



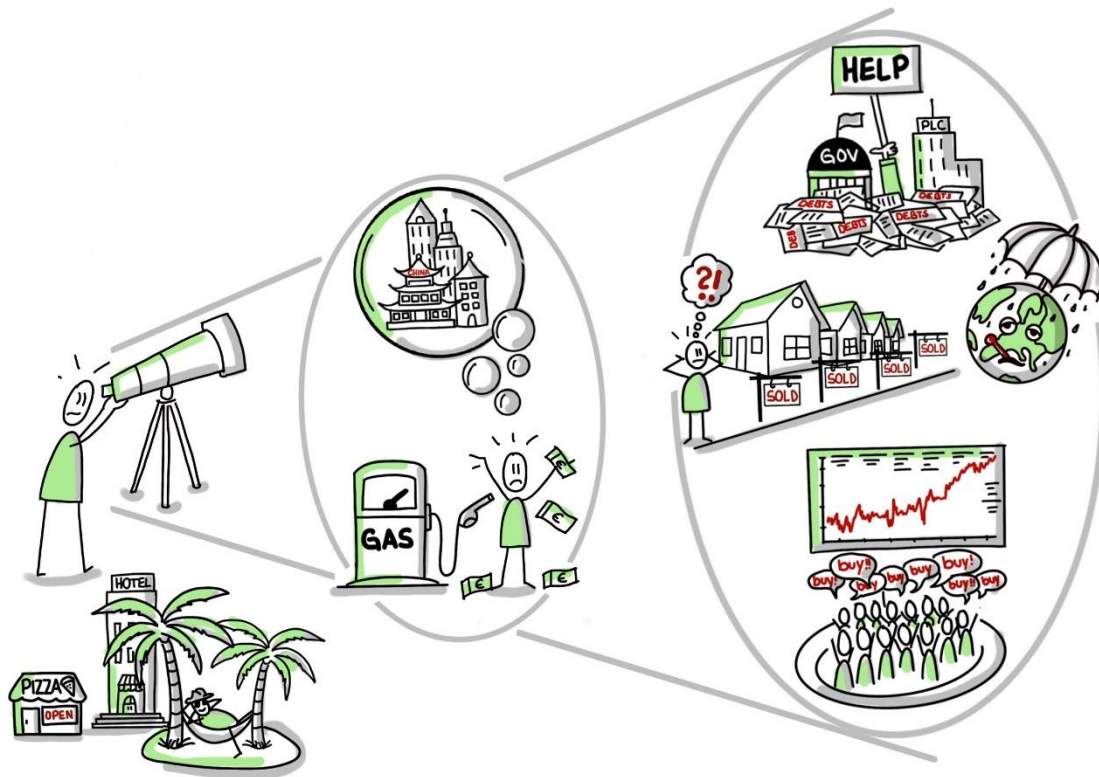
EUROPEAN CENTRAL BANK

EUROSYSTEM

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Financial Stability Review

SUERF



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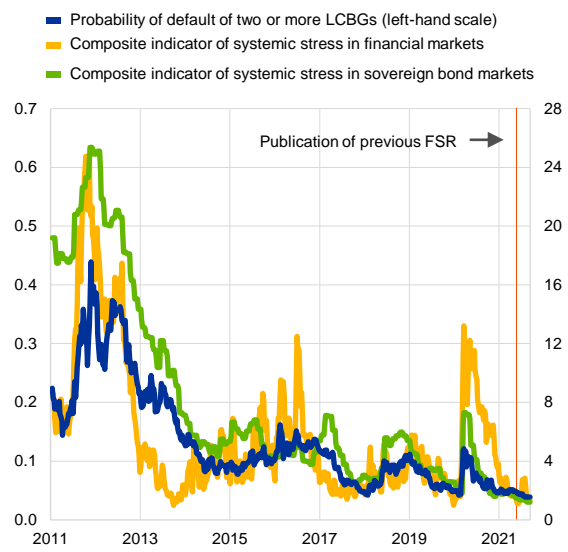
## **Near-term pandemic risks lessen, vulnerabilities ahead build up**

- Corporates, sovereigns and banks have avoided tail risk outcomes
- Supply disruptions and energy prices pose risks to inflation and growth
- Vulnerabilities have been increasing in euro area property markets
- Signs of stretch are continuing in financial markets and non-banks

# Near-term pandemic risks lessening, but medium-term vulnerabilities building up

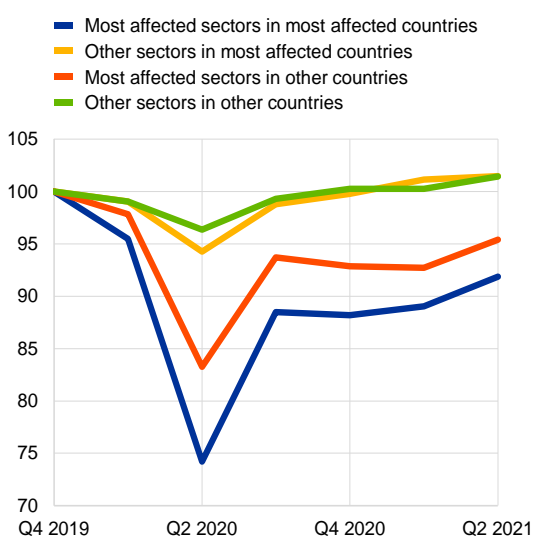
- Short-term financial stress indicators at record low levels, as recovery broadens to more sectors
- But medium-term vulnerabilities are on the rise – driven by debt, financial assets and real estate

## Near-term financial stress indicators for banks, markets and sovereigns (LHS: Probability; RHS: percentages)



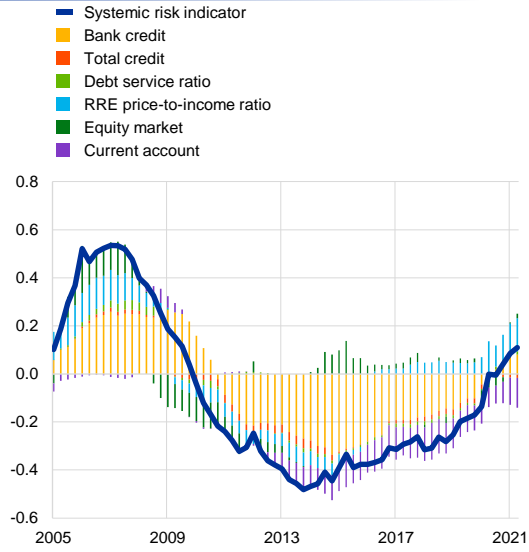
Sources: ECB and ECB calculations.  
Note: Based on contemporaneous financial market data.

