EUROPEAN CENTRAL BANK

EUROSYSTEM

Financial Stability Review

November 2019

Press briefing

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Structure and contents	
Overview	Infographic and main messages
5 chapters	➢ Macro-financial environment ➢ Financial markets ➢ Banking sector ➢ Non-banks ➢ Macroprudential policy implications **NEW!**
8 boxes	Including on bond valuations, bank misconduct costs, climate risk-related disclosures and fund portfolio rebalancing
2 special features	➢ Euro area bank profitability: where can consolidation help? ➢ Assessing the systemic footprint of euro area banks

Signs of asset mispricing suggest potential for future corrections

- Very low yield environment
- Robust risk appetite
- Valuations contingent on low yields
- Safe-haven asset inflation

Yield curve

75%

of significant banks have return on equity of below 8%

Growing challenges from cyclical headwinds to bank profitability

- Eroding interest margins
- Slightly rising cost of credit risk
- High cost inefficiencies
- Plateauing capital positions

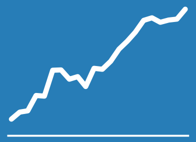
Lingering private and public debt sustainability concerns

- Weaker growth prospects
- Releveraging of high-yield firms
- Rising property prices
- Low interest payment burdens

45%

of all rated market-based corporate debt is rated BBB

Non-liquid assets



Increased risk-taking by non-banks may pose risks to capital market financing

- Profitability and solvency challenges
- Higher credit and duration risk
- Pockets of illiquidity
- Growing real economy financing

The financial stability environment remains challenging…

…but euro area banks are adequately capitalised, with a 14.2% CET1 ratio.

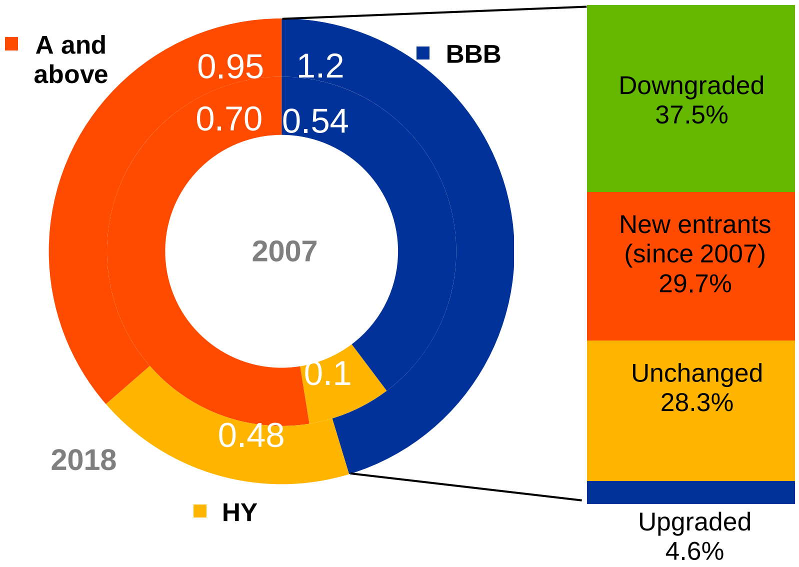
All euro area countries have activated macroprudential measures…

…even so, more active use of macroprudential policies could be appropriate to contain vulnerabilities.

- Pronounced systemic vulnerability
- Moderate systemic vulnerability
- Potential systemic vulnerability

