EUROPEAN CENTRAL BANK
EUROSYSTEM

Outlook for euro area financial stability in the current economic environment

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Key themes shaping the financial stability outlook

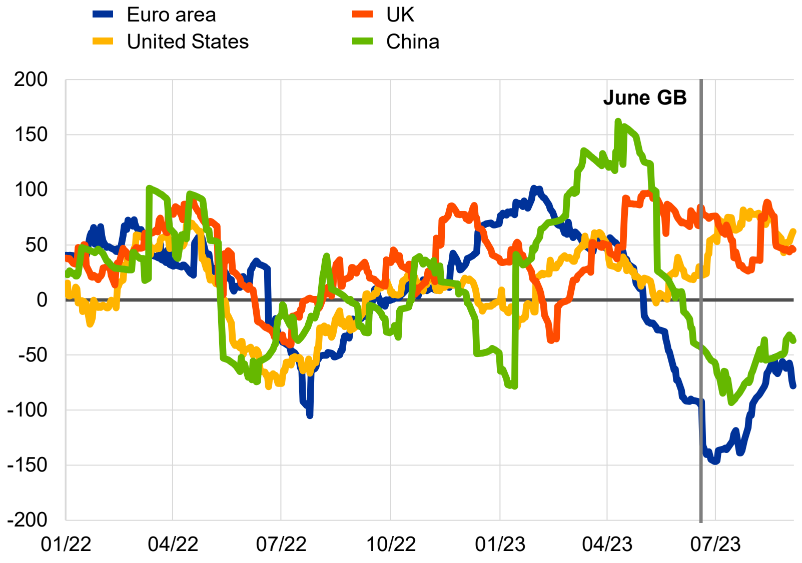
1. Corporate, household and sovereign resilience tested by higher interest rates
2. Strong bank performance to face asset quality and funding headwinds
3. Elevated valuations leave markets and non-banks vulnerable to negative surprises

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

Citi Economic Surprise Index

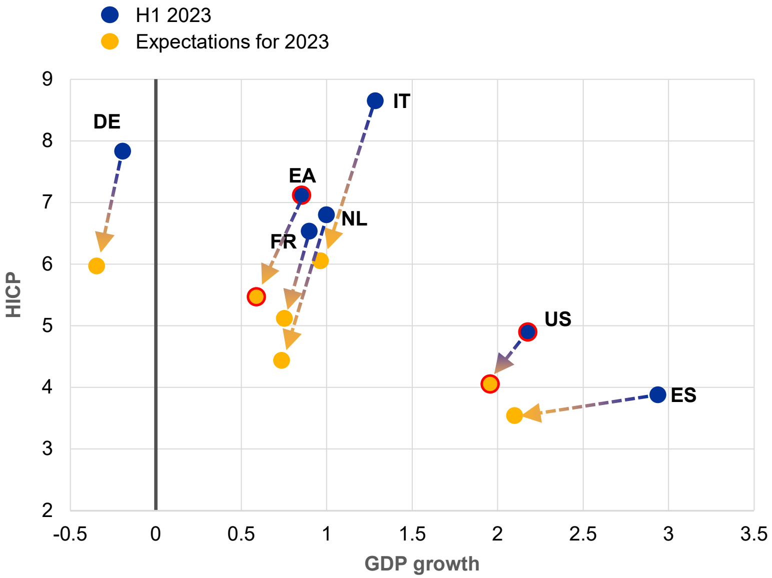
Jan. 2022 - Aug. 2023; index



Sources: Bloomberg and Citi.

Inflation and GDP growth

H1 23 and FY23 expectations; percentages



Sources: Eurostat and Consensus Economics.

