EUROPEAN CENTRAL BANK
EUROSYSTEM

November 2023
Financial Stability Review

SUERF

23 November 2023

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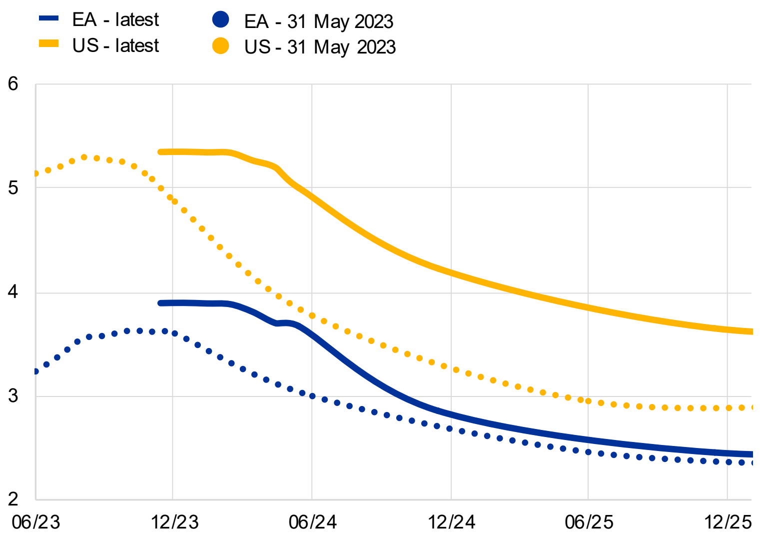
Context: A fragile macro-financial and geopolitical environment

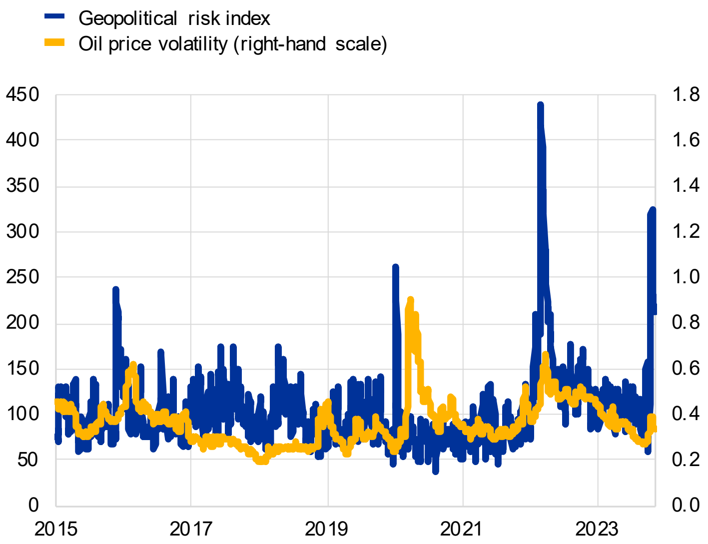
- Tighter financing conditions are gradually propagating to the real economy, with the full impact yet to materialise
- Downside risks to economic growth and geopolitical tensions

Market-implied short-term interest rate expectations
31 May 2023, 14 Nov. 2023, percentages



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

Geopolitical risk index and implied oil price volatility
1 Jan. 2015 – 14 Nov. 2023, indices, 7-day moving averages



Sources: Caldara and Iacoviello (2022) and ECB (Option-Implied Probability Density Functions).

Outline

Euro area financial stability outlook remains fragile

1

Markets vulnerable to adverse dynamics
- triggered by macro-financial surprises or geopolitical risks
- amplified by high credit and liquidity risk in non-banks

2

Non-financial sectors challenged by rising debt service costs
- full impact of tighter financial conditions not yet felt
- indebted households, firms and governments most at risk

3

Headwinds to bank profitability yet to fully materialise
- bank profitability bolstered so far by higher interest rates
- headwinds associated with deteriorating asset quality, lower lending volumes and higher funding costs

