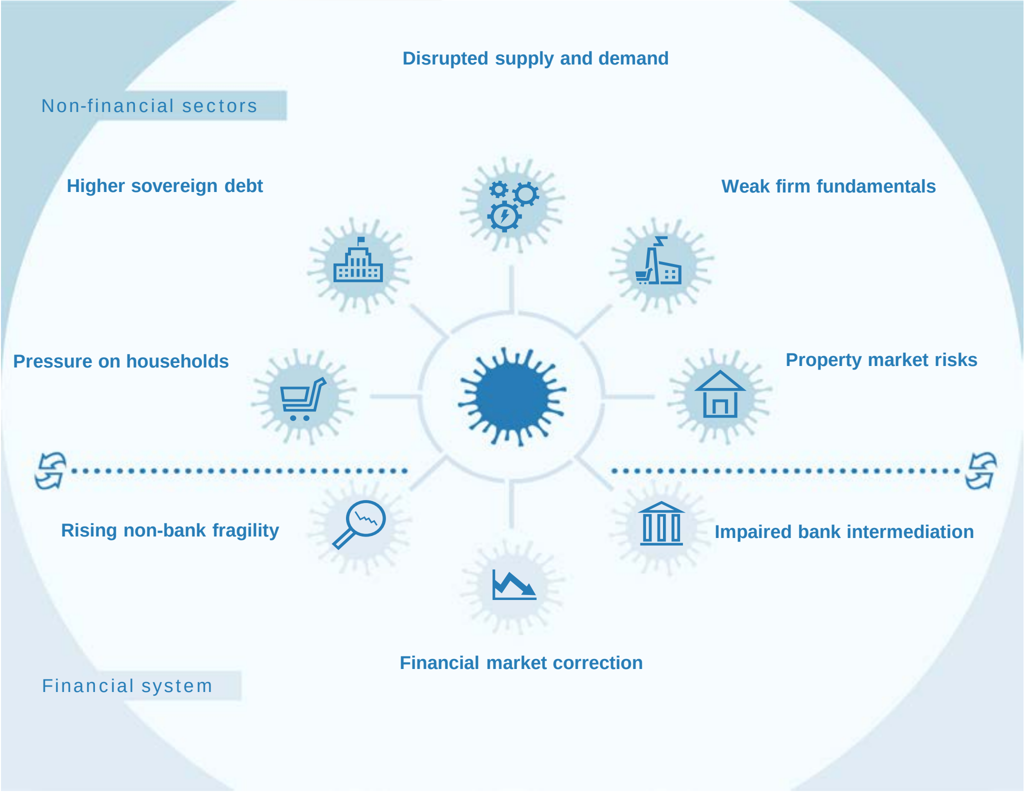
EUROPEAN CENTRAL BANK
EUROSYSTEM

May 2020

Financial Stability Review

26 May 2020

The spread of the coronavirus (COVID-19) triggered a chain of unparalleled social and economic disruption, testing financial system resilience



Shock interacts with vulnerabilities identified in November 2019 FSR

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

Yield curve

75%

of significant banks have return on equity of below 8%

Growing challenges from cyclical headwinds to bank profitability

- Eroding interest margins
- Slightly rising cost of credit risk
- High cost inefficiencies
- Plateauing capital positions

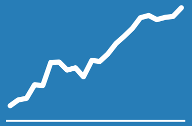
Lingering private and public debt sustainability concerns

- Weaker growth prospects
- Releveraging of high-yield firms
- Rising property prices
- Low interest payment burdens

45%

of all rated market-based corporate debt is rated BBB

Non-liquid assets



Increased risk-taking by non-banks may pose risks to capital market financing

- Profitability and solvency challenges
- Higher credit and duration risk
- Pockets of illiquidity
- Growing real economy financing

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.

Pronounced systemic vulnerability

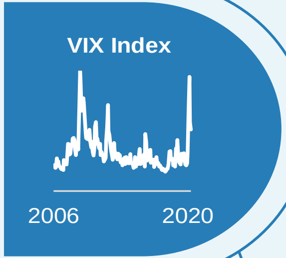
Moderate systemic vulnerability

Potential systemic vulnerability

Risks to financial stability have increased markedly (May 2020 FSR)

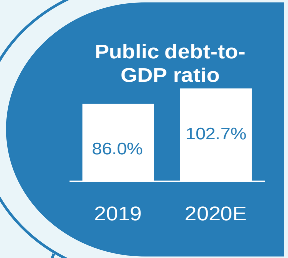
Tighter financial conditions and fragile functioning in some markets