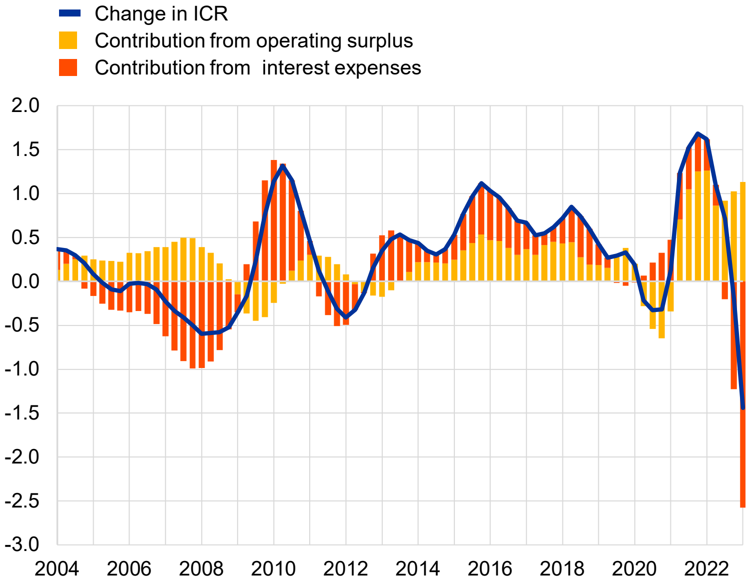
Note: Consensus Economics forecasts for 2023 as at 04/09/23.

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

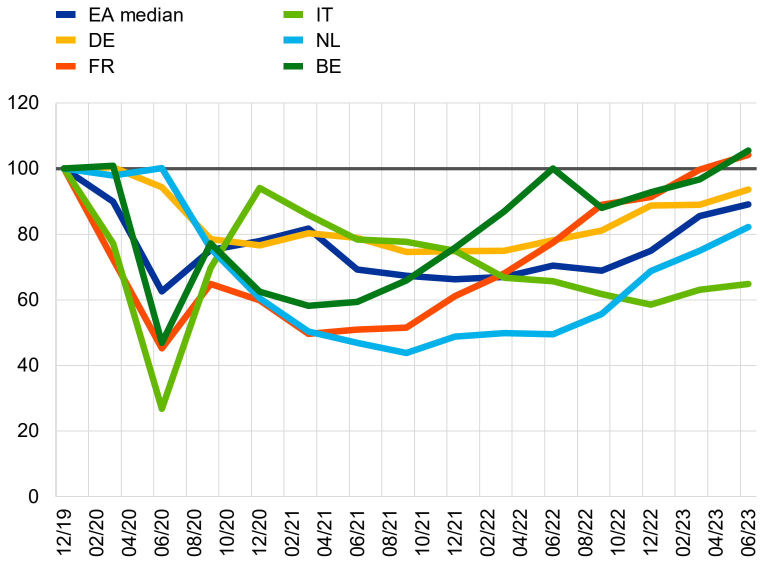
Q1 2004-Q1 2023, percentage points



Sources: ECB, Eurostat and ECB calculations.

Corporate insolvencies in the euro area

Q4 2019 - Q2 2023; index: Q4 2019=100

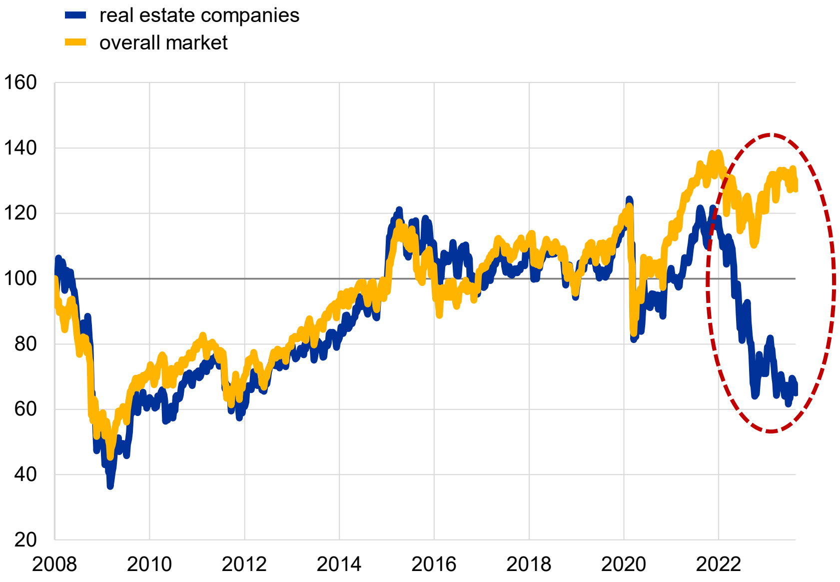


Source: Eurostat.

