EUROPEAN CENTRAL BANK

EUROSYSTEM

Financial Stability Review

May 2018

Press Briefing

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Overview

A revamped FSR

Changes introduced in this FSR May issue:

1) **Overview -** more thematic and comprehensive view on the key vulnerabilities for euro area financial stability

2) Section on **Recommendations and Policy considerations** - in the Overview, goes beyond financial regulation

3) Two new systemic risk indicators – gauging consequences of financial instability for the real economy (GDP-at-Risk).

> ***Financial Stability Risk Index (FSRI)***: near-term recessionary effects of financial stress,
>
> ***Cyclical Systemic Risk Indicator (CSRI)***: medium-term consequences of financial instability

4) **Scenario analysis** in banking section significantly changed: main risks mapped into two broad and internally coherent adverse scenarios

5) **New chapter** discusses **developments in the regulatory framework** of the whole financial system

1 Introduction

The euro area financial stability environment has continued to be favourable

Supported by

- Robust economic expansion
- No signs of excessive credit growth
- Strengthened bank resilience

Challenged by

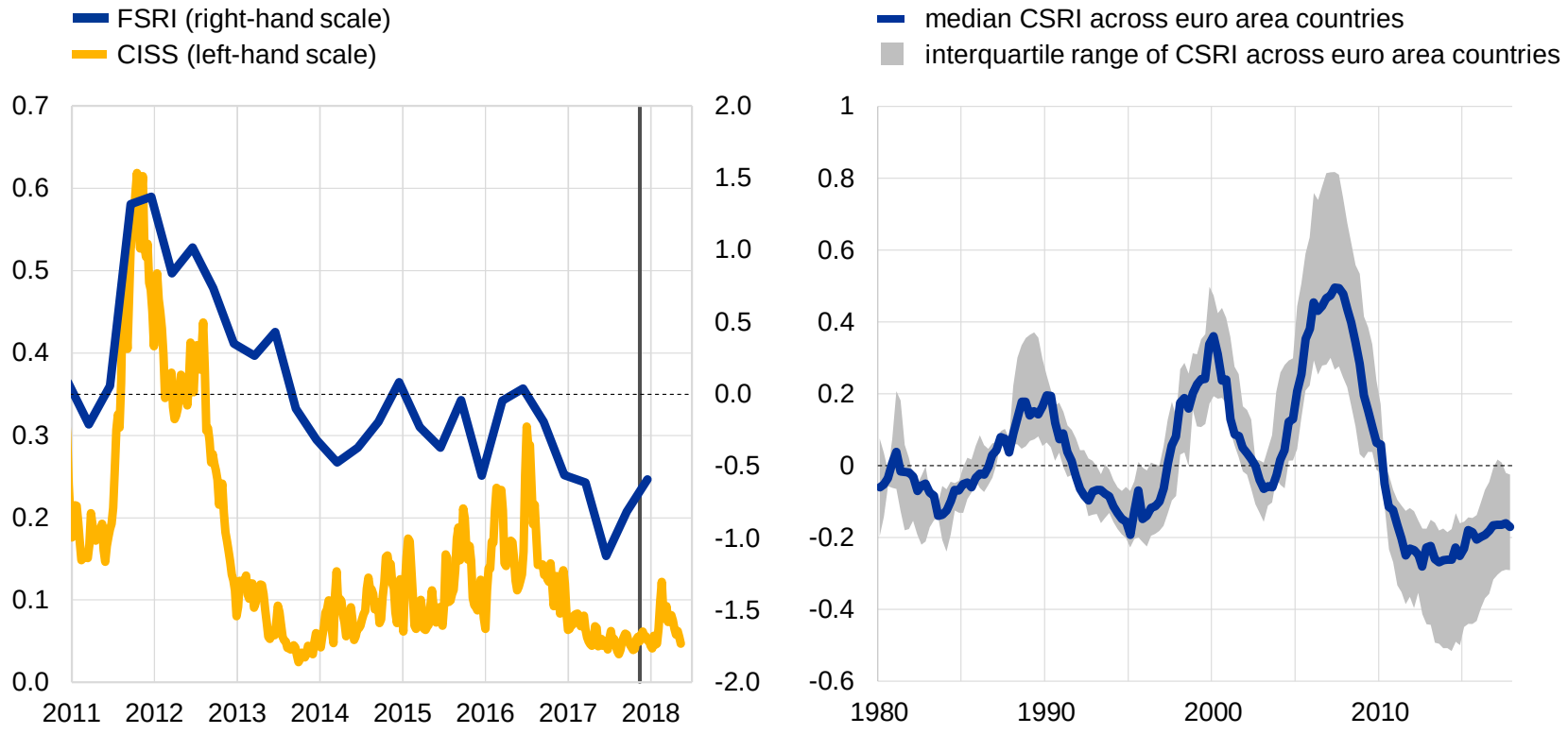
- Continued risk-taking in markets
- Pockets of stretched valuations in certain segments

1 Introduction

- Economy-wide and financial market indicators of near-term and medium-term systemic risk remained contained

