EUROPEAN CENTRAL BANK

EUROSYSTEM

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ECB Financial Stability Review

November 2015

25 November 2015

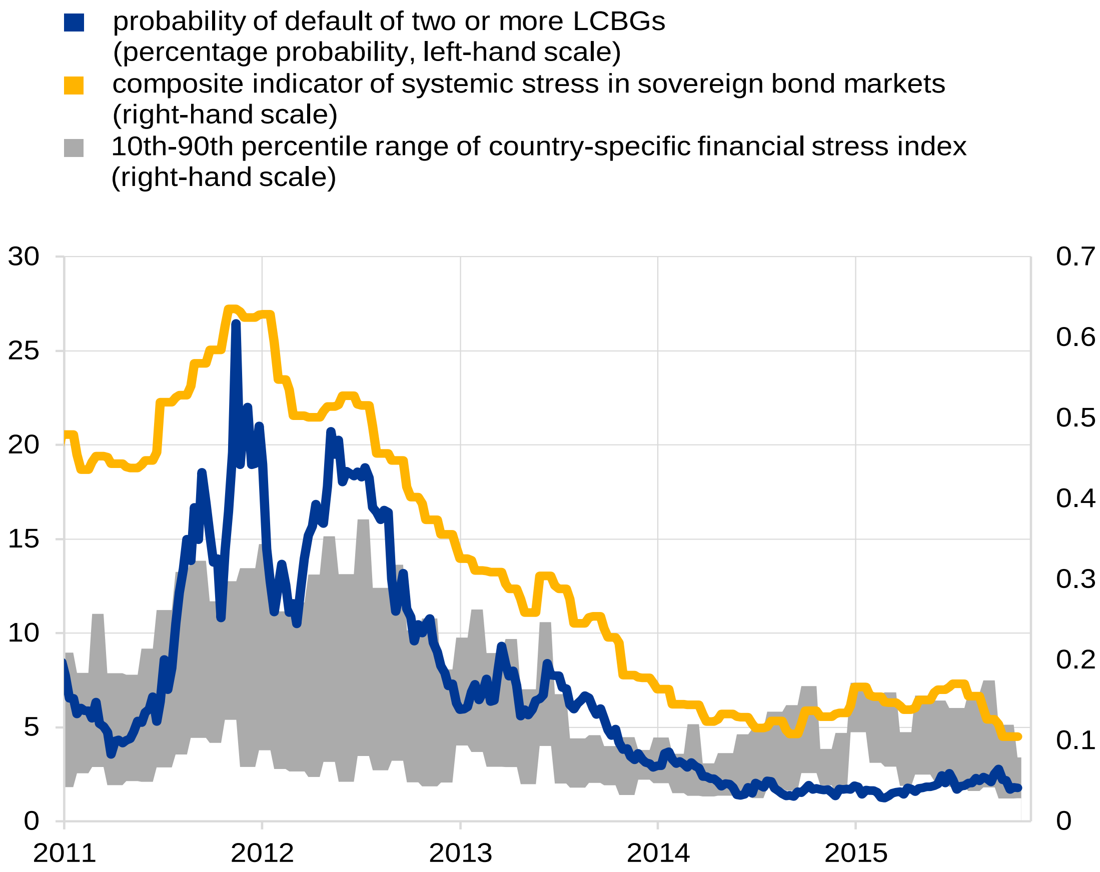
Press Conference

Key developments since the last FSR

- General low level of **systemic risk** in the euro area, as shown by aggregate indicators and the position in the financial cycle.
- Main risks associated with **possible reversal of risk premia**, affecting bond and equity prices, triggered by a US rate increase, the vulnerability of emerging markets and the prospects of low nominal growth in the euro area. So far, there are limited signs of broad-based stretched **asset valuations in the euro area.**
- **Bank profitability still weak,** in a low interest rate environment combined with a large stock of non-performing loans in certain countries. Banks improved their capital positions, and proved resilient to shocks to financial conditions**.** **Insurance companies** with significant challenges regarding future profitability.
- **Indebtedness** remains elevated across public and private sectors acting as a brake on growth and continued some debt sustainability concerns.
- **Non-bank market-based finance** continued to grow with possible challenges resulting from liquidity risks amid signs of increased maturity transformation and signs that the **asset management industry** are taking on more risk.

Financial stress index, composite indicator of sovereign systemic stress and the probability of default of two or more banking groups

(Jan. 2011 – Nov. 2015)



Sources: Bloomberg and ECB calculations.

