



EUROPEAN CENTRAL BANK

EUROSYSTEM

November 2023 Financial Stability Review

Press briefing

22 November 2023



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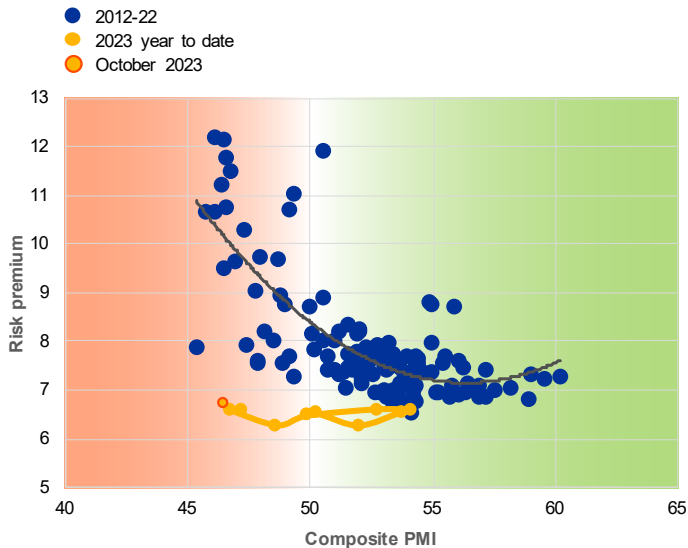
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Asset price valuations are vulnerable to interest rates remaining higher for longer than currently expected and to economic growth disappointments

Risk premia in the euro area equity market and composite PMI

Jan. 2012-Oct. 2023; index, percentages

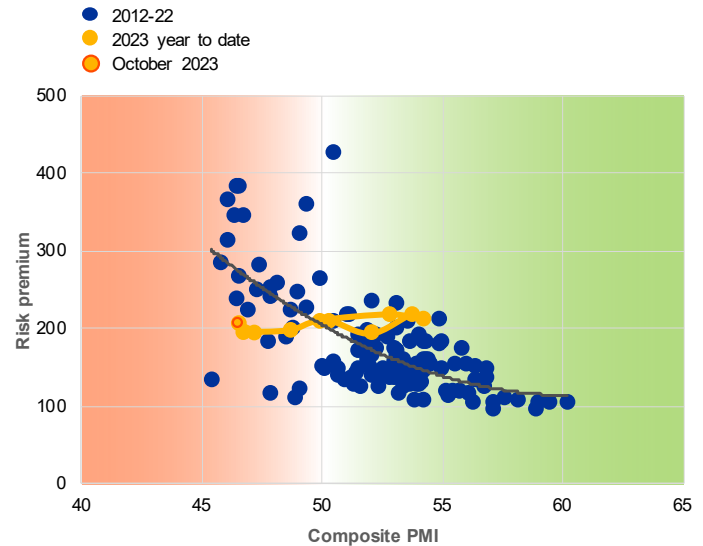


Sources: Bloomberg Finance L.P., S&P Global Market Intelligence, ECB calculations.

Note: Equity risk premia are calculated as the five-year CAPE yield for the EURO STOXX less the five-year real (inflation-swap-adjusted) German government bond yield.

Risk premia in the euro area corporate bond market and composite PMI

Jan. 2012-Oct. 2023; index, basis points



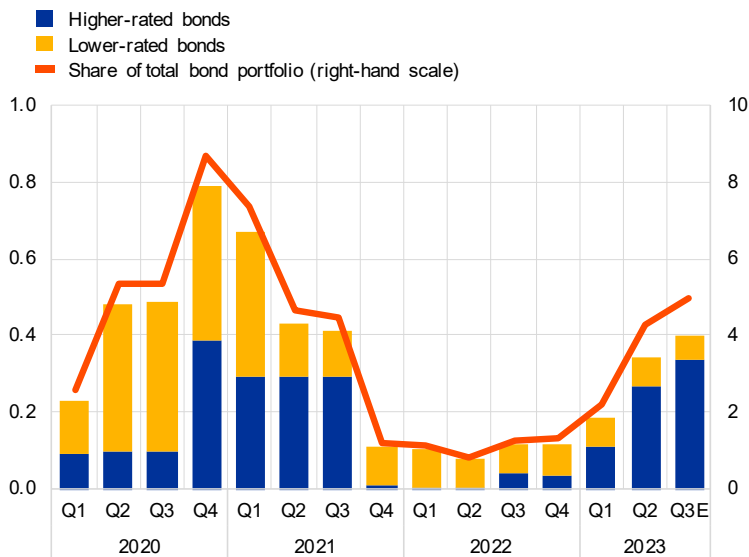
Sources: Bloomberg Finance L.P., S&P Global Market Intelligence, ECB calculations.

