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ECB Financial Stability Review

May 2016

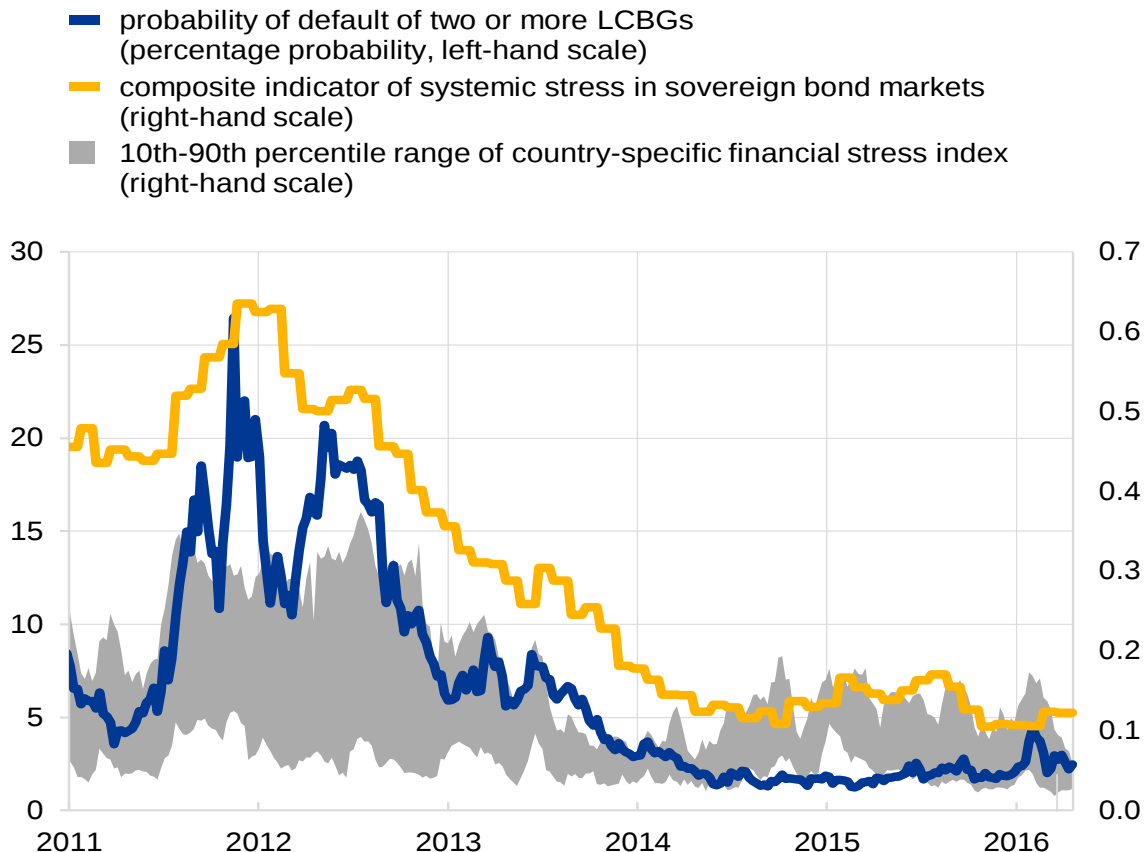
Press Conference

24 May 2016

Measures of euro area systemic risk have remained contained

Financial stress index, composite indicator of sovereign systemic stress and the probability of default of two or more banking groups

Jan. 2011 – May 2016



- Bouts of volatility around the turn of the year. ECB measures announced in March calmed market sentiment
- Overall, the euro area financial system has been able to absorb the tensions
- Standard indicators of bank, fiscal and financial stress all standing at low levels in early May

Sources: Bloomberg and ECB calculations.

Notes: "Probability of default of two or more LCBGs" refers to the probability of simultaneous defaults in the sample of 15 large and complex banking groups (LCBGs) over a one-year horizon. The financial stress index measures stress in financial markets at the country level based on three market segments (equity, bond and foreign exchange) and the cross-correlation among them. For details, see Duprey, T., Klaus, B. and Peltonen, T., "Dating systemic financial stress episodes in the EU countries", Working Paper Series, No 1873, ECB, December 2015.

Risk 1

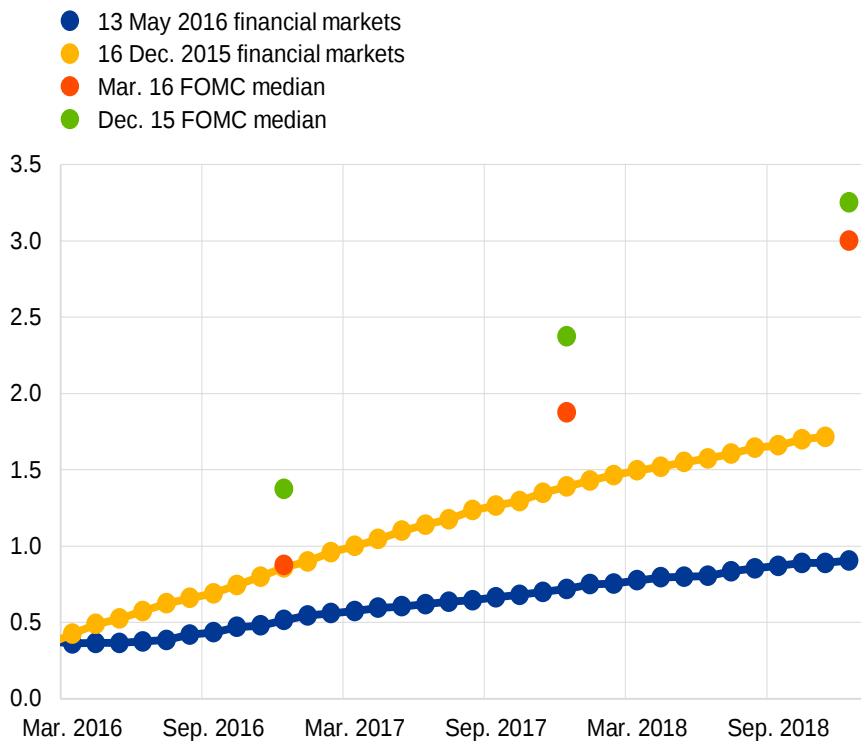
Further increase of risk premia and financial turmoil, triggered by emerging market stress and persistently low commodity prices

