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

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- **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 incentivicing 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

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- **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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