Financial stability risk index (FSRI) for the euro area economy and composite indicator of systemic stress in financial markets (CISS) (left panel) and median of cyclical systemic risk indicator (CSRI) across euro area countries (right panel)

left panel: Jan. 2011 – May 2018; Q1 2011 – Q4 2017; right panel: Q1 1980 – Q4 2017, median and interquartile range

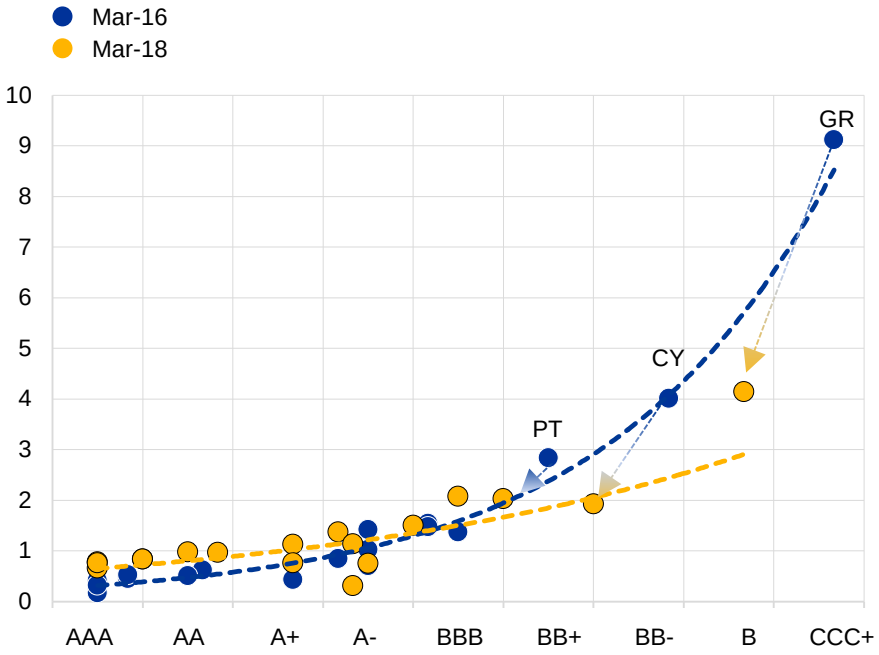


Sources: Bloomberg, ECB, Eurostat and ECB calculations.

2 Macro, fiscal and overall credit environment

- Low financing costs for euro area sovereigns
- Still high indebtedness in the sovereign sector

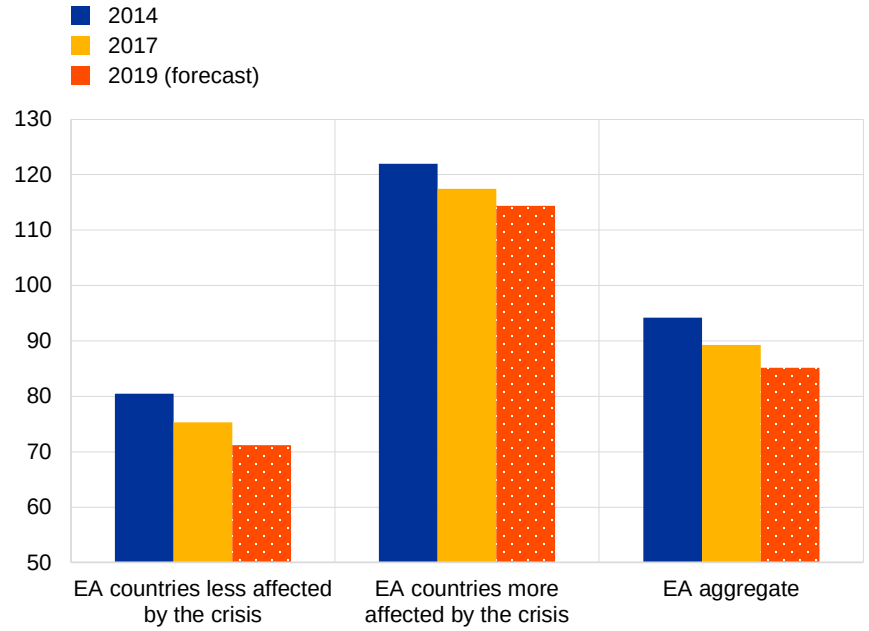
10-year government bond yields and credit ratings of euro area sovereigns
Ratings, percentages per annum



Sources: Standard & Poors, Moody's, Fitch, ECB and ECB calculations.

Notes: The rating score represents the average rating by the three major rating agencies, Moody's, Standard & Poor's and Fitch. The bond yields indicate the long-term interest rate for convergence purposes (secondary market yields of government bonds with maturities of ten, or close to ten, years).