1 - Corporate, household and sovereign resilience tested by higher interest rates

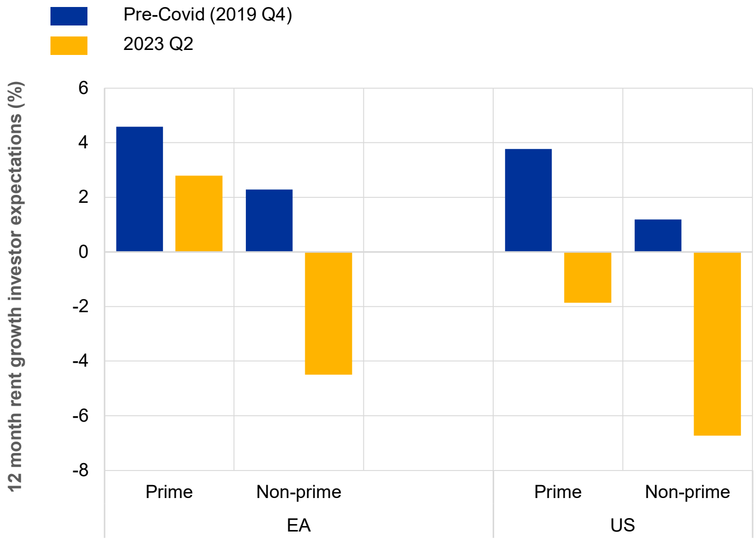
- Property companies increasingly challenged by the downturn in commercial real estate markets
- Non-prime office sector facing severe challenges, but prime office in euro area holding up better than in US

European stock prices: real estate firms vs. the market
Index: Jan. 2008 = 100



Source: Bloomberg.

Rent growth outlook for offices
12 month rent growth expectations; percentages



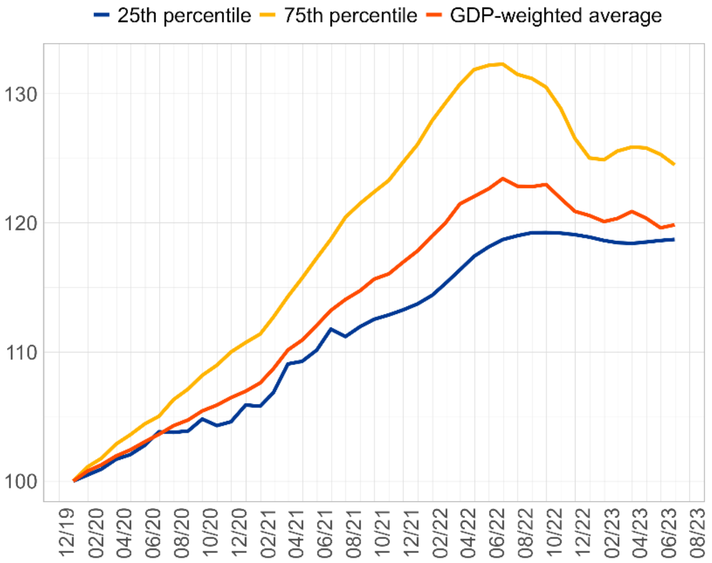
Source: RICS.

