EUROPEAN CENTRAL BANK

EUROSYSTEM

# Sources of risk and vulnerabilities for financial stability

SUERF/ESM workshop

“Safeguarding Macro & Financial Stability in a Fragile Environment – transmission channels”

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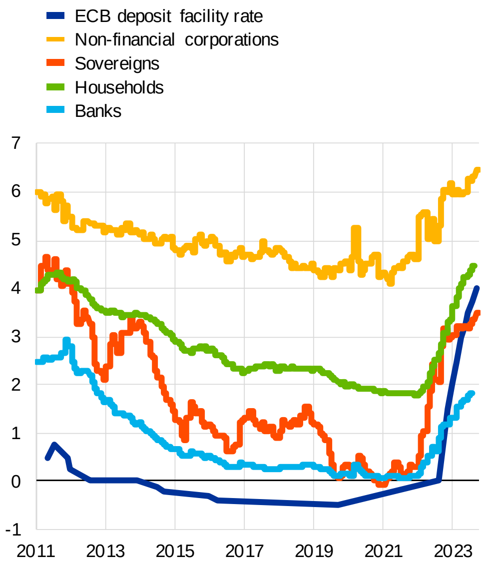
# *Context:* A fragile macro-financial and geopolitical environment

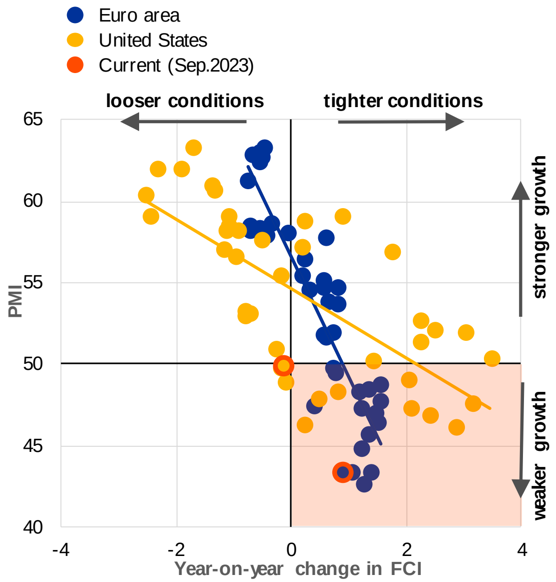
- Tighter financing conditions are gradually propagating to the real economy, with the full impact yet to materialise
- Renewed flare-up of geopolitical tensions could adversely impact macro-financial conditions

**Composite funding costs across euro area economic sectors**
Jan. 2011 – Sep. 2023, percentages



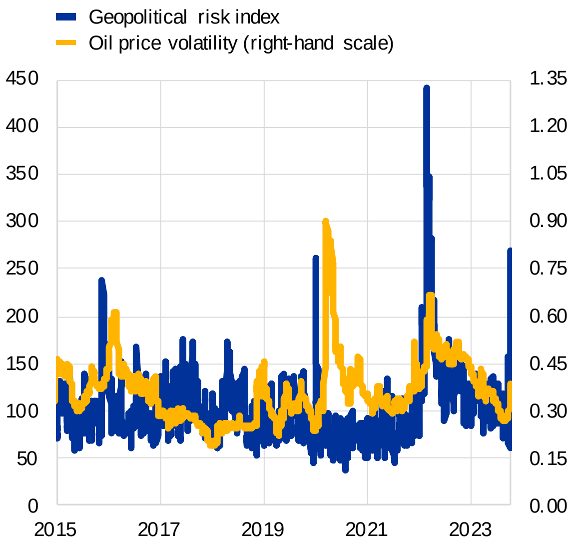

Sources: ECB(MIR), ECB and ECB calculations

**Financial conditions and manufacturing PMIs for the euro area and US**
Jul. 2020 – Sep. 2023, diffusion index, percentages




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

**Geopolitical risk index and oil price volatility** 1 Jan. 2015 – 20 Oct. 2023, indices, 7-day moving averages




Sources: Caldara and Iacoviello (2022) and ECB (PDF)

