May 2024
Financial Stability Review

Press briefing

16 May 2024
Euro area financial stability vulnerabilities have eased, but the outlook remains fragile

1. A cohort of vulnerable households, corporates and sovereigns is being tested by rising debt service costs, while a property market downturn is challenging real estate firms.

2. Euro area banks have been a source of resilience, but low valuations suggest that current profitability may not be sustainable due to asset quality, funding and revenue headwinds.

3. Pricing-for-perfection in financial markets and non-bank liquidity fragilities are creating the potential for outsized market reactions to adverse shocks.
1st theme: **Vulnerable households, corporates and sovereigns tested by rising debt service costs**

- On average, non-financial sectors have remained resilient and seen their indebtedness decline, with only sovereign debt above pre-pandemic levels.
- Debt service costs are likely to remain high and may continue creeping up for some, challenging vulnerable households, firms and sovereigns.

**Household, corporate and sovereign indebtedness**
Percentages of GDP

<table>
<thead>
<tr>
<th></th>
<th>Pre-pandemic</th>
<th>Pandemic peak</th>
<th>Latest</th>
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</thead>
<tbody>
<tr>
<td><strong>Households</strong></td>
<td>50</td>
<td>60</td>
<td>70</td>
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<tr>
<td><strong>NFCs</strong></td>
<td>110</td>
<td>120</td>
<td>130</td>
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<td><strong>Sovereigns</strong></td>
<td>120</td>
<td>130</td>
<td>140</td>
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**Lending rates to the euro area non-financial private sector**
Jan. 2015-Mar. 2024, percentages

Sources: Eurostat and ECB (QSA), ECB (MFI, MIR) and ECB calculations.
1st theme: Vulnerable households, corporates and sovereigns tested by rising debt service costs

- The outlook for commercial real estate markets continues to deteriorate...
- …with real estate firms facing increasing profitability pressure

Rent growth expectations for the office market over the next 12 months
Q4 2023, percentages

Median net profit margin and share of firms with negative net profit in the real estate sector
Q1 2017-Q3 2023, percentages

Sources: S&P Global Market Intelligence and ECB calculations.
Changes in the euro area general government debt-to-GDP ratio and its drivers
2021-25, percentages of GDP and percentage point contributions

<table>
<thead>
<tr>
<th>Year</th>
<th>Change in debt-to-GDP</th>
<th>Diff. between interest paid and nominal growth</th>
<th>Primary balance plus deficit-debt adjustment</th>
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<tbody>
<tr>
<td>2021</td>
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<td>2025</td>
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Ten-year government bond yields and sovereign credit ratings
31 Oct. 2023, 30 Apr. 2024, percentages, ratings


1st theme: Vulnerable households, corporates and sovereigns tested by rising debt service costs

- The drop in sovereign debt-to-GDP ratios has been driven by the post-pandemic recovery in nominal GDP
- Low growth potential and weak cyclically-adjusted primary balance imply that sovereign debt is likely to stabilise at higher levels than before the pandemic in several euro area countries
2nd theme: Banks have remained resilient, but face headwinds from asset quality, funding and revenues

- Decline in bank profits already visible in Q4 2023 (q-o-q), with mild additional declines expected
- Euro area bank valuations generally remain below those of international peers

### ROE and ROE outlook based on analyst expectations

**Q4 2021-Q4 2023, percentages**

- Return on equity (trailing)
- Return on equity (ann. quarterly)
- Interquartile range

### Price-to-book ratios of euro area banks and global peers

**3 Jan. 2020-3 May 2024, ratio**

- US banks
- Japanese banks
- UK banks
- Scandinavian banks
- Euro area banks

Sources: LSEG, Bloomberg Finance L.P. and ECB calculations.
2nd theme: *Banks have remained resilient, but face headwinds from asset quality, funding and revenues*

- Weaker asset quality for commercial real estate loans, consumer credit and loans to micro firms
- Floating rate assets could turn into a headwind for interest income as market reference rates are expected to fall
- Funding costs likely to remain high as maturing liabilities reprice at higher levels and the composition of bank funding shifts towards a higher share of term deposits and bonds

### NPL ratios by sector and corporate NPL ratios by firm size

<table>
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<th>Q1 2020-Q4 2023, percentages</th>
<th>Lending rates on loans to the non-financial private sector</th>
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<td>Jan. 2019-Nov. 2025, percentages</td>
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#### NPL ratios by sector

- **Total loans**
- **Commercial real estate**
- **Other portfolios**

#### NPL ratios by firm size

- **Micro firms**
- **Other portfolios**

#### Lending rates on loans to the non-financial private sector

- **Floating-rate loans**
- **Fixed-rate loans**
- **3M EURIBOR**
- **3M EURIBOR forward swap rate**
3rd theme: Risk of outsized financial market reactions to disappointing news

- Stock markets close to record highs, high-yield corporate bond spreads near record lows
- A return of financial risk-taking, with particularly risky assets showing very strong performance

Global equity markets and high-yield corporate bond spreads
1 Jan. 2021-7 May 2024, index, basis points

Global asset class performance since the previous FSR was published
22 Nov. 2023-7 May 2024, percentages

Sources: Bloomberg Finance L.P. and ECB calculations.
3rd theme: Risk of outsized financial market reactions to disappointing news

- Low volatility can lead to a substantial compression of risk premia
- …and incentivize additional risk-taking

### Implied equity market volatility relative to interest rate volatility
Jan. 2000-Apr. 2024, ratio

![Graph showing implied equity market volatility relative to interest rate volatility for the Euro area and United States from January 2000 to April 2024.](image)

### Risk premia versus implied volatility indices for euro area risky assets
Mar. 2014-Apr. 2024, percentages

![Graph showing risk premia versus implied volatility indices for high-yield corporate bonds and equity (right-hand scale) for the Euro area from March 2014 to April 2024.](image)

Sources: Bloomberg Finance L.P. and ECB calculations.
Liquidity mismatch and leverage among euro area investment funds
Q4 2023, ratios, bubble size: total assets, € trillions

- Risk that non-banks with liquidity fragilities could amplify market corrections and transmit stress to the wider financial system
- Real estate funds with unrealised losses also face liquidity mismatches and rising redemptions could increase the potential for forced sales

Cumulative changes in share prices of euro area REITs
Q1 2022-Q4 2023, cumulative percentage change in share prices

Sources: Bloomberg Finance L.P., ECB (IVF) and ECB calculations.

Note: REITs stands for real estate investment trusts.
Preserve banking sector resilience and enhance the macroprudential framework for banks

- Maintain existing capital buffers and borrower-based measures to ensure resilience
- Further enhance macroprudential space in the medium term
- Continue to make the regulatory framework for banks more effective

A strong capital markets union requires a solid institutional and policy framework for non-banks

- EU-wide supervision and a macroprudential framework for non-banks is key for financial stability
- Implementing FSB recommendations in the EU should be a top priority
- A stable and resilient NBFI sector would support the broader objectives of the capital markets union
The euro area banking system is resilient and well-placed to face higher risks thanks to active prudential policy in recent years.

Enhanced macroprudential policy space, regulatory reform and faithful implementation of the final parts of Basel III can help to ensure durable resilience.

Structural vulnerabilities in non-banks continue to require a comprehensive policy response.