OVERVIEW

Euro area stress has remained moderate…

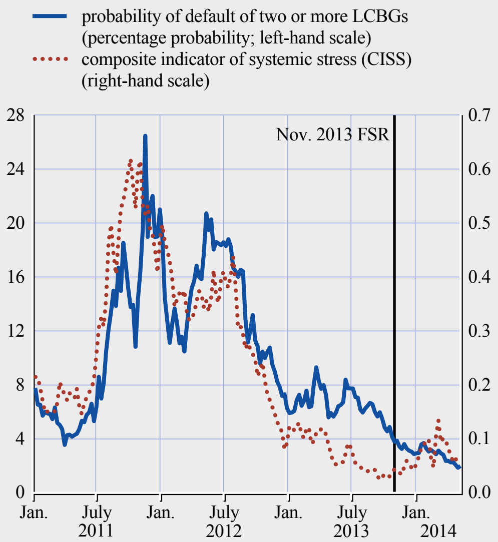
Financial stress indicators have remained low and stable after a marked fall that began almost two years ago. In particular, measures of banking system stress have eased further as banking union preparations have gathered pace, with continued associated efforts to strengthen the euro area banking sector. There has also been little sign of stress across the broader financial system (see Chart 1). In this vein, the financial stability risks confronting the euro area can be grouped into two broad categories. First, "legacy" issues from the global financial crisis have receded somewhat but still remain latent. For the euro area, these mainly relate to unfinished progress in the banking and sovereign domains. A second broad set of risks are those that can be considered as "emerging" – mainly stemming from a continued global search for yield which has left the financial system more vulnerable to an abrupt reversal of risk premia.

… amid progress in addressing banking and sovereign vulnerabilities

Action to address legacy risks from the crisis continues for both banks and sovereigns. For the euro area *banking sector,* one key measure of progress in cleaning up and strengthening balance sheets involves the amount of new capital – since the onset of the global financial crisis euro area banks have issued some €267 billion of quoted shares (see Chart 2), in addition to other forms of capital strengthening (e.g. retained earnings, contingent convertible bond issuance, state aid, etc.). More recently, since the third quarter of 2013, when discussions about the ECB's comprehensive assessment intensified, significant banking groups in the euro area have bolstered their balance sheets by over €95 billion through equity issuance, one-off provisions, contingent convertible (CoCo) bond issuance and capital gains from asset disposals. At the same time, progress by euro area *sovereigns* in implementing fiscal consolidation and structural reforms has also been significant, although the pace has been uneven across countries. The improved sentiment towards sovereigns

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

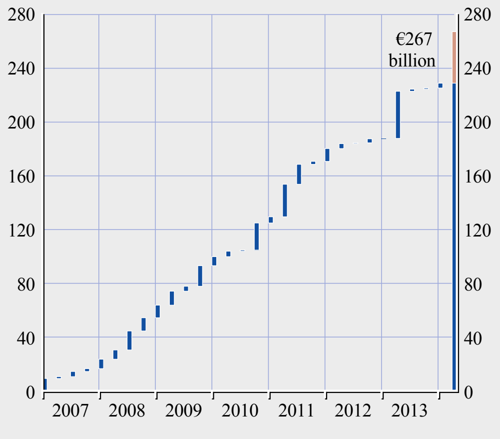
(Jan. 2011 – 16 May 2014)



Sources: Bloomberg and ECB calculations.
Note: See Charts 2.1 and 3.15 for more detail on these indicators.

Chart 2 Quoted shares issued by euro area MFIs

(Q1 2007 – Q2 2014; EUR billions)



Sources: ECB, banks' financial reports, market research and ECB calculations.
Note: Q2 2014 data include announced but not yet completed deals.

resulted in significantly declining yields on lower-rated euro area sovereign bonds, which in some cases reached levels last seen before the eruption of the euro area-centred second wave of the global financial crisis in 2010.

The challenge ahead is to ensure that efforts are sustained to finalise and implement necessary reforms and to ensure that the crisis conditions do not re-emerge. For euro area banks, continued action is needed to mitigate investor scepticism about the sector, while at the same time ensuring that the bank deleveraging process is not unduly reducing the supply of credit to the economy. Similarly, continued action by sovereigns is needed to address public debt sustainability challenges – notably progress in restoring the soundness of public finances while working to boost macroeconomic growth prospects.

