November 2021

Financial Stability Review

Webinar on Global and European Financial Stability Risks

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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

Improved bank profitability, but structural challenges remain
- Slower asset quality deterioration
- Muted corporate lending
- Rising share of negative deposit rates
- Slightly lower capital ratios

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.

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

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
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)

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

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

Sources: Our world in data.
Sources: European Commission, ECB.
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)

Interest rate-growth differentials versus debt-to-GDP (percentage and percentage of GDP)

Sovereign, bank and non-financial corporate CDS spreads (Basis points)

Sources: ECB and ECB staff calculations.
Households resilient, but pockets of vulnerabilities as housing market powers ahead

HH savings and pandemic support across income quintiles (Q2 2021)

- Share of households expecting to receive COVID-19 government support during the next 12 months
- Savings rate (right-hand scale)

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)

- Euro area aggregate
- Euro area capital cities
- Lending for house purchase

Sources: ECB and ECB calculations.

RRE price growth and overvaluation across countries (Q2 2021, Q4 2019; percentages)

- No ESRB recommendation or warning
- ESRB recommendation
- ESRB warning

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)

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

Corporate leverage increased
(debt/EBITDA, EURO STOXX)

Source: Statistical Data Warehouse.

Source: iBoxx, ECB calculations.

Sources: Bloomberg, ECB calculations
Stretched valuations in financial markets

Earnings uncertainty remains elevated
(EURO STOXX earnings expectations)

- Standard deviation of forward earnings (left-hand scale)
- Surplus of forward over trailing earnings (right-hand scale)

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

- 12-months forward earnings
- Price

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

- Return deviations from long-term average

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

Source: Refinitiv Datastream.
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.
Evolution of listed banks’ ROE and euro area GDP forecasts
(Percentages)

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

Annual changes in net interest income and contributing factors
Percentages

Sources: Bloomberg Finance L.P., Consensus Economics and ECB calculations.
Sources: Bloomberg Finance L.P. and ECB calculations.
Notes: "Nordic countries" refers to Denmark, Finland and Sweden.

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

Distribution of insurance corporations’ bond holdings by credit rating

Percentages of bond portfolio

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

Percentages of bond portfolio, € billions

Sources: Lipper, ECB SHSS and ECB calculations.

Sources: ECB SHSS and ECB calculations.

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)

- Share of loans with LTV>90 (new production)
  - Euro area aggregate
  - 10th/90th percentiles

- Share of loans with LTI>6 (new production)

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

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<th>Borrower-based measures</th>
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Source: ESRB and national notifications.

European Datawarehouse GmbH (EDW) and ECB, ECB calculations.
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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Improved bank profitability, but structural challenges remain

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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)

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)

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

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

**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.

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

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