
# OVERVIEW

*Euro area stress has remained moderate…*

Despite intermittent financial market turbulence, euro area systemic stress has remained at low levels. Indicators of stress among euro area banks and sovereigns have declined further to levels last seen before the outbreak of the global financial crisis in 2007. Stress across the broader financial system has also remained contained (see Chart 1).

*… but vulnerabilities remain…*

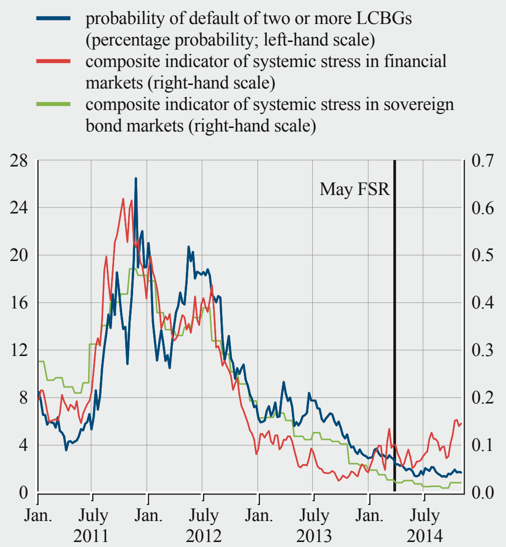
This belies a delicate situation, in which generally benign financial market sentiment has contrasted with a weak, fragile and uneven economic recovery. In fact, the environment of low nominal growth and high unemployment is the major underlying factor driving the challenges to financial stability. The resulting apparent disconnect between real economic and financial cycles has had implications for credit provision. On the one hand, bank-intermediated credit remains scarce, given a combination of weak demand and credit terms that may discourage borrowing and investment, which hinders the economic recovery. ECB monetary policy action – including the asset-backed securities purchase programme, the new covered bond purchase programme, and the targeted longer-term refinancing operations (TLTROs) – is providing key support, in particular to specific market segments that play a fundamental role in the financing of the economy. On the other hand, market-intermediated credit is rather abundant and available at conditions that resemble pre-crisis standards, underpinned by a global search for yield.

*… despite progress in addressing banking and sovereign vulnerabilities*

Amid these economic and financial developments, progress has continued in addressing legacy issues from the euro area crisis. A strengthening of euro area *bank* balance sheets continues, supported by the ECB's comprehensive assessment. Capital positions have been strengthened further, amid increased transparency and balance sheet repair. Notwithstanding this progress in enhancing balance sheet resilience, many euro area – as well as global – banks are still confronted with profitability challenges amid a cyclical recovery proceeding at different speeds around the globe. At the same time, progress in repairing balance sheets in the *non-financial sector* also continues apace. In particular, euro area *sovereigns* have focused on repairing fiscal fundamentals alongside structural reforms, although at an uneven pace across countries. Public debt sustainability challenges nonetheless remain, implying that the work of restoring the soundness of public finances is unfinished, while structural reform efforts are needed to enhance macroeconomic growth prospects.

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

(Jan. 2011 – 14 Nov. 2014)




Sources: Bloomberg and ECB calculations.
Notes: "Probability of default of two or more LCBGs" refers to the probability of simultaneous defaults in the sample of 15 large and complex banking groups (LCBGs) over a one-year horizon. For more information on composite indicators of systemic stress, see the notes to Chart 1.11.

*Three key risks to euro area financial stability*

A combination of these legacy issues as well as emerging risks yields three key risks to euro area financial stability over the next year and a half (see Table 1) that have the potential to be mutually reinforcing if triggered. Underlying all of these key risks is the uncertainty surrounding the weak, fragile and uneven economic recovery and the current period of very low inflation, which has the potential to aggravate and trigger the existing vulnerabilities should the current situation continue for longer than expected or conditions deteriorate further.

## 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.

*Key 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*

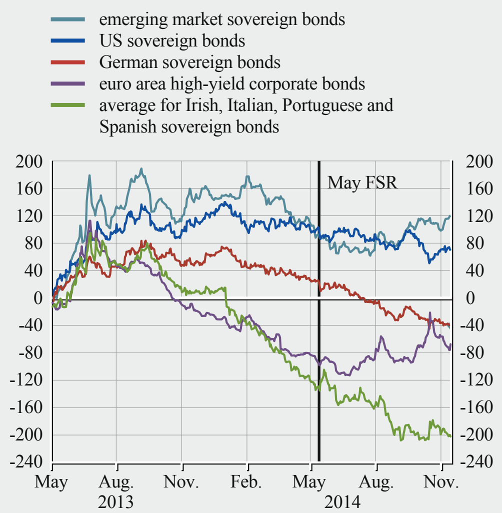
*Continued global search for yield…*

Despite bouts of volatility – linked to rising geopolitical tensions and weak economic data – a search for yield has persisted across global financial markets. The price of risk has remained low in most market segments, supported by historically low risk-free rates and measures of market volatility. This has been associated with an increased correlation within and across euro area bond, equity and money markets reminiscent of the years before the onset of the global financial crisis.