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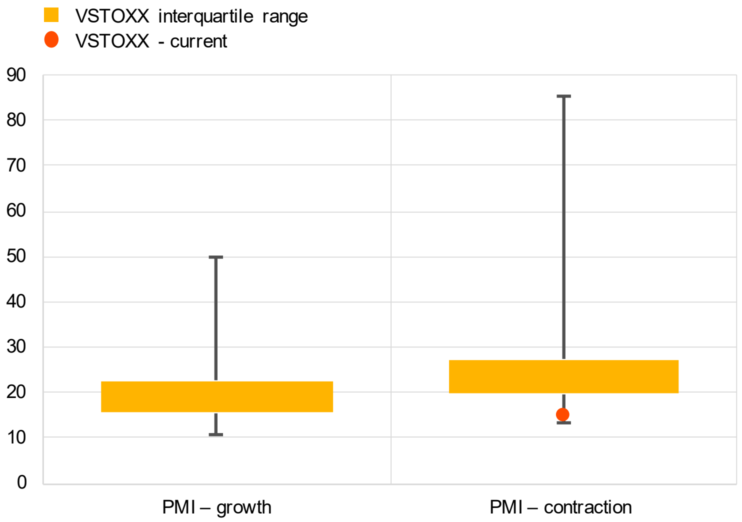
Asset price valuations are vulnerable to interest rates remaining higher for longer than currently expected and to economic growth disappointments

Frequency distribution of euro area implied equity volatility (VSTOXX) split by PMI direction

2 Jan. 2012 – 14 Nov. 2023, index

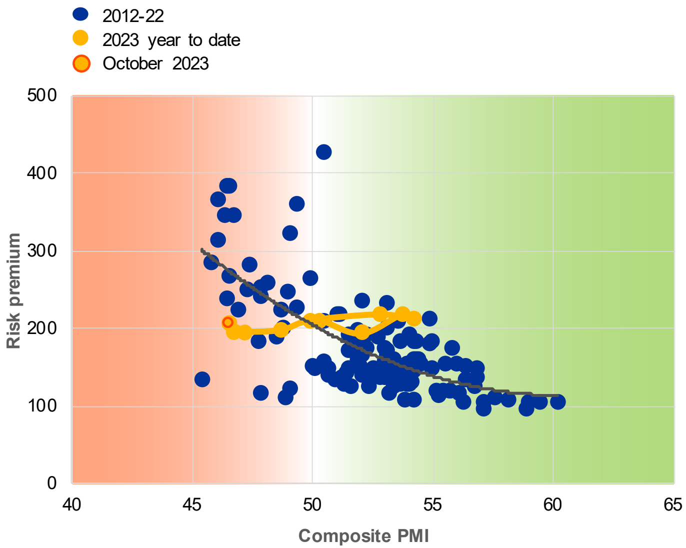


Sources: Bloomberg Finance L.P., S&P Global Market Intelligence, ECB calculations.

Note: based on Composite Purchasing Managers' Index (PMI) with readings above 50 indicating growth.

Credit spreads on euro area corporate bonds and composite PMI

Jan. 2012 – Oct. 2023; x-axis: index, y-axis: percentage points



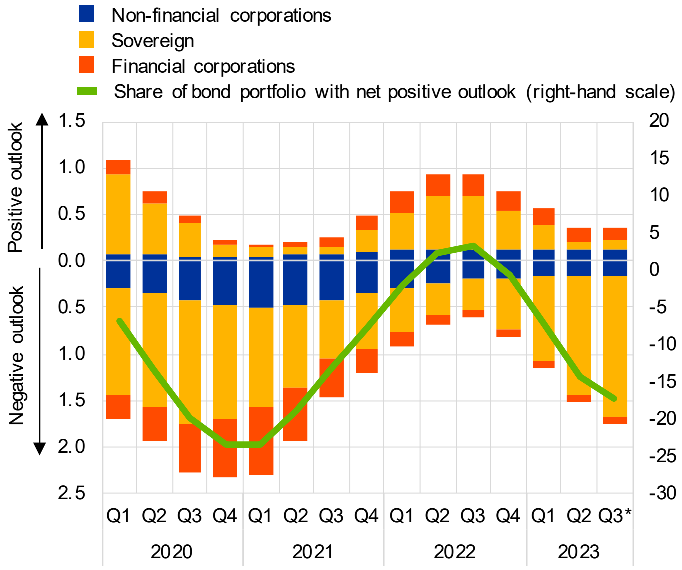
Sources: Bloomberg Finance L.P., S&P Global Market Intelligence, ECB calculations.

Note: Credit risk premia are calculated as the option-adjusted spread for BBB-rated corporate bonds with a residual maturity of 5-7 years..