Signs of hunt for yield causing imbalances

As legacy risks have receded, a growing search for yield has progressively become more pervasive across regions and market segments. This has in many ways benefited both euro area banks and sovereigns, given the resulting lower borrowing costs and improved access to equity and bond markets. But as the breadth of the search for yield widens at the global level, risks of a possible reassessment of risk premia with implications for global financial markets are increasing. Some of the capital inflows to euro area sovereigns and banks appear to have been based on relative return considerations (e.g. dependent on continued emerging market concerns and perceptions of inexpensive euro area assets). Such flows might prove to be fickle absent prospects of strong absolute returns differentiated by underlying country and bank-specific macroeconomic prospects.

Three key risks to euro area financial stability

These legacy and emerging issues group into three key risks to euro area financial stability that should predominate over the next year and a half (see Table 1). The three risks – described in more detail below – are conceptually distinct in many ways but not independent – rather, if triggered they have the potential to be mutually reinforcing. These key risks also encompass bank funding challenges underlying past stress, notably from broader concerns about the possibility of a reassessment of risk premia.

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, amid pockets of illiquidity and likely asset price misalignments	↑ (medium-level systemic risk)
2. Continuing weak bank profitability and balance sheet stress in a low inflation and low growth environment	→ (medium-level systemic risk)
3. Re-emergence of sovereign debt sustainability concerns, stemming from insufficient common backstops, stalling policy reforms, and a prolonged period of low nominal growth	↓ (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 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.

Key risk 1: Abrupt reversal of the global search for yield, amid pockets of illiquidity and likely asset price misalignments

A further broad-based compression of risk premia…

Financial markets have seen a further compression of risk premia, increasingly pervasive across asset classes and major geographical regions. This reflects increased investor confidence owing to improved fundamentals, an intensification in search-for-yield behaviour, and some rebalancing of portfolios from emerging to advanced economies. In Europe, the preference for riskier assets has been evident in the compression of credit spreads in sovereign and corporate bond markets, but also in valuations of other assets such as equities and the prime segment of commercial property (i.e. modern office and retail space in capital cities).

… in sovereign debt…

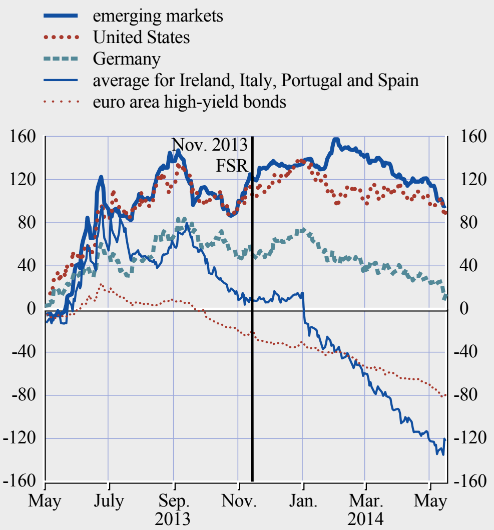
The reduction in risk premia has been pronounced in the euro area, owing to some normalisation after previous outflows, in combination with higher foreign demand. This has resulted in a decline in fragmentation across national borders – with a large decline in yields on lower-rated euro area government bonds since the beginning of 2014 (see Chart 3). Growth in the non-domestic investor base contributed to this development, some of which stems from a redirection of flows owing to geopolitical and emerging market tensions. At the same time, yields on higher-rated benchmark global government bonds remain at historical lows.

… and corporate bond markets

Risk premia have also continued to decline in global corporate credit markets, especially in the euro area, with high-yield corporate spreads narrowing to levels last observed in October 2007. Much of the investor demand has been in the high-yield segment (see Chart 4), which supported high-yield issuance and issuance of subordinated debt and CoCos by euro area banks. As spreads on high-yield bonds have compressed to pre-crisis levels, growth in products offering a higher yield but lower protection for lenders (such as “covenant-lite” loans) has strengthened, in particular within US markets.

Chart 3 Cumulative changes in bond yields since May 2013

(2 May 2013 – 16 May 2014; cumulative change in basis points; ten-year sovereign bond yields)



Source: Bloomberg.

