EUROPEAN CENTRAL BANK

EUROSYSTEM

# November 2021

# Financial Stability Review

Press conference

17 November 2021

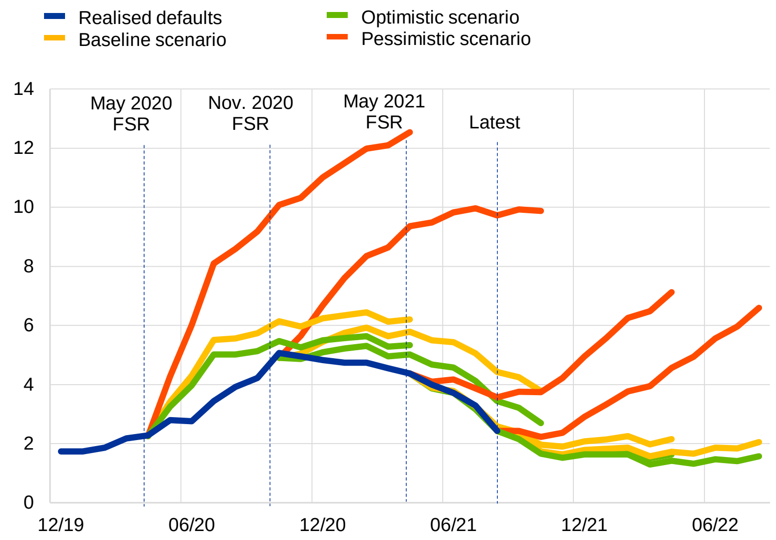
## Near-term pandemic risks lessen, vulnerabilities ahead build up

- Corporates, sovereigns and banks have avoided tail risk outcomes
- Supply disruptions and energy prices pose risks to inflation and growth
- Vulnerabilities have been increasing in euro area property markets
- Signs of stretch are continuing in financial markets and non-banks

# Near-term corporate insolvency and sovereign funding tail risks have fallen

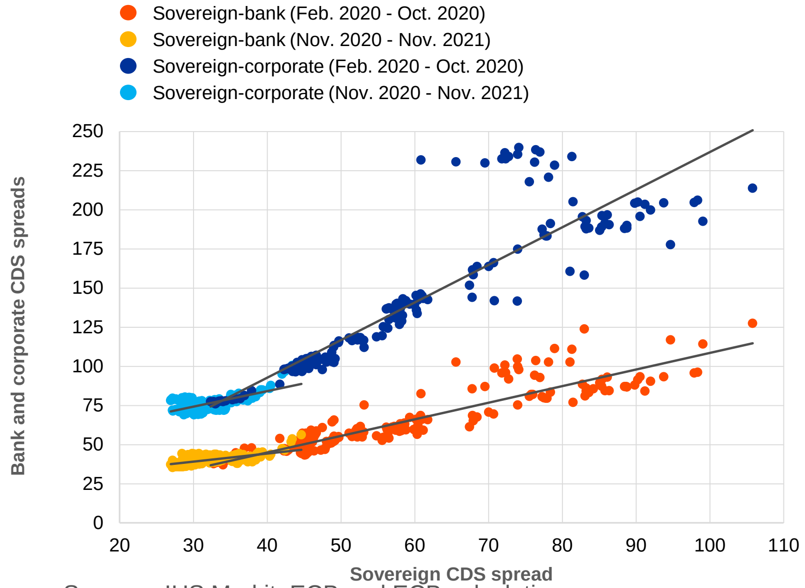
- Default rates have remained below most optimistic forecasts, with a general pick-up in earnings
- Further declines in spreads for lower-rated sovereigns as conditions remain very benign, while governments extend debt maturity. Corporate and bank spreads co-move

**European speculative-grade 12-month trailing default rates**
(percentages)




Source: Moody’s Analytics.