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

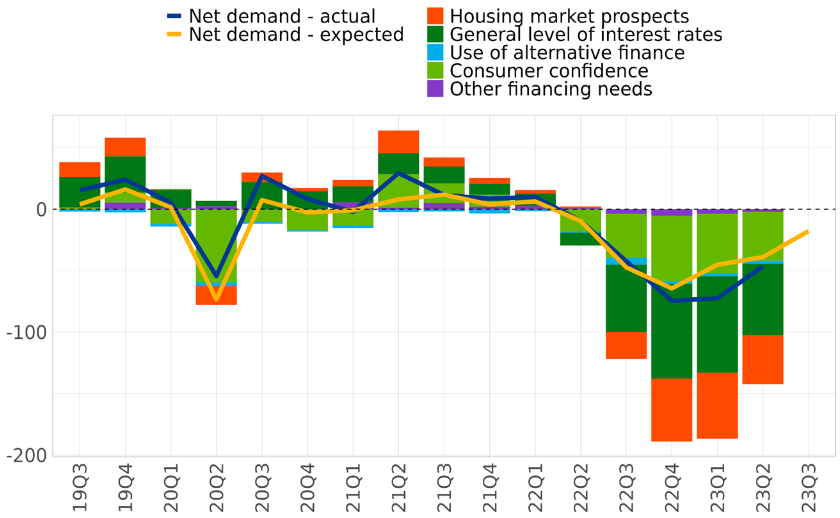
Index: Jan. 2020 = 100



Sources: CB, Europace (Germany), Statistics Netherlands, Central Statistics Office (Ireland), Confidencial Imobiliário (sourced from BIS, Portugal), Arco Real Estate (Latvia), meilleursagents.com (France), immobiliare.it (Italy), indomio.es (Spain), pxdata.stat.fi (Finland), nbs.sk (Slovakia) and ECB calculations.

Euro area household loan demand

Net balances of survey responses



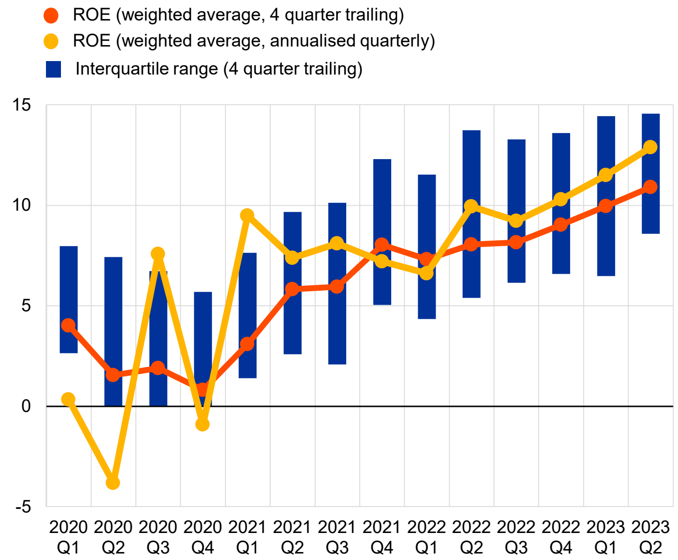
Source: ECB Bank Lending Survey.

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

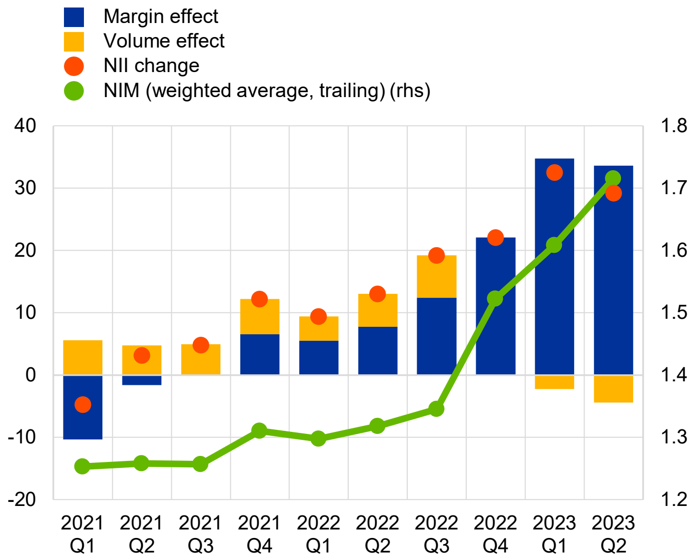
Q1 2020 – Q2 2023; percentages



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

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

Q1 2021 – Q2 2023; percentages and p.p.