In Europe, this global strong demand for riskier assets has been most prominently seen in corporate and sovereign bond markets (see Charts 2 and 3), but also in valuations of other assets such as

### Chart 2 Cumulative changes in bond yields since May 2013

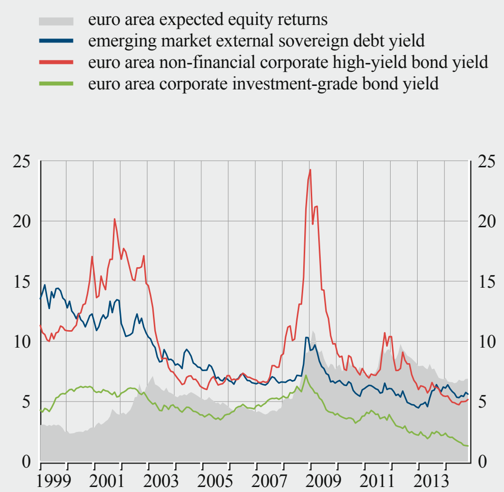
(2 May 2013 – 14 Nov. 2014; cumulative change in basis points; ten-year sovereign bond yields)




Sources: Bloomberg and JPMorgan Chase & Co.

### Chart 3 Selected bond yields and expected euro area equity returns

(Jan. 1999 – Oct. 2014; percentages)

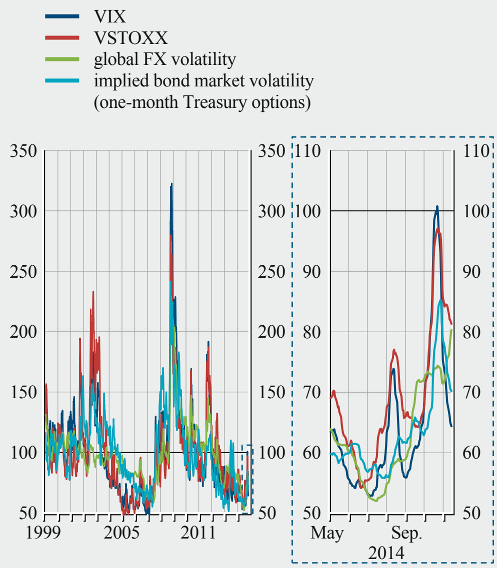



Sources: Bloomberg, Bank of America/Merrill Lynch indices, R. Shiller (Yale University), ECB and ECB calculations.
Note: The euro area expected equity return is the inverted Shiller cyclically adjusted price/earnings ratio.

equities and the prime segment of commercial property (i.e. modern office and retail space in capital cities). During the bouts of volatility in recent months linked to weak economic data releases and geopolitical tensions, investors showed some signs of increased credit risk aversion, especially towards high-yield corporates and, more recently, vulnerable sovereigns (see Chart 2), but appeared willing to continue to seek yield by increasing duration exposures to higher-rated issuers.

**Chart 4 Implied market volatilities**

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




Source: Bloomberg.

*… dependent on sustained risk appetite*

The resilience of strong investor demand for lower-rated bonds, equities and other higher-yielding asset classes depends on continued strong risk appetite. Indeed, outflows from high-yield bonds and bouts of increased financial market volatility in recent months (see Chart 4) highlight investor uncertainty regarding valuations and the potential for sharp adjustments in the future. Global investor sentiment remains sensitive to changes in the economic outlook, geopolitical tensions and emerging market risks, notably related to larger economies such as China. In addition, while monetary policy settings in major economies, including the euro area, provide an anchor for expectations regarding short-term interest rates, yields on longer-dated bonds remain vulnerable to an increase in US term premia.

