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ECB Financial Stability Review

May 2014

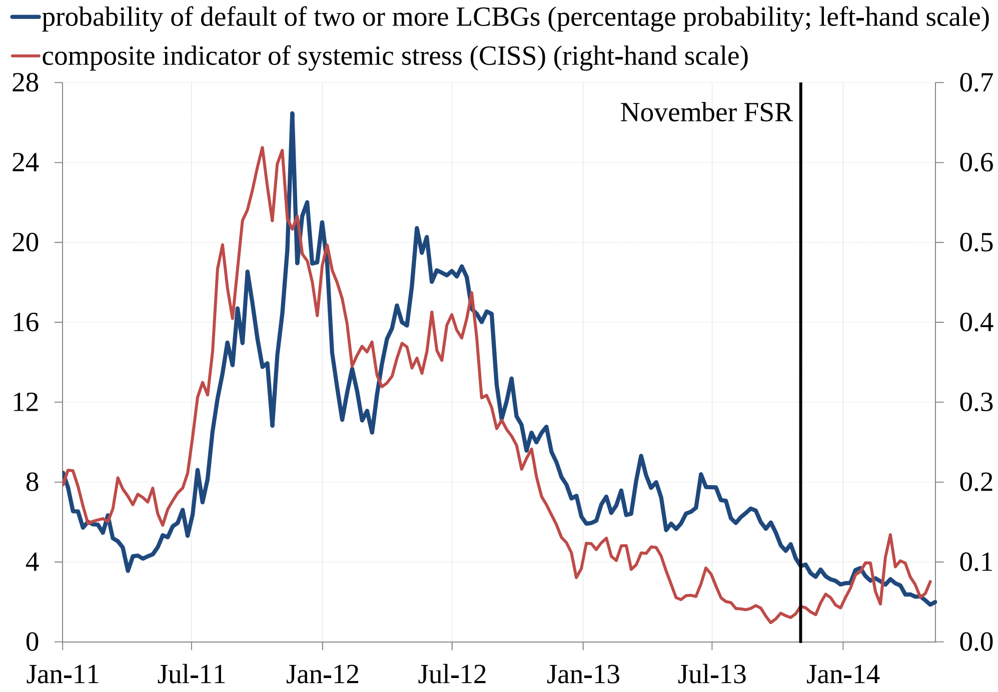
28 May 2014

Press conference presentation

- Measures of banking system stress have eased further as banking union preparations have gathered pace and banks have improved balance sheets

- Little sign of stress also across the broader financial system

Measures of financial market and banking sector stress in the euro area
(Jan. 2011 – 16 May 2014)



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.

Main risks and vulnerabilities

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	↑
2. Continuing weak bank profitability and balance sheet stress in a low inflation and low growth environment	→
3. Re-emergence of sovereign debt sustainability concerns, stemming from insufficient common backstops, stalling policy reforms, and a prolonged period of low nominal growth	↓