## Country and sector dispersion in gross value added (index, Q4 2019=100)



Sources: Eurostat and ECB calculations.

## Medium-term systemic risk indicator (SRI) and driving contributing factors (Q1 2005-Q2 2021, deviation from mean)



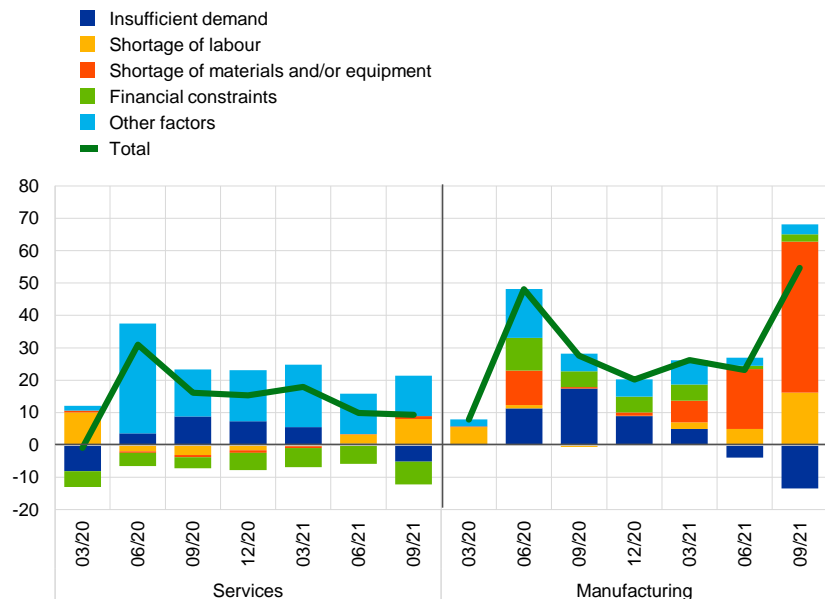
Sources: ECB and ECB calculations.  
Note: Based on macro-financial variables that capture build-up of financial imbalances over the next 3 years.

# Supply chain bottlenecks start to constrain output, whilst energy commodity prices rise

- Enterprises in both the manufacturing and the services sectors report that production is being hampered by a shortage of material (manufacturing) and labour (services)
- Sharp increases in energy commodity prices due to increased demand and decreased supply in H2 2021

## Production limits in the services and manufacturing sectors

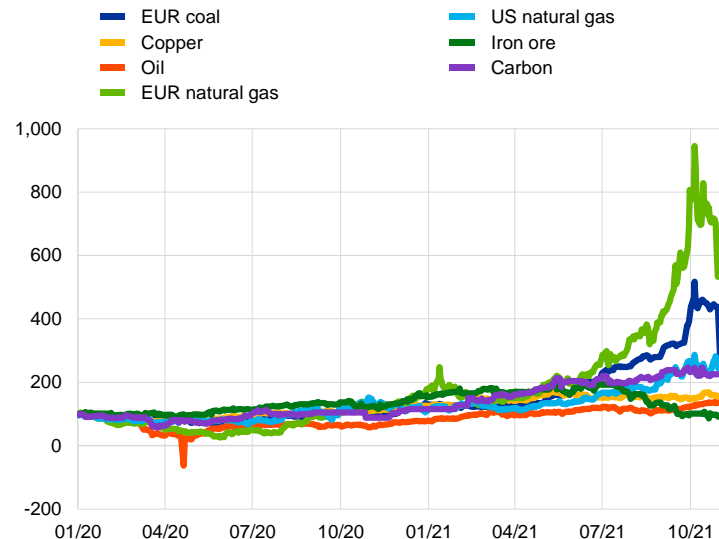
(Q1 2020-Q3 2021; % of respondents, point deviations from averages)



Sources: European Commission and ECB calculations.

## Commodity future price changes since January 2020

(1 Jan. 2020-9 Nov. 2021, percentages)



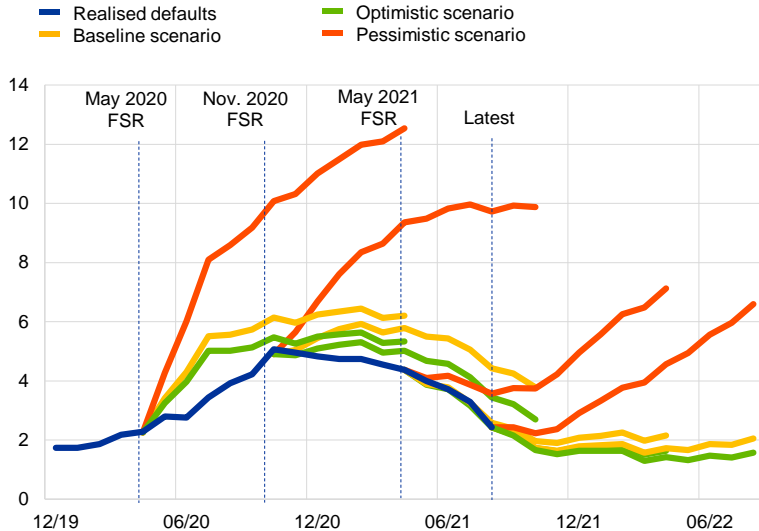
Sources: Bloomberg Finance L.P. and ECB calculations.