- Broad-based increase in risk premia
- Rising corporate downgrades
- Loss of market liquidity
- Growing rollover risks



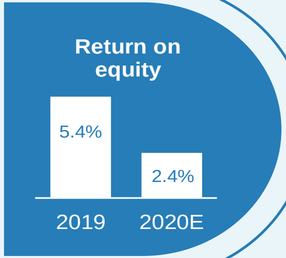
Large increase in debt burden, especially public debt

- Significant lost output
- Rising borrowing costs
- Lower income and earnings
- Potential property market correction



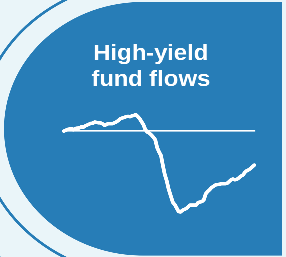
Weaker bank intermediation potential and profitability

- Increased loss-absorbing capacity
- Deteriorating asset quality
- Continued margin compression
- Historically low market valuations



Vulnerable non-banks amplifying market movements

- High exposures to risky non-financials
- Sizeable valuation losses on portfolios
- Large outflows testing funds' liquidity
- Hit to insurers' solvency and profitability



The euro area financial system has weathered the immediate stress, supported by monetary, fiscal and prudential policies.

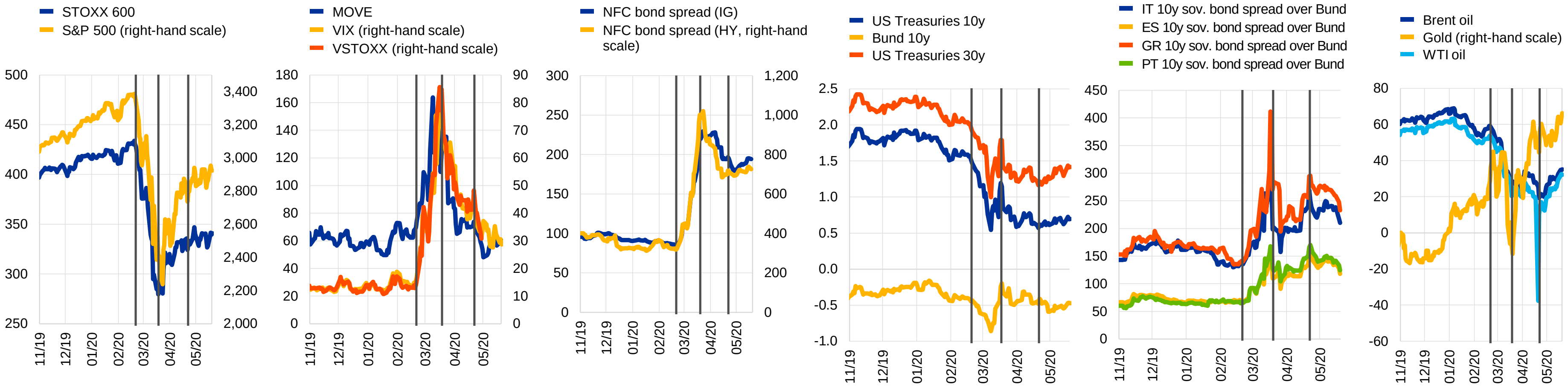
Increased resilience of euro area banks helps, including the €140 billion of capital relief action by authorities.

Legacy debt and the potential for financial fragmentation pose pronounced medium-term challenges to both economic recovery and financial stability.

Equity prices fell, spreads widened and volatility increased – most likely amplified by record high valuations at the start of 2020

- Large and abrupt adjustment in markets from late February, reflecting a deterioration in economic outlook
- Subsequent stabilisation, and partial reversal, following a broad range of policy announcements

Developments in major global financial asset markets
(first panel: index; second panel: volatility index; third panel: basis points; fourth panel: percentages per annum; fifth panel: basis points; sixth panel: US dollars per barrel and US dollars per ounce)