Chart 4 Global investor flows into selected funds

(Jan. 2004 – May 2014; USD billions)

Source: EPFR.

The sustainability of the lower risk premia environment could be tested

The sustainability of recent strong demand for euro area assets rests on the persistence of three key drivers. First, investor confidence to date has been supported by further progress on European safety nets, ratings upgrades, improving fiscal prospects and lower political uncertainty. However, continued confidence depends on the sustainability of the ongoing economic recovery where risks remain on the downside.

Second, the durability of investor flows towards lower-rated euro area bonds, equities and other asset classes such as commercial property depends on continued strong risk appetite. Foreign investment in lower-rated euro area bond markets has been symptomatic of a search for yield, with investors first pushing for shorter durations up to the point where risk-adjusted returns become negligible, at which point they either extend duration or move further down the credit quality spectrum. Similarly, commercial property price dynamics suggest a growing bifurcation between strong price increases in the prime segment and relatively moribund developments in the non-prime segment. Transaction volumes in commercial property markets have reached their highest levels since 2008, underpinned by a surge in cross-border investments – in particular from non-European investors – which has accounted for almost half of the increase. Global investor sentiment is currently sensitive to, for example, developments in emerging markets, including geopolitical risks related to Ukraine and Russia, which could lead to increases in risk aversion. Moreover, the potential for downside risks to Chinese growth has increased and any unearthing of Chinese vulnerabilities would likely have important ramifications for global risk aversion. In addition, while prevailing monetary policy settings in major economies such as the euro area, the United Kingdom and Japan provide a strong anchor for expectations regarding short-term interest rates, yields on longer-dated bonds remain vulnerable to an increase in US term premia.

Third, some of the bond and equity market improvement in the euro area relates to the rebalancing of portfolios away from emerging markets, amid worsening economic and financial conditions in these economies. Inflows to euro area bond and equity markets since mid-2013 have tended to coincide with a prolonged period of capital outflows from emerging markets, in particular those with poorer underlying fundamentals.

As the search for yield has intensified, so have concerns regarding the build-up of imbalances and the possibility of a sharp and disorderly unwinding of recent investment flows. Continued low yields may place additional pressure on investors to improve returns, which could push investors into leveraged positions and/or lower-quality assets with low liquidity. In addition, low secondary market liquidity in corporate and emerging market bond markets could amplify future asset price developments, especially as losses in the next default cycle could be more substantial than during previous cycles due to the significant growth in the high-yield bond segment with a downward drift in ratings.

Stable and predictable policies are key to prevent an abrupt risk reversal

As the potential for adjustment in financial markets remains, supervisors need to ensure that banks, insurers and pension funds have sufficient buffers and/or hedges to withstand a normalisation of yields.

Key risk 2: Continuing weak bank profitability and balance sheet stress in a low inflation and low growth environment

Banks remain vulnerable to a further deterioration in asset quality…

Euro area banks continue to operate in a low profitability or loss-making environment, compounded by a continued deterioration in asset quality in some banking sectors. Although some tentative signs of a levelling-off in the pace of non-performing loan formation have emerged in some countries, the turning point does not appear to have been reached yet. Indeed, more than half of euro area significant banking groups reported losses in the second half of 2013 as high loan loss provisioning needs continued to weigh heavily on euro area banks' financial performance, which – once correcting for provisioning – closely resembles that of their global peers (see Chart 5).

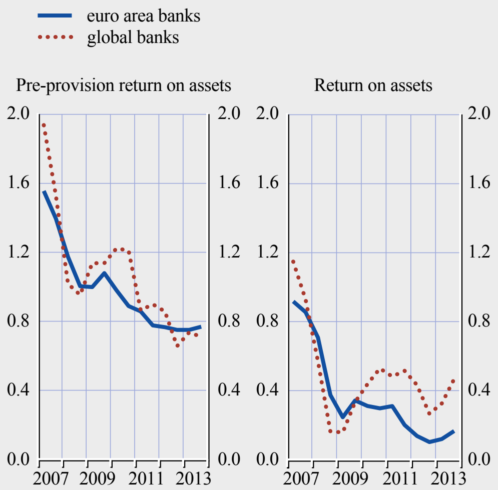
The risk of a further deterioration in credit quality remains significant amid a still relatively weak (albeit improving) and uneven economic outlook, although stepped-up loan loss provisioning and increased capital buffers in large parts of the euro area banking sector may well serve as risk-mitigating factors. Amid continued downside risks to a fragile euro area economic recovery, high private sector indebtedness in many countries, coupled with only slowly improving income and earnings prospects, may weigh on borrowers' debt servicing capabilities if indebtedness is not substantially declining. Likewise, muted nominal growth prospects may create challenges for balance sheet adjustment. At the same time, some euro area banks are confronted with increasing risks from emerging market exposures. All told, the need for loan loss provisioning may therefore still remain high for some time, also in anticipation of the ECB's comprehensive assessment.