At the same time, financial stability risks may arise from investor complacency especially during periods of weak returns on financial assets when investors hunt for yield. Such periods have the potential to breed systemic risks, if they lead to an excessive build-up of leverage or maturity extension and mismatches. While leverage in the banking sector has remained in check, signs of increasing leverage have started to emerge in securities markets and among shadow banking entities, albeit from relatively low levels. In addition, continued low yields may place additional pressure on investors to improve returns by taking on higher duration risk exposures.

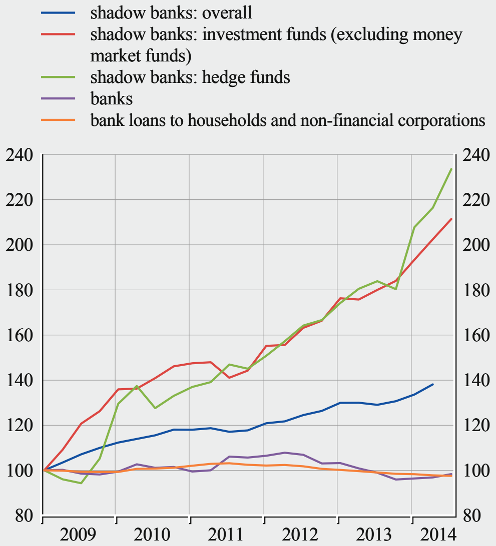
Along with signs of some increase in leverage and duration, concerns remain that the impact of a possible reversal of hunt-for-yield flows could be amplified by low market liquidity in some segments. For instance, although primary bond markets have seen continued strong investor demand, secondary market liquidity, in particular in corporate bond markets, has deteriorated in recent years. This has included lower daily trading volumes – in an environment of significantly higher amounts outstanding – and a reduction in the number of market-makers. Markets that are important for the functioning of bond markets, such as repo markets, have seen reduced activity since the outbreak of the financial crisis as well.

*Vulnerabilities have been growing in the shadow banking sector…*

Although the euro area banking sector remains exposed to the risk of a repricing of market risk, the steady increase in the euro area shadow banking sector in recent years, amid a gradual shift from bank to market-based funding in the economy, suggests that vulnerabilities are likely to have been growing more in this segment (see Chart 5). Any problem confronting investment funds could, however, propagate quickly to the banking sector and the real economy since they are highly interconnected with euro area credit institutions and an important source of funding for euro area banks, non-financial corporates and governments. The euro area investment fund sector has doubled in size since 2009, with assets reaching €8.9 trillion in the third quarter of 2014. Almost all of these funds are open-ended and the share of liquid assets as a percentage of shares/units issued has declined from 40% in 2009 to 33% in the third quarter of 2014. This raises stability concerns as demandable equity in these funds can have the same fire-sale properties as short-term debt funding. In addition, some segments of the shadow banking sector appear to have become more concentrated, for instance with the largest global asset managers accounting for an increasing share of assets under management.

**Chart 5 Assets of selected euro area financial sectors**

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




Sources: ECB and ECB calculations.

*… which calls for implementation of prudential policies*

With monetary policies aimed at preserving price stability, prudential policies are needed to address vulnerabilities from financial excesses. As the potential for adjustment in financial markets remains, micro- and macro-prudential policies need to be considered to ensure that financial intermediaries have sufficient buffers to withstand a reversal of risk premia. It also calls for further initiatives to monitor and assess vulnerabilities in the growing shadow banking sector, and for continued efforts to improve the oversight and the tools available for mitigating action as currently available tools have limited scope to deal with risks from shadow banking activities.

*Key risk 2: Persistent weak bank profitability in a weak, fragile and uneven macroeconomic recovery*

*Bank profitability remains weak…*

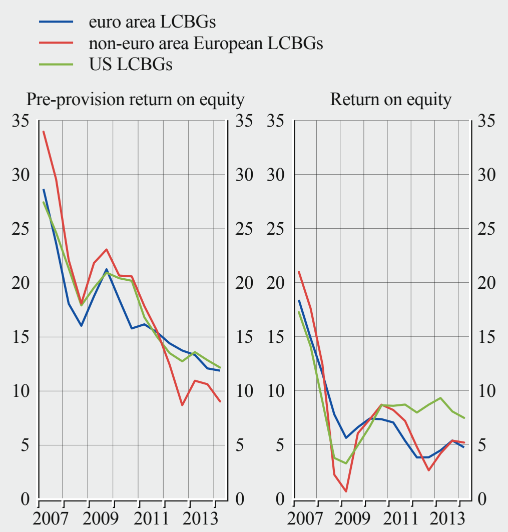
A confluence of cyclical and structural factors has led to a low profitability or loss-making environment for euro area banks. Clearly, the emergence from crisis and recession in the euro area has had a significant impact – with one-fifth of euro area significant banking groups[1] reporting losses in the first half of 2014, albeit down considerably from more than half of the banks reporting losses in the second half of 2013. Sluggish bank profitability has, however, not only been a challenge specific to euro area banks. Their aggregate financial performance closely resembles that of non-euro area European banks and – once correcting for provisioning – also that of their US peers (see Chart 6).

