OVERVIEW

Euro area stress moderate amid financial market stress…

Financial stress has remained moderate in the euro area in recent months, despite periods of considerable global financial market turbulence. Measures of systemic stress in the banking sector have declined markedly since the peaks that followed the intensification of the sovereign debt crisis in mid-2011 (see Chart 1). A broad composite measure of systemic stress across major euro area financial asset classes has fallen even further, to lows not seen since global financial strains first emerged in the summer of 2007.

… as euro area fundamentals continue improving

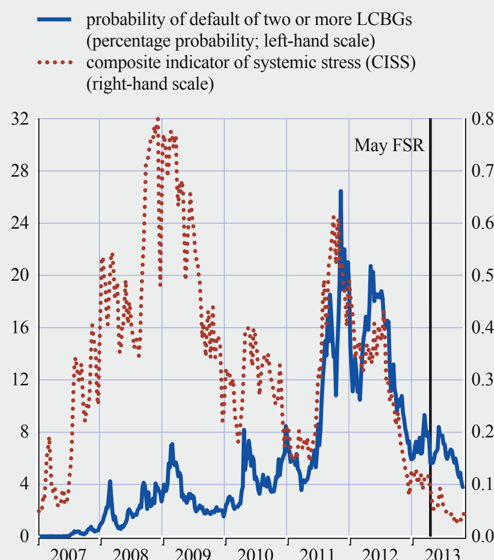
This resilience partly reflects the improvement of euro area fundamentals since the height of the euro area crisis in 2011. Fiscal consolidation and structural reforms have continued in the euro area, though at an uneven pace across countries. At the same time, higher capital and liquidity buffers are being built up in the banking sector, strengthening shock-absorption capacity, which should improve bank performance over time. Complementing national policy measures, tangible progress has been made towards building a banking union. The progress in the area of banking is matched by developments in financial markets, where bond and equity market indicators – such as yield differentials and curve slopes – reflect a favourable re-evaluation of euro area fundamentals vis-à-vis other economic regions (particularly emerging market economies), as well as somewhat lower intra-area fragmentation over the last half-year.

But financial stability conditions remain fragile

Notwithstanding these advances, the euro area adjustment process remains incomplete. Further efforts are needed to remove the risk of further negative interactions, at the country level, among stressed sovereigns, diverging economic growth prospects and bank fragility. First, there is a need to correct a loss of competitiveness which has restrained economic growth in some countries, as well as to further address remaining public and private sector indebtedness. Second, the outlook for bank profitability remains weak; this is partly because the process of bank restructuring – including downsizing – remains incomplete, and partly due to the protracted impact of loan losses on provisions and reported earnings. Aggravating this, considerable (albeit diminished) fragmentation in the availability and cost of bank funding persists in some countries. To help resolve these hurdles, further progress towards establishing a banking union will make an important contribution. As preparations for the operational start of the single supervisory mechanism gain momentum, complementary steps are needed to establish a single and effective European common bank resolution framework.

Chart 1 Measures of financial market and banking sector stress in the euro area

(Jan. 2007 – 15 Nov. 2013)



Sources: Bloomberg and ECB calculations.
Note: See Charts 2.3 and 3.13 for more details on these indicators.

Four key risks to euro area financial stability

The above-mentioned vulnerabilities, as well as the challenges inherent in a global economy only slowly emerging from the financial and economic crisis, help explain the prospective risks for euro area financial stability depicted in Table 1. The four risks in the table are listed separately for clarity, but are not independent – rather, if triggered they have the potential to be mutually reinforcing.

Table 1 Key risks to euro area financial stability

	Current level (colour) and recent change (arrow)*
1. Economic and financial shocks that affect asset valuations and bank profitability, eroding confidence in the euro area financial sector	medium-level systemic risk, →
2. Renewed tensions in sovereign debt markets as a result of delayed national reforms, unforeseen bank recapitalisation needs or a rise in global bond yields	medium-level systemic risk, →
3. Global financial market turbulence, with asset mispricing and low market liquidity	medium-level systemic risk, ↑
4. Bank funding challenges in stressed countries that force banks to deleverage excessively	potential systemic risk, ↓

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, based on the judgement of the ECB's staff. The arrows indicate whether this risk has intensified since the previous FSR.