Notes: "Probability of default of two or more LCBGs" refers to the probability of simultaneous defaults in the sample of 15 large and complex banking groups (LCBGs) over a one-year horizon. The financial stress index measures stress in financial markets at the country level based on three market segments (equity, bonds and foreign exchange) and the cross-correlation among them. For details, see Duprey, T., Klaus, B. and Peltonen, T., "Dating systemic financial stress episodes in the EU countries", Working Paper Series, ECB (forthcoming). For details of the composite indicator of sovereign systemic stress, see Section 1.2. in the FSR

- Bouts of volatility during summer months related to difficulties surrounding the negotiations in Greece and the correction in Chinese stock prices
- Overall bank, fiscal and financial stress has remained contained in the euro area (and countries)

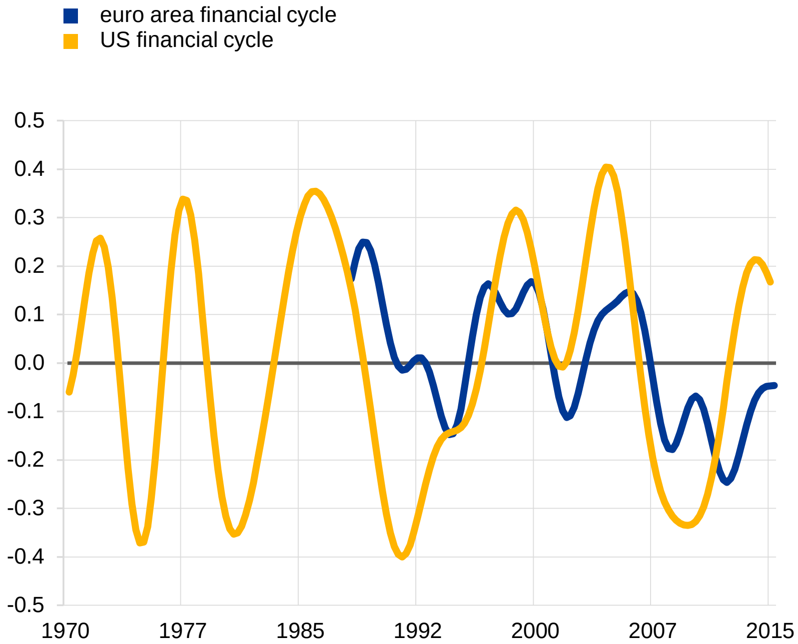
RISK 1

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

Risk 1: Financial cycle estimates for the euro area do not signal a credit-driven asset price boom

Financial cycles in the euro area and the United States

(Q1 1970 – Q2 2015, euro area series starts in Q2 1987, normalised deviation from historical median)

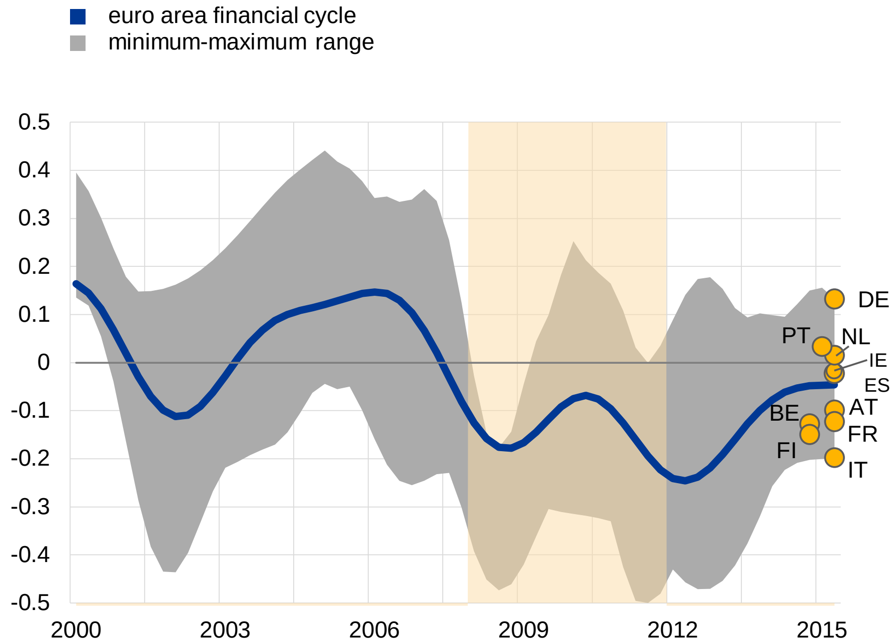


Sources: Bloomberg and ECB calculations

Note: The financial cycle is an indicator which captures common cyclical movements in credit and asset prices (total credit, residential property prices, equity prices, and bond prices). See Schüler, Y., Hiebert, P. and Peltonen, T.,, "Characterising the financial cycle: A multivariate and time-varying approach," ECB Working Paper No1846, ECB 2015.

Financial cycles across euro area countries

(Q1 2000 – Q2 2015; normalised deviation from historical median)



Sources: Bloomberg and ECB calculations.

