

Vítor Constâncio

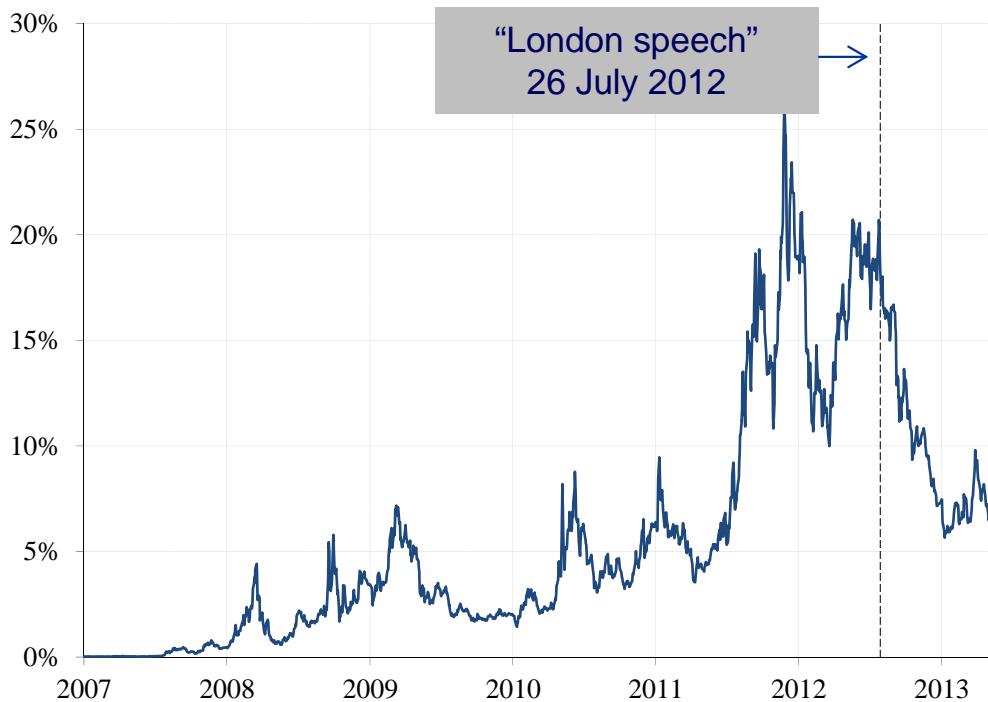
ECB Financial Stability Review

29 May 2013

Press briefing presentation

Indicators of financial stress across (i) banks and (ii) financial markets at lowest levels in two years...

Probability of a simultaneous default by two or more euro area large and complex banking groups - systemic risk measure (SRM) (percentages; 1-year horizon; 5-day moving average)



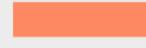
Composite indicator of systemic stress (CISS) for the euro area (5-day moving average)



Sources: Thomson Reuters and ECB calculations.

Sources: ECB and ECB calculations.

Key risks to euro area financial stability

	Current level and recent change
1. Further decline in bank profitability, linked to credit losses and a weak macroeconomic environment	
2. Renewed tensions in sovereign debt markets due to low growth and slow reform implementation	
3. Bank funding challenges in stressed countries	
4. Reassessment of risk premia in global markets, following a prolonged period of safe-haven flows and search for yield	
considerable systemic risk	
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 the change since the previous FSR.

Main risks and vulnerabilities

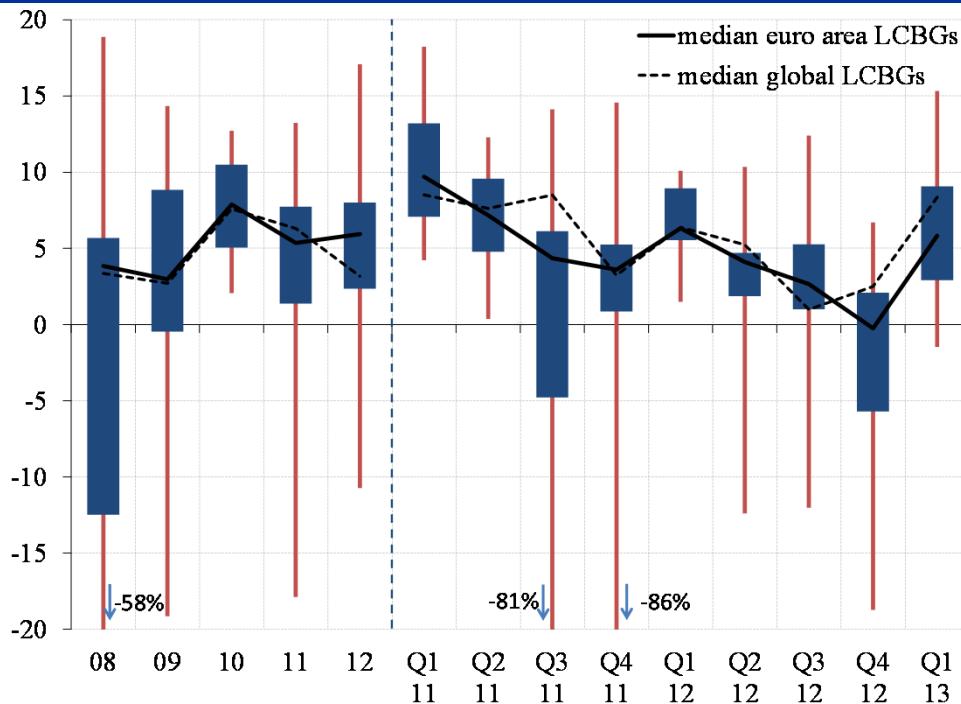
Risk 1 - Further decline in bank profitability, linked to credit losses and a weak macroeconomic environment