pronounced systemic risk

medium-level systemic risk

potential systemic risk

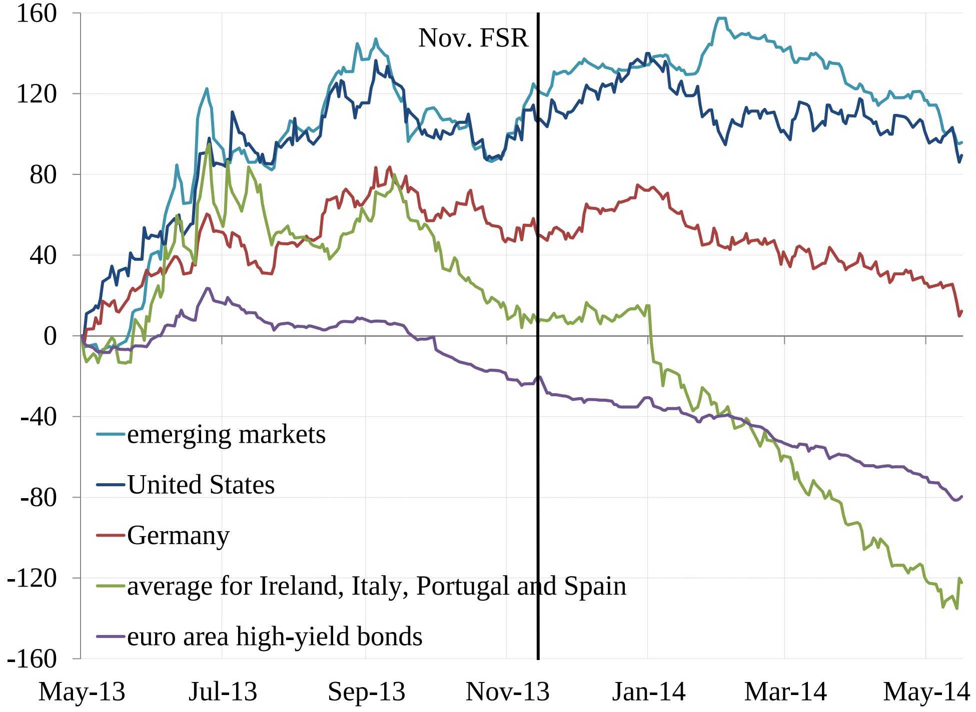
*The colour indicates the current level of the risk which is a combination of the probability of materialisation and an estimate of the likely systemic impact of the identified risk over the next year and a half, based on the judgement of the ECB's staff. The arrows indicate whether this risk has intensified since the previous FSR.

Risk 1- Abrupt reversal of the global search for yield amid pockets of illiquidity and likely asset price misalignments

Financial markets have seen a further compression of risk premia…

…with spreads on high-yield global corporate bonds falling to pre-crisis levels

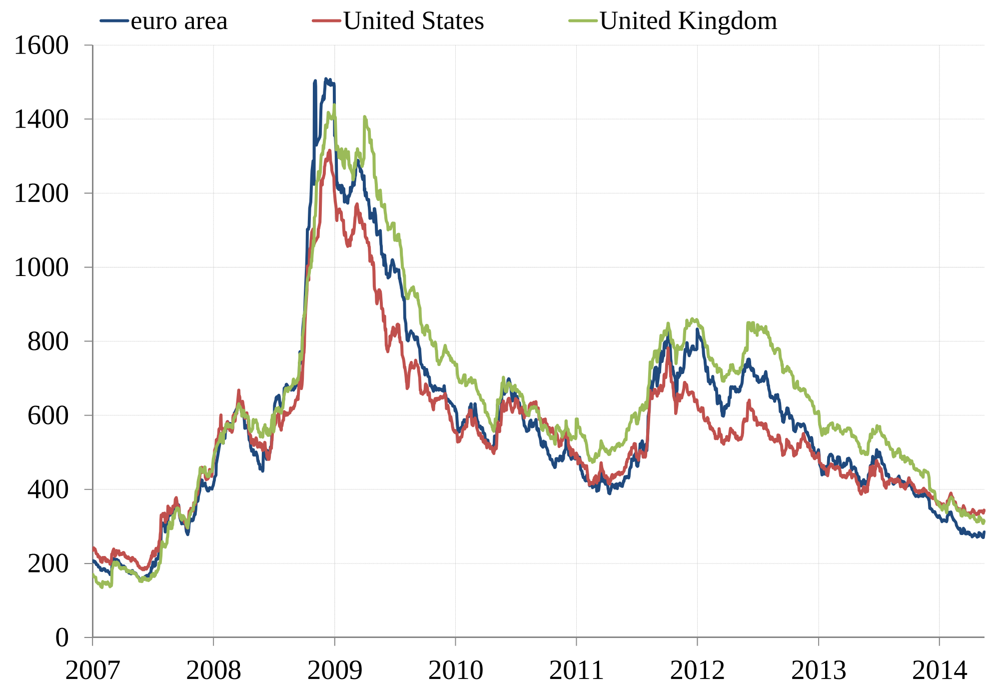
Cumulative changes in bond yields since May 2013
(2 May 2013 – 16 May 2014; cumulative change in basis points since 2 May 2013; ten-year sovereign bond yields)



Source: Bloomberg.