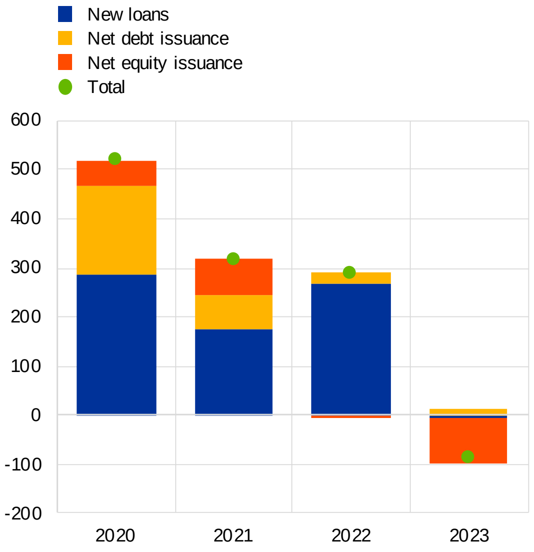
# Financial stability outlook remains fragile

1. Corporate, household and sovereign resilience tested by higher interest rates
2. Strong bank performance set to face asset quality and funding cost headwinds
3. Markets and non-banks vulnerable to negative surprises

# 1. Corporate, household and sovereign resilience tested by higher interest rates

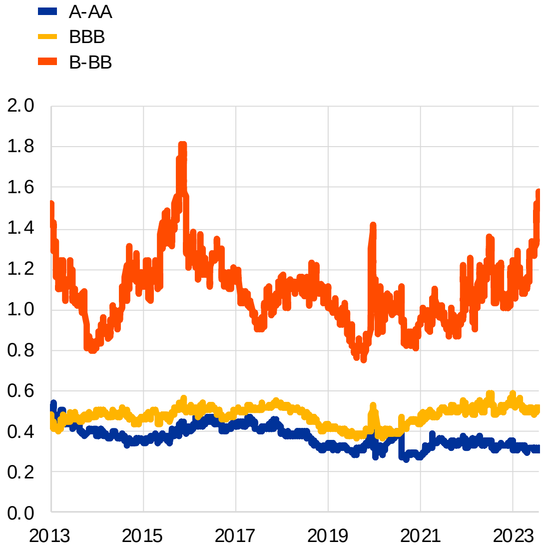
- Tighter financing conditions have led to a material drop in firms' demand for external financing
- Expected default frequencies are on the rise, especially for a cohort of more vulnerable firms

**Financing flows of non-financial firms by funding instrument**
2020-23, € billions



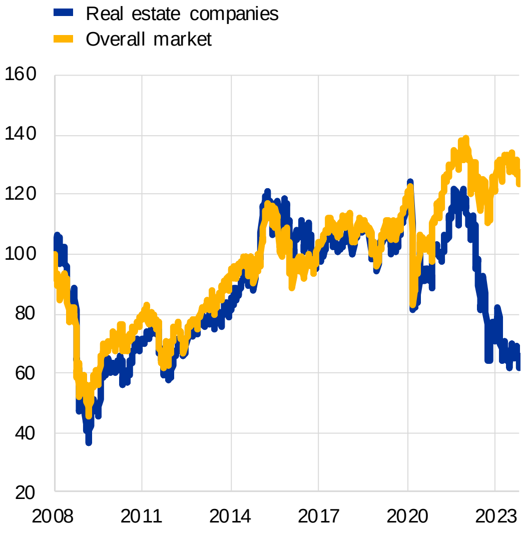

Sources: ECB (BSI), ECB(CSEC). Notes: 2023 figures capture the period January to August.

**Corporate EDFs by rating category in the euro area**
1 Apr. 2013-20 Oct. 2023, percentages




Sources: Moody's, Compustat and ECB calculations.