Persistent weak bank profitability could become a systemic concern if it limits banks' ability to improve their shock-absorbing capacity via retained earnings and provisioning. This could prevent

1 "**Significant banking groups**" (SBGs) refers to around 90 euro area banking groups (depending on data availability) and is the consolidated group level analogue of the significant banks that fall under direct ECB supervision. Alongside this group of banks, the FSR also contains analysis of a sub-set of 18 euro area "**large and complex banking groups**" (LCBGs) – which is a sub-set of the SBGs – and 22 global LCBGs which are the largest, least substitutable and most interconnected banks. For further details, see "A new bank sample for the ECB's Financial Stability Review", *Financial Stability Review*, ECB, November 2013.

**Chart 6 Pre- and post-provision return on equity of euro area and global large and complex banking groups (LCBGs)**

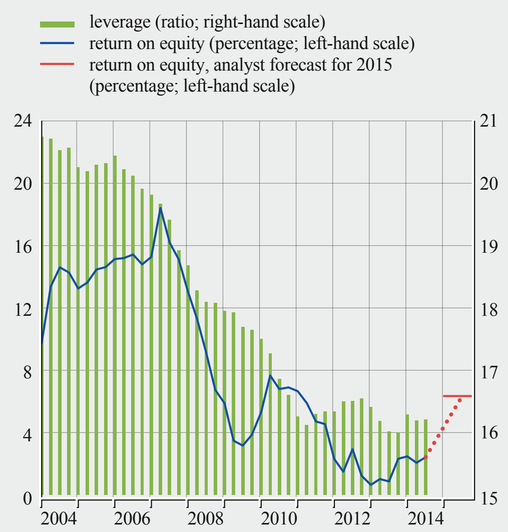
(H1 2007 – H1 2014; percentages; medians; two-period moving average)




Sources: SNL Financial and ECB calculations.
Note: "Non-euro area European LCBGs" include banks from the United Kingdom, Switzerland, Sweden and Denmark.

**Chart 7 Return on equity and leverage of euro area significant banking groups**

(Q1 2004 – 2015; medians)




Sources: Bloomberg and ECB calculations.

banks around the world from engaging in new profitable lending activities and lead to more structural business model-related concerns in a low growth environment. In such circumstances, banks might be tempted to take on more risk to improve profitability, which in turn could make them more vulnerable to future shocks.

*… due to both cyclical and structural factors…*

Cyclical headwinds affecting profitability are expected to dissipate as the economic environment improves, and signs of a levelling-off in the pace of non-performing loan formation have emerged in some countries. That said, the turning point does not appear to have been reached yet in some countries and the fragile and uneven economic recovery points to continued downside risks to the credit quality of banks' borrowers. At the same time, large one-off costs stemming from past conduct irregularities weigh on banks and could lead to market volatility, in particular for some large euro area banks that are active in capital market businesses.

Although cyclical factors mainly related to high loan loss provisioning needs continue to weigh heavily on euro area banks' financial performance, the fact that for many banks their return on equity has fallen below their cost of equity – shareholders' expected rate of return – also points to a structural need for further balance sheet adjustment in parts of the banking system. Current lower levels of profitability are also a result of – the much needed – de-risking of bank balance sheets, including a stark reduction in leverage (see Chart 7). The challenge for banks is therefore to improve profitability without unduly taking on risk.

While the challenges confronting banks can to a large extent be linked to legacy issues stemming from the financial crisis, including the weak economic environment, in some countries signs of new potential risks are emerging. In particular, property market developments in both the residential and (prime) commercial segments in some countries have been frothy, leaving property markets vulnerable to correction should investor sentiment deteriorate. The numerous property-related instruments in the newly acquired macro-prudential toolkit may contribute to attenuating financial cycles, while also increasing the resilience of banks and their borrowers.