Global high-yield corporate bond spreads

(Jan. 2007 – 16 May 2014; basis points)

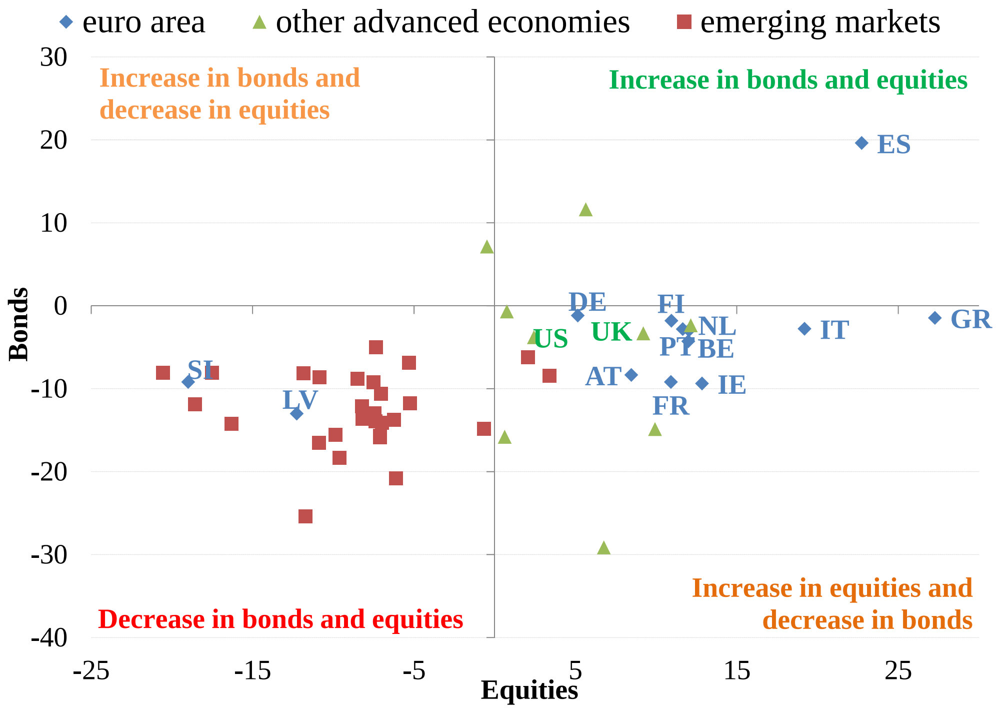


Source: Bank of America Merrill Lynch..

Risk 1- Abrupt reversal of the global search for yield amid pockets of illiquidity and likely asset price misalignments

Investors have rotated out of investment grade bonds into high-yield bonds and equities

Cumulated equity and bond portfolio flows
(22 May 2013 – 16 May. 2014;percentage of total assets invested at 26 May 2013)