**Stock prices of real estate firms versus the overall market**
4 Jan.2008 – 20 Oct. 2023, Jan. 2008 = 100

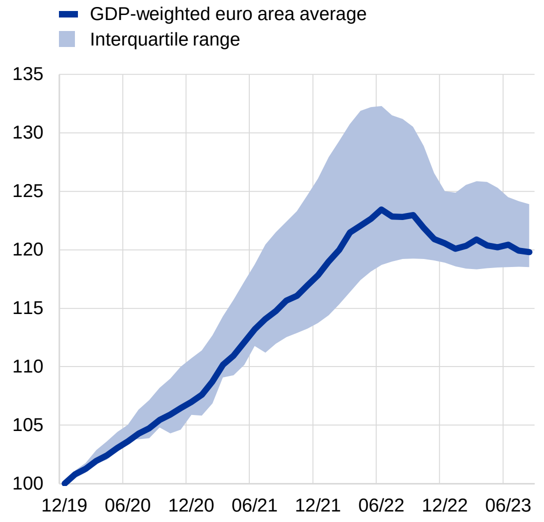



Sources: Bloomberg Finance L.P. and ECB.

# 1. Corporate, household and sovereign resilience tested by higher interest rates

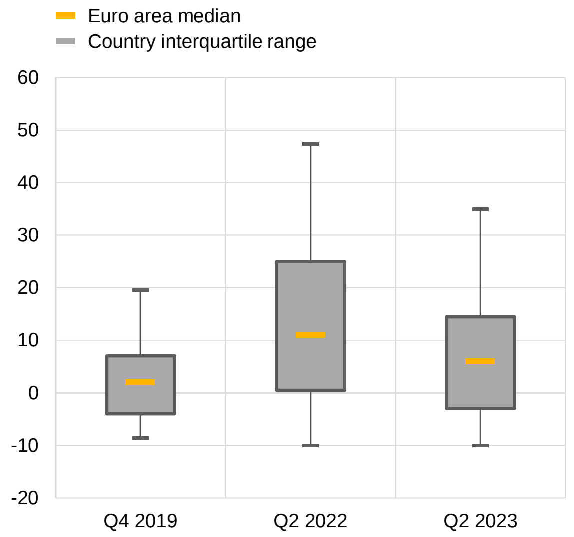
- Residential real estate markets continued to cool, as higher funding costs weigh on affordability
- Further corrections cannot be excluded and could compound household vulnerabilities

**House price patterns in the euro area**
Index: Jan. 2020 = 100



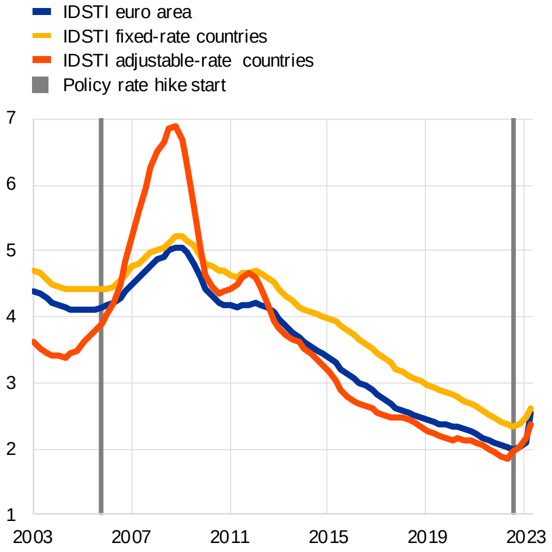

Sources: CB, Europace (Germany), Statistics Netherlands, Central Statistics Office (Ireland), Confidencial Imobiliário (sourced from BIS, Portugal), Arco Real Estate (Latvia), meilleursagents.com (France), immobiliare.it (Italy), indomio.es (Spain), Finish Statistics office, nbs.sk (Slovakia) and ECB calculations.

