EUROPEAN CENTRAL BANK

EUROSYSTEM

Financial Stability Review
November 2018

Press Briefing

Luis de Guindos

29 November 2018

The financial stability environment has become more challenging

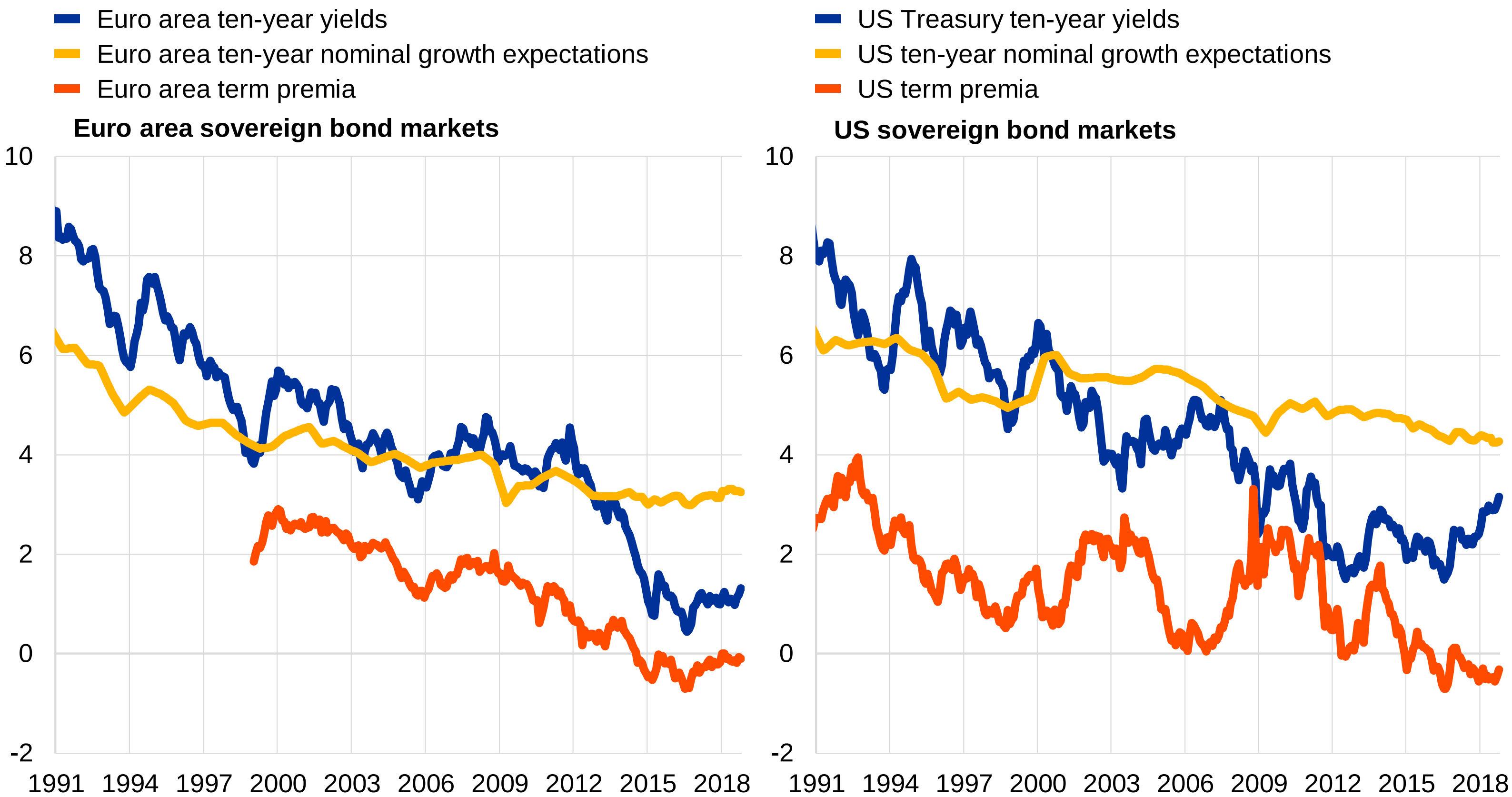
Four key risks over a two-year horizon

1. Disorderly increase in risk premia ➡
2. Debt sustainability concerns ⬆
3. Hampered bank intermediation capacity ➡
4. Liquidity strains in the investment fund sector ⬆

Term premia at historical lows

Long-term government bond yields, nominal GDP growth expectations and term premia in the euro area and the United States

(Jan. 1991-Oct. 2018, percentages per annum, annual percentage changes)