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 in investment funds make adverse feedback more likely for some asset classes

Downgrades in euro area NBFI sector bond portfolios

Q1 2020-Q3 2023E; left-hand scale: € trillions, right-hand scale: percentages



Sources: ECB and ECB calculations.

Note: Values for Q3 2023 are estimated by applying observed rating and outlook actions in Q3 on the latest available holdings data referring to Q2 2023. Higher-rated bonds are defined as those with a worst issuer rating of AA- or higher.

- Non-banks continue to face high credit risks, despite some rebalancing of their investment portfolios towards safer assets
- Low liquid asset holdings could expose investment funds to the potential risk of forced asset sales if macro-financial outcomes deteriorate

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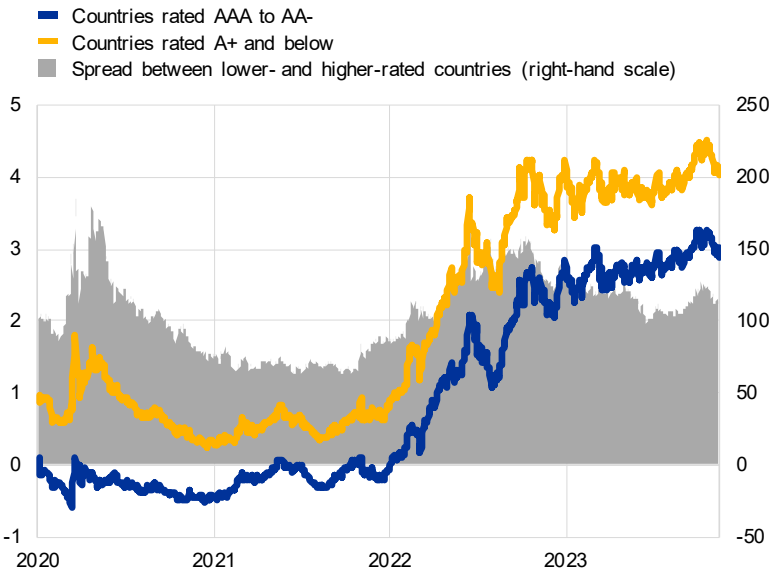
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Nascent signs that euro area sovereign bond market resilience is being tested by higher interest rates

10-year government bond yields by rating bucket

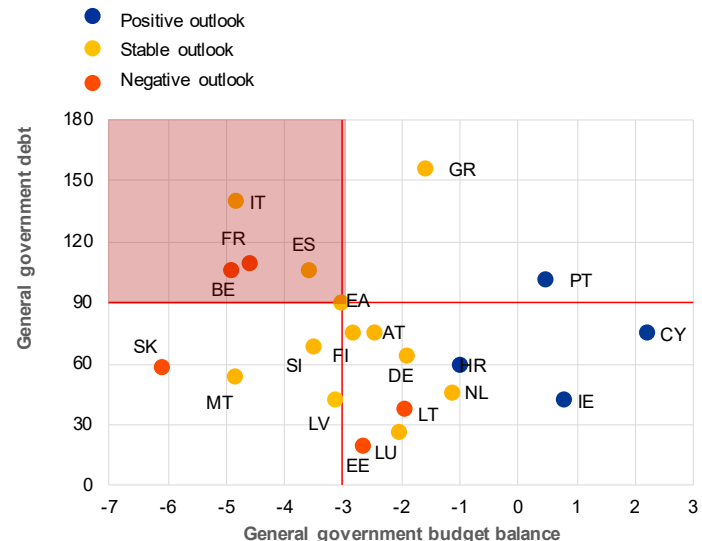
1 Jan. 2020-14 Nov. 2023; left-hand scale: percentages, right-hand scale: basis points



