



EUROPEAN CENTRAL BANK

EUROSYSTEM

Vítor Constâncio

ECB Financial Stability Review

May 2015

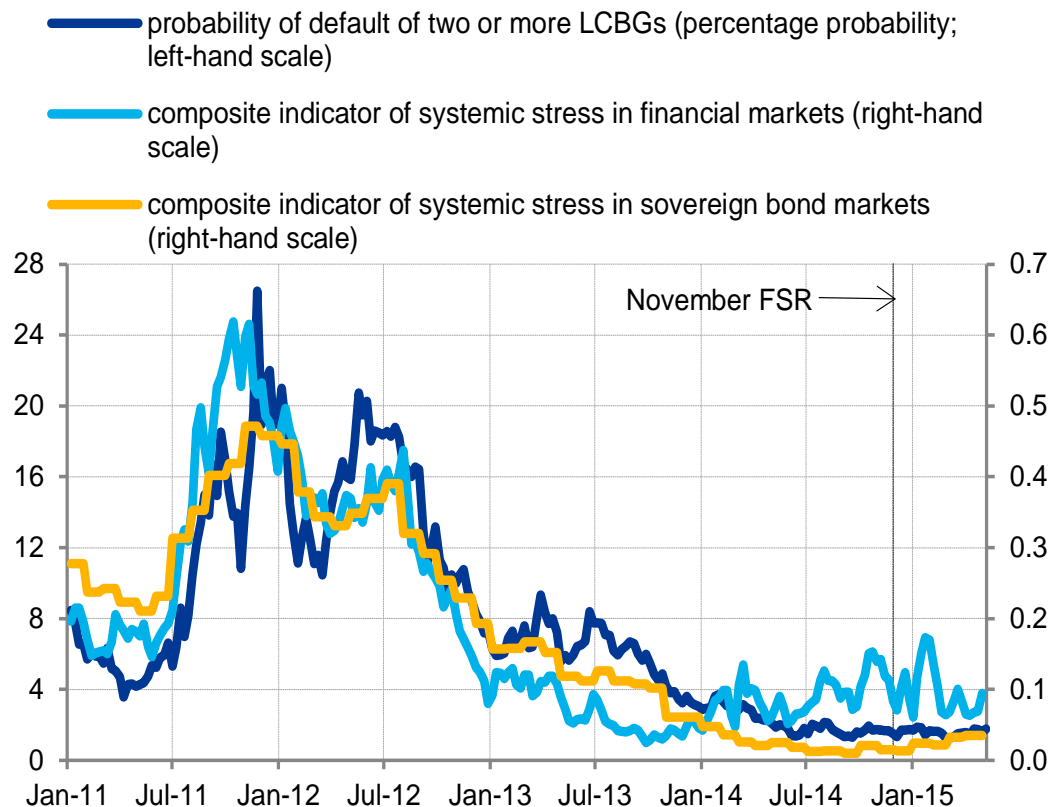
28 May 2015

Press briefing presentation

- **Euro area financial system stress, as extracted from market indicators, has remained overall low over the past six months, despite shorter periods of higher financial market volatility**
 - **Indicators of stress among euro area banks and sovereigns remain at low levels**
 - **Systemic stress across the broader financial system also contained**

Measures of financial market, banking sector and sovereign stress in the euro area

(Jan. 2011 – May 2015)



Sources: Bloomberg and ECB calculations.

Notes: (i) "Probability of default of two or more LCBGs" refers to the probability of simultaneous defaults in sample of 15 large and complex banking groups (LCBGs) over a one-year horizon. (ii) For further details on the CISS methodology, see Hollo, D., Kremer, M. and Lo Duca, M., "CISS – a composite indicator of systemic stress in the financial system", Working Paper Series, No 1426, ECB, March 2012.