Weak profitability amid rising NPLs:
Low profitability

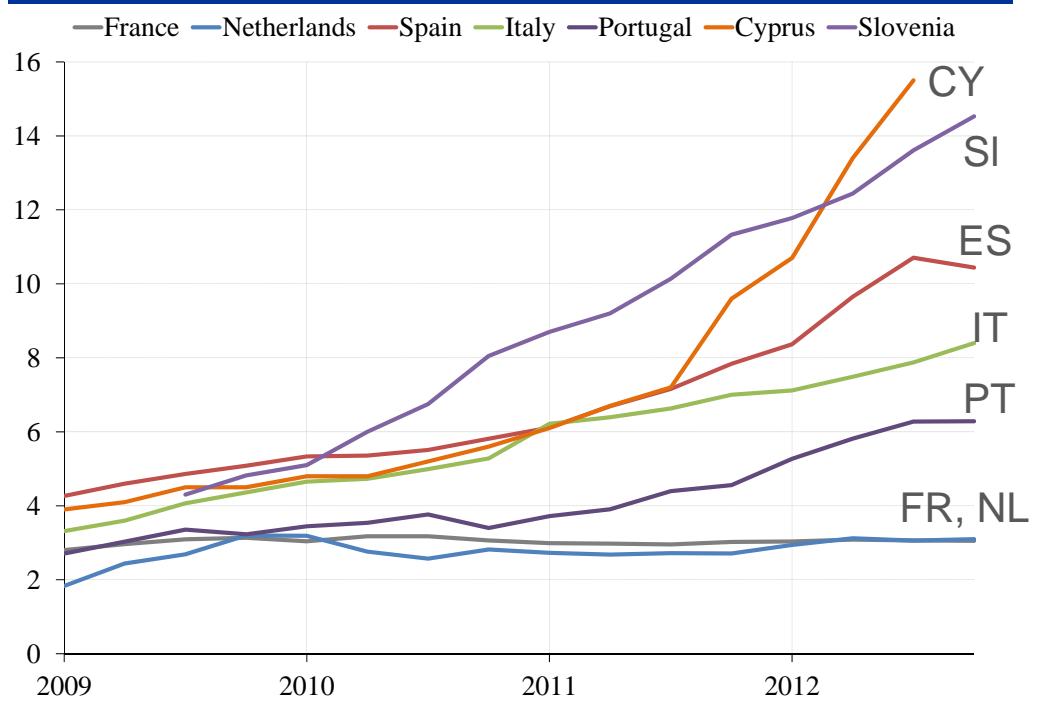
Rising NPL ratios

Return on equity of euro area and global large and complex banking groups
(percentages; maximum, minimum and interquartile distribution across euro area LCBGs)



Source: Individual institutions financial reports.

Non-performing loan ratios in selected euro area countries
(percentage of total loans)



Source: National central banks.

Main risks and vulnerabilities

Risk 1 - Further decline in bank profitability, linked to credit losses and a weak macroeconomic environment

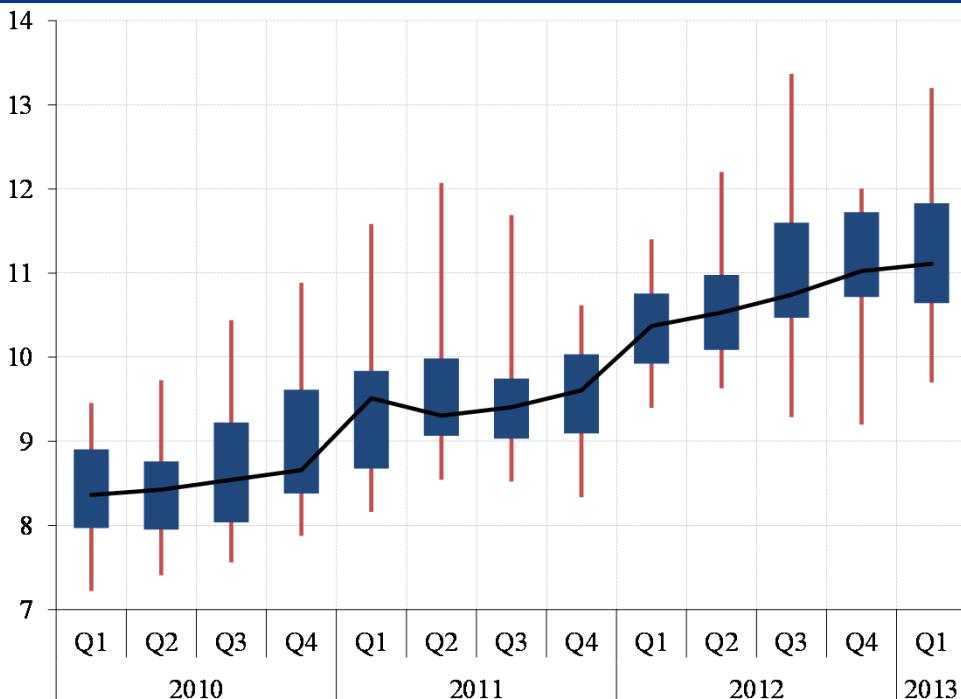


Improving solvency positions

CT1 capital steadily rising

Core Tier 1 capital ratios of euro area large and complex banking groups

(percentages; maximum, minimum, interquartile distribution and median)

