EUROPEAN CENTRAL BANK

EUROSYSTEM

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# ECB Financial Stability Review

November 2013

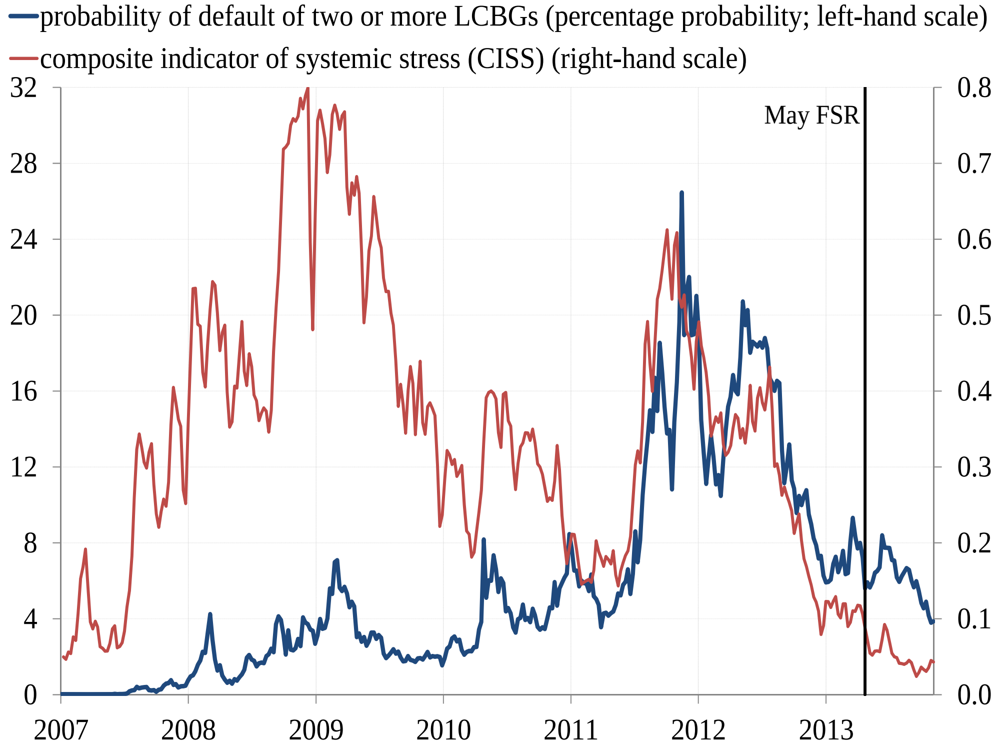
27 November 2013

Press conference presentation

- **Systemic banking sector stress at 2½ year low**
  - ✓ lowest since euro area sovereign debt crisis intensified in mid-2011

- **Systemic stress across major financial markets at 6 year low**
  - ✓ Lowest since first global financial strains in summer 2007

**Measures of financial market and banking sector stress in the euro area**
(Jan. 2007 – 15 Nov. 2013)




Source: Bloomberg and ECB calculations.

Note: Probability of two or more of a sample of 15 large and complex banking groups (LCBGs) defaulting simultaneously over a one-year horizon.

**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 | ⇨ |
| 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 | ⇨ |
| 3. Global financial market turbulence, with asset mispricing and low market liquidity | ⇧ |
| 4. Bank funding challenges in stressed countries that force banks to deleverage excessively | ⇩ |

pronounced systemic risk

medium-level systemic risk

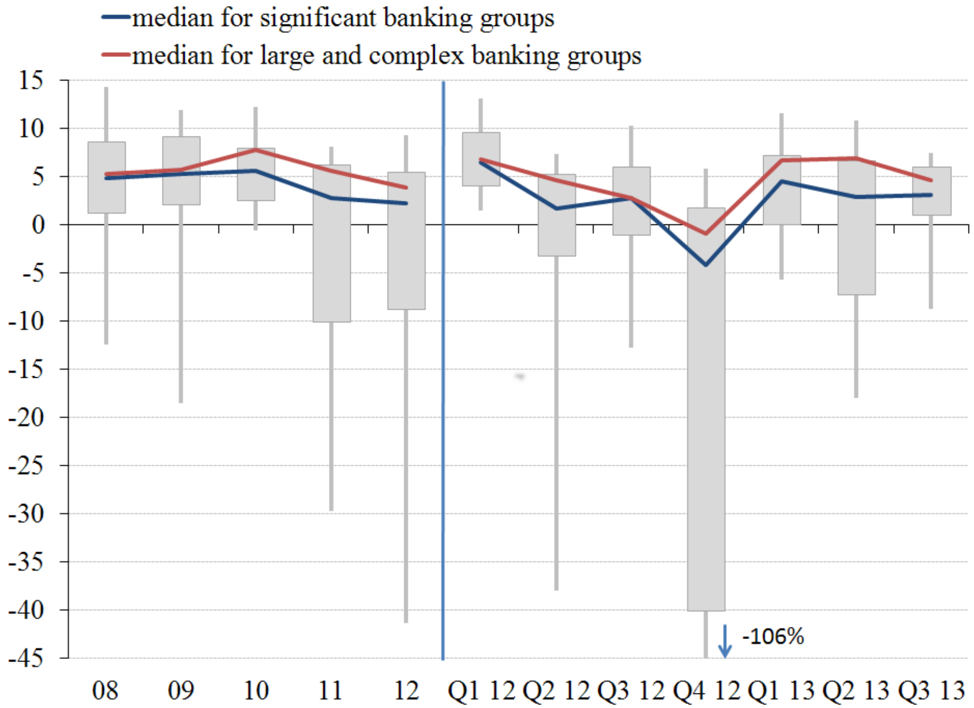
potential systemic risk

* 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.

## Risk 1 - Economic and financial shocks that affect asset valuations and bank profitability, eroding confidence in the euro area financial sector

Profit generation continues to be a challenge for euro area banks…

**Euro area banks' return on equity**
(2008 – Q3 2013; percentages; 10th and 90th percentile and interquartile range distribution across significant banking groups (SBGs))

