EUROPEAN CENTRAL BANK

EUROSYSTEM

# May 2021

# Financial Stability Review

Press conference

19 May 2021

# Financial stability vulnerabilities remain elevated

**Vulnerabilities clustering in some countries**

**US yields rise and market exuberance continues**

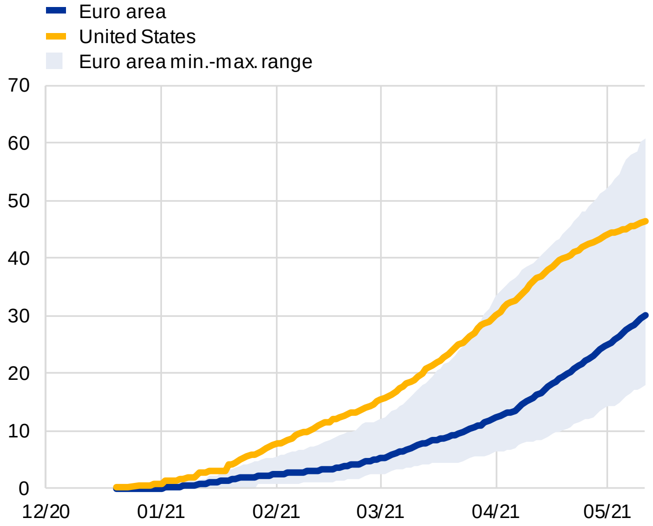
**More optimism on banks, although with reservations about provisions**

**Climate-related transition and physical risks are material**

# Third wave delays the economic recovery, particularly for some sectors

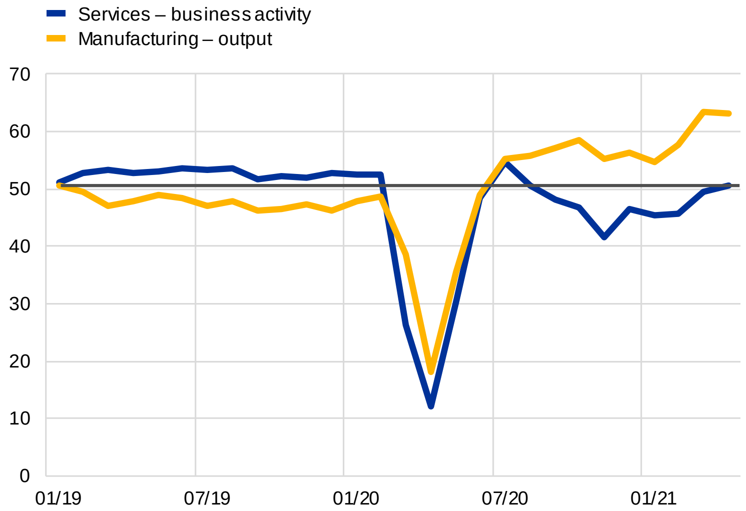
- Third wave of infections has delayed the euro area economic recovery, but vaccinations are now catching up
- Costs of lockdown, and policy support reliance, increasingly concentrated in some sectors/countries

**Vaccination rates (first dose)**
(1 Dec. 2020-11 May 2021, percentage of population)




Sources: ourworldindata.org and ECB calculations.

**Euro area PMIs by sector**
(Jan. 2019-Apr. 2021; 50 = no change on previous month)

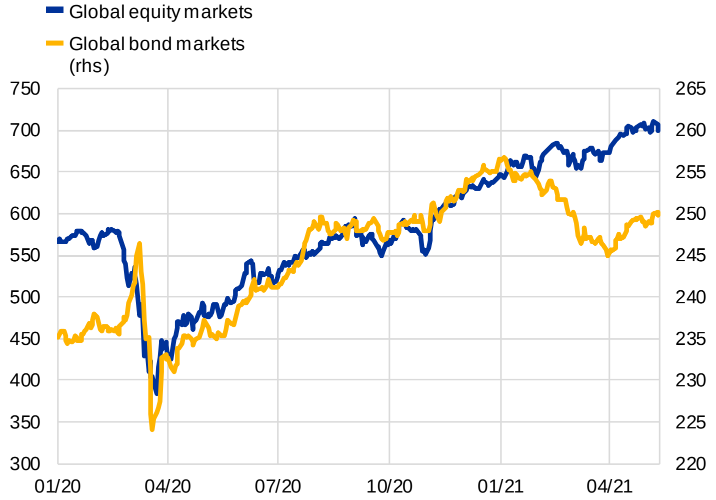



Sources: IHS Markit and ECB calculations.

