EUROPEAN CENTRAL BANK

EUROSYSTEM

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.

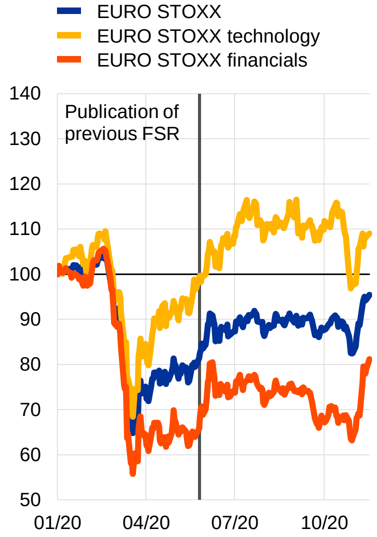
- Policy measures have addressed liquidity challenges and protected financial stability – as time goes on, solvency issues are becoming more prominent.

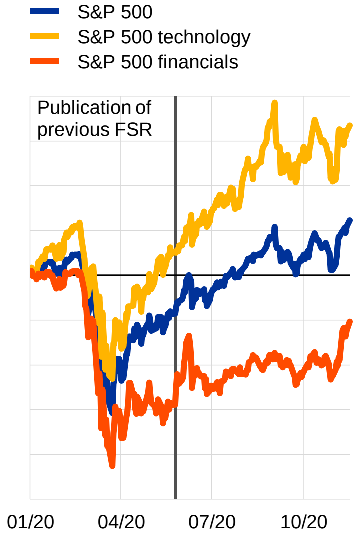
- Bank profitability prospects are very weak, and losses could materialise with a lag relative to the economic recovery.

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

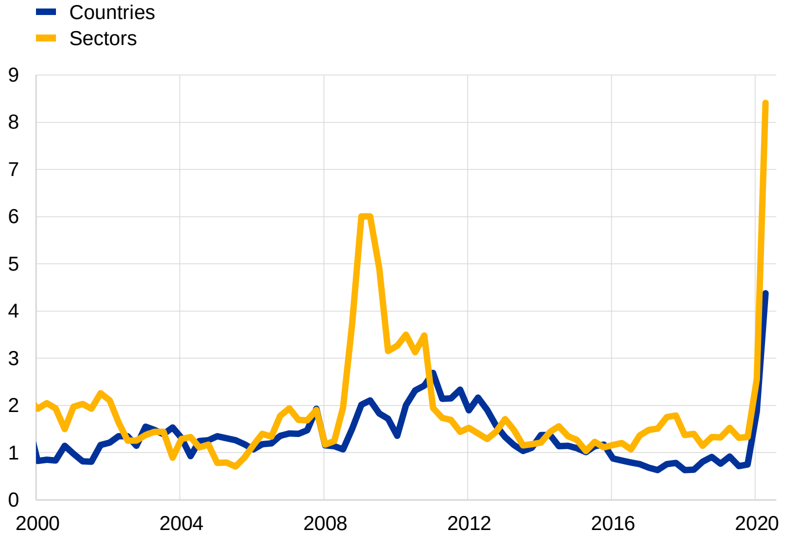
Development of the EURO STOXX and S&P 500 and selected sectoral constituents
Indices, 1 January 2020 = 100





Sources: Bloomberg Finance L.P and ECB calculations.

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

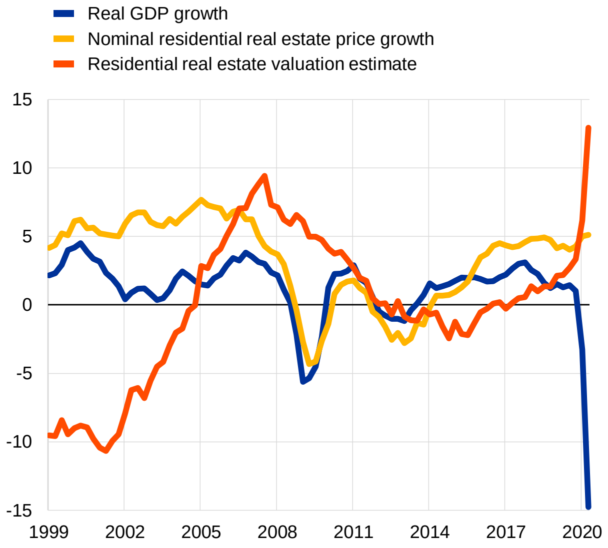


Sources: Eurostat and ECB calculations.