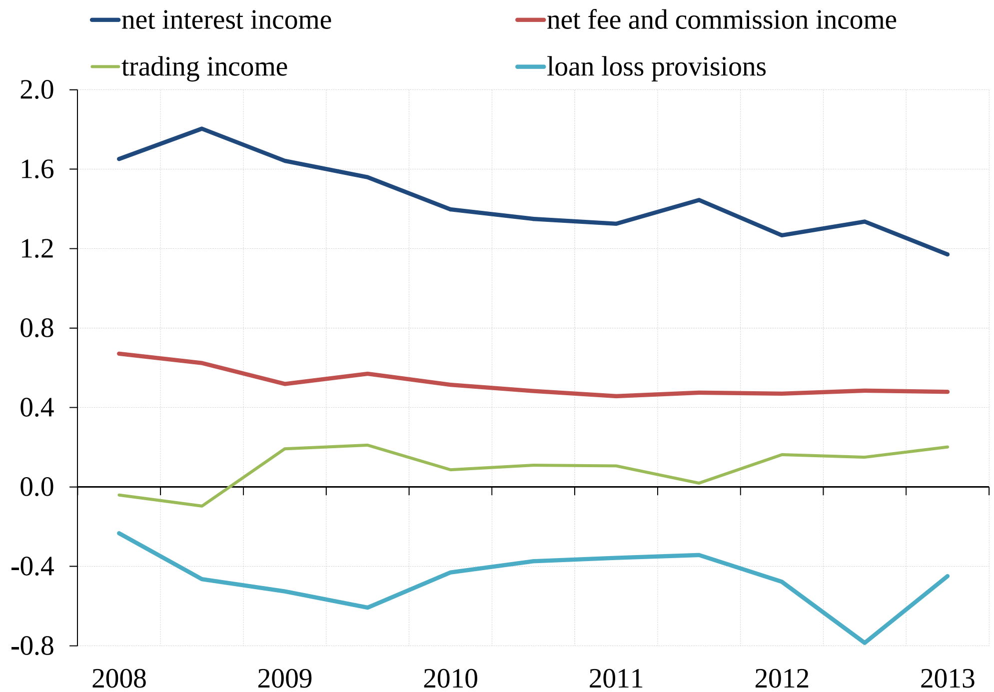



Source: SNL Financial.

Note: Based on publicly available data on SBGs, including LCBGs, that report annual financial statements and on data on a subset of those banks that report on a quarterly basis.

**Breakdown of euro area banks' sources of income**

(H 1 2008 – H1 2013; percentage of total assets)




Source: SNL Financial.

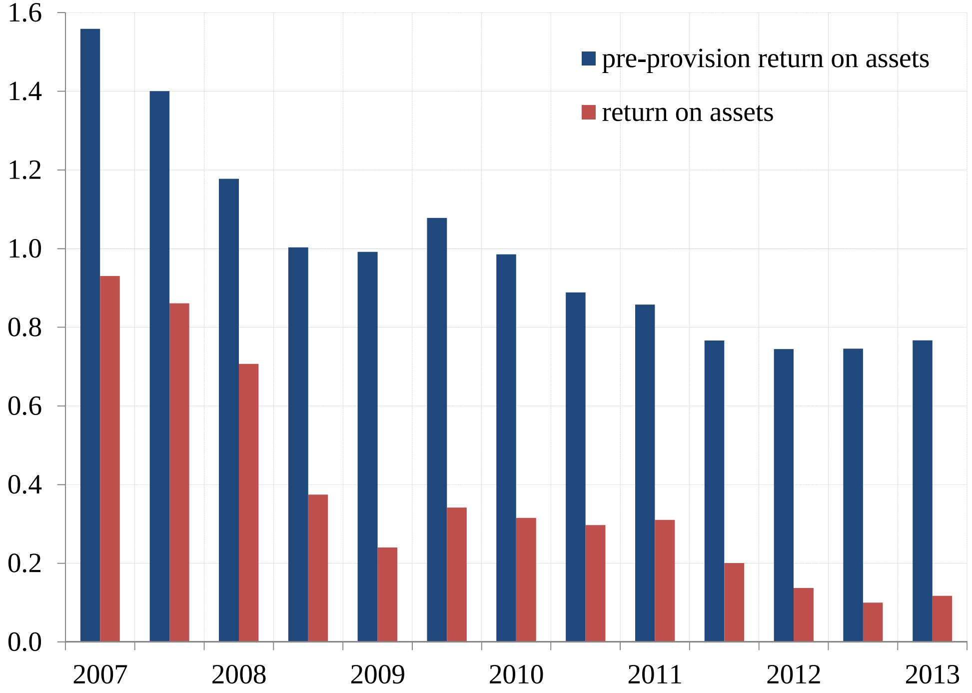
Note: Based on publicly available data on SBGs, including LCBGs, that report semi-annual financial statements.

## Risk 1 - Economic and financial shocks that affect asset valuations and bank profitability, eroding confidence in the euro area financial sector

…with provisions for non-performing loans as the main contributor to low profitability

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

(H1 2007 – H1 2013; percentages; medians)

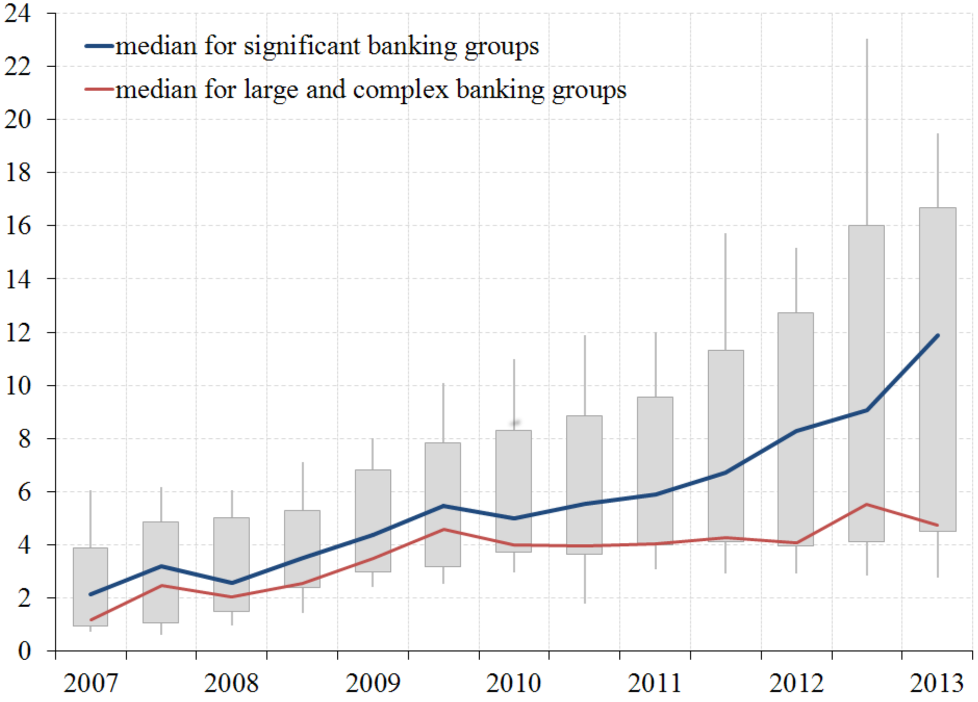



Source: SNL Financial.

