EUROPEAN CENTRAL BANK
EUROSYSTEM

May 2023
Financial Stability Review

SUERF

1 June 2023

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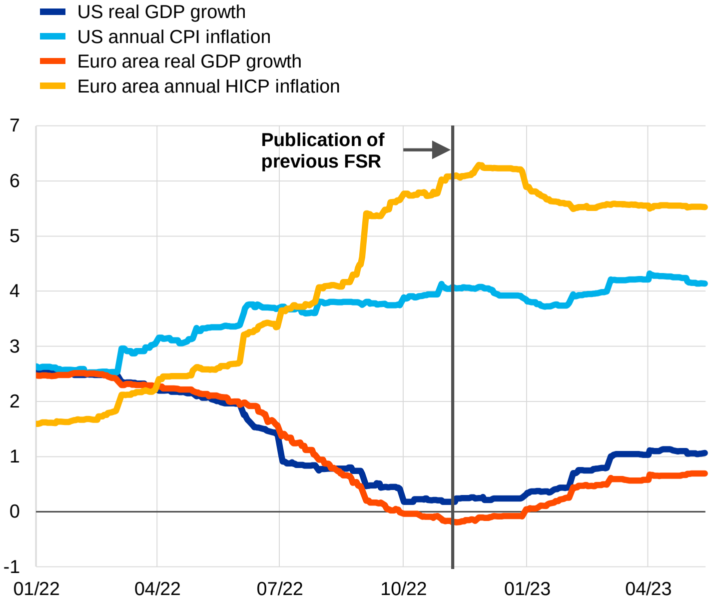
Context: A fragile macro-financial environment

- Despite some improvement at the turn of the year, weak macro-financial prospects remain a challenge
- Banking sector stresses in the US and Switzerland had limited spillover to large euro area banks, financial markets and sovereigns

Real GDP growth and inflation forecasts for the euro area and United States in 2023

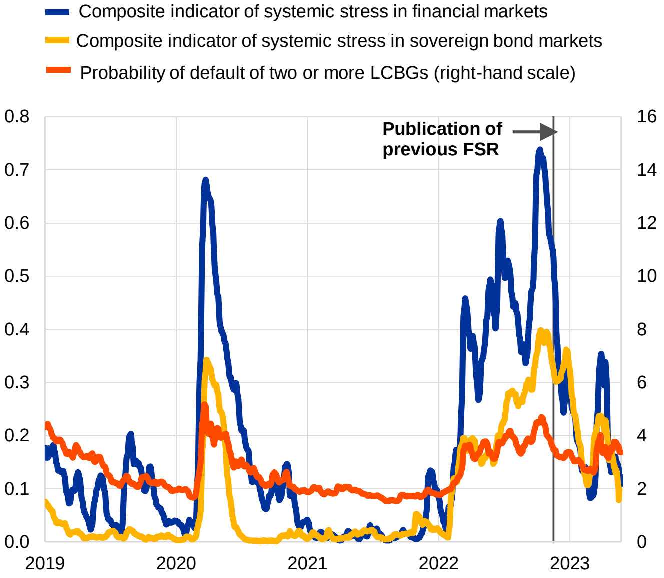
10 January 2022-23 May 2023, percentages



Source: Consensus Economics.

Near-term financial stress indicators for banks, financial markets and sovereigns