The risk profile of non-bank portfolio exposures combined with liquidity vulnerabilities of investment funds make adverse feedback more likely for some asset classes

Holdings in NBFI sector bond portfolios with negative and positive rating outlooks

Q1 2020 – Q2 2023; left: € trillions; right: percentages

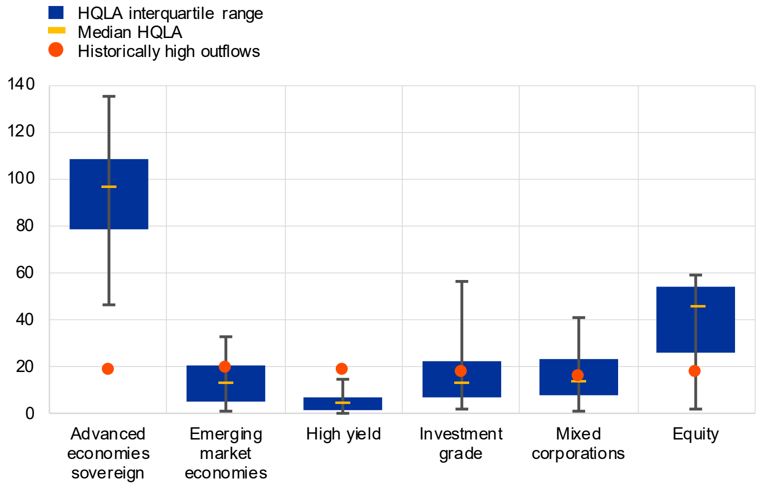


Sources: ECB and ECB calculations.

Note: rating outlook refers to the average from Moody's, S&P and Fitch as at the cut-off date 14 November 2023.

Frequency distribution of investment funds' stocks of high-quality liquid assets versus worst outflows

Q2 2023 (HQLA), Jan. 2007 – June 2023 (outflows), percentage of total net assets



Sources: Refinitiv Lipper IM, ECB (CSDB) and ECB calculations.

Note: The box plots show the distribution of fund-level stocks of high-quality liquidity assets (HQLA), calculated according to the Basel Liquidity Coverage Ratio Requirements for HQLA for banks. Whiskers refer to the 5th and 95th percentiles of the distribution, respectively. The red dots show the worst outflows for each fund category – calibrated in line with ESMA's stress simulation for investment funds* - as the 5% expected shortfall, which averages monthly fund-level net flows experienced between Jan. 2007 and June 2023 by a sample of bond and equity funds below the 5th percentile of the distribution.

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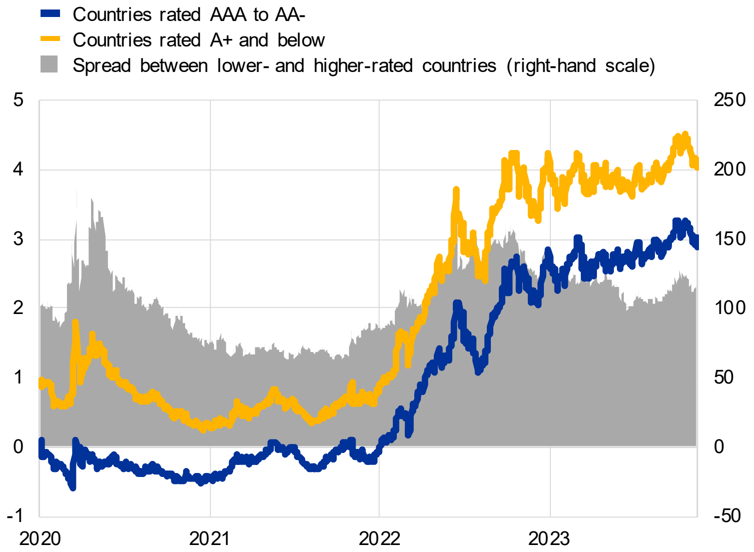
Nascent signs that euro area sovereign bond market resilience is being tested by higher interest rates