General government debt-to-GDP ratios across the euro area
percentages of GDP



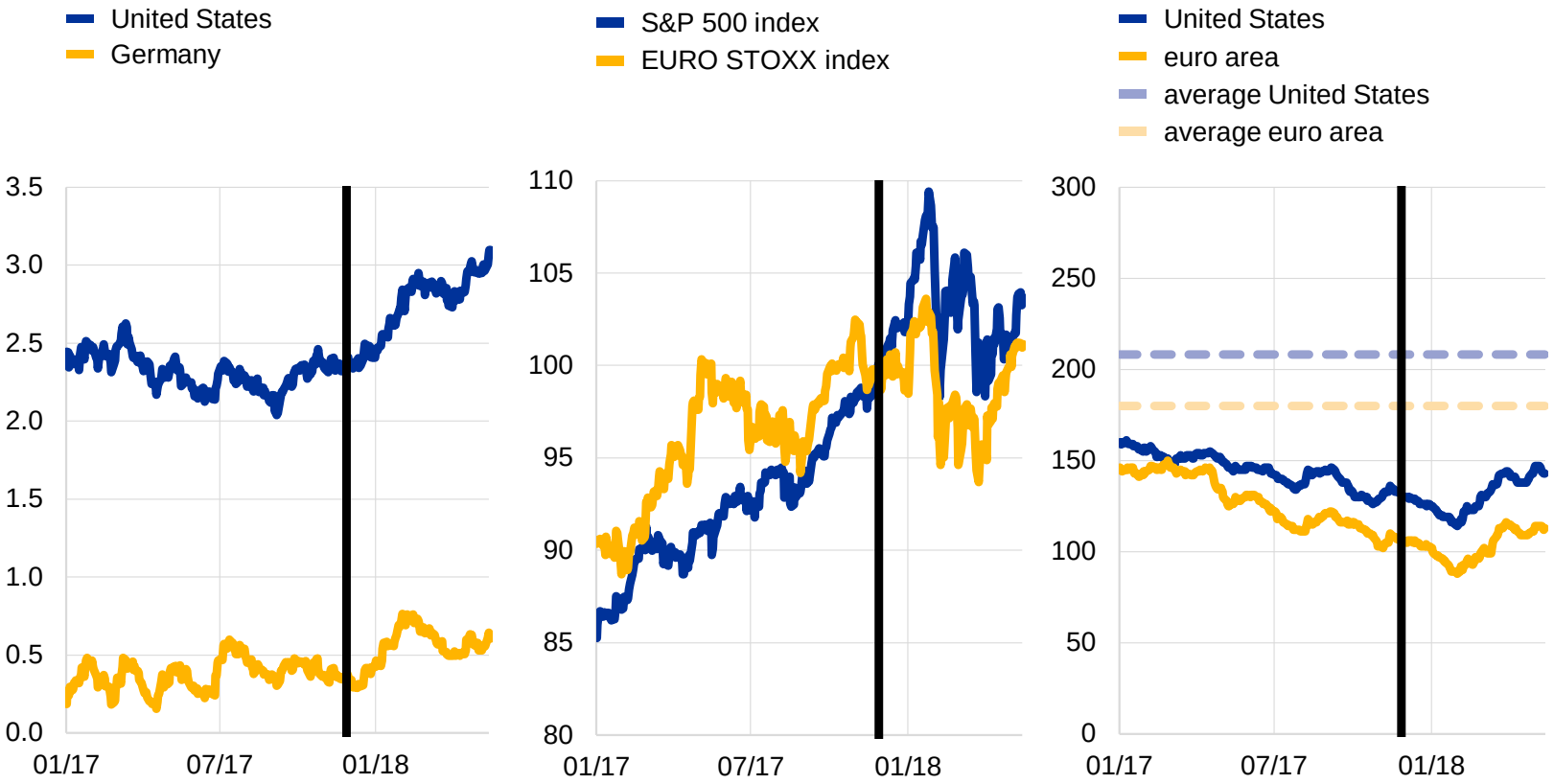
Sources: European Commission (AMECO Database) and ECB calculations.

3 Financial markets and valuations

- US and euro area bond yields edged up, while the upward trend in stock prices came to a halt

Ten-year sovereign bond yields, stock prices and BBB corporate bond spreads in the United States and in the euro area

Jan. 2017 – May 2018; left panel: percentages per annum; middle panel: index: 29 November 2017 = 100; right panel: basis points



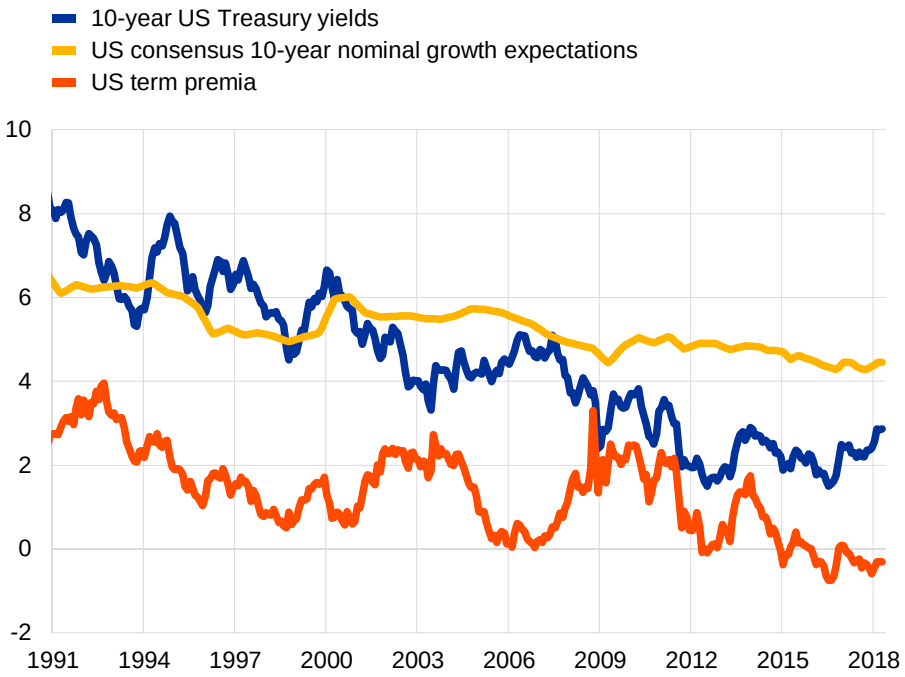
Sources: Bloomberg, Bank of America Merrill Lynch and ECB calculations.