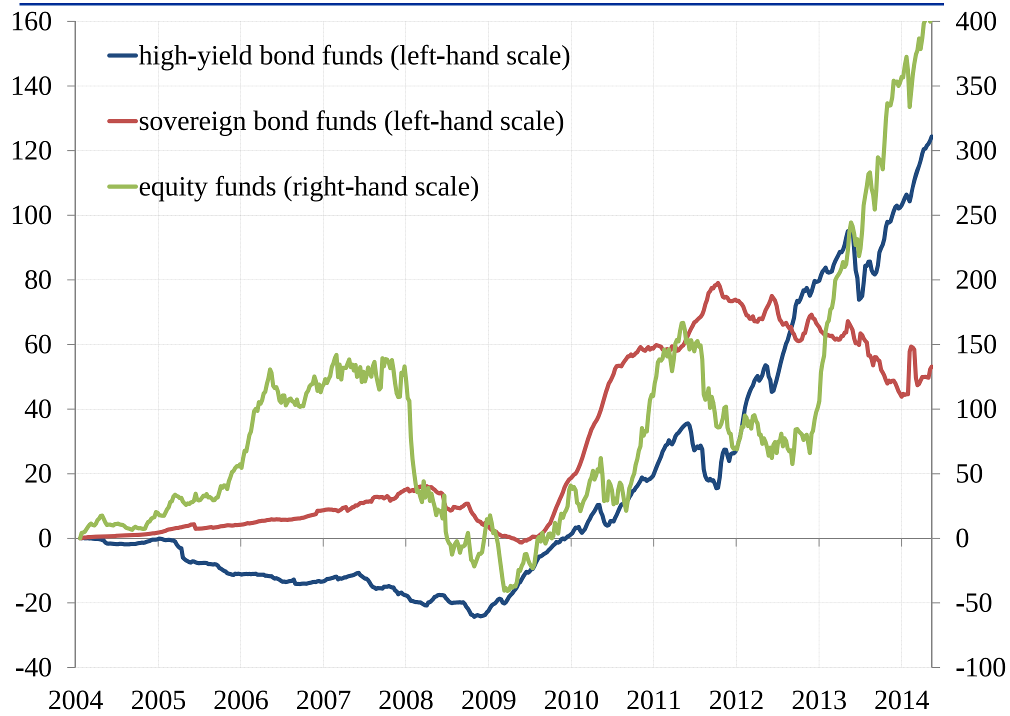


Sources: EPFR and ECB calculations

Notes: The data cover both traditional and alternative funds domiciled globally with $23.5 trillion in total assets. Investment in high-yield funds continued to increase suggesting that outflows were from investment-grade funds.

Global investor flows into selected funds

(Jan. 2004 – May 2014; USD billions)



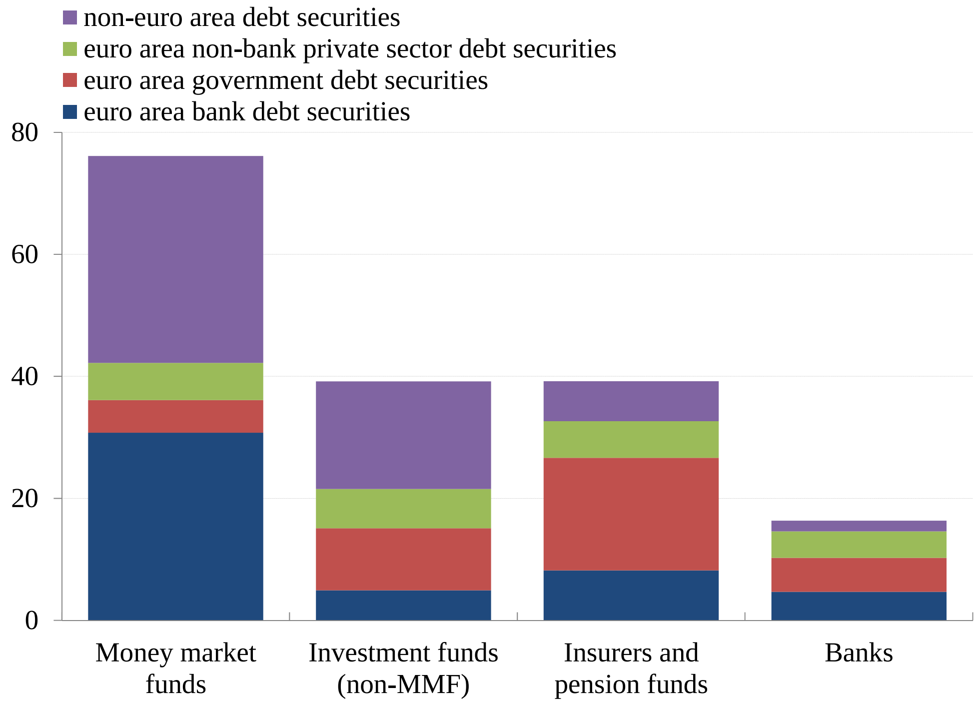
Source: EPFR.

Notes: The data cover both traditional and alternative funds domiciled globally with $23.5 trillion in total assets.

Risk 1- Abrupt reversal of the global search for yield amid pockets of illiquidity and likely asset price misalignments

Money market and investment funds are most directly exposed to global bond market corrections

Euro area institutional investors' debt securities holdings
(Dec. 2013; percentage of total assets)



Sources: ECB and ECB calculation.

