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**Key takeaways from the ECB's new Financial Stability Review**

Laurent CLERC

Director for Research and Risk Analysis

Autorité de Contrôle Prudentiel et de Résolution

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# KEY MESSAGES FROM THIS NEW ISSUE OF THE ECB'S FSR

**This new issue of the ECB's FSR provides quite a gloomy perspective:**

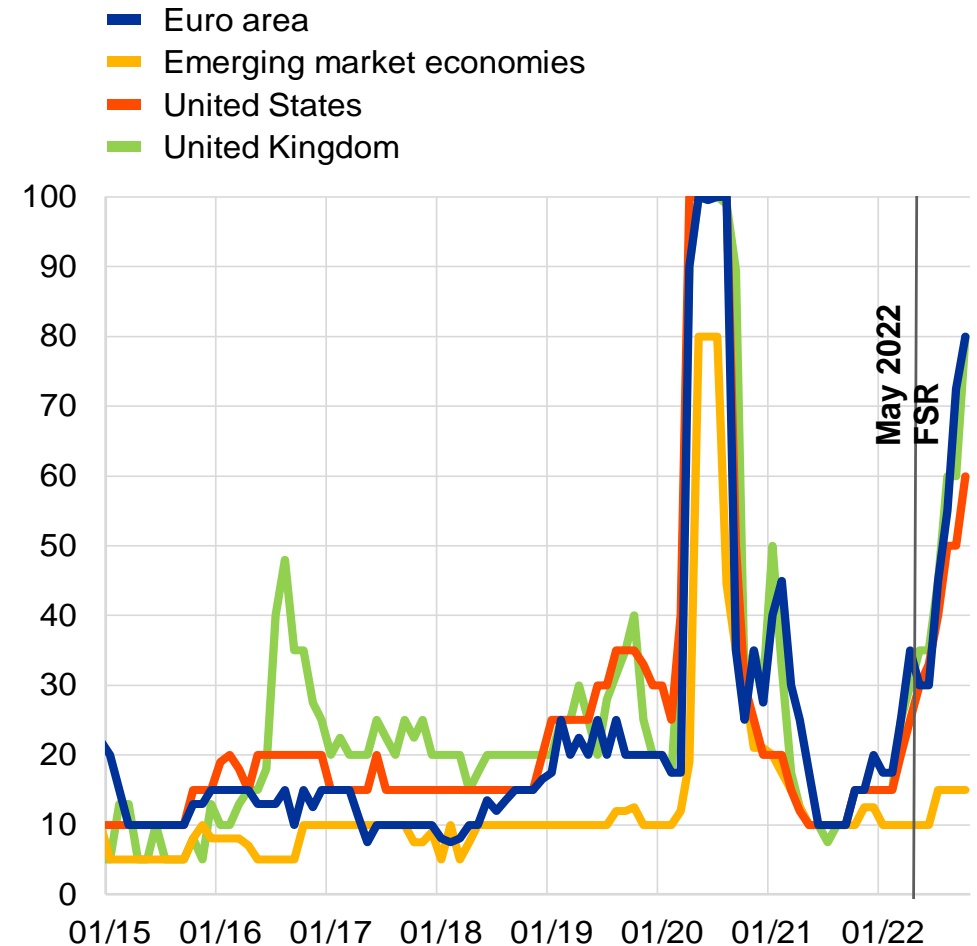
1. Both macroeconomic and financial conditions further deteriorated since the Summer of 2022
2. As financial conditions tighten, the vulnerabilities of more indebted sovereigns, households and corporates are increasing
3. The risk of disorderly market stress rises amid higher volatility and potential for further asset repricing
4. A weaker economy, increased credit risk and deteriorating asset quality may weigh on bank profitability prospects in the medium term
5. The FSR also points at persistent vulnerabilities in the non-bank financial sector and recurring liquidity challenges

# BACK TO THE 1970'S?

The current situation recalls to some extent that of 1973:

- A context of huge geopolitical uncertainty & war economy/era
- A massive supply shock affecting energy, commodity and food prices
- A surge in inflation, risk premia and interest rates significantly deteriorating financial conditions
- An anticipated strong & negative impact on economic perspectives

