EUROPEAN CENTRAL BANK

EUROSYSTEM

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ECB Financial Stability Review

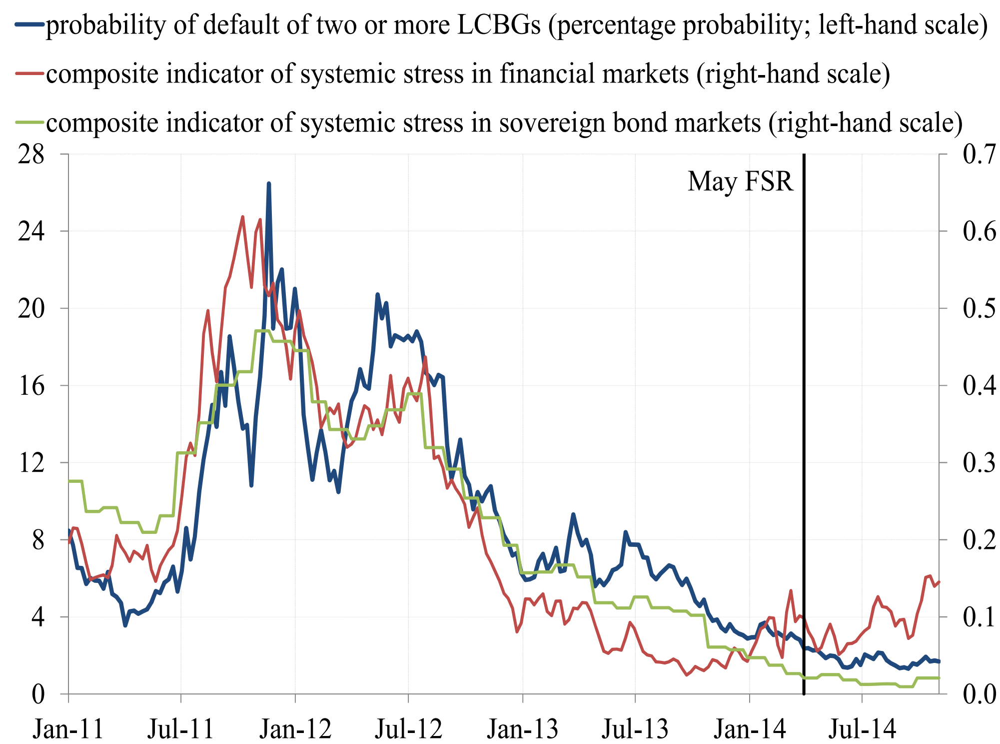
November 2014

27 November 2014

Press briefing presentation

- **Euro area systemic stress has remained at low levels …** despite intermittent financial market turbulence
  - ➢ Indicators of stress among euro area banks and sovereigns remain at low levels
  - ➢ Systemic stress across the broader financial system also contained

Measures of financial market, banking sector and sovereign stress in the euro area
(Jan. 2011 – 14 Nov. 2014)



Sources: Bloomberg and ECB calculations.

Notes: (i) “Probability of default of two or more LCBGs” refers to the probability of simultaneous defaults in sample of 15 large and complex banking groups (LCBGs) over a one-year horizon. (ii) For further details on the CISS methodology, see Hollo, D., Kremer, M. and Lo Duca, M., “CISS – a composite indicator of systemic stress in the financial system”, Working Paper Series, No 1426, ECB, March 2012.

Main risks and vulnerabilities

Table 1 Key risks to euro area financial stability

	Current level (colour) and recent change (arrow)*
1. Abrupt reversal of the global search for yield, amplified by pockets of illiquidity, with signs of a growing use of leverage in the non-bank financial sector	⇨
2. Persistent weak bank profitability in a weak, fragile and uneven macroeconomic recovery	⇨
3. Re-emergence of sovereign debt sustainability concerns, amid low nominal growth and wavering policy determination for fiscal and structural reforms	⇧

