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Signs of asset mispricing suggest potential for future corrections
- Very low yield environment
- Robust risk appetite
- Valuations contingent on low yields
- Safe-haven asset inflation

Growing challenges from cyclical headwinds to bank profitability
- Eroding interest margins
- Slightly rising cost of credit risk
- High cost inefficiencies
- Plateauing capital positions

Lingering private and public debt sustainability concerns
- Weaker growth prospects
- Releveraging of high-yield firms
- Rising property prices
- Low interest payment burdens

The financial stability environment remains challenging...
...but euro area banks are adequately capitalised, with a 14.2% CET1 ratio.

All euro area countries have activated macroprudential measures...
...even so, more active use of macroprudential policies could be appropriate to contain vulnerabilities.
Private debt: pockets of vulnerability in non-financial corporations; exuberant real estate markets in some countries

Outstanding euro area corporate debt by issuer rating and changes since 2007
(2007, 2018, € trillions, percentages)

Sources: S&P Global Market Intelligence and ECB calculations.
Note: HY: high-yield.

Real residential property price and mortgage lending growth in the euro area
(Q3 2015-Q2 2019, 4-year annual percentage change)

Sources: ECB and ECB calculations. Note: RWs: risk weights.
Non-banks: increased exposure to riskier assets

Breakdown of debt securities held by euro area investment funds by credit rating
(Q4 2013-Q2 2019, share of total debt securities holdings)

Breakdown of debt securities held by euro area investment funds by liquidity bucket
(Q4 2013-Q2 2019, € trillions)

Source: ECB Securities Holdings Statistics by Sector (SHSS).
Non-banks: higher credit and liquidity risks for investment funds

Search for yield in investment funds

- Strong inflows into bond and money market funds globally have continued
- Riskier holdings
- Increased liquidity mismatch
  - Stress episodes in UCITS funds illustrating risk of large-scale outflows
- Leverage can add to procyclical investor behaviour and accelerate outflows

Cash and liquid holdings for all types of bond funds by credit risk profile
(percentage of total assets)

Sources: Refinitiv and ECB Centralised Securities Database.
Banks: profitability expected to remain weak

ECB forecasts for banks’ return on equity in 2019-21 under the baseline scenario (percentages, weighted average, interquartile range)

Sources: Individual institutions’ financial reports, European Banking Authority, ECB and ECB calculations.

Contribution of core revenues and impairments to changes in euro area banks’ return on equity (percentage points)

Sources: ECB supervisory statistics and ECB calculations.
Banks: structural cost issues persist

Euro area banks’ aggregate cost-to-income and cost-to-assets ratios
(2009-Q2 2019, percentages)

Source: ECB consolidated banking statistics.

Banks’ stock returns by bank funding structure
(percentages)

Source: Bloomberg.
Banks: solvency solid even under adverse scenario

- Under baseline case, euro area banks are able to build up capital ratios (meeting new regulatory requirements)
- Adverse scenario is a tail event consistent with main risks materialising over next two years including:
  - Deterioration of global macro conditions
  - Fall in euro area GDP (by ca. 1.7% in 2021) and corporate earnings, rise in unemployment (to 10% in 2021)
  - Steepening of yield curve (long rates rise)

**Capital ratio change under the baseline and adverse scenarios**
(Common Equity Tier 1 ratio, percentages)

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<th>Year/GDP Indicator</th>
<th>Baseline 2021</th>
<th>Adverse 2021</th>
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<tr>
<td>2018</td>
<td></td>
<td>-3.1 ppt</td>
</tr>
<tr>
<td>Capital ratio change</td>
<td>+0.9 ppt</td>
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Source: ECB calculations.
Macroprudential policy implications

The CCyB is still only a tiny fraction of euro area banks’ capital requirements

- While the overall level of capital is considered appropriate, a higher CCyB may be merited in a few countries
- A higher share of releasable buffers within overall capital requirements would strengthen macroprudential policy support in a downturn
- Further measures could counter risks from RRE and CRE markets in some countries
- Unintentional barriers to banking sector consolidation should be examined
- Need for faster progress on macroprudential tools for non-banks
- Climate risk monitoring requires better disclosures

Sources: ECB, Eurostat and ECB calculations.
Note: CCyB: countercyclical capital buffer.