Notes: The vertical lines refer to the publication of the previous FSR on 29 November 2017. The right panel shows averages since January 2002.

3 Financial markets and valuations

- Upward risks to long-term government bond yields over the medium term

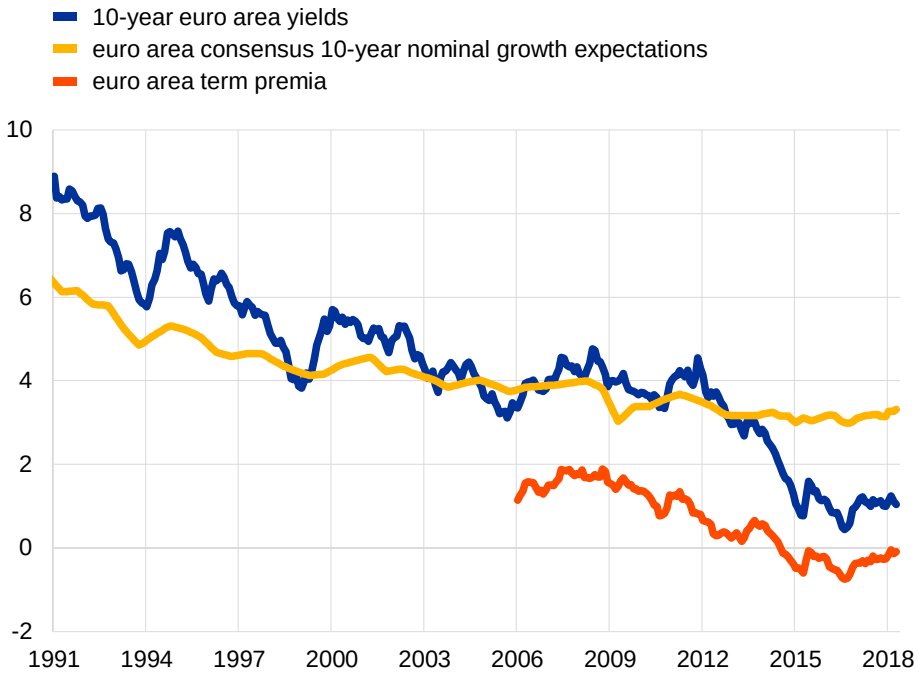
Long-term government bond yields, nominal GDP growth expectations and term premia in the United States
Jan. 1991 – Apr. 2018; percentages per annum, annual percentage changes



Sources: Thomson Reuters Datastream, Federal Reserve Bank of New York and ECB calculations

Notes: For the US decomposition, see Adrian, T., Crump, R., Mills, B. and Moench, E., "Treasury Term Premia: 1961-Present", Liberty Street Economics, Federal Reserve Bank of New York, May 2014, available at http://libertystreeteconomics.newyorkfed.org.

Long-term government bond yields, nominal GDP growth expectations and term premia in the euro area
Jan. 1991 – Apr. 2018; percentages per annum, annual percentage changes