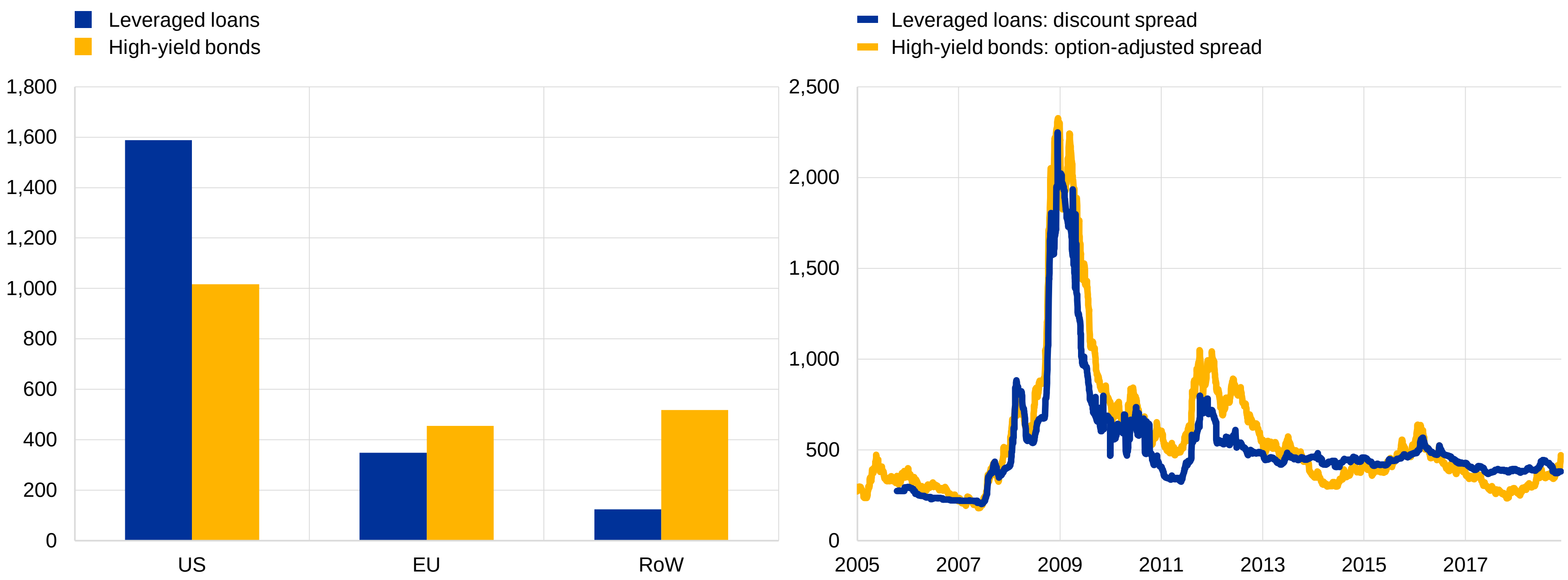


Sources: Thomson Reuters, Consensus Economics and ECB calculations.

Notes: Before 1999, euro area bond yields are approximated by ten-year bond yields in Germany. The euro area ten-year term premium shown in the chart is estimated on the basis of overnight index swap rates using an affine term structure model following the methodology of Joslin, S., Singleton, K.J. and Zhu, H., “A New Perspective on Gaussian Dynamic Term Structure Models”, *The Review of Financial Studies*, Vol. 24(3), March 2011, pp. 926-970.

Leveraged loans: a vivid illustration of the compressed price of risk

Amount outstanding (left panel), credit spreads for European leveraged loans and high-yield bonds (right panel)
(left panel: Oct. 2018, € billions; right panel: Jan. 2005-Nov. 2018, basis points)