# Corporate insolvency risks lower than feared previously

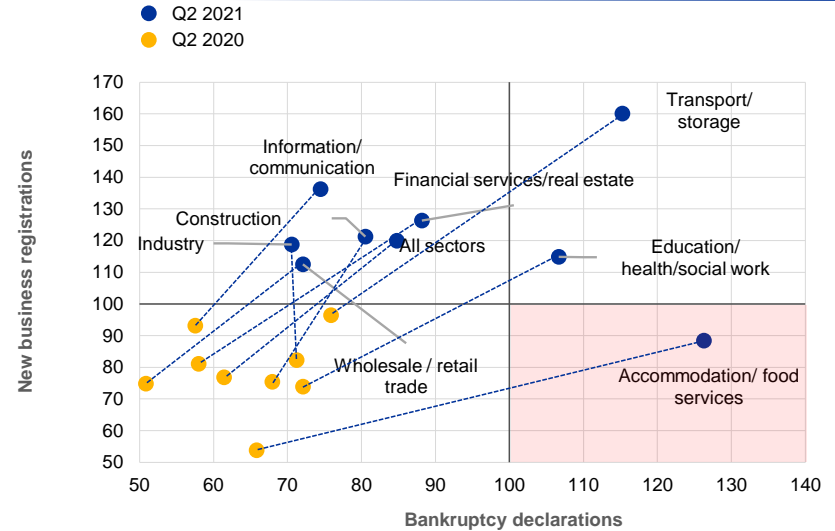
- Default rates remained below most optimistic forecasts, with a general pick up in earnings
- Some signs of net increase in insolvency in very affected sectors, and a cohort of highly indebted firms remains, especially in some sectors

## European speculative grade 12-month trailing default rates (percentages)

## Bankruptcy declarations and new business registrations (Q2 2020, Q2 2021, indices: 2015-19 = 100)



Source: Moody's Analytics.

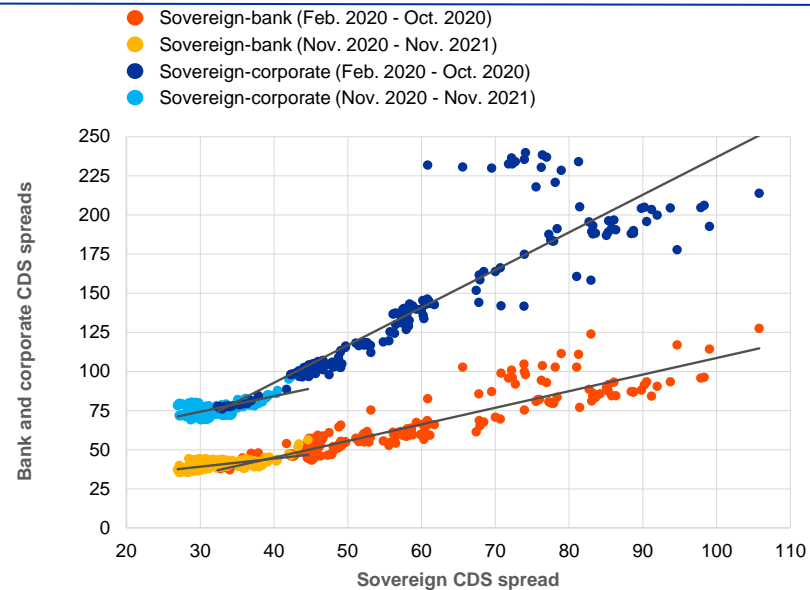


Sources: Eurostat and ECB calculations.

# Sovereign funding risks remain low, but debt likely to remain elevated

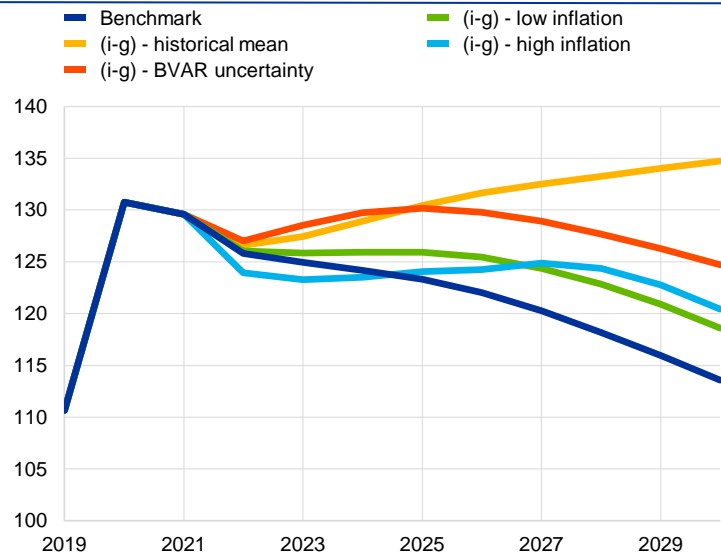
- Further declines in spreads for lower-rated sovereigns as conditions remain very benign while governments extend debt maturity. Corporate and bank spreads co-move.
- But sovereign debt levels expected to remain elevated for some time, especially for higher-debt countries

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



Sources: IHS Markit, ECB and ECB calculations

## Simulated sovereign debt-to-GDP paths for higher-debt euro area countries (2019-2030, percentages of GDP)

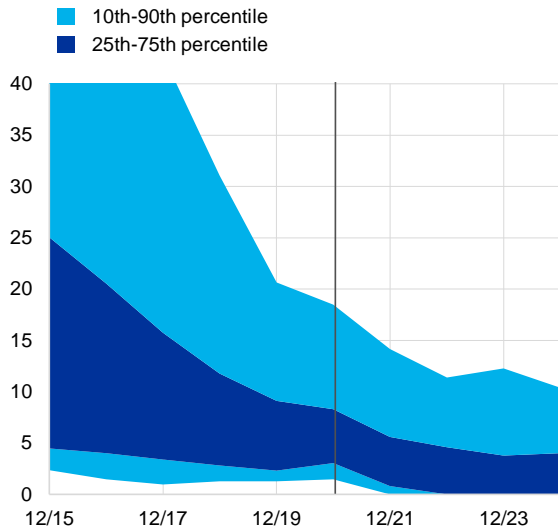


Sources: ECB and ECB calculations. Note: Higher-debt countries include EA countries with a 2019 debt-to-GDP ratio over 90%: BE, GR, ES, FR, IT, CY, PT.