- *Global environment (EMEs and oil prices, US interest rates)*
- *Euro area asset markets*

Receding risks of sharp upward adjustments of euro area rates stemming from US

US Federal funds interest rate forecasts by the Federal Open Market Committee (FOMC) and financial markets

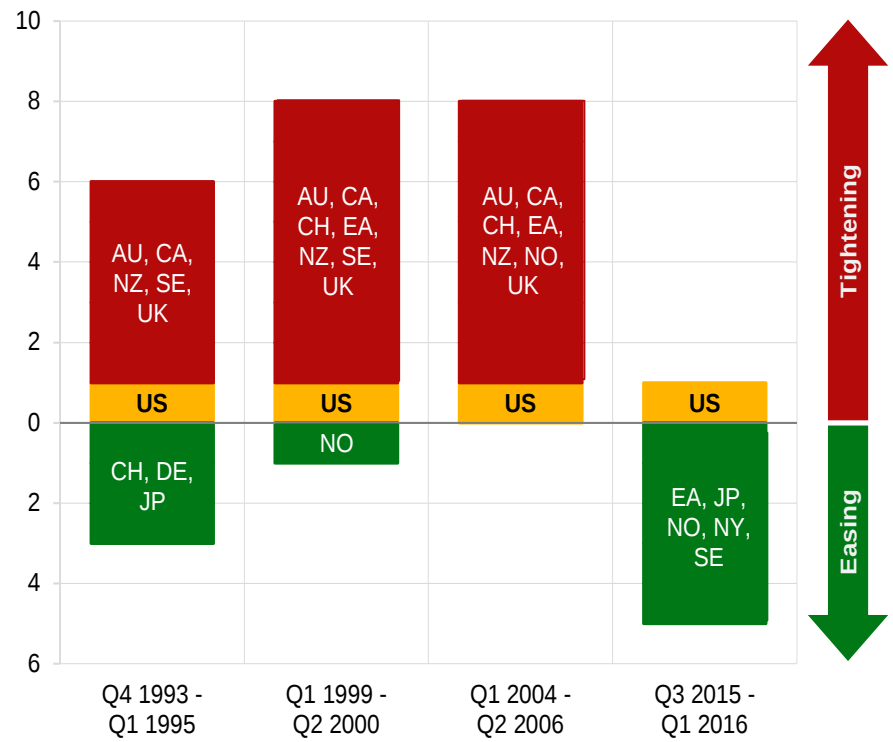
Percentages per annum, forecasts for 2016, 2017 and 2018



Source: Bloomberg.

Episodes of US monetary policy tightening cycles and the respective policy stance in other advanced economies

Quarterly data, 1993 to 2016



Sources: Bloomberg and ECB calculations.

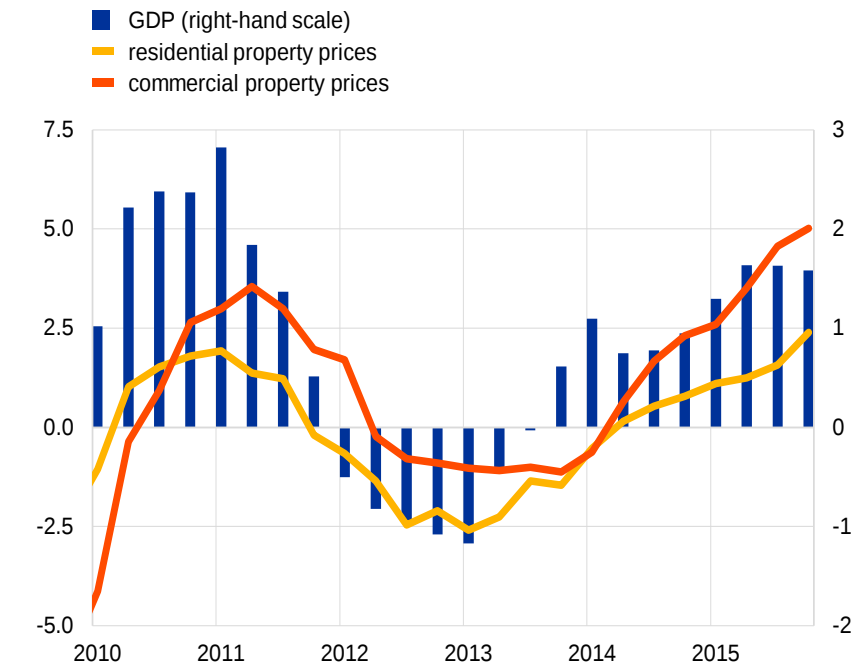
Notes: The chart identifies major Fed monetary policy tightening cycles since 1994. G10 central bank tightening (easing) of monetary policy is defined by an increase (decrease) of the main policy rate by more than 25 basis points over the Fed tightening cycle. Given the non-conventional measures adopted over recent years, the 25 basis point threshold is not applied to the most recent Fed monetary tightening cycle (Q4 2015 onwards). The Bundesbank's policy rates have been used as a proxy for the ECB's monetary policy before 1999. EA stands for euro area.