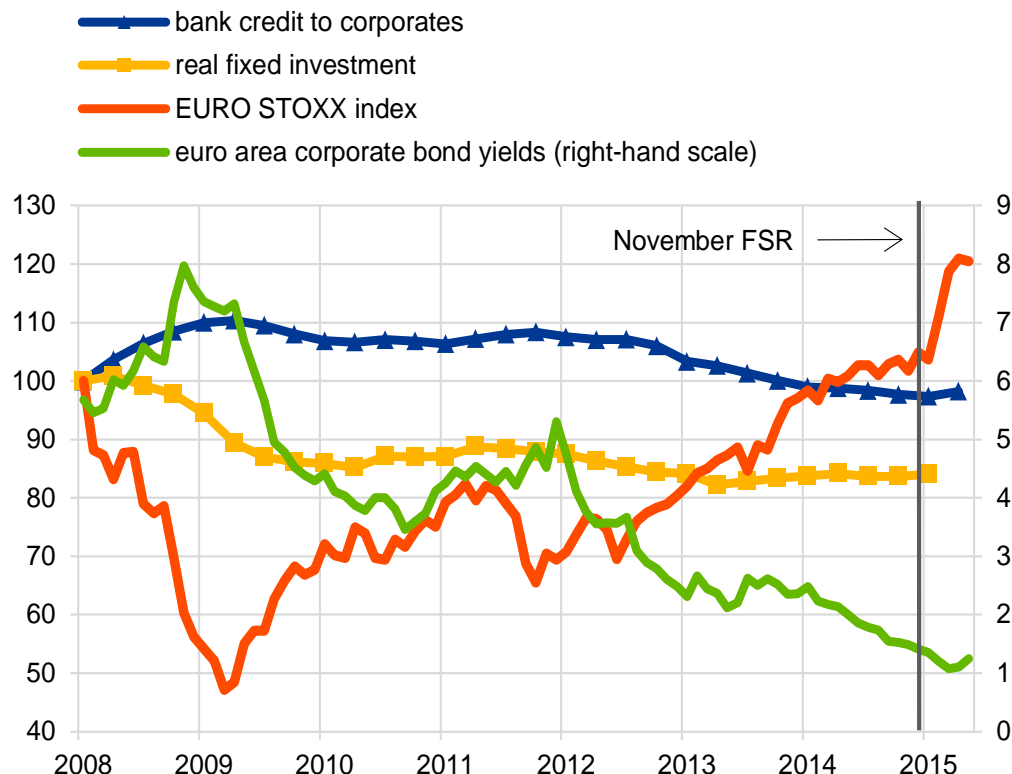
Recent developments

■ Euro area financial and economic indicators signal a stark dichotomy in risk-taking

- High financial risk-taking. The prices of financial assets in most segments have continued to rise ...
- ... but, the recent increases in asset prices have not been accompanied by growing leverage in the banking sector nor by rapid private sector credit expansion.
- Economic risk-taking in the euro area is clearly lagging.

High financial risk-taking, low sovereign yields, subdued credit growth coupled with subdued economic risk-taking

(Jan. 2008 to Mar. 2015, index: Jan. 2008 = 100)



Sources: Thomson Reuters Datastream and ECB.

Note: The Iboxx euro corporate bond all maturity index is employed.

1. Abrupt reversal of compressed global risk premia amplified by low secondary market liquidity
2. Weak profitability prospects for banks **and insurers** in a low nominal growth environment, amid slow progress in resolving problem assets
3. Rise of debt sustainability concerns in the sovereign **and corporate sectors** amid low nominal growth
4. **Prospective stress and contagion effects in a rapidly growing shadow banking sector**

Current level (colour)
and recent change
(arrow)*



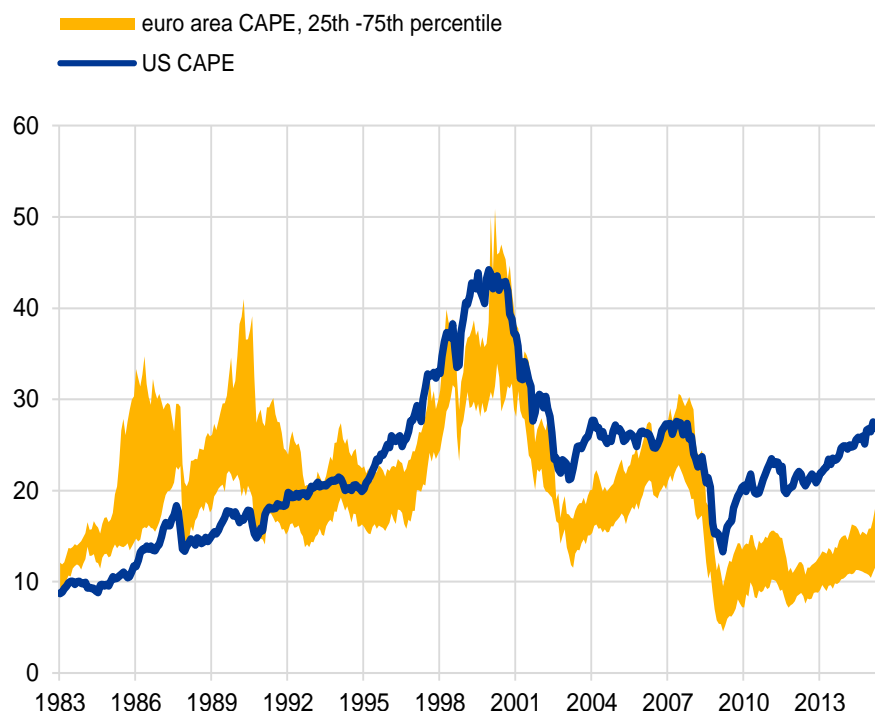
Main risks and vulnerabilities

Risk 1 - Abrupt reversal of compressed global risk premia amplified by low secondary market liquidity



Stock prices broadly in line with fundamentals in the euro area, valuations somewhat stretched for US stock prices