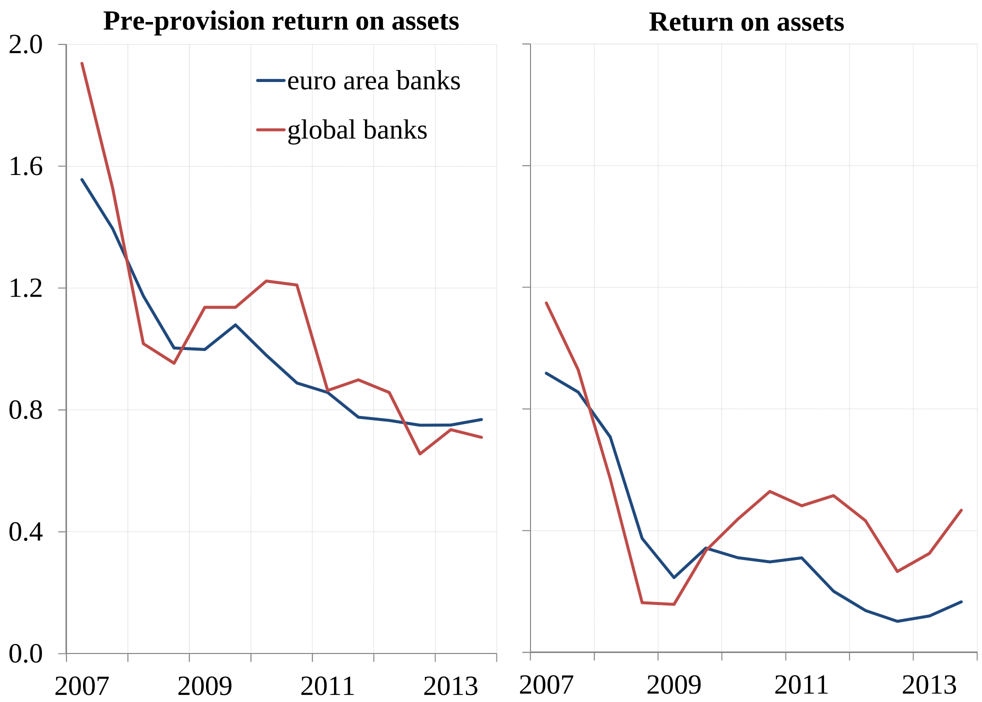
Sustainability of demand for euro area asset rests on 3 key drivers

- Sustainability of the ongoing euro area economic recovery
- Geopolitical developments and concerns regarding Chinese vulnerabilities
- Relative value considerations
  - continuation of portfolio rebalancing and outflows from emerging markets

Risk 2 - Continuing weak bank profitability and balance sheet stress in a low inflation and low growth environment

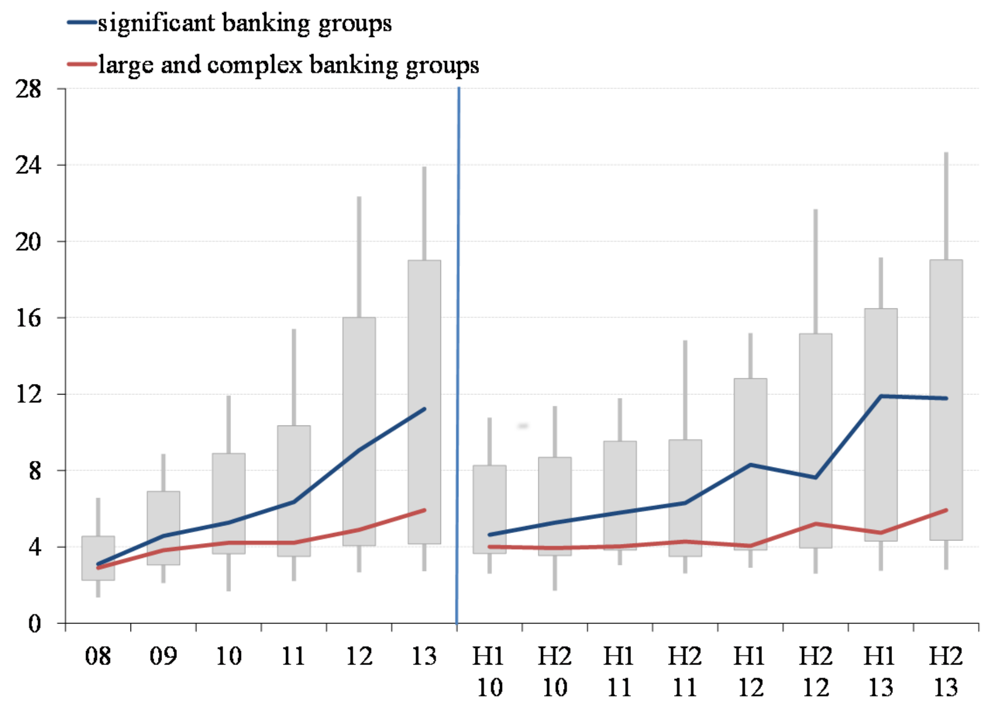
Euro area banks continue to operate in a low profitability or loss-making environment mainly due to high loan loss provisioning needs…