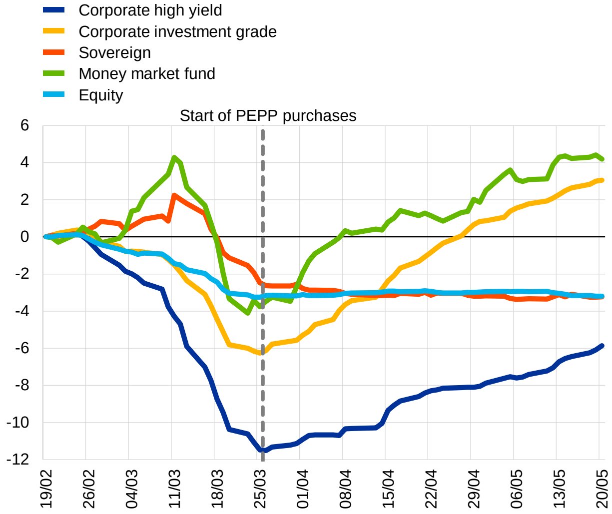
Sources: ECB, Thomson Reuters Eikon, BvD News, web searches for “credit lines” and ECB calculations.

Notes: Red vertical lines mark start of global market correction (20 February), ECB announcement of PEPP (18 March) and ECB decision to continue accepting downgraded bonds as collateral (22 April).

Large-scale investment fund outflows in early March tested resilience of funds

- High-yield funds saw largest outflows, but even money market funds and sovereign funds experienced outflows, as cash needs of investors rose
- Low liquid asset holdings reduced capacity of funds to manage the outflows and led to forced asset sales

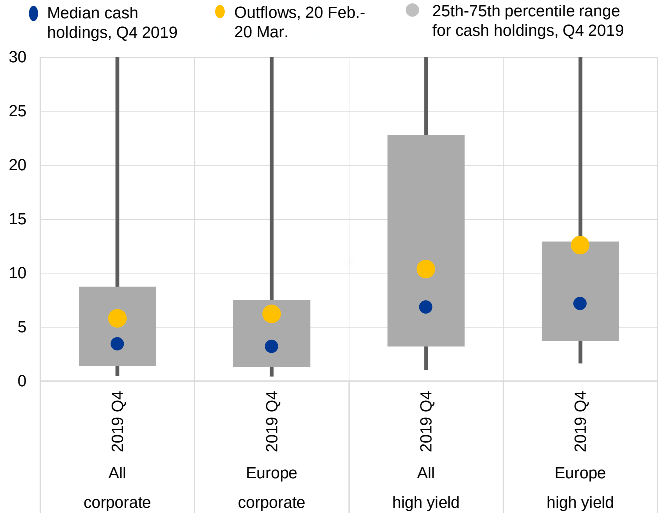
Cumulative flows of euro area-domiciled funds
(percentage of assets under management)



Sources: Dealogic , iBoxx, EPFR and ECB calculations.

Note: PEPP: pandemic emergency purchase programme.

Outflows and liquid asset holdings of euro area bond funds by asset class
(percentage of total assets)

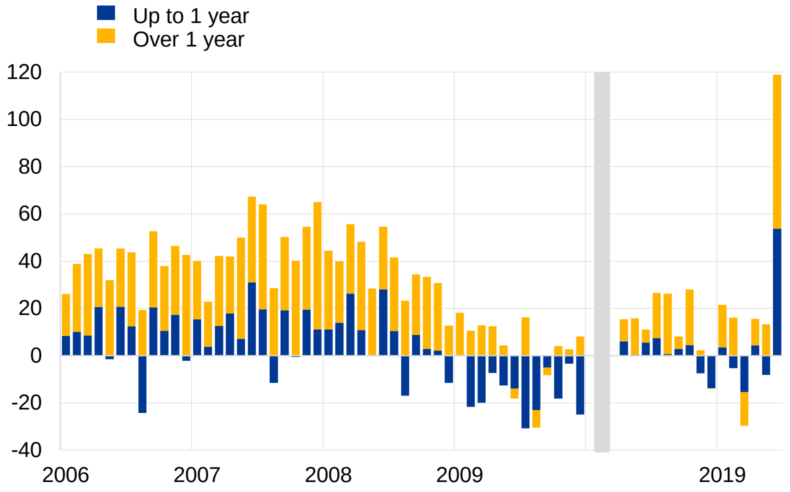


Sources: Refinitiv, EPFR and ECB calculations.