Risk premia on euro area asset prices remain contained

- Continued recovery in residential and commercial property markets
- Aggregate euro area residential real estate valuation estimates conceal some cross-country divergence

Commercial and residential property prices and GDP growth in the euro area

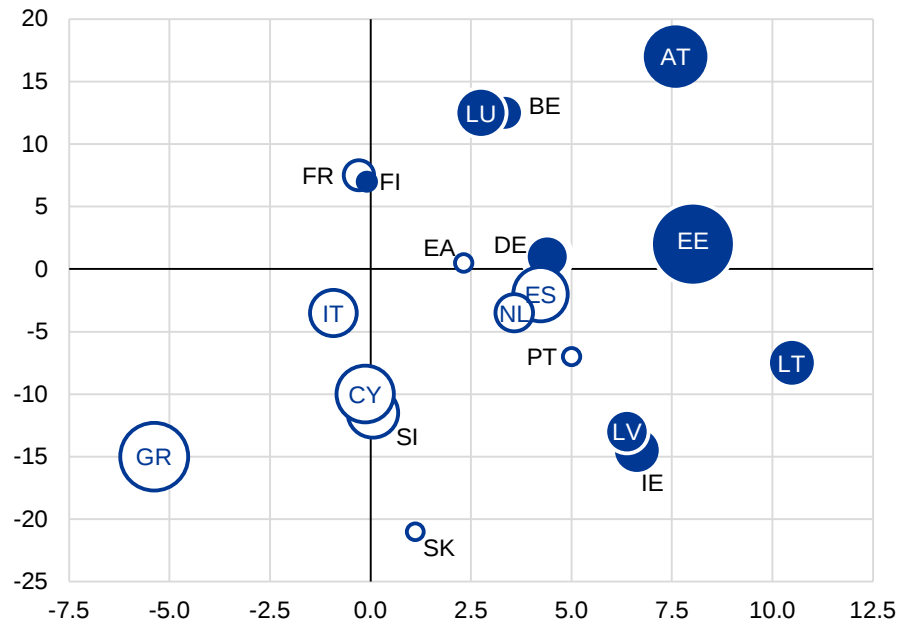
Q1 2010 – Q4 2015; percentage changes per annum



Sources: ECB and experimental ECB estimates based on MSCI and national data.

Residential property price growth (x-axis) and valuations (y-axis)

Q4 2015; annual percentage changes; percentages



Source: ECB.

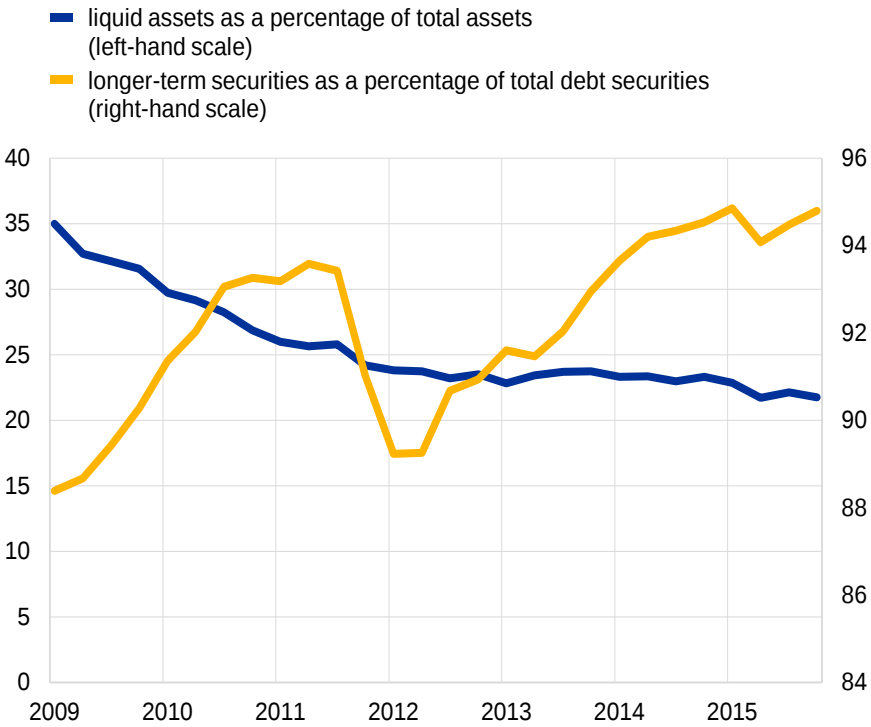
Notes: The size of the bubble represents the overall price growth between 2011 and 2015. Light bubbles indicate overall negative price growth, while dark bubbles refer to overall positive price growth. Average valuation is based on the price-to-income ratio and the new model-based estimate (BVAR). For details of the methodology, see Box 3 in Financial Stability Review, ECB, November 2015. Malta is excluded. EA stands for euro area.