10-year government bond yields by rating bucket

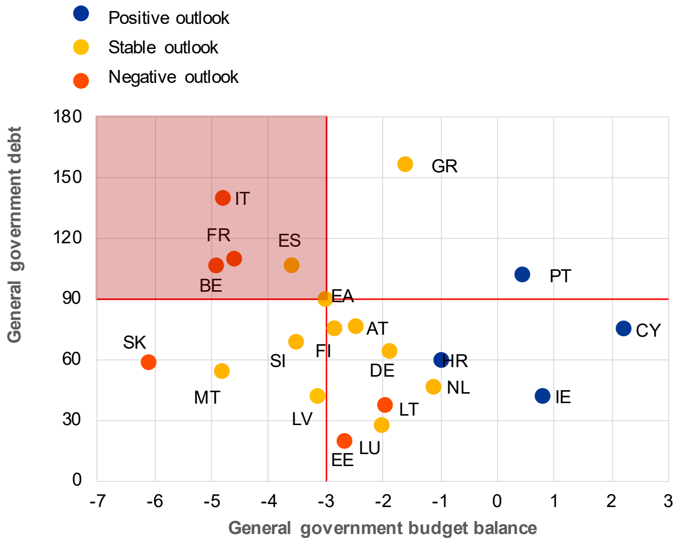
1 Jan. 2020-14 Nov. 2023; left-hand scale: percentages, right-hand scale: basis points



Sources: Bloomberg Finance L.P., Refinitiv, S&P Global Market Intelligence, Moody's Analytics, Fitch Ratings.

General government debt, budget balance and rating outlooks across the euro area

2023-24, percentages of GDP

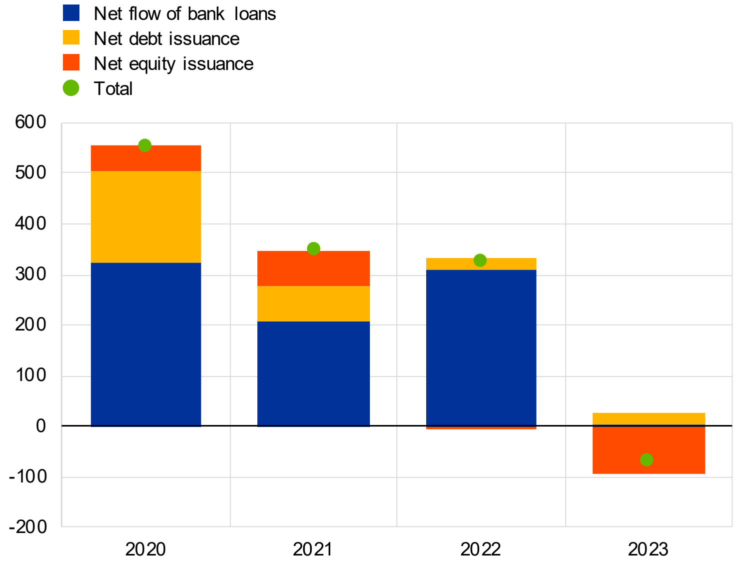


Sources: Bloomberg Finance L.P., European Commission (AMECO).
Notes: The vertical and horizontal red lines indicate the Maastricht deficit criterion of 3% of GDP and the 90% sovereign debt-to-GDP threshold based on findings in the empirical literature, respectively. Rating outlook refers to the average from Moody's, S&P and Fitch as at the cut-off date 14 November 2023.

Tighter financial conditions have led to a material drop in firms' demand for external financing, while markets are pricing-in higher default rates on low-rated bonds

External financing flows of euro area non-financial corporations, by funding instrument

2020-23, € billions

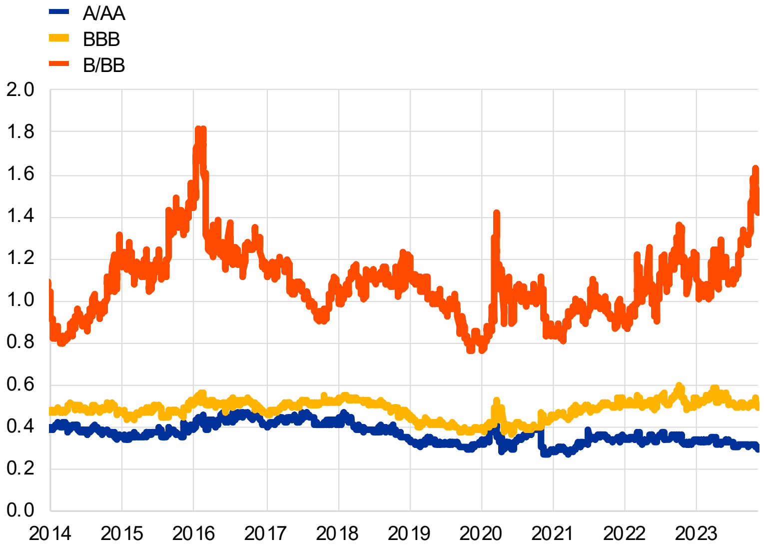


Source: ECB (Balance Sheet Items, Securities Issues Statistics).