# Bank news positive, as profitability on a path towards pre-pandemic levels

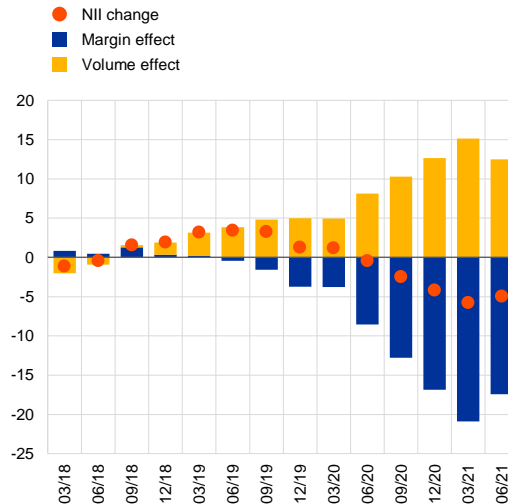
- Banks' profitability improves on lower impairments and higher revenues
- But reliance on investment banking and mortgage lending income means medium-term outlook is still challenging for euro area banks

**Distribution of past and model-implied median NPL ratios across country-sectors**  
(2015-24, percentages of total loans)



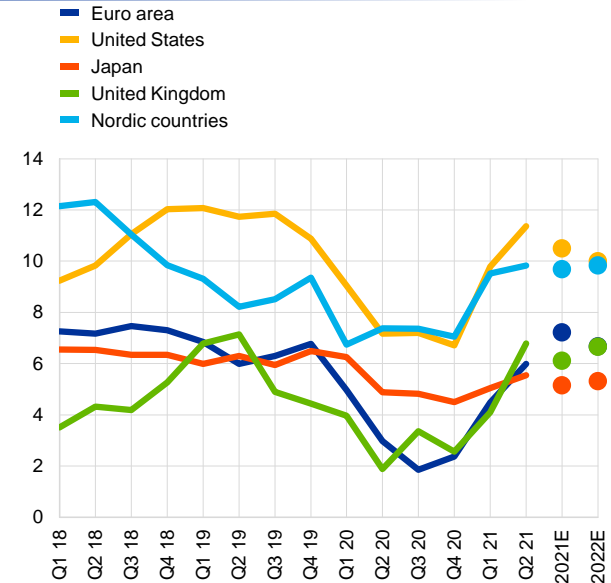
Sources: ECB supervisory data, ORBIS, Capital IQ, Bloomberg Finance L.P., Eurostat and ECB calculations.

**Annual changes in net interest income and contributing factors**  
(Q1 2018-Q2 2021, percentages)



Sources: ECB supervisory data and ECB calculations.

**Median bank ROE and ROE forecasts in major advanced economies**  
(Q1 2018-Q2 2021, percentages)



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

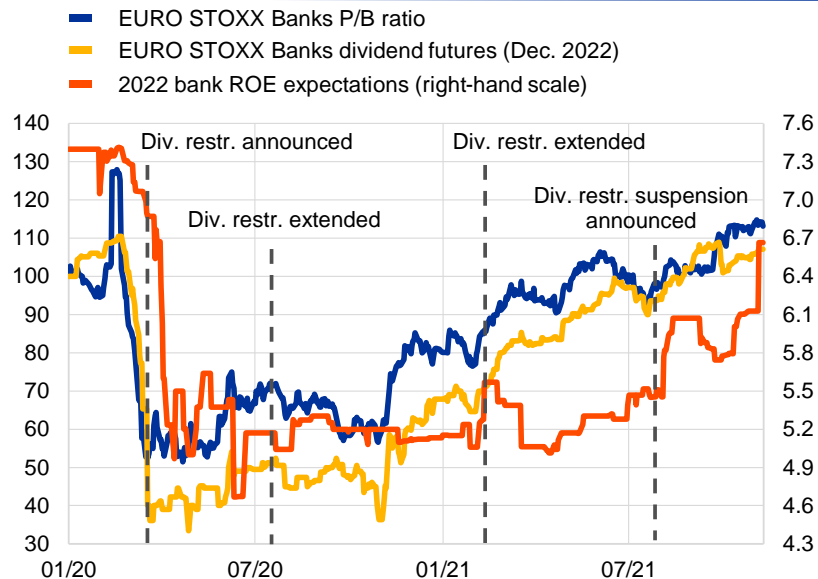
Notes: "Nordic countries" refers to Denmark, Finland and Sweden.  
www.ecb.europa.eu ©

# Sentiment remained positive as bank profitability on path towards pre-pandemic levels

- Banks' equity price valuations have reflected improved outlook
- Since June better capitalised banks tended to outperform the sector amid capital distribution plans

## Euro area banks' dividend futures and P/B ratio, and analysts' ROE expectations

(1. Jan. 2020-9. Nov. 2021; index: 1. Jan 2020 = 100; percentages)

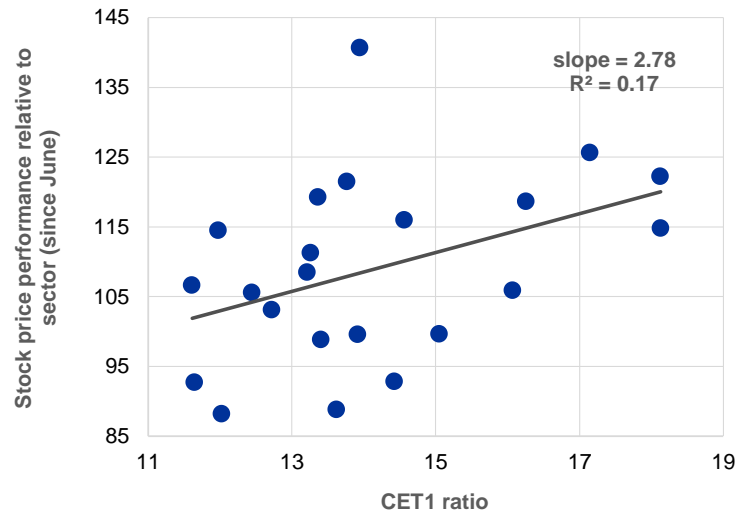


Sources: Bloomberg Finance L.P. and ECB calculations.