pronounced systemic risk

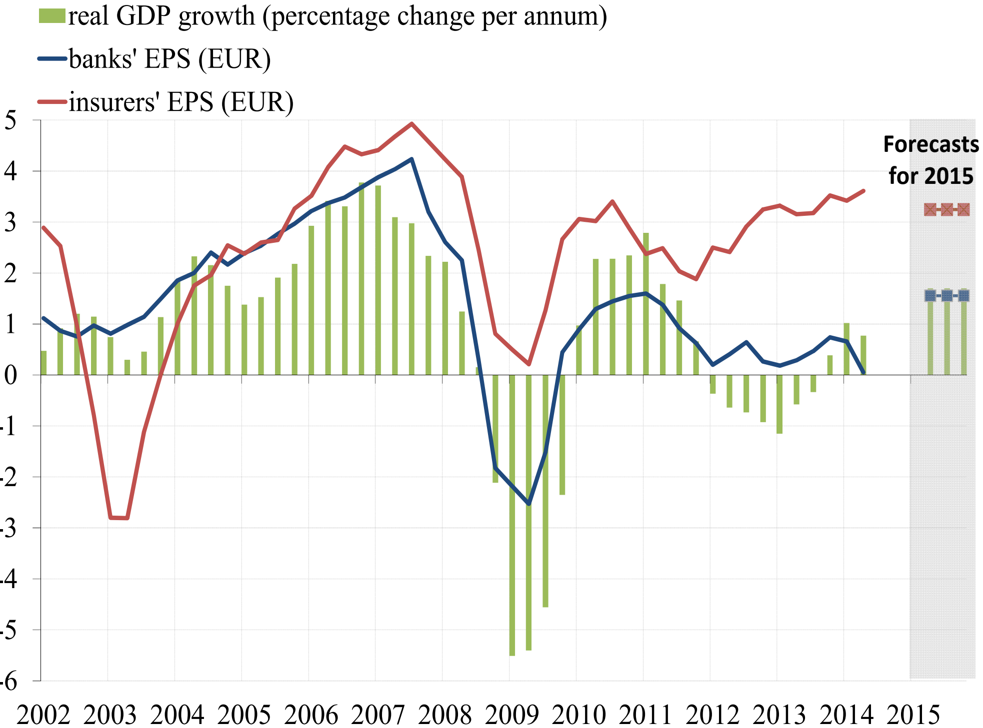
medium-level systemic risk

potential systemic risk

*The colour indicates the current level of the risk which is a combination of the probability of materialisation and an estimate of the likely systemic impact of the identified risk over the next year and a half, based on the judgement of the ECB's staff. The arrows indicate whether this risk has intensified since the previous FSR.

- **Economic growth outlook is underlying all key risks:**
  - Significant uncertainty surrounding the weak, fragile and uneven economic recovery and the current period of very low inflation
  - Has the potential to aggravate and trigger the existing vulnerabilities if the current situation continues for longer than expected or conditions deteriorate further

Annualised earnings per share (EPS) for selected large euro area financial institutions and real GDP growth in the euro area
(Q1 2002 – 2015)



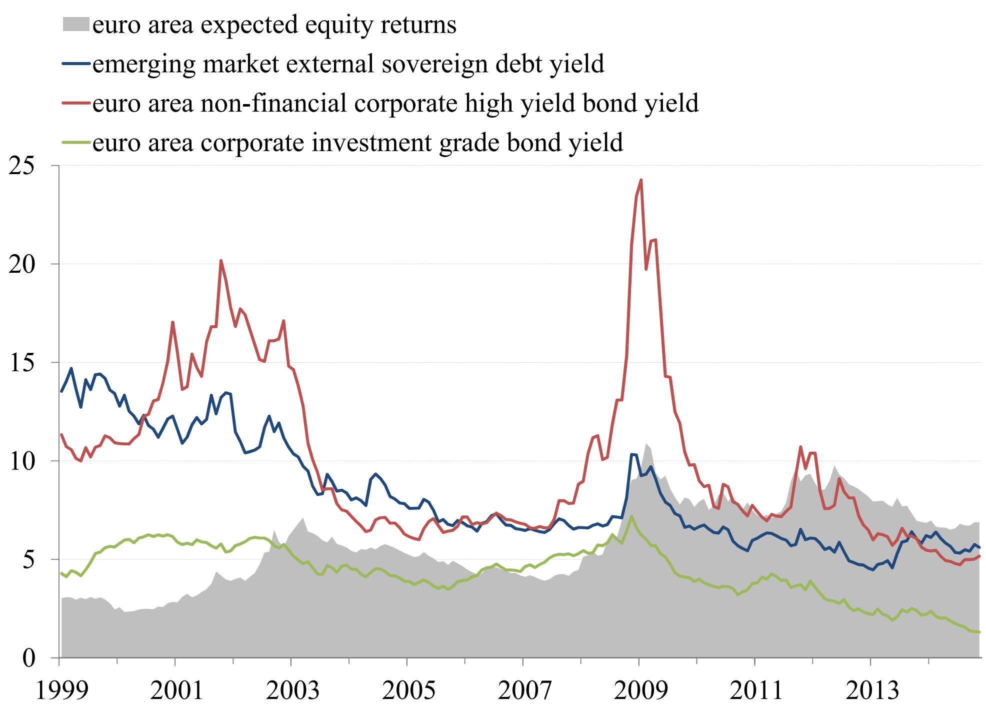
Sources: ECB, European Commission, Thomson Reuters Datastream and ECB calculations.