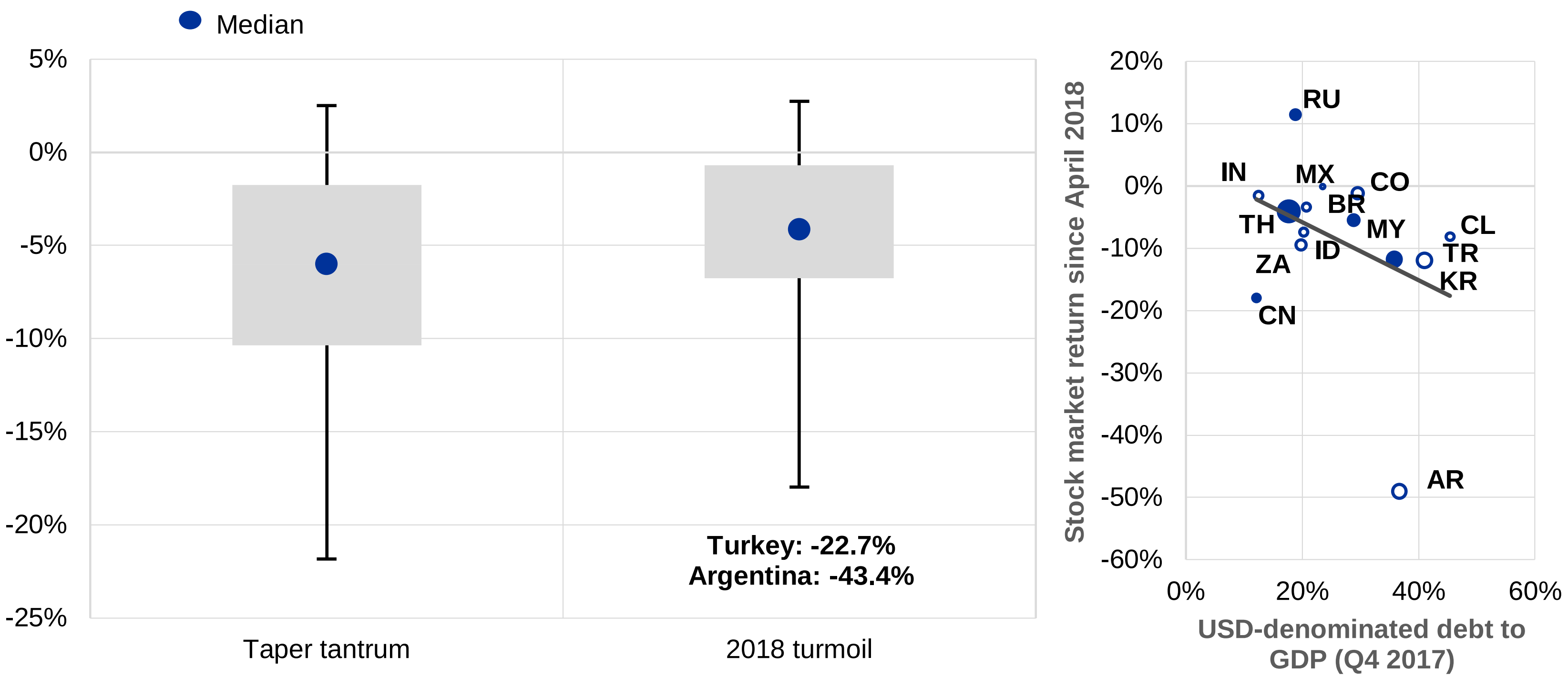


Sources: Bloomberg, Thomson Reuters, Bank of America Merrill Lynch, Association for Financial Markets in Europe and ECB calculations.

1 - Disorderly increase in risk premia

Sharp corrections in selected emerging market economies (EMEs)

EME exchange rate developments during the stressed periods in 2013 and 2018 (left panel); stock market returns and USD-denominated debt to GDP for EMEs (right panel)
(left panel: changes in the US dollar per local EME currency (May 2013-Dec. 2013 (taper tantrum) and Jan. 2018-Nov. 2018 (2018 turmoil)); maximum, minimum, interquartile range and median; right panel: y-axis: changes in the local equity price index; x-axis: USD-denominated debt as a percentage of GDP)