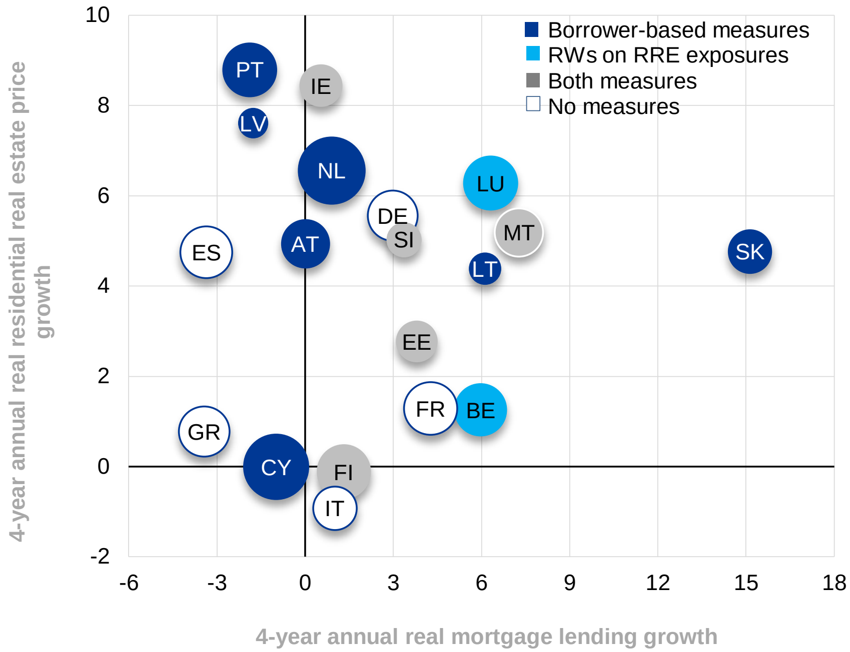
Private debt: pockets of vulnerability in non-financial corporations; exuberant real estate markets in some countries

Outstanding euro area corporate debt by issuer rating and changes since 2007
(2007, 2018, € trillions, percentages)



Sources: S&P Global Market Intelligence and ECB calculations.
Note: HY: high-yield.

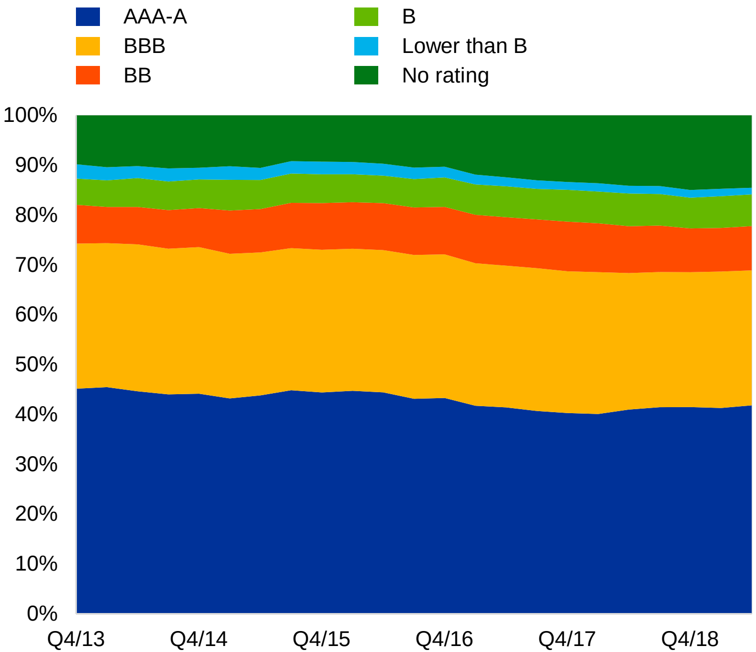
Real residential property price and mortgage lending growth in the euro area
(Q3 2015-Q2 2019, 4-year annual percentage change)



Sources: ECB and ECB calculations. Note: RWs: risk weights.