… although efforts have been significant to bolster shock-absorption capacities…

Continued asset quality challenges, which are in many ways tied to the economic cycle, contrast with ongoing progress made in cleaning up bank balance sheets and bolstering capital positions. Since the third quarter of 2013, when discussions about the ECB's comprehensive assessment intensified, significant banking groups in the euro area have strengthened their balance sheets significantly (see Chart 6). Some of the actions by banks remain a result of – in some cases already planned – measures to de-risk balance sheets, to improve capital levels amid previously identified insufficiencies and to repay state aid received during the financial crisis. Other measures appear to constitute preparatory action ahead of the comprehensive assessment – thereby reducing any

Chart 5 Pre- and post-provision return on equity of euro area significant banking groups and global banks

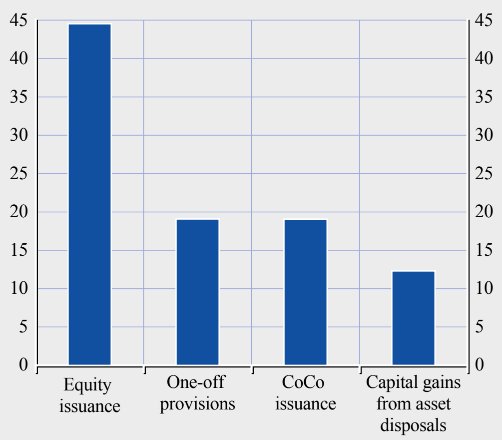
(H1 2007 – H2 2013; percentages; two-period moving average)



Sources: SNL Financial and ECB calculations.

Chart 6 Balance sheet strengthening by euro area significant banking groups since July 2013

(EUR billions)



Sources: SNL Financial, Dealogic, banks' financial reports, market research and ECB calculations.
Note: One-off provisions include provisions related to reclassifications and on extraordinary items identified by banks as being related to the asset quality review.

risk of congestion in bank capital markets after the publication of the comprehensive assessment results, should additional shortfalls be identified.

Euro area banks have continued to actively reduce the size of their balance sheets. Euro area MFIs (euro area-domiciled assets only) have reduced their total assets by €4.3 trillion since May 2012 (see Chart 7). Significant banking groups in the euro area have reduced the size of their *consolidated* balance sheets (that is, including assets outside the euro area) by over €5 trillion – a 20% decline – since their respective peak values (which on aggregate was in the first half of 2012, though differing across banks).

Chart 7 Evolution of total assets of euro area MFIs

(May 2012 – Mar. 2014; EUR trillions)

Source: ECB.
Notes: The red bars signal a decline and the green bars an increase in the given month.

The extent of asset reductions has, however, varied greatly across banks. Moreover, it is difficult to assess to what extent the asset shedding has led to a true de-risking of balance sheets. Indeed, the bulk of the reduction in euro area-domiciled assets has stemmed from a reduction in derivative positions, mainly in non-vulnerable euro area countries, accounting for around half of the decline in assets since the peak in May 2012. Furthermore, balance sheet reductions have also had a negative impact on credit to the real economy in some countries, with a cutback in loans to the non-financial private sector (including asset transfers) in more vulnerable euro area countries accounting for an additional one-third of the overall asset decline since May 2012.