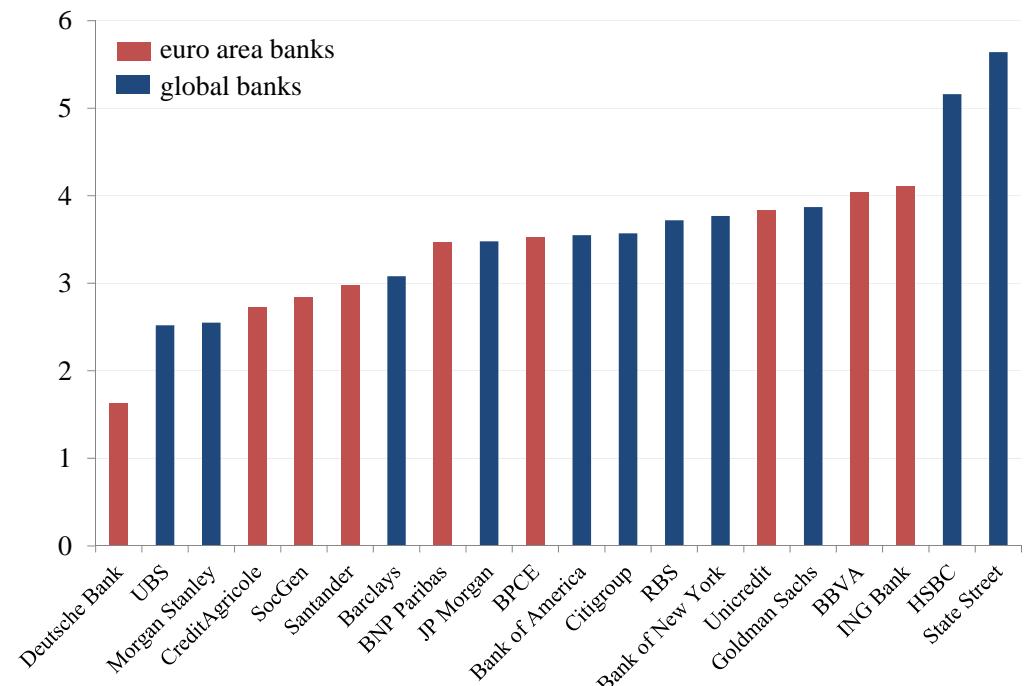


Source: SNL Financial.

Leverage ratios that on the same IFRS basis compare well with US banks

Leverage ratios of selected euro area and global banking groups

(Q4 2012; percentages; IFRS-equivalent estimates of adjusted tangible equity over adjusted tangible assets)



Source: Thomas M. Hoenig, Vice Chairman of the Federal Deposit Insurance Corporation (FDIC), "Basel III Capital: A Well-Intended Illusion", speech at the International Association of Deposit Insurers 2013 Research Conference in Basel, Switzerland, April 2013.

Main risks and vulnerabilities

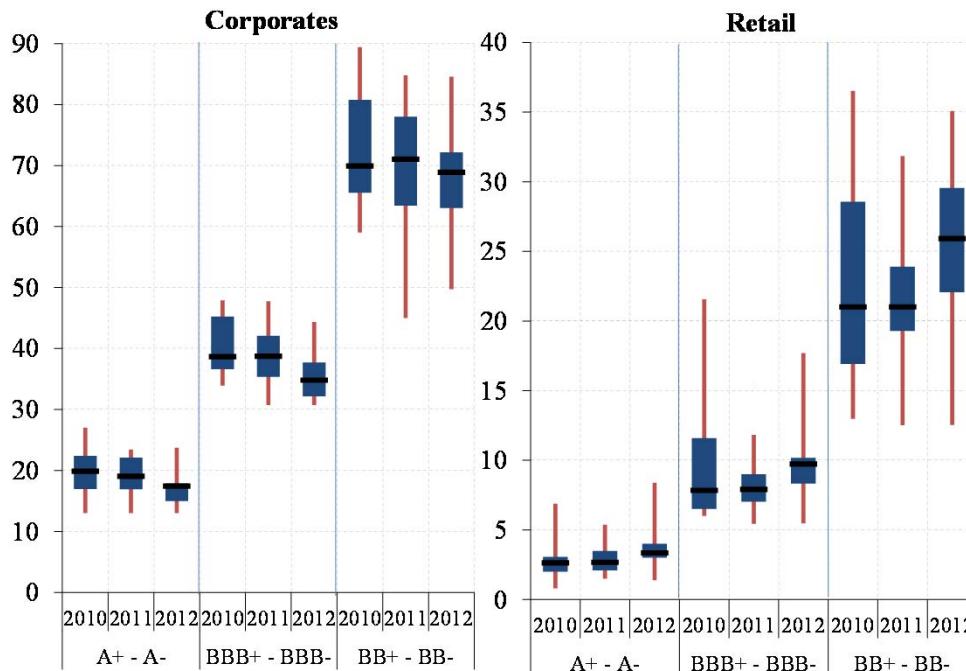
Risk 1 - Further decline in bank profitability, linked to credit losses and a weak macroeconomic environment



Concerns about credit risk weights

Euro area large and complex banking groups' risk weights for corporate and retail credit exposures
(percentages; maximum, minimum, interquartile distribution and median)

A - levels



B - changes



Sources: Individual institutions' Pillar 3 reports and ECB calculations.

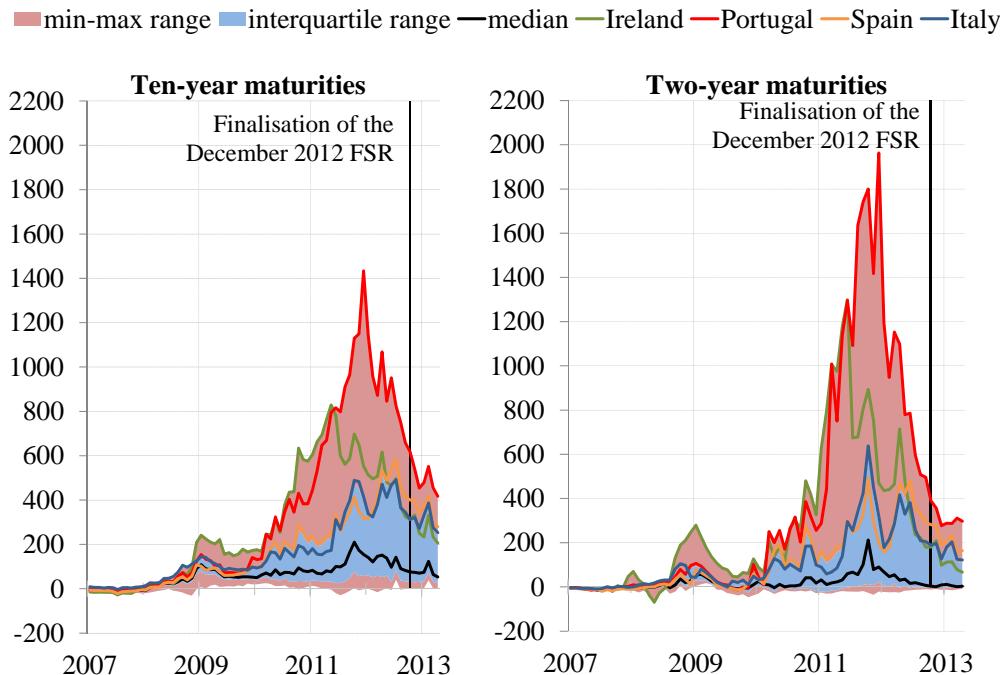
Main risks and vulnerabilities

Risk 2 - Renewed tensions in sovereign debt markets due to low growth and slow reform implementation