# Financial markets exhibit robust risk sentiment as US yields rise

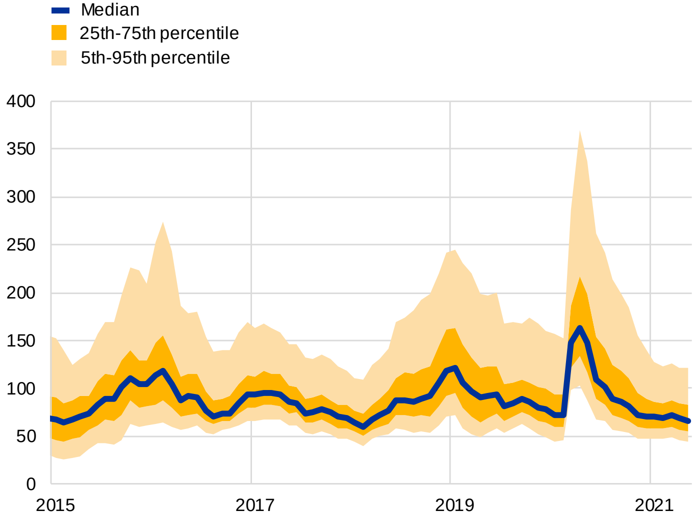
- As US interest rates rose and global bond markets sold off, equity markets saw a renewed rally
- Ongoing search for yield has pushed corporate bond spreads to multi-year lows, susceptible to correction

**Global equity and bond market price developments**
(1 Jan. 2020-11 May 2021, indices)




Source: Bloomberg Finance L.P.

**Range of euro area investment-grade non-financial corporate bond spreads**
(Jan. 2015-May 2021, basis points)

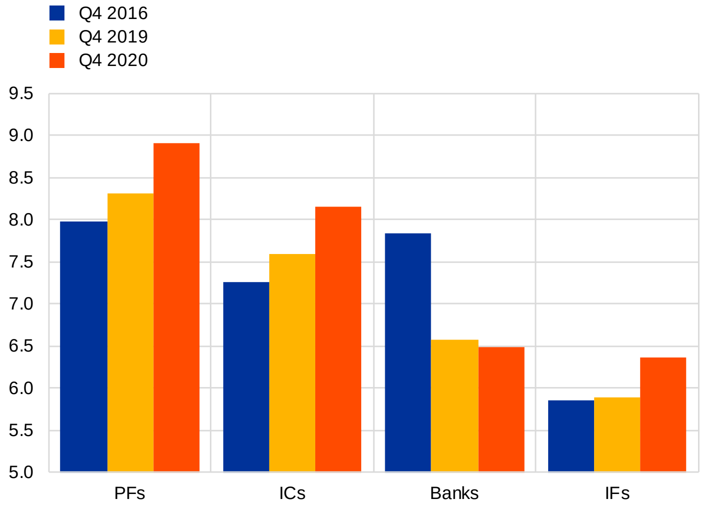



Sources: IHS Markit and ECB calculations.

# Non-banks have continued to increase duration, liquidity and credit risks

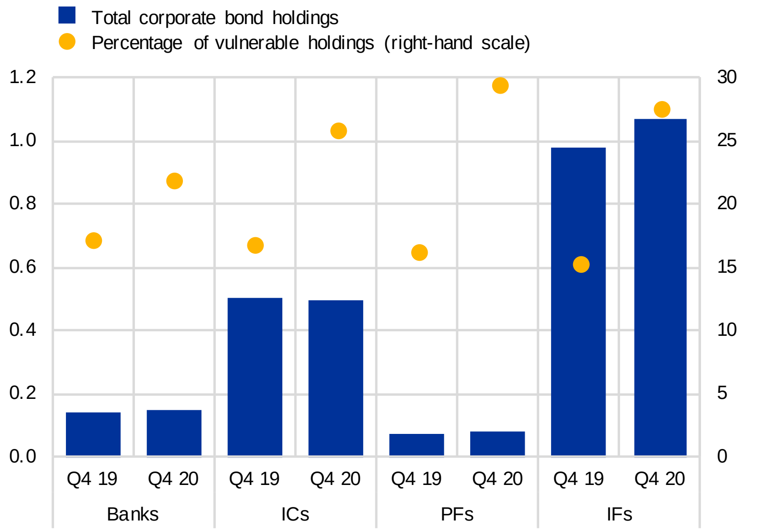
- Non-bank financial institutions have become more sensitive to a yield shock, given increased bond portfolio duration, and have become more exposed to US markets
- Non-bank financial institutions continue to have large exposures to corporates with weak fundamentals

