions followed by increase/decrease in ROE in a two-year horizon.

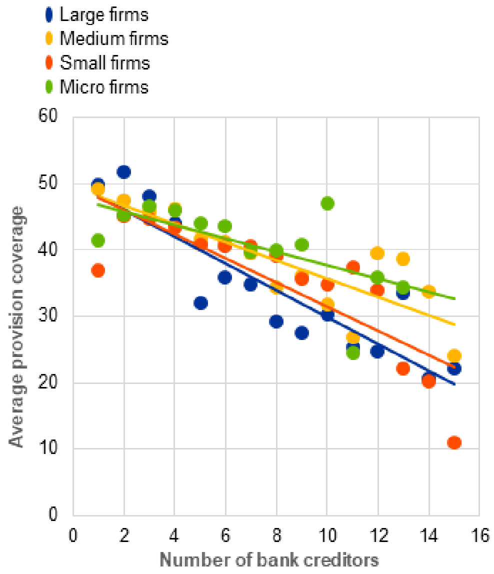
Special Feature C: Resolving multi-creditor corporate NPLs

- Multi-creditor loans overrepresented among NPLs, and less well provisioned by banks
- Improving transparency about creditor relationships would allow investors to buy out and consolidate loans to distressed firms, leading to easier debt restructuring and higher NPL prices

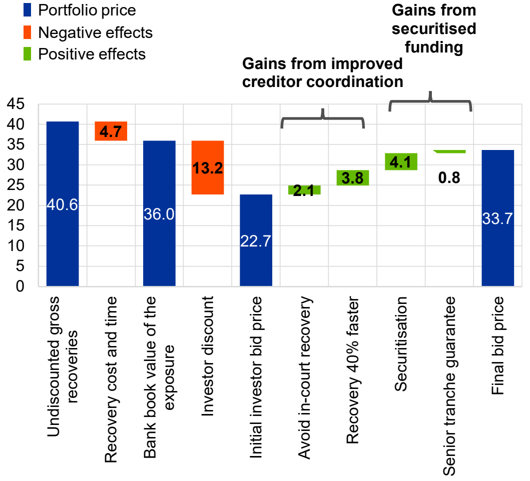
Distribution of performing and non-performing loans by number of bank creditors
(percentages)



Provision coverage by number of bank creditors and firm size
(percentages)



Pricing of a stylised NPL portfolio
(percentage of gross book value)



Note: improved creditor coordination is assumed to reduce the recovery period from 4.1 years to 2.5 years and avoid costs of judicial resolution. Investor discount assumes investor cost of capital of 10% .

Sources: ECB supervisory data, AnaCredit, EBA insolvency benchmarking report, and ECB calculations.