2 January 2019-23 May 2023, percentages and probability of default (banks)



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

Key messages of the May 2023 FSR

Euro area financial stability outlook remains fragile

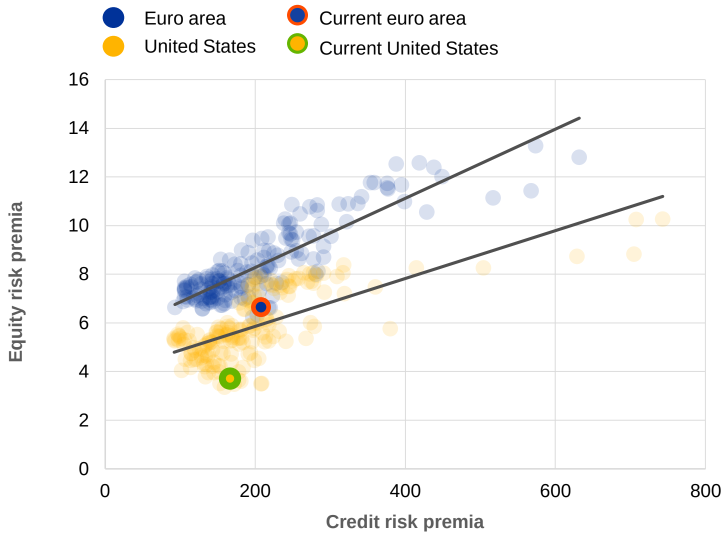
1. High valuations and low market liquidity make markets vulnerable to negative surprises
2. Resilience of corporates, sovereigns and households is being tested by higher interest rates
3. Euro area banks resilient to stress, although liquidity and asset quality concerns are surfacing

Theme 1: High valuations and low market liquidity make markets vulnerable to negative surprises

- Risk premia in financial markets are compressed, both in absolute and relative terms
- Decline in market liquidity leaves financial markets more vulnerable to adverse dynamics

Equity and credit risk premia for the euro area and the United States

3 January 2009-23 May 2023, percentages, basis points

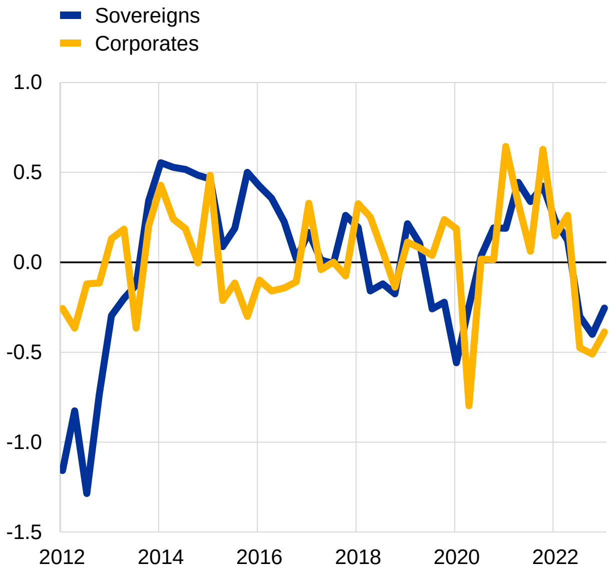


Sources: Bloomberg Finance L.P. and ECB calculations.

Notes: Risk premia calculated as 5-year cyclically adjusted price earnings (CAPE) yield for the EURO STOXX less 5Y real (inflation swap adjusted) German government bond yield; credit risk premia calculated as option-adjusted spread for EUR denominated BBB-rated corporate bonds with residual maturities of 5-7 years.

Composite indicators for euro area bond market liquidity

Q1 2012-Q1 2023, z-scores



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

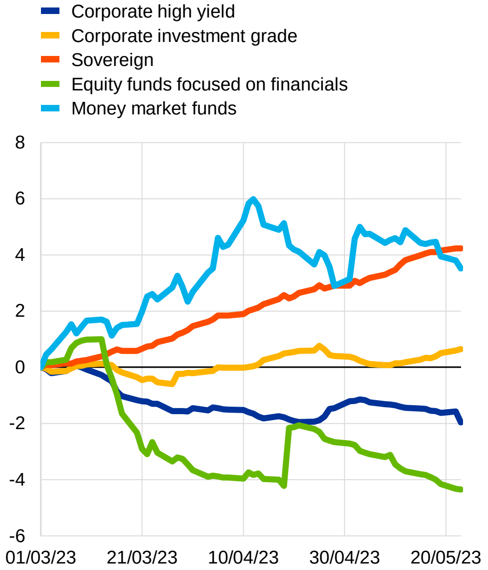
Note: Market liquidity indicators comprise tightness, immediacy, depth, breadth and resilience indicators.