Vulnerabilities remain elevated in property markets

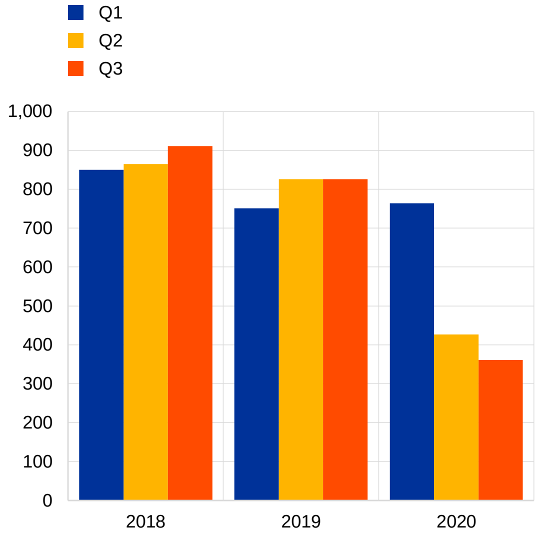
- Contrasting commercial and residential property market developments
- Liquidity has been low and valuation metrics suggest that price corrections are likely

Real GDP growth, nominal RRE price growth and RRE valuation estimates
annual percentage changes, percentages



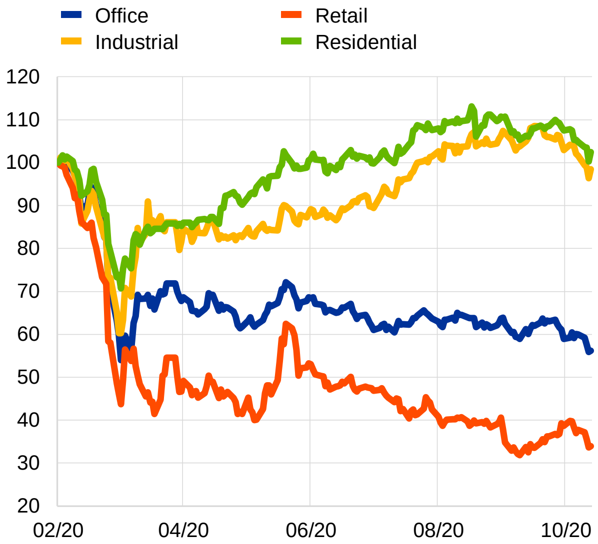
Source: ECB and ECB calculations.

CRE transactions in the euro area
Number of transactions



Sources: RCA and ECB calculation.

Sectoral REIT price indices
index, 17 February 2020 =100



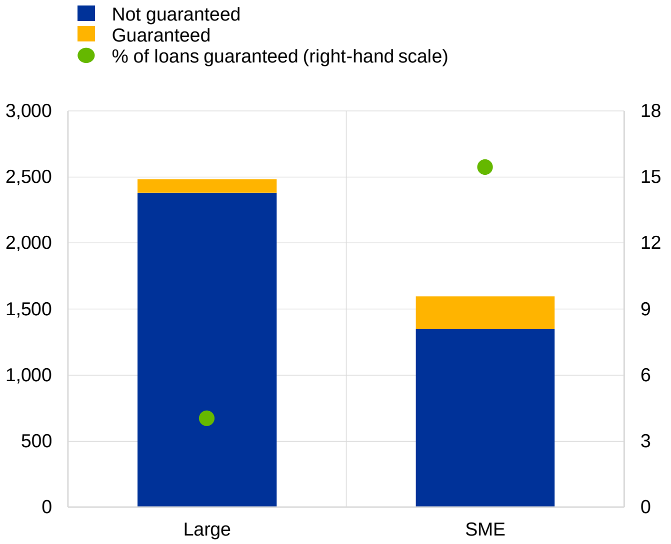
Source: Bloomberg Finance L.P..

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

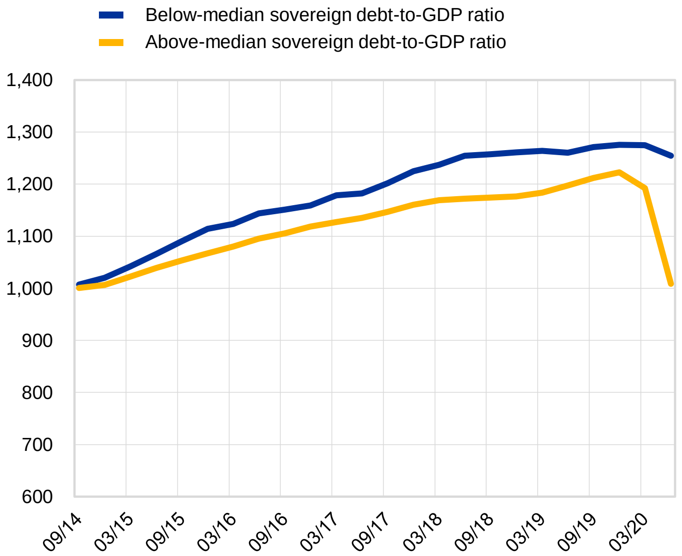
DE, IT, FR, ES; Q2 2020; € billion (left scale), % (right scale)



Sources: Anacredit, FINREP and national sources.