Higher liquidity and maturity mismatches

- Risks from liquidity and maturity transformation of euro area bond funds are growing
- Shift in investment funds' asset allocation - from higher to lower-rated debt securities

Share of liquid assets and longer-term debt securities

Q1 2009 – Q4 2015; percentages

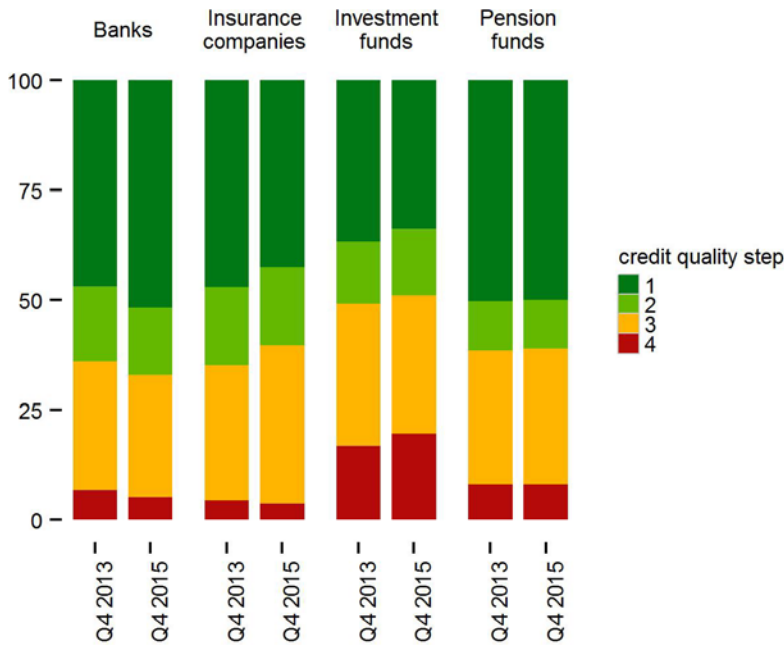


Sources: ECB and ECB calculations.

Notes: Liquid assets include euro area government bonds, deposits and loan claims with MFIs. Longer-term securities include bonds with an initial maturity above two years.

Euro area financial institutions' debt securities holdings by rating category and sector

Q4 2013; Q4 2015; percentages of total holdings



Sources: ECB and ECB calculations.

Notes: Credit quality steps are defined in accordance with the Eurosystem credit assessment framework (ECAAF), which provides a harmonised rating scale classifying ratings into three credit quality steps. The first category includes securities rated from AAA to AA-, the second from A+ to A- and the third from BBB+ to BBB-. A fourth category is added which includes all rated securities with a rating below credit quality step three. The analysis is based on the nominal amounts of euro and foreign currency-denominated securities, including "alive" and "non-alive" securities. The investment fund sector excludes money market funds.

Risk 2

Weak profitability prospects for banks and insurers, with banks' intermediation additionally constrained by unresolved problems in reducing non-performing loans

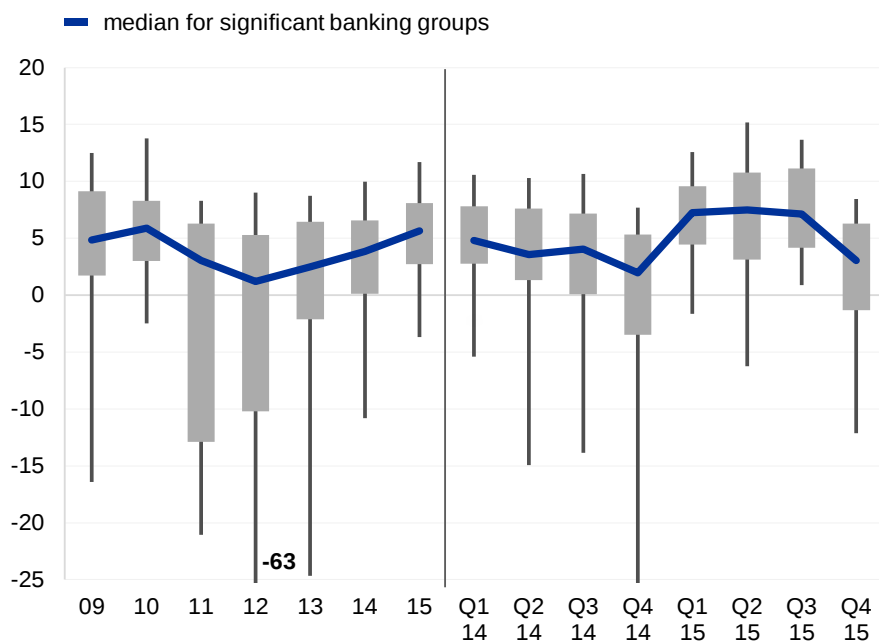
- *Market turmoil, banks' valuations and funding conditions*
- *Banks' profitability*
- *Structural challenges*
- *Challenges in the insurance sector*

Bank profitability remains subdued

- Slight pick-up in euro area banks' profitability in 2015 as a whole, but weaker performance in the last quarter
- The increase in euro area banks' aggregate net profits was mainly driven by lower impairments and higher non-interest income

Return on equity for euro area significant banking groups

Percentages; 10th and 90th percentile, interquartile range and median for SGBs



Source: SNL Financial.

Notes: Based on publicly available data on significant banking groups. Annual and quarterly data are based on a sample of 78 and 43 SGBs respectively.

Decomposition of changes in euro area SGBs' net income between 2014 and 2015

EUR billions



Sources: SNL Financial and ECB calculations.