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

**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 (SBGs))



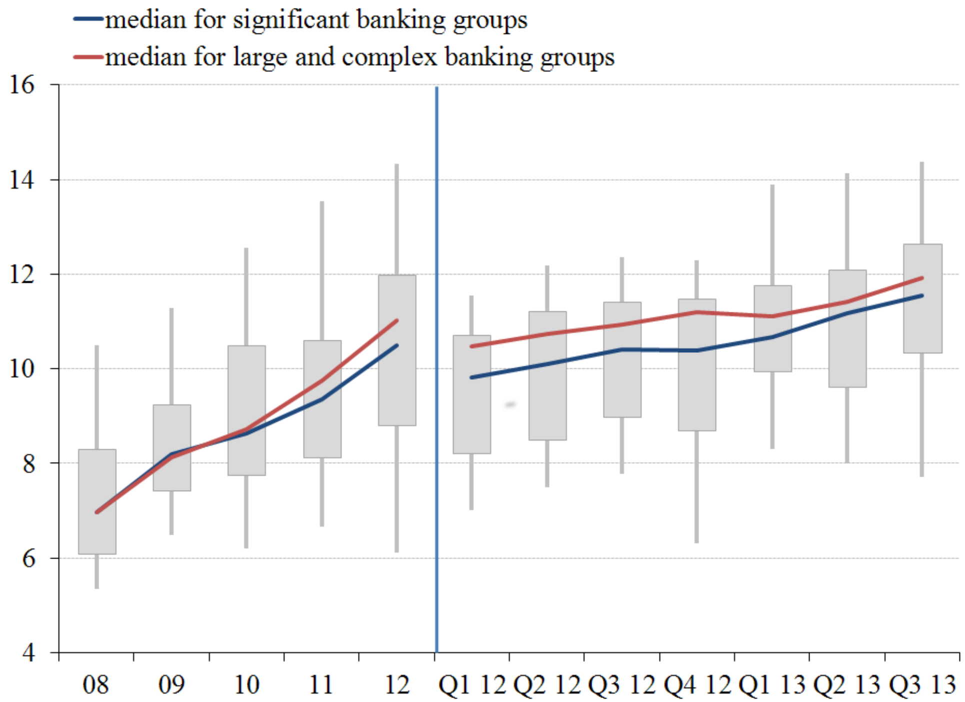

Source: SNL Financial.

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

## Risk 1 - Economic and financial shocks that affect asset valuations and bank profitability, eroding confidence in the euro area financial sector

Core Tier 1 ratios have continued to increase…

**Core Tier 1 capital ratios of euro area banks**
(2008 – Q3 2013; percentages; 10th and 90th percentile and interquartile range distribution across SBGs)

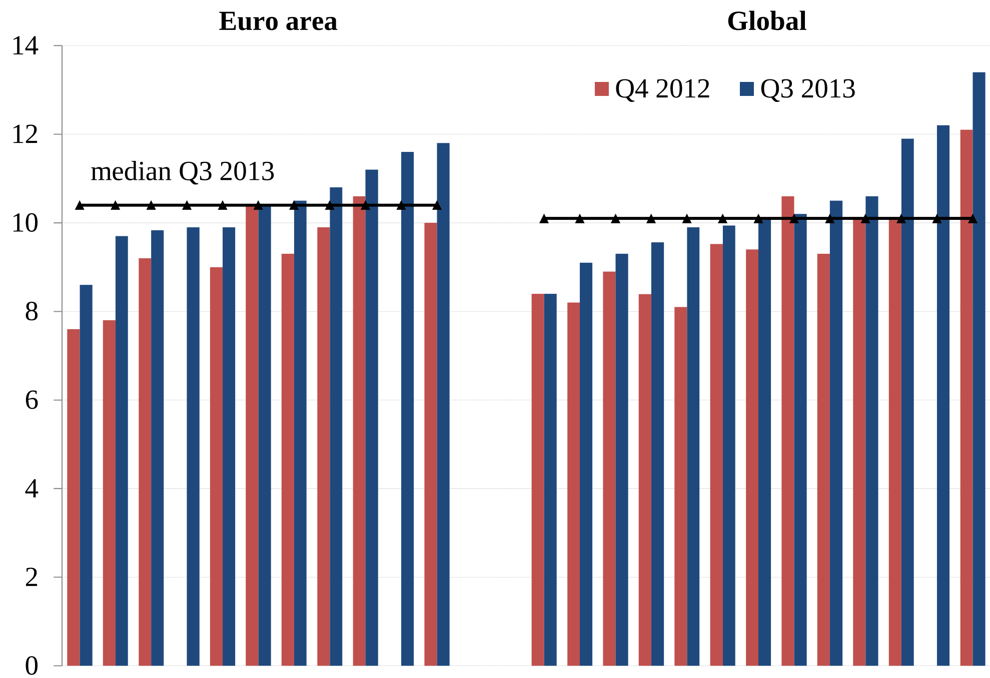



Source: SNL Financial.

Note: Based on publicly available data on SBGs, including LCBGs, that report annual financial statements and on data on a subset of those banks that report on a quarterly basis.

…and banks have taken further steps towards meeting more stringent Basel III requirements

**Basel III common equity Tier 1 capital ratios of euro area and global large and complex banking groups**
(percentages)



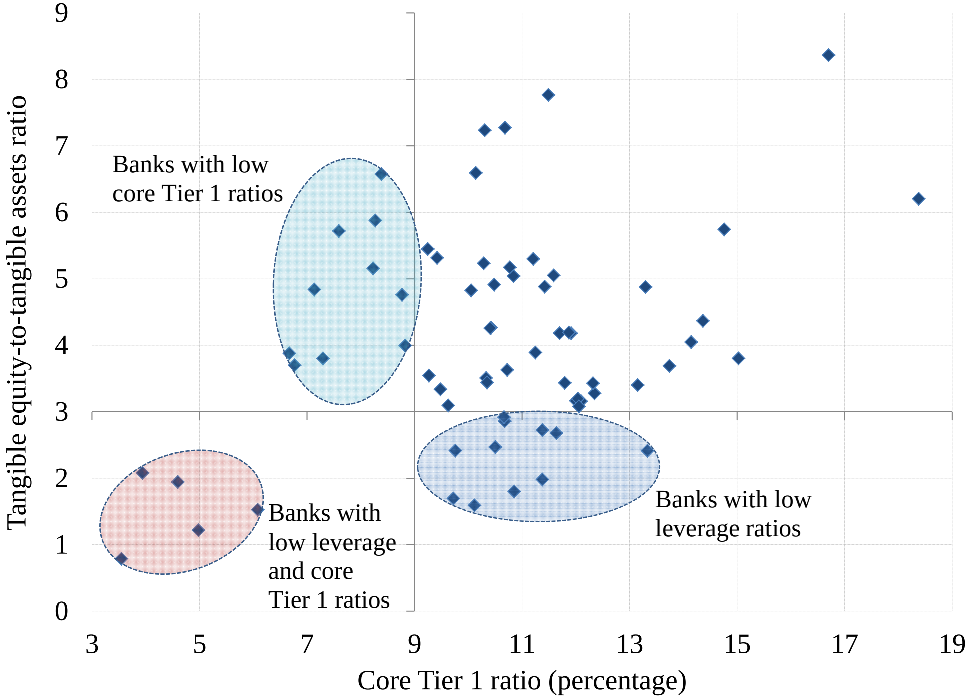

Source: SNL Financial.