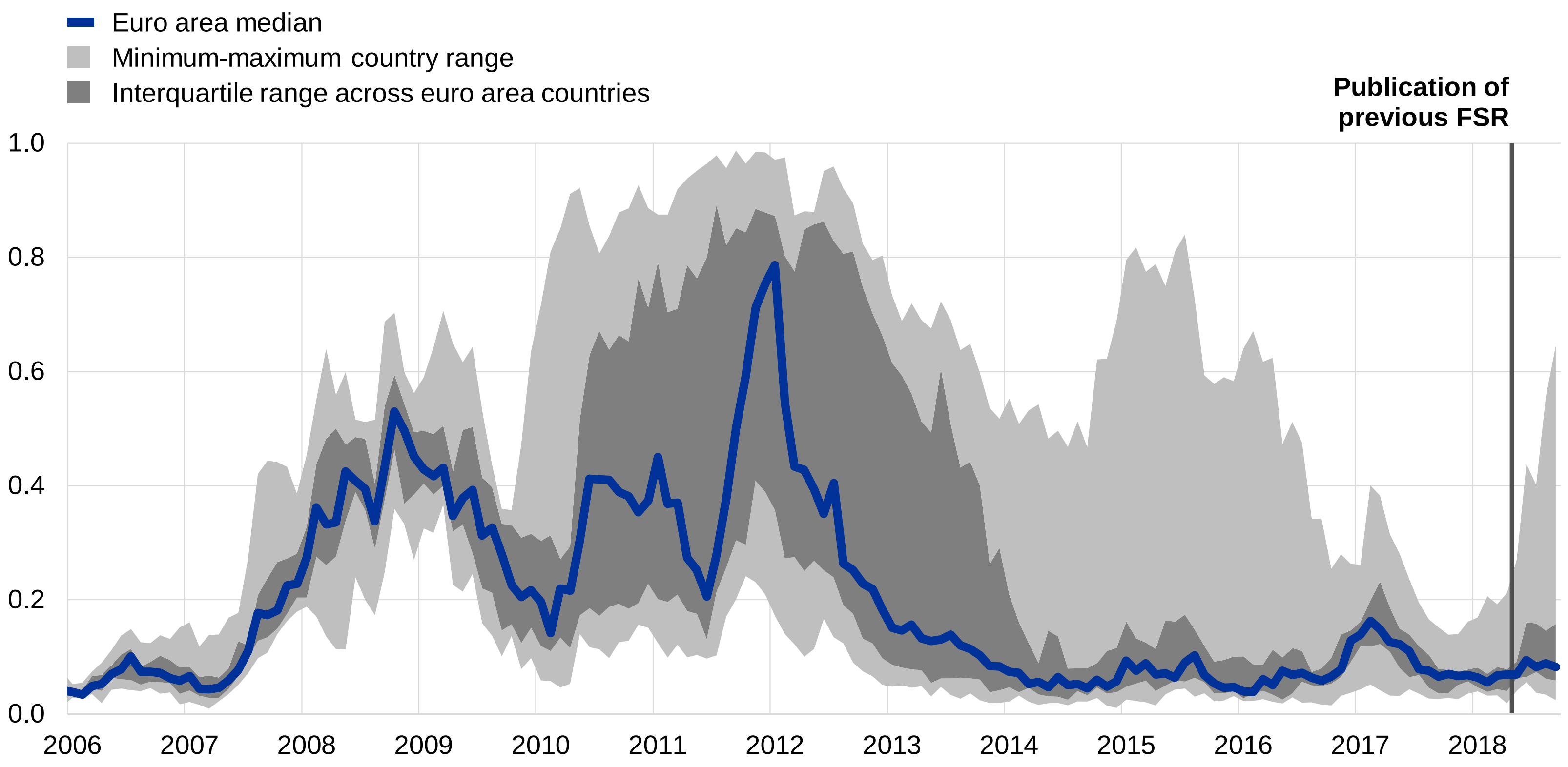


Sources: Bloomberg, Haver Analytics and Thomson Reuters.

Notes: Left panel: AR , BR, CN, ID, IN, MX, MY, RU, SA, TH, TR and ZA. Right panel: MSCI country indices in local currency are used to calculate the stock market returns from April to October 2018. The size of the bubble is commensurate to the current account deficit. Current account surplus countries are shaded in blue.

Isolated increase in sovereign bond market tensions

Composite indicator of systemic stress in the euro area sovereign bond markets
(Jan. 2006-Oct. 2018)

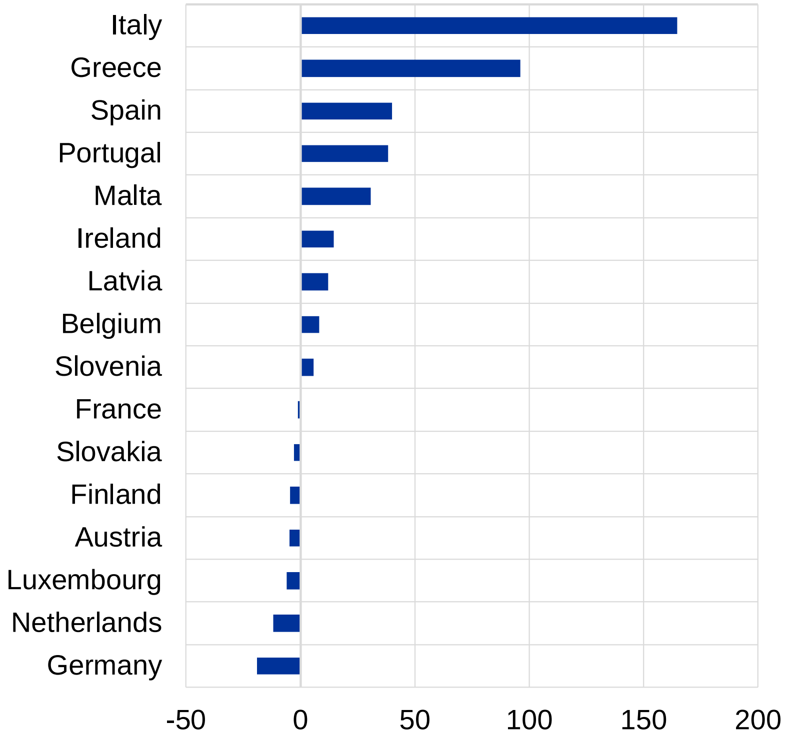


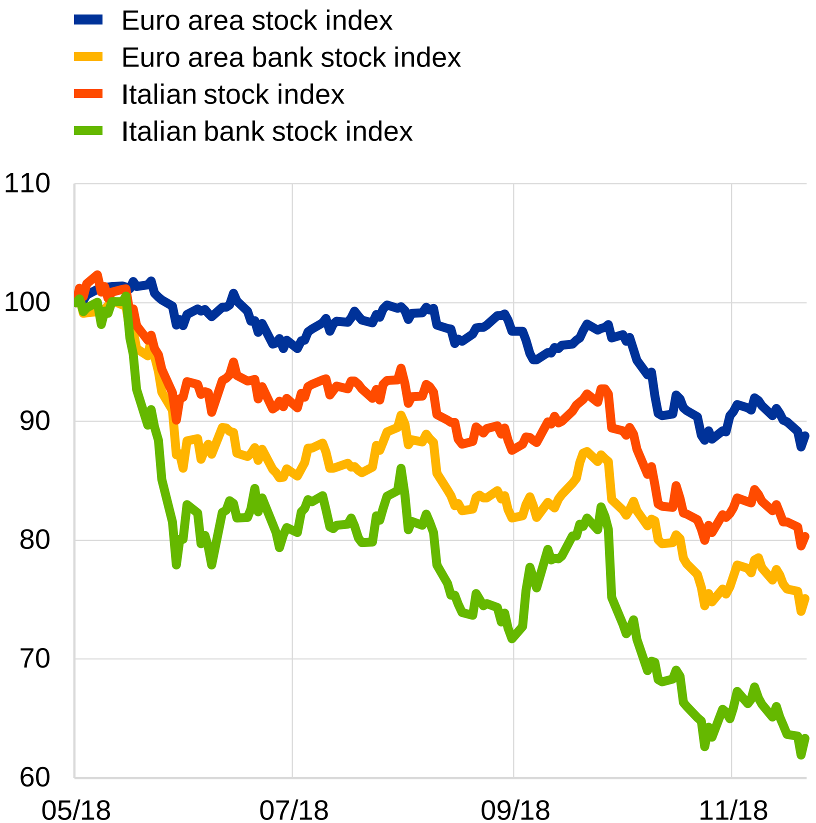
Sources: ECB and ECB calculations.