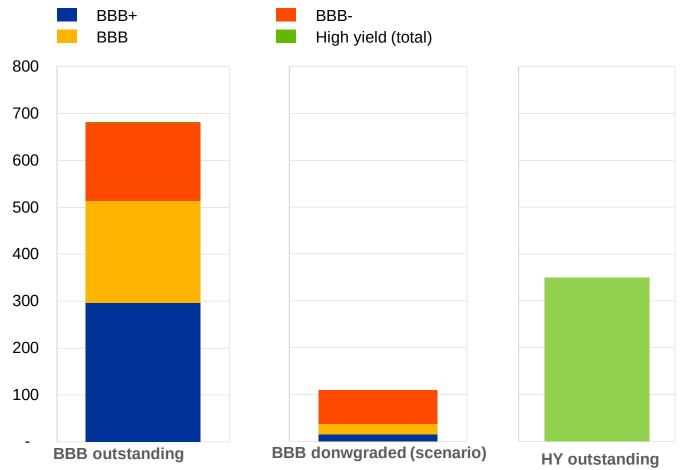
Corporate cash-flow challenges are leading to downgrades

- Collapse in corporate cash flows prompted sizeable credit provision in March, half of it short term
- When combined with existing high leverage of some corporates, downgrades – especially from BBB to high yield – are expected to increase. A wave of “fallen angels” could flood the high-yield bond market

Developments in short-term bank loans in March 2020
(monthly flows, € billions)



BBB-rated bonds outstanding (left panel), downgraded in a 2008/09-like scenario (middle panel) and high-yield bonds outstanding (right panel)(€ billions)

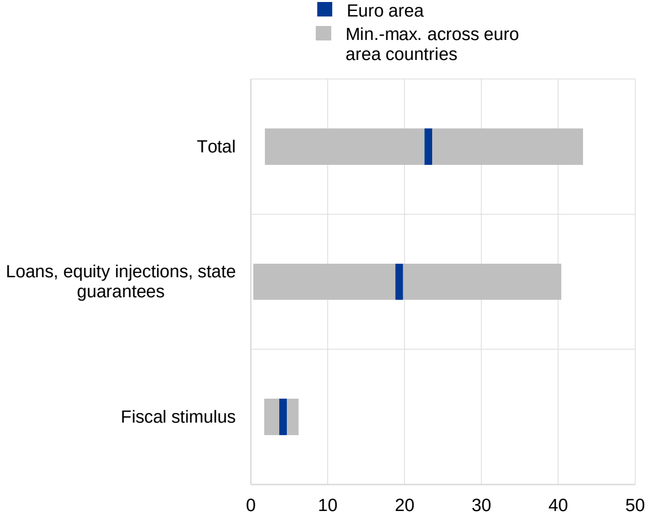


Sources: ECB and ECB calculations.

Fiscal relief attenuates near-term impact, but increases future debt challenges

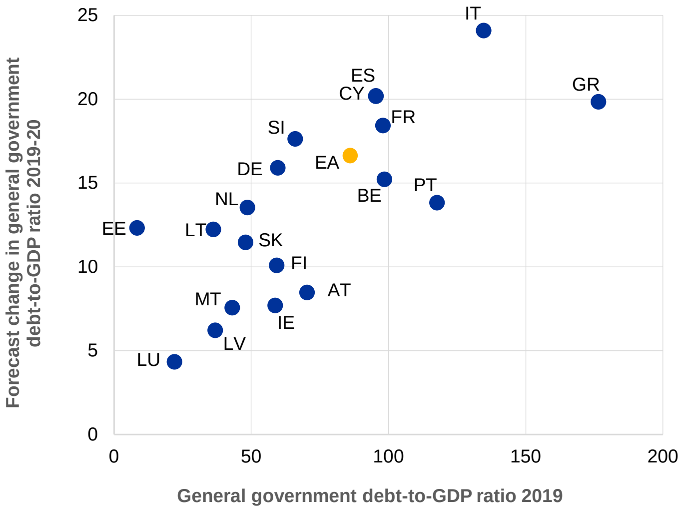
- Governments have offered large-scale fiscal relief that should support recovery – both through current spending and contingent guarantee schemes
- This implies a large increase in near-term financing needs, and an accompanying increase in debt levels, particularly in countries that had limited fiscal space

Discretionary measures and guarantees of euro area governments
(percentage of GDP)



Sources: 2020 National Government Stability Programmes, ECB and ECB calculations.