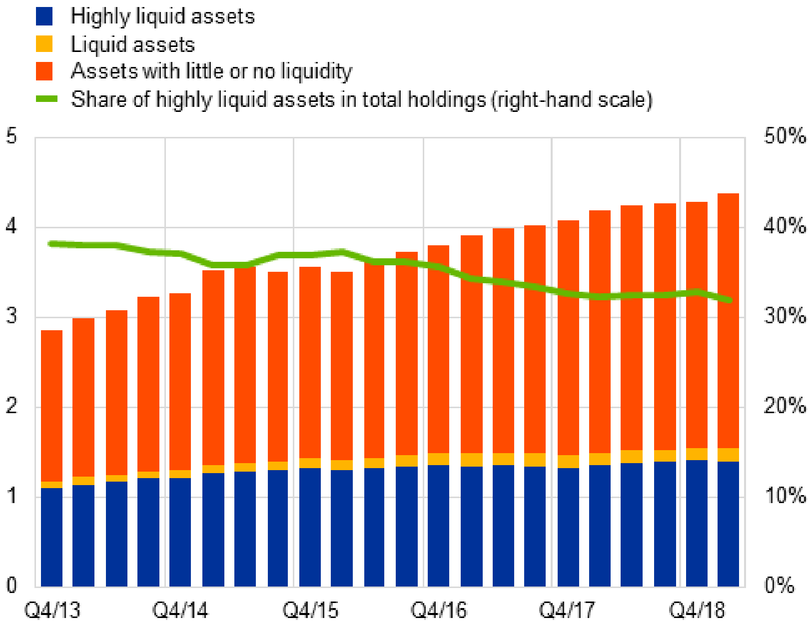
Non-banks: increased exposure to riskier assets

Breakdown of debt securities held by euro area investment funds by credit rating
(Q4 2013-Q2 2019, share of total debt securities holdings)



Source: ECB Securities Holdings Statistics by Sector (SHSS).

Breakdown of debt securities held by euro area investment funds by liquidity bucket
(Q4 2013-Q2 2019, € trillions)



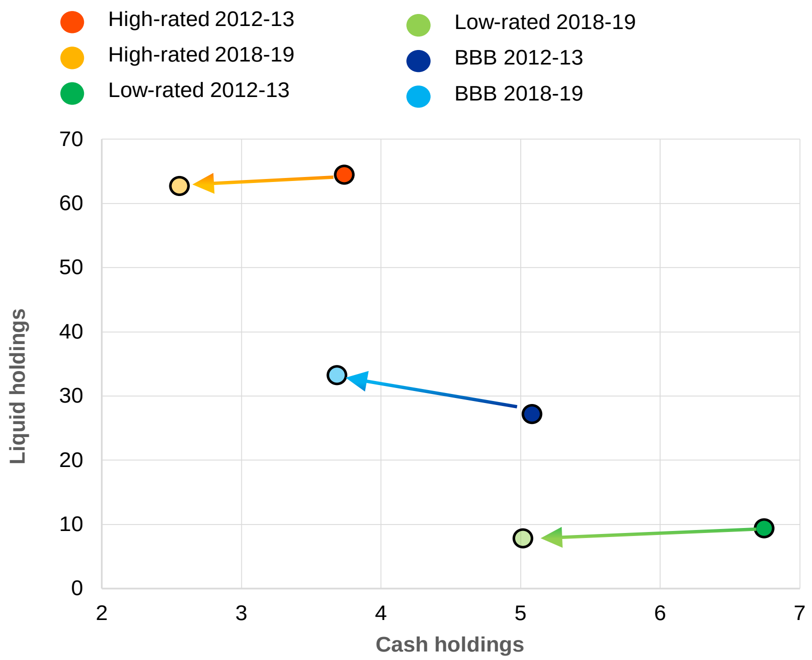
Source: ECB SHSS.

Non-banks: higher credit and liquidity risks for investment funds

Search for yield in investment funds

- Strong inflows into bond and money market funds globally have continued
- Riskier holdings
- Increased liquidity mismatch
  - Stress episodes in UCITS funds illustrating risk of large-scale outflows
- Leverage can add to procyclical investor behaviour and accelerate outflows