Notes: The SovCISS is available for the euro area as a whole and for 11 euro area countries. The methodology of the SovCISS is described in Garcia-de-Andoain, C. and Kremer, M., “Beyond spreads: measuring sovereign market stress in the euro area”, *Working Paper Series*, No 2185, ECB, October 2018.

Large price falls in Italian bond and stock markets

Changes in ten-year sovereign bond yields across euro area countries (left panel) and stock market indices (right panel)
(left panel: daily data, changes in basis points between 1 May 2018 and 21 Nov. 2018; right panel: daily data, 1 May 2018-21 Nov. 2018, stock prices indexed to 100 on 1 May)

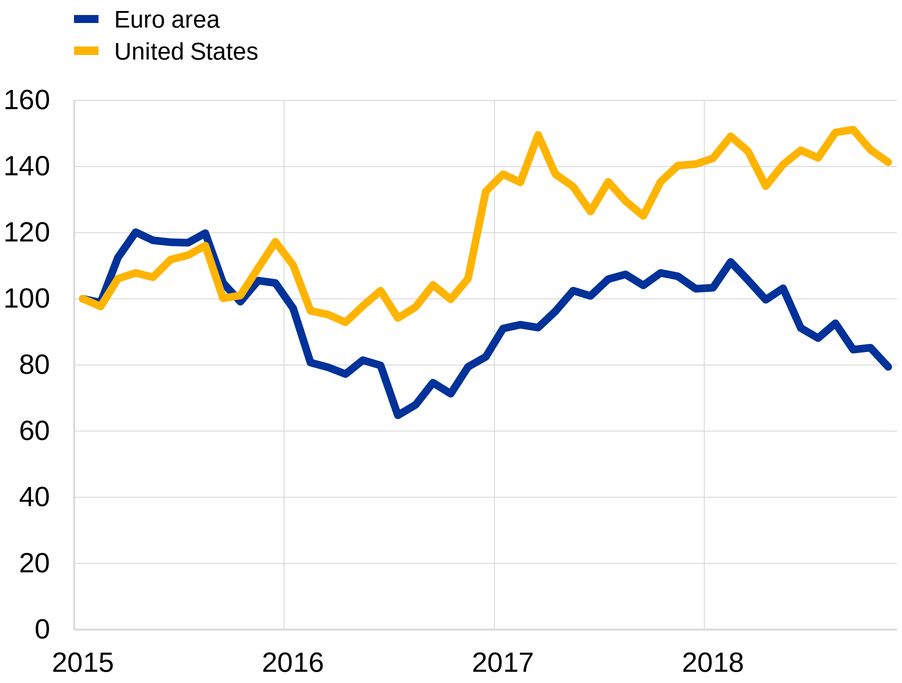




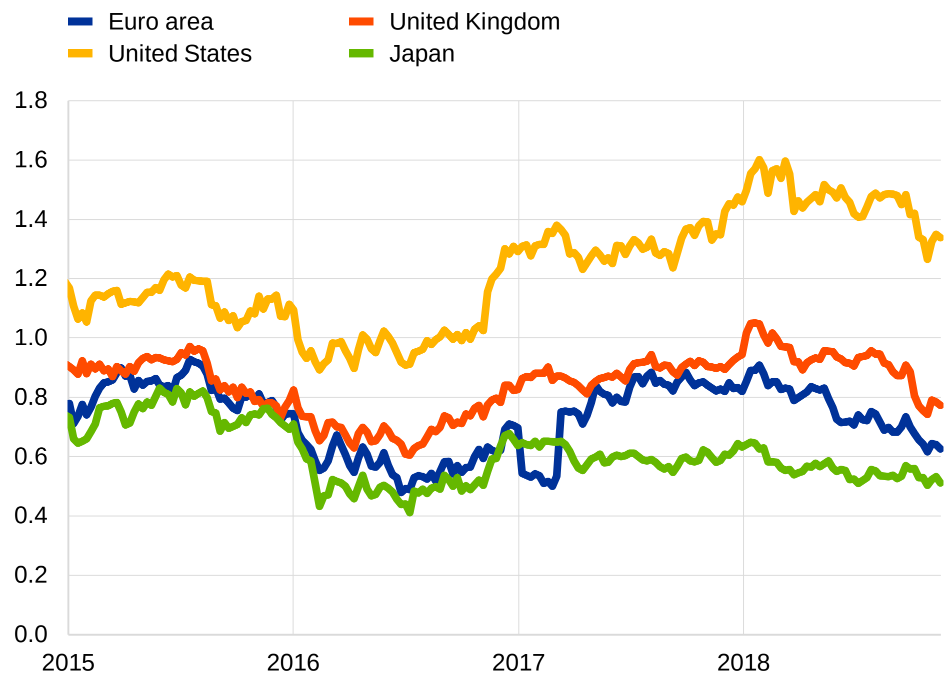
Sources: Thomson Reuters and Bloomberg.