Theme 1: High valuations and low market liquidity make markets vulnerable to negative surprises

- Banking sector stresses and market volatility had limited impact on investment flows, as funds are gradually de-risking
- Low liquid asset holdings remain a source of risk for forced asset sales in adverse market conditions

Cumulative daily euro area money market, bond and equity fund flows

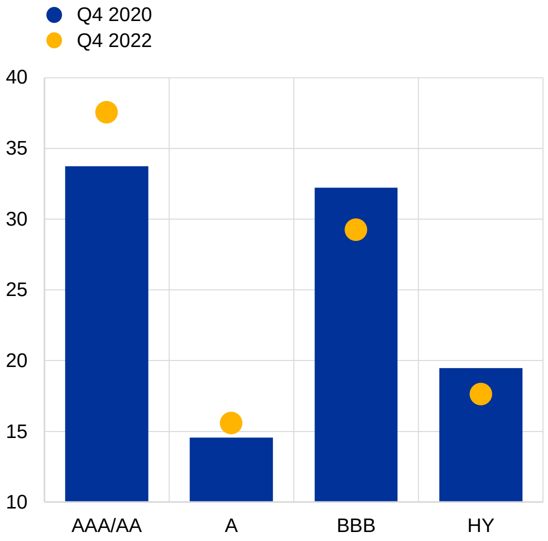
1 March-23 May 2023; percentage of total net assets



Sources: ECB, S&P Global Market Intelligence, European Commission and ECB calculations.

Share of investment funds' bond holdings in total rated bond holdings

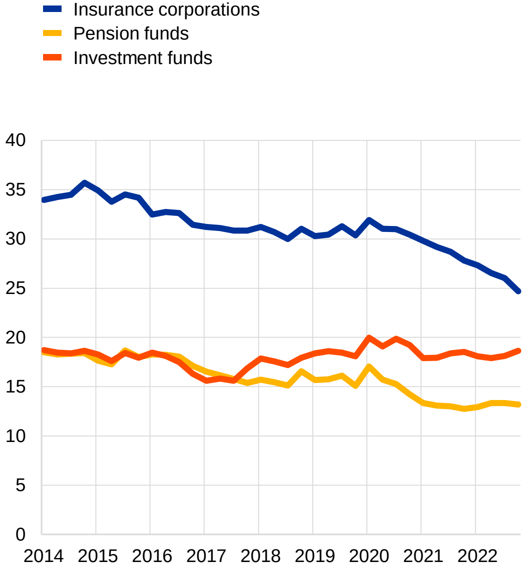
Q4 2020, Q4 2022, percentages



Sources: EPFR Global, ECB and ECB calculations.

Share of high-quality liquid assets in total securities holdings, by sector

Q1 2014-Q4 2022, percentages



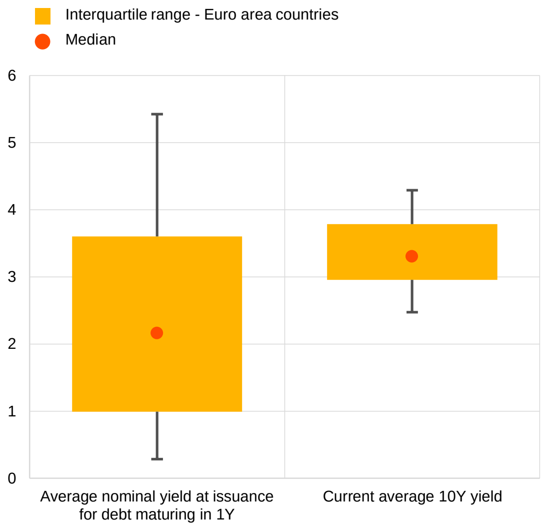
Sources: ECB and ECB calculations.

Theme 2: Resilience of corporates, sovereigns and households is being tested by higher interest rates

- Over time, higher interest rates are likely to put pressure on sovereigns, notably those with high rollover needs
- Rapidly declining interest coverage ratios of firms suggests highly indebted ones are being tested by tightening financial conditions