Key risk 1: Economic and financial shocks that affect asset valuations and bank profitability, eroding confidence in the euro area financial sector

A weak economy is weighing on bank profitability…

Profit generation continues to be a challenge for euro area banks. The protracted economic downturn since 2011 has impacted credit quality, while interest margins have remained compressed. Subdued growth prospects and high unemployment continue to weigh on bank performance in a number of euro area countries, particularly when interacting with high private sector indebtedness (see Chart 2). Any upward spike in interest rates from low levels, for instance given turbulence in global bond markets, could also present challenges for bank profitability.

Recent macroeconomic data have contained promising signs that the euro area is emerging from a business cycle trough. Economic sentiment data, in particular, have been pointing to an expansion gaining traction following a year and a half of recession in the euro area. However, the recovery remains gradual, with the latest ECB staff macroeconomic projection of an increase in euro area real GDP of 1.0% in 2014. Moreover, downside risks surrounding the macroeconomic outlook for the euro area dominate, also aggravated by increasing downside risks to the health of emerging market economies, which have contributed strongly to global economic growth over the last years.

A potentially weak economic recovery presents challenges for a return to more profitable intermediation activity of banks. An increasing recognition of loan losses suggests banks are internalising the impacts of a weak economy on credit quality. Non-performing loans (NPLs)

Chart 2 Unemployment, economic growth and private sector indebtedness across euro area countries

(percentages)

Sources: Eurostat and ECB.
Notes: The size of the bubbles shows the size of private sector indebtedness as a percentage of GDP as of the second quarter of 2013. Data on non-financial firms include cross-border inter-company lending, which may be particularly relevant for countries where international holding companies are traditionally located (e.g. Ireland and Luxembourg).

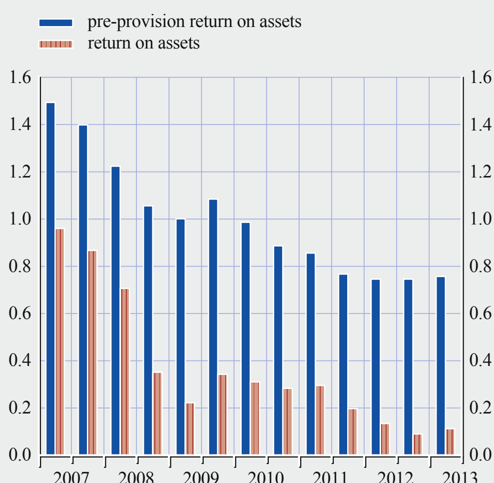
and the associated provisioning have grown to such an extent that they have been the major contributor to the low return on assets of euro area significant banking groups since 2009 (see Chart 3).

> Around 130 significant euro area banks will fall under the direct supervision of the ECB in November 2014. Accordingly, this Review introduces a new set of "**significant banking groups**" (SBGs) – the consolidated group level analogue of these significant banks, which amounts to up to 90 banking groups (depending on data availability). Alongside this new group of banks, the Review also retains its traditional analysis of "**large and complex banking groups**" (LCBGs), both at the euro area and global level. Box 5 contains further details on these bank samples.

Up to now, impaired loan growth has been disproportionately affecting euro area banks outside the group of largest banks (see Chart 4). Determining an appropriate degree of provision coverage during periods of economic uncertainty is complex, given the multitude of decisions needed regarding the appropriate classification of loans and realistic collateral valuation. But on aggregate, although provisioning is increasing, it has barely kept pace with the deterioration in asset quality, on average, highlighting a potential further need for additional reserves to strengthen bank balance sheet resilience in case asset quality deteriorates further. *Prima facie*, provisioning needs would be greatest where there is a combination of exposures to highly indebted households and firms, volatile asset prices (notably property prices), rising unemployment and weak domestic demand. Such vulnerabilities might also interact in some countries with lengthy legal procedures in case of borrower insolvency, thereby fostering balance sheet uncertainty and constraining banks' lending ability.