## Risk 1 - Economic and financial shocks that affect asset valuations and bank profitability, eroding confidence in the euro area financial sector

Core Tier 1 capital ratios for some banks give a signal about solvency that is contradictory with leverage ratios. On the other hand, the stock market reacts more to capital ratios than to leverage ratios

### Leverage versus core Tier 1 capital ratios of euro area banks

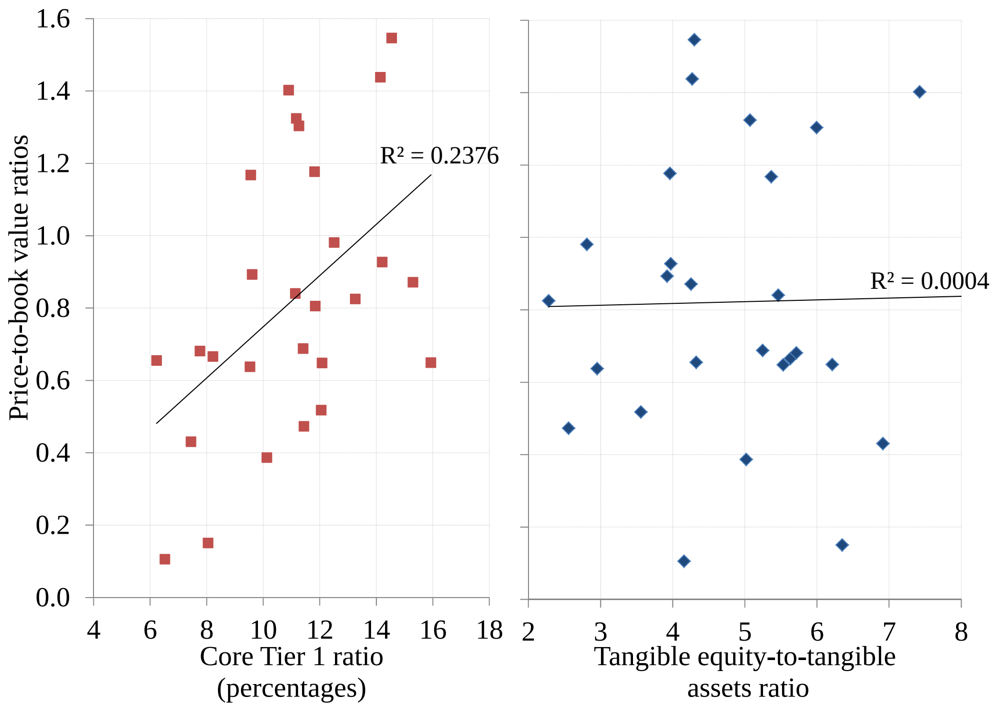
(2012; euro area significant banking groups)




Source: SNL Financial.

### Capital and leverage ratios vs. price-to-book value ratios of listed euro area banks

(H1 2013; euro area significant banking groups)

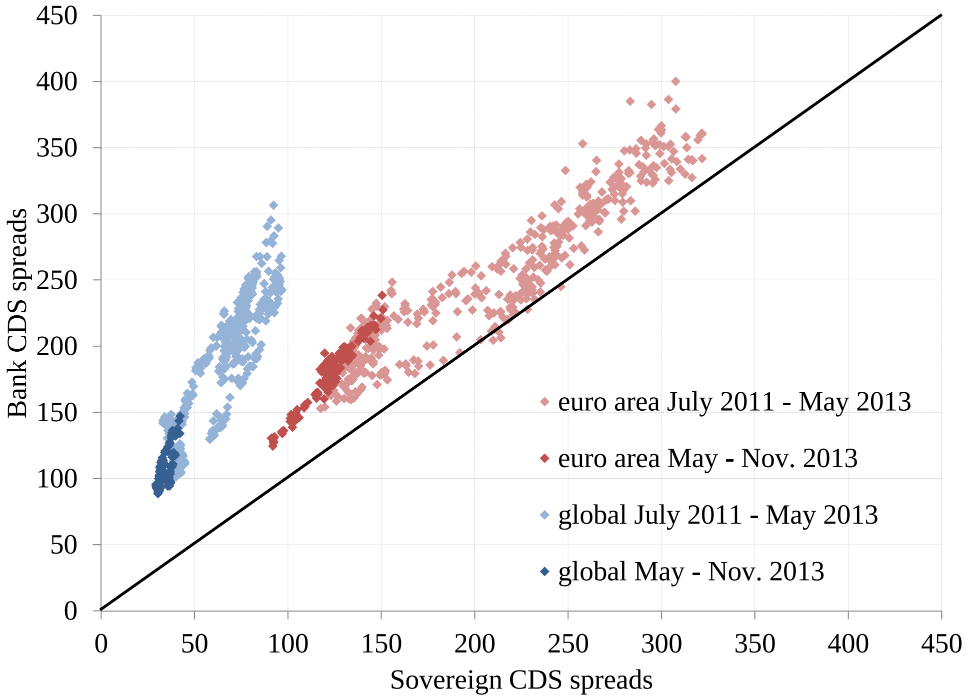



Source: SNL Financial.

