Outlook for euro area financial stability in the current economic environment

33rd ECBC Plenary Meeting

13 September 2023

Cornelia Holthausen
Director General Macroprudential Policy and Financial Stability
Key themes shaping the financial stability outlook

1. Corporate, household and sovereign resilience tested by higher interest rates
2. Strong bank performance to face asset quality and funding headwinds
3. Elevated valuations leave markets and non-banks vulnerable to negative surprises
1 - Corporate, household and sovereign resilience tested by higher interest rates

- Economic data for the euro area has continued to disappoint, as growth prospects have deteriorated, inflation is expected to decline only gradually and recession probabilities have risen again.
1 - Corporate, household and sovereign resilience tested by higher interest rates

- Corporate profitability has been holding up but higher interest rates has weakened debt servicing capacity
- Insolvencies have risen across countries, some of which are above pre-pandemic levels now

Change in euro area corporate interest coverage ratio and driving components
Q1 2004-Q1 2023, percentage points

Sources: ECB, Eurostat and ECB calculations.

Corporate insolvencies in the euro area
Q4 2019 - Q2 2023; index: Q4 2019=100

Source: Eurostat.
1 - Corporate, household and sovereign resilience tested by higher interest rates

- Property companies increasingly challenged by the downturn in commercial real estate markets
- Non-prime office sector facing severe challenges, but prime office in euro area holding up better than in US

**European stock prices: real estate firms vs. the market**

Index: Jan. 2008 = 100

**Rent growth outlook for offices**

12 month rent growth expectations; percentages

Source: Bloomberg.

Source: RICS.
1 - Corporate, household and sovereign resilience tested by higher interest rates

- Residential property markets remain in a broadly orderly downturn …
- …although higher financing costs and declining mortgage loan demand may not yet be fully reflected in property prices.

RRE price developments in selected countries
Index: Jan. 2020 = 100

Euro area household loan demand
Net balances of survey responses

Sources: CB, Europace (Germany), Statistics Netherlands, Central Statistics Office (Ireland), Confidencial Imobiliario (sourced from BIS, Portugal), Arco Real Estate (Latvia), meilleuragents.com (France), immobiliare.it (Italy), indomio.es (Spain), pxdata.stat.fi (Finland), nbs.sk (Slovakia) and ECB calculations.
2 - Strong bank performance to face asset quality and funding headwinds

- Euro area bank profitability improved further in the second quarter of 2023…
- … thanks mainly to widening net interest margins

**ROE of listed euro area banks**
Q1 2020 – Q2 2023; percentages

**Decomposition of y-o-y changes in quarterly net interest income of euro area banks**

Sources: Bloomberg and ECB calculations.
Note: Calculations based on a sample of 29 listed euro area significant institutions.
2 - Strong bank performance to face asset quality and funding headwinds

- Analysts expect the of ROE of listed euro area banks to peak at around 12% before declining …
- After years of decline, default rates on corporate and retail exposures have started to increase

Market analysts’ ROE projections for euro area banks for 2023 and 2024
Q2 2023, 2023-2024 forecasts, percentages

ROE (weighted average, 4 quarter trailing)
ROE (median, 4 quarter trailing)
Interquartile range (4 quarter trailing)

Sources: Bloomberg and ECB calculations.
Note: Calculations based on a sample of 29 listed euro area significant institutions.

Default rates on euro area banks’ corporate and retail exposures
Q4 2018-Q2 2023; percentages

Sources: ECB supervisory data and ECB calculations.
Notes: Observed new default/non-defaulted exposures. IRB-reporting significant institutions. Four-quarter trailing figures. Euro area exposures only.
2 - Strong bank performance to face asset quality and funding headwinds

- Bond spreads remain elevated, while deposit repricing is still limited
- Bank funding costs are expected to increase further as liabilities continue to reprice and funding composition moves back towards long-run averages (estimated increase is 116 basis points)

Deposit betas of historic hiking cycles for euro area banks
1999-2023; percentages

Current and outstanding rates paid on deposits and bonds
June 2022 – July 2023; percentages

Sources: ECB MIR and ECB calculations.

Notes: Hiking cycles are defined starting from the month of the first increase in the deposit facility rate (DFR) to the month before the next decrease.

Sources: ECB and Dealogic.

