The ECB Financial Stability Review: Discussion

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* The views are mine and do not necessarily reflect those of the EBA
Main Risks and Vulnerabilities Identified in the ECB FSR

- **Corporate insolvencies** have been less severe but **supply chain bottlenecks** more severe than anticipated.

- **Residential real estate** prices and affordability are becoming a serious issue.

- Despite **higher debt levels**, outlook for public finances is stable, but conditional on (g-i) remaining positive.

- Surge in **valuations of risk assets** did anticipate the post-COVID recovery in earnings, but falling real yields could now be incentivising risk-taking beyond fundamentals.

- **Willingness to use of regulatory capital buffers** is limited and banks with lower managerial buffers reduce lending/ lose market share in downturns.
Some Interesting Details Identified in the ECB FSR

- Many regulatory support measures (moratoria) have expired without much impact – but government support schemes continue and show some deterioration in credit quality

- **Recommends targeted measures to address RRE vulnerabilities** – there is some interplay with the implementation of the new Basel III rules that could be taken into account

- **Duration risk is an important vulnerability for non-banks** – in a high-leverage environment, not only the level in interest rates but also rising volatility could be a trigger

- **Shifting stock-bond correlations** – a factor complicating portfolio diversification and risk management

- **Stablecoin risks** – Like money market funds, but also similar to ETFs, with sponsors and on/off boarding. Regulatory treatment of crypto assets is forthcoming in EU (MiCA)
Some Additional Issues that May Warrant Attention

❖ The report identifies plenty of vulnerabilities but is less clear about potential triggers. Faster than expected/intended moves higher in interest rates; medium-term policy action to tackle distributional effects (e.g. housing affordability); enforcing climate transition ....

❖ Cross-border differences in COVID recovery process. US, UK, CEE could be moving earlier on policy normalisation which may create financial spill-over effects to EU

❖ ESG transition risks warrant careful monitoring as investment patterns are shifting quickly. COVID recovery has highlighted the potential of supply-side distortions in case of sudden shifts in consumption/ physical investment / financing patterns

❖ Operational/cyber risk is on the rise. EU banks continue reported both more loss events and higher losses related to cyber risk. Ransomware attacks and supply chain attacks are increasing in frequency and sophistication

❖ The framework for new EU regulation on Investment Firms entered into force in June 2021. Includes capital, reporting and disclosure requirements that are stricter for large global players and will be phased-in in stages over the coming years
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