## 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

### Decline in CDS spreads of sovereigns/banks but still closely related in the euro area

**Sovereign and bank CDS spreads**
(July 2011 – 15 Nov. 2013; basis points)

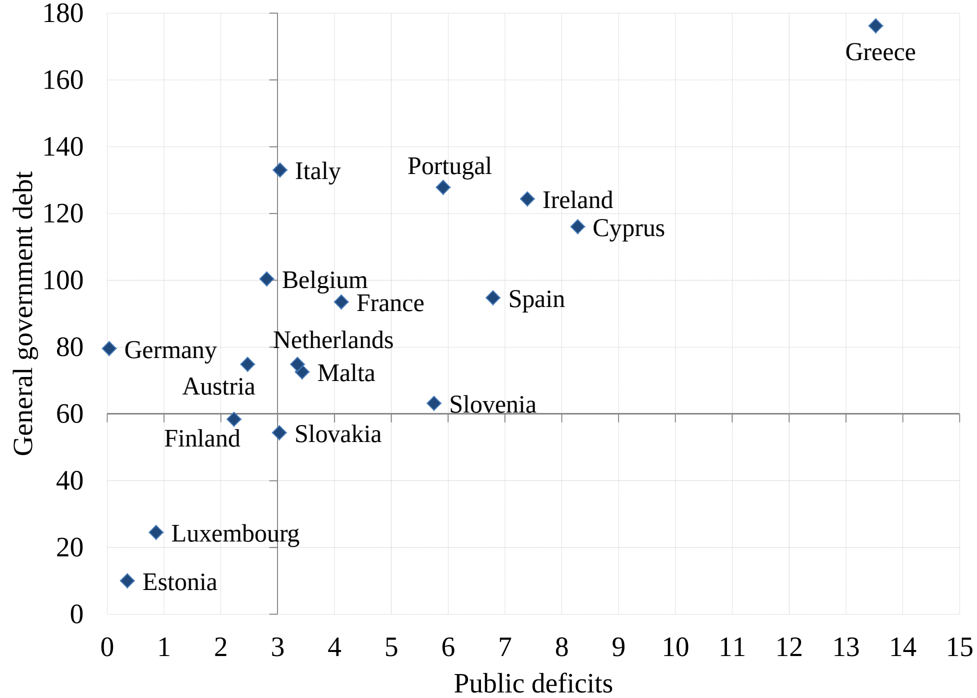



Sources: Bloomberg and ECB calculations.

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).

### Continued fiscal adjustment but it remains incomplete in several countries

**General government debt and deficits in the euro area**
(2013; percentage of GDP)

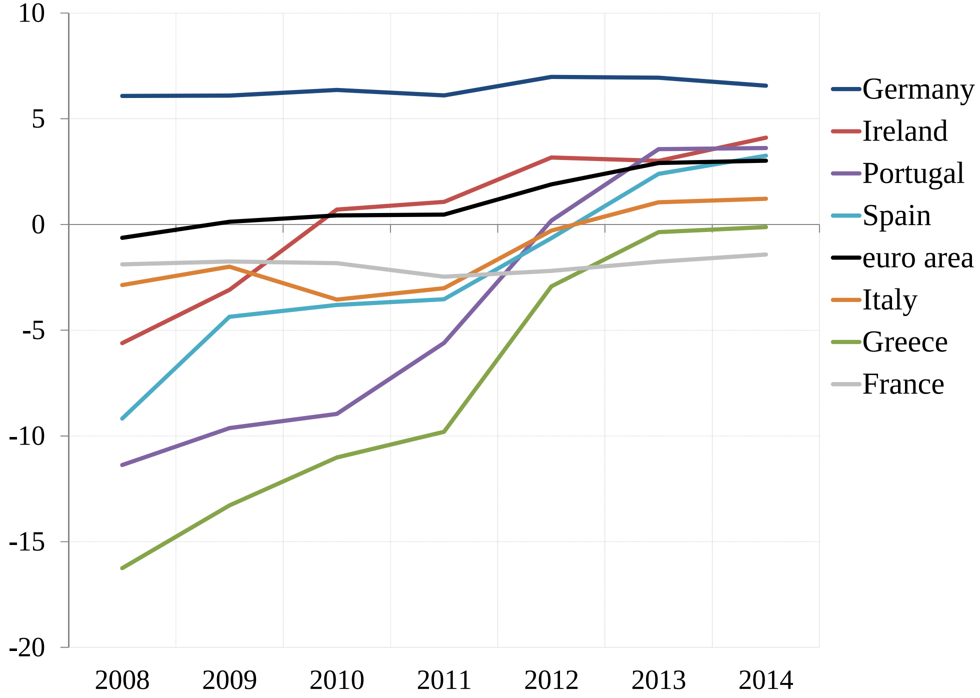



Source: European Commission.

## 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

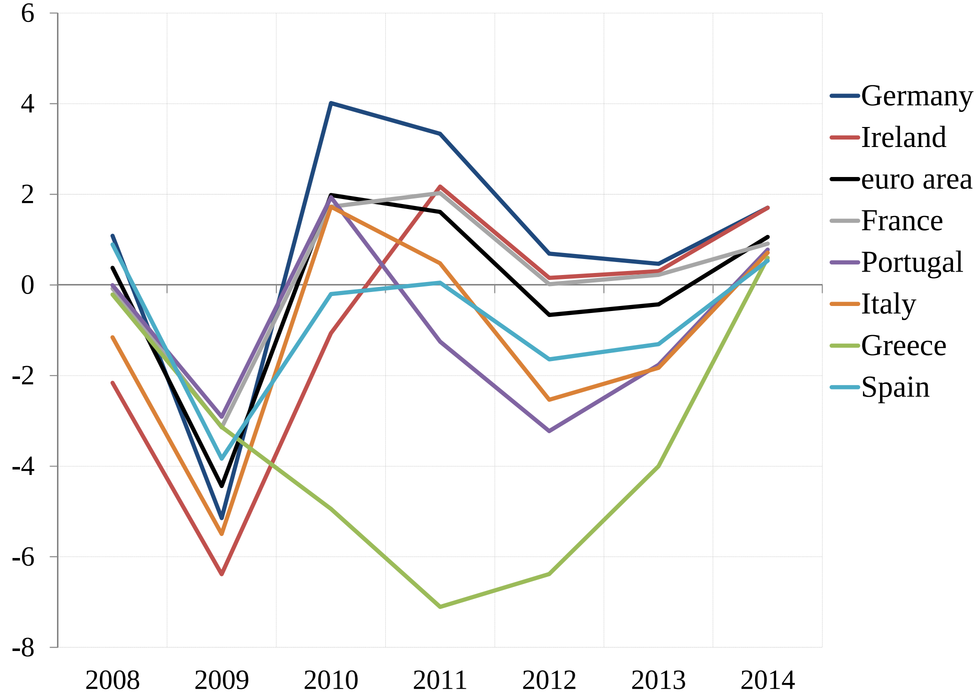
On the other hand, a positive development is that most countries under stress have reduced their external borrowing requirements and almost all of them, according to recent forecasts, will have an external surplus already in 2013 and economic growth in 2014

**External borrowing (-) / lending (-)**
(2008 – 2014; percentage of GDP)




Source: European Commission.