Notes: ECB forecasts for real GDP growth and analyst estimates for earnings per share.

Risk 1 - Abrupt reversal of the global search for yield, amplified by pockets of illiquidity, with signs of a growing use of leverage in the non-bank financial sector

A search for yield has continued across global financial markets…

Selected bond yields and expected euro area equity returns
(Jan. 1999 – Oct. 2014; percentages)

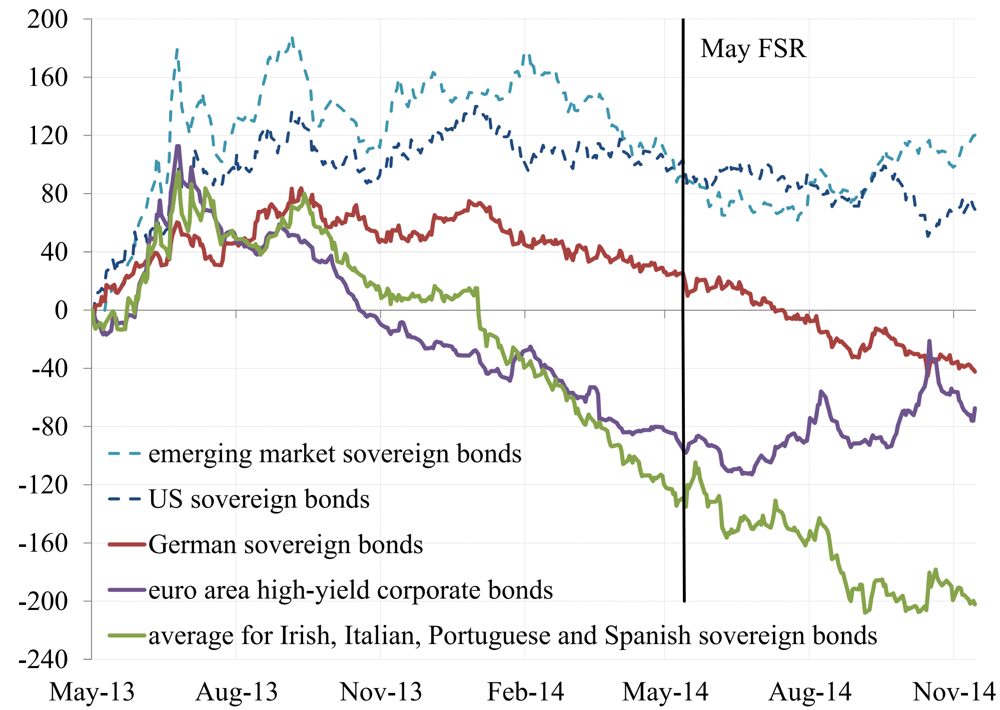


Sources: Bloomberg, Bank of America/Merrill Lynch indices, R. Shiller, (Yale University), ECB and ECB calculations.

Note: The euro area expected equity return is the inverted Shiller cyclically-adjusted price/earnings ratio.