Pre- and post-provision return on assets of euro area significant banking groups and global banks
(H1 2007 – H2 2013; percentages)



Sources: SNL Financial and ECB calculations.

Impaired loans of euro area banks
(2008 – 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 at least on a semi-annual basis.

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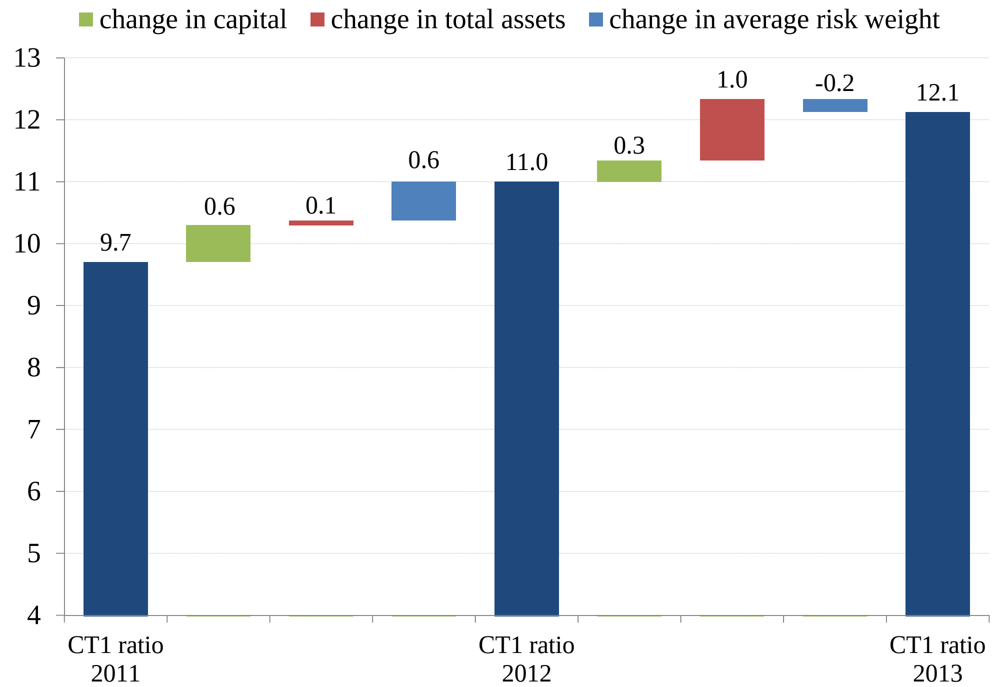
Risk 2 - Continuing weak bank profitability and balance sheet stress in a low inflation and low growth environment

…but continued progress has been made in cleaning up bank balance sheets and bolstering capital positions