**Sovereign, bank and non-financial corporate CDS spreads**
(basis points)

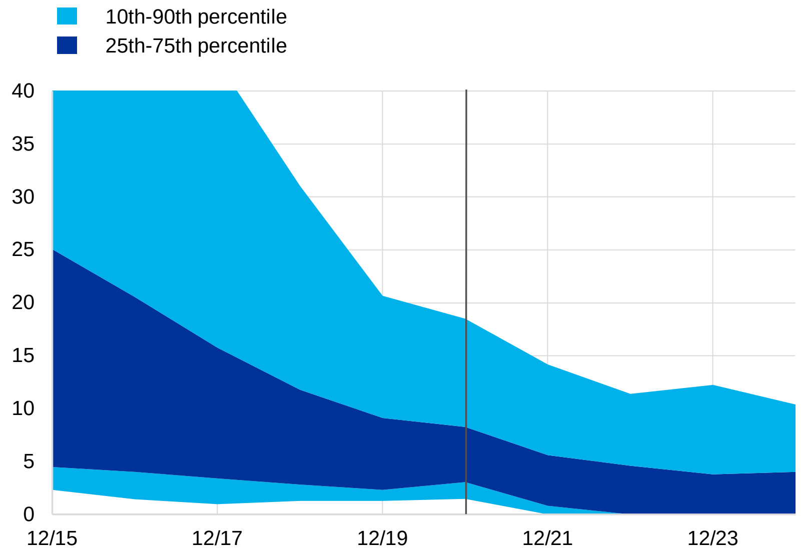



Sources: IHS Markit, ECB and ECB calculations.

# Bank news also positive so far, as profitability returns to pre-pandemic levels

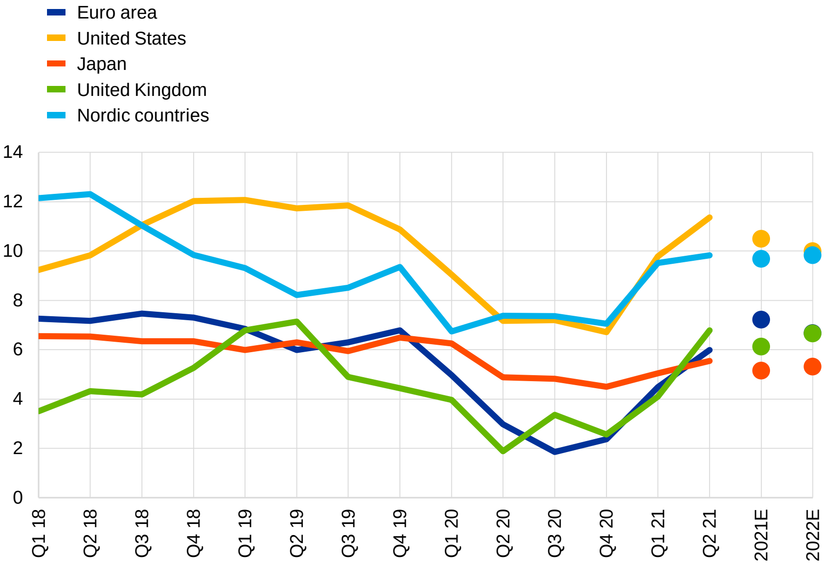
- Banks' profitability improves on lower impairments and higher revenues
- But reliance on investment banking and mortgage lending income means medium-term outlook is still challenging for euro area banks

**Distribution of past and model-implied (future) median NPL ratios across country-sectors**
(2015-24, percentages of total loans)




Sources: ECB supervisory data, ORBIS, Capital IQ, Bloomberg Finance L.P., Eurostat and ECB calculations.