Sovereign bond yields on debt maturing within one year and current 10-year yield

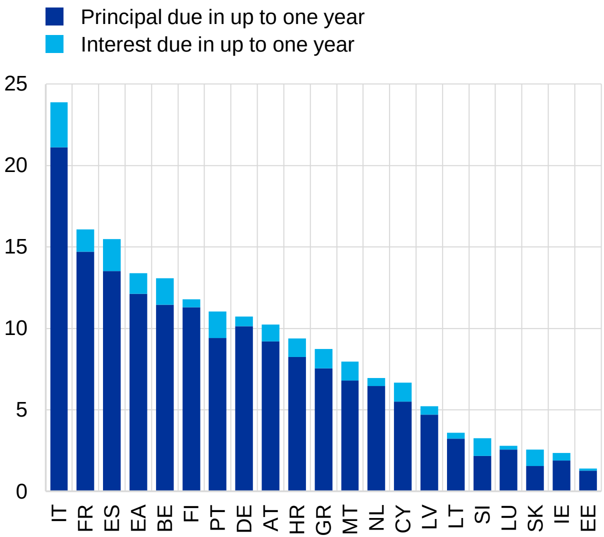
May 2023, percentages



Sources: ECB and ECB calculations.

Gross debt service of government securities due over the next 12 months

April 2023, percentages of GDP

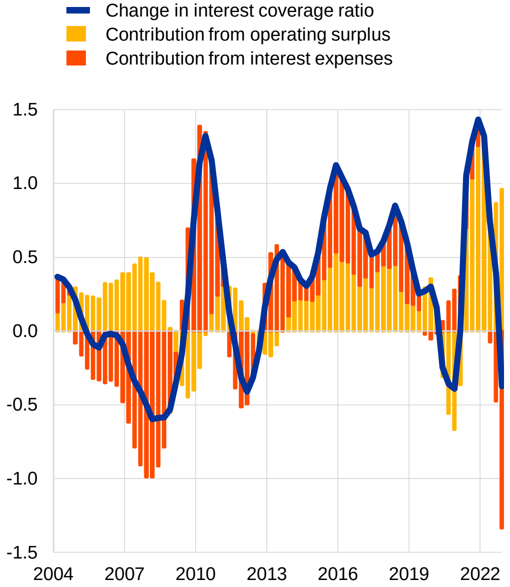


Sources: ECB and ECB calculations.

Note: Sovereign debt servicing needs capture all marketable securities instruments and all original maturities with residual maturity of less than 1 year.

Change in corporate interest coverage ratio and drivers

Q1 2004-Q4 2022, percentage point changes



Sources: ECB and ECB calculations.

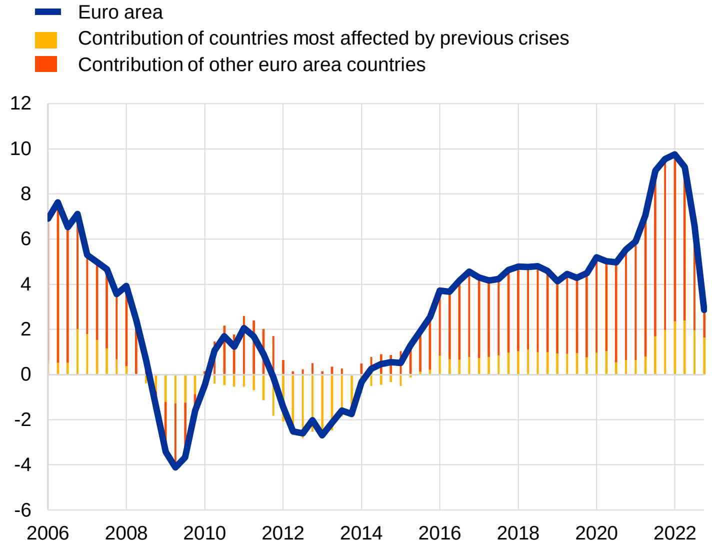
Note: the interest coverage ratio is defined as the ratio of gross operating surplus to gross interest payments before the calculation of FISIM (financial intermediation services indirectly measured).