Note: Based on publicly available data for a sample of 83 euro area SGBs

Scope for efficiency gains in the banking sector

- Branch network rationalisation and headcount reductions brought efficiency gains in some euro area banking sectors
- Low market concentration and higher cost inefficiency suggest there is scope for efficiency gains from consolidation

2009-14; x-axis: change in the number of branches (blue) and employees (yellow); y-axis: change in the cost-to-income ratio

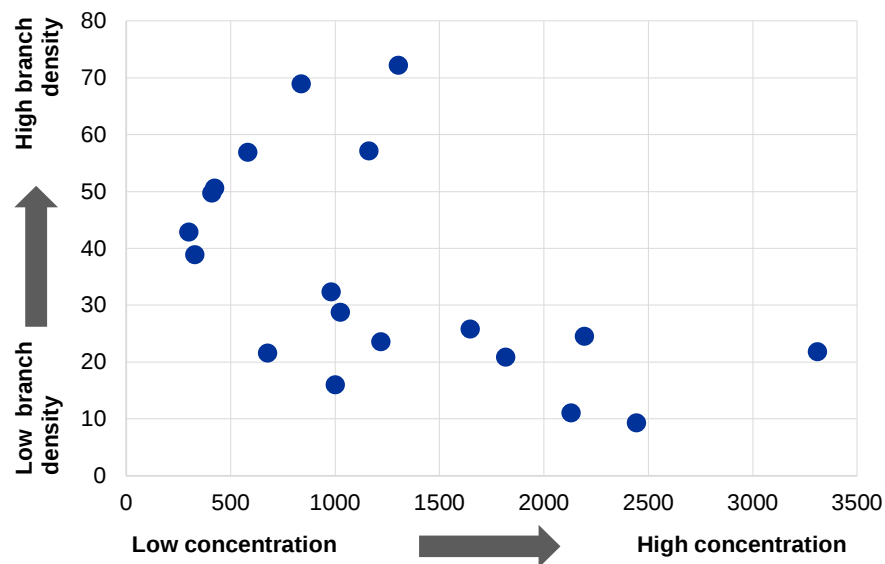
2009-2014; percentage changes (x-axis); percentage point changes (y-axis)



Sources: ECB and ECB calculations.

Market concentration and branch network density in euro area countries

2014; x-axis: Herfindahl index; y-axis: number of bank branches per 100,000 people



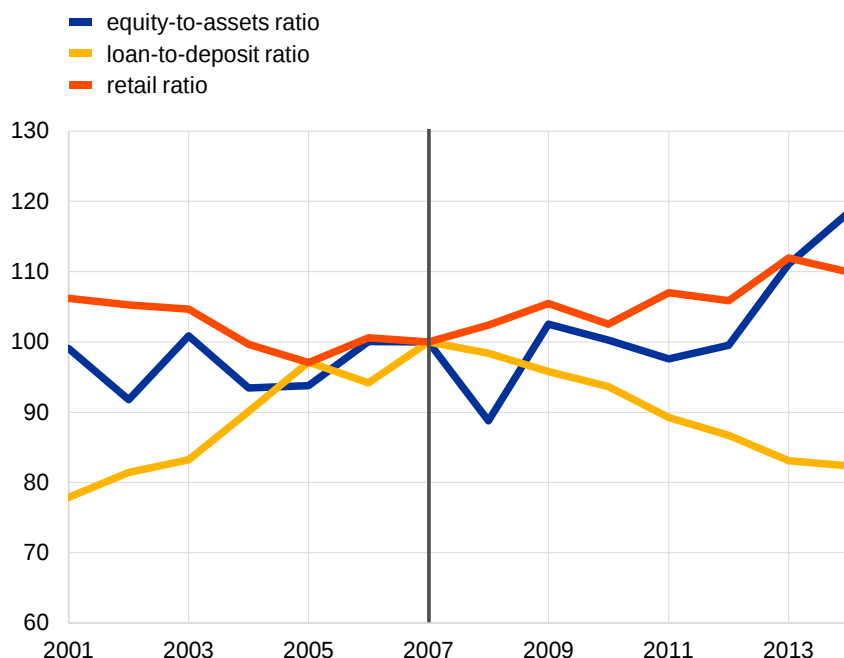
Source: ECB.

Banks' adjustment to new business models

- Shift in EU banks' business models since the crisis to lower leverage, reduced reliance on wholesale funding and higher reliance on retail activities
- Income diversification gradually increased compared with crisis lows, while cost efficiency did not show any improvement in the post-crisis period

Changes in EU significant banking groups' key business model characteristics after the crisis