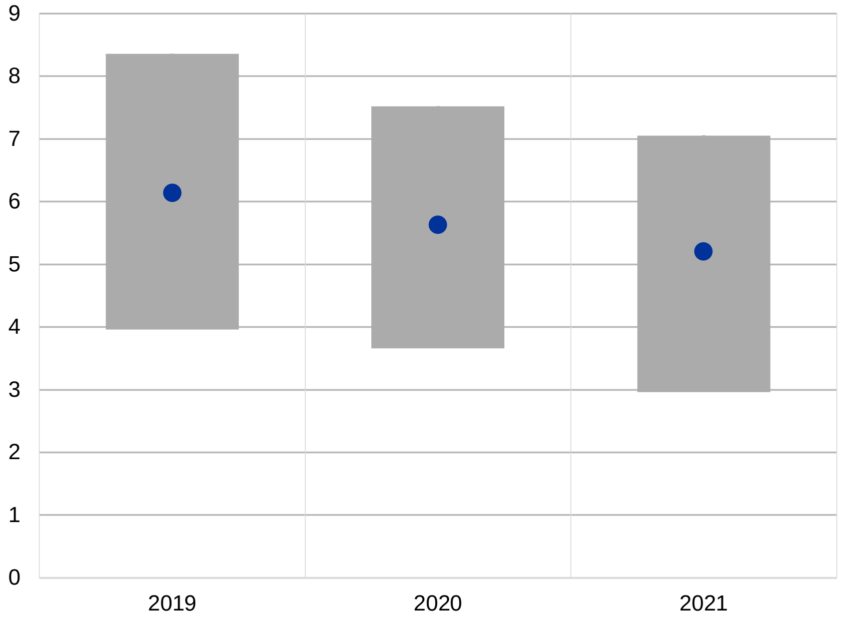
Cash and liquid holdings for all types of bond funds by credit risk profile
(percentage of total assets)



Sources: Refinitiv and ECB Centralised Securities Database.

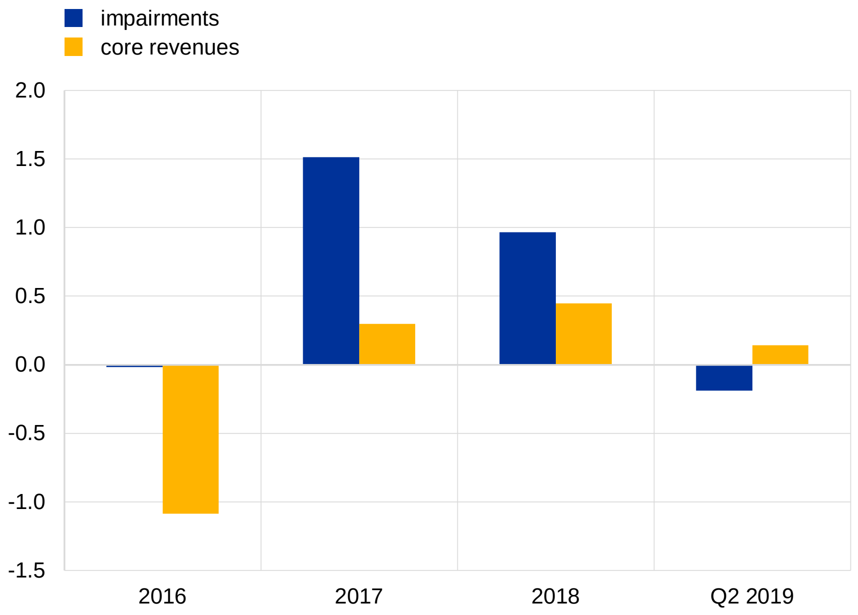
Banks: profitability expected to remain weak

ECB forecasts for banks' return on equity in 2019-21 under the baseline scenario
(percentages, weighted average, interquartile range)



Sources: Individual institutions' financial reports, European Banking Authority, ECB and ECB calculations.