Chart 3 Pre- and post-provision return on assets of euro area banks

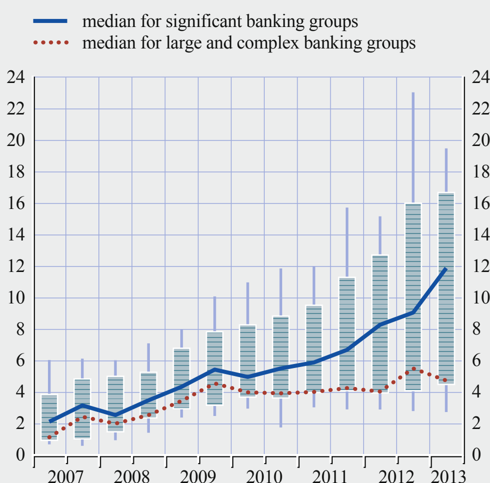
(H1 2007 – H1 2013; percentages; medians)



Source: SNL Financial.
Note: Based on publicly available data on significant banking groups that report semi-annual financial statements.

Chart 4 Impaired loans of euro area banks

(H1 2007 – H1 2013; percentage of total loans; 10th and 90th percentiles and interquartile range distribution across significant banking groups)



Source: SNL Financial.
Note: Based on publicly available data on SBGs, including LCBGs, that report semi-annual financial statements.

… amid a continued strengthening of regulatory capital ratios…

These challenges, which are in many ways tied to the economic cycle, contrast with a structural improvement in the solvency positions of euro area banks. The median core Tier 1 capital ratio for euro area significant banking groups reached 11.3% in the first half of 2013 – a more than four percentage point increase from the beginning of the global financial crisis in 2008. This progress also corresponds to further steps towards meeting more stringent Basel III requirements over time. Progress in reducing simple (i.e. not risk-weighted) measures of balance sheet leverage has, however, been more mixed. Higher capital levels, complemented by contained use of balance sheet leverage, as foreseen in the Basel III guidelines, should provide a more solid buffer against possible losses and a more sustainable basis for banking activity going forward.

… but further action appears needed

Continued action is needed to mitigate lingering investor scepticism regarding euro area bank balance sheets. Market valuations for euro area banks have remained below their book valuation since 2009, while those of US peers have risen above 1 during 2013. While some of this difference may relate to subdued profitability prospects for euro area banks, it also relates to questions regarding asset quality transparency, which would benefit from more extensive disclosure, a cleaning-up of bank balance sheets and removal of legal obstacles to NPL resolution. Importantly, the ECB has started a comprehensive assessment of the most significant euro area banks, which are expected to fall under its supervisory remit in November 2014. The achievement of the three main goals of this exercise, namely to (i) enhance transparency, through the quality of information available on the condition of banks, (ii) provide the basis for repairing those balance sheets which are stretched by identifying and implementing necessary corrective actions as needed, and (iii) build confidence by assuring all stakeholders that banks are fundamentally sound and trustworthy, will be positive for financial stability. In settings where weak profits prevent banks from increasing capital via retention of earnings, banks need to consider alternative avenues for raising additional external capital.

Key risk 2: Renewed tensions in sovereign debt markets as a result of delayed national reforms, unforeseen bank recapitalisation needs or a rise in global bond yields