2001-14; index: 2007=100

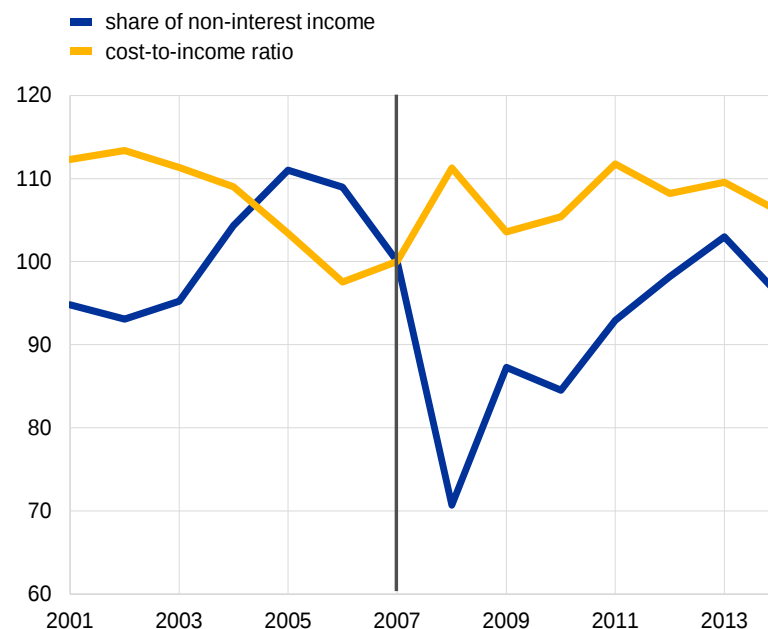


Sources: Bloomberg, SNL Financial and ECB calculations.

Notes: The index is based on the median value for each indicator. The retail ratio is calculated as the ratio of customer deposits plus (net) customer loans over total assets

Changes in EU significant banking groups' non-interest income share and cost-to-income ratio after the crisis

2001-14; index: 2007=100



Sources: Bloomberg, SNL Financial and ECB calculations.

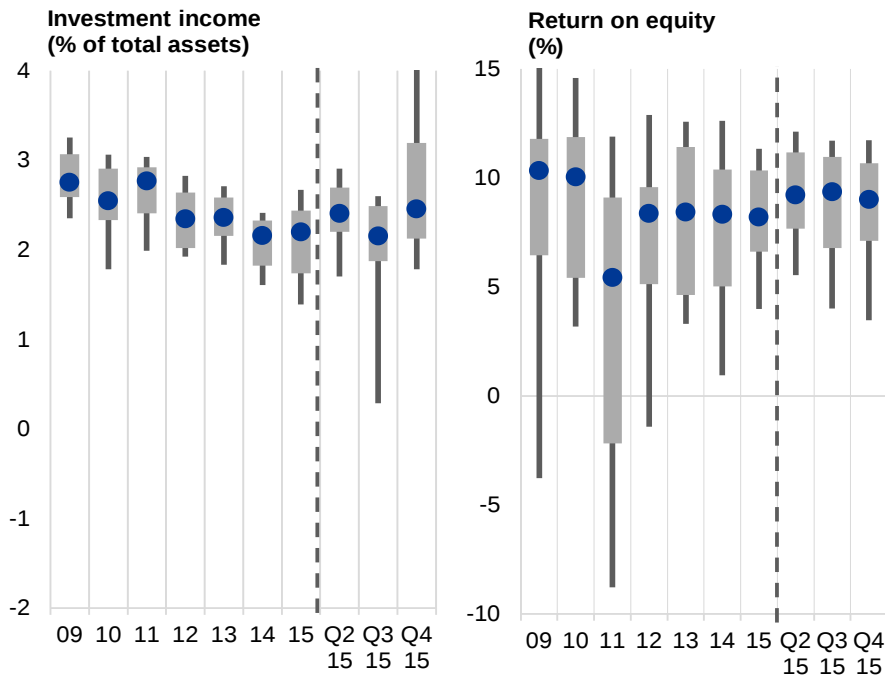
Note: The index is based on the median value for each indicator.

Euro area insurers: Stable profitability amid signs of increased risk taking

- Investment income bounced back in the last quarter of 2015 supported by realised gains in financial markets
- Exposures to higher-yielding bonds continue to increase

Investment income and return on equity for a sample of large euro area insurers

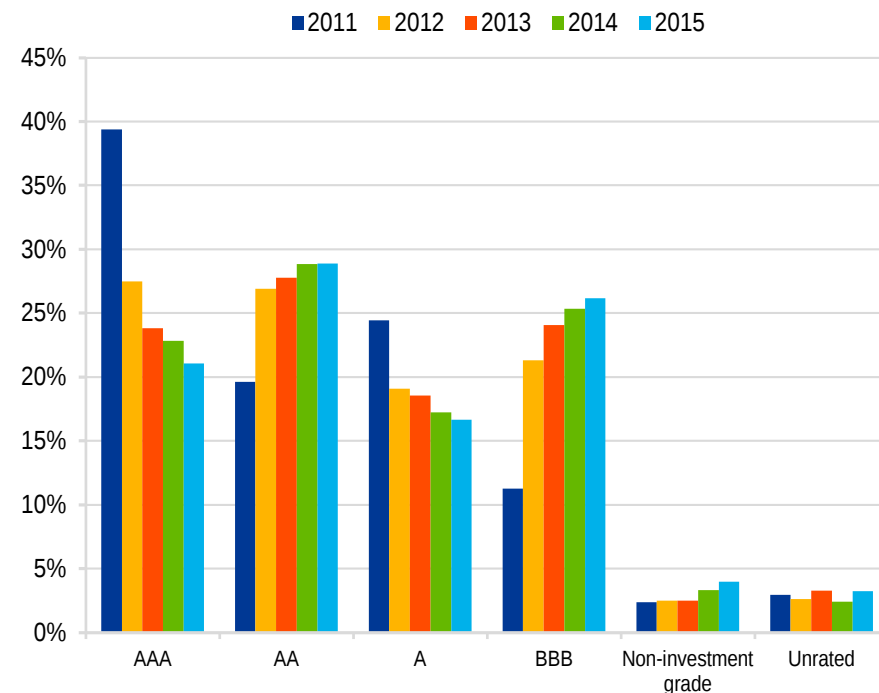
2009 – Q4 2015; percentages; 10th and 90th percentiles, interquartile distribution and median



Sources: Bloomberg, individual institutions' financial reports and ECB calculations.
Note: Investment income excludes unrealised gains and losses.