**Overvaluation estimates for residential real estate across euro area countries**
Q4 2019, Q2 2022, Q2 2023, percentages




Source: ECB

**Interest debt service to income (IDSTI) ratio of households**
Q1 2003 – Q2 2023, percentages

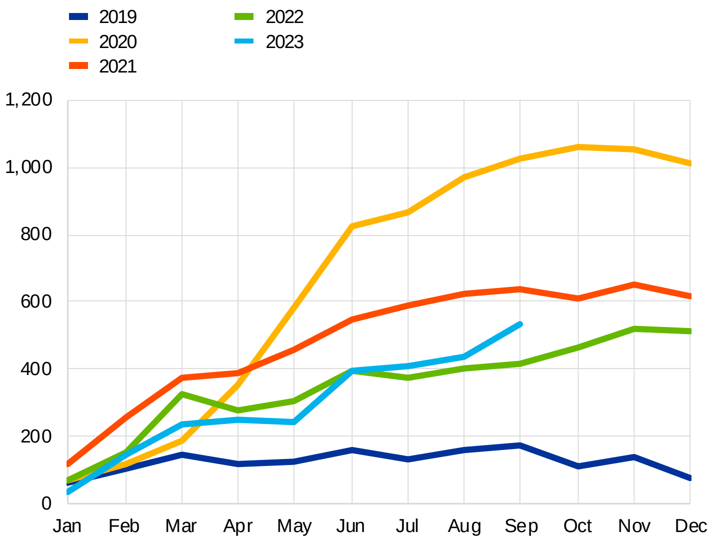



Sources: ECB and ECB calculations.

# 1. Corporate, household and sovereign resilience tested by higher interest rates

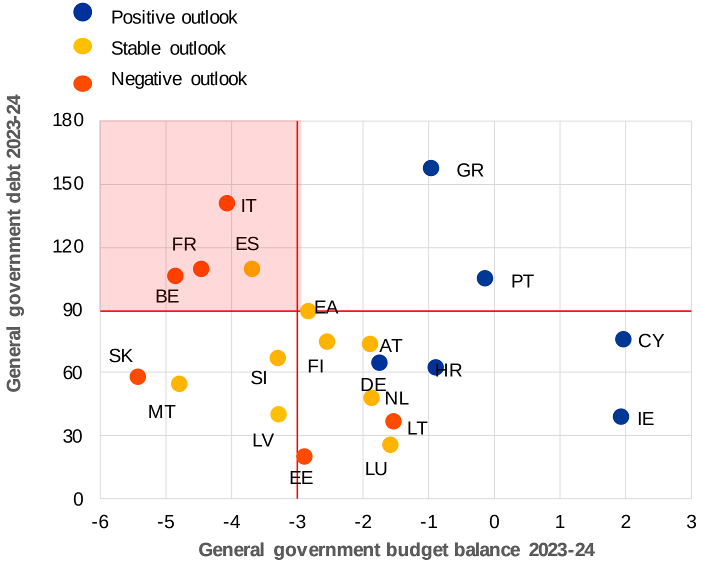
- Strong issuance by euro area sovereigns has been smoothly absorbed by the market so far
- Higher funding costs and less prudent fiscal policies could reignite sovereign debt sustainability concerns

**Net issuance of government debt securities in the euro area**
Jan. 2019 – Sep. 2023, € billions




Source: ECB.

**General government debt, budget balance and rating outlooks across the euro area**
2023-24, percentages of GDP

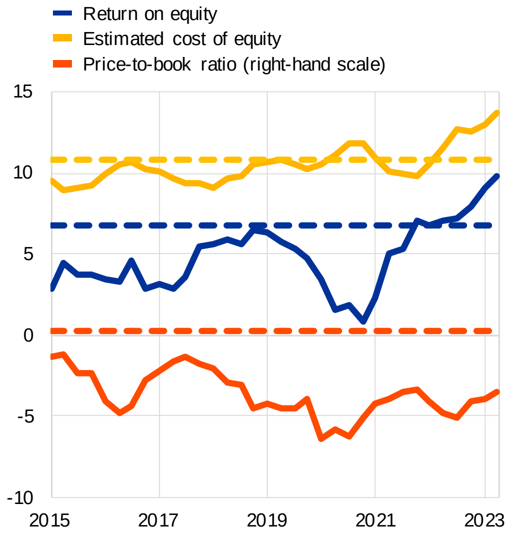



Sources: Moody`s, S&P, Fitch, European Commission (AMECO).