**Median bank ROE in major advanced economies**
(percentages)

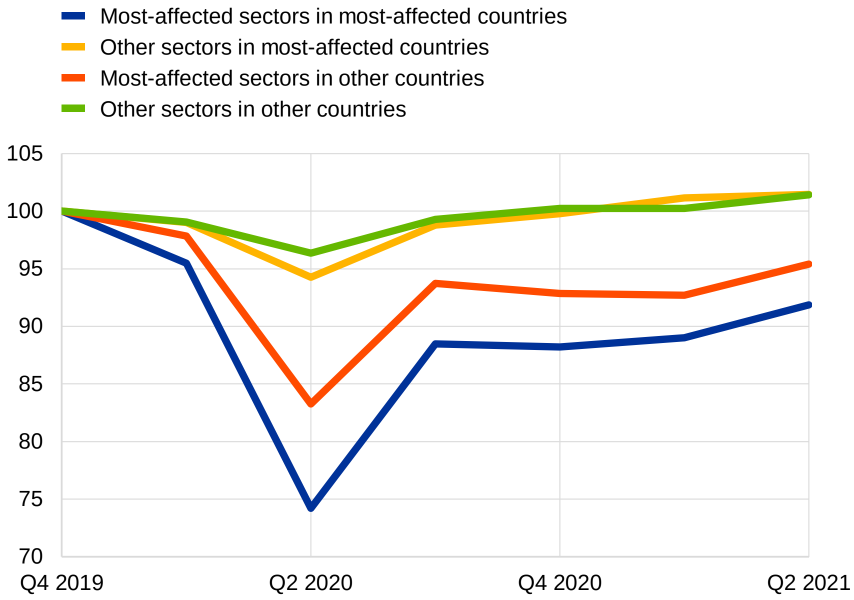



Sources: Bloomberg Finance L.P. and ECB calculations.
Notes: "Nordic countries" refers to Denmark, Finland and Sweden.

# Economic recovery has broadened, but with headwinds from supply chains and energy

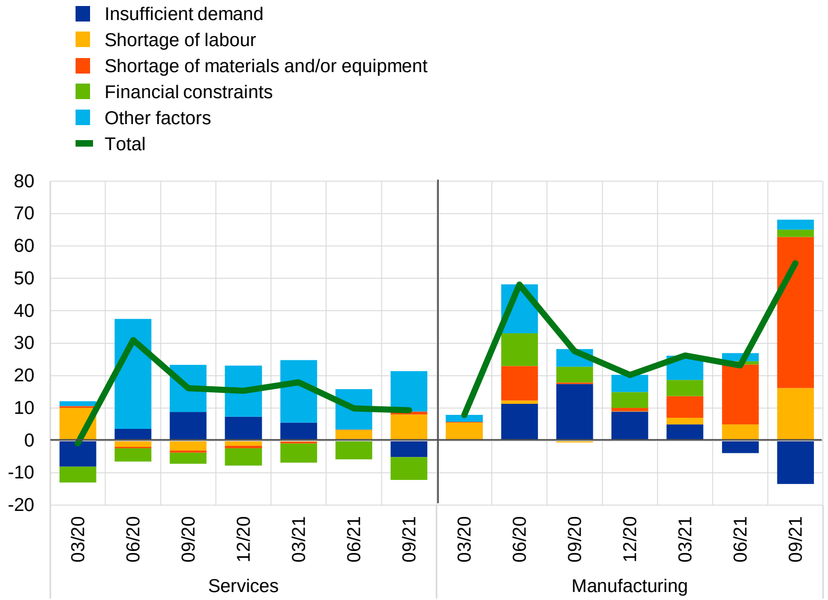
- Easing of lockdown measures was followed by economic recovery broadening to more sectors and countries
- But the outlook for the economy and inflation is facing headwinds from global supply chain issues (shortages of materials and labour) and the recent sharp increase in energy costs

**Country and sector dispersion in gross value added**
(Q4 2019-Q2 2021, Q4 2019=100)




Sources: Eurostat and ECB calculations.