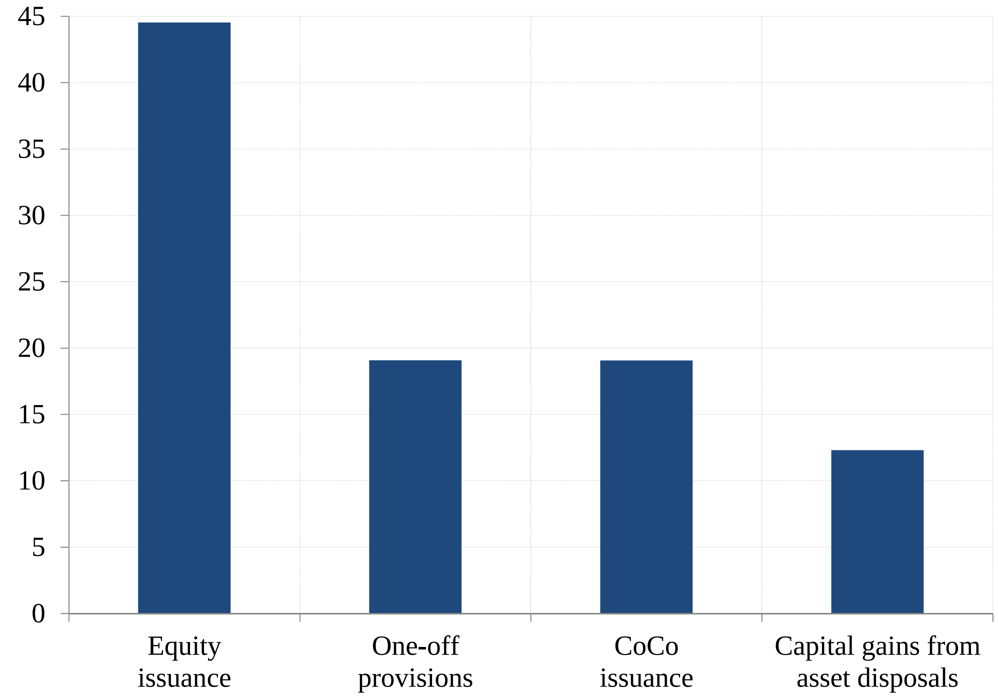
Decomposition of changes in euro area banks' aggregate core Tier 1 ratio
(2011 – 2013; percentages and percentage points)



Source: SNL Financial.

Notes: The aggregate core Tier 1 ratio is based on publicly available data for a sample of 69 SBGs. The positive contributions of changes in total assets and average risk weight represent deleveraging and de-risking respectively.

Balance sheet strengthening by euro area significant banking groups since July 2013
(EUR billions)



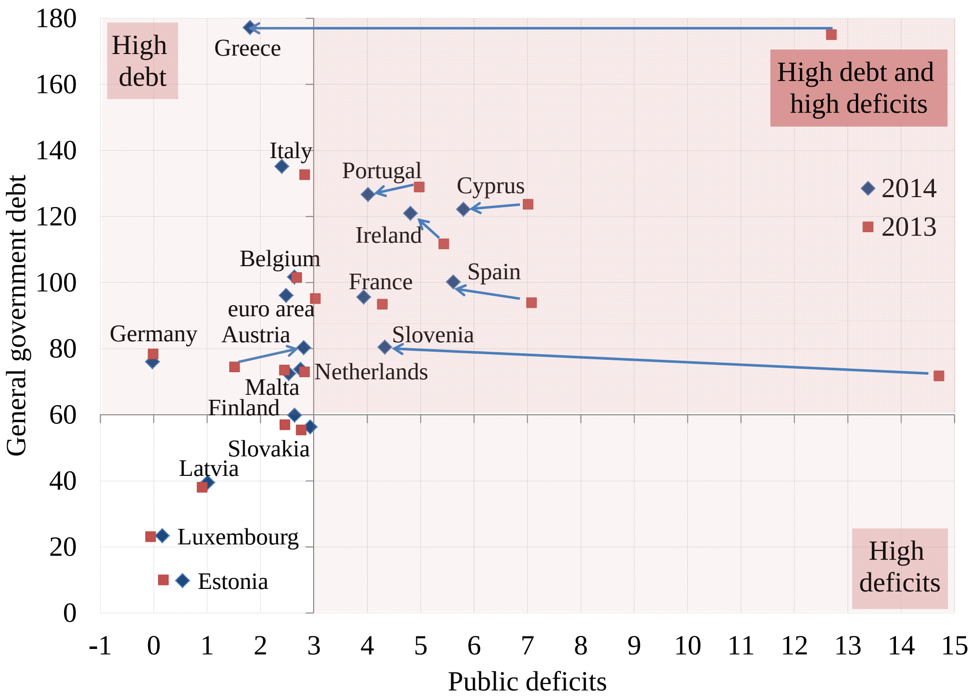
Sources: SNL Financial, Dealogic, banks' financial reports, market research and ECB calculations.