Sovereign tensions remain contained…

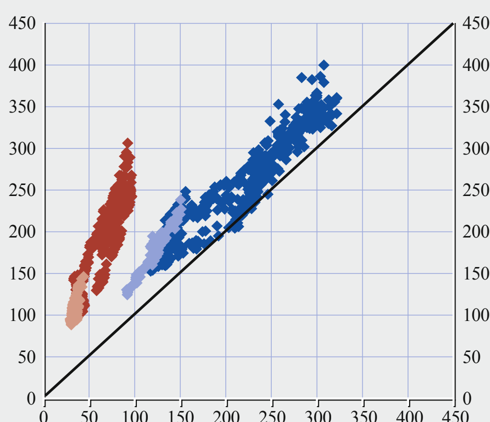
Following their significant easing in the second half of 2012, sovereign tensions have remained contained despite observed volatility in global financial markets. Spreads of ten-year sovereign bond yields over benchmark overnight index swap rates currently stand around the same levels as those that prevailed in May this year – prior to the onset of global bond market volatility – for most countries. Importantly, such spreads have fallen over the period for several countries subject to intermittent stress over the last years, to the tune of 55 basis points in Spain, 50 basis points in Ireland, 30 basis points in Italy and 25 basis points in Portugal. Relatively less favourable developments for the latter two countries can be linked to political uncertainty during the summer. In stark contrast to more severe stress phases over the last years, these uncertainties at the country level have been digested by markets as idiosyncratic rather than systemic in nature, with limited spillover effects on broader market sentiment. These bond market developments are also reflected in credit default swap (CDS) pricing, where CDS spread levels for sovereigns are well below the peaks witnessed during the more acute phases of the crisis. That said, the CDS-implied sovereign-bank link in the euro area still appears stronger than in other economies such as the United States (see Chart 5).

… but the need for further policy action remains

Continued adjustment towards sustainable fiscal positions has helped to underpin this improved market sentiment towards euro area sovereigns. Such adjustment nonetheless remains incomplete for several countries (see Chart 6). These fiscal imbalances, amplified by competitiveness shortfalls,

Chart 5 Sovereign and bank CDS spreads

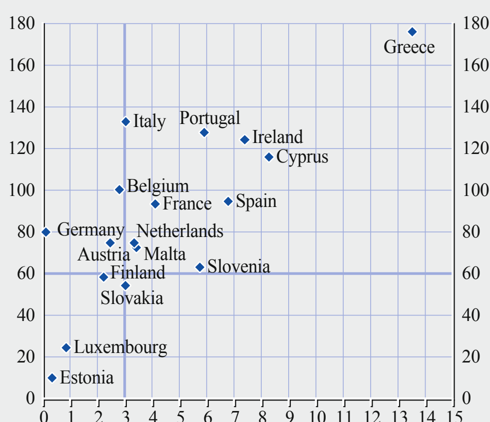
(July 2011 – 15 Nov. 2013; basis points)



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).

Chart 6 General government debt and deficits in the euro area

(2013; percentage of GDP)



Source: European Commission.

remain closely linked to prevailing sovereign bond market premia. While the fiscal and structural adjustment to date in several member countries has been noteworthy, implementation risks remain a cause for concern. These concerns relate to any potential for reform fatigue or complacency at the national level. Importantly, implementation risks are also present at the supra-national level, where strains could re-emerge should policy advances stall towards completing EMU and durably weakening the links between sovereigns and banks. Moreover, the current situation involving more benign market conditions remains fragile, and could be shattered in the event of renewed global bond market turbulence.

Fiscal vulnerabilities are only one element underlying the adverse feedback between sovereigns, domestic banks and macroeconomic conditions at the heart of past euro area strains. Weakening the negative feedback loop between banks and sovereigns requires a multi-pronged strategy at the national level to ensure public debt sustainability – balancing a need to address both fiscal imbalances and economic growth – while at the same time addressing the risk of contingent liabilities for sovereign balance sheets stemming from the banking sector. The European Commission's rules on state aid to banks have helped to clarify an EU-wide regime for public interventions in troubled financial institutions. Building upon this progress, further steps are needed to clarify backstops for financial sector distress – be they public or private – at the national or European level.

Key risk 3: Global financial market turbulence, with asset mispricing and low market liquidity

A global bond market correction...