…albeit with some rebalancing out of high-yield corporates and emerging markets over last ½ year

Cumulative changes in bond yields since May 2013
(2 May 2013 – 14 Nov. 2014; cumulative change in basis points; ten-year sovereign bond yields)

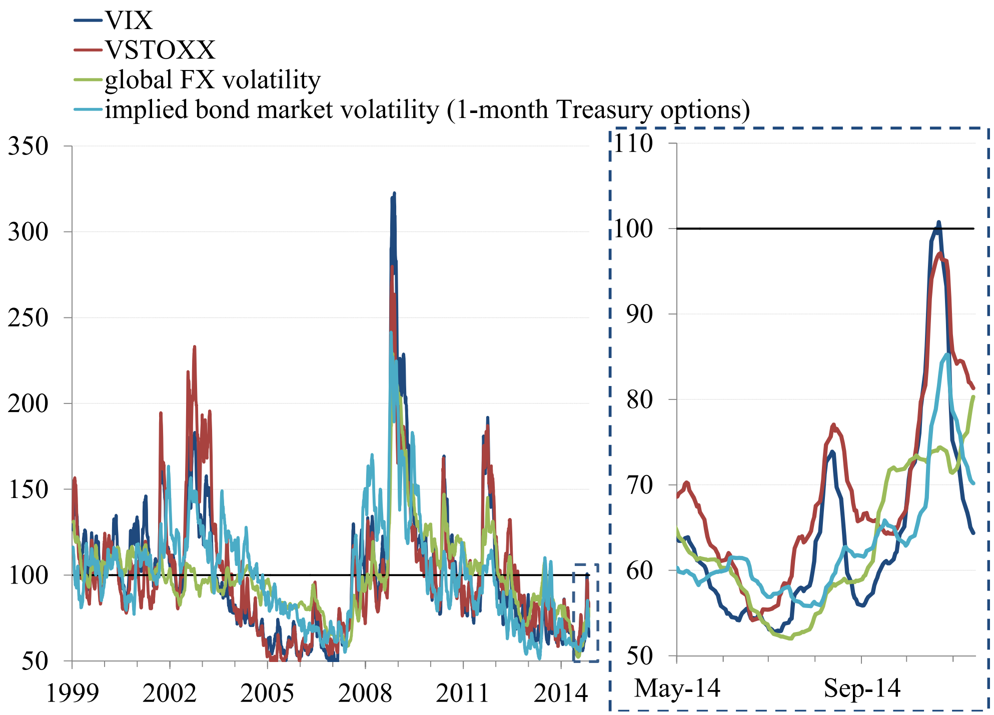


Sources: Bloomberg and JP Morgan Chase & Co.

Risk 1 - Abrupt reversal of the global search for yield, amplified by pockets of illiquidity, with signs of a growing use of leverage in the non-bank financial sector

Increased financial market volatility in recent months highlight investor uncertainty regarding valuations

Implied market volatilities
(Jan. 1999 – 14 Nov. 2014; ten-day moving average; index: average since 1999 = 100)

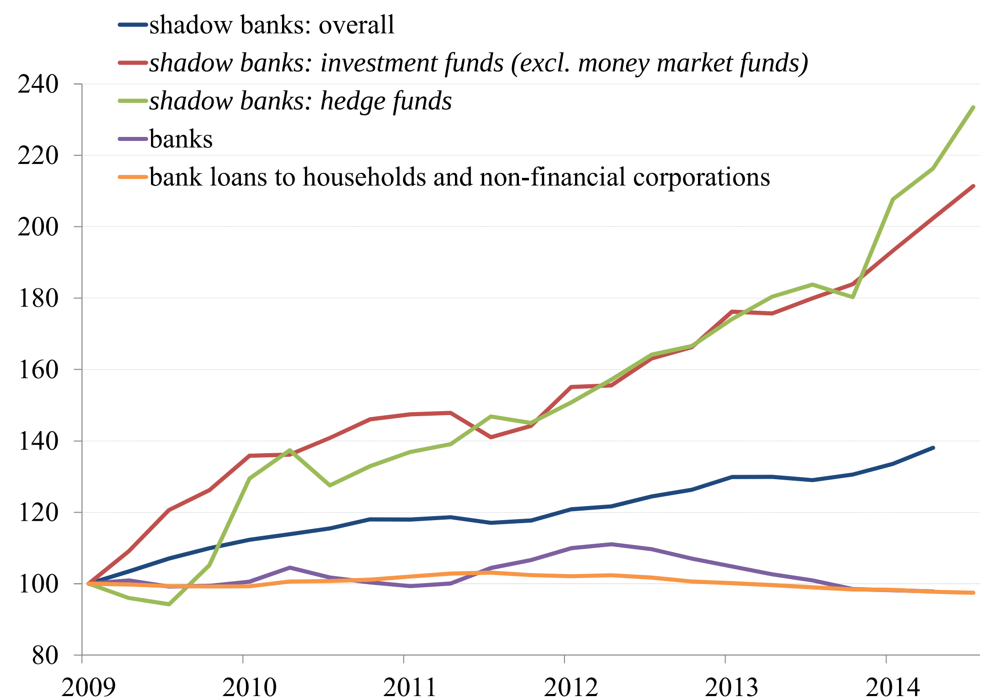


Source: Bloomberg.