… which has increased confidence in the banking sector

The progress in balance sheet repair, combined with ongoing implementation of the banking union, has contributed to a marked improvement in sentiment towards the euro area banking sector. Euro area large and complex banking groups' price-to-book ratios have risen to their highest levels in more than three years. These ratios nonetheless remain below 1 for a number of banks, which highlights that concerns continue to linger about banks' asset quality and earnings outlook. The comprehensive assessment carried out by the ECB will make a significant contribution in this regard by bringing more transparency to banks' balance sheets. By identifying and implementing necessary action, the comprehensive assessment will also contribute to banks' balance sheet repair and confidence building, which will support the banking sector's ability to extend credit.

Key risk 3: Re-emergence of sovereign debt sustainability concerns, stemming from insufficient common backstops, stalling policy reforms, and a prolonged period of low nominal growth

Sovereign tensions have eased…

Sovereign tensions have eased considerably, and in many ways, quite rapidly. Yields on lower-rated euro area sovereign bonds have declined and in some cases reached levels last seen before the eruption of the euro area-centred wave of the global financial crisis in 2010.

Two main factors have underpinned this recent decline in yields, building on the strong narrowing of euro area sovereign yields following the announcement of Outright Monetary Transactions (OMTs) in 2012. First, continued progress towards weakening the links between sovereigns by building a banking union has contributed to the improved sentiment towards euro area sovereigns. Second, euro area countries have made further significant adjustment towards more sustainable fiscal positions. Fiscal outcomes in 2013 beat targets in all EU-IMF programme countries at that time (Cyprus, Greece, Ireland and Portugal) while public deficits are expected to fall to 2.5% of GDP in the euro area as a whole in 2014, with notable improvements compared with 2013 expected in several countries (see Chart 8). In some cases, the large projected improvement of fiscal balances in 2014 can mainly be explained by one-off bank recapitalisation costs in 2013 in several countries, notably in Greece and Slovenia (see Chart 8). In this environment, the aggregate euro area public debt-to-GDP ratio is expected to peak in 2014 at 96% of GDP, with primary surpluses contributing to a foreseen reduction in debt in 2015 for the first time in seven years. This comes amid an exit from support programmes in Ireland, Spain and Portugal over the last months.

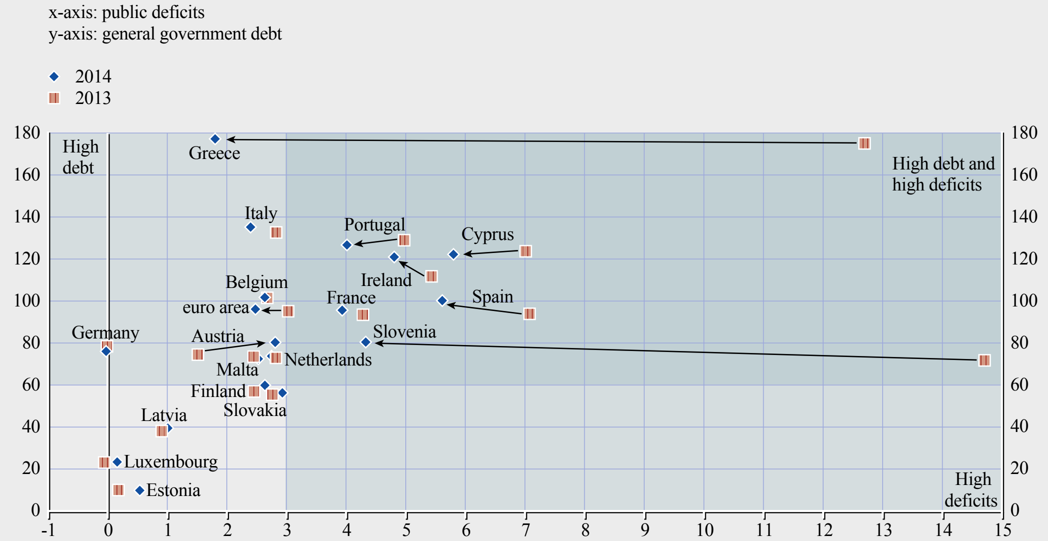
… but public debt sustainability challenges remain

Despite the continued improvement in sentiment towards euro area sovereigns, public debt sustainability challenges persist given still elevated and, in a number of countries, further increasing public debt levels amid weak nominal growth prospects. In addition, while newly approved bail-in rules might insulate public balance sheets from future national costs of bank recapitalisation, particularly once fully implemented in 2016, still incomplete supranational backstops imply a continued potential for adverse feedback loops between banks and sovereigns.