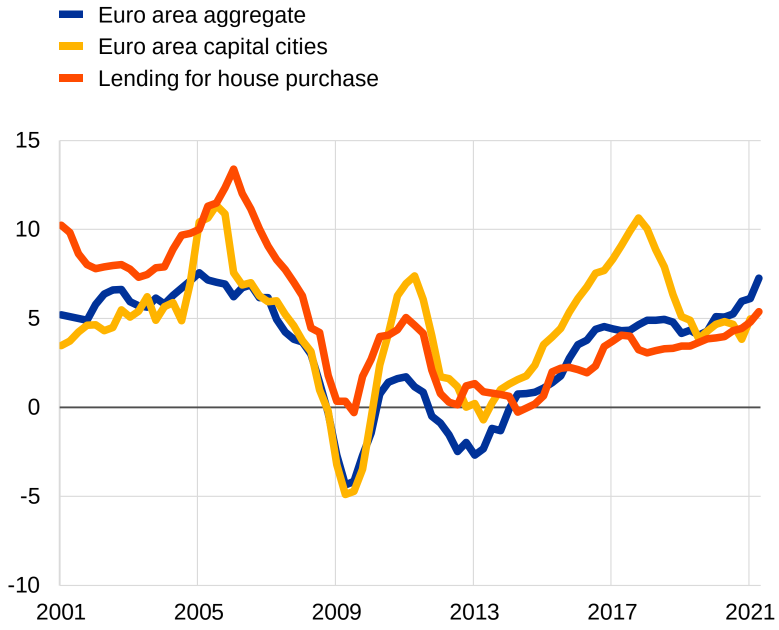
**Production limits in the services and manufacturing sectors**
(Q1 2020-Q3 2021, % of respondents, point deviations from averages)




Sources: European Commission and ECB calculations.

# Vulnerabilities increasing in buoyant euro area housing markets

**RRE prices on aggregate and in capital cities, and lending for house purchase**
(Q1 2001-Q2 2021, annual percentage changes)



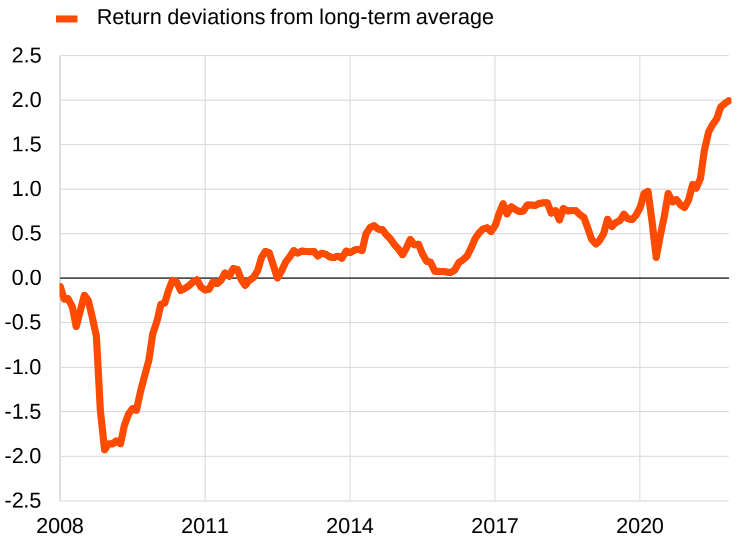

Sources: ECB and ECB calculations.

- Mortgage lending and RRE price growth have continued to accelerate
- Signs of further loosening of RRE lending standards, with debt servicing kept low
- Strength of RRE markets is coupled with buoyant mortgage lending, and there is evidence of a progressive deterioration in lending standards, as reflected by the increasing share of loans with high loan-to-value and loan-to-income ratios