# 2. Strong bank performance set to face asset quality and funding cost headwinds

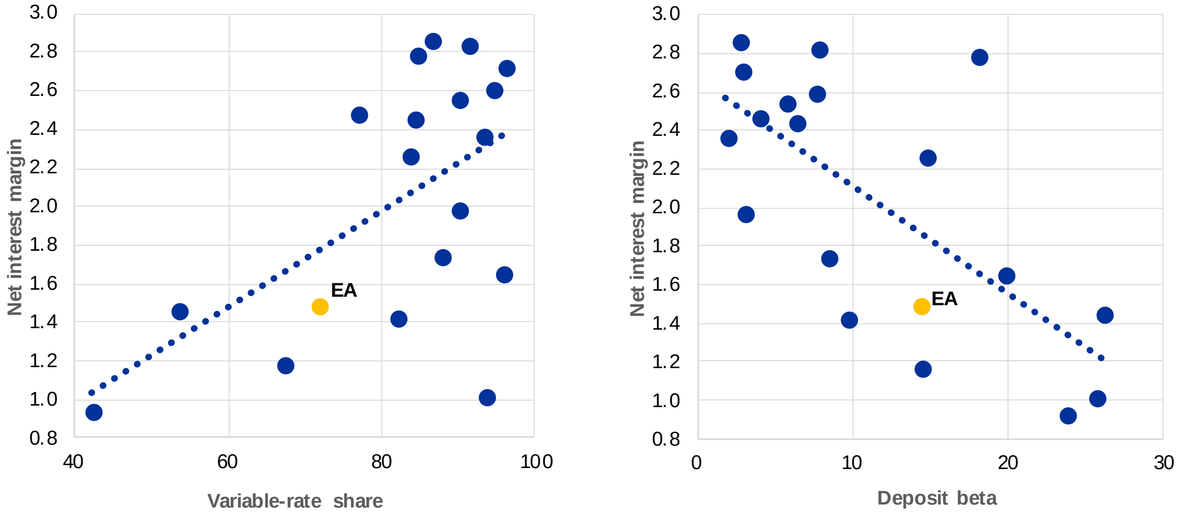
- Bank profits have increased further, primarily driven by strengthened net interest income
- Greatest margin expansion observed where loans are contracted at floating rates and where deposit betas are low

**Euro area banks' cost of equity, return on equity and price-to-book ratios**
Q1 2015 – Q2 2023, percentages




Sources: Bloomberg Finance L.P and ECB calculations.
Note: Horizontal dashed lines depict long-term averages between Q4 2000 and Q2 2023.

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



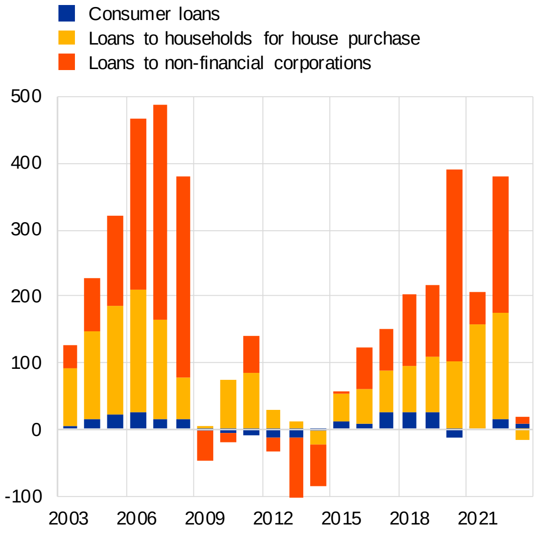

Sources: ECB (Supervisory Banking Statistics), ECB (BSI and MIR) and ECB calculations.