Notes: The chart compares current rates to the outstanding rates paid on deposits and bonds maturing over the next two years. All MFI and OFI liabilities are assumed to mature. MFI and OFI interest rates are proxied by the weighted average Euribor between 07/22-06/23.
3 - Elevated valuations leave markets and non-banks vulnerable to negative surprises

- Stock markets back at pre Ukraine war levels despite decelerating growth and higher yields on other assets
- For the first time, yields on US equities fall below those of cash and corporate bonds

**Stock market developments**

Index: Jan 2020 = 100

**Yields across asset classes in the US**

Percentages

Source: Bloomberg.
3 - Elevated valuations leave markets and non-banks vulnerable to negative surprises

- Credit spreads have narrowed as central bank interest rates and default rate expectations have risen

**Euro area corporate IG credit spreads**

**Corporate high yield credit spreads and default rates – Europe**

**Sources:** Bloomberg and ECB calculations.

Notes: European speculative grade default rates between March 22 and February 23 are taken from an earlier data release, which excluded Russian issuers. www.ecb.europa.eu ©
3 - Elevated valuations leave markets and non-banks vulnerable to negative surprises

- Non-banks continue to shift towards sovereign debt exposures while reducing exposures to vulnerable corporates, but credit risks remain

**Euro area investment funds’ debt transactions**

Q1 2022 – Q1 2023; € billion

![Graph showing debt transactions](image)

**Euro area non-banks’ exposure to vulnerable corporates**

Q1 2021 – Q1 2023; left-hand side: percentage of total corporate exposures; right-hand side: value € billions

![Graph showing exposure to vulnerable corporates](image)

Sources: SHSS, CSDB and ECB calculations.

Notes: Transactions in market value. “IG” includes AAA/AA and A ratings, “HY” includes BB, B, C, CC, CCC and D ratings.
Macroprudential policy: preserve existing resilience

Macroprudential action since the pandemic has increased the banking sector’s resilience

Challenging environment for macroprudential policy
- Elevated uncertainty
- Signs of turning financial cycle
- High accumulated vulnerabilities

Ensure banking sector resilience

Capital-based measures
- Maintain existing capital buffers
- Consider targeted increases, avoiding procyclical effects
- Banks should not increase payout ratios

Borrower-based measures
- Ensure sound lending standards and sustainable debt
- Complement capital-based measures
- Flexibility may be used to guarantee availability of credit
Strengthen the already robust and comprehensive EU regulatory framework for banks

Recent turmoil in the US and Swiss banking sectors calls for broad and consistent application in all jurisdictions of global regulatory reforms

**Full, faithful and timely implementation of Basel III**
- Ensure that banks continue to be well-capitalised
- Foster trust in EU banking system
- Additional levers for supervisory scrutiny

**AT1 and creditor hierarchy in EU resolution framework**
- In EU, AT1 instruments are written down or converted if CET1 ratio falls below thresholds
- Capital instruments do not have permanent contractual write-down clauses activated in case of public support
- EU resolution framework: detail creditor hierarchy if troubled bank bears losses
- This sequence has been consistently applied in past cases and will continue to guide the actions of ECB and SRB in future crisis interventions

**Completing the banking union remains a key priority**
- Advance EU reform of bank crisis mgt and deposit insurance framework
- Establish common backstop to the Single Resolution Fund
- Introduce a European Deposit Insurance Scheme
Persistent structural vulnerabilities and the risk of renewed stress make it vital to enhance the resilience of the non-bank financial sector

Mitigating liquidity mismatch in open-ended funds
- Aligning redemption terms with asset liquidity
- Making greater use of anti-dilution liquidity management tools to mitigate first-mover advantages
- Ensuring sufficient amounts of liquid assets

Addressing risks from non-bank leverage
- Need for a holistic perspective across NBFI sector entities and activities
- Restricting leverage at the entity level
- Strengthening risk management practices at prime brokers/dealer banks
- (Re-) considering the role of haircuts and margins
- Enhancing data and leverage metrics

Enhancing non-banks’ liquidity preparedness to meet margin and collateral calls
- Increased transparency of margining, especially for clients
- Better governance and contingency planning for adverse scenarios
- More robust stress testing
- Ensuring adequate levels and diversification of liquidity buffers

➢ International policy coordination is key
➢ Authorities should take an active role in identifying and addressing emerging risks