Sovereign indebtedness in the euro area and expected changes in 2020
(percentage of GDP and percentage points)

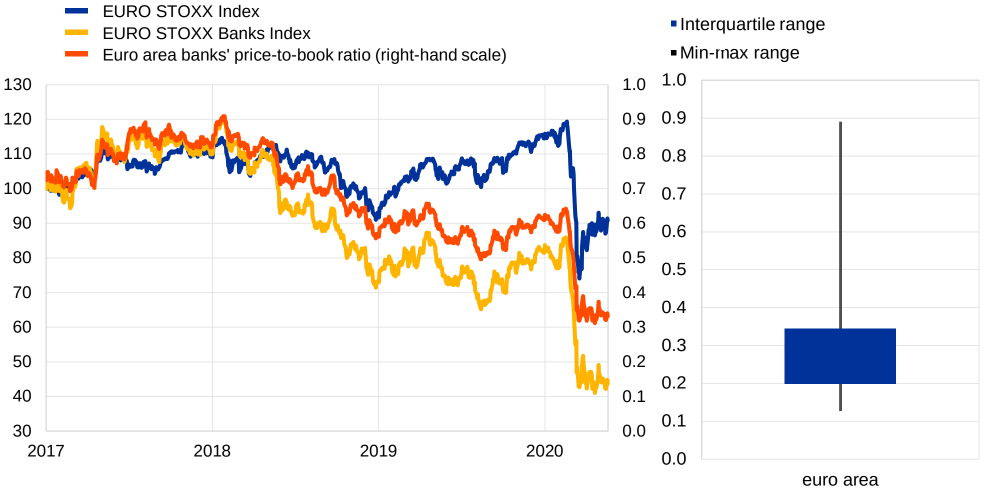


Sources: European Commission (AMECO) and ECB calculations.

Bank stock valuations fell more than the market, despite strong capital positions

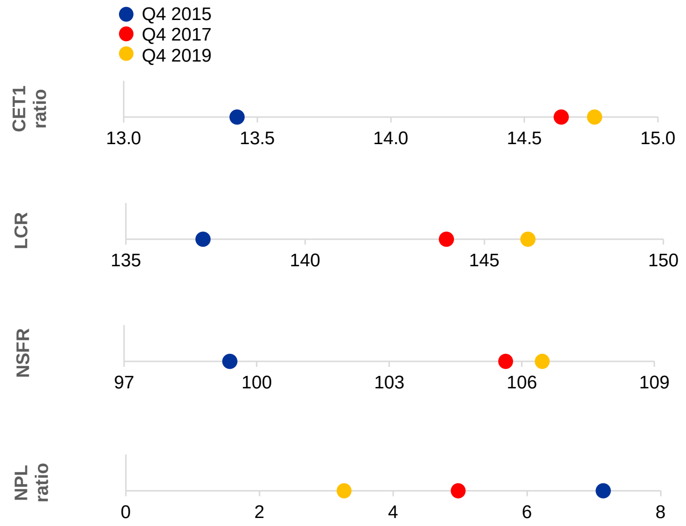
- Bank stocks underperformed the wider market during the sell-off; price-to-book ratios for euro area globally systemically important banks reached close to 0.3 amid a high degree of heterogeneity across individual banks
- Euro area banks entered this episode with much stronger capital and liquidity positions than in 2008

EURO STOXX and EURO STOXX Banks Indices, as well as euro area banks' price-to-book ratios and their distribution
(index: 1 Jan. 2017 = 100, percentages)



Source: Bloomberg.

Euro area banks' Common Equity Tier 1, liquidity coverage, net stable funding and non-performing loan ratios
(percentages)

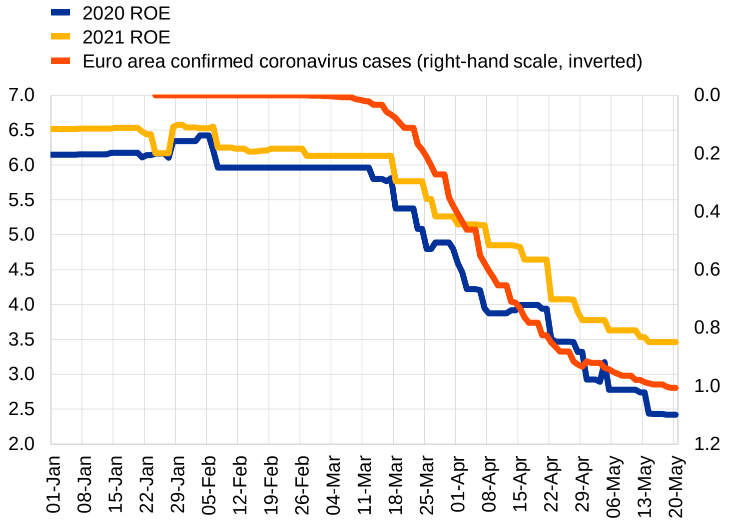


Sources: ECB supervisory statistics and ECB calculations.