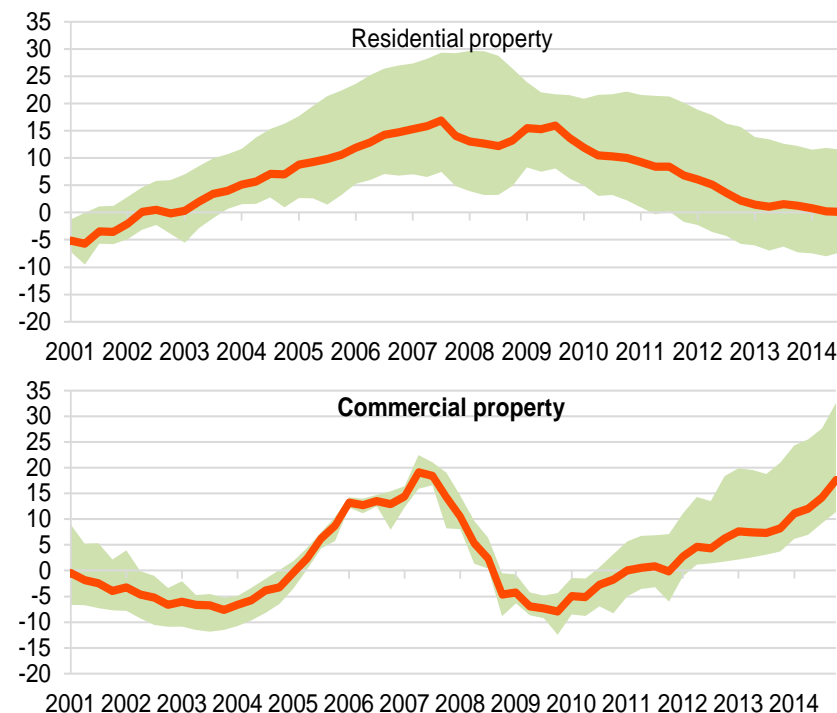
(Jan. 1983 - May 2015, yellow shaded area represents the 25-75 percentiles)



Sources: Thomson Reuters Datastream, Robert Shiller's homepage (<http://www.econ.yale.edu/~shiller/data.htm>) and ECB calculations.

Notes: Cyclically adjusted price/earnings (CAPE) ratios for the euro area and the United States. The cyclically adjusted price/earnings ratios for the euro area are imputed from Datastream's stock market indices. The US CAPE is taken from Robert Shiller's homepage.

Valuation estimates for euro area residential and prime commercial property above their long-term average (Q1 2009 - Q3 2014; average of price changes in Austria, France, Germany, Ireland, the Netherlands and Spain)



Sources: Jones Lang Lasalle, ECB and ECB calculations.

Note: Valuation estimates for residential property prices are based on four different valuation methods: price-to-rent ratio, price-to-income ratio and two model-based methods. For details of the methodology, see Box 3 in ECB, Financial Stability Review, June 2011. For further details on valuation estimates for prime commercial property, see Box 6 in ECB, Financial Stability Review, December 2011.

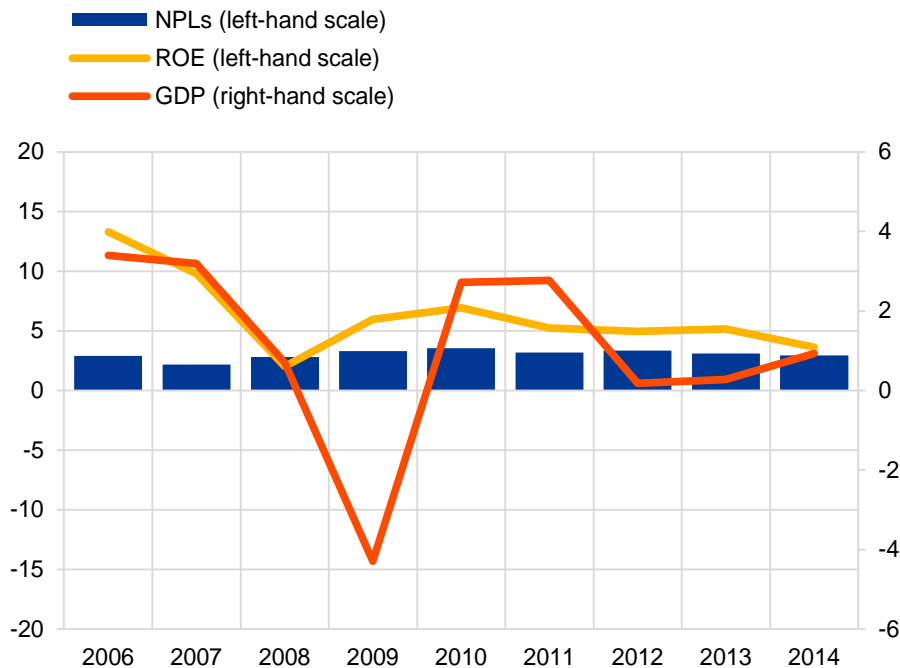
Main risks and vulnerabilities

Risk 2 - Weak profitability prospects for banks and insurers in a low nominal growth environment, amid slow progress in resolving problem assets



Non-performing loans broadly stable in the majority of euro area countries ...

(2006 – 2014; annual percentage changes (GDP); median NPLs as a share of total loans, median ROE, non-vulnerable countries)