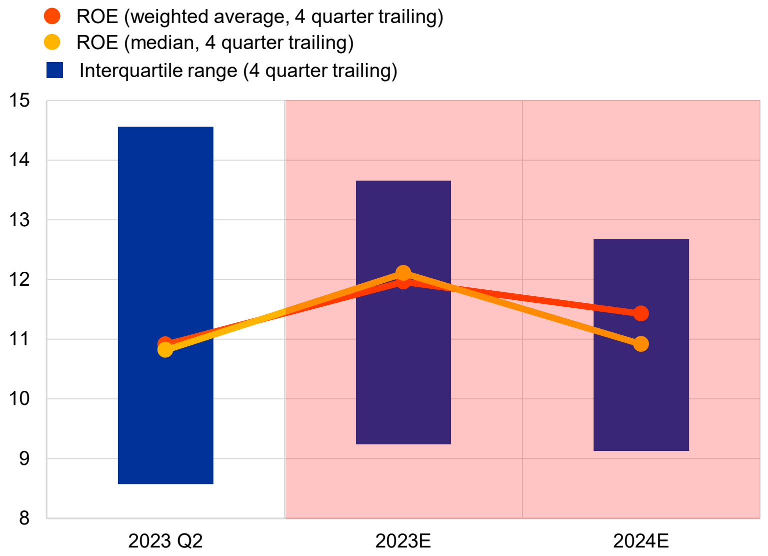
Sources: Bloomberg and ECB calculations.
Note: Calculations based on a sample of 26 listed euro area significant institutions.

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

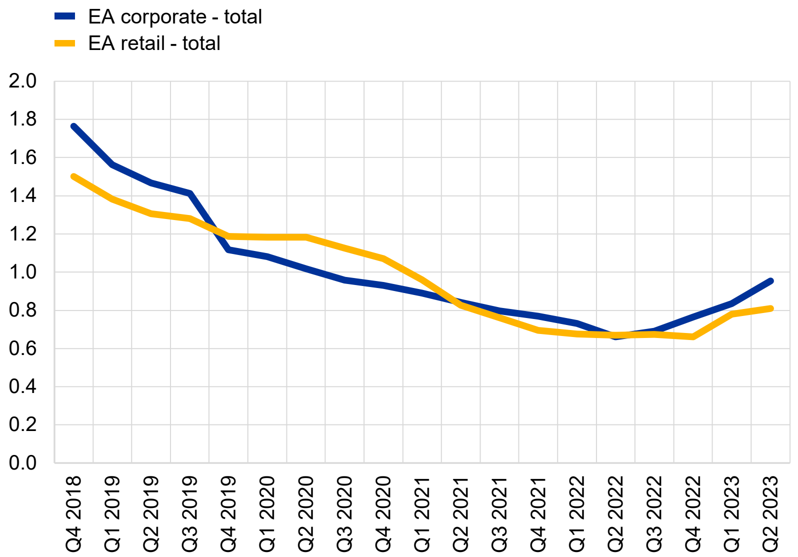
Q2 2023, 2023-2024 forecasts, percentages



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

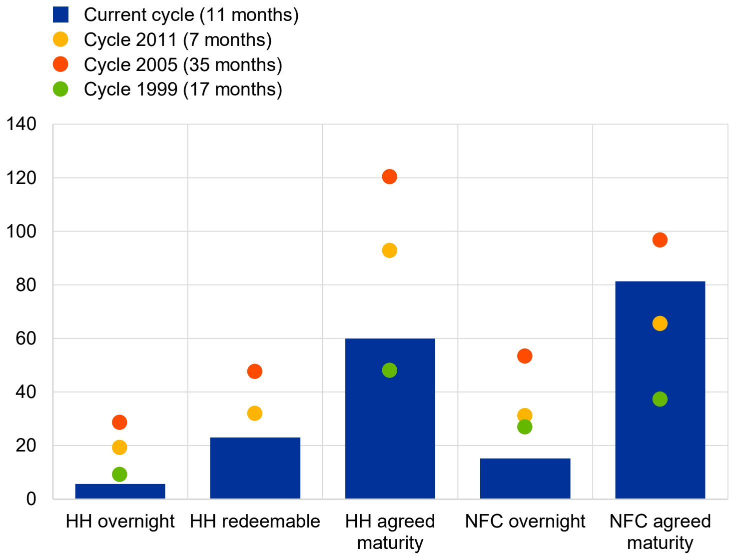


Sources: ECB supervisory data and ECB calculations.
Notes: Observed new defaults/non-defaulted exposures. IRB-reporting significant institutions. Four-quarter trailing figures. Euro area exposures only.