Euro area banking sector challenges reflected in stock price developments and valuations

Stock market developments (left panel); price-to-book ratio for banks in advanced economies (right panel)
(left panel: Jan. 2015-Nov. 2018, index: Jan. 2015 = 100; right panel: Jan. 2015-Nov. 2018, ratio)



Sources: Thomson Reuters and ECB calculations.

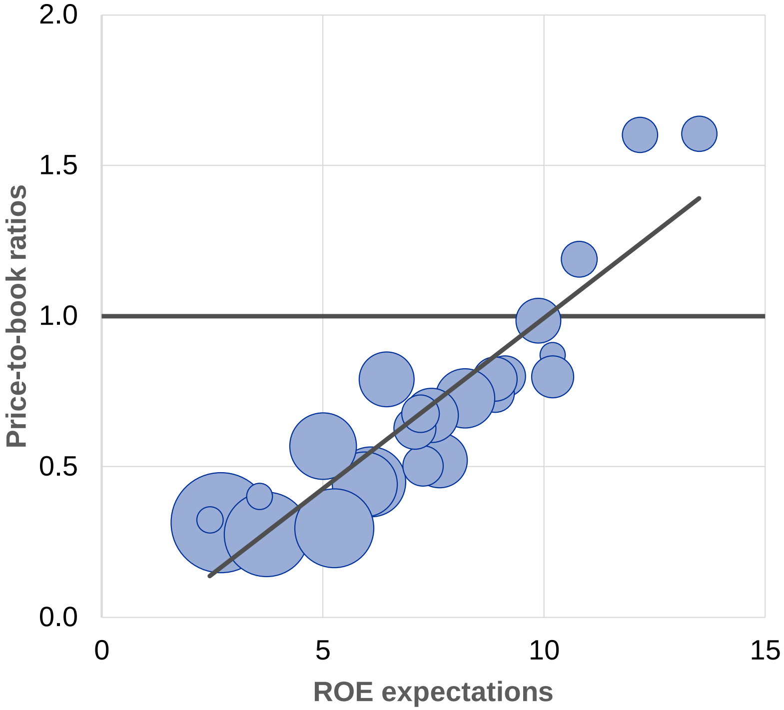


Sources: Bloomberg, Thomson Reuters and ECB calculations.

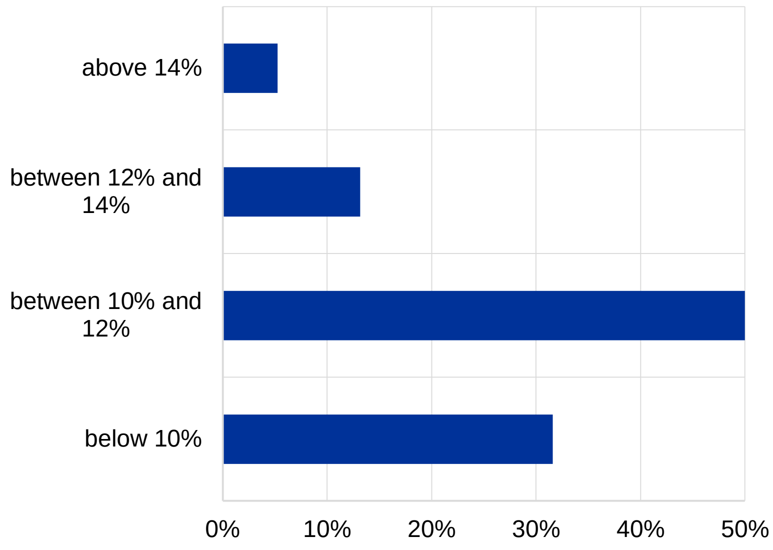
A large share of euro area banks is not delivering the returns required by investors

Price-to-book ratios, one-year-ahead ROE expectations and NPL ratios (left panel) and European banks' long-term sustainable profitability targets (right panel)
(left panel: ROE expectations (Sep. 2018), NPLs (Q2 2018), annual percentages and ratio; right panel: July 2018 EBA questionnaire)

The bubble sizes are proportional to banks' NPL ratios



Your bank can operate on a longer-term basis with a return on equity:



Sources: Bloomberg, European Banking Authority (EBA) and ECB calculations.

Notes: Right panel: the results are taken from the EBA's Risk Assessment Questionnaire, which reports the responses from banks and market analysts. ROE stands for return on equity and NPL for non-performing loan.