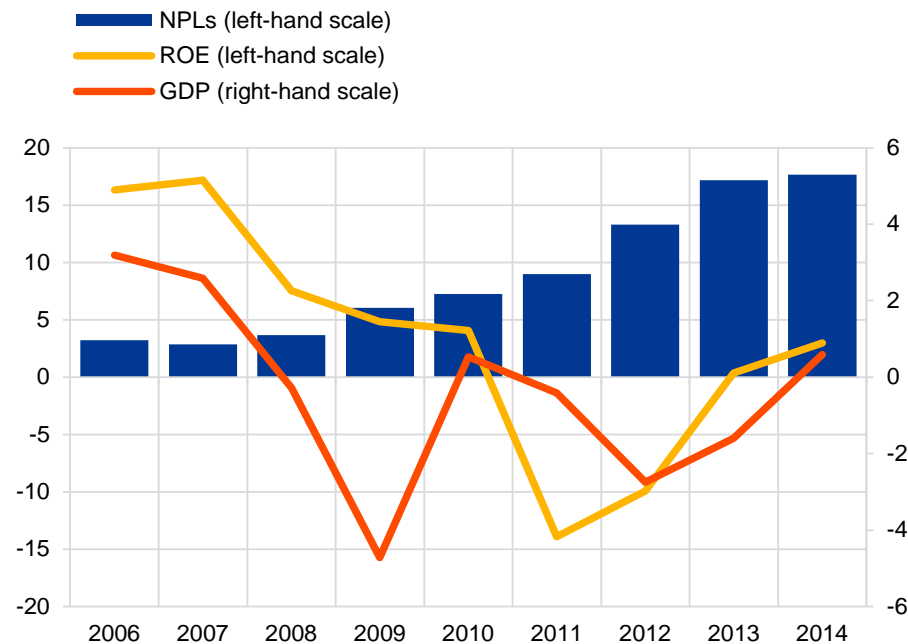


Sources: SNL Financial, Eurostat and ECB calculations.

Note: Return on equity (ROE), non-performing loans (NPLs) and GDP growth in non-vulnerable countries. Euro area countries excluding Spain, Italy, Portugal, Greece, Cyprus and Slovenia.

...while the cyclical downturn in certain areas has contributed to a high outstanding stock of non-performing assets

(2006 – 2014; annual percentage changes (GDP); median NPLs as a share of total loans, median ROE, vulnerable countries)



Sources: SNL Financial, Eurostat and ECB calculations.

Note: Return on equity (ROE), non-performing loans (NPLs) and GDP growth in vulnerable countries. Vulnerable countries: Spain, Italy, Portugal, Greece, Cyprus and Slovenia.

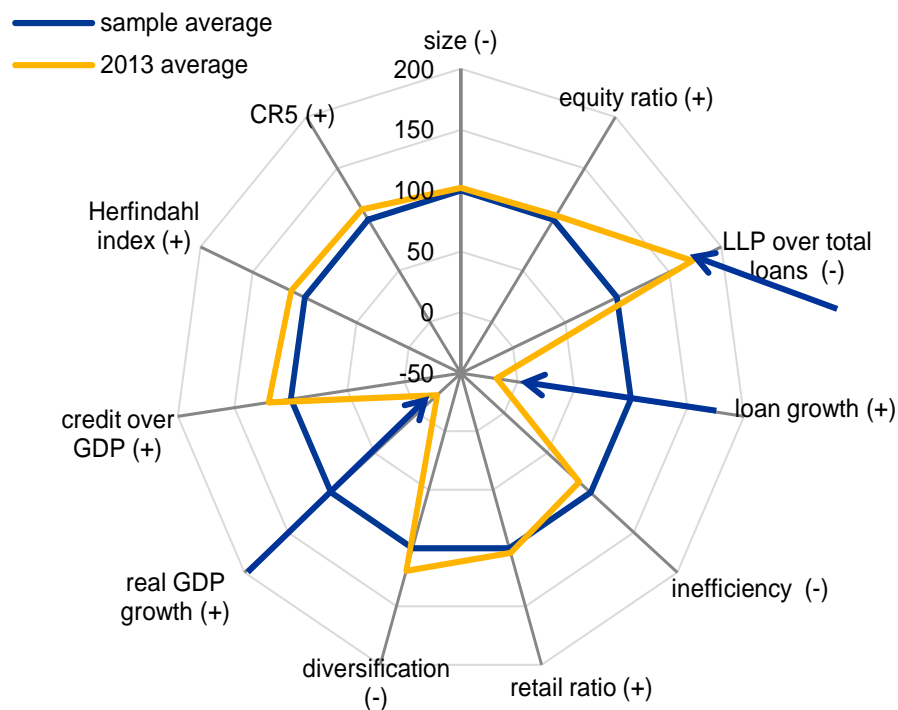
Main risks and vulnerabilities

Risk 2 - Weak profitability prospects for banks and insurers in a low nominal growth environment, amid slow progress in resolving problem assets



Currently, EU bank profitability is mainly being suppressed by weak cyclical factors ...

(1994 – 2013; ratios and percentages)