## One-year ahead recession probabilities



Source: ECB's FSR



# 2022 VS. 2023?

- **Paradoxically, while most of the shocks (“black swans”) occurred in 2022, the worst is still expected to come next year. In 2022:**
  - The real sector (both households and firms) so far have resisted and absorbed the shocks, but alike the COVID crisis, the situation differs across sectors and countries, especially those exposed to energy
  - Default rates have increased but not commensurately to the shocks and still remain below pre-COVID levels;
  - Unemployment has remained rather stable;
  - Cash rich firms have been able to accommodate for substantial wage increases, moderating the fall in real disposable income
  - A large share of existing debt has been contracted at fixed rates mitigating the risk of sharp increases in debt services
  - Financial institutions, in particular banks and insurance companies, despite sometimes heavy losses in particular on fixed-income markets are still generating positive results and should benefit from interest rate increases
- **But...**
  - Uncertainty has not disappeared and may not vanish in the short-term
  - Macroeconomic and market indicators have been deteriorating continuously
  - Markets have been experiencing growing liquidity shortages
  - Banks, and more largely financial institutions, which are used to frontload their funding are currently experiencing costlier and tighter funding conditions, potentially bearing on their next year’s activity and ability to finance their financing needs (e.g. MREL shortfalls)
- **So the question is whether a recession next year is almost certain (80%) or still conditional given the high uncertainty (//Covid crisis and the expected “tsunami of defaults”) but also the policy responses and the resilience of the actors**



# INTENDED VS. UNINTENDED EFFECTS?

- **The risk diagnosis provided in the ECB's FSR takes place in a context where:**
  - monetary policy and macro-prudential policies are on the tightening mode: the ECB is even calling for further pre-emptive actions on the macroprudential side and many national authorities are still considering further actions to increase the resilience of their financial sector;
  - So there are trade-offs and authorities are balancing the risks of being pro-cyclical
  - Additional actions may be however required to dampen inflation risks and expectations
  - Part of the cooling down of the economy is thus intended
  - ECB quantitative tightening is mostly driven by declines in TLTROs at a pace which is anticipated and to controlled by banks, with limited expected effects on financial conditions
- **Unintended effects may therefore stem from:**
  - New shocks on energy/commodity prices ; further disruption in supply chains ; inability of Europe to cope with the energy crisis; a deepening of geopolitical risks
  - Market and liquidity risks: the ECB still points to stretched valuations on some asset markets



# FACTORS OF RESILIENCE

## They depend upon:

- the capacity of actors to withstand the shocks: so far so good for firms, households, banks and insurance companies thanks to previous policy supports, solid balance sheets and cushions in the form of extra-savings; debt at fixed rates for a significant portion of households and firms;
- This is consistent with declining NPLs up to Q2 2022; however, as pointed out by the ECB, banks are now moving a significant share of their exposures in IFRS stage 2, reflecting their concerns on asset quality and credit risk, consistently with their economic outlook: so the question here is whether provisions will be sufficient;
- Strength of inflation: it is expected to peak in 2022Q4 but there is still the possibility of more persistence of spill-overs to core components (e.g. lagged effects of wage negotiations);
- The policy response: monetary and fiscal policies with more limited space for the latter



# MAIN CAUSES FOR CONCERN

## They are related to:

- The balance of risks, which remains tilted to the downside in Europe, with deteriorated macroeconomic perspectives;
- Market and liquidity risks: recent episodes on energy markets (cf. the FSR special issue), the UK Gilts-market, as well as tighter funding conditions highlight the potential for renewed episodes of market volatility and diminishing liquidity on certain market segments ; tensions are exacerbated by increasing interest rates and search for higher yields potentially triggering destabilising outflows from some sectors;
- NBFIs sector vulnerabilities and risky behaviours:
  - The UK recent market shock shows that despite more than a decade of financial regulation, bad incentives and bad management are still weakening the financial system: here a combination of short term financing and leverage on repo markets, wrong way risk and inappropriate use of derivatives but on plain vanilla instruments
  - It raises in addition the issue of the pro-cyclicality of margin calls and its scope for contagion on underlying collateral markets