Bond investments of selected large euro area insurers split by rating category

2011- 2015; percentage of total investment portfolio; weighted averages



Sources: JPMorgan Cazenove, individual institutions' financial reports and ECB calculations.
Note: Based on available data for 15 large euro area insurers and reinsurers.

Risk 3

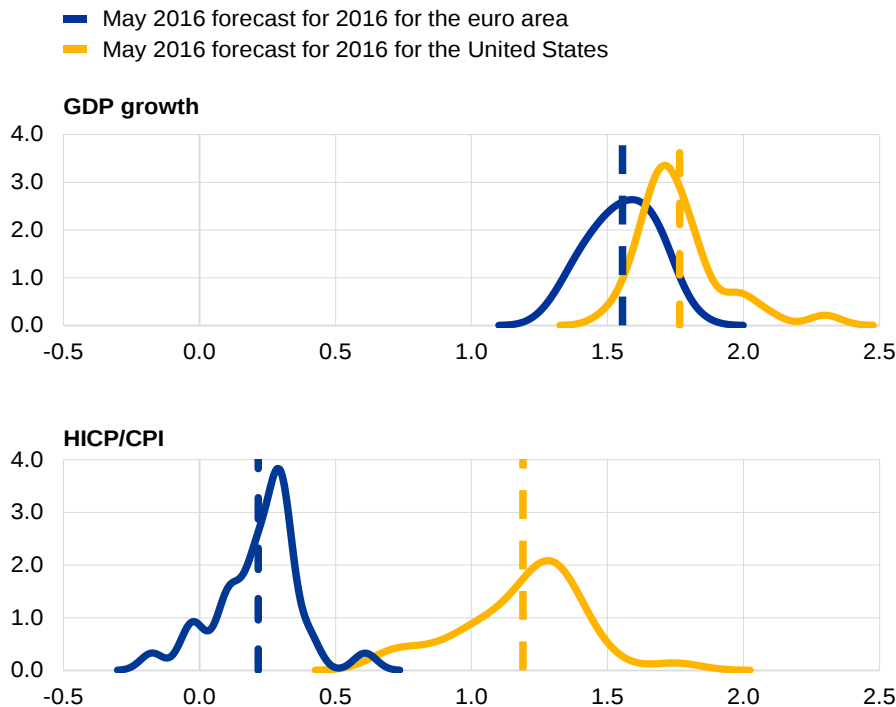
Rising debt sustainability concerns in sovereign and non-financial private sectors amid heightened political uncertainty and low nominal growth

- *Elevated debt across euro area non-financial sectors*
- *Challenges from weak nominal economic prospects and political issues*

Downside risks to nominal growth coupled with higher political risks

- Low nominal growth in the euro area contrasts with more benign conditions in the United States
- Political risks pose a challenge to fiscal and structural reform implementation

Distribution of the 2016 real GDP growth and HICP/CPI forecasts for the euro area and the United States probability density

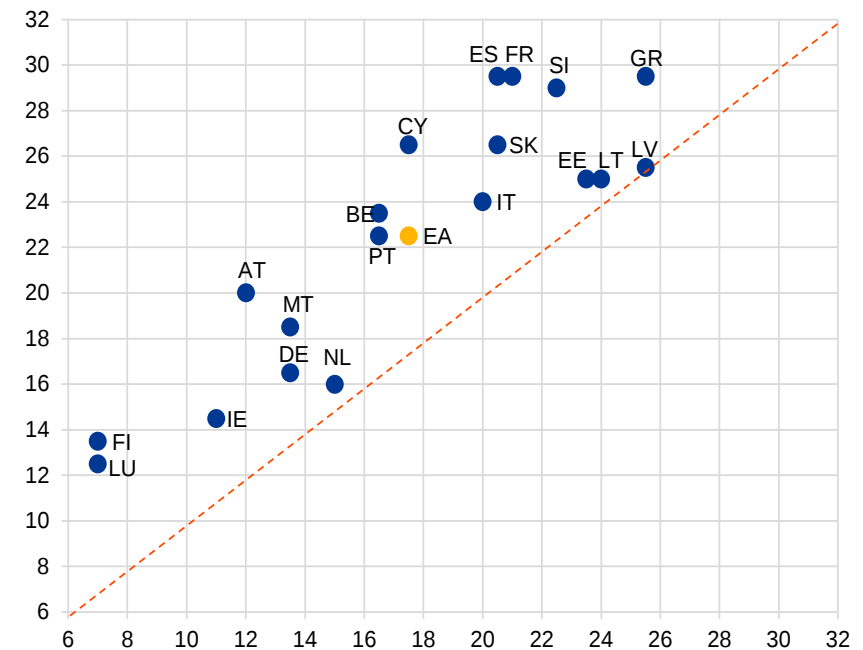


Sources: Consensus Economics and ECB calculations.

Note: The dashed lines represent the average real GDP growth and HICP/CPI forecast values.

Political risk ratings in the euro area and individual euro area countries

x-axis: spring 2008; y-axis: spring 2016



Sources: PRS Group (International Country Risk Guide) and ECB calculations.