Generalised easing of sovereign stress:
Lower common risk premia

Spread between euro area sovereign bond yields and the overnight index swap (percentages)

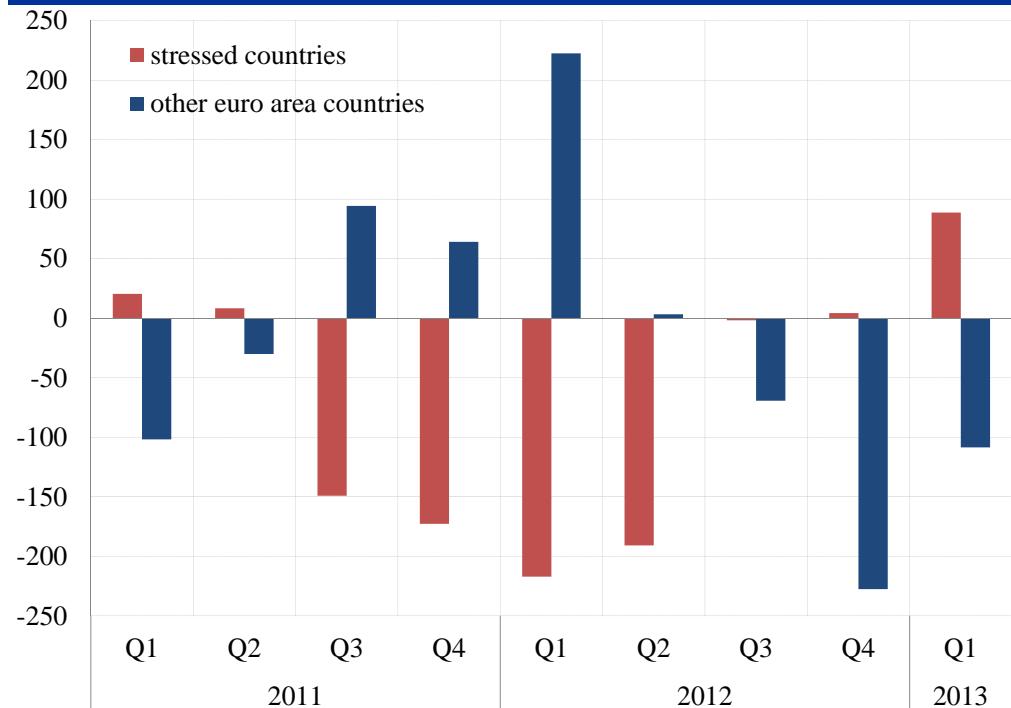


Source: Bloomberg.

Net inflows of private capital

Net private financial flows

(EUR billions; sum of net FDI flows, net portfolio investment and net other investment)



Source: ECB.

Main risks and vulnerabilities

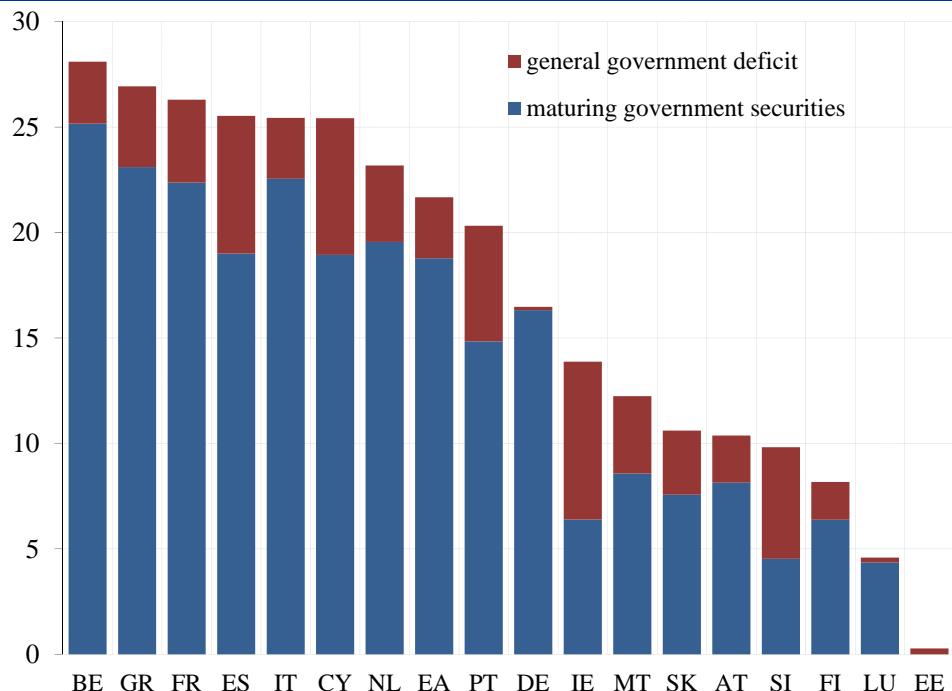
Risk 2 - Renewed tensions in sovereign debt markets due to low growth and slow reform implementation