**Real GDP growth**
(2008 - 2014; percentage change per annum)



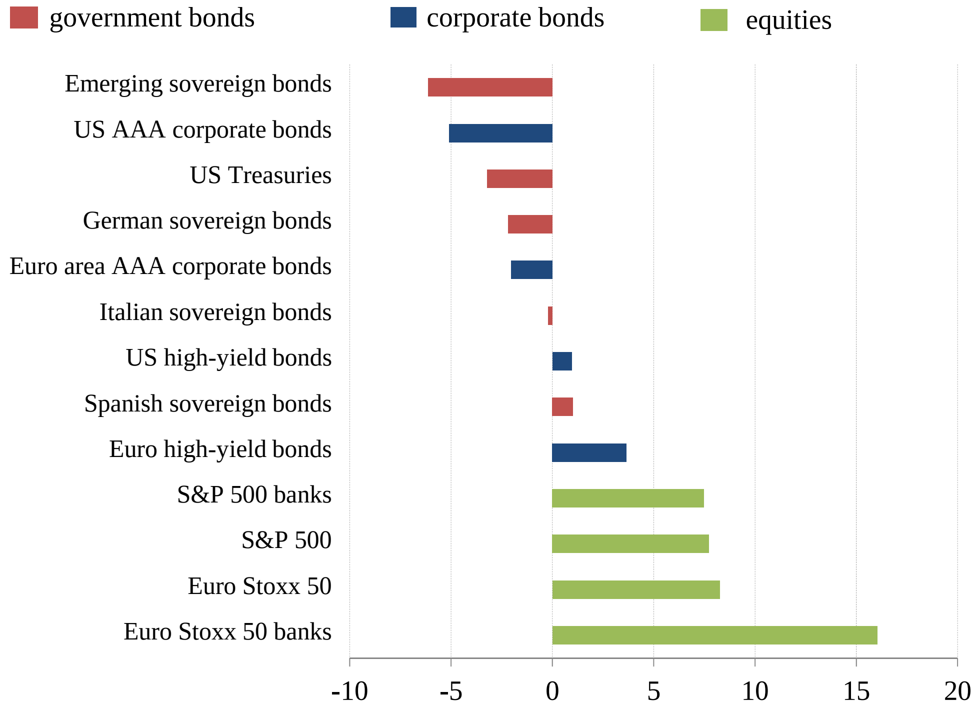

Source: European Commission.

## Risk 3 - Global financial market turbulence, with asset mispricing and low market liquidity

Significant price adjustments across a wide range of asset categories since May…

### Developments since May in prices of selected global assets

(22 May – 15 Nov. 2013; percentage changes)

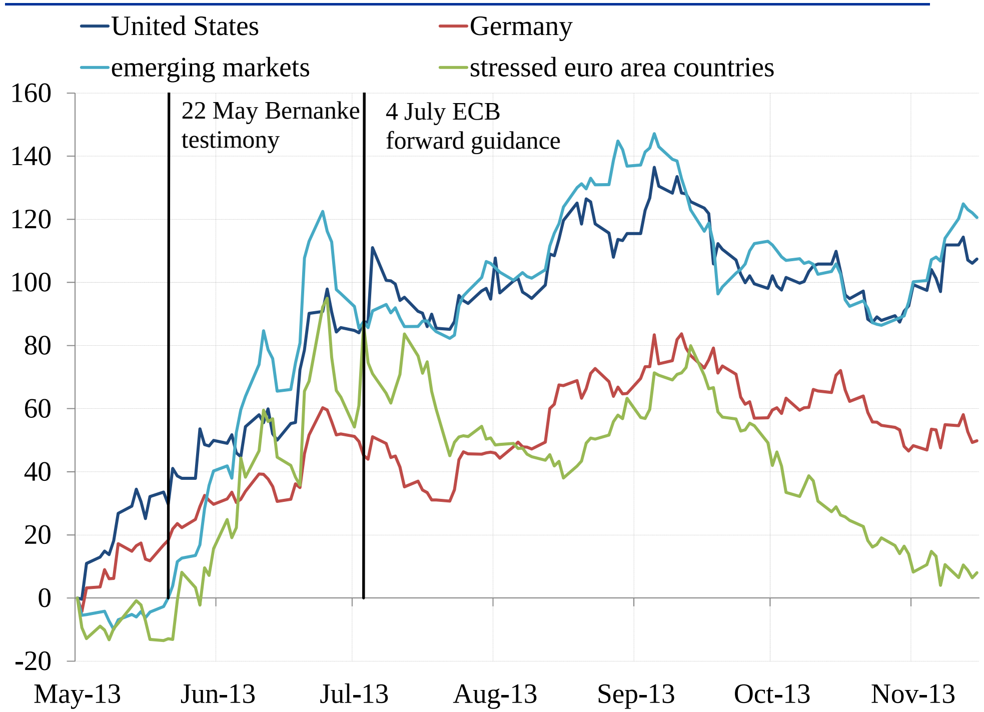



Sources: Bloomberg, Bank of America/Merrill Lynch and iBoxx.

…particularly in bond markets which might be a harbinger of further realignment

### 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.

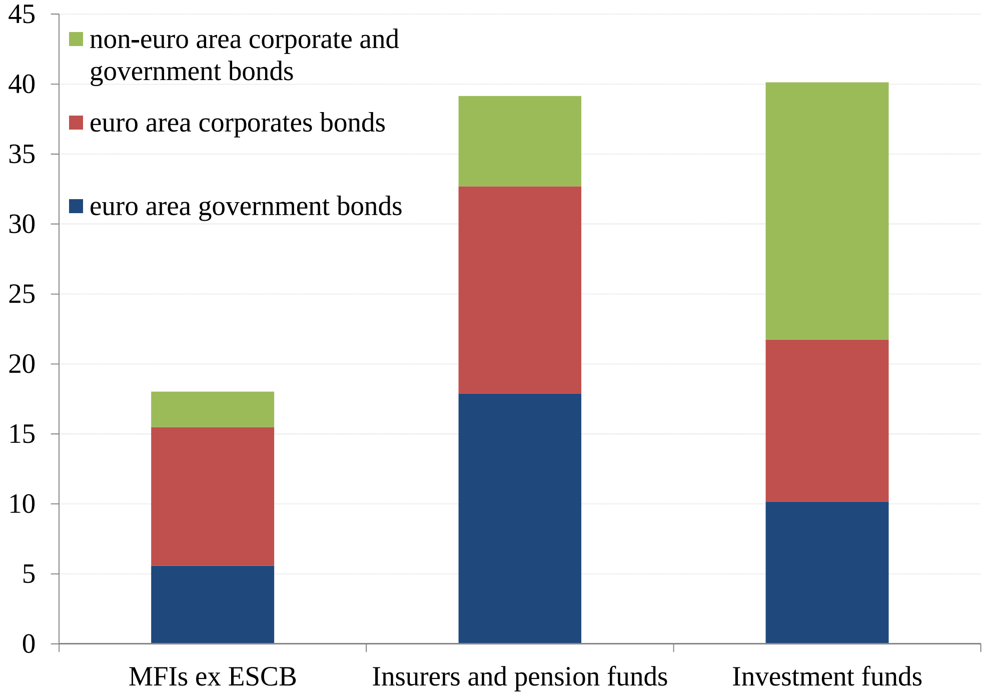
Note: “Stressed euro area countries” refers to the average of bond yields in Ireland, Italy, Portugal and Spain.