Note: 2023 figures capture the period from January to September..

Expected euro area corporate defaults, by rating category

1 Jan. 2014-14 Nov. 2023, percentages

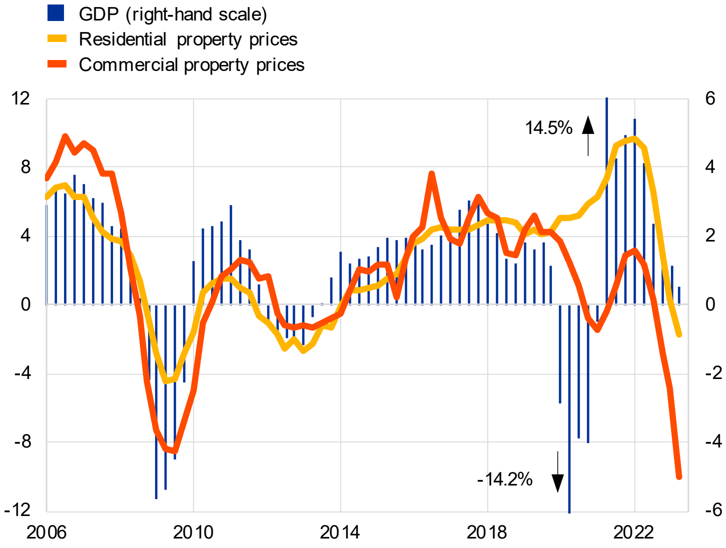


Sources: Moody's Analytics, Intercontinental Exchange and ECB calculations.

Risk of disorderly correction in property markets, especially commercial real estate

Real GDP growth, and residential and commercial real estate prices

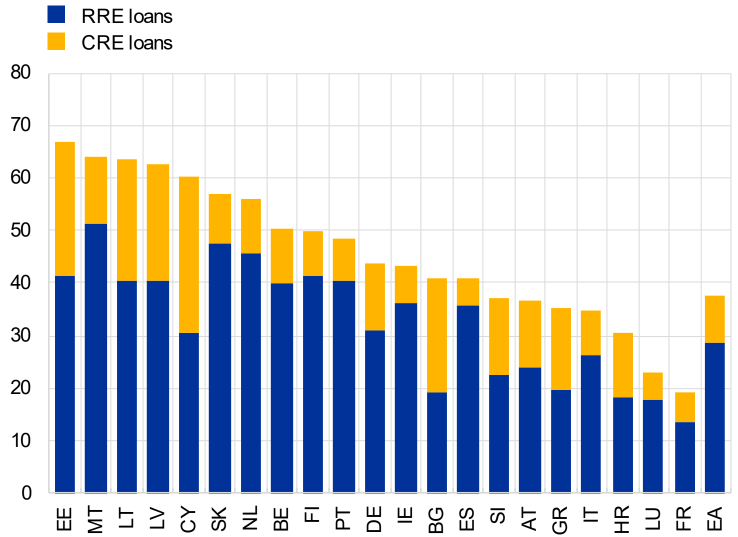
Q1 2006-Q2 2023, annual percentage changes



Sources: Eurostat, ECB (Real Estate Statistics) and ECB calculations.

Bank exposures to real estate – residential (RRE) and commercial (CRE)

Q4 2022, percentages of total loans and advances



Source: ECB (supervisory data).