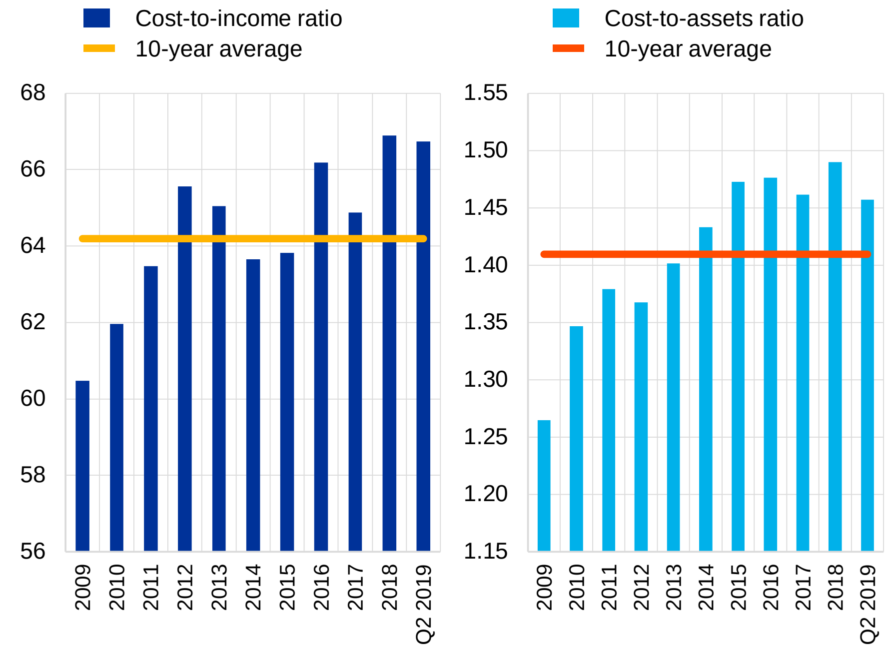
Contribution of core revenues and impairments to changes in euro area banks' return on equity
(percentage points)



Sources: ECB supervisory statistics and ECB calculations.

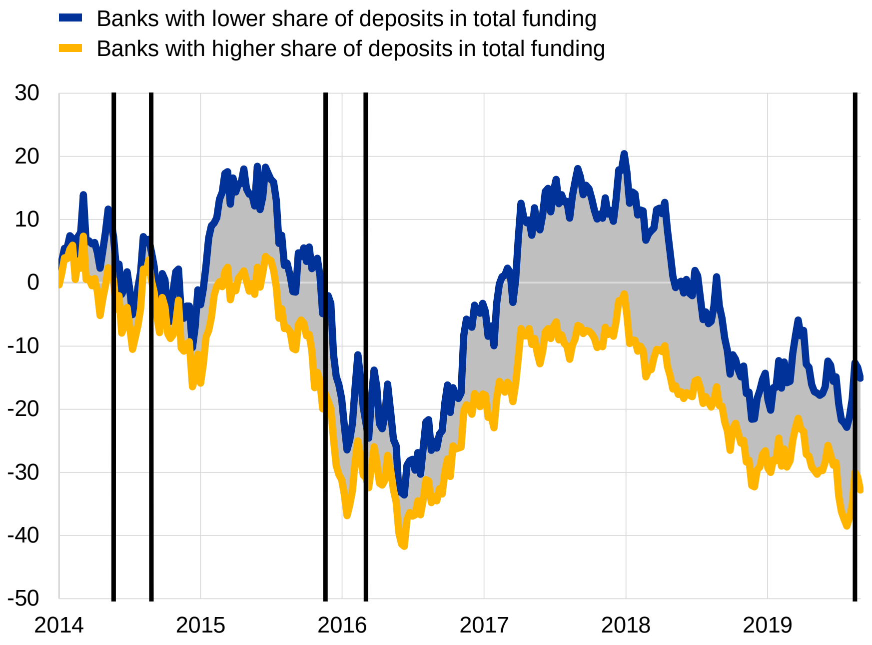
Banks: structural cost issues persist

Euro area banks' aggregate cost-to-income and cost-to-assets ratios
(2009-Q2 2019, percentages)



Source: ECB consolidated banking statistics.