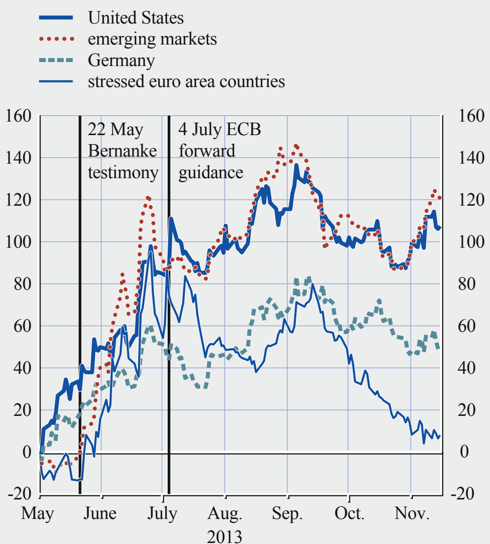
Starting in May, there was a significant repricing in global bond markets, which took place largely because of changing monetary policy expectations in the United States – with increased foreign exchange market volatility and stress borne largely by emerging market economies. Euro area bond market impacts were, however, also apparent – and can be differentiated by two key phases.

... with differing impacts on benchmark rates and risk premia

A first sovereign bond market adjustment phase involved sharp upward movements in key global benchmark interest rates, compounded by increased premia on riskier assets. What became a global bond market sell-off started in May and continued largely unabated until the end of June. Reflecting an uncertain global economic growth outlook, the sell-off was particularly pronounced for assets perceived as riskier – including sovereign debt of vulnerable euro area countries (see Chart 7). Timely forward guidance on monetary policy in July – from both the ECB and the Bank of England – attenuated unfounded upward movements in European money market rates. These measures contributed to a second phase of global bond market adjustment, this time involving a decline in global risk aversion and credit spreads. Ultimately, following this global bond market turbulence, benchmark yields have increased across the globe. The upward drift in yields was greatest in emerging market economies as well as perceived "safe havens". Overall, ten-year US benchmark Treasury yields stand over 100 basis points higher than their early May level, similar to the average increase across a broad group of emerging market economies. For the euro area, benchmark German Bund yields are up by 50 basis points from their May levels, while on average bond yields in more vulnerable euro area countries such as Ireland, Italy and Spain have fallen back to their May 2013 levels.

Chart 7 Cumulative changes in ten-year sovereign bond yields since May

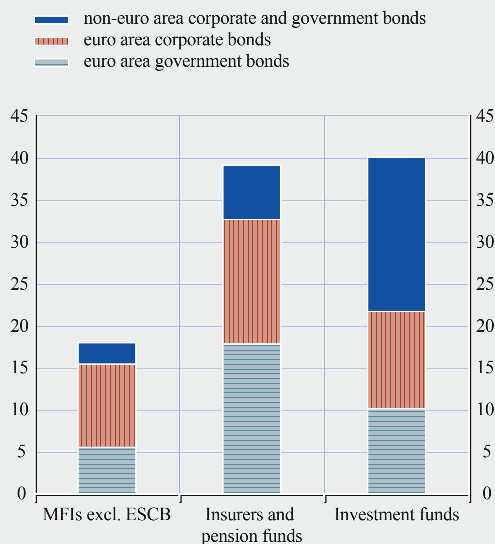
(2 May – 15 Nov. 2013; cumulative change in basis points since 2 May)



Source: Bloomberg.
Note: "Stressed euro area countries" refers to the average of bond yields in Ireland, Italy, Portugal and Spain.

Chart 8 Bond holdings of euro area MFIs, insurers and pension funds and investment funds

(Q2 2013; percentage of total assets)



Sources: ECB and ECB calculations.

Uncertain distribution of losses…

The financial stability consequences of this turbulence require an understanding of the distribution of losses – something which is unfortunately not possible to accurately measure given limited aggregate information on hedging. For the United States, estimates from the Federal Reserve suggest capital losses for US bond holders alone were around 10% through early summer 2013. Though significant, this figure was lower than the losses resulting from previous noteworthy bond market adjustments, in particular the turbulent episode in 1994. Within the euro area, direct exposure to debt markets as a proportion of assets appears to fall mainly on the side of institutional investors and less on banks (see Chart 8). That said, incomplete information on where absolute losses were greatest obfuscates a complete understanding of vulnerabilities which have resulted from bond market turbulence to date. It cannot be ruled out that ultimate exposures are concentrated among a limited number of entities which may now be more vulnerable to any further severe market shock. Such losses are potentially compounded by an environment of historically low prevailing yields in some countries, which continues to constitute a risk for institutional investors such as insurance companies.