**Duration of bond portfolios across financial institutions**
(2016-2020, years)




Sources: ECB (SHSS) and ECB calculations.

**Non-financial corporate bond holdings of euro area financial sectors**
(Q4 2019, Q4 2020, € billions, percentages)

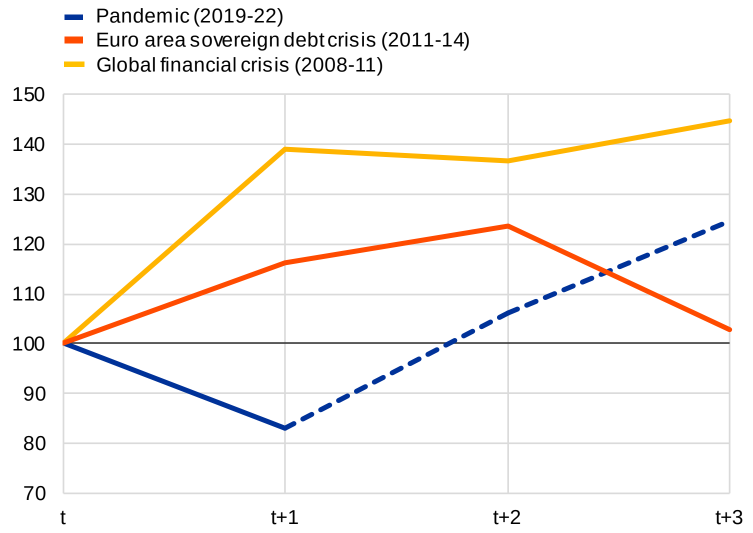



Sources: ECB (SHSS) and ECB calculations.

# Corporate solvency challenges ahead

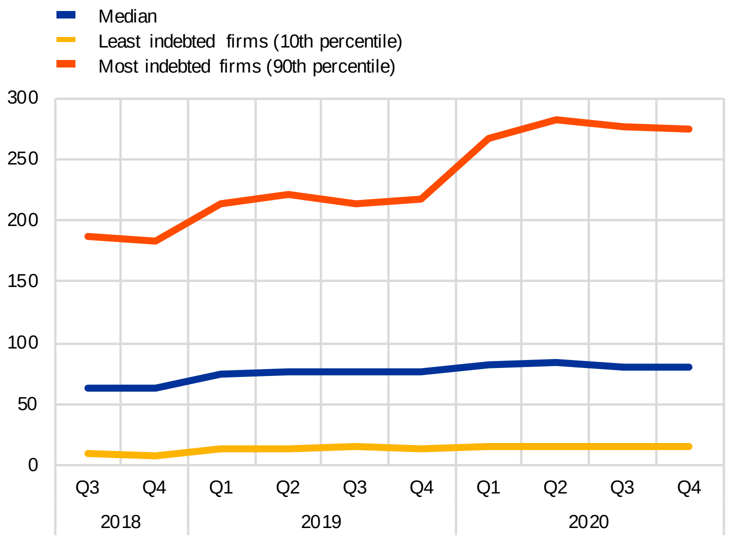
- Corporate insolvencies expected to normalise and possibly rise further as pandemic ends
- Reliance on debt has increased among a tail of already vulnerable firms amid growing rollover risks
- Corporate stress may spill over to other parts of the economy

**Development of corporate insolvencies during different crisis episodes and private sector forecasts**
(indices)




Sources: Allianz Euler Hermes and ECB calculations.