Steady increase in the euro shadow banking sector suggests that vulnerabilities are likely to have been growing more in this segment

Assets of selected euro area financial sectors

(Q1 2009 – Q3 2014; index: Q1 2009 = 100)



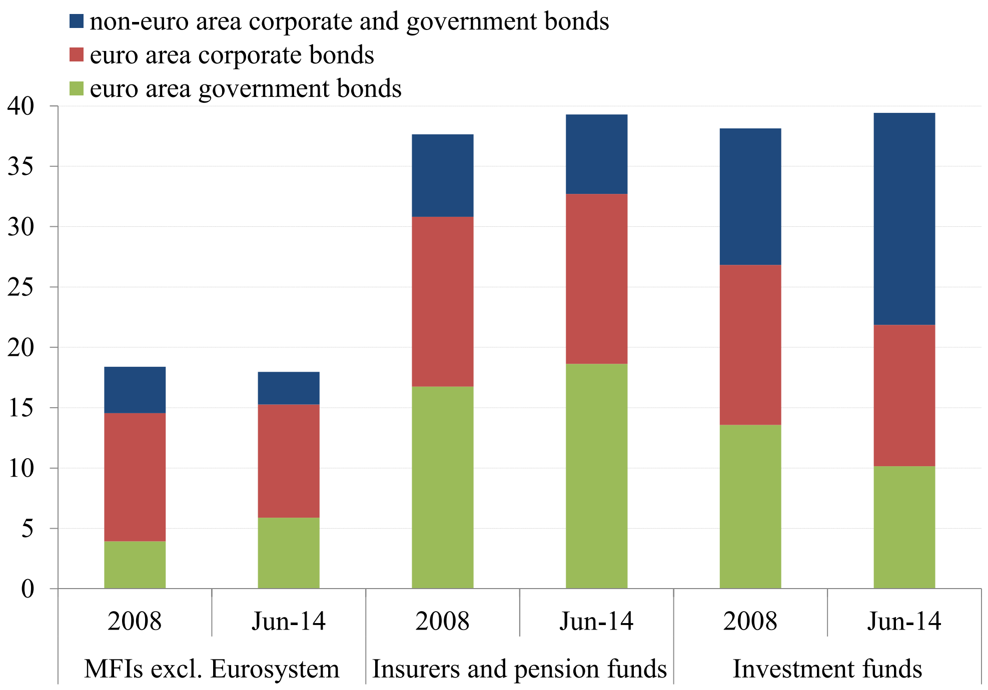
Sources: ECB and ECB calculations.

Risk 1 - Abrupt reversal of the global search for yield, amplified by pockets of illiquidity, with signs of a growing use of leverage in the non-bank financial sector