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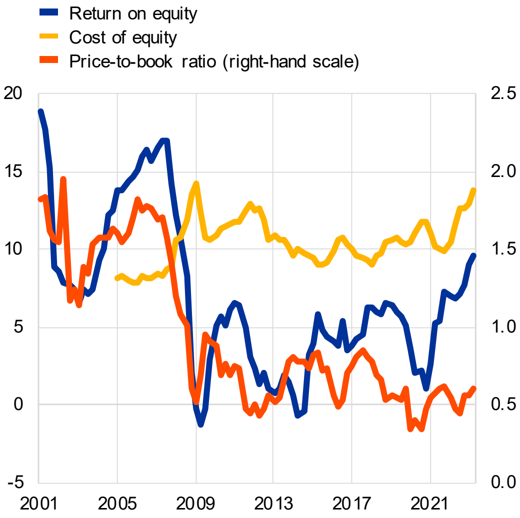
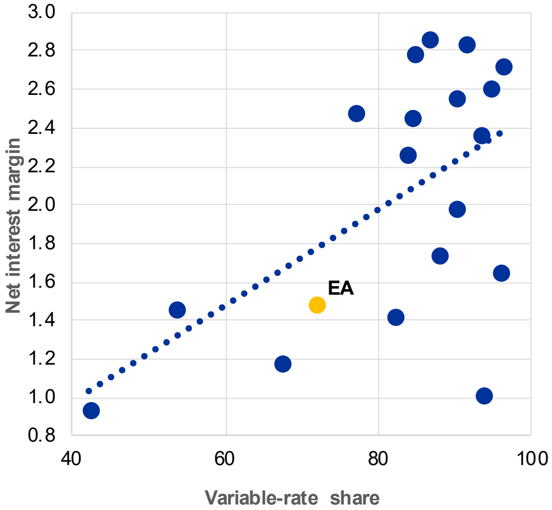
Strengthened net interest income pushes bank profitability to multi-year highs, with greatest margin expansion seen for variable rate lending and low deposit betas

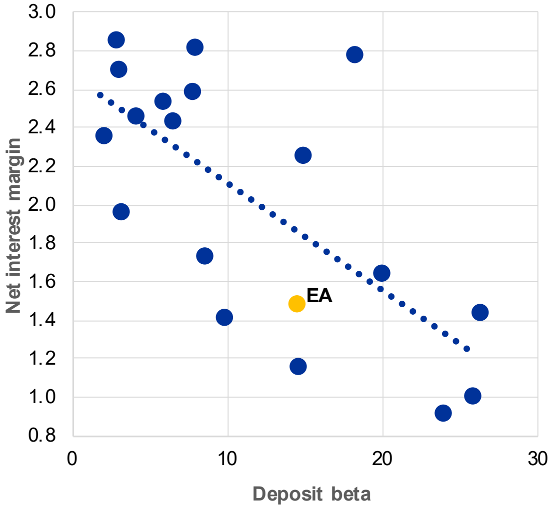
Return on equity, cost of equity and price-book ratios for euro area banks
Q1 2001 – Q2 2023, percentages



Sources: Bloomberg Finance L.P., ECB (supervisory data) and ECB calculations.
Note: return on equity and price-to-book ratio are calculated on the basis of a balanced sample of 19 euro area banks.

Share of variable-rate lending and deposit betas vis-à-vis net interest margins across euro area countries
Q2 2023, percentages



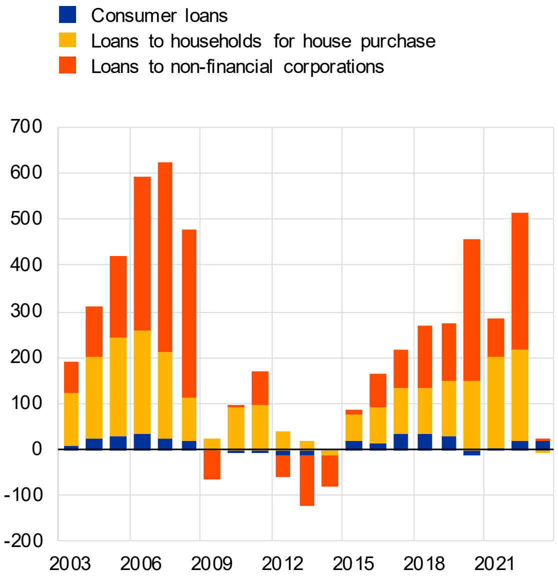


Sources: ECB (supervisory data), ECB (Balance Sheet Items and MFI Interest Rate Statistics) and ECB calculations.