Non-financial firm profits by sovereign indebtedness

2014-20, € billions

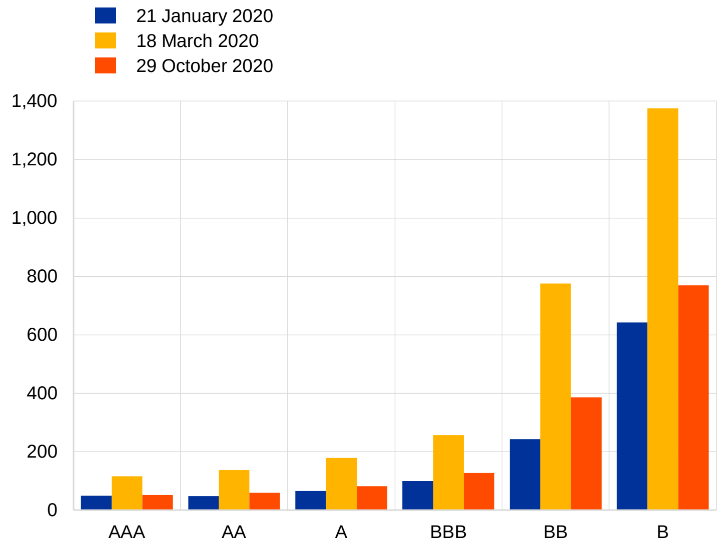


Sources: European Comission and ECB calculations.

But corporate spreads and insolvencies remain low

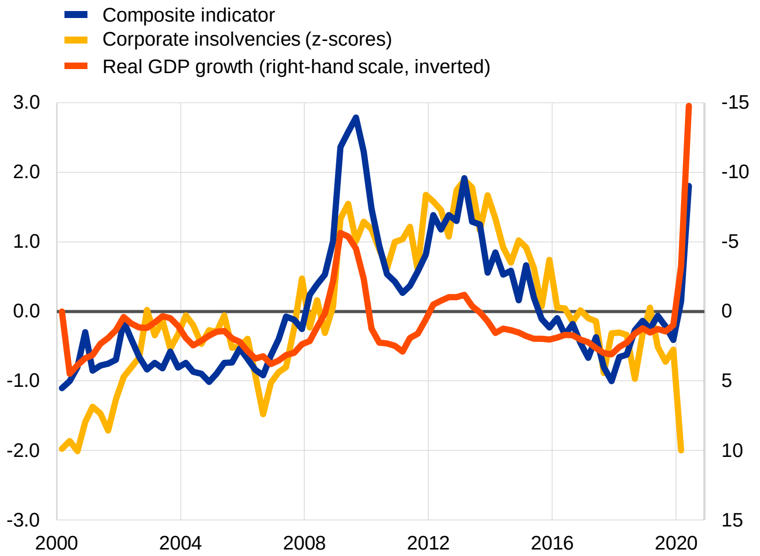
- Corporate spreads have declined to near pre-Covid levels despite weakened earnings...
- …which may reflect the mitigating impact of policy support on defaults and insolvencies

Corporate bond spread per rating category
basis points and ratings



Sources: IHS Markit and ECB calculations.

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

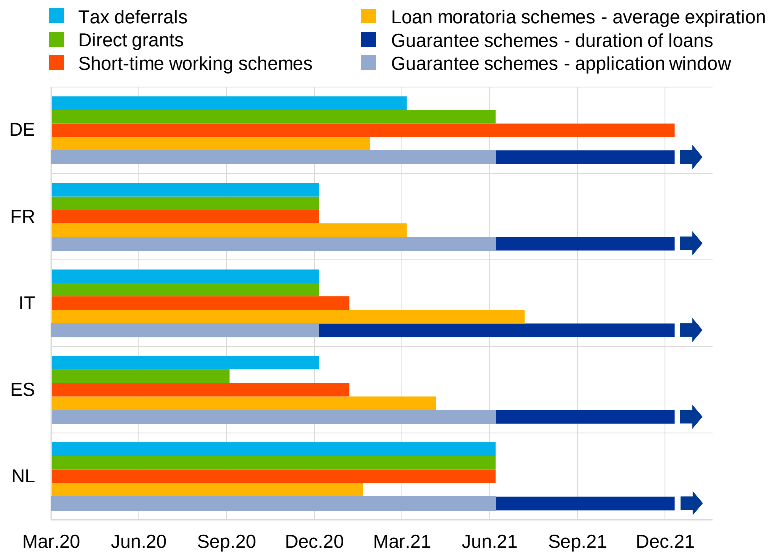


Source: Eurostat, ECB, IHS Markit, and ECB calculations.