Direct exposure to debt markets for institutional investors…

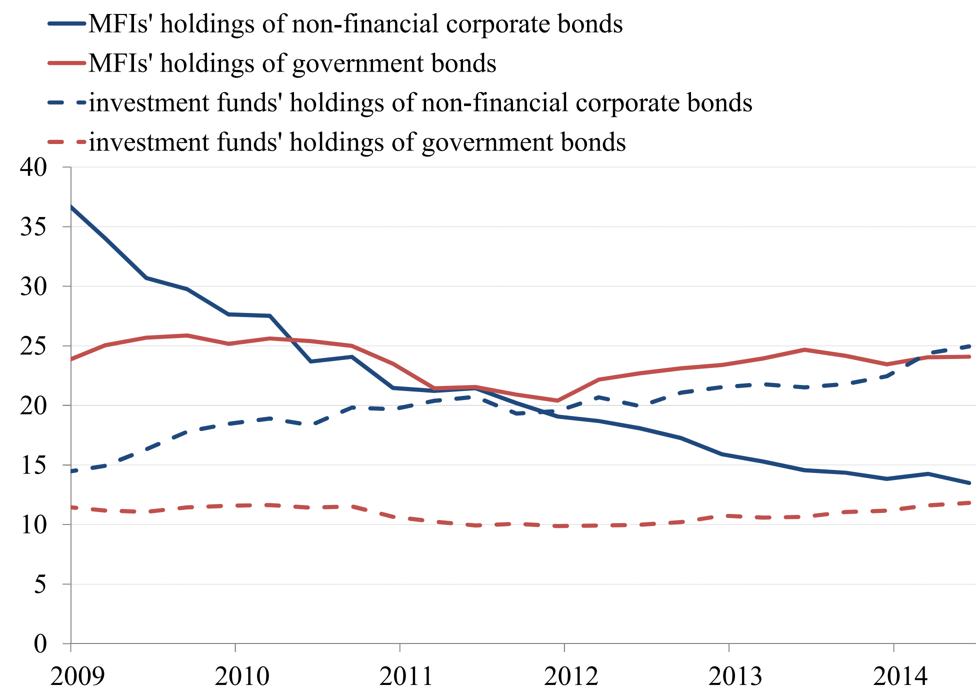
… and less on banks

Bond holdings of euro area MFIs, insurers and pension funds and investment funds
(percentage of total assets)



Source: ECB.

Share of euro area bonds held by euro area MFIs and investment funds
(Q1 2009 – Q2 2014; percentage of total bonds outstanding)

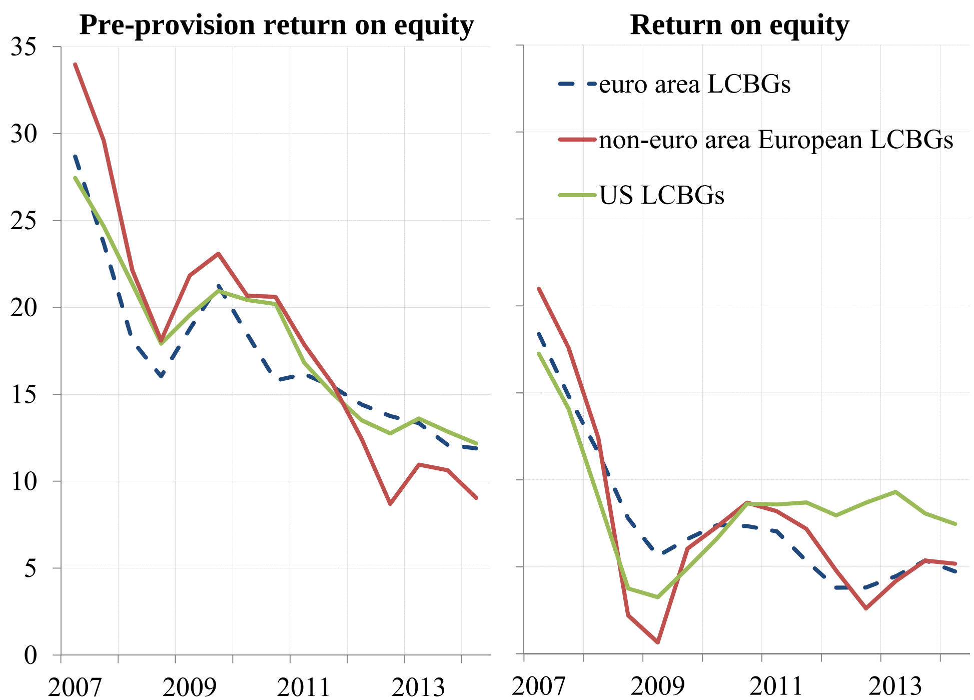


Source: ECB.

Risk 2 - Persistent weak bank profitability in a weak, fragile and uneven macroeconomic recovery

Continued weak bank profitability – not only for euro area banks – amid cyclical headwinds…

Pre- and post-provision return on equity of euro area and global large and complex banking groups
(H1 2007 – H1 2014; percentages; medians)