Theme 2: Resilience of corporates, sovereigns and households is being tested by higher interest rates

- The property market cycle is turning, as higher interest rates are weighing on affordability
- Increasing challenges for commercial real estate, with cyclical factors compounding structural changes in demand

Euro area residential property price growth

Q1 2006-Q4 2022, annual percentage changes

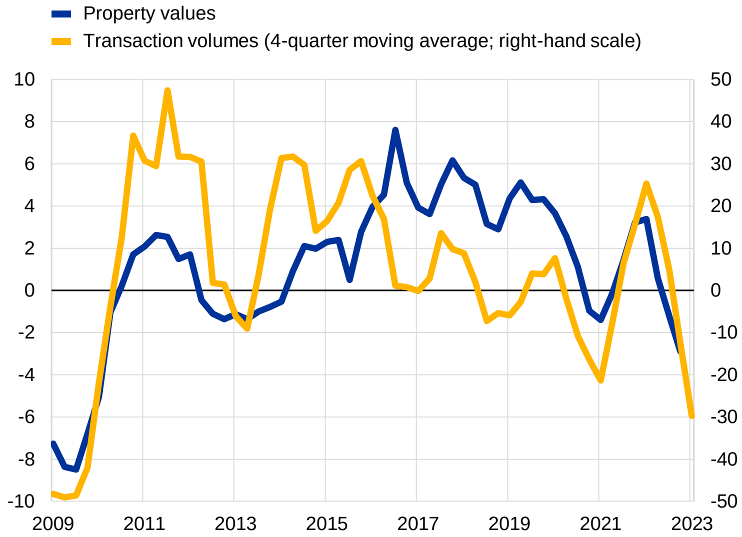


Sources: ECB and ECB calculations.

Note: Previous crises episodes include the global financial crisis and the euro area sovereign debt crisis.

Euro area commercial property values and transaction volumes

Q1 2009-Q1 2023, annual percentage changes



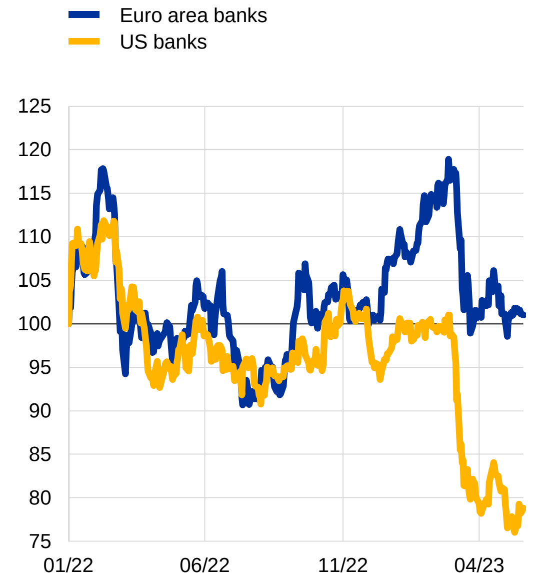
Sources: ECB, RCA and ECB calculations.

Theme 3: Euro area banks resilient to stress, although liquidity and asset quality concerns are surfacing

- Strong fundamentals at the sector level have helped insulate euro area banks from US and Swiss banking sector stresses
- Funding liquidity for euro area banks has, however, been showing signs of deterioration

Euro area and US bank stocks relative to the broad market

3 January 2022-23 May 2023, index, 3 Jan. 2022=100

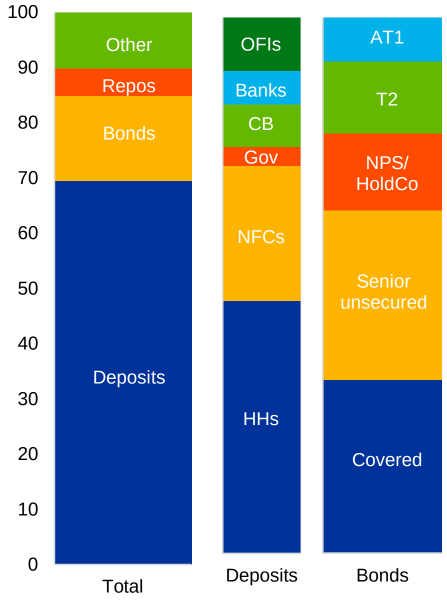


Sources: Bloomberg Finance L.P. and ECB.

Note: Index relative to the broad market. Values above (below) 100 indicate bank stocks outperforming (underperforming) the market.