Trade off between ending government policy support too early or too late

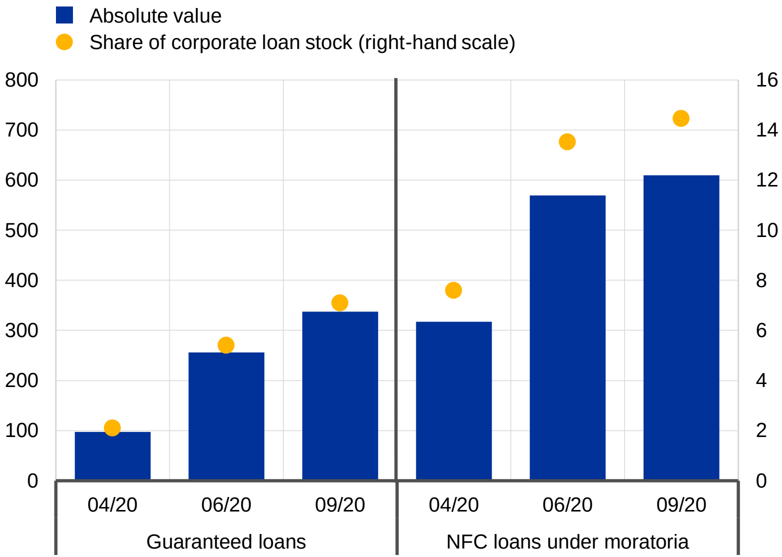
- Euro area non-financial firms and households are cushioned by various government support measures
- But risks arise either from a premature end to measures or from prolonged support

Timeline of the phasing-out of different policies
Dates



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.

Euro area banks' corporate loan books affected by guarantees and moratoria
€ billions, percentages

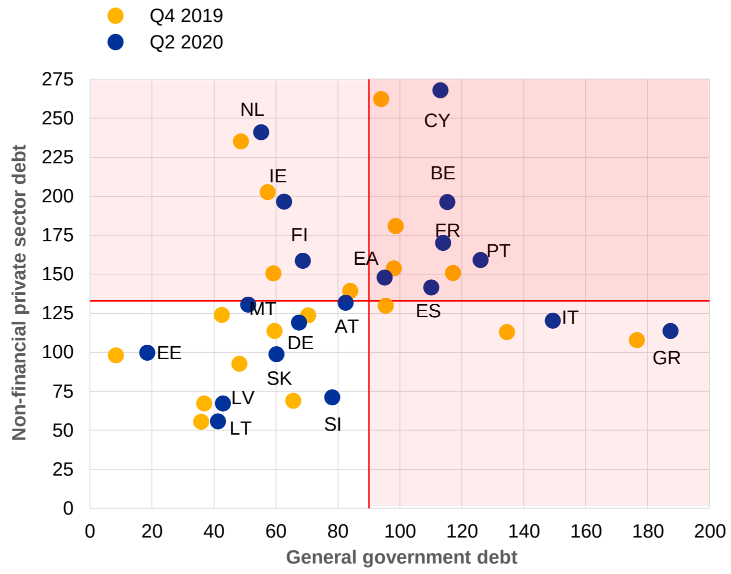


Sources: EBA, national authorities and ECB calculations.

Medium term risk from potential sovereign-corporate-bank nexus

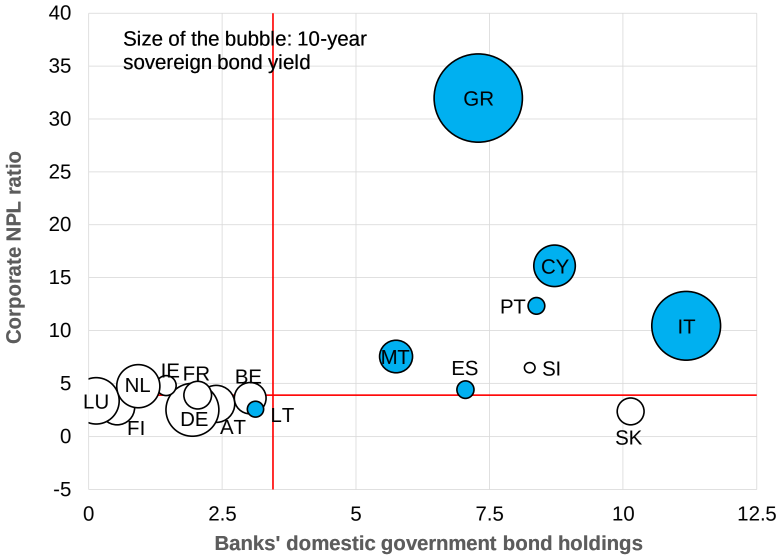
- Debt sustainability concerns are on the rise, even if mitigated in the near-term by low interest rates, favourable financing conditions and large-scale supranational support