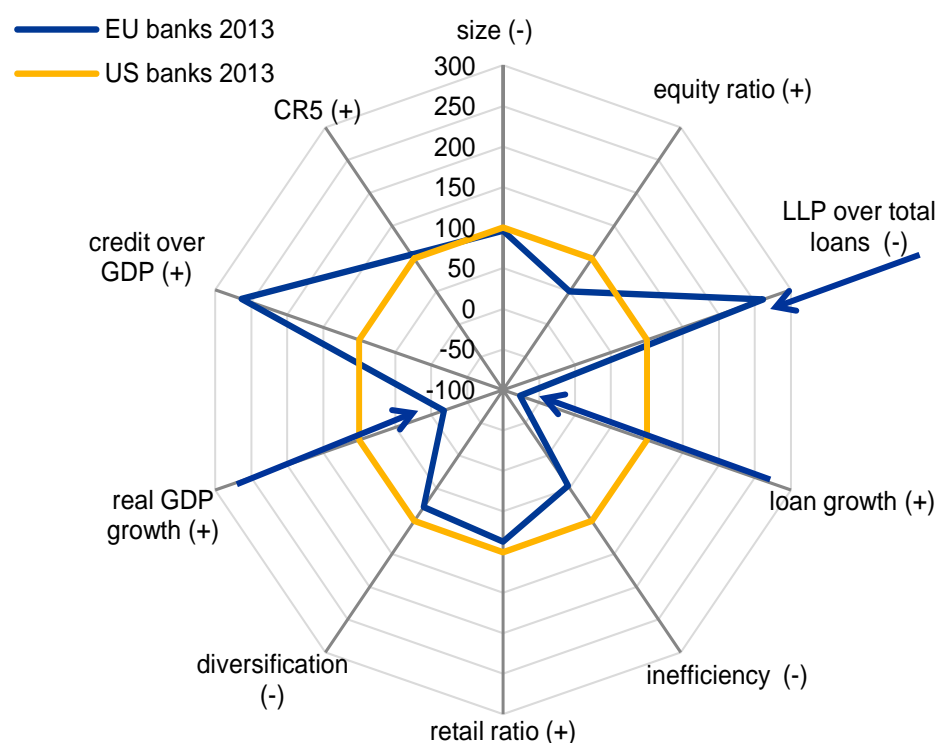


Sources: Bloomberg, Eurostat, SNL Financial and ECB calculations.

Notes: Current state of EU banks' profitability determinants against historical benchmarks (sample average). The historical averages have been normalised to 100. Current values of the indicators are measured in terms of deviations from historical averages.

The importance of cyclical developments for EU bank profitability is confirmed when comparing it with that of their US peers

(end-2013; ratios and percentages)



Sources: Bloomberg, Eurostat, SNL Financial and ECB calculations.

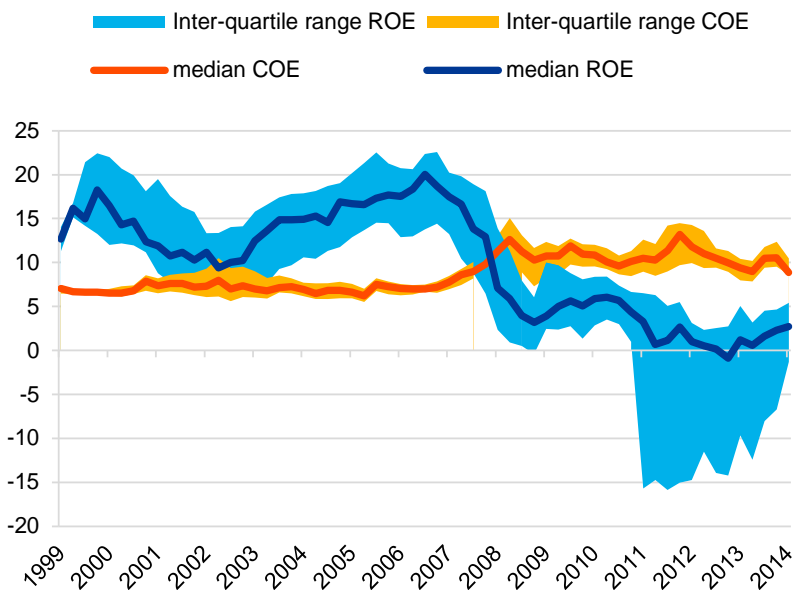
Notes: Current state of EU banks' profitability determinants against their US peers (US measures normalised to 100). The US-based indicators have been normalised to 100. Current values of the EU-based indicators are measured in terms of deviations from the US indicators. 24 large US banks are considered.

Main risks and vulnerabilities

Risk 2 - Weak profitability prospects for banks and insurers in a low nominal growth environment, amid slow progress in resolving problem assets



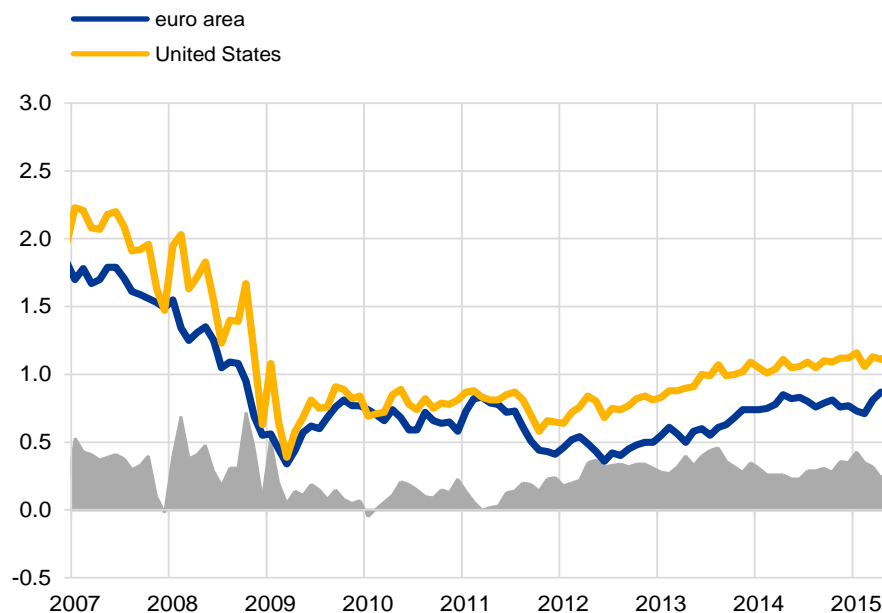
Still substantial gap between euro area banks' cost of equity and the return on equity (Q1 1999 - Q4 2014)



Sources: Bloomberg, Thomson Reuters, Consensus and ECB calculations.