## Risk 3 - Global financial market turbulence, with asset mispricing and low market liquidity

Direct exposure to debt markets for institutional investors and less on banks…

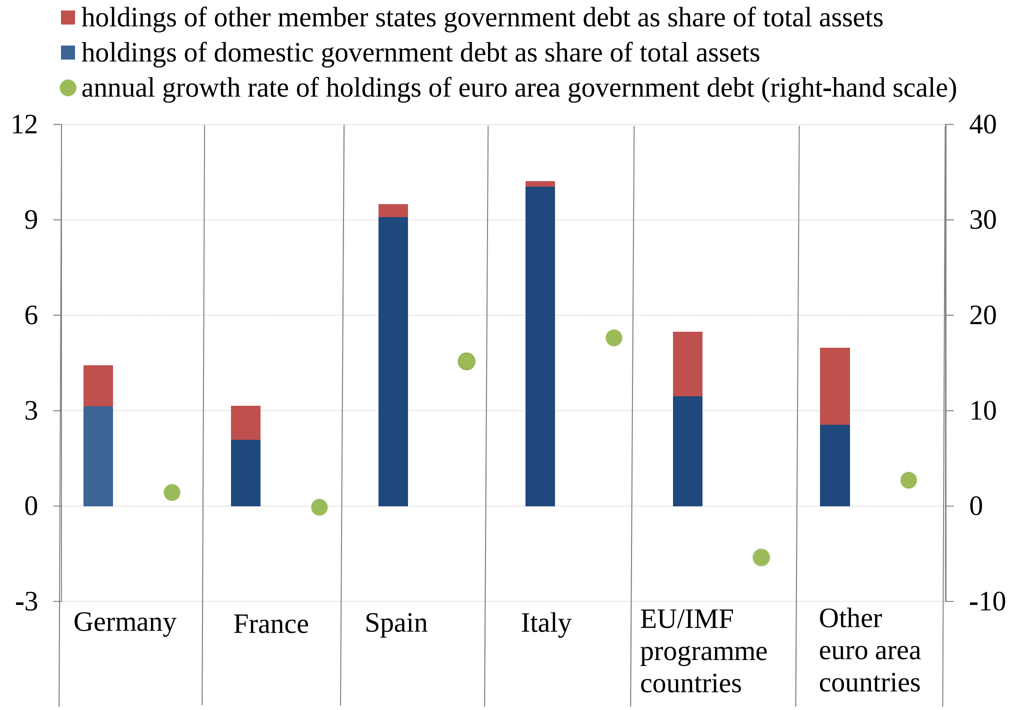
…but with continued expansion of banks' government debt holdings in most countries

**Bond holdings of euro area MFIs, insurers and pensions funds and investment funds**
(Q2 2013; percentage of total assets)




Sources: ECB and ECB calculations.

**MFIs' holdings of domestic and other euro area sovereign debt, broken down by country**
(Sep. 2012 – Sep. 2013; percentages)

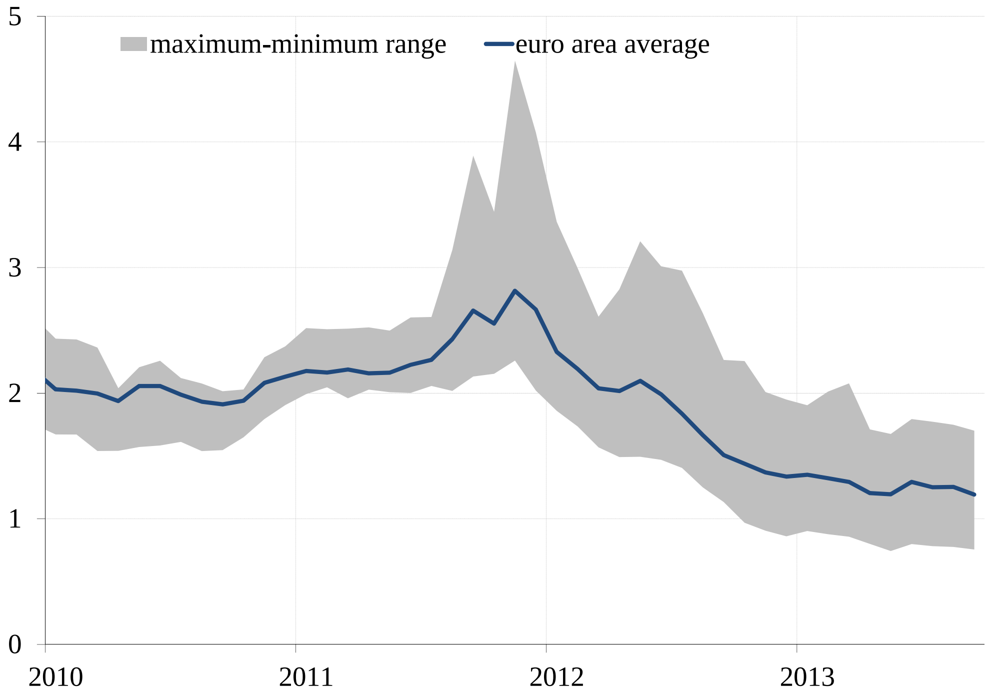



Source: ECB.

## Risk 4 - Bank funding challenges in stressed countries that force banks to deleverage excessively

Composite bank funding costs reached their lowest level for more than 3 years…

**Composite bank cost of deposit and unsecured market debt funding in selected euro area countries**
(Jan. 2010 – Sep. 2013; percentages; max. – min. range across the four largest euro area countries)

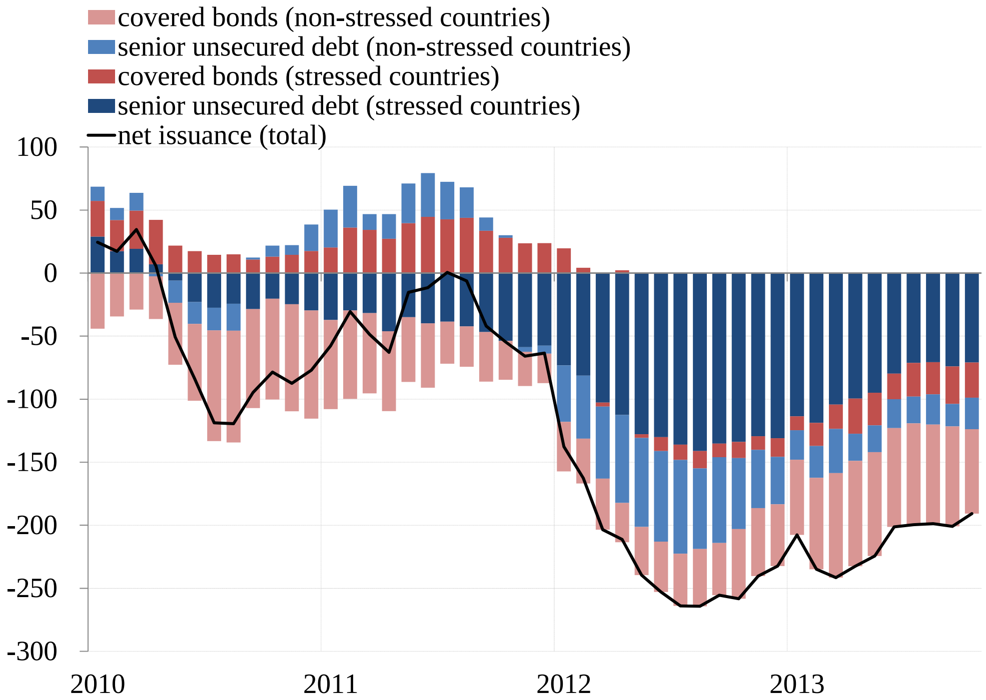



Sources: ECB, Merrill Lynch Global Index and ECB calculations.