Indebtedness of the general government and non-financial private sector across the euro area
Q4 2019 vs. Q2 2020, percentages of GDP



Sources: ECB and ECB calculations.

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

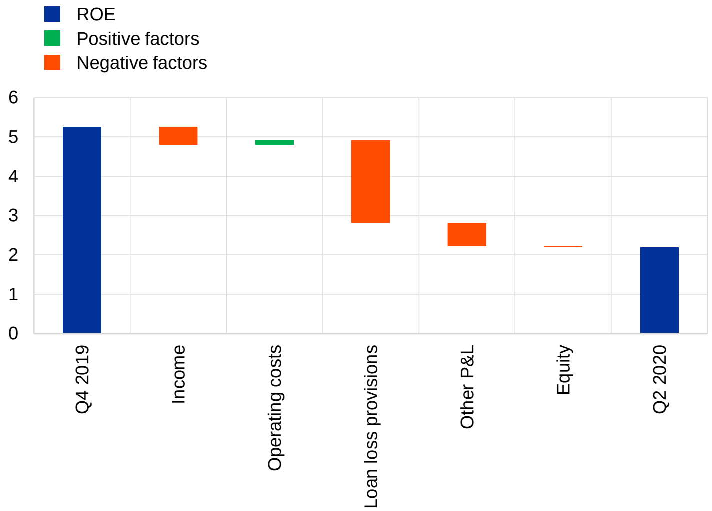


Sources: ECB (BSI statistics and supervisory statistics), Bloomberg and Reuters.

Even weaker bank profitability prospects

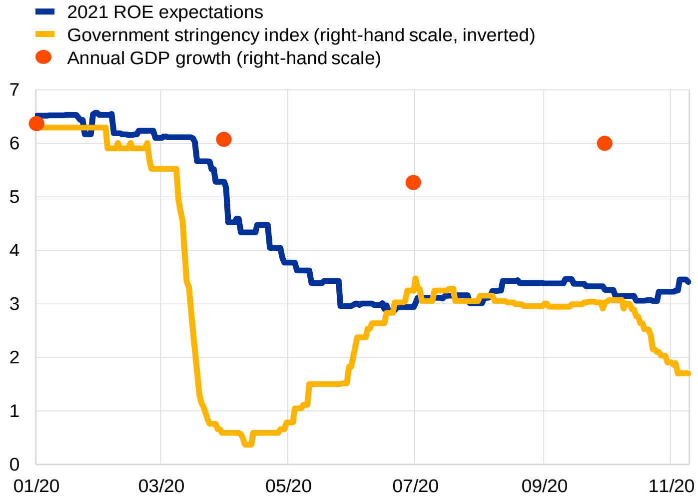
- In Q2 bank profitability fell markedly as loan loss provisions rose and other sources of income came under pressure
- Looking ahead, analysts expect persistently low profitability

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



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

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



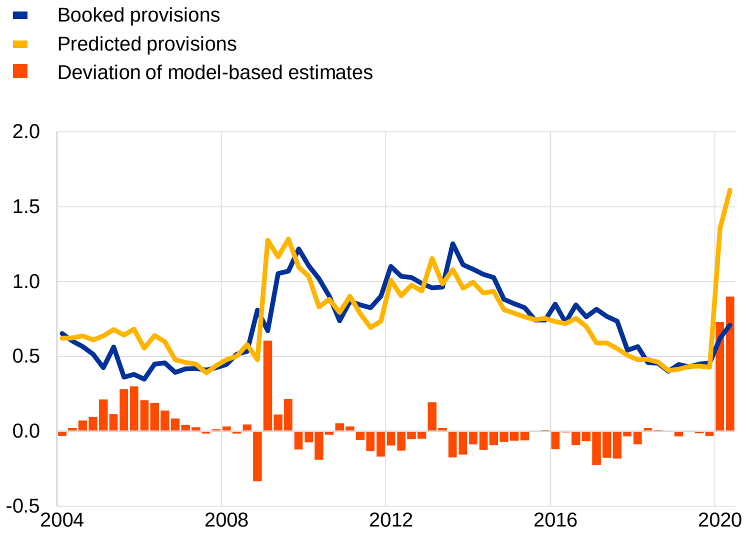
Sources: Bloomberg Finance L.P., Oxford COVID-19 Government Response Tracker, ECB and ECB calculations.