Aggregate liability structure of euro area significant institutions

Q4 2022, percentages

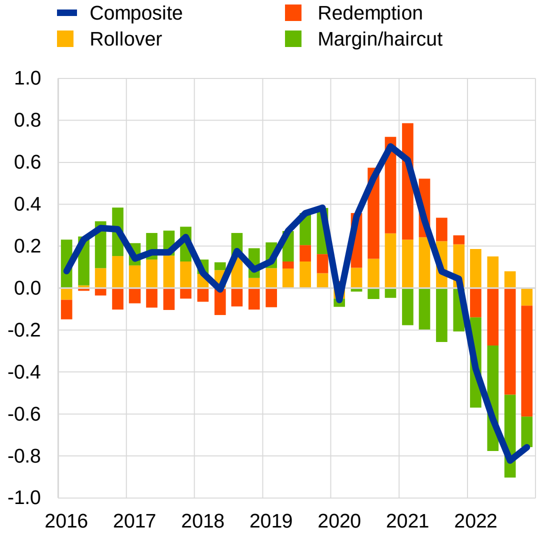


Sources: ECB and ECB calculations.

Note: OFIs – other financial institutions. CB – central banks. Gov. – governments. NFC – non-financial corporations. HHs – households. AT1 – Additional Tier 1 instruments. T2 – Tier 2 securities. NPS/HoldCo – senior non-preferred securities.

Composite funding liquidity index for euro area banks

Q1 2016-Q4 2022; z-scores

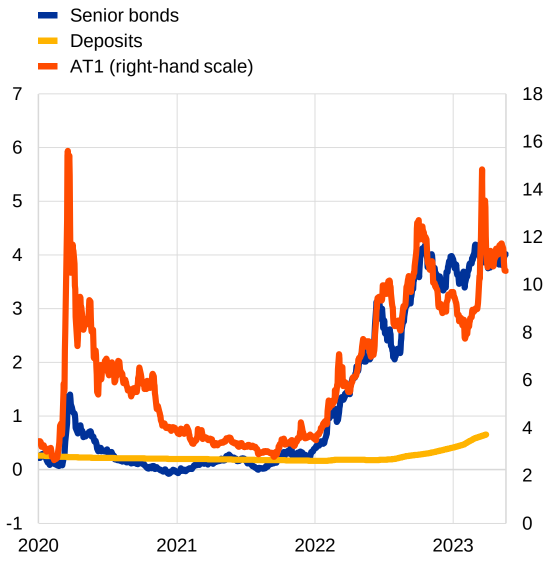


Sources: ECB, Bloomberg Finance L.P. and Refinitiv.

Theme 3: Euro area banks resilient to stress, although liquidity and asset quality concerns are surfacing

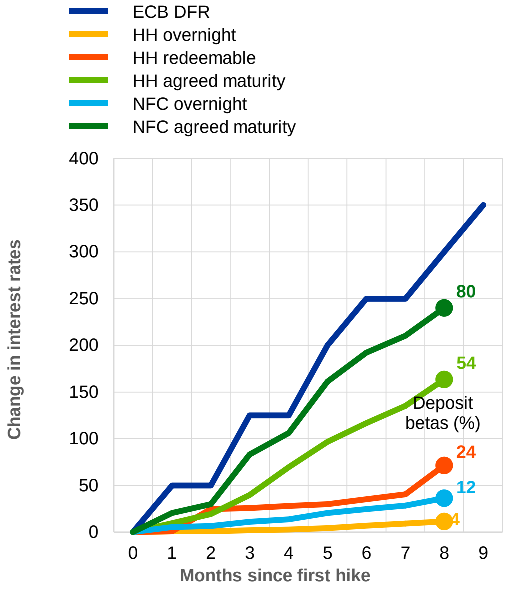
- Higher funding costs will inevitably pass through to the funding instruments of banks
- Incipient signs of deteriorating asset quality may also create challenges going forward