*… although efforts to build a stronger banking sector have been significant*

Amid current legacy and new challenges confronting banks, efforts to clean up balance sheets, bolster capital positions and adjust business models continue. Bank balance sheets have been strengthened further, with a clear shift towards capital increases in 2014 – related to the comprehensive assessment carried out by the ECB – from deleveraging and de-risking in previous years. This has happened amid a significant reduction in the size of bank balance sheets since mid-2012. However, signs have emerged that the asset reduction process might have come to an end (see Chart 8), which, together with continuously improving capital buffers, can be seen as a positive development as it suggests that the trough in the bank performance cycle might have been reached. Aggregate data, however, conceal notable differences across banks and countries and further adjustments are needed in parts of the banking sector.

**Chart 8 Evolution of total assets of euro area monetary financial institutions**

(May 2012 – Sep. 2014; EUR trillions)


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

While the comprehensive assessment ensured that significant banks in the euro area have sufficient capital levels, progress needs to continue in parts of the banking system to address remaining fragilities and uncertainties. Further measures in this respect need to be taken mainly by banks themselves and needed action is likely to differ across banks or national banking sectors depending on whether banks are, for instance, faced with possible overcapacity in parts of the banking sector, high costs, or limited diversification of their income sources. In addition, continued prudent asset valuation enforcement, as well as timely and accurate risk controls by banks, should encourage banks to develop appropriate systems to deal with credit risk and enhance their capacity to deal with distressed borrowers. At the same time, further official sector policies can also provide support – in particular, legal frameworks should be sought that facilitate a timely and low-cost resolution of non-performing loans, thereby enabling a smooth interaction between banks and their distressed borrowers and freeing up additional lending capacity.

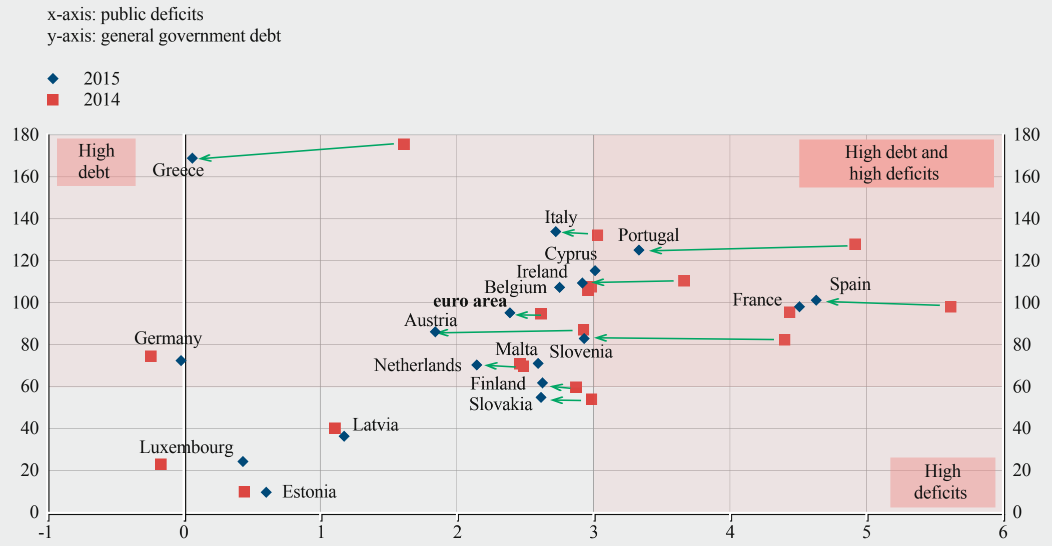
*Key risk 3: Re-emergence of sovereign debt sustainability concerns, amid low nominal growth and wavering policy determination for fiscal and structural reforms*

*Sovereign stress has remained contained…*

Sovereign stress has remained contained in the euro area since the publication of the May FSR, albeit with increasing challenges from a deterioration in the economic growth outlook. Building on the improved sovereign debt market conditions following the announcement of Outright Monetary Transactions in 2012 and more recent ECB policy action, market sentiment – especially towards more vulnerable euro area countries – has remained relatively favourable in recent months. Some gradual strengthening in cyclical economic conditions and the ongoing adjustment of fiscal fundamentals underpinned this development. The aggregate euro area fiscal deficit is expected to continue to fall and stay below the 3% Maastricht threshold this year as consolidation efforts and

**Chart 9 General government debt and deficits in the euro area**

(percentage of GDP)




Source: European Commission.

various reform and administrative measures have started to bear fruit and tax revenues have grown more strongly than initially expected in some countries. In addition, the unwinding of financial sector support is expected to contribute positively to the improvement of fiscal positions in 2014 and beyond in many countries (see Chart 9).