# 2. Strong bank performance set to face asset quality and funding cost headwinds

- Notable cooling of bank credit demand, resulting in substantially lower lending flows to households and firms
- Asset quality set to weaken, and bank funding costs set to rise further as bonds reprice and deposit betas adjust

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

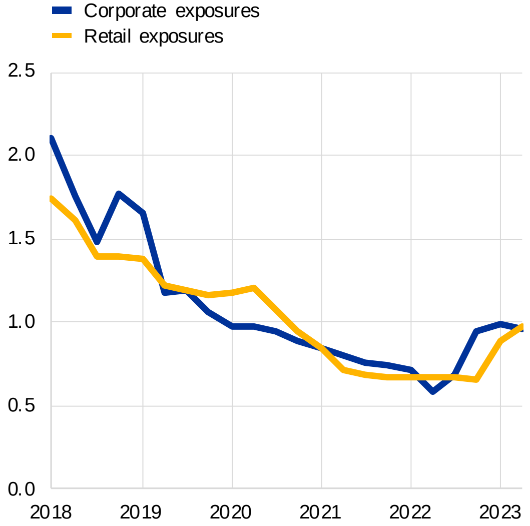
2003-23, € billions




Sources: ECB (BSI) and ECB calculations

## Annualised quarterly default rates on banks' retail and corporate exposures

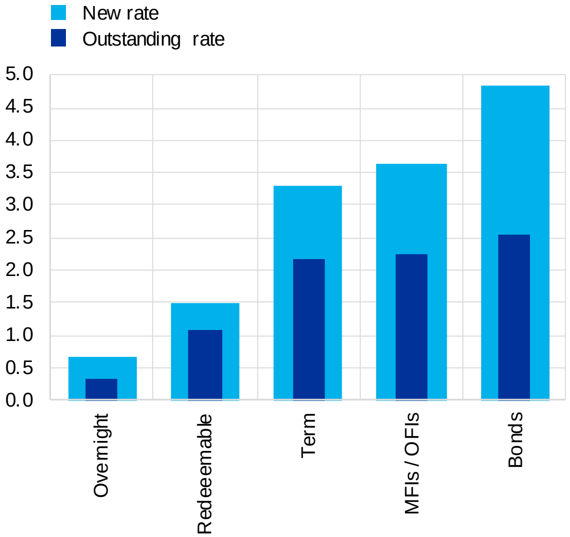
Q1 2018 – Q2 2023, percentages




Sources: ECB (supervisory data)

## Current and outstanding rates on bank deposits and bonds

September 2023, percentages



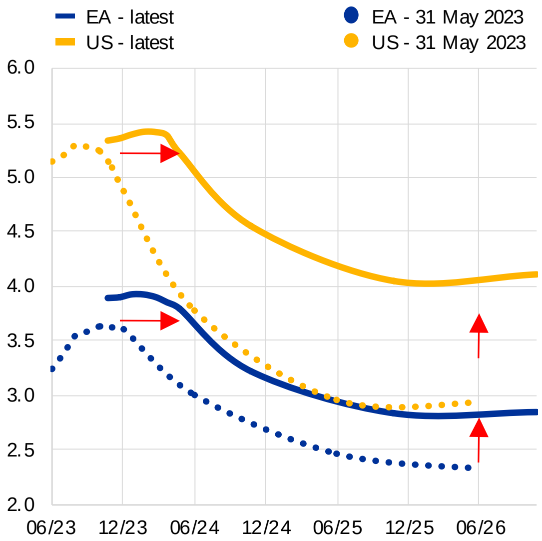

Sources: ECB (MIR), ECB, Dealogic and ECB calculations

Note: Except for bonds, existing rates show the average annual rate paid over the last 12 months and the latest monthly value to account for the timing of P&L recognition of higher expenses.

# 3. Markets and non-banks vulnerable to negative surprises

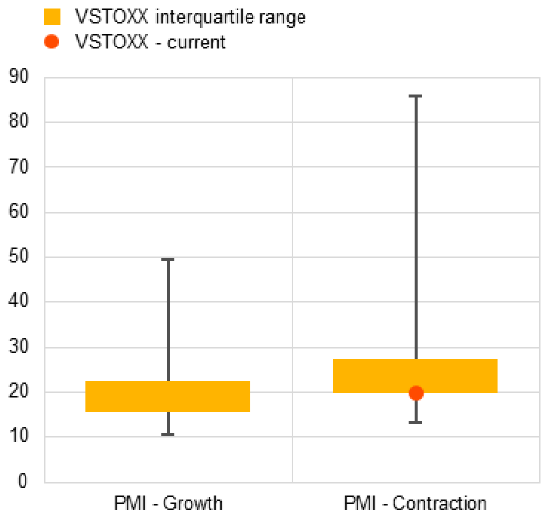
- Implied volatility and risk premia have been unusually low in financial markets
- Risk sentiment remains sensitive to negative inflation and/or growth surprises