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

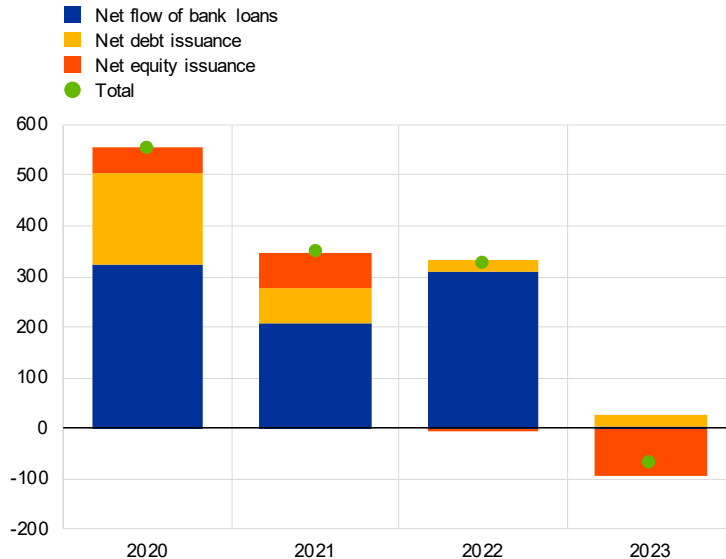


Sources: Bloomberg Finance L.P., European Commission (AMECO). Note: The vertical and horizontal red lines indicate the Maastricht deficit criterion 3% of GDP and the 90% sovereign debt-to-GDP threshold based on findings in the empirical literature, respectively. The chart has been updated to take into account rating actions after the cut-off date of the FSR on 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

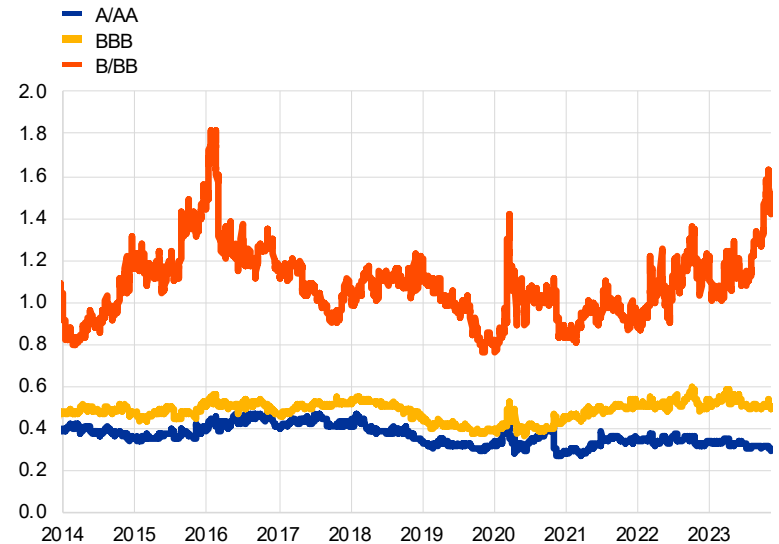


Source: ECB (Balance Sheet Items, Securities Issues Statistics).

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

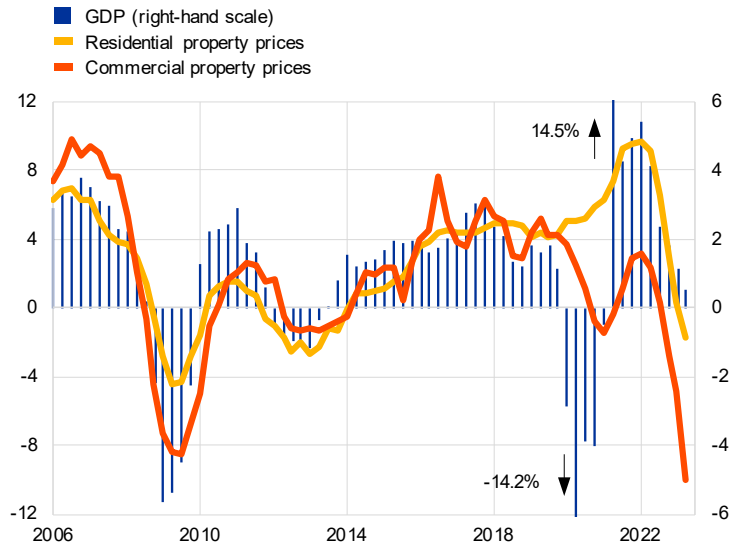


Sources: Moody's Analytics, Intercontinental Exchange and ECB calculations.