# Financial markets showing extension in signs of stretch

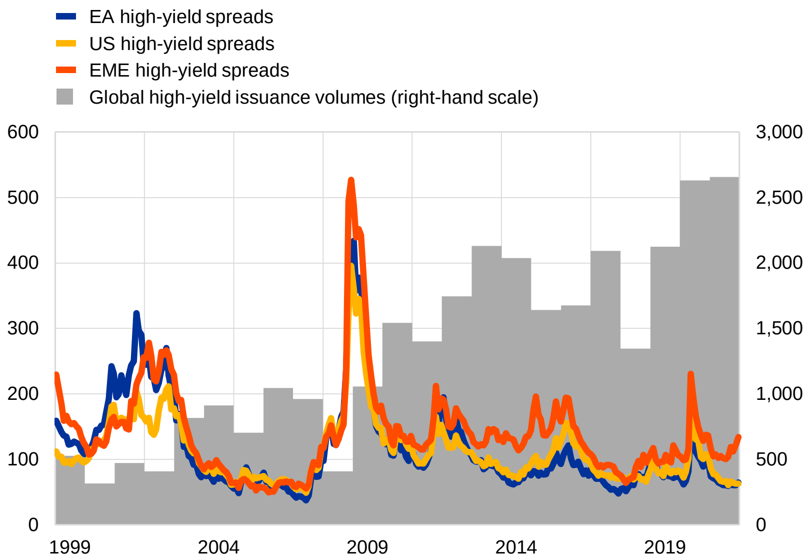
- Historically low real yields and elevated valuations have left some equity markets and higher-risk bond markets vulnerable to adverse interest rate and growth shocks
- Search-for-yield activity has also supported growth in novel, riskier asset classes, such as crypto tokens

**Deviation of a basket of global financial assets from long-term average**
(Jan. 2008-Nov. 2021, number of standard deviations)




Sources: Refinitiv, Bloomberg Finance L.P., ECB and ECB calculations.

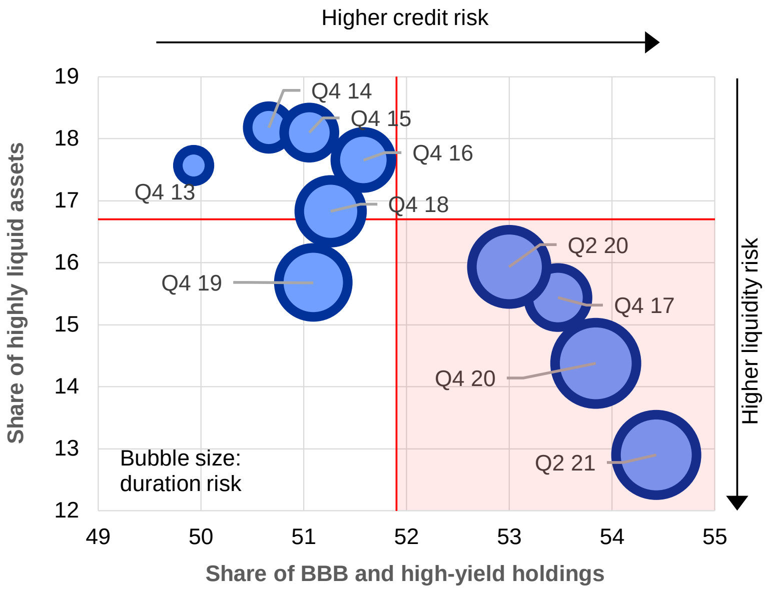
**Global high-yield corporate bond issuance and high-yield bond spreads**
(Jan. 1999-Oct. 2021, basis points, USD billions)




Sources: Dealogic, Bloomberg Finance L.P. and ECB calculations.

# Non-banks increasingly sensitive to shifts in sentiment or interest rates

**BBB and high-yield holdings and highly liquid assets of investment funds**
(Q4 2013-Q2 2021, percentages)




Sources: ECB (SHSS) and ECB calculations.