Notes: The ICRG's political risk rating comprises the following sub-categories: (1) government stability, (2) socioeconomic conditions, (3) investment profile, (4) internal conflict, (5) external conflict, (6) corruption, (7) military in politics, (8) religious tensions, (9) law and order, (10) ethnic tensions, (11) democratic accountability and (12) bureaucracy quality. The risk ratings range from zero (highest risk) to 100 (least risk). The original values were transformed by subtracting them from 100 for illustration purposes. Spring 2008 values represent data for May 2008, while figures for spring 2016 are for April 2016 (i.e. the latest available figure). The euro area (EA) value is calculated as a simple average of the values for the individual euro area economies.

Risk 4

Prospective stress in the investment fund sector amplified by liquidity risks and spillovers to the broader financial system

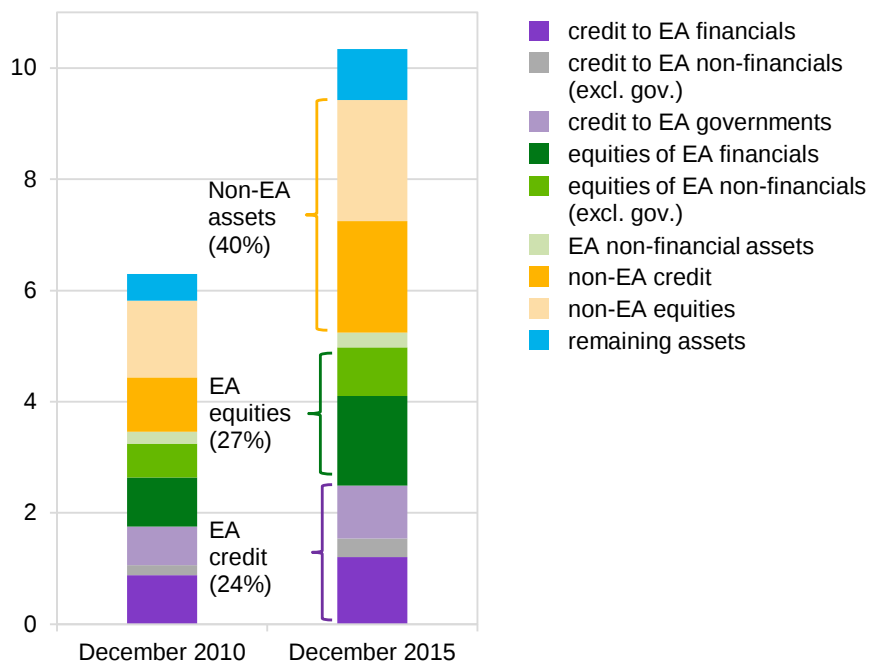
- *Continued strong growth and risk taking in investment fund industry*

High growth and increased risk-taking among investment funds

- Growing role of investment funds in channeling debt and equity to the domestic economy and abroad
- Bond fund exposures to the more risky segments of the market have increased

Assets by type

Dec. 2010 and Dec. 2015; EUR trillions

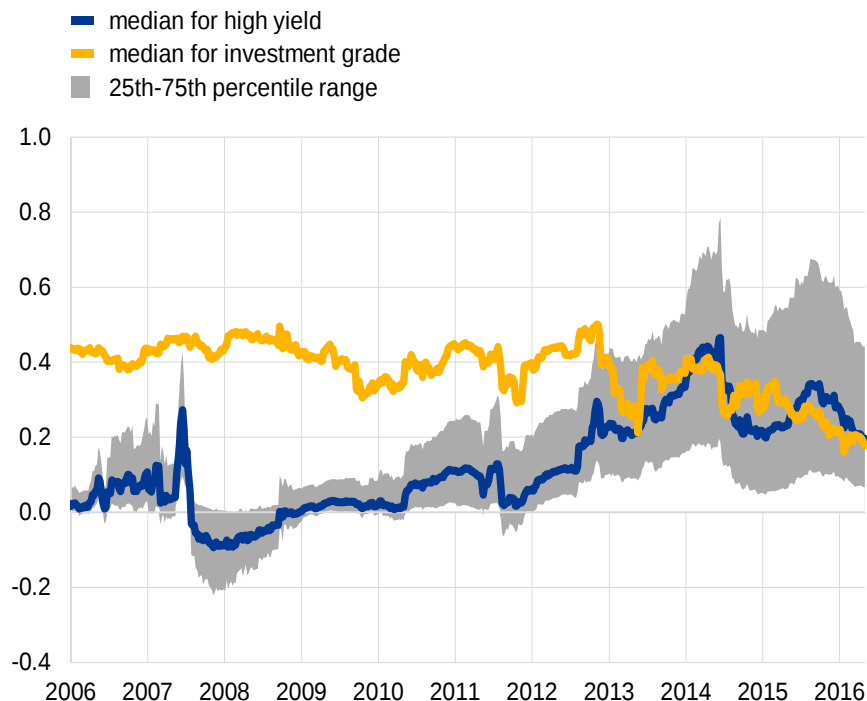


Sources: ECB and ECB calculations.

Notes: Credit includes loans and debt securities; non-financial assets include real estate and other non-financial assets. The assets are valued by market prices. EA stands for euro area.

Estimated market betas relative to a benchmark index

Jan. 2006 – Apr. 2016



Sources: Lipper IM, Thomson Reuters Datastream, EPFR and ECB calculations.

Notes: CAPM betas have been calculated for a rolling window of 52 weeks. The sample includes 2,600 bond funds, which are EUR-denominated, with a euro area investment focus, and not flagged as government bond funds. The underlying market benchmark is Barclay's Pan European High Yield index.