… while the possibility of further corrections remains

The recent global financial market turbulence might be a harbinger of further realignment of risk premia with fundamentals in bond markets (or even an overshooting), not least as yields on higher-rated sovereign and high-yield corporate bonds remain at historically low levels. Moreover, recent outflows from bond funds have been low compared with the substantial inflows since 2009, while the outflows to date have depleted cash cushions, in particular for emerging market funds, leaving them more vulnerable to further redemptions. Reduced cash buffers, combined with low secondary market liquidity in emerging and corporate bond markets, could amplify future asset price developments. In addition, recent bond losses may place additional pressure on investors to seek yield and avoid duration, which could push investors into leveraged positions and/or lower-quality assets with low liquidity. Lastly, euro area financial stability could suffer should spillovers accompany any onset of stress in key emerging market economies.

Stable and predictable policies are key to prevent abrupt risk reversal

As the potential for further adjustment remains significant, supervisors need to ensure that banks, insurers and pension funds have sufficient buffers and/or hedges to withstand a normalisation of yields by stress-testing their balance sheets. Stable and predictable macroeconomic policies, as well as efforts (such as forward guidance) to reduce market uncertainty surrounding central banks' reaction functions, are key to ensuring a smooth exit from non-standard central bank measures without an abrupt rise in bond yields.

Key risk 4: Bank funding challenges in stressed countries that force banks to deleverage excessively

Bank funding conditions continue to improve on aggregate…

Bank funding conditions in the euro area continue to normalise. Average composite bank funding costs reached their lowest level for more than three years for most countries (see Chart 9) and across all major debt instruments. In addition, country fragmentation in deposit-based funding has subsided, with continued deposit inflows in most countries, including for several countries under stress. As a result, euro area banks' funding structures have continued to shift towards arguably more stable – and away from more volatile – funding sources. Indeed, the shares of wholesale funding and foreign deposits have fallen further, in part stemming from a gradual deleveraging process in the euro area banking sector. A fall in excess liquidity in the euro area has corresponded to reduced reliance on central bank funding, with around half of the initial amount of the three-year longer-term refinancing operations (LTROs) repaid before maturity.

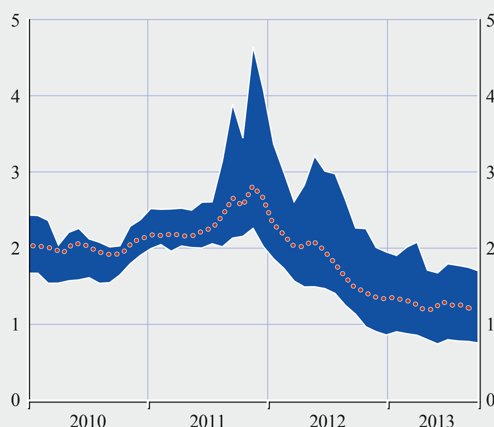
… but fragmentation persists…

These positive developments on aggregate have not been sufficient to eliminate fragmentation in bank funding markets. Funding remains fragmented in terms of the availability and the cost

Chart 9 Composite bank cost of deposit and unsecured market debt funding in selected euro area countries

(Jan. 2010 – Sep. 2013; percentages; maximum-minimum range across the four largest euro area countries)

maximum-minimum range
euro area average

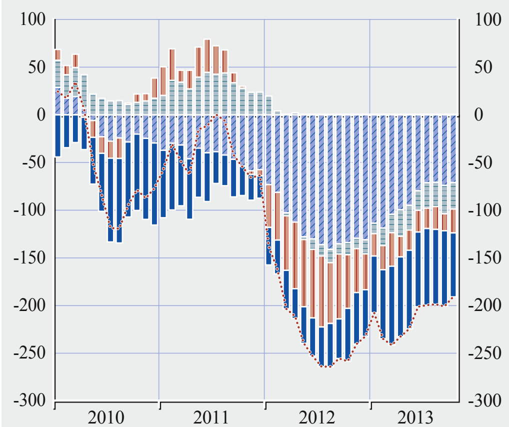


Sources: ECB, Merrill Lynch Global Index and ECB calculations.
Note: Deposit rates (for both retail and institutional investors) and cost of market-based debt financing for Germany, France, Italy and Spain, weighted using outstanding amounts taken from the ECB's MFI balance sheet statistics.