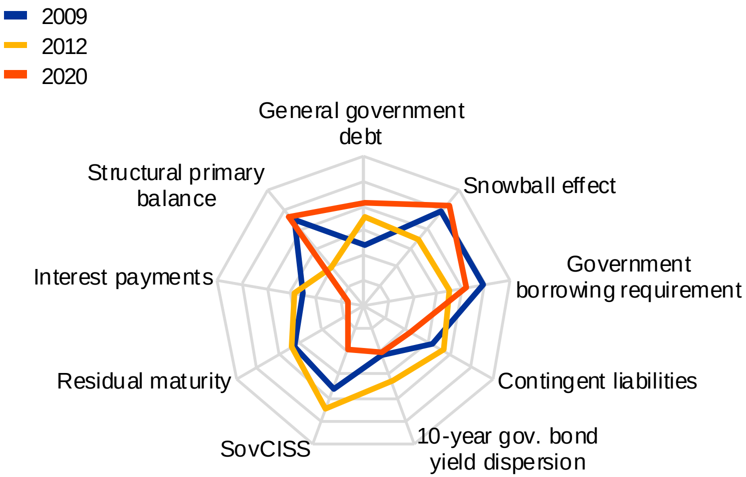
**Debt-to-equity ratios across euro area non-financial corporations**
(Q3 2018-Q4 2020, percentages)




Sources: S&P Capital IQ and ECB calculations.

# Benign financing conditions mitigate near-term sovereign debt sustainability risks

**Selected fiscal vulnerability indicators during different crisis episodes** (z-scores)




**Centre of the cobweb indicates lower risk**

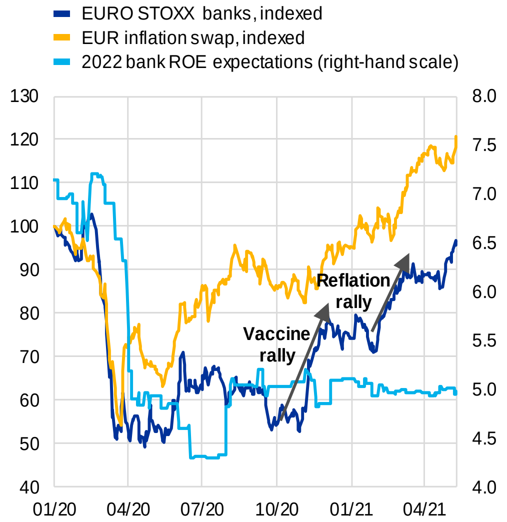
Sources: European Commission, ECB and ECB calculations.

- The continued need for policy support may add to medium-term sovereign debt sustainability concerns
- Governments have taken advantage of benign financing conditions to extend debt maturity and benefit from low yields
- Policy exit may be more challenging in countries with stronger policy reliance

# Outlook for euro area banks depends on evolution of loan losses and lending

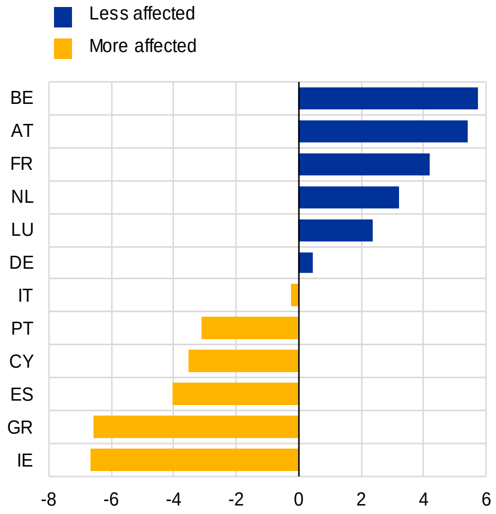
- Euro area bank stock prices have recovered from low levels, but market analysts' ROE forecasts are unchanged, and outturns have been very varied across euro area countries
- Recent tightening of lending standards and uncertain demand may weigh on future loan income

**Euro area bank stock prices, analysts' ROE expectations and inflation expectations**
(2 Jan. 2020-11 May 2021, percentages, index)