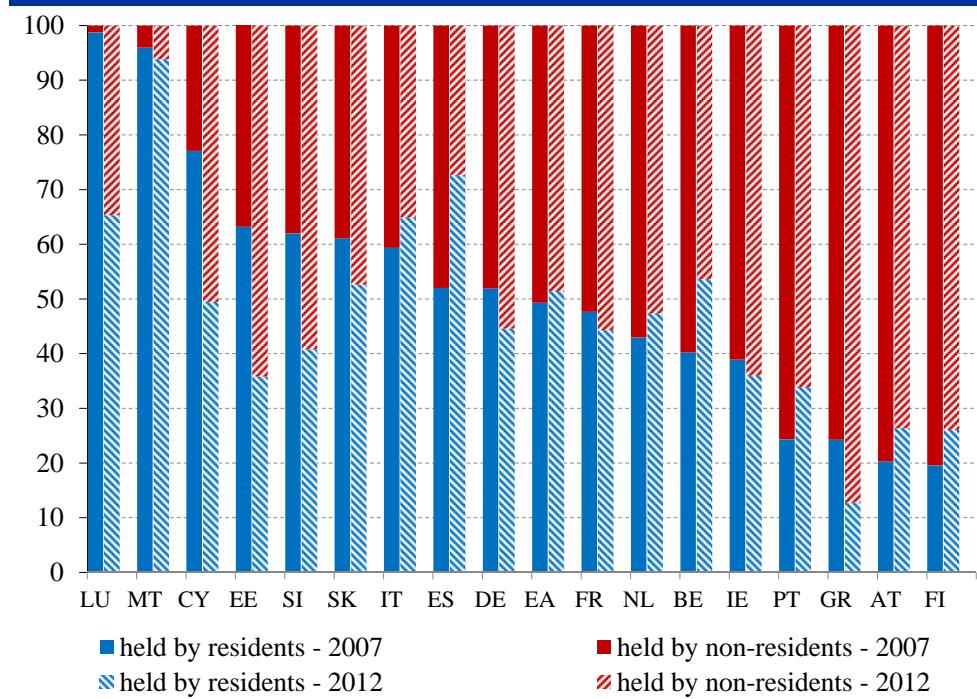
But vulnerabilities still in place:

Large sovereign refinancing needs but higher percentage of domestic debt holders

Maturing securities and projected deficit financing needs of euro area governments in 2013
(percentage of GDP)



Total general government debt by residency of creditors
(percentage of total government debt)



Source: European Commission.

Sources: ECB, European Commission's 2013 spring economic forecast (for total government debt) and ECB calculations.

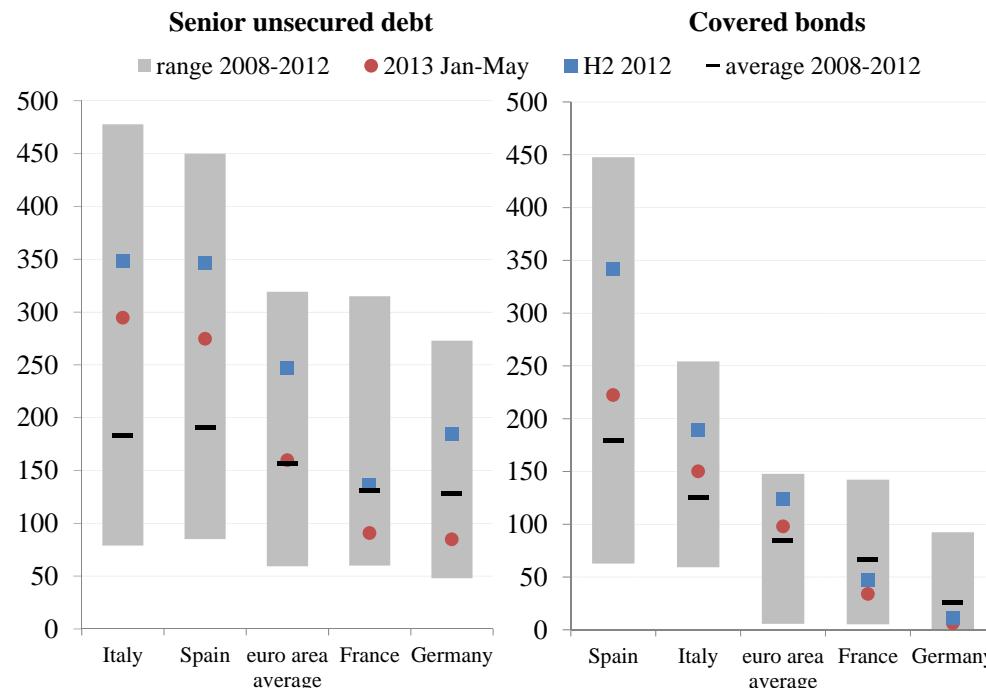
Risk 3 - Bank funding challenges in stressed countries



Fragmentation persists in bank funding markets

Pricing: Geography and size matters

Spreads on senior unsecured debt and covered bonds in selected euro area countries (basis points; spread over swaps)

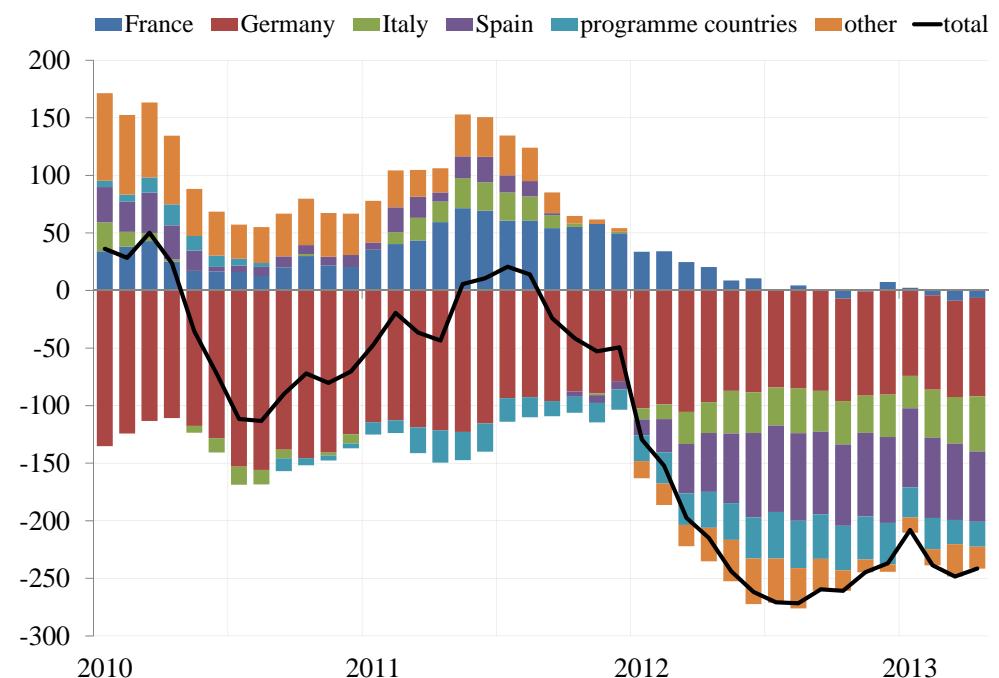


Sources: Dealogic and ECB calculations.