**Market-implied short-term interest rate expectations**
31 May 2023, 23 Oct. 2023, percentages



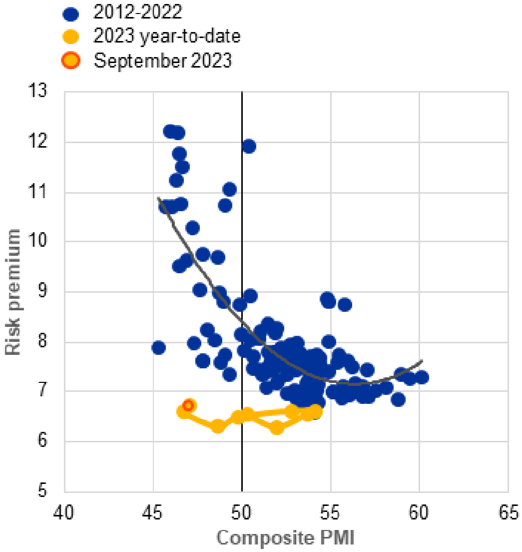

Sources: Bloomberg Finance L.P. and ECB calculations.

**VSTOXX box plots split by direction of PMI**
2 Jan. 2012 – 17 Oct. 2023, index




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

**Euro area equity market risk premium versus composite PMI**
Jan. 2012 – Sep. 2023, index, percentage points



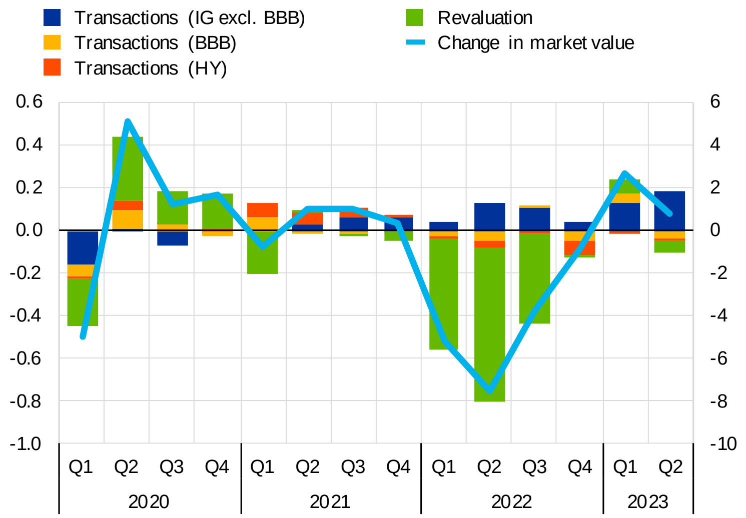

Sources: Bloomberg Finance L.P., S&P Global Market Intelligence and ECB calculations.

# 3. Markets and non-banks vulnerable to negative surprises

- Despite continued de-risking, the portfolios of non-banks are vulnerable to increases in credit risk
- Investment funds may amplify any adverse market dynamics given structurally low liquidity buffers

## Drivers of euro area NBFI sector bond portfolio dynamics by credit rating

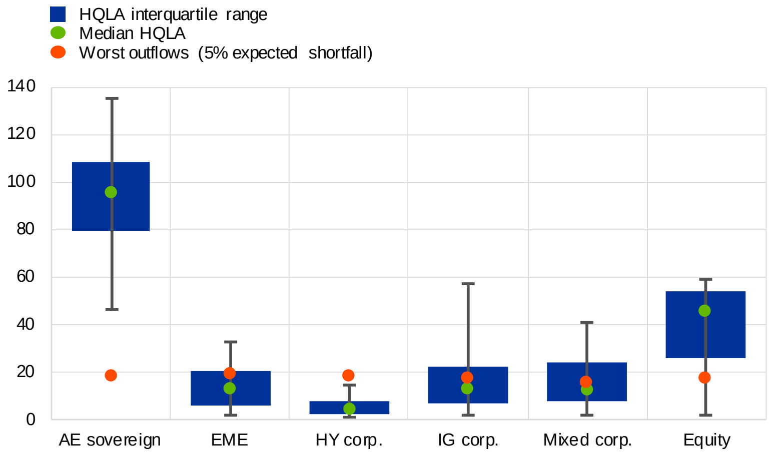
Q1 2020 – Q2 2023; left: € trillions; right: percentages