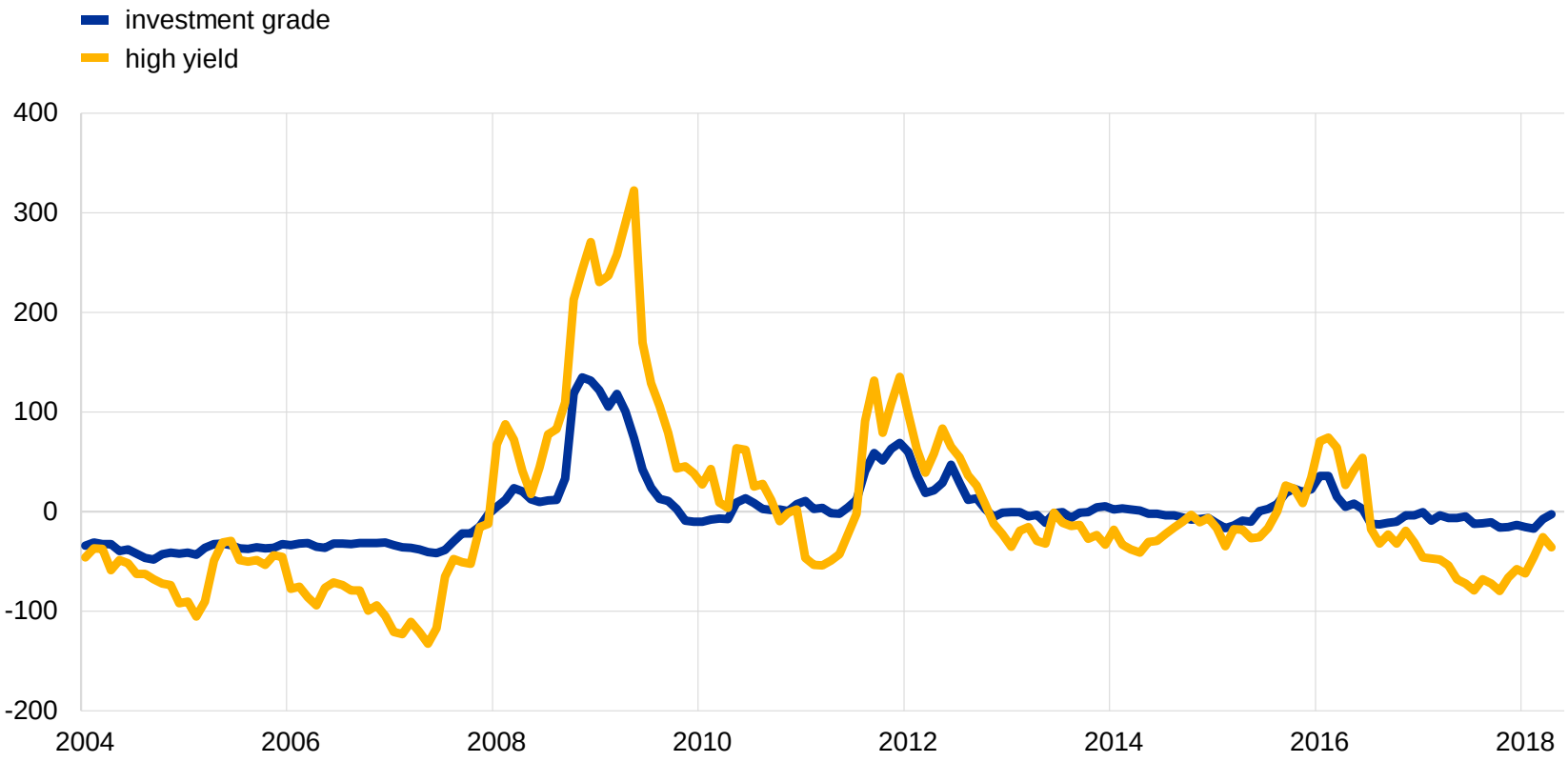


Sources: Thomson Reuters Datastream, Consensus Economics and ECB calculations

Notes: Before 1999, the euro area bond yields are approximated by ten-year bond yields in Germany. The euro area term premia estimates (based on ten-year OIS rates) use an affine term structure model following the methodology used by Joslin, S., Singleton, K.T. and Zhu, H., "A New Perspective on Gaussian Dynamic Term Structure Models", Review of Financial Studies, Vol. 24(3), March 2011, pp. 926-970.

- Valuations stretched for euro area high yield corporate bonds

Excess bond risk premia on euro area investment-grade and high-yield non-financial sector bonds
Jan. 2004 – Apr. 2018; basis points