Notes: Based on EUR-denominated fixed rate deals with an issue size of at least EUR 250 million. For covered bonds, only mortgage-backed bonds are included. Excludes retained deals.

Volumes: weak everywhere

Net issuance of medium and long-term debt securities by euro area banks (12-month rolling, EUR billions)



Source: Dealogic.

Notes: Excludes retained deals.

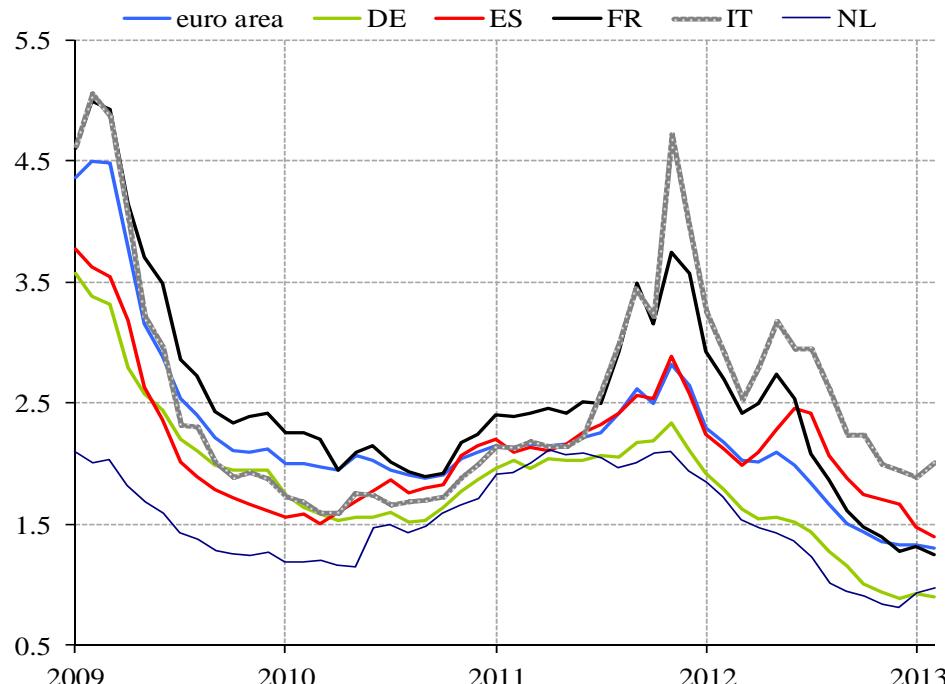
Risk 3 - Bank funding challenges in stressed countries



Fragmentation persists:

Though bank funding costs have significantly decreased everywhere

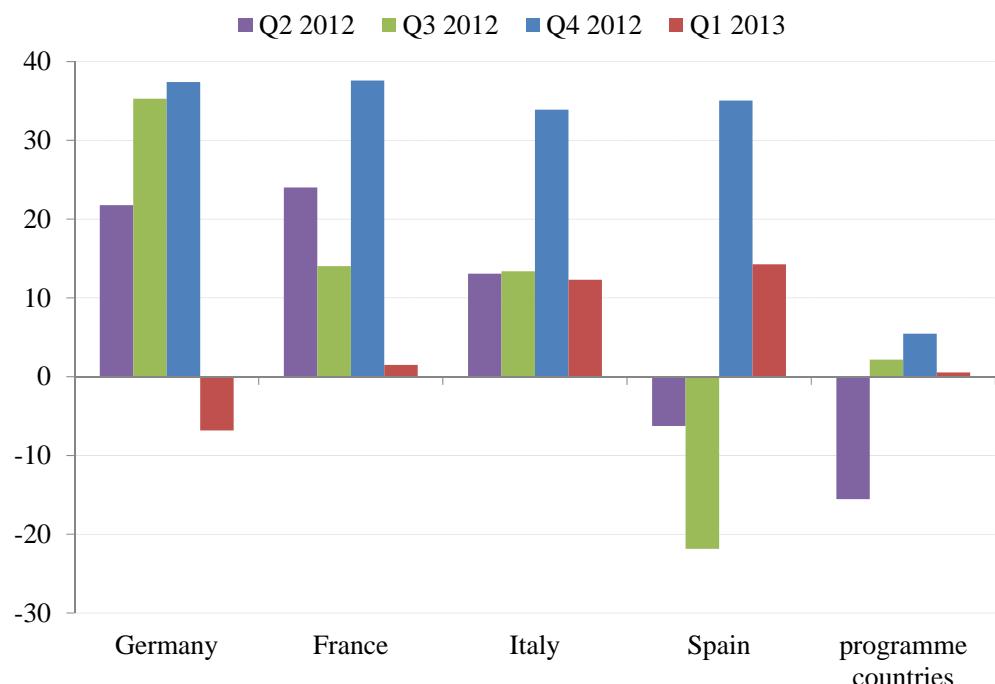
Composite cost of bank funding (deposit and market funding weighted average) (percentages per annum)



Source: ECB.

Deposit increase in the periphery

Deposit flows in selected euro area countries (EUR billions)



Source: ECB.