Note: Div. restr.: dividend restrictions

## Bank stock price performance relative to the sector vis-à-vis capital ratio

(4 Jun.-9. Nov. 2021; index: 4 June 2021 = 100)



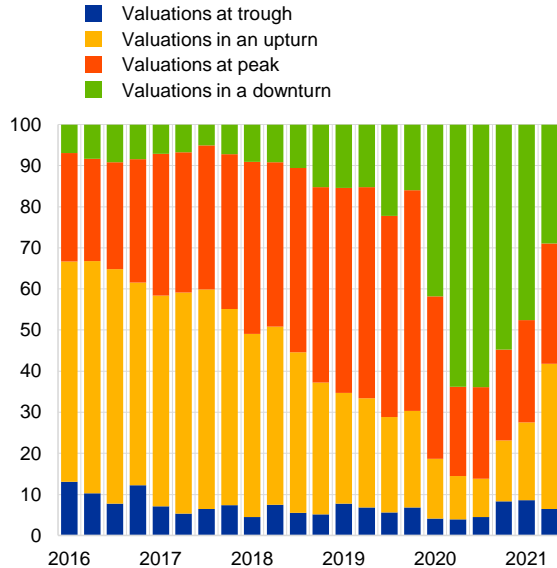
Sources: ECB, Bloomberg Finance L.P. and ECB calculations.



# Conditions in CRE markets have improved, but the outlook for lower-quality CRE remains poor

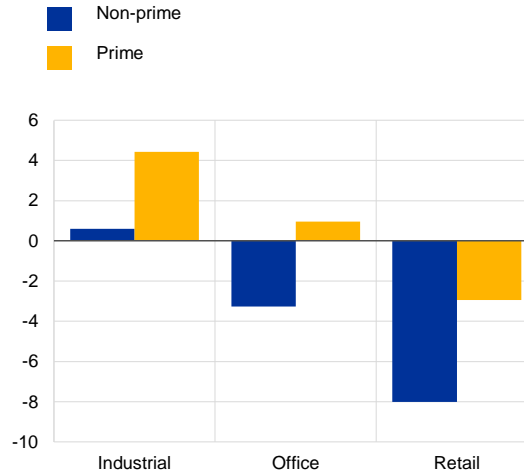
- While overall market sentiment has improved, an elevated share of investors still sees CRE markets in downturn
- More than half of recently-acquired CRE exposures are outside the euro area but investment funds have sizeable exposures too

## CRE market sentiment (percentage of respondents)



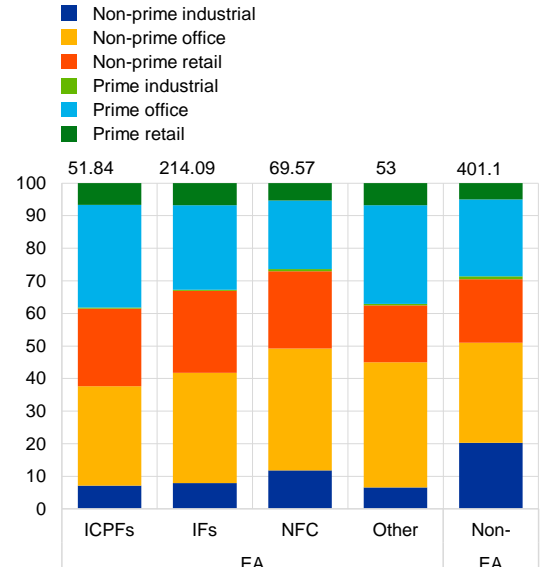
Sources: RICS and ECB calculations.

## 12-months-ahead rent change expectations (Q2 2021, percentages)



Sources: Real Capital Analysis and ECB calculations.

## CRE purchases by investor type (2015-19, percentages and € billions)



Sources: RICS, Real Capital Analysis and ECB calculations.

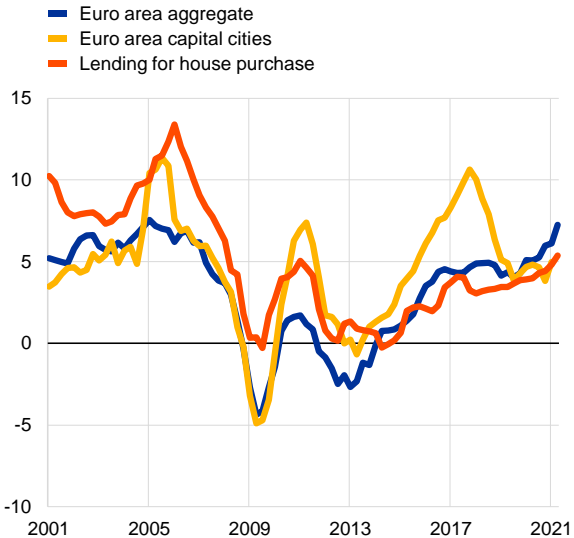
# Vulnerabilities increasing in housing markets

- Mortgage lending and RRE price growth have continued to accelerate
- Signs of further loosening of RRE lending standards, with debt servicing kept low

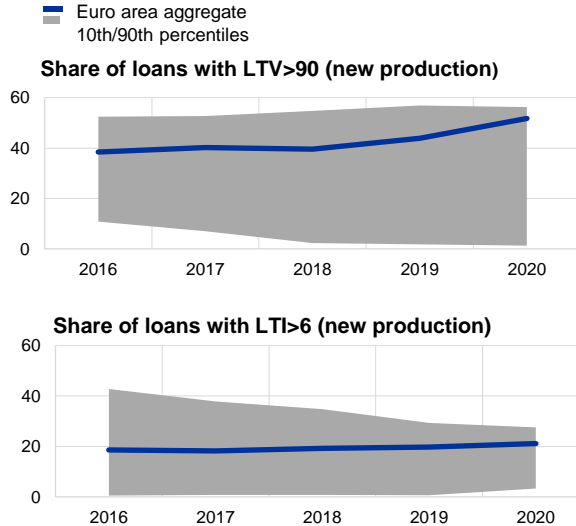
## RRE prices on aggregate and in capital cities, and lending for house purchase (annual percentage changes)

## Shares of high LTV and high LTI loans in new securitised mortgage loans (percentage of total new RRE loans used in securitisations)

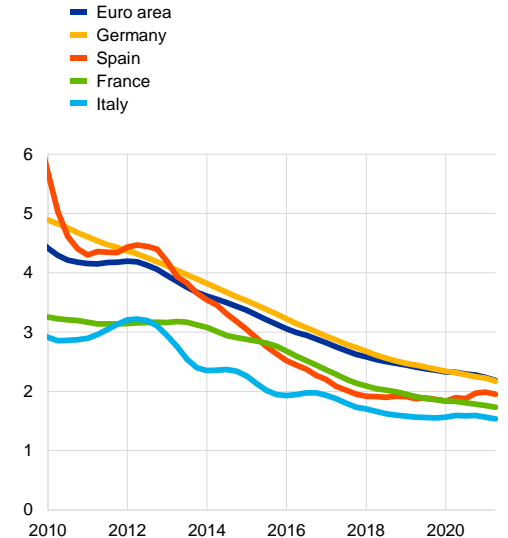
## Share of households' gross interest payments in disposable income (percentages)



Sources: ECB and ECB calculations.