Chart 10 Net issuance of senior unsecured (debt and covered bonds in the veuro area)

(Jan. 2010 – Oct. 2013; EUR billions; 12-month net issuance; moving sum)

covered bonds (non-stressed countries)
senior unsecured debt (non-stressed countries)
covered bonds (stressed countries)
senior unsecured debt (stressed countries)
net issuance (total)



Source: Dealogic.
Note: Excludes retained deals.

of market funding both according to the country where banks are located and their balance sheet strength (which, in turn, is tightly correlated with bank size). While debt issuance has fallen markedly for most banks since 2010 (see Chart 10), issuance by smaller banks from vulnerable countries over the last 12 months is 70% down from a comparable period leading up to mid-2011. Clearly, access to medium- and longer-term funding at sustainable costs remains a challenge for a number of mid-sized and smaller euro area banks in stressed countries. With sizeable amounts of bank debt maturing over the coming months, persistently high funding costs for a set of challenged banks could amplify pressures for deleveraging of a disorderly nature – with an associated negative impact on economic welfare and growth.

… and confidence in banks needs to be reinforced

While much of the prevailing fragmentation appears to have economic underpinnings, regulatory uncertainty regarding the potential for bailing-in of creditors might also play a role. In this respect, work continues to clarify resolution arrangements. While such measures are necessary, further steps towards a genuine euro area banking union would durably address fragmentation, assuaging remaining concerns of not only bank investors but also depositors.

ONGOING REGULATORY INITIATIVES

Strengthening of the regulatory and supervisory frameworks has continued…

Progress towards a safer post-crisis financial environment continues, with advancements in European and global regulatory initiatives in the areas of financial institutions, markets and infrastructures. Much of the progress made refers to banks – in particular the adoption of the Capital Requirements Regulation and Directive (CRR/CRD IV) that implements the Basel Committee's new global standards for capital and liquidity (Basel III) in the EU as of 1 January 2014.

… in particular with a banking union for the euro area

But perhaps the most significant achievement within the euro area concerns the advances towards a banking union. Among the various facets of a genuine banking union, progress has been greatest in moving towards a single supervisory mechanism (SSM), where concrete progress continues towards effective micro- and macro-prudential oversight being conferred upon the ECB. At the same time, headway continues to be made in relation to a second pillar of banking union and a necessary complement to single supervision – namely in the area of common resolution. This includes the establishment of an EU framework for bank recovery and resolution (BRRD), which will help to foster ex-ante clarity on the application of bail-in at the EU level, following instances earlier this year where a heterogeneity of approaches with respect to bail-ins of banks' unsecured creditors created some uncertainty regarding consistency of creditor treatment in the event of bank distress. Progress in the area of common resolution has also been made with the European Commission's proposal for a Single Resolution Mechanism (SRM) aimed at setting up a unique system for resolution, with a Single Resolution Board and a Single Bank Resolution Fund, for the resolution of banks in SSM-participating Member States. Advances in supervision and resolution require an eventual complement of a third pillar of banking union, namely a European system for deposit protection.

Financial stability will benefit from continued progress in completing regulatory reform not only for banks, but also financial markets and infrastructures. From a euro area perspective, a swift and complete implementation of the building blocks of the banking union is arguably the most pressing need – given its potential to durably address key financial stability threats outlined in this Review, including by weakening feedback loops between banks and national authorities, whilst also fostering a reintegration of euro area financial markets which is a necessary complement to European Monetary Union. Notwithstanding the considerable regulatory progress to date, continued momentum is needed to strengthen oversight not only of banks, but also of a growing shadow banking sector and derivatives markets.