But lower lending volumes, the prospect of higher funding costs and incipient signs of asset quality deterioration point to future decline

Year-to-date loan flows to households and non-financial corporations

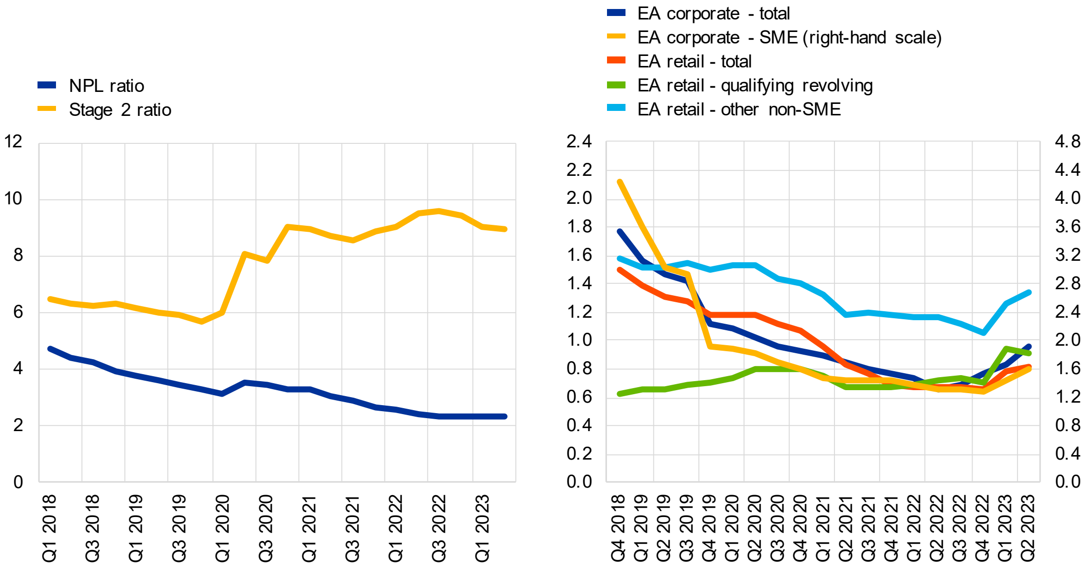
2003-2023, € billions



Sources: ECB (Balance Sheet Items) and ECB calculations.

NPL and Stage 2 ratios for total loans; Default rates on corporate and retail exposures

left graph: Q1 2018-Q2 2023, percentages; right graph: Q4 2018-Q2 2023, percentages



Source: ECB (supervisory data). Notes: Left graph: based on a balanced sample of 81 euro area significant institutions. Right graph: IRB-reporting significant institutions. Four-quarter trailing figures. Euro area exposures only.

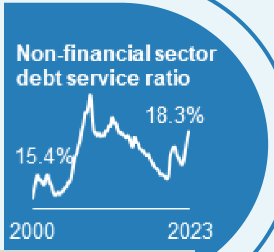
Theme 1

Markets are vulnerable to higher interest rates, slowing growth and geopolitical risks

- Markets see high risk of elevated inflation
- Refinancing risk rises for weaker borrowers
- Slower growth may make risk premia widen
- “AI rally” raises overvaluation concerns

Theme 2

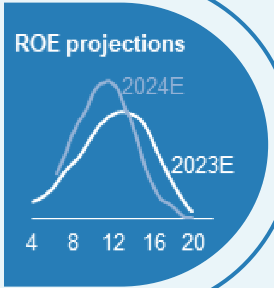
Weak economic outlook threatens debt servicing capacity of the non-financial sector



- Sovereign debt sustainability concerns resurface
- Higher funding costs could spur corporate defaults
- A turning labour market could hamper debt servicing
- Real estate correction may turn disorderly

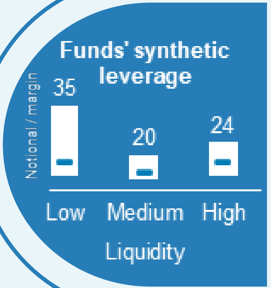
Theme 3

Headwinds to bank profitability as asset quality concerns and funding costs rise



- Further uptick in payment arrears possible
- Sharp decline in lending growth
- Rising cost of deposit funding
- Persistent gap between COE and ROE

Rising credit risk could add to liquidity and leverage concerns in non-banks



- Rising credit risk in portfolios
- Liquidity and leverage risks in funds persist
- Exposures to declining real estate valuations
- Insurers could face profitability challenges

On the back of active prudential policy in recent years, the euro area banking system is resilient and well-placed to face higher risks.

Targeted macroprudential policy action, regulatory reform and faithful implementation of Basel III can help to ensure durable resilience.

Structural vulnerabilities in non-banks continue to require a comprehensive and decisive policy response.