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)

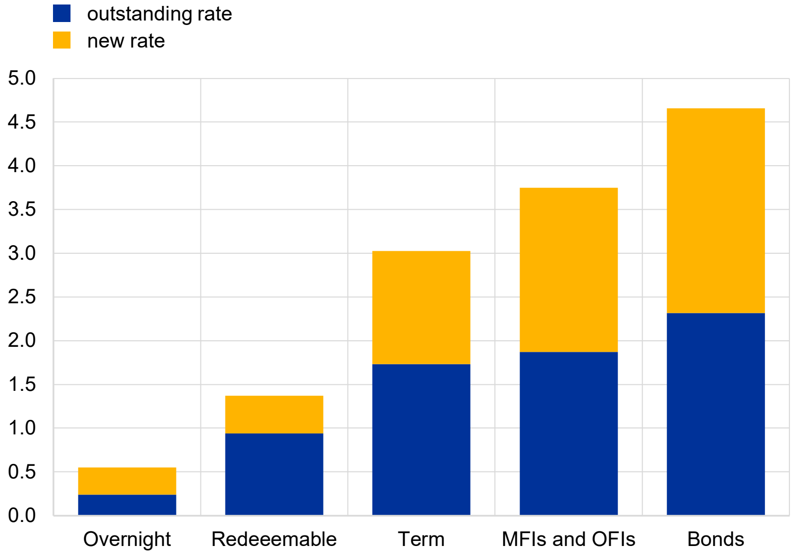
Deposit betas of historic hiking cycles for euro area banks
1999-2023; percentages



Sources: ECB MIR and ECB calculations.

Note: 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.

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



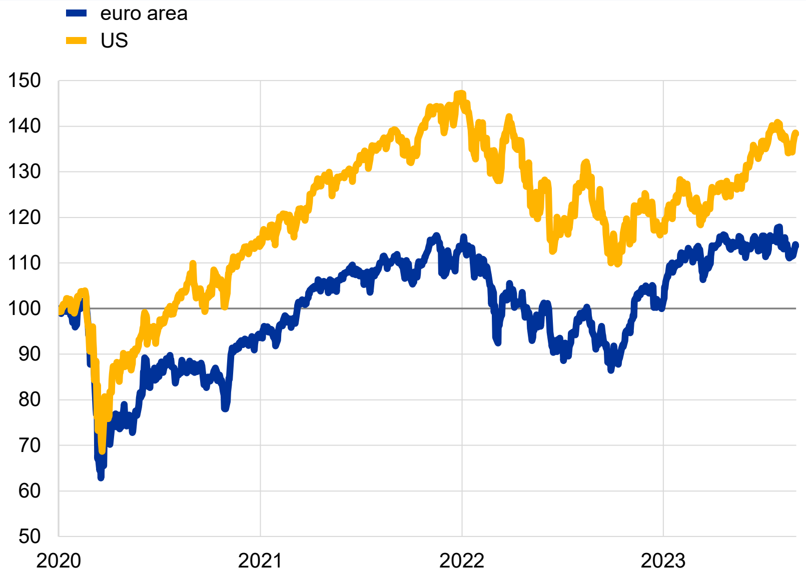
Sources: ECB and Dealogic.

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 €STR between 07/22- 06/23.

3 - Elevated valuations leave markets and non-banks vulnerable to negative surprises