Sources: EDW and ECB calculations.



Sources: ECB and ECB calculations.

Notes: data available for Belgium, Germany, Spain, France, Italy, the Netherlands and Portugal, total weighted by GDP.

# Financial markets showing increasing signs of stretch

- Expectations of slower recovery and inflationary pressures saw real yields fall to all-time lows
- Stretch in some asset valuations increases the likelihood of market corrections while growth in novel, risky tokens continues to expand

## Euro area real yields, inflation expect. and economic surprise index

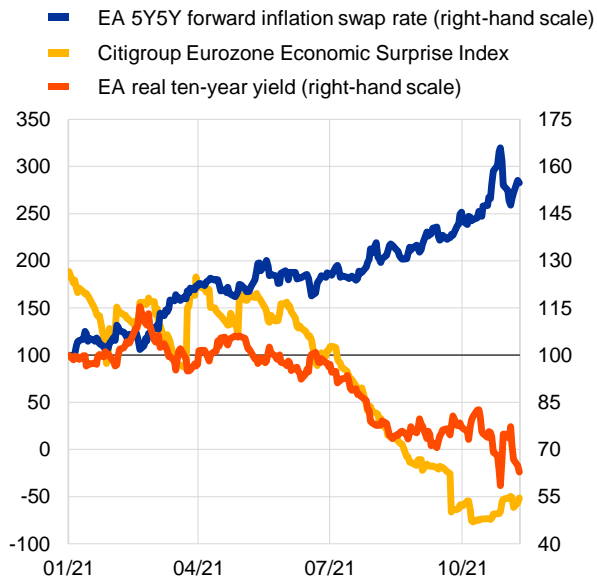
(index: 1 Jan. 2021 = 100, percentage)

## Deviation of a basket of global financial assets from long-term average

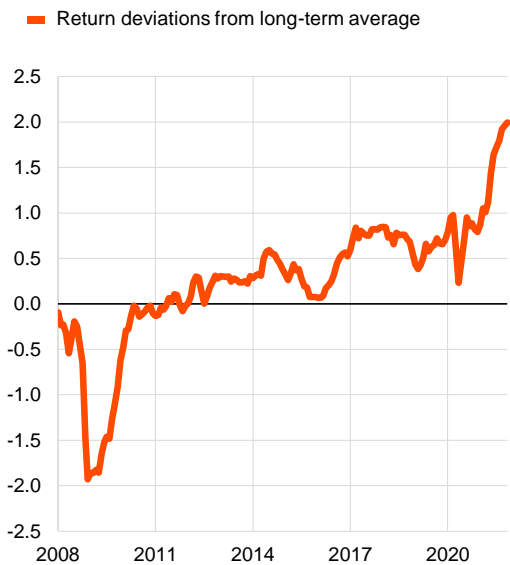
(number of standard deviations)

## Market capitalisation of largest stablecoins

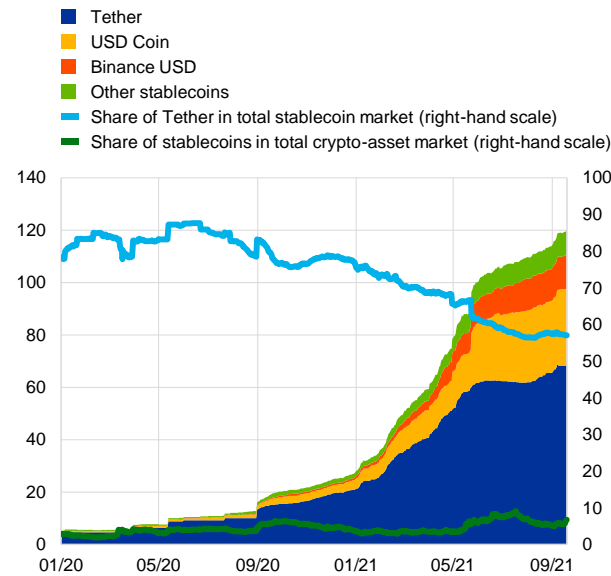
(LHS: USD billions; RHS: percentages)



Sources: Refinitiv and ECB calculations.



Sources: ECB and ECB calculations.