Bank funding costs by type of instrument
2 January 2020-23 May 2023, percentages



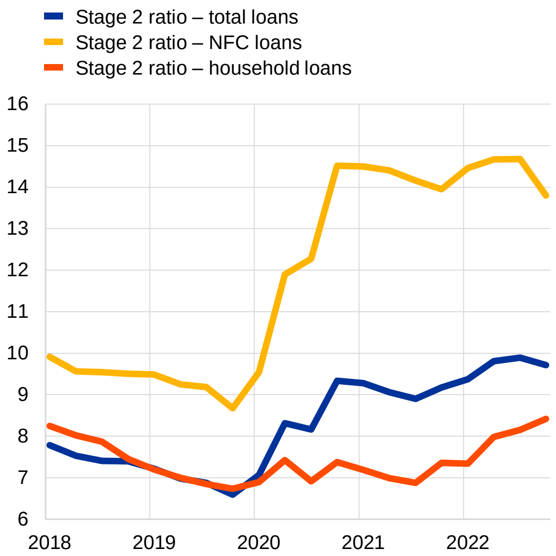
Sources: Refinitiv and ECB calculations.

Pass-through of policy interest rates to household and corporate deposit rates
basis points, deposit betas as percentages of changes in deposit facility rate (DFR)



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

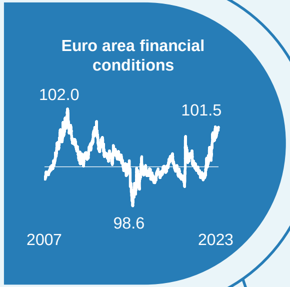
Stage 2 ratios for total loans (with breakdown for firms and households)
Q1 2018-Q4 2022, percentages



Sources: Bloomberg and ECB supervisory data (based on 102 significant institutions).

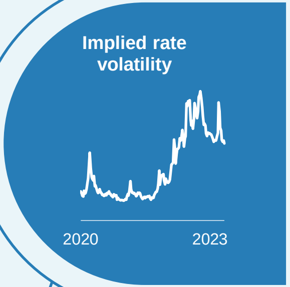
Financial conditions are testing the non-financial sector’s debt servicing ability

- Inflation fuelling tighter financial conditions
- Risk of a disorderly property price correction
- Uneven corporate recovery
- Sovereign funding costs set to increase



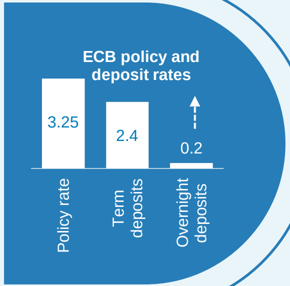
Markets remain vulnerable amid elevated rate volatility

- Sticky inflation may add volatility
- Recession fears re-emerge
- Equity risk premia may widen
- Global risks are rising



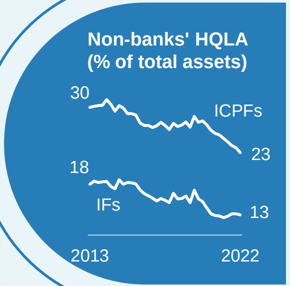
Higher bank funding liquidity and credit risk

- Looming asset quality concerns
- Muted lending activities
- Lingering cost inefficiencies
- Rising cyber risks



Economic uncertainty may raise liquidity and credit risk in non-banks

- Significant holdings of high-risk assets
- Vulnerabilities in real estate exposures
- Liquidity risks from fund outflows
- Inflation may weigh on non-life insurers



Active use of prudential policies in recent years means the euro area banking system is well-placed to withstand shocks.

Targeted macroprudential policy action and completion of the banking union could further enhance resilience.

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

Background slides

Boxes and Special Features

Chapter 1 – Box 1 – Corporate vulnerabilities and the risks of lower growth and higher rates

Box 2 – The role of institutional investors in residential real estate markets

Chapter 2 – Box 3 – Foreign investors' role in euro area sovereign bond markets

Chapter 3 – Box 4 – Euro area bank deposit costs in a rising interest rate environment

Box 5 – Accounting discretion and provisioning behaviour around credit events

Chapter 4 – Box 6 – Credit substitution for corporates: loans vs market-based finance

Chapter 5 – Box 7 – Non-bank financial institutions' liquidity preparedness and leverage

Special Feature A – Market and funding liquidity in the context of monetary policy normalisation

Special Feature B – Key linkages between banks and non-bank financial institutions

Special Feature C – Climate change and sovereign risk (incl. box on climate stress test)