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

Real GDP growth, and residential and commercial real estate prices

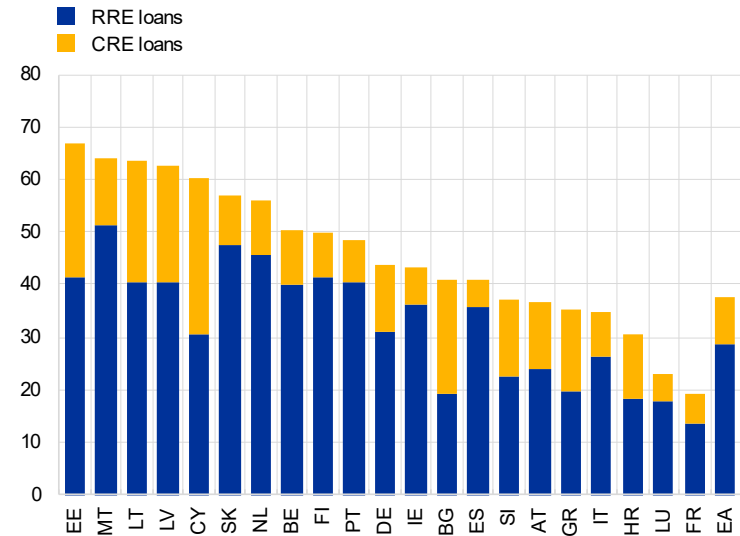
Q1 2006-Q2 2023, annual percentage changes



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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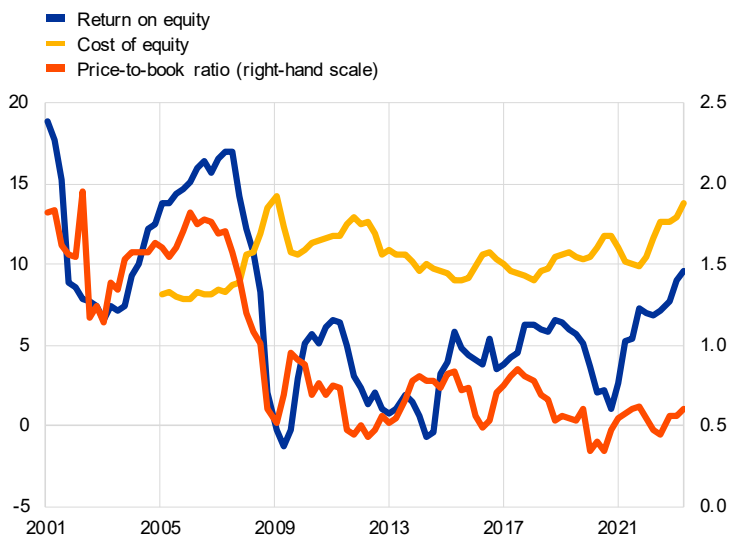
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Strengthened net interest income pushes bank profitability to multi-year highs, with greatest margin expansion seen for corporate lending

Return on equity, cost of equity and price-to-book ratios for euro area banks

Q1 2001-Q2 2023, percentages

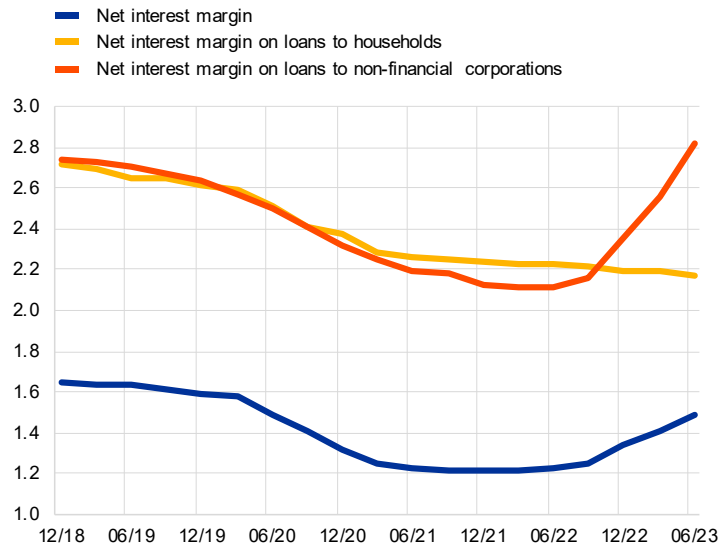


Sources: Bloomberg Finance L.P., ECB (supervisory data) and ECB calculations.

Note: Return on equity and price-to-book ratio are based on a balanced sample of 19 euro area banks.