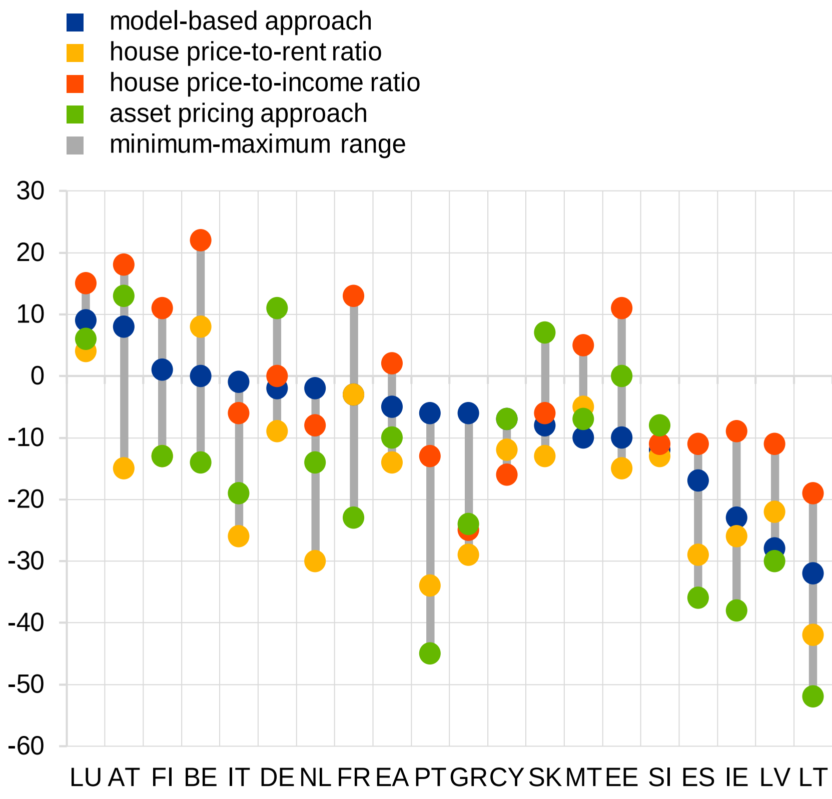
Notes: See Schüler, Y., Hiebert, P. and Peltonen, T., "Characterising the financial cycle: a multivariate and time-varying approach", Working Paper Series, No 1846, ECB, 2015. The grey area marks the locations of financial cycles of ten euro area countries (AT, BE, DE, ES, FI, FR, IE, IT, NL and PT). The yellow area indicates times of financial turmoil (Q1 2008 – Q4 2011). Figures for BE and FI refer to Q4 2014, while figures for PT refer to Q1 2015.

Risk 1: Strong differences in property market conditions across the euro area

A new model-based valuations metric for residential property markets – Box 3

Residential property price valuations for euro area countries

(Q2 2015, percentages; deviation from long-term averages or model-based equilibria of indicators)



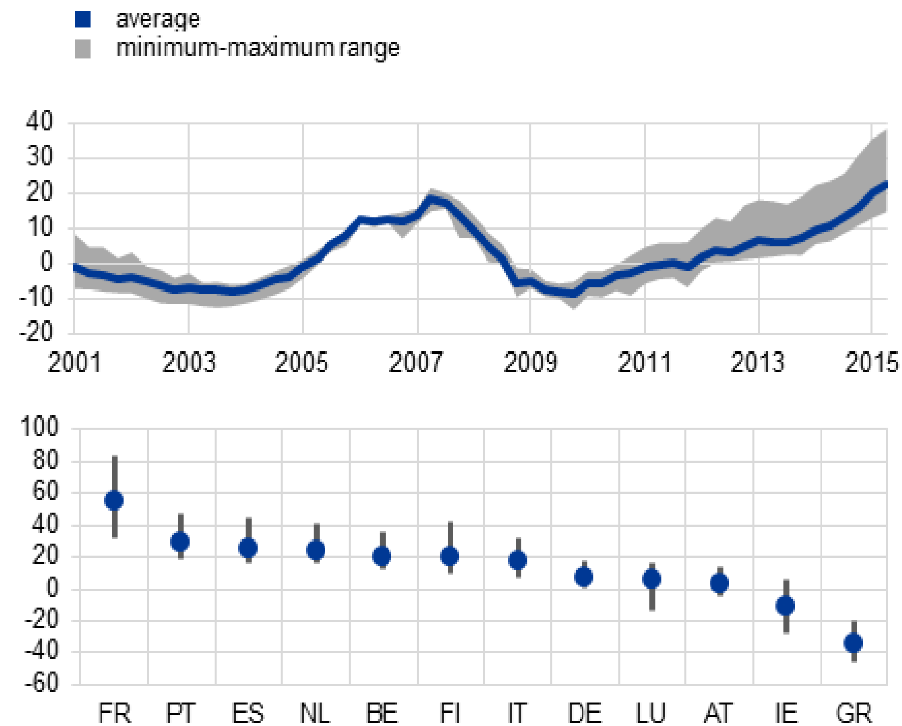
Sources: Eurostat and ECB calculations.

Notes: For methodological details on the two statistical indicators and the asset pricing approach, see Box 3 in Financial Stability Review, ECB, June 2011, while for more details on the model-based approach see Box 3 in Financial Stability Review, ECB, November 2015.