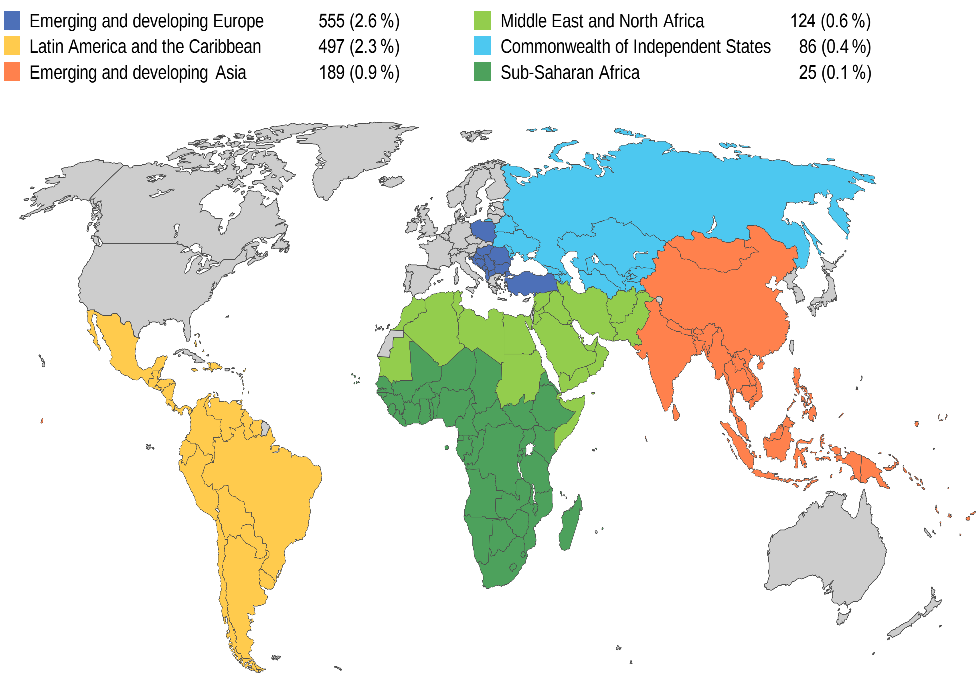
Banks - Two sensitivity analyses to complement EBA stress test

Scenario cut-off date: end-2017

Not capturing EME and sovereign market stress

Impact: **around 30 to 70 basis points** in addition to overall capital ratio depletion of 380 basis points

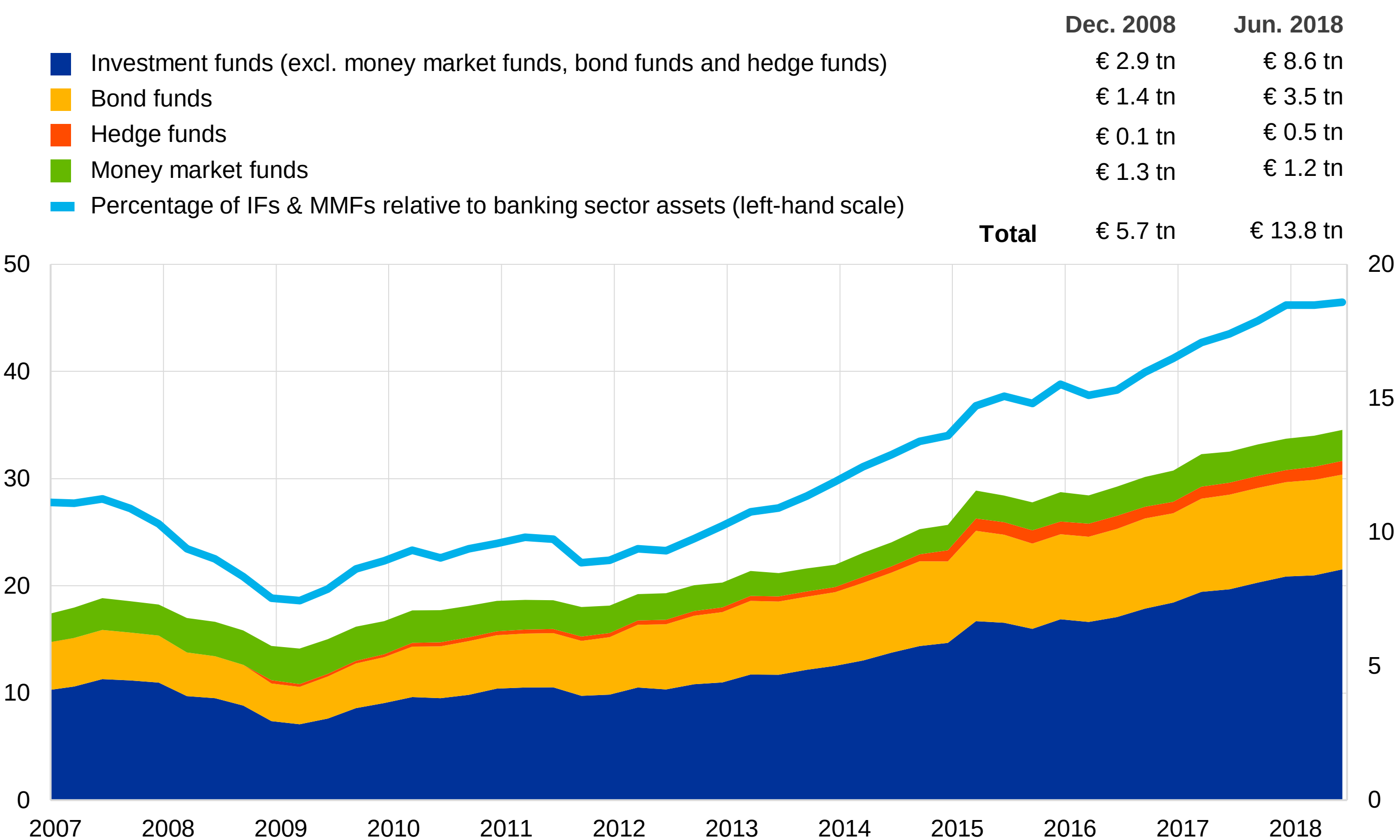
Euro area banks' exposure to EMEs
(Q1 2018, € billions, percentage of total assets)