Main risks and vulnerabilities

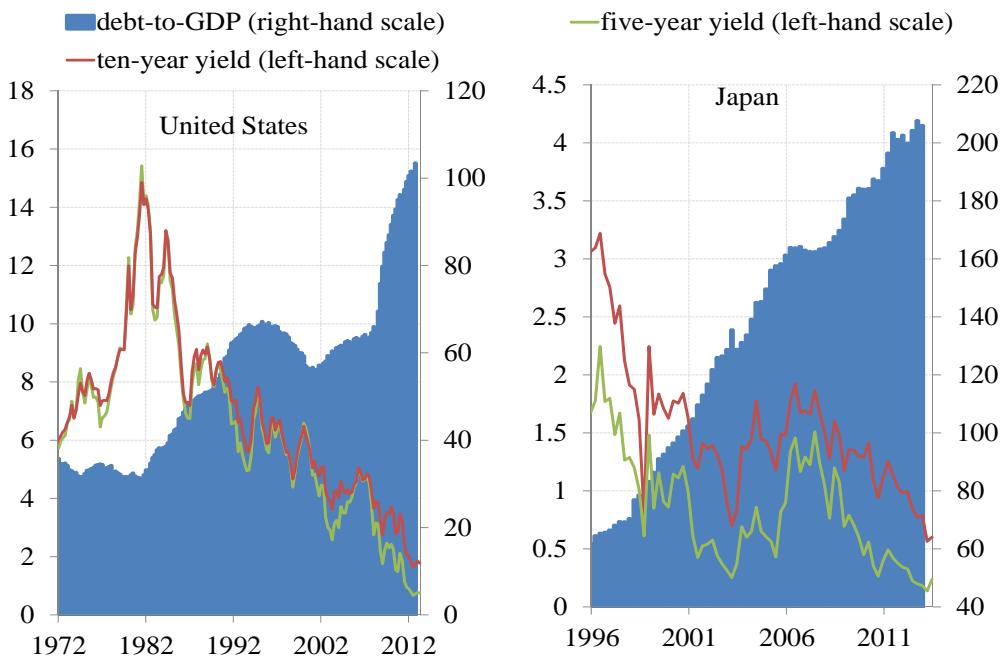
Risk 4 - Reassessment of risk premia in global markets, following a prolonged period of safe-haven flows and search for yield



Credit cycle and financial flows

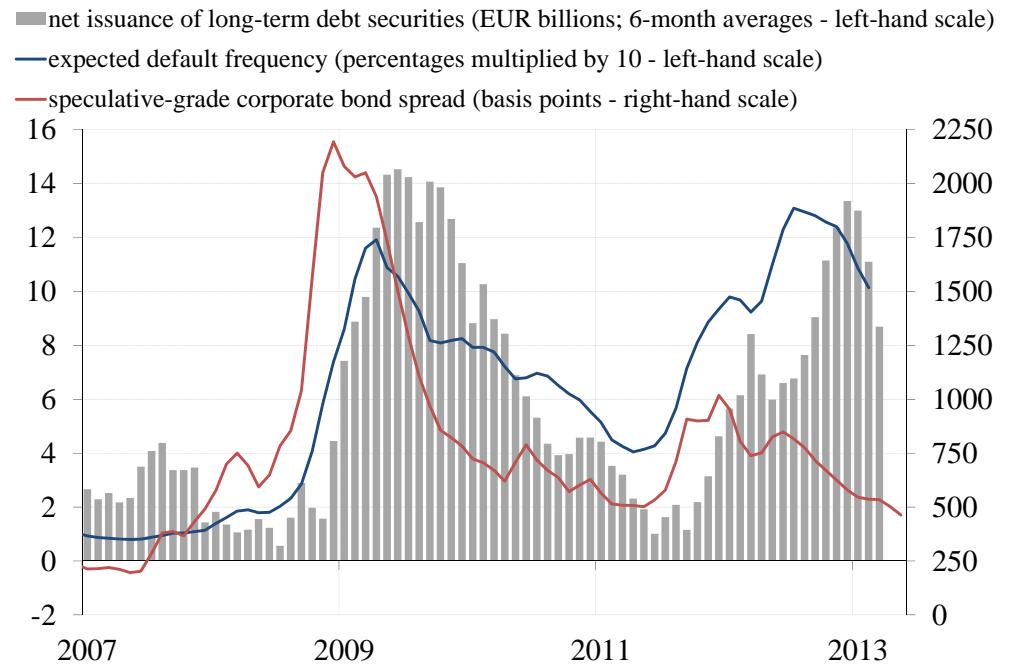
Credit markets strong everywhere

Yields on government bonds and debt-to-GDP levels for the US and Japan



Possible underestimation of risk

High-yield bond spreads, bond issuance and expected default frequency within one year of euro area non-financial corporates



Sources: Federal Reserve Bank of St. Louis, Bloomberg and ECB calculations.

Sources: Moody's, Bloomberg and ECB.

Mapping main systemic risks into adverse macro-financial scenarios

Risk	Scenario	Key assumptions driving impact on GDP
Decline in bank profitability, linked to credit losses and a weak macroeconomic environment	Economic growth scenario	Shocks to investment and consumption as well as user cost of capital and nominal wages
Renewed tensions in euro area sovereign debt markets due to low growth and slow reform implementation	Sovereign debt crisis scenario	An aggravation of the sovereign debt crisis fuelling increases in interest rates and stock price declines
Bank funding challenges in stressed countries	Funding stress scenario	Restricted access to funding fuelling bank deleveraging and restricting loan supply
Reassessment of risk premia in global markets	Risk aversion scenario	A shock to confidence and rise in risk aversion worldwide fuelling stock price declines, corporate bond yield increases and eventually affecting euro area external demand

Overall impact on euro area GDP growth under the baseline and the adverse scenarios