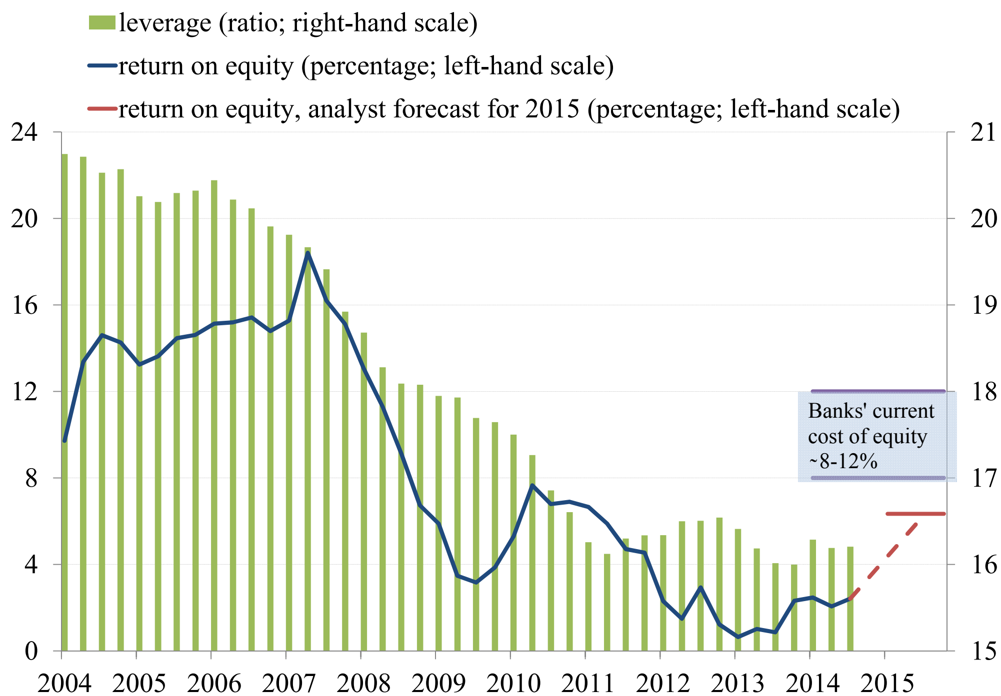


Sources: SNL Financial and ECB calculations.

Note: "Non-euro area European LCBGs" include banks from the United Kingdom, Switzerland, Sweden and Denmark. Two-period moving average.

… and much needed de-risking of bank balance sheets with further balance sheet adjustment needed in parts of the banking system

Return on equity and leverage of euro area significant banking groups
(Q1 2004 – 2015; medians)



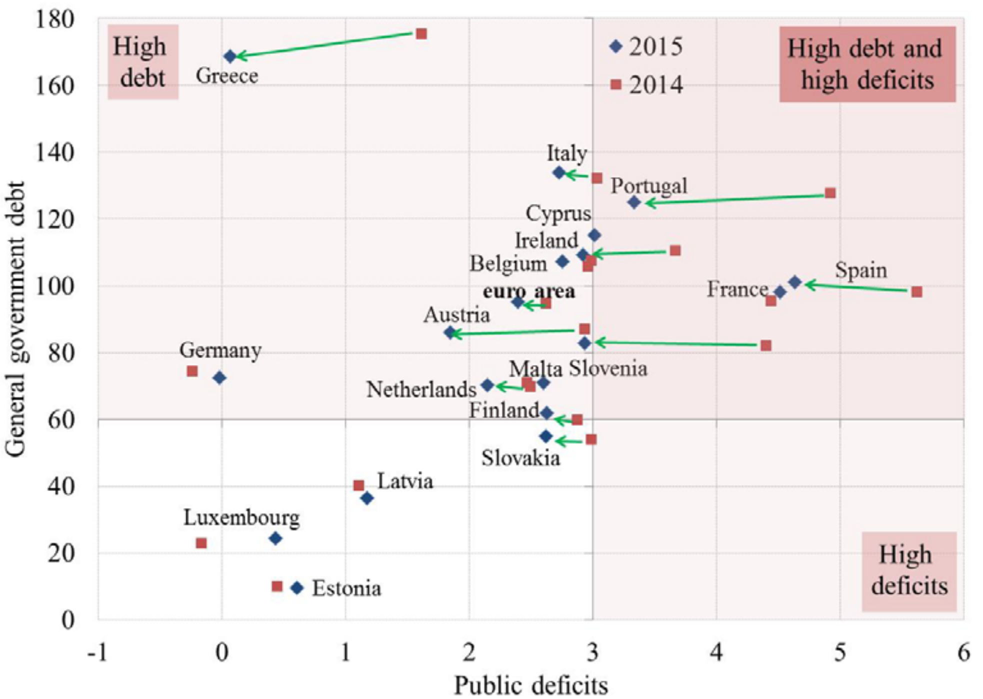
Sources: Bloomberg and EBA.
Notes: The cost of equity estimate is taken from banks' replies to the EBA risk assessment questionnaire for banks reported in EBA, "Risk Assessment of the European Banking System", June 2014.