- Low holdings of liquid assets have left non-banks (especially investment funds) vulnerable to large-scale outflows
- And their duration risk has continued to rise, rendering portfolios vulnerable to interest rate shocks
- Non-banks have also continued absorbing the bulk of the record issuance of high-yield corporate bonds – increasing their credit risk exposure

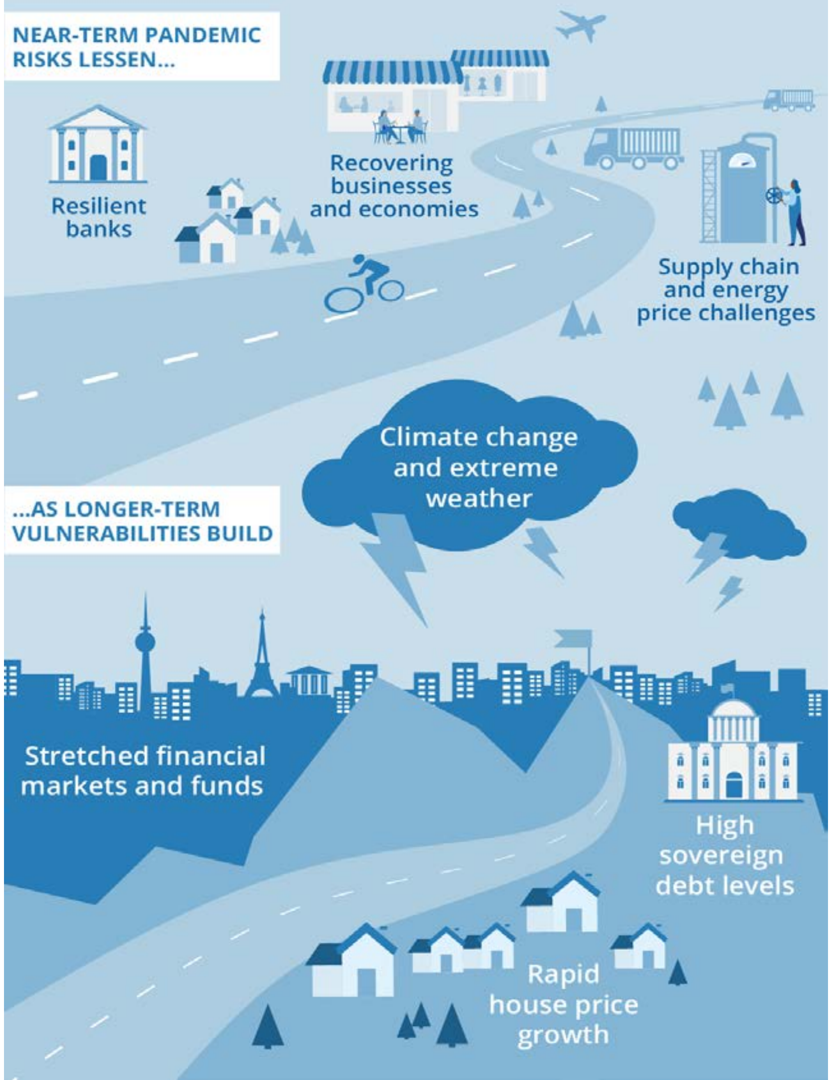
# Financial stability policies gradually tilt to address medium-term challenges

## Gradually shift policy emphasis to addressing medium-term vulnerabilities

- Consider **gradual adjustment of targeted macroprudential policy measures** to address RRE vulnerabilities
- Start considering gradual **increase in counter-cyclical capital buffers** where economic and banking sector outlook are favourable

## Enhance the regulatory framework to ensure long-term resilience

- Ensure full, timely and consistent **imple-mentation of final Basel III reforms** to address shortcomings in existing framework
- Develop a **holistic macroprudential approach for non-banks**, embedded in international coordination
- Enhance resilience of **money market funds**


NEAR-TERM PANDEMIC RISKS LESSEN...
Resilient banks
Recovering businesses and economies
Supply chain and energy price challenges
Climate change and extreme weather
...AS LONGER-TERM VULNERABILITIES BUILD
Stretched financial markets and funds
High sovereign debt levels
Rapid house price growth