Notes: 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.

…although debt issuance has fallen markedly for most banks since 2010

**Net issuance of senior unsecured debt and covered bonds in the euro area**
(Jan. 2010 – Oct. 2013; EUR billions; 12-month net issuance)




Source: Dealogic.

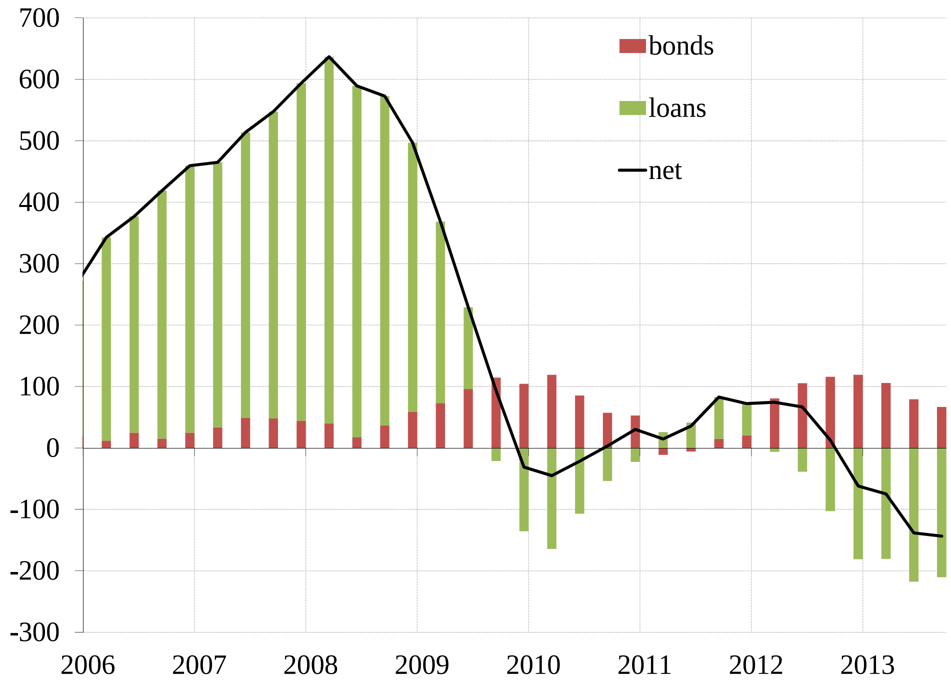
Note: Excludes retained deals.

## Risk 4 - Bank funding challenges in stressed countries that force banks to deleverage excessively

The net external financing of euro area firms continued to fall in 2013…

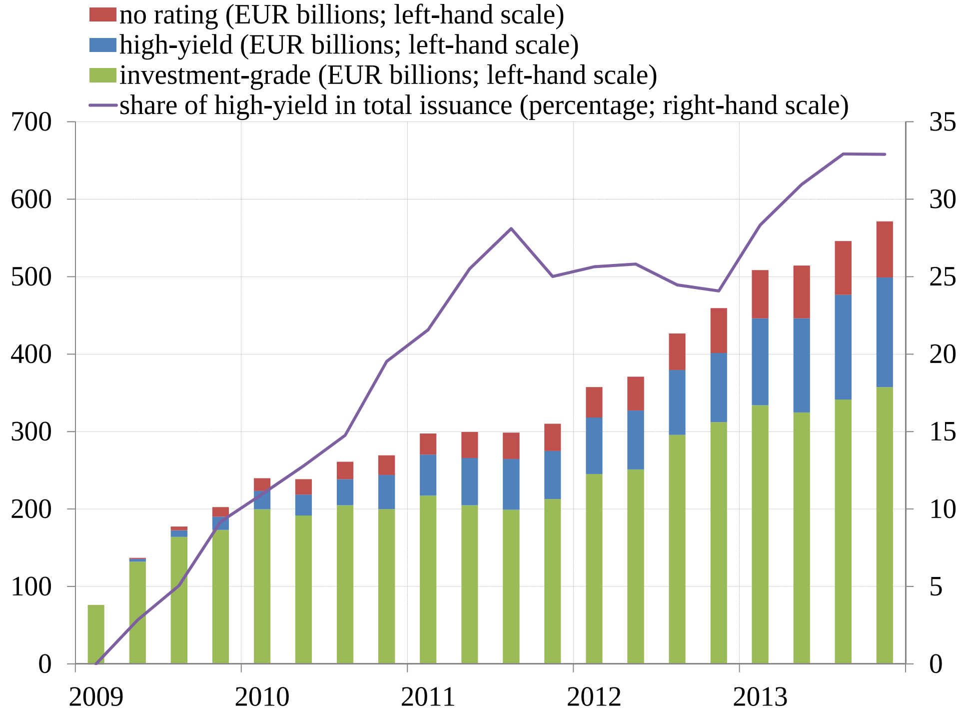
…but with continued increases in bond issuance

### External financing of euro area non-financial corporations
(Q1 2006 – Q3 2013; EUR billions; net annual flows)




Sources: ECB and ECB calculations.

### Cumulative net issuance of debt securities by non-financial corporations in the euro area
(Q1 2009 – Q4 2013)




Source: Dealogic.

Note: Data for the fourth quarter of 2013 refers to the period up to 15 November.

# Conclusions

**Financial stability has improved… but remains fragile, and vulnerable to negative shocks**

## Positive developments

- Measures of systemic stress at low levels by recent historical standards
- Improving euro area macro-financial environment, amid progress in balance sheet cleanup
- Higher capital and liquidity buffers are being built up in the banking sector
- Progress has been made towards building a banking union
- Somewhat lower intra-area fragmentation over the last half-year

## Remaining vulnerabilities

- Remaining fiscal imbalances need to be further addressed
- The outlook for bank profitability remains weak; bank restructuring remains incomplete
- Compressed global risk premia, with related potential for further financial market turbulence
- Remaining fragmentation in the availability and cost of bank funding in some countries