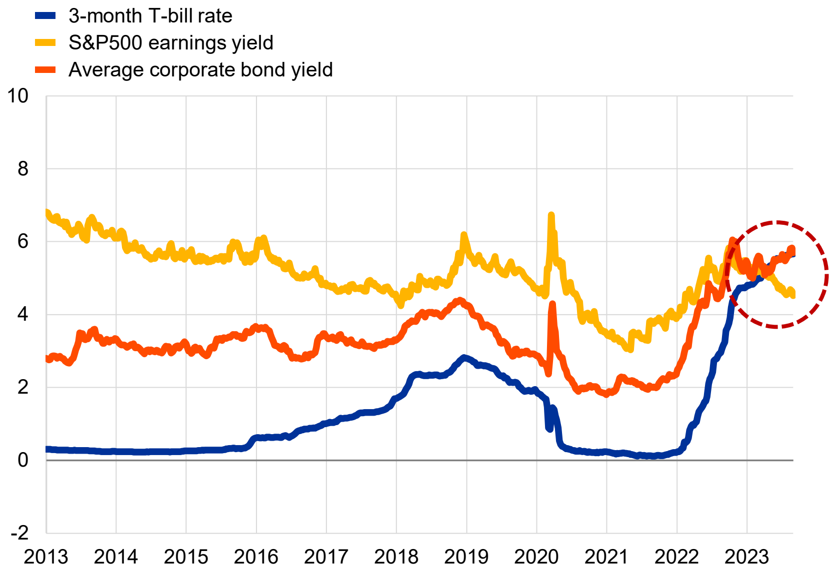
- Stock markets back at pre Ukraine war levels despite decelerating growth and higher yields on other assets
- For the first time, yields on US equities fall below those of cash and corporate bonds

Stock market developments
Index: Jan 2020 = 100



Source: Bloomberg.

Yields across asset classes in the US
Percentages

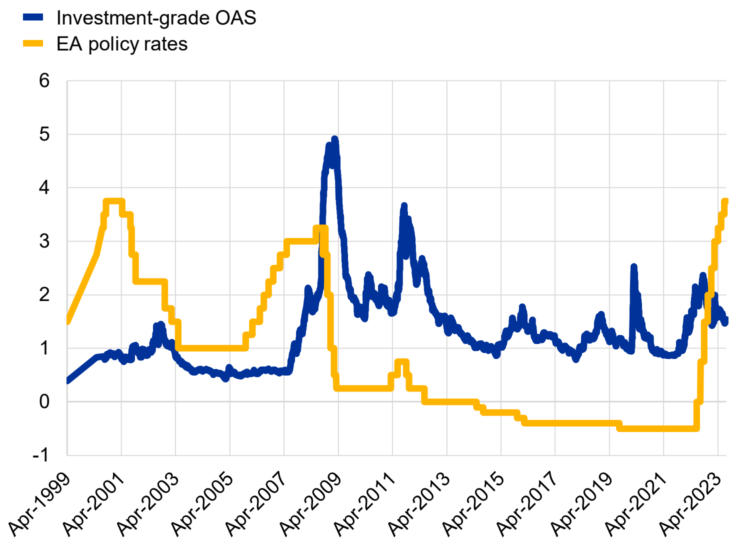


Source: Bloomberg.

3 - Elevated valuations leave markets and non-banks vulnerable to negative surprises

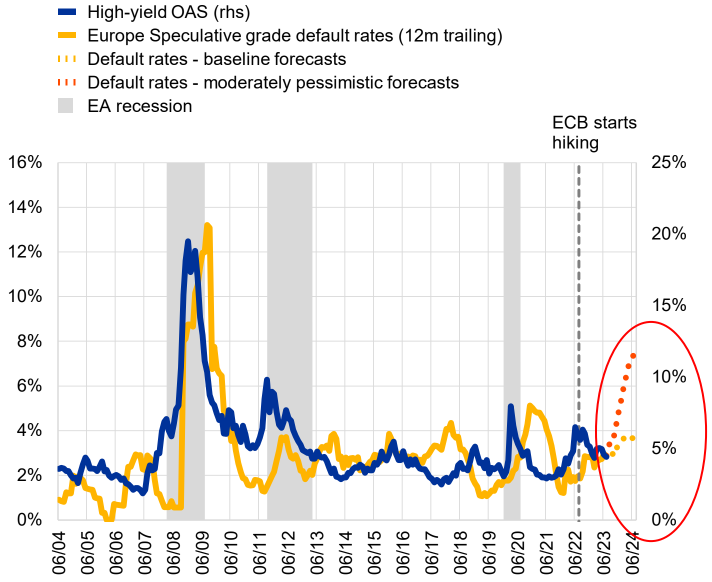
- Credit spreads have narrowed as central bank interest rates and default rate expectations have risen

Euro area corporate IG credit spreads
Percentages



Sources: Bloomberg and ECB calculations.

