November 2020
Financial Stability Review

Directorate General Macroprudential Policy and Financial Stability
November 2020 FSR – Key messages

• Dispersed (K-shaped) impact on countries and sectors could lead to concentration of risks in some areas.

• Policy measures have addressed liquidity challenges and protected financial stability – as time goes on, solvency issues are becoming more prominent.

• Bank profitability prospects are very weak, and losses could materialise with a lag relative to the economic recovery.
Dispersed economic and financial market impact of the pandemic

- Rebound of the equity market has been differentiated across countries and sectors
- Economic recovery from lows in Q2 has been highly dispersed across sectors and countries

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

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

Sources: Bloomberg Finance L.P and ECB calculations.
Sources: Eurostat and ECB calculations.
Vulnerabilities remain elevated in 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

CRE transactions in the euro area Number of transactions

Sectoral REIT price indices index, 17 February 2020 =100
Corporate sector vulnerabilities rising, albeit unevenly

- 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)

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

Source: Anacredit, FINREP and national sources.

Source: European Commission and ECB calculations.
But corporate spreads and insolvencies remain low

- Corporate spreads have declined to near pre-Covid levels despite weakened earnings...
- …which may reflect the mitigating impact of policy support on defaults and insolvencies

Corporate bond spread per rating category
basis points and ratings

Composite corporate vulnerability indicator, corporate insolvencies and real GDP growth for the euro area
Z-scores and percentages

Sources: IHS Markit and ECB calculations.
Trade off between ending government 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

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<th>Policy Type</th>
<th>Mar.20</th>
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<th>Sep.20</th>
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Euro area banks’ corporate loan books affected by guarantees and moratoria
€ billions, percentages

Guaranteed loans

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.

NFC loans under moratoria

Sources: EBA, national authorities 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

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

Sources: ECB and ECB calculations.

Sources: ECB (BSI statistics and supervisory statistics), Bloomberg and Reuters.
Even weaker bank profitability prospects

- In Q2 bank profitability fell markedly as loan loss provisions rose and other sources of income came under pressure
- Looking ahead, analysts expect persistently low profitability

**Euro area banks’ ROE and drivers of change**
Q4 2019, Q2 2020, percentage point contributions

**Government stringency index, real GDP growth and 2021 ROE forecasts**
31 Dec. 2019-9 Nov. 2020, percentages

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

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- **Q4 2019**
  - Income
  - Operating costs
  - Loan loss provisions
  - Other P&L
  - Equity

- **Q2 2020**
  - ROE
  - Positive factors
  - Negative factors

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Uncertainty on adequacy of provisions may explain very low bank valuations

- Uncertainty on adequacy of some euro area banks’ provisions may be one factor behind price-to-book ratios that remain lower than global peers.

**Actual and model-implied provisions of euro area banks**
Q1 2004-Q2 2020, percentage of total loans

**Evolution of banks’ price-to-book ratios**
20 Feb.–17 Nov. 2020, percentage changes

Sources: ECB supervisory data and ECB calculations.

Notes: based on a sample of 59 listed banks.
Policy Roadmap

**Economic policies**

- Fiscal expansion
- Monetary accommodation
- European initiatives
  Provide fiscal and monetary support

- Avoid distortionary impacts
- Gradual policy exit
- Exploit benefits of EU policies
  Carefully balance risks from cliff edges

- Debt sustainability
- Sovereign-firm-bank nexus
- Side effects of low rates
  Manage medium-term financial stability risks

**Contain immediate economic fallout**

- Limit procyclicality while enhancing resilience
  - Bank capital buffer release
  - Dividend restrictions
  - “CRR quick fix”

- Respond to perceived policy uncertainties
  - Gradually restore capital
  - Options for managing NPLs
  - Develop contingency plans

- Strengthen institutional and policy set-up
  - Banking union and CMU
  - Macroprudential space
  - Non-bank regulation

**Ensure near-term recovery**

**Prepare for the future**

Sources: ECB.
Ensuring that capital buffers are usable is crucial for macroprudential policy

- Risk weights have fallen most for banks closest to the CBR suggesting an attempt to boost capital ratios by “de-risking” (nevertheless, banks closest to CBR continued to lend as much as other banks)
- Communication on replenishing buffers will play an important role in making buffers usable in case of need: replenishing too early or too aggressively could prolong the economic downturn

Interquartile range of the change in average RW (left) and in loans to NFCs and households (right)

Reduced lending growth resulting from different buffer replenishment paths
percentage deviation from baseline at the end of 2024

Sources: SUP data, ECB calculations.
Notes: Significant institutions.
Investment funds have not improved their liquidity buffers despite inflows

- 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

**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

**Cumulative investment fund flows**
percentage of AuM

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

Sources: Refinitiv (Lipper) and ECB calculations.
The EU Renewed Sustainable Finance Strategy: role of disclosure requirements

**EU RENEWED SUSTAINABLE FINANCE STRATEGY**

**Climate-related disclosure requirements**

- Market Sphere
  - Raise investor awareness
  - Improve internal and external risk assessment
  - More accurate pricing of climate risk

- Supervisory and regulatory sphere
  - Improve data quality
  - Enhance transparency
  - Advance climate-stress testing

**MARKET SPHERE**

- Facilitate Market Discipline
- Accelerate market-driven finance for transition

**CAPITAL MARKET UNION (CMU)**

- Towards a genuine single European capital market
- Developing and integrating capital markets

**TO REDUCE CLIMATE-RELATED FINANCIAL RISK**

- Improve risk monitoring and assessment
- Reduce climate-related financial risk
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

Further weakening of bank profitability amid higher credit losses
- Low market valuations
- Increasing latent credit risk
- Rising sovereign exposure
- Improved funding conditions

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…

… and ensure bank capital buffers are usable to avoid excessive deleveraging, while developing an effective macroprudential framework for non-banks.