Valuation estimates of prime commercial property at the euro area and country levels

(Q1 2001 – Q2 2015; percentages; distribution across valuation estimates)

(Q2 2015; percentages; distribution across valuation estimates)



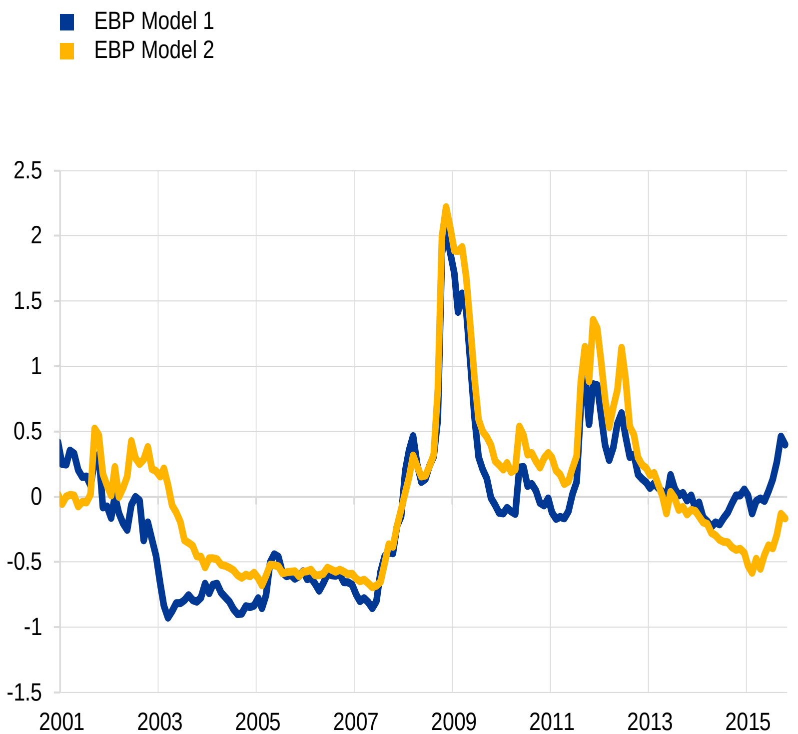
Sources: Jones Lang Lasalle and ECB calculations.
Note: For details on valuation estimates for prime commercial property, see Box 6 in Financial Stability Review, ECB, December 2011.

Risk 1: No general overvaluation of corporate bonds and equities

The increase in spreads has brought valuations within the range of fairly priced to slightly under-priced

Euro area non-financial corporations' excess bond premium

(Jan. 2001 – Oct. 2015; percentage points)



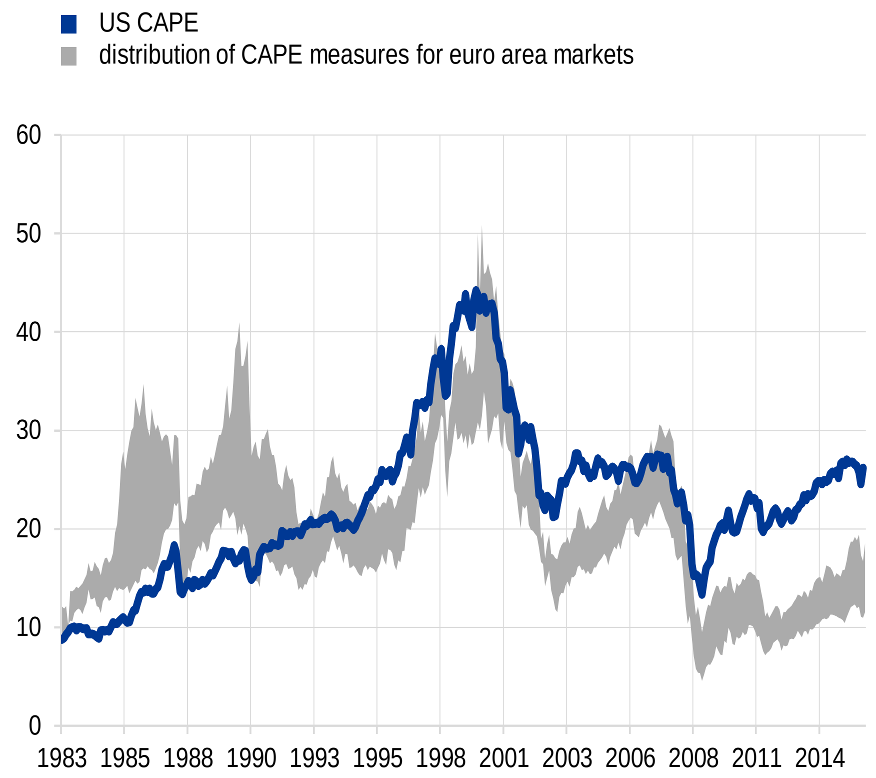
Sources: Bloomberg, Merrill Lynch and ECB calculations.