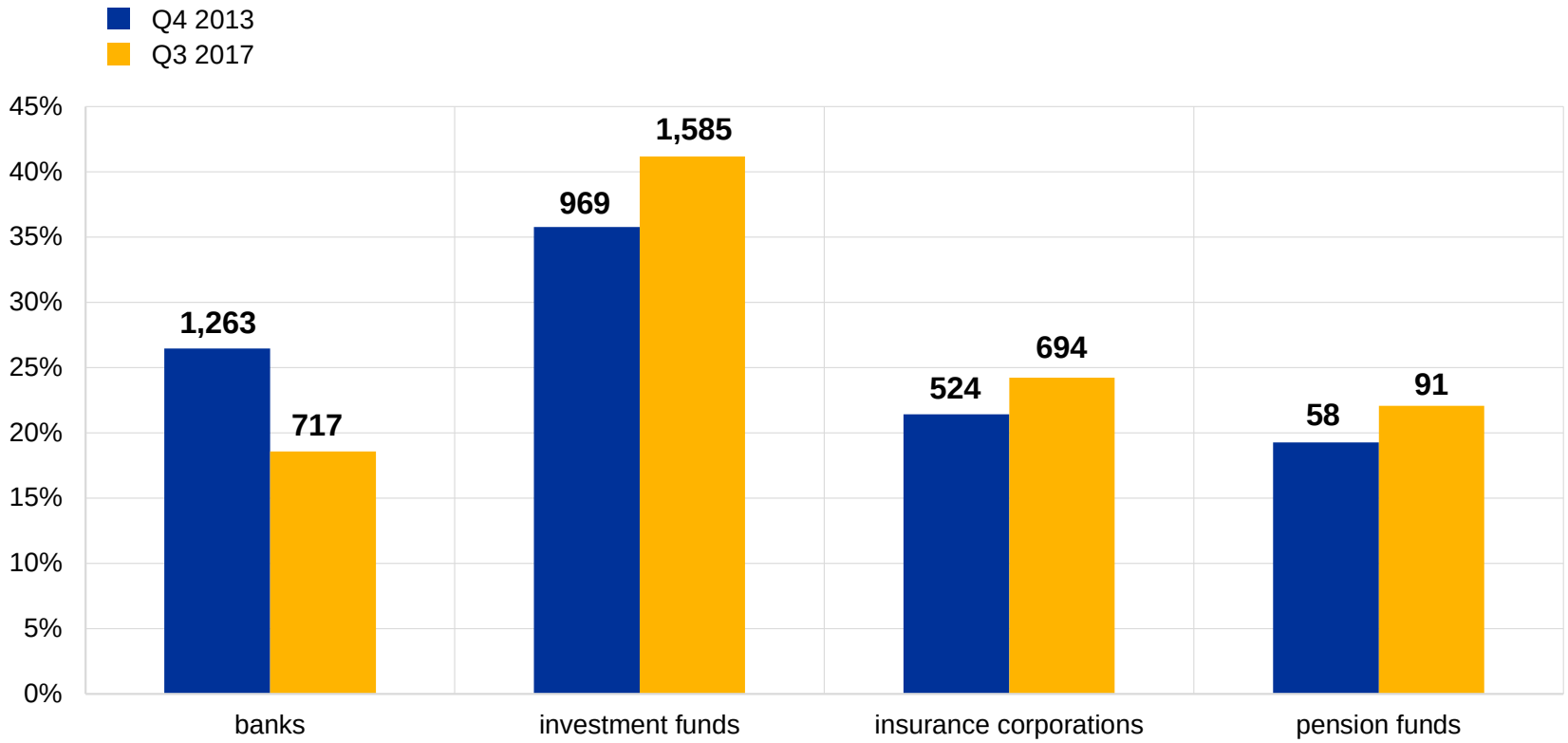
Sources: iBoxx and Moody's

Notes: The excess bond premium (EBP) is defined as the deviation of credit spreads from measures of credit risk and liquidity risk at individual bond level. The series represent averages from two ECB models.

3 Financial markets and valuations

- Most euro area financial institutions (except banks) have increased their exposures to lower-rated bonds

Share of lower-rated financial and non-financial corporate bonds in financial sectors' bond portfolios
percentages of total bond portfolio, € billions



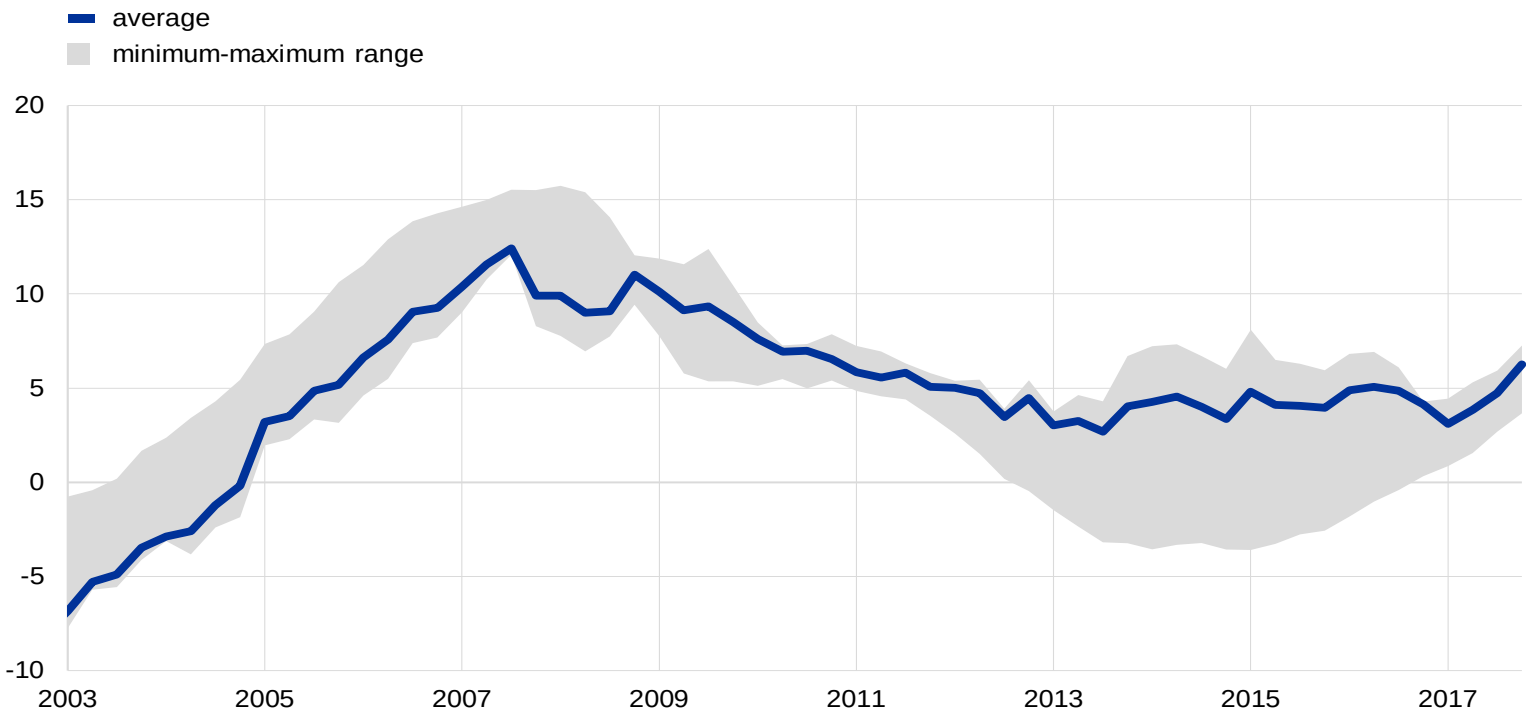
Sources: ECB Securities Holding Statistics (SHS) and ECB calculations.