Note: Cost of equity (COE) and return on equity (ROE) for a large sample of listed euro area banks. Based on the sample of 33 euro area banks included in the Euro STOXX index.

Slightly higher valuations of euro area banks in 2015, but they still trade at a discount vis-à-vis their US peers (Jan. 2007– May 2015, grey shaded area represents the difference between United States and the euro area)



Source: Thomson Reuters Datastream.

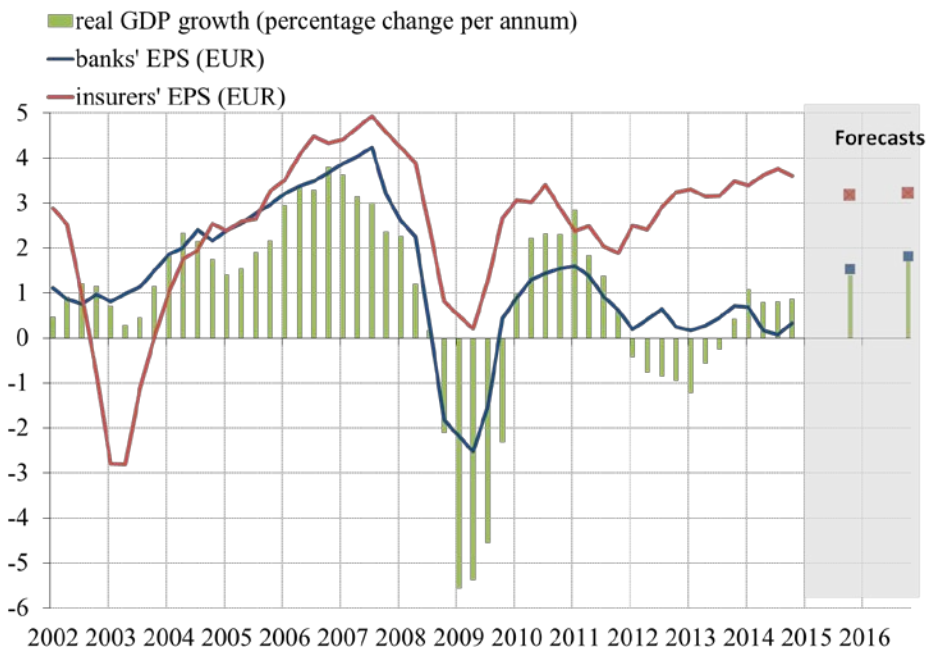
Note: Price-to-book ratio for euro area and US banks

Main risks and vulnerabilities

Risk 2 - Weak profitability prospects for banks and **insurers** in a low nominal growth environment, amid slow progress in resolving problem assets

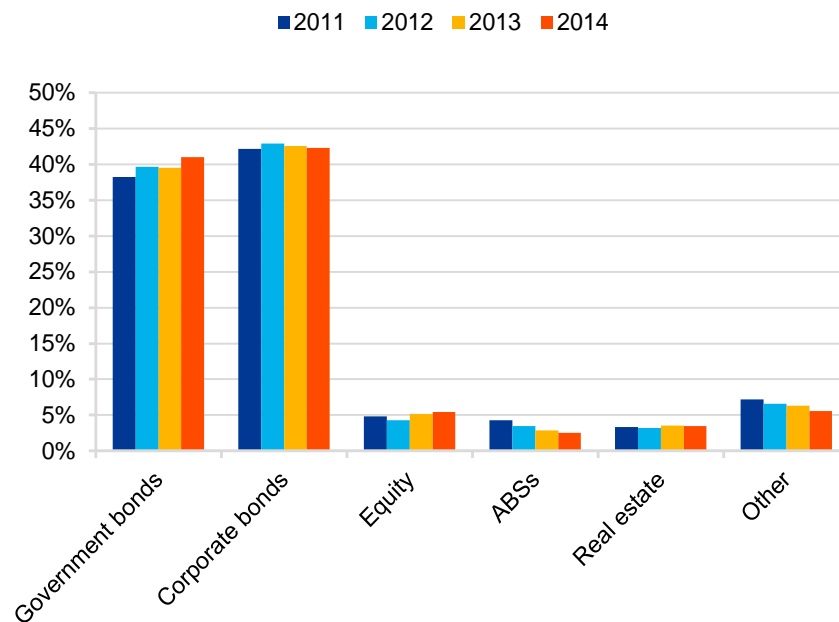


Despite the challenging environment, market-based indicators suggest a stable outlook for euro area **insurers**
(Q1 2002 – 2016)



Sources: Thomson Reuters, Datastream, ECB and ECB calculations.

Insurance companies' investment portfolios still dominated by fixed income securities
(2011 – 2014; percentage of total investments; weighted averages)

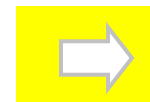


Sources: JPMorgan Cazenove, individual institutions' financial reports and ECB calculations.