Euro area banks' net interest margin for lending to households and non-financial corporations

Q4 2018-Q2 2023, percentages

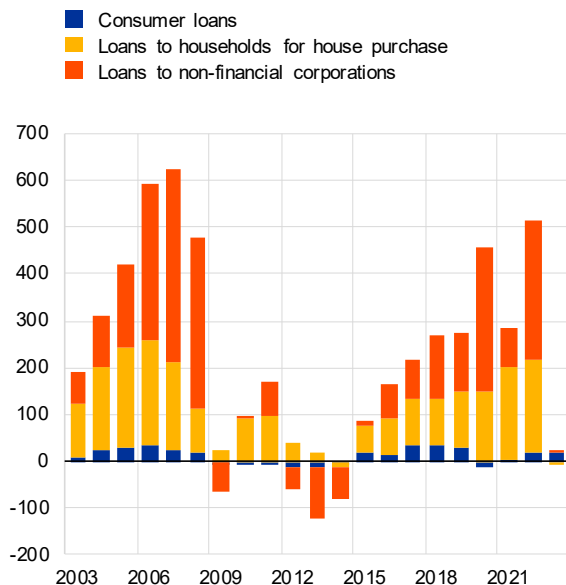


Source: ECB (supervisory data).

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

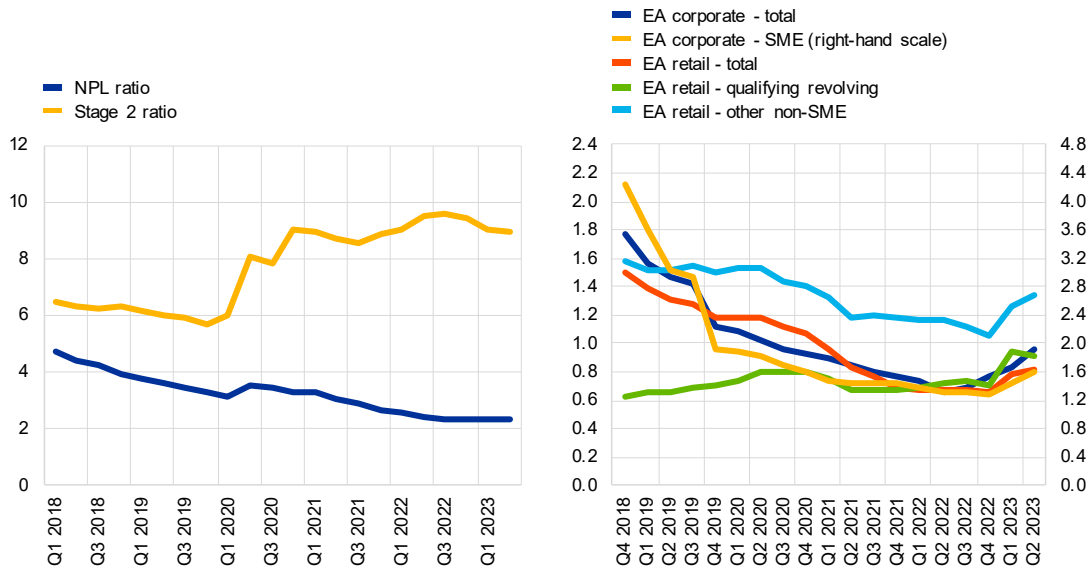
2003-23, € billions



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

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

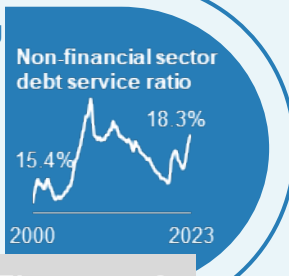
left graph: Q1 2018-Q2 2023, percentages; right graph: Q4 2018-Q2 2023, percentages



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.

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 2



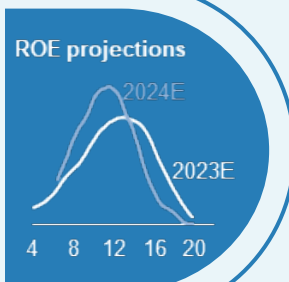
Theme 1

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

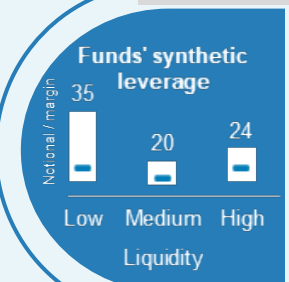
- Markets see high risk of elevated inflation
- Refinancing risk rises for weaker borrowers
- Slower growth may make risk premia widen
- “AI rally” raises overvaluation concerns

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



Theme 3



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.