Notes: Corporate bonds issued globally by both financial and non-financial companies. Lower-rated bonds are BB- and below. The figures above the columns show the market value of lower-rated bond holdings.

3 Financial markets and valuations

- Euro area residential real estate prices slightly above those suggested by fair-value estimates

Residential property prices at the euro area level: deviations from estimated fair value
Q1 2003 – Q4 2017, percentages, average valuations, minimum-maximum range across valuation estimates



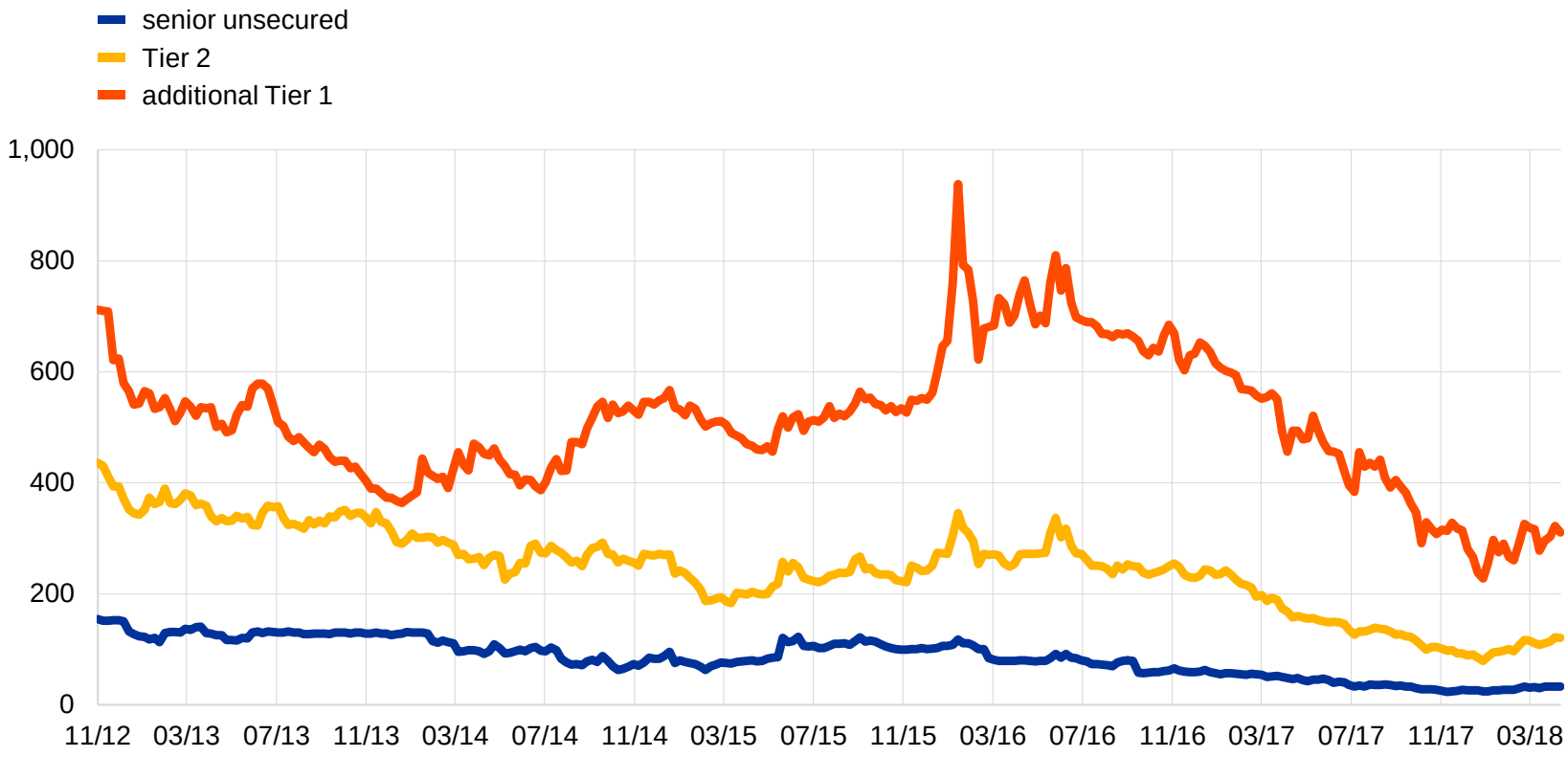
Sources: ECB and ECB calculations.