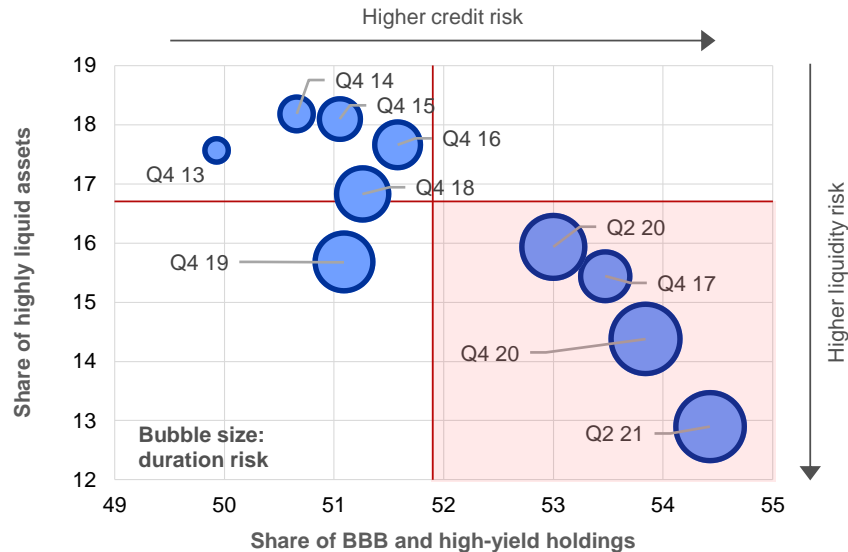


Sources: Dealogic, ECB calculations

# Non-banks increasingly sensitive to shifts in sentiment or interest rates

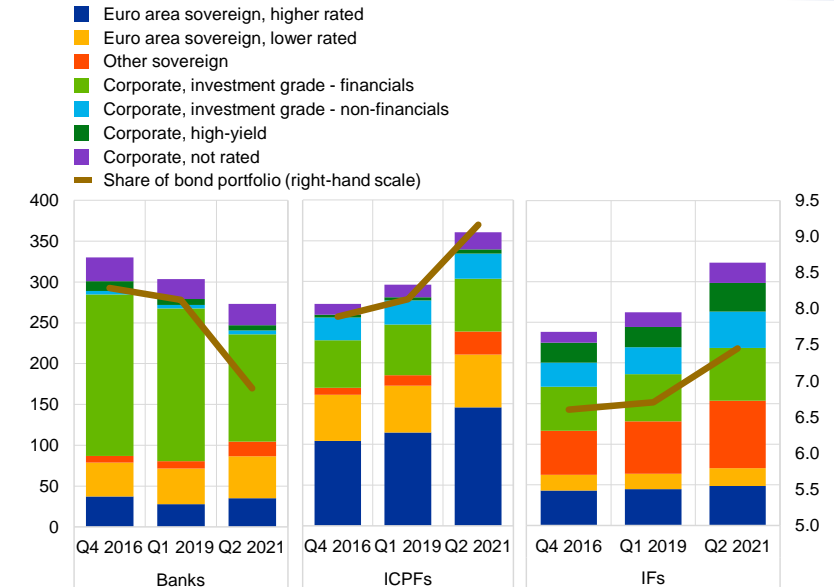
- Non-banks continue absorbing the bulk of the record-high issuance of high-yield corporate bonds
- Duration exposure of non-banks has continued to rise, rendering portfolios vulnerable to interest rate shocks

## BBB and high-yield holdings and highly liquid assets of investment funds (Q4 2013-Q2 2021, percentages, years)



Sources: ECB (SHSS) and ECB calculations.

## Bond portfolio valuation losses by euro area holding sector under a 1 percentage point rise in interest rates (LHS: € billions; RHS: percentage of bond portfolio)



Sources: ECB and ECB calculations.

# Financial stability policies gradually tilt to address medium-term challenges

## Gradually shift policy emphasis to addressing medium-term vulnerabilities

- Consider **gradual adjustment of targeted macroprudential policy measures** to address RRE vulnerabilities
- Start considering gradual **increase in counter-cyclical 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 resilience of **money market funds**

# Case for further adjustment of measures to address RRE vulnerabilities

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

	ESRB warning/ recommendation in September 2019	Borrower-based measures					Capital measures			
		Loan-to- -value limit	Debt- service-to- -income limit	Debt-to- -income limit	Maturity limit	Interest rate sensitivity test	Legally binding measures	Risk weight on IRB mortgages	Risk weight on STA mortgages	
BE	Recommendation	●	●	●				●		
FI	Recommendation	●				●	✓			
LU	Recommendation	●					✓	●	●	
NL	Recommendation	●	●		●		✓	●		
DE	Warning	No measures in place								
FR	Warning		●		●		✓			
AT		●	●		●					
CY		●	●				✓			
EE		●	●		●		✓	●		
IE		●		●			✓		●	
LV		●	●	●	●		✓			
LT		●	●		●	●	✓			
MT		●	●		●		✓		●	
PT		●	●		●					
SK		●	●	●	●	●	✓			
SI		●	●		●		✓		●	

- As the economic recovery unfolds, macroeconomic and financial sector policies are adjusting gradually.
- Most EA countries have RRE policies in place. However, in some countries policies are absent or not sufficiently tight

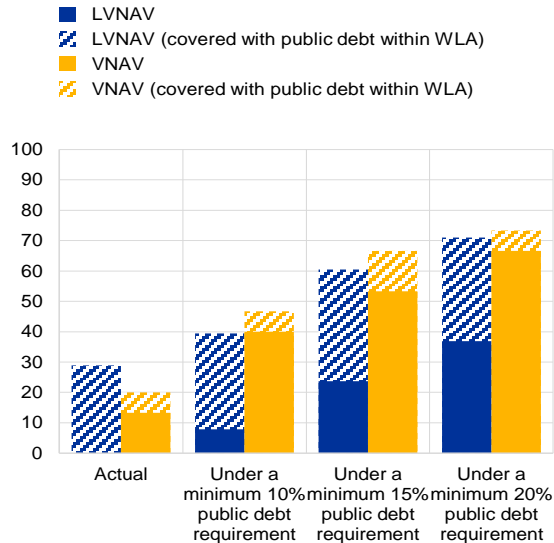
Source: ESRB and national notifications.

# Strengthening the asset liquidity of MMFs

- Objective: limit liquidity mismatches in these funds and diversify their sources of liquidity
- A higher share of MMF public debt holdings would help managers to deal with large and unexpected outflows, while outstanding short-term public debt would be more than sufficient to meet increased demand

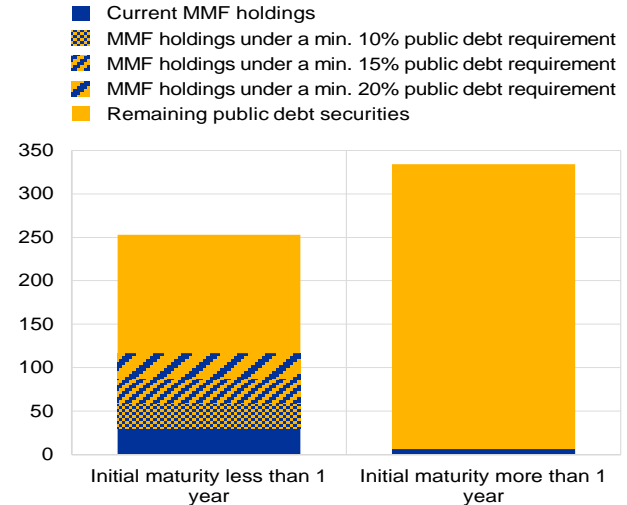
## Share of MMFs able to meet outflows by liquidating public debt based on March 2020 turmoil