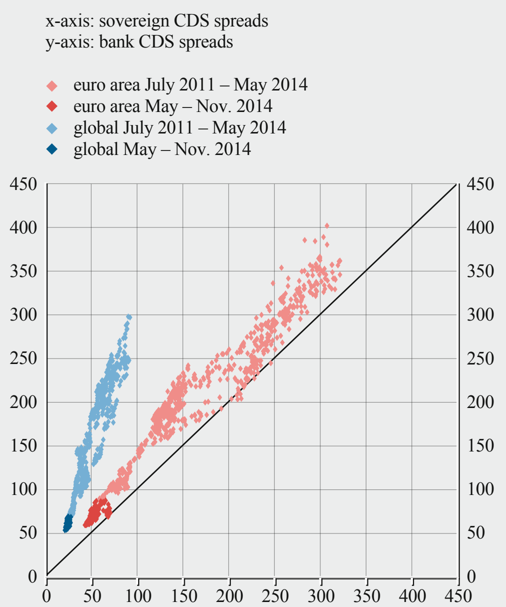
Sentiment towards sovereigns has also been supported by continued progress towards weakening the links between sovereigns and banks. Most notably, banking union preparations have continued with its first pillar, the Single Supervisory Mechanism (SSM), in place since 4 November. Regulatory initiatives – such as new bail-in rules – have also helped to weaken links between euro area banks and sovereigns, although the continued significant correlation in euro area banks' and sovereigns' borrowing costs highlights the need for continued progress (see Chart 10).

*… but public debt sustainability challenges persist…*

Despite the relatively benign sentiment towards euro area sovereigns, public debt sustainability challenges persist in the context of continued high debt levels in many countries, heightened

**Chart 10 Sovereign and bank credit default swap 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).

downside risks to the economic outlook and a low inflation environment. Uncertainties relating to sovereign debt sustainability are likely to remain over the medium term as government debt-to-GDP ratios are projected to stay at levels well above 100% in several euro area countries. This highlights the need for further adjustment of fiscal and economic fundamentals relevant for debt sustainability.

Debt sustainability concerns in the medium term remain susceptible to potential setbacks related to the aforementioned necessary further adjustment as well as the weak nominal growth outlook. The needed adjustment could run the risk of being delayed due to the recent relative calm in euro area financial markets, which has the potential to breed complacency in terms of fiscal consolidation and structural reforms. Reinforced rules at the European level should help to mitigate such risks, but reform fatigue or complacency at the national level could lead to a reassessment of sentiment towards euro area sovereigns. Debt sustainability concerns could also resurface during a prolonged period of very low inflation or if the economic outlook deteriorates, which would limit governments' room for manoeuvre for further fiscal adjustment.

***… which are also linked to search for yield and banking sector concerns***

Clearly, risks to the sovereign outlook are also closely linked to the risks stemming from the ongoing global search for yield or further stress in the banking sector. 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, and could also translate into losses for banks on their sovereign debt holdings. In addition, while new bail-in rules will help shield public balance sheets and taxpayers from future national costs of bank recapitalisation, the potential for renewed adverse feedback loops between banks and sovereigns also remains. Continued efforts to swiftly and effectively implement all pillars of the banking union as well as the Bank Recovery and Resolution Directive are therefore needed.

## MACRO-PRUDENTIAL POLICY ACTION AND REGULATORY INITIATIVES

***Policy action and regulatory advancements have continued***

Progress towards a safer financial system continues, with macro-prudential policy action and regulatory advancements at both the European and global levels.

In line with newly acquired macro-prudential policy mandates, a number of euro area countries have already announced and also implemented macro-prudential measures. These include *systemic risk measures* aimed at mitigating vulnerabilities stemming from the significant size, high concentration and interconnectedness of banking sectors. Different types of *residential property measures* have been adopted as well, with the aim of addressing unfavourable developments in property markets.

In the regulatory field, progress in strengthening banking sector resilience has continued, including weakening the links between sovereigns and banks. Notably, significant achievements have been made since the publication of the last issue of the FSR in the areas identified as central elements of an integrated financial framework in Europe, particularly in the euro area, namely the establishment of a Single Supervisory Mechanism, a common resolution framework and a Single Resolution Mechanism, along with more harmonised deposit insurance scheme parameters. Measures have not only been taken in the banking domain, however, but also across other financial institutions, as well as market infrastructures. Perhaps most importantly, as shadow banking grows in breadth around the world, regulation of this segment has also gathered pace.