Euro area banks' profitability outlook has deteriorated

- Analysts' expectations of euro area banks' return on equity (ROE) have been lowered even further, not just for 2020 but also for 2021
- This reflects a combination of current pressures on loan losses and trading revenues, as well as weaker prospects for future loan growth and margins
- This adds to the need for structural change in the euro area banking sector

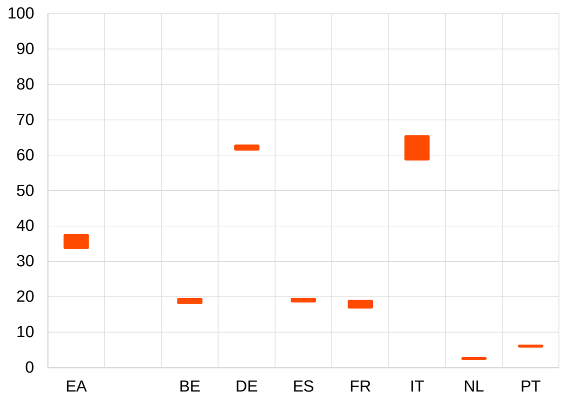
Evolution of ROE forecasts for listed banks for 2020 and 2021 and confirmed coronavirus cases in the euro area
(percentages and millions of confirmed cases)



Sources: Bloomberg and ECB calculations.

Loan guarantee schemes transfer some risk to governments

Potential share of bank losses transferred to governments assuming full take-up of guarantees
(range for alternative scenarios, percentage of total estimated losses)

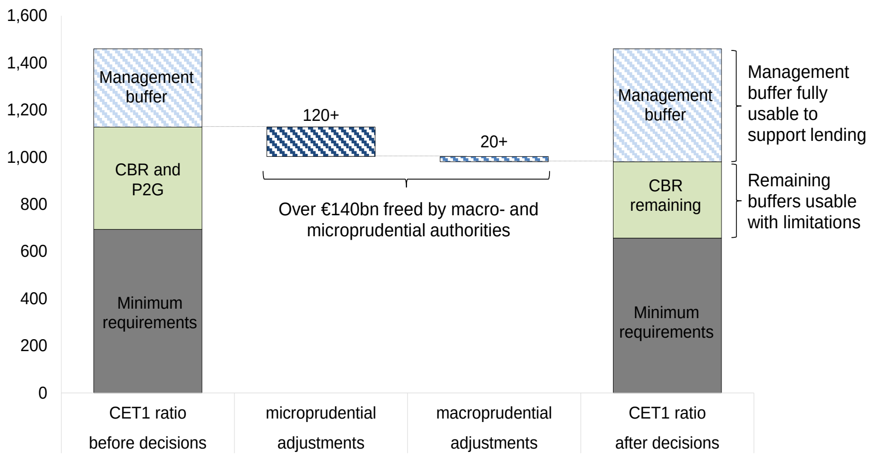


Sources: ECB, national authorities and ECB calculations based on Orbis.

- Government loan guarantee schemes are a key part of the fiscal support measures
- **If fully deployed,** they could transfer over 30% of losses that materialise to governments
- The success of the schemes hinges on their take-up and the ability of borrowers to access loans quickly

Prudential measures help banks to support the real economy

CET1 capital and capital buffers in the euro area
(€ billions, Q4 2019)



- Prudential authorities acted to free up over €140 billion of bank capital, suspend dividend payouts (approx. €27.5 billion of capital) and enhance flexibility in accounting rules and NPL recognition
- Overall impact potentially big, but market stigma and fear of downgrades may limit the use of capital buffers; use of remaining buffers also limited by leverage ratio constraints

Sources: COREP (common supervisory reporting), notifications of national designated authorities and websites of national authorities.

Note: CBR: combined buffer requirement; P2G: Pillar 2 guidance.

Medium-term risks to financial stability have increased markedly

The financial system has faced an economic shock of enormous scale, speed and global breadth in the wake of the coronavirus pandemic

Wide-ranging policy measures, including monetary and prudential policies, helped prevent a seizing-up of the financial system and support the recovery. But medium-term vulnerabilities have risen and may pose challenges to that recovery

Existing vulnerabilities of some sovereigns, highly leveraged corporates and the non-bank financial sector amplified the response in financial markets and increase the risks ahead

Euro area banks are supported by better capital and liquidity positions than in the past, but are still likely to face significant losses and further pressure on profitability. These developments underscore the need for consolidation and structural change in the sector