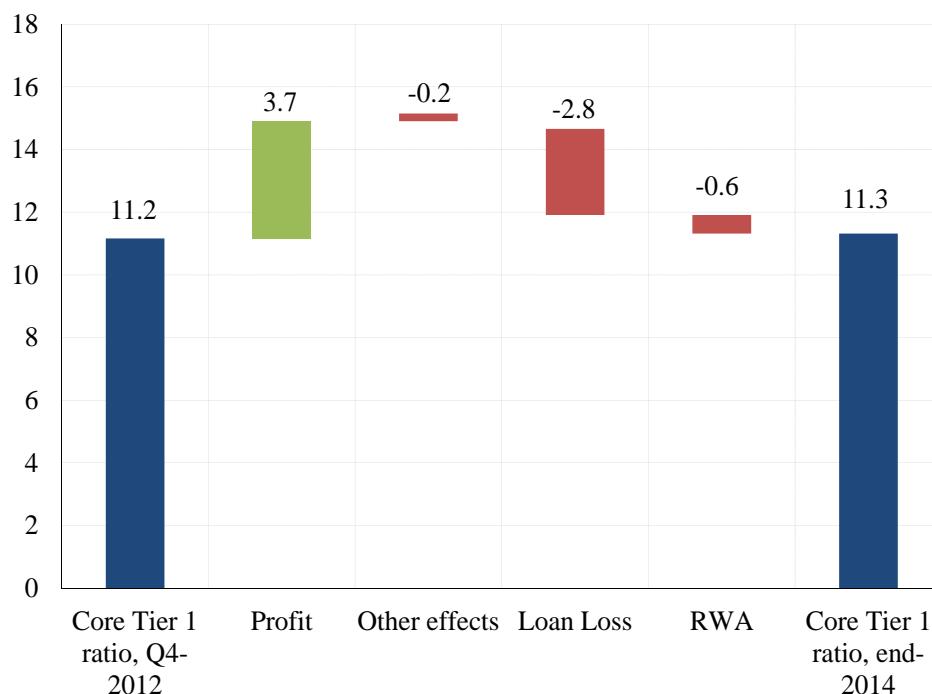
	2013	2014
Baseline (EC Spring 2013 Forecast; annual growth rate)	-0.4%	1.2%
<i>percentage point deviations from baseline growth rates:</i>		
Economic growth scenario	-0.4	-0.9
Sovereign debt crisis scenario	-0.3	-0.6
Joint debt crisis & economic growth scenario	-0.5	-1.2
Funding stress scenario	-1.6	-0.3
Risk aversion scenario	-0.6	-0.5

Forward-looking solvency analysis based on the four key systemic risks

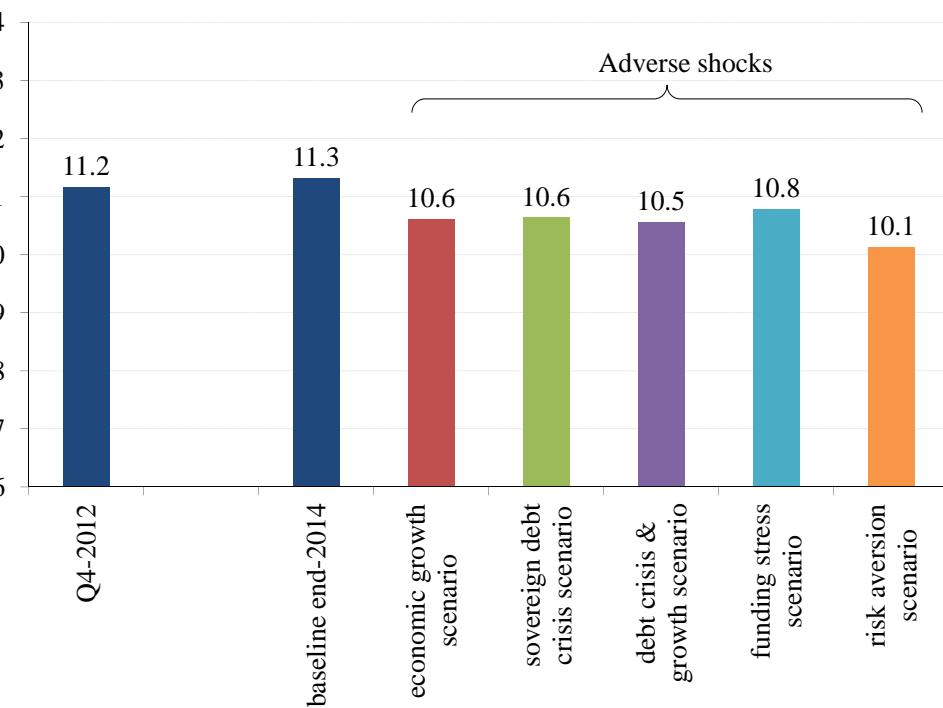
Improving baseline

Negative adverse scenario impact

Average contribution of profits, loan losses and risk-weighted assets to core Tier 1 capital ratios of euro area LCBGs under the baseline scenario (percentage; percentage point contribution)



Average core Tier 1 capital ratios of euro area LCBGs under the baseline and adverse scenarios (2012-2014; percentage; average of euro area banks)



Sources: Individual institutions' financial reports, EBA, ECB and ECB calculations.

Conclusions

- FINANCIAL STABILITY HAS IMPROVED BUT REMAINS FRAGILE.
- A number of positive developments have been observed:
 - Stress in the euro area financial sector has fallen from previous peaks.
 - Reduction of spreads and yields of stressed countries' sovereign bonds.
 - Banks in countries under stress experienced an *increase of retail deposits and an increase in capital and reserves*.
 - Banks' *cost of funding* declined supported by policy actions.
 - Banks (including those from stressed countries) have been *reducing reliance on the Eurosystem*.
- However, the situation remains fragile and risks deterioration due to weak growth and banking sector vulnerabilities:
 - Banks' *profitability* will continue to be a challenge in the present environment of recession and high unemployment: more growth is needed both in non-stressed countries and stressed countries.
 - Some banks' *balance sheets still in need of repair*: a rigorous balance sheet assessment is necessary.
 - *Sovereign debt crisis* still impacts banks' funding conditions. No separation of banks and sovereigns achieved: necessary to implement banking union.
 - *Financial fragmentation* remains an issue both at country level (core vs. countries under stress) and at bank level (LCBGs vs. mid-sized & small banks).
 - Subdued *issuance of unsecured bank bonds* since February.