Note: Based on available data for 15 large euro area insurers and reinsurers.

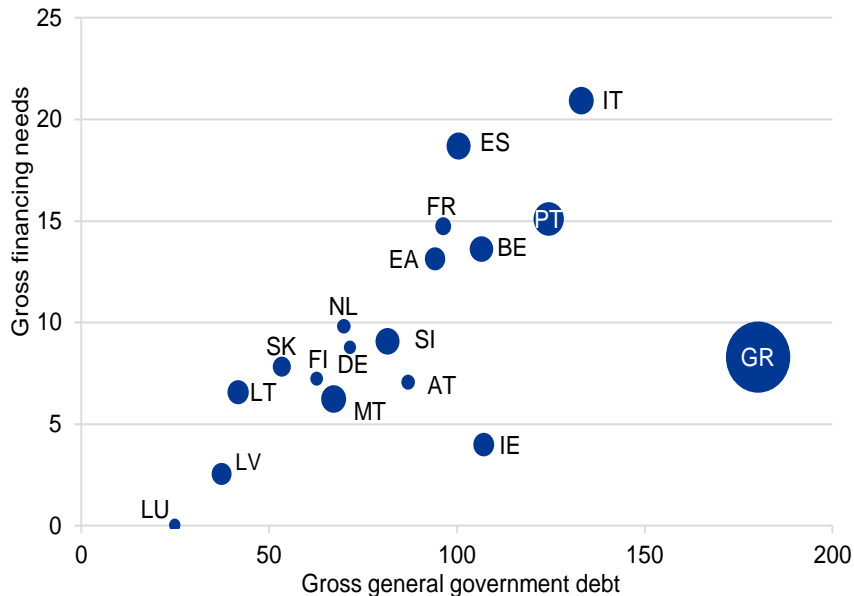
Main risks and vulnerabilities

Risk 3 - Rise of debt sustainability concerns in the sovereign and corporate sectors amid low nominal growth



2015 financing needs are substantial for several euro area countries

(2015; percentage of GDP; percentages)

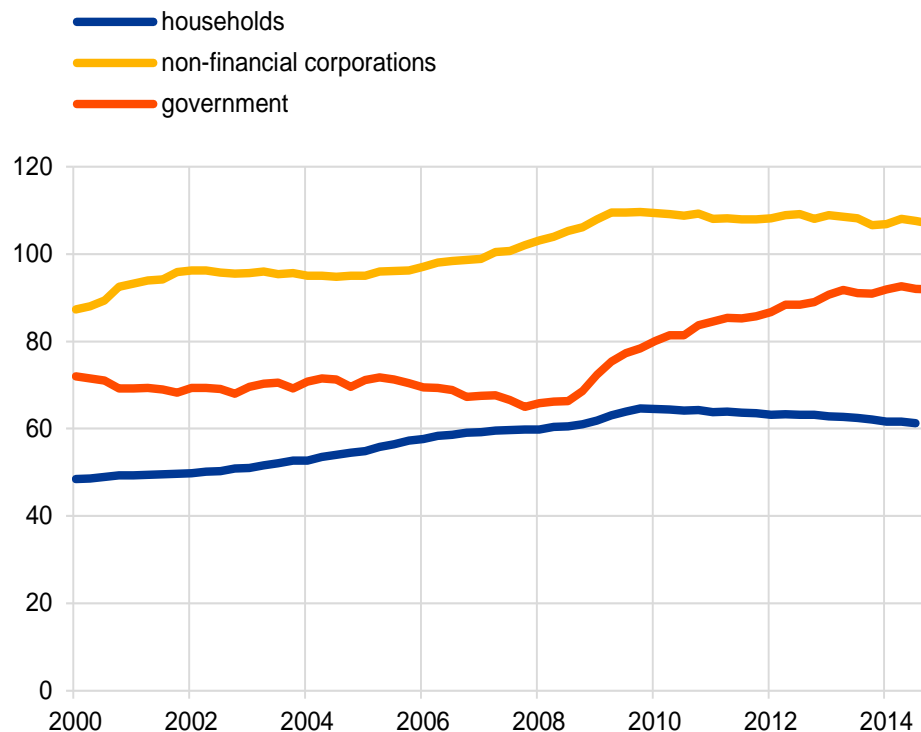


Sources: European Commission and Bloomberg.

Note: The size of the bubble reflects the 2015 year-to-date average ten-year government bond yield.

Euro area debt remains elevated also in the private sector

(2000 – 2014; Debt as a percentage of GDP)



Sources: Eurostat and ECB.

Notes: Based on ESA 2010 standards, except for general government debt from Q1 2000 to Q4 2005, for which the ESA 1995 has been used. Non-financial corporate debt is unconsolidated, comprising loans (incl. intra-sectoral loans), debt securities and pension reserves. For the household sector, the series ends in Q3 2014; for the remaining series, the last data points are for Q4 2014.

