Bank profitability has improved but the outlook remains very challenging

- Euro area bank profitability and valuations remain low
- Model-based estimates point to some risk of under-provisioning. But these do not take into account the impact of extraordinary policy measures in reducing credit risk

**Analyst return on equity expectations for euro area and US banks**
2020 – 2022; percentages

**Bank price-to-book ratios**

**Model-based estimates of under-provisioning by euro area banks**
Q1 2004 – Q3 2020; loan loss provisions as a percentage of total loans

Sources: Bloomberg, ECB supervisory data and ECB calculations.
Mitigant factors not included: direct support, moratoria, guarantees, quicker recovery, different sectoral crisis impact.
Corporate sector conditions remain weak, uneven and uncertain

- Corporate earnings stabilised in Q3 2020, albeit at significantly suppressed levels
- Vulnerabilities remain elevated but with large differences across sectors and countries

Non-financial corporate earnings and earnings expectations
Q4 2018 – Q4 2020; Q4 2018 = 100

Source: Allianz Euler Hermes.

Expected insolvencies in euro area countries
Index: 2019 = 100

Source: Bloomberg.

Return on equity across corporate sectors in the euro area
Q1 2008 – Q3 2020; percentages

Source: Bloomberg.
A virtuous circle between sovereigns, banks and corporates

Sovereigns

- Lower corporate insolvencies and NPLs
- Favourable financing conditions in sovereign bond markets
- Stable banks supporting the economic recovery

Banks

- Lower corporate insolvencies and NPLs
- Favourable financing conditions and ample access to credit

Corporates

- Higher tax revenues and growth after the pandemic
- Direct transfers and guarantee schemes

Monetary policy

Fiscal policy
Potential emergence of a vicious circle between sovereigns, banks and firms

- Corporate and banking sector vulnerabilities are clearly linked, and also closely intertwined with sovereigns, as well as depending on policy support.

Indebtedness of the general government and the non-financial corporate sector across the euro area
Q4 2019, Q3 2020, percentages of GDP

Sources: Bloomberg and ECB.
Notes: White bubbles indicate negative values.
The red horizontal and vertical lines indicate sample medians.

Issuer ratings of sovereigns and banks in the euro area
Rating buckets

Sources: DBRS, Fitch Ratings, Moody’s, Standard & Poor’s and ECB calculations.

Note: The bubble size indicates the combined debt of sovereigns and banks (debt securities issued) in a country as a share of the euro area total.

Banks’ domestic government bond holdings and corporate NPL ratios across the euro area
x-axis: % of total assets, y-axis: % of total corporate loans

Sources: Bloomberg and ECB.
Notes: White bubbles indicate negative values.
The red horizontal and vertical lines indicate sample medians.
Continued fiscal and monetary support for as long as necessary can avoid a vicious circle between sovereigns, banks and corporates.
Summing up

Key vulnerabilities to euro area financial system stability:

1. Low bank profitability and challenging outlook
2. Nexus between sovereigns, banks and firms – risk of a vicious circle

A balanced and cautious **phasing-out of fiscal and monetary policy support** is of the essence

**Risks of an early withdrawal are higher** than the risks associated with keeping support measures in place for too long. But care needs to be taken to avoid moral hazard