Corporate high yield credit spreads and default rates – Europe
Percentages



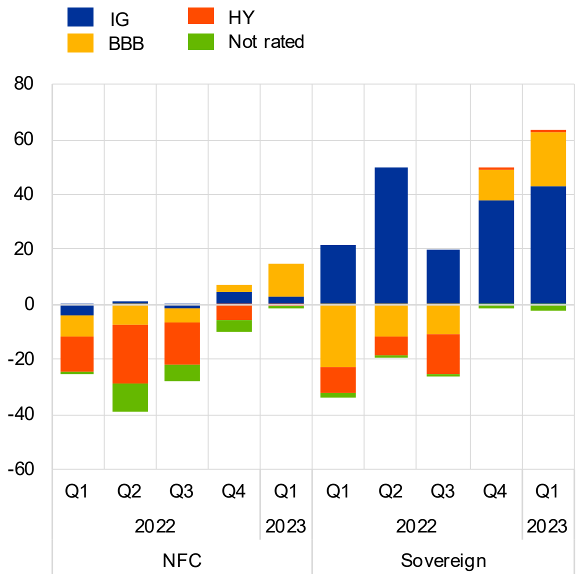
Sources: Moody's, Bloomberg and ECB calculations.

Notes: European speculative grade default rates between March 22 and February 23 are taken from an earlier data release, which excluded Russian issuers.

3 - Elevated valuations leave markets and non-banks vulnerable to negative surprises

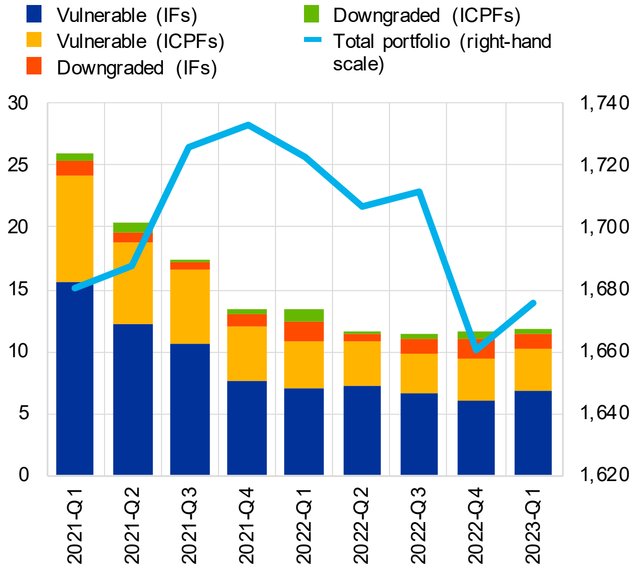
- Non-banks continue to shift towards sovereign debt exposures while reducing exposures to vulnerable corporates, but credit risks remain

Euro area investment funds' debt transactions
Q1 2022 – Q1 2023; € billion



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.

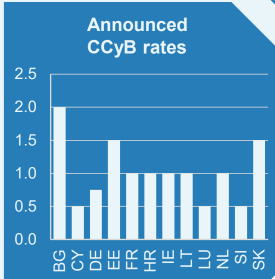
Euro area non-banks' exposure to vulnerable corporates
Q1 2021 – Q1 2023; left-hand side: percentage of total corporate exposures; right-hand side: value € billions



Sources: SHSS, CSDB and ECB calculations.
Notes: Securities are classified as vulnerable when the rating company classifies the issuer under negative credit watch or negative credit outlook

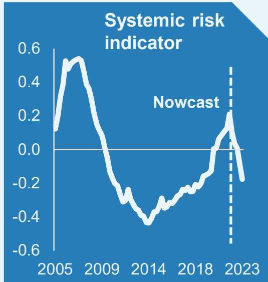
Macroprudential policy: preserve existing resilience

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, avoding 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

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

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

Non-banks – need for a comprehensive policy response

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

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

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

➢ International policy coordination is key

➢ Authorities should take an active role in identifying and addressing emerging risks