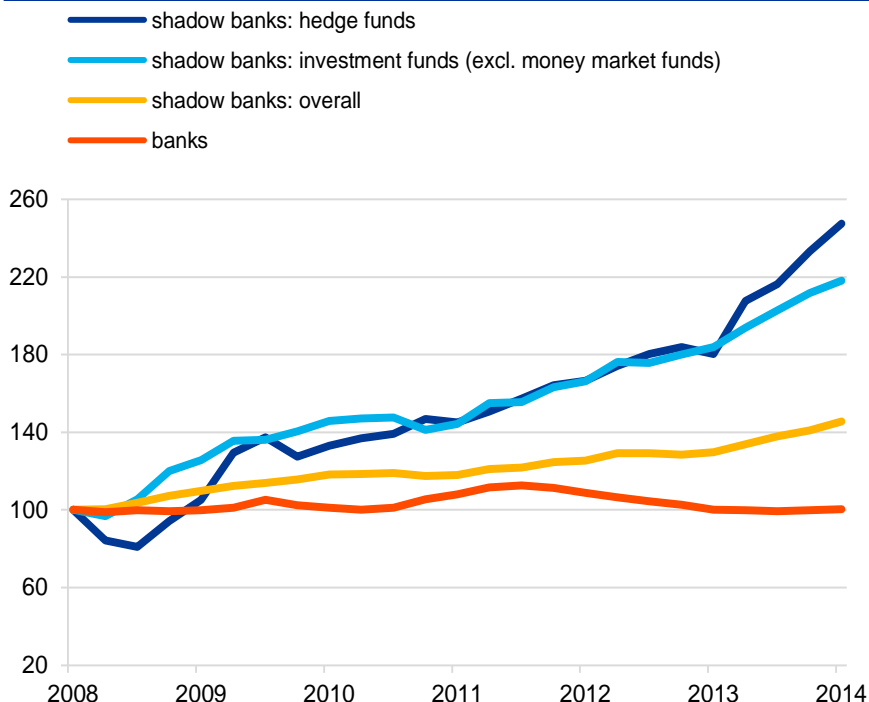
Main risks and vulnerabilities

Risk 4 - Prospective stress and contagion effects in a rapidly growing shadow banking sector



Steady increase in the euro shadow banking sector suggests that vulnerabilities are likely to have been growing more in this segment

(Q4 2008 – Q4 2014; index: Q4 2008 = 100)

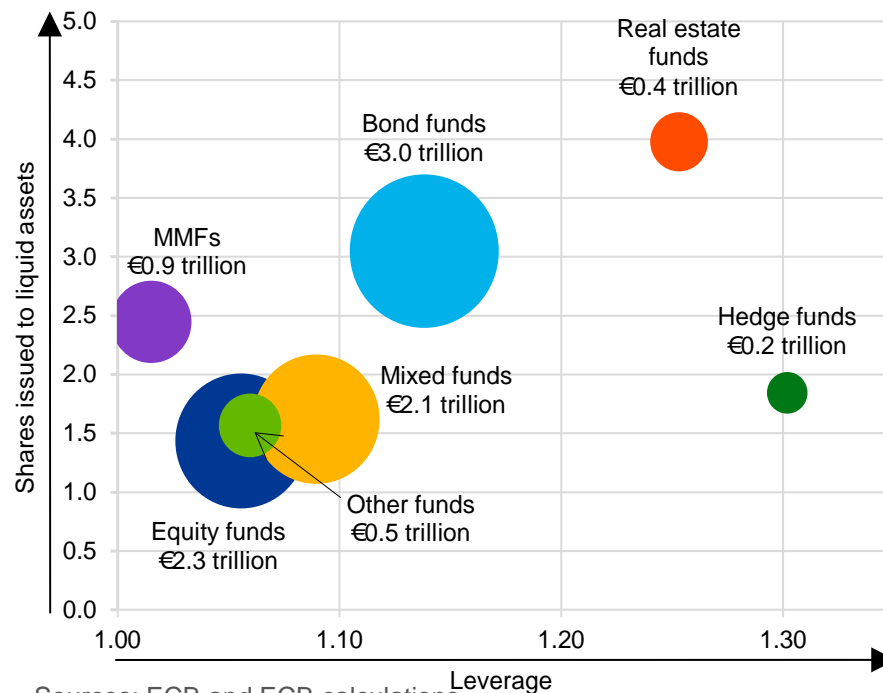


Sources: ECB and ECB calculations.

Note: Assets of selected euro area financial sectors

Bond and real estate funds most likely to amplify shocks and impose externalities on the system

(Data as of Q4-2014), x-axis: Leverage (total assets / shares and units issued), y-axis: Liquidity mismatch (shares and units issued / liquid assets)



Sources: ECB and ECB calculations.

Note: Liquidity mismatch and leverage among euro area money market and investment funds. Bubble size: total assets in EUR trillions

- **Euro area systemic stress contained but with vulnerabilities**
 - Downside risks to economic growth have receded ...
 - ... and asset prices have increased over the past six months but still without generalised overvaluations...
 - ... while lower-than-average turnover ratios and deal sizes imply high price sensitivity to market shocks
 - Market-intermediated credit rather abundant and available on rather generous terms
- **Several policy challenges**
 - The need for a strict focus of the ECB's monetary policy on its price stability mandate, together with country and sector challenges, suggests a strong role for macroprudential policy in dealing with any systemic risk related to potential asset price imbalances
 - Further initiatives needed to monitor and assess vulnerabilities in the growing shadow banking sector
 - Banks' balance sheets strengthened further but combination of cyclical and structural challenges to profitability needs to be tackled
 - Public and private debt ratios still high and in need of correction with potential sustainability challenges if higher nominal growth not sustained