Notes: The excess bond premium (EBP) is the aggregate mean of the deviation of credit spreads from measures of credit risk and liquidity risk at individual bond level, taken from the Merrill Lynch EMU corporate bond indices for non-financial corporations. See further details in FSR, Chart 2.11.

Despite significant price corrections, CAPE measures still signal some overvaluation in US equities but not in euro area equities

Cyclically adjusted price/earnings ratio for euro area and US stock markets

(Jan. 1983 – Nov. 2015; grey area represents the 25th-75th percentiles)



Sources: Thomson Reuters Datastream, Robert Shiller's homepage (http://www.econ.yale.edu/~shiller/data.htm) and ECB calculations.
Notes: The cyclically adjusted price/earnings (CAPE) ratio for the euro area is imputed from Datastream's stock market indices. The US CAPE is taken from Robert Shiller's homepage

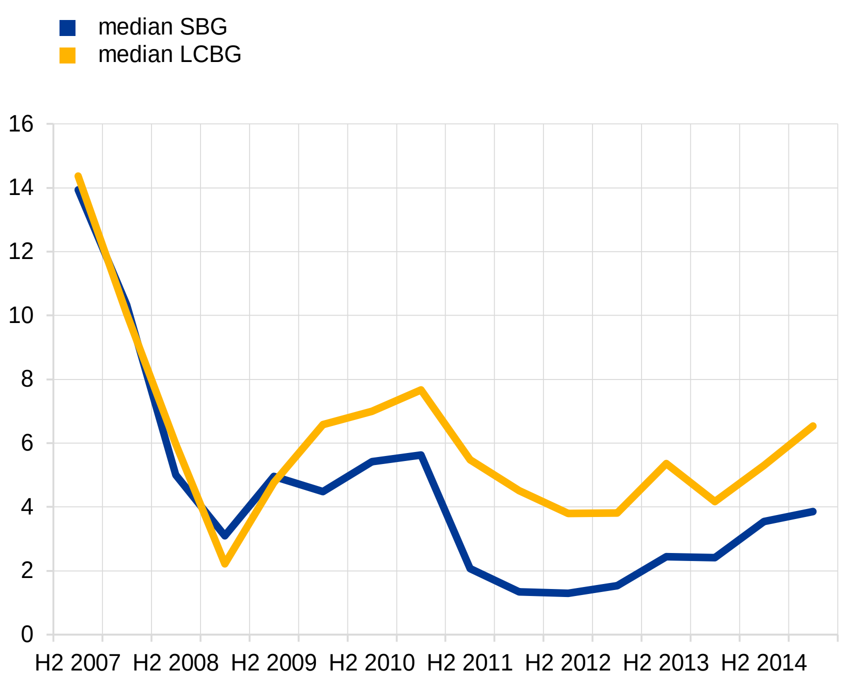
RISK 2

Weak profitability prospects for banks and insurers in a low nominal growth environment, amid incomplete balance sheet adjustments

Risk 2: Bank’s profitability showed improvement in the first half of 2015

Return on equity for euro area significant banking groups

(H2 2007 – H1 2015; percentages; median values)

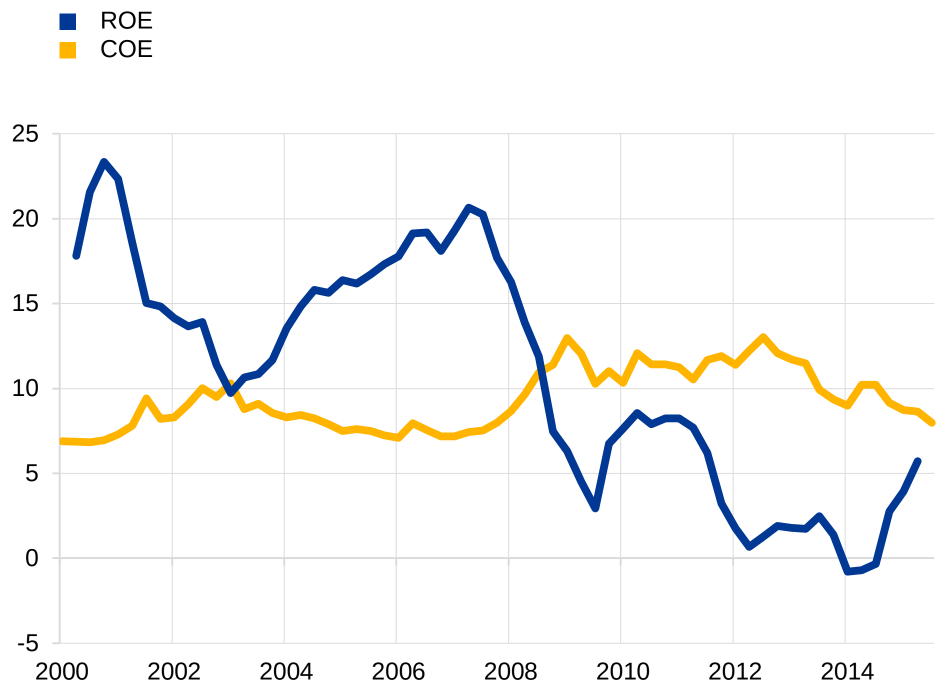


Source: SNL Financial.