Banks' stock returns by bank funding structure
(percentages)

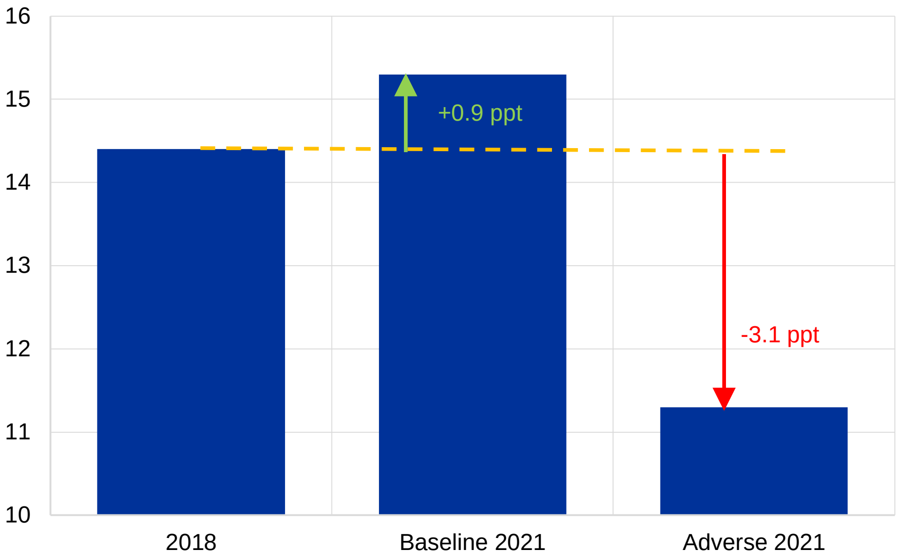


Source: Bloomberg.

Banks: solvency solid even under adverse scenario

- Under baseline case, euro area banks are able to build up capital ratios (meeting new regulatory requirements)
- Adverse scenario is a tail event consistent with main risks materialising over next two years including:
  - Deterioration of global macro conditions
  - Fall in euro area GDP (by ca. 1.7% in 2021) and corporate earnings, rise in unemployment (to 10% in 2021)
  - Steepening of yield curve (long rates rise)

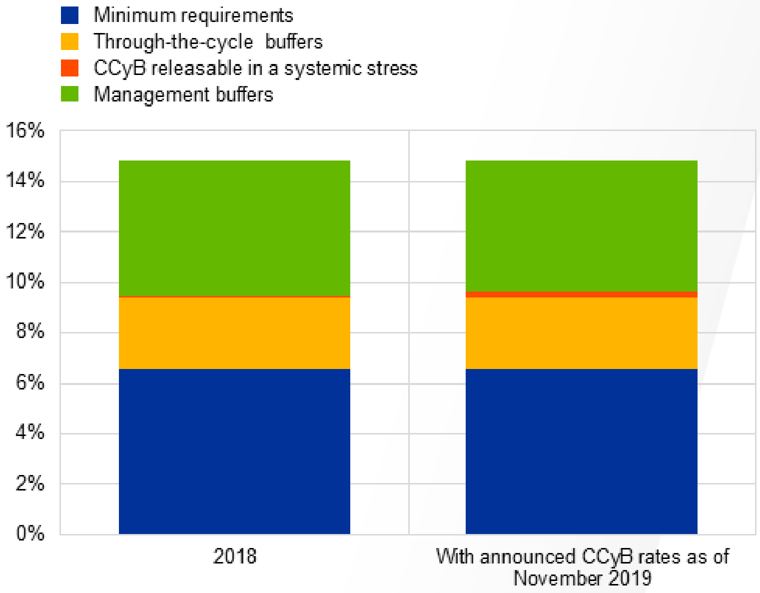
Capital ratio change under the baseline and adverse scenarios
(Common Equity Tier 1 ratio, percentages)



Source: ECB calculations.

Macroprudential policy implications

The CCyB is still only a tiny fraction of euro area banks' capital requirements



Sources: ECB, Eurostat and ECB calculations.

Note: CCyB: countercyclical capital buffer.

- While the overall level of capital is considered appropriate, a higher CCyB may be merited in a few countries
- A higher share of releasable buffers within overall capital requirements would strengthen macroprudential policy support in a downturn
- Further measures could counter risks from RRE and CRE markets in some countries
- Unintentional barriers to banking sector consolidation should be examined
- Need for faster progress on macroprudential tools for non-banks
- Climate risk monitoring requires better disclosures