(March 2020, percentages)



## Euro area public debt with a residual maturity of less than one year

(€ billions)



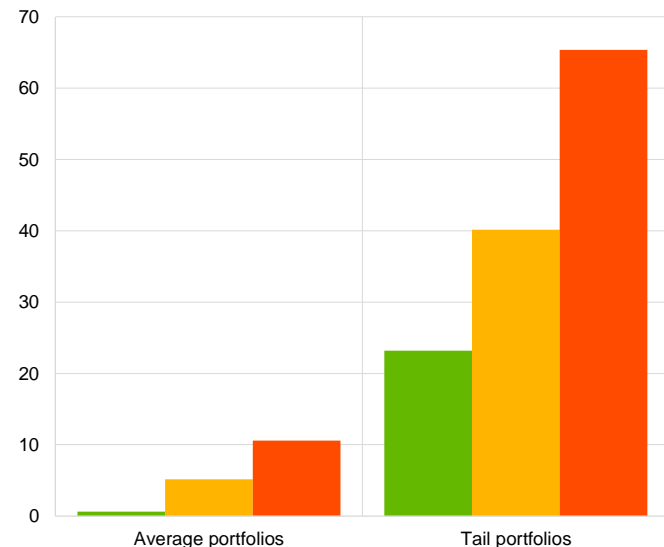
# And continued efforts to strengthen resilience and support climate transition

- There are a number of other initiatives to strengthen the structural resilience of the euro area financial system and prepare for the challenges of the future.
- These include:
  - Full and timely **implementation of Basel 3**
  - Completion of the **Banking Union**
  - Support an **orderly climate transition** including through action on disclosures and standards

## Projected increase in losses on banks' corporate loan books under various climate scenarios

(€ billions)

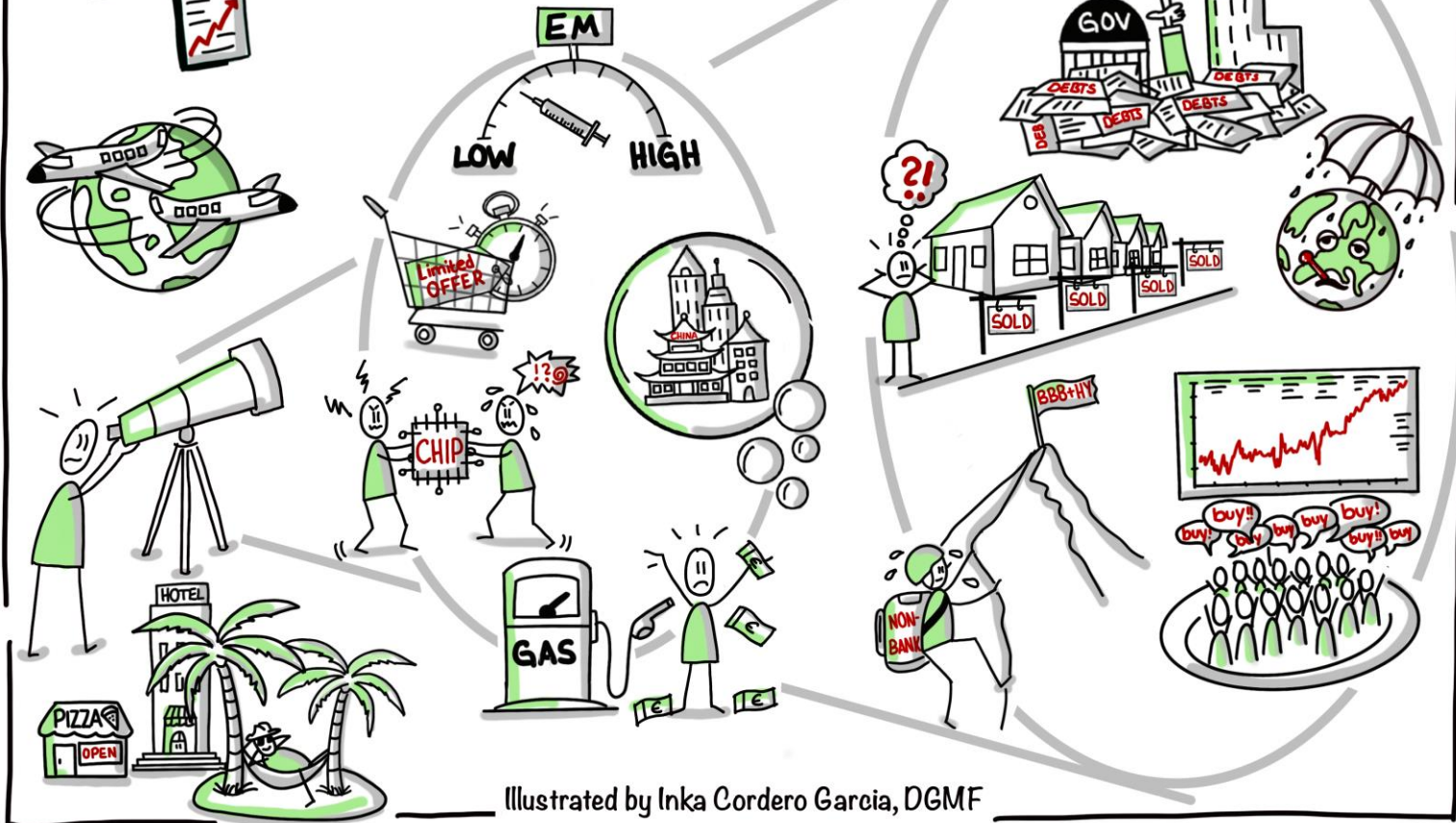
- Orderly transition
- Disorderly transition
- Hot house world



Sources: ECB and ECB calculations based on NGFS scenarios (2020)



# FSR Nov 2021



Illustrated by Inka Cordero Garcia, DGMF