Notes: Based on publicly available data on significant banking groups. Two-period moving averages.

Return on equity and cost of equity for listed euro area banks

(Q1 2000 – Q3 2015; percentages)



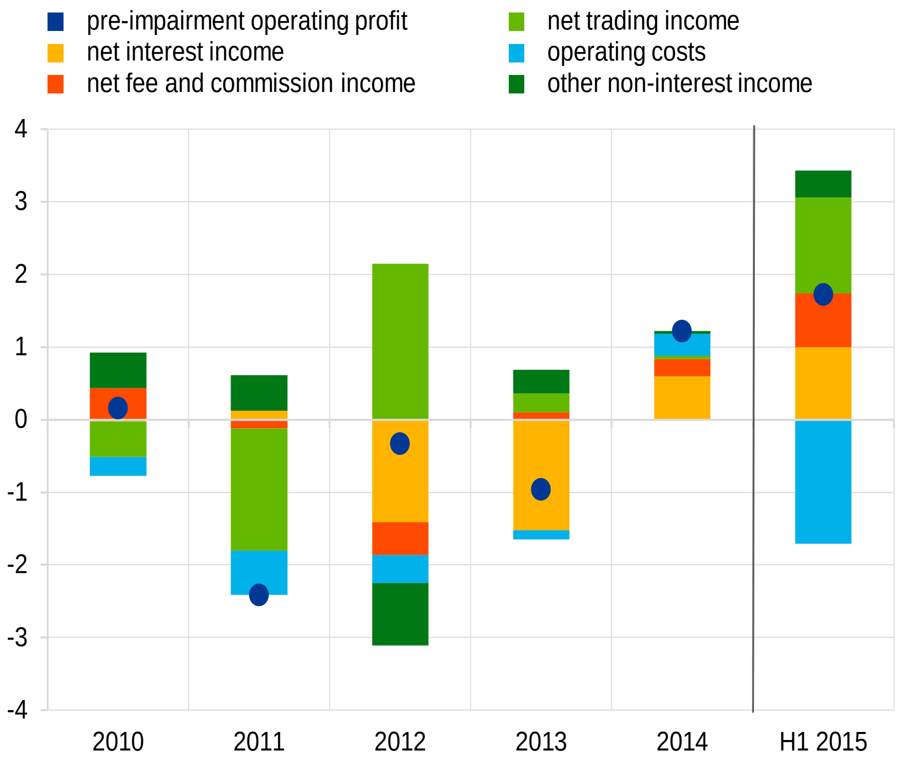
Sources: Bloomberg, Thomson Reuters Datastream, Consensus Economics and ECB calculations.

Notes: Based on the sample of all 33 euro area banks included in the EURO STOXX index. For further information, see Chart 3.3 in Section 3.

Risk 2: Banks' net interest margins remained low but capital ratios improved

Contribution of main operating profit components to the change in euro area significant banking groups' return on equity

(2010 – H1 2015; percentage points)



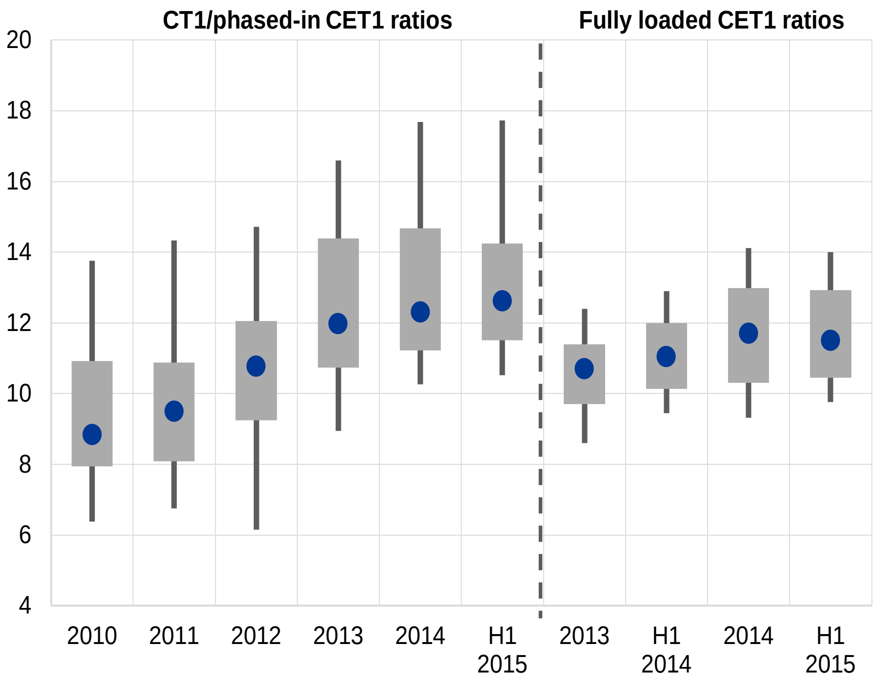
Source: SNL Financial.