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

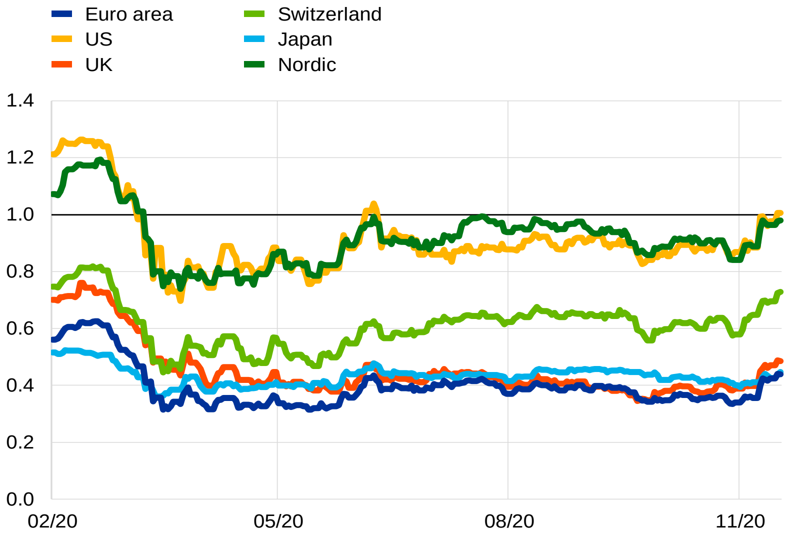
Q1 2004-Q2 2020, percentage of total loans



Sources: ECB supervisory data and ECB calculations.

Evolution of banks' price-to-book ratios

20 Feb.-17 Nov. 2020, percentage changes



Sources: Sources: Bloomberg Finance L.P. 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 ⇨ **Ensure near-term recovery** ⇨ **Prepare for the future**

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

Financial sector policies

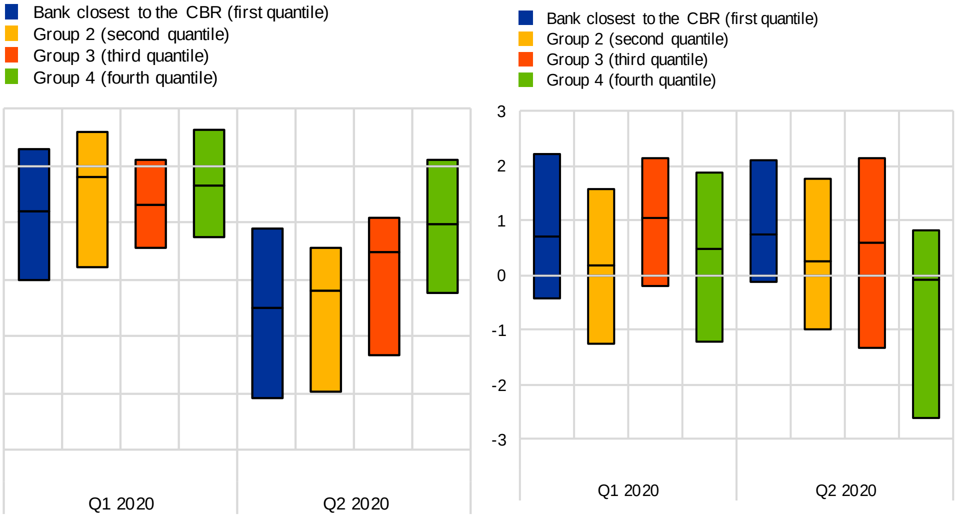
Sources: ECB.

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)

p.p.

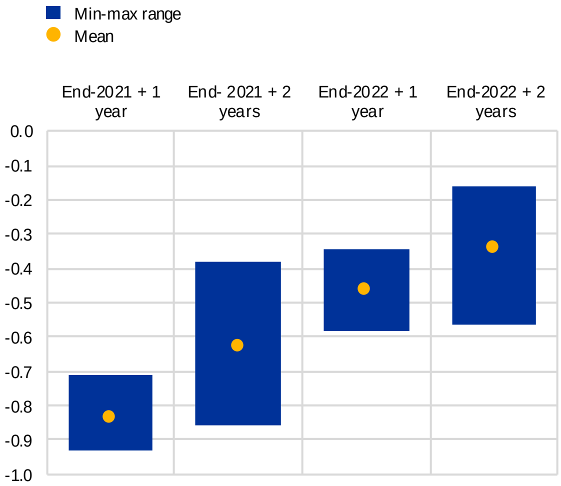


Sources: SUP data, ECB calculations.