This suggests unfinished adjustment of fiscal and economic fundamentals relevant for debt sustainability. With the recent relative calm in euro area financial markets having the potential to breed complacency in terms of fiscal consolidation and structural reforms, there is a risk that fiscal adjustment could again revert to pro-cyclical tendencies. Reinforced rules at the European level should help to mitigate such risks, as substantial further structural adjustments are needed in most countries to put public debt on a firmly declining path. Any potential for reform fatigue or complacency at the national level could lead to a reassessment of sentiment towards euro area sovereigns.

Chart 8 General government debt and deficits in the euro area

(percentage of GDP)

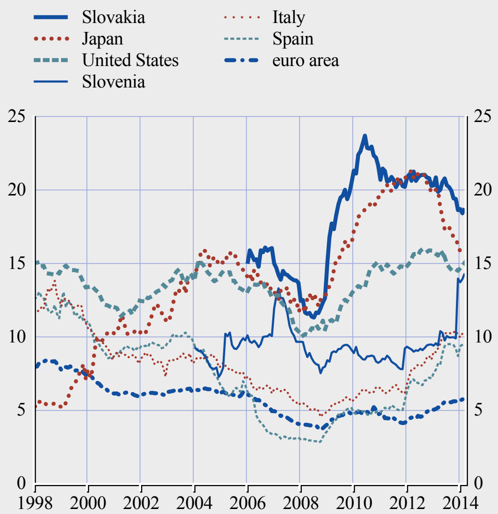


Source: European Commission.
Note: High debt and high deficits refer to values above the Maastricht criteria.

Clearly, risks to the sovereign outlook are not distinct from the risk of an abrupt reversal of the global search for yield, or further stress in the banking sector should credit quality worsen and banks face further significant losses. A generalised abrupt reversal of the global search for yield could lead to renewed increases in sovereign bond yields, in particular in lower-rated euro area countries. This poses concerns as the gross sovereign financing needs for 2014 as a whole remain significant in many euro area countries. It would also result in losses for banks since holdings of sovereign debt have been on an increasing path in several euro area countries in recent years, although the levels are generally below those seen in other key advanced economies (see Chart 9).

Chart 9 Domestic sovereign bond holdings by banks

(Jan. 1998 – Mar. 2014; percentage of total banking sector assets)



Sources: ECB, Federal Reserve and Bank of Japan.
Note: Data for the United States include sovereign bonds and agency mortgage-backed securities.

ONGOING REGULATORY INITIATIVES

Strengthening of the regulatory and supervisory frameworks has continued

Progress towards a safer post-crisis financial system has continued, with advancements both at the global and European levels in the areas of financial institutions, markets and infrastructures. Further progress has, in particular, been made in weakening the links between sovereigns and banks and in building a more resilient banking sector. The SSM is well on track to start operations in November and, following the completion of a public consultation, the ECB published the SSM Framework Regulation on 25 April 2014.

The European Parliament on 15 April 2014 approved three measures which will bring the EU further down the road towards banking union. First, the Bank Recovery and Resolution Directive (BRRD), which will provide common and efficient tools and powers for addressing a banking crisis pre-emptively and managing failures of credit institutions and investment firms in an orderly way. Second, the establishment of a Single Resolution Mechanism (SRM) aimed at setting up a unique system for resolution, with a Single Resolution Board and a Single Resolution Fund in its centre. Third, progress towards a third pillar of banking union, namely a European system for deposit protection, was also made with the approval of the agreement on the Deposit Guarantee Scheme Directive (DGSD). In addition to these decisions, on 29 January 2014 the European Commission presented its proposal for a Regulation on structural measures for EU credit institutions, which aims at improving the resilience of European banks by preventing contagion to traditional banking activities from banks' trading activities.

Financial stability will benefit from continued progress in completing regulatory reform not only for banks, but also for 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, including by weakening feedback loops between banks and national authorities. Notwithstanding the substantial progress so far, continued momentum is needed to reinforce oversight not only of banks, but also of a growing shadow banking sector and derivatives markets.