Notes: Based on aggregate data for 69 significant banking groups. H1 2015 changes are based on annualised values.

Solvency ratios improved on a phased-in CET1 basis, but remained broadly stable on a fully loaded basis

Core Tier 1/common equity Tier 1 capital ratios of significant banking groups in the euro area

(2010 – H1 2015; percentages; 10th and 90th percentiles, interquartile distribution and median)



Source: SNL Financial.

Notes: Based on publicly available data for a sample of 76 significant banking groups (phased-in CET1) and 55 significant banking groups (fully loaded CET1) respectively.

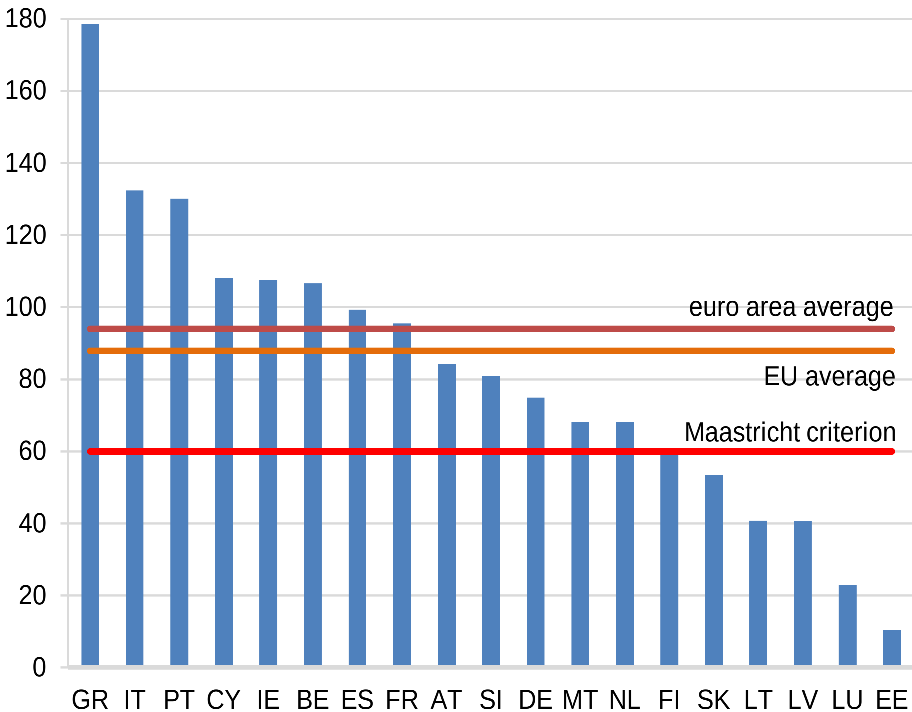
RISK 3

Rising debt sustainability concerns in the public and non-financial private sectors amid low nominal growth

Risk 3: Debt sustainability concerns remain elevated in the public sector

Public debt-to-GDP ratios in the euro area

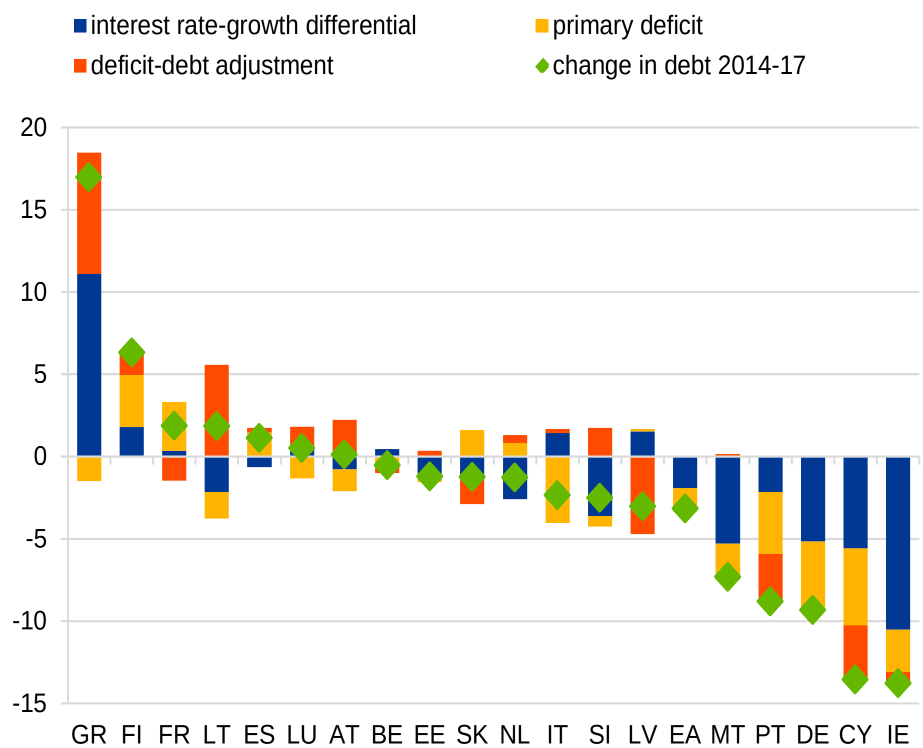
(2014; percentage of GDP)