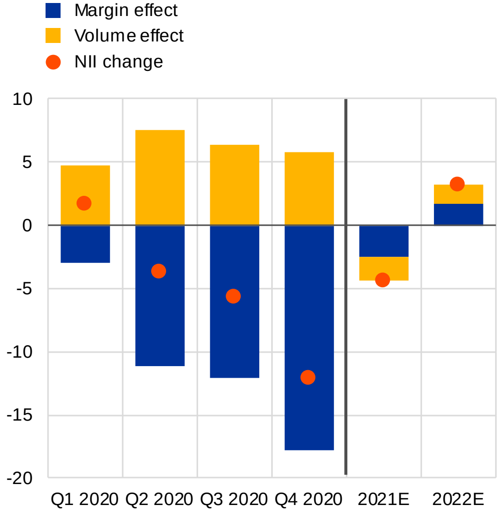

Sources: Bloomberg Finance L.P. and ECB calculations.

**Banks' ROE across countries**
(Q4 2020, percentages)




Sources: ECB supervisory data and ECB calculations.

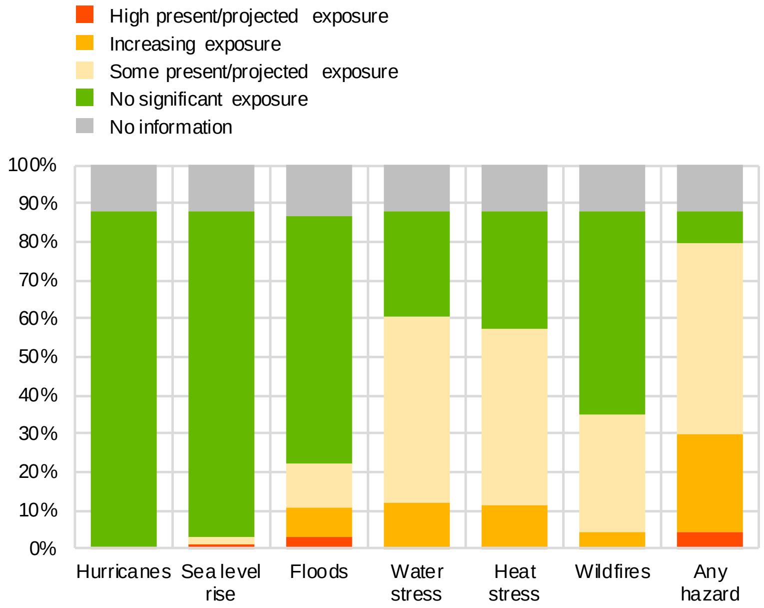
**Annual changes in net interest income and contributing factors**
(percentage changes, ppt contributions)




Sources: ECB supervisory data and ECB calculations.

# Climate-related risks to financial stability are material

**Share of euro area banks' credit exposures to firms by firm physical risk level**
(percentages)




Sources: Four Twenty Seven, ECB AnaCredit and ECB calculations.

- New data collections and methodologies reinforce previous findings of potential systemic relevance of climate-related financial stability risks
- Risks appear to be somewhat concentrated in some sectors, geographical regions and individual banks
- Preliminary results from climate stress test indicate clear benefit to financial system of acting early to limit climate change

Growing balance sheet vulnerabilities in non-financial sectors

Further weakening of bank profitability amid high credit risk exposure

Further increasing duration, liquidity and credit risks of non-banks

TARGETED POLICIES SHOULD CONTINUE TO SUPPORT THE RECOVERY AMID PANDEMIC-RELATED UNCERTAINTY AND THE POTENTIAL FOR CREDIT RISK MATERIALISATION

Targeted and tailored economic policies to support viable borrowers

Improve credit risk management and use of capital buffers

Effective NPL solutions

Macroprudential approach for non-banks and other regulatory actions

# Financial stability vulnerabilities remain elevated

The increasingly uneven economic impact of the pandemic has led to a **clustering of risks** in some sectors and countries.

The recent **rise of long term interest rates** has increased focus on asset **repricing risks,** which may affect non-bank financial institutions with high duration, liquidity and credit risks.

Euro area **bank valuations have improved, but profitability challenges remain**. Interlinkages between sovereigns, banks and corporates may amplify risks to financial stability.

Euro area financial institutions face **material exposures to climate-related risks,** but effective green finance can help foster an orderly transition to a low-carbon economy.