Sources: ECB and ECB calculations.

## Distribution of funds' HQLA stock and worst outflows

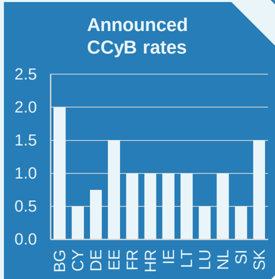
Q2 2023 (HQLA), Jan. 2007-June 2023 (outflows), percentage of total net assets




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

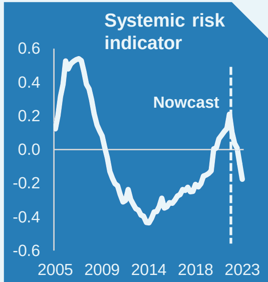
# Macroprudential policy: preserve existing resilience

**Macroprudential action since the pandemic has increased the banking sector's resilience**




**Challenging environment for macroprudential policy**

- Elevated uncertainty
- Signs of turning financial cycle
- High accumulated vulnerabilities




## Ensure banking sector resilience

### Capital-based measures

- Maintain existing capital buffers
- Consider targeted increases, avoiding procyclical effects
- Banks should not increase pay-out ratios

### Borrower-based measures

- Ensure sound lending standards and sustainable debt
- Complement capital-based measures
- Flexibility may be used to guarantee availability of credit

# Strengthen the already robust and comprehensive EU regulatory framework for banks

**Recent turmoil in the US and Swiss banking sectors calls for broad and consistent application in all jurisdictions of global regulatory reforms**

### Full, faithful and timely implementation of Basel III

- Ensure that banks continue to be well-capitalised
- Foster trust in EU banking system
- Additional levers for supervisory scrutiny

### Completing the banking union remains a key priority

- Advance EU reform of bank crisis management and deposit insurance
- Establish common backstop to the Single Resolution Fund
- Introduce a European Deposit Insurance Scheme
- Implement a framework for liquidity in resolution in accordance with FSB Guiding Principles and international best practices

### AT1 and creditor hierarchy in EU resolution framework

- In EU, AT1 instruments are written down or converted if CET1 ratio falls below thresholds
- Capital instruments do not have permanent contractual write-down clauses activated in case of public support
- EU resolution framework: detail creditor hierarchy if troubled bank bears losses
- This sequence has been consistently applied in past cases and will continue to guide the actions of ECB and SRB in future crisis interventions

# Non-banks – need for a comprehensive policy response

**Persistent structural vulnerabilities and the risk of renewed stress make it vital to enhance the resilience of the non-bank financial sector**

### Mitigating liquidity mismatch in open-ended funds

- Aligning redemption terms with asset liquidity
- Making greater use of anti-dilution liquidity management tools to mitigate first-mover advantages
- Ensuring sufficient amounts of liquid assets

### Enhancing non-banks' liquidity preparedness to meet margin and collateral calls

- Increased transparency of margining, especially for clients
- Better governance and contingency planning for adverse scenarios
- More robust stress testing
- Ensuring adequate levels and diversification of liquidity buffers

### Addressing risks from non-bank leverage

- Need for a holistic perspective across NBFI sector entities and activities
- Restricting leverage at the entity level
- Strengthening risk management practices at prime brokers/ dealer banks
- (Re-) considering the role of haircuts and margins
- Enhancing data and leverage metrics

- ➢ International policy coordination is key
- ➢ Authorities should take an active role in identifying and addressing emerging risks