Risk 3 - Re-emergence of sovereign debt sustainability concerns, amid low nominal growth and wavering policy determination for fiscal and structural reforms

Ongoing fiscal adjustments, but challenges include weak, fragile and uneven economic prospects

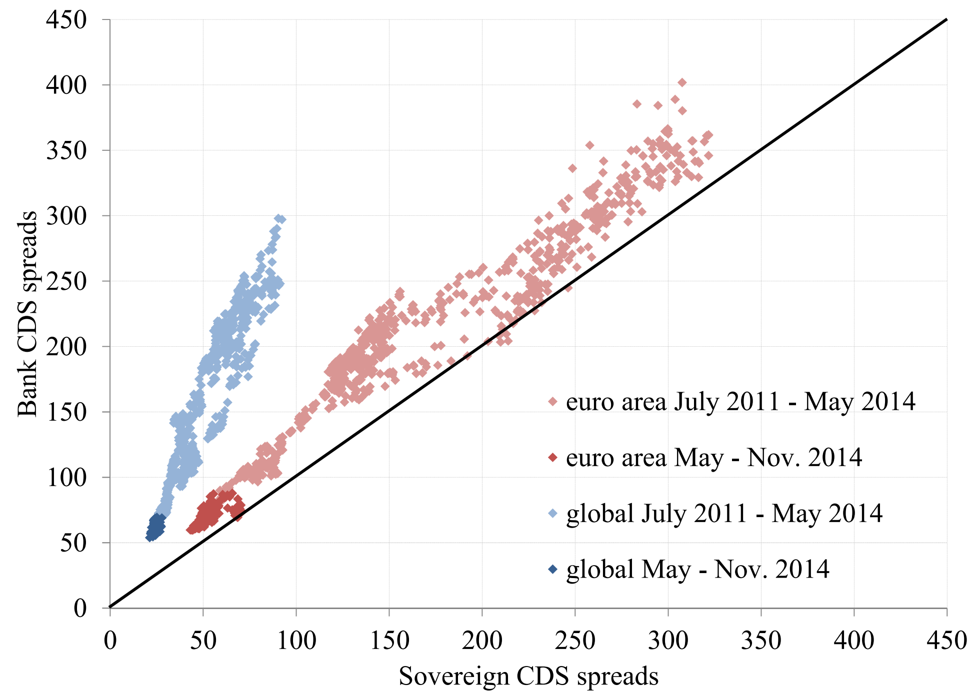
Unfinished progress towards weakening the links between sovereign and banks from height of crisis

General government debt and deficits in the euro area
(percentage of GDP)



Source: European Commission.

Sovereign and bank CDS spreads
(July 2011 – 14 Nov. 2014; basis points)



Sources: Bloomberg and ECB calculations.

Note: Average CDS spread for euro area and global LCBGs versus the average sovereign CDS spread where the LCBGs are headquartered (France, Germany, Italy, Spain and the Netherlands for euro area LCBGs and the United States, the United Kingdom, Switzerland, Denmark, Sweden and Japan for global LCBGs).

Conclusions

- **Euro area systemic stress contained, but belies a delicate situation**
  - Bank-intermediated credit remains scarce and uneven
  - Market-intermediated credit rather abundant and available on rather generous terms
- **Main financial stability risks a combination of *legacy* and *emerging* issues**
  - A global search for yield continues …
  - … amid remaining challenges for euro area banks and sovereigns
- **Several policy challenges**
  - Micro- and macro-prudential polices need to be considered to ensure that financial intermediaries can withstand a reversal of risk premia
  - Further initiatives needed to monitor and assess vulnerabilities in the growing shadow banking sector
  - Banks' balance sheets strengthened further but combination of cyclical and structural challenges to profitability needs to be tackled
  - In the non-financial sector, progress in repairing balance sheets also continues … but public debt sustainability far from assured amid changeable market sentiment