Notes: Significant institutions.

Reduced lending growth resulting from different buffer replenishment paths

percentage deviation from baseline at the end of 2024

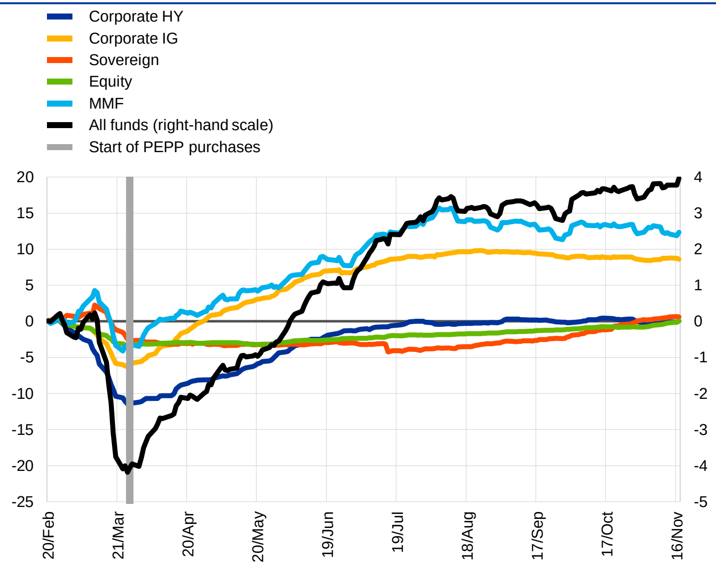


Sources: Simulations based on Budnik et al. (2020) and Darracq Pariès et al. (2019, 2020).

Investment funds have not improved their liquidity buffers despite inflows

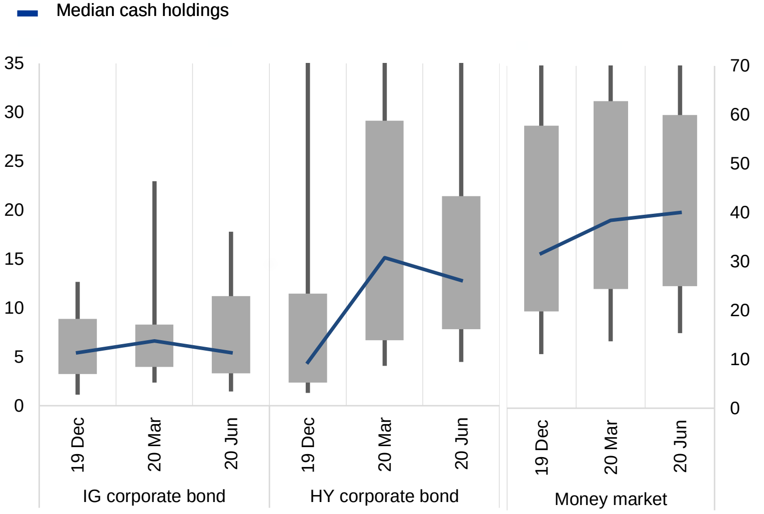
- Investment funds received significant inflows since start of PEPP purchases
- After temporary increase following the March turmoil, funds’ cash holdings reverted back to pre-crisis levels