Source: European Commission

Changes in public debt levels across euro area

(2014-2017; percentage points of GDP)

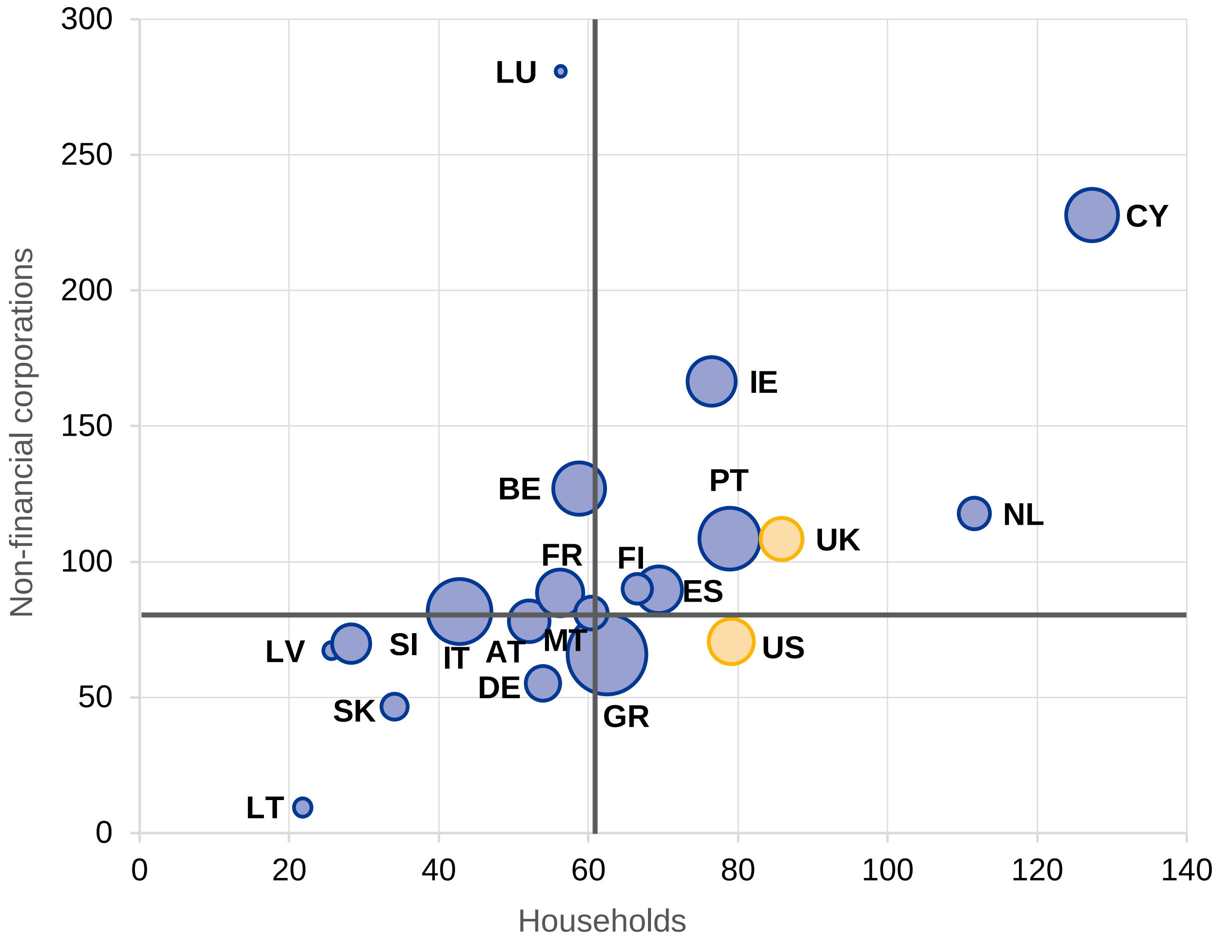


Source: European Commission's autumn 2015 economic forecast.

Note: For more details on the deficit-debt adjustment, see the article entitled "From government deficit to debt: bridging the gap", Monthly Bulletin, ECB, April 2007.

Risk 3: Debt sustainability concerns in public and non-financial private sectors

Non-financial corporate and household indebtedness in the euro area
(Q2 2015; percentage of GDP)



- Still elevated public and non-financial private sector debt levels
- Insufficient progress in deleveraging in several countries

Sources: European Commission and ECB.