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

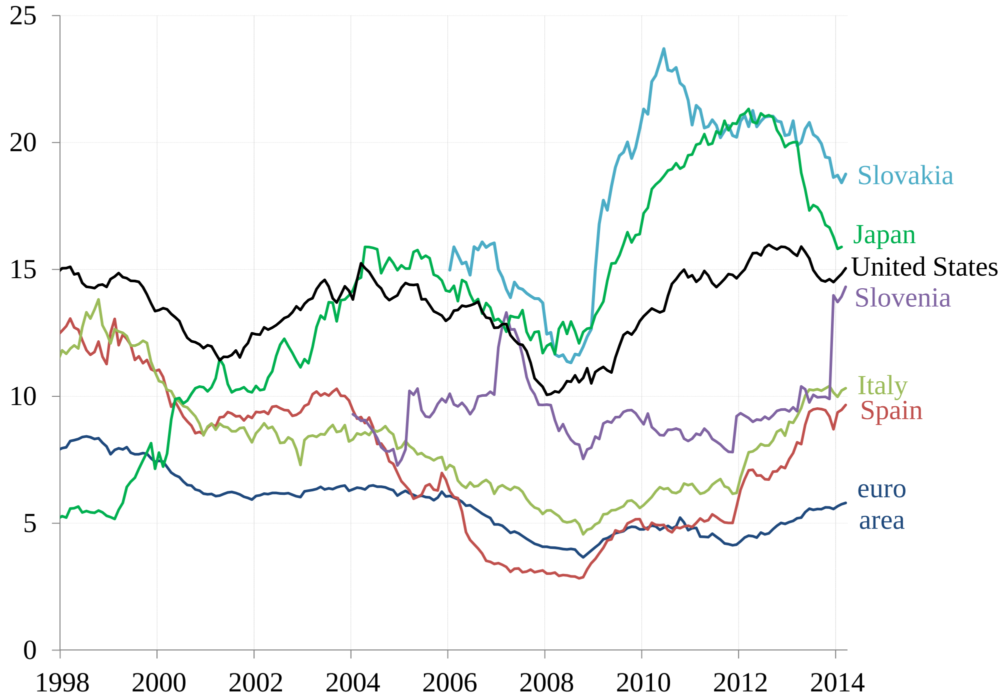
Sovereign tensions have eased amid further fiscal adjustment but sovereign borrowing costs and banks' sovereign bond holdings are vulnerable to abrupt reversal of the search for yield

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



Source: European Commission.

Domestic sovereign bond holdings by banks
(Jan. 1998 – Mar. 2014; percentage of total banking sector assets)



Sources: ECB, Federal Reserve and the Bank of Japan.

Notes: Data for the United States include sovereign bonds and agency-backed mortgage-backed securities.

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Conclusions

Financial stability has improved but risks remain… which can be grouped into two broad categories:

“Legacy” issues from the global financial crisis have receded somewhat but still remain

- Mainly relate to unfinished progress in the banking and sovereign domains and to the still relatively weak (albeit improving) and uneven economic outlook
- But action to address legacy risks from the crisis continues for both banks and sovereigns
- 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

“Emerging” issues – which has left the financial system more vulnerable to an abrupt reversal of risk premia

- A growing search for yield has progressively become more pervasive across regions and market segments
- The sustainability of investor demand could be negatively impacted should, for example, the economic recovery slow down or geopolitical and emerging market vulnerabilities be unearthed
- Financial institutions need to have sufficient buffers and/or hedges to withstand a possible re-assessment of risk premia