Cumulative investment fund flows
percentage of AuM



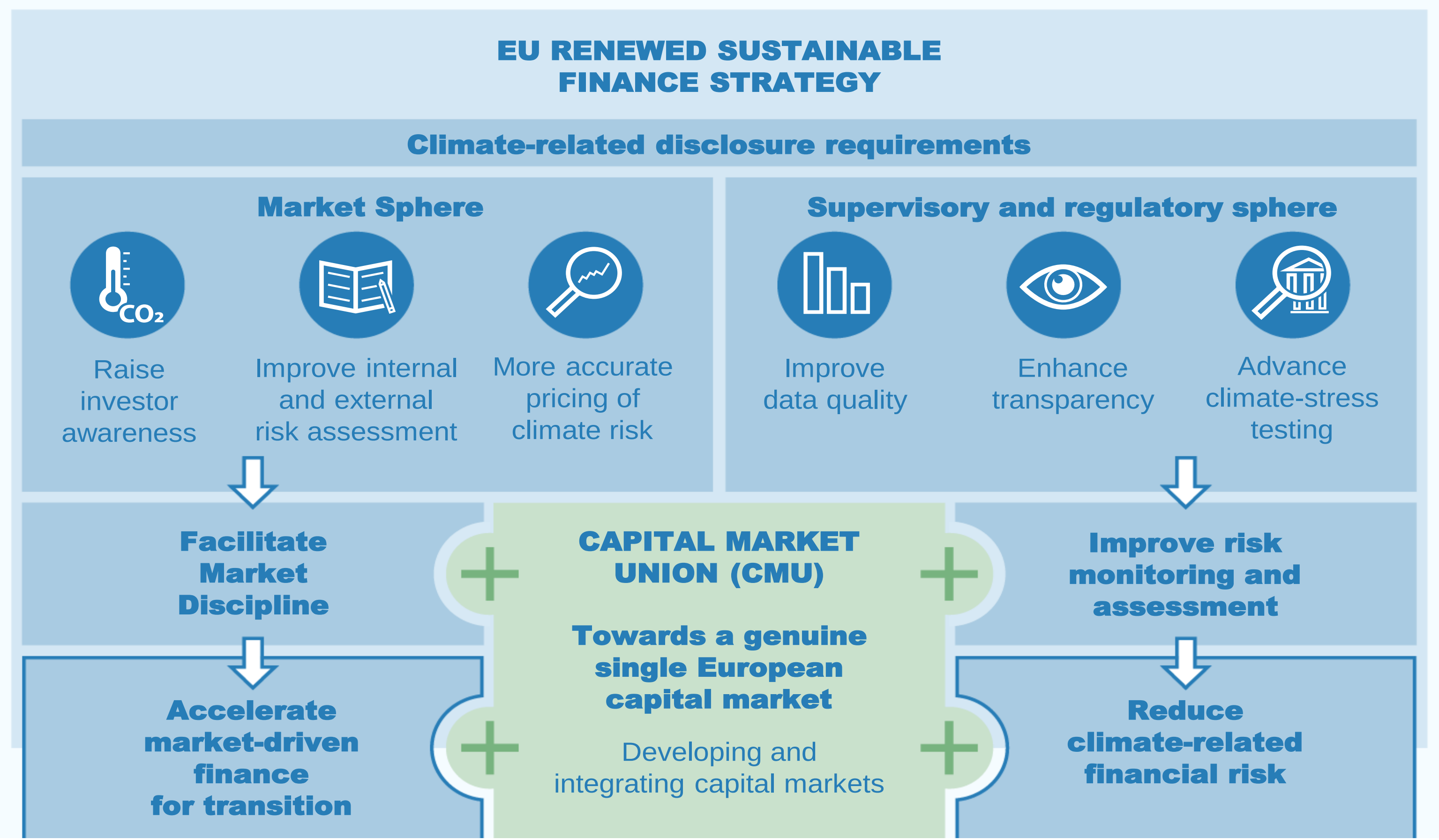
Sources: EPFR Global and ECB calculations.
Note: Data refer to euro area-domiciled funds only.

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



Sources: Refinitiv (Lipper) and ECB calculations.

The EU Renewed Sustainable Finance Strategy: role of disclosure requirements

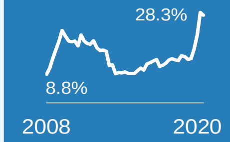


Financial stability vulnerabilities have increased

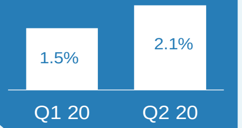
Growing vulnerability to asset price correction

- Elevated negative rating outlooks
- Increasing corporate leverage
- Rising asset price inflation
- Growing equity sector dispersion

High-yield firms rated B- or lower



Default probability of new corporate loans



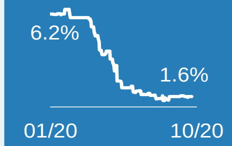
Rising debt servicing challenges of firms, households and sovereigns

- Reassessment of sovereign risk
- Rising corporate insolvencies
- Lower household incomes
- Risk of property market correction

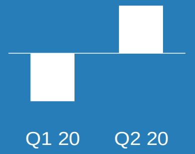
Further weakening of bank profitability amid higher credit losses

- Low market valuations
- Increasing latent credit risk
- Rising sovereign exposure
- Improved funding conditions

Analysts' 2020 bank ROE forecasts



Debt securities transactions of funds



Increasing credit and liquidity risk of non-banks amid renewed risk-taking

- Renewed fund inflows
- Increased exposure to corporate credit risk
- Decline in cash and liquid asset holdings
- Profitability challenges for insurers

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.