Notes: The fair value estimations are based on four different methods: the price-to-rent ratio, the price-to-income ratio and two model-based methods, i.e. an asset pricing model and a new model-based estimate (BVAR).The average is based on the price-to-income ratio and the new model-based method. For details of the methodology, see Box 3 in Financial Stability Review, ECB, June 2011, as well as Box 3 in Financial Stability Review, ECB, November 2015.

4 Banking sector

- Banks' bond spreads remain close to historical lows

Bond spreads of large euro area banks by debt instrument
Nov. 2012 – May 2018; median Z-spreads in basis points



Sources: Bloomberg and ECB calculations.

Notes: Based on a sample of 21 large euro area banks. Z-spreads are defined as the difference (in basis points) between the yield to maturity of a bank's bond and the yield of a maturity-matched euro swap.

Scenarios that could test the resilience of financial institutions

Global market turmoil propagating through the financial system

- Spillovers to the euro area from a disruptive repricing of term and other risk premia
- Increased public debt sustainability concerns
- Turmoil amplified by outflows from illiquid investment funds

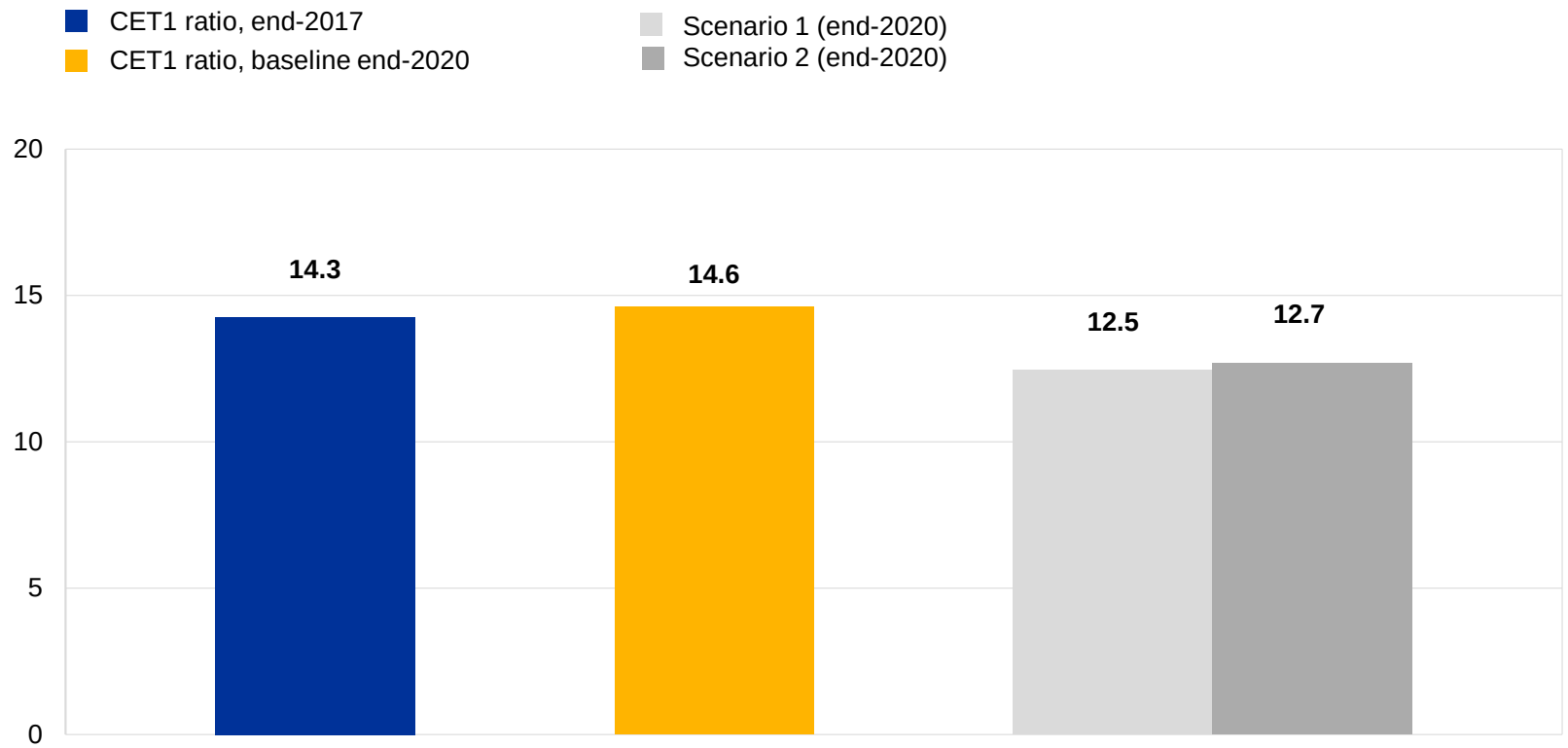
Real economic downturn leading to

- Impaired intermediation capacity of banks amid weak performance and structural challenges
- Elevated private debt sustainability concerns

4 Banking sector

- The materialisation of key financial stability risks could lead to sizeable losses for banks but aggregate capital positions would remain adequate

CET1 capital ratios of euro area banking groups under the baseline and adverse scenarios
Percentages



Sources: Individual institutions' financial reports, EBA, ECB and ECB calculations.

Notes: The scenario analysis covers about 100 large and medium-sized banking groups directly supervised by the ECB.