4 - Liquidity strains in the investment fund sector

Rapid expansion of the euro area investment fund sector since the global financial crisis

Total assets of euro area investment funds
(Q1 2007-Q2 2018, percentages, € trillions)



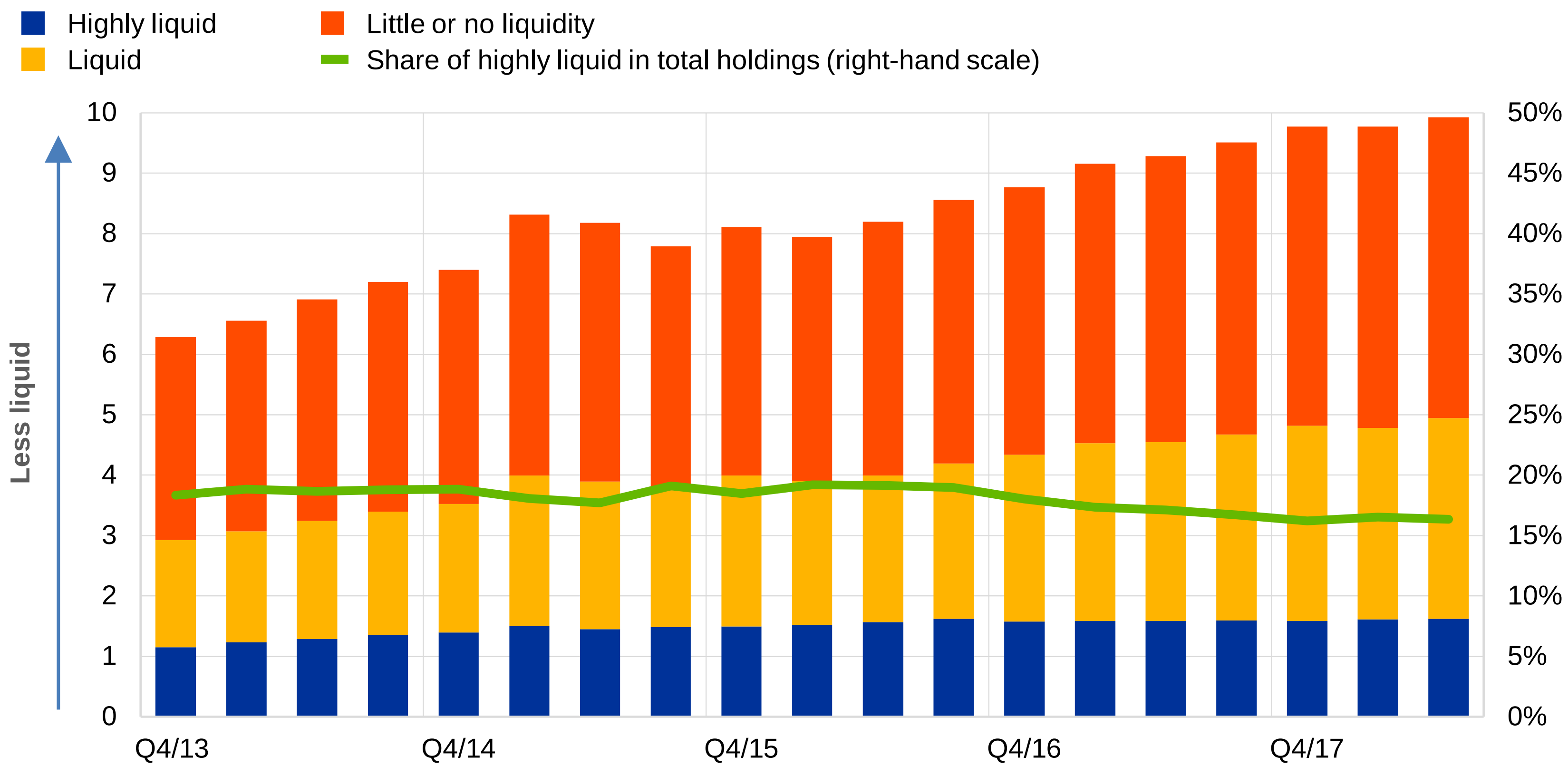
Sources: ECB investment fund statistics and banking sector statistics.

Notes: Banking sector assets refers to total assets of euro area credit institutions (excluding central banks). IFs stands for investment funds and MMFs for money market funds.

4 - Liquidity strains in the investment fund sector

Increased liquidity risk among investment funds

Breakdown of securities held by euro area investment funds by liquidity characteristics (left panel) and their holdings of debt securities (right panel)
(Q4 2013-Q2 2018, € trillions, percentages)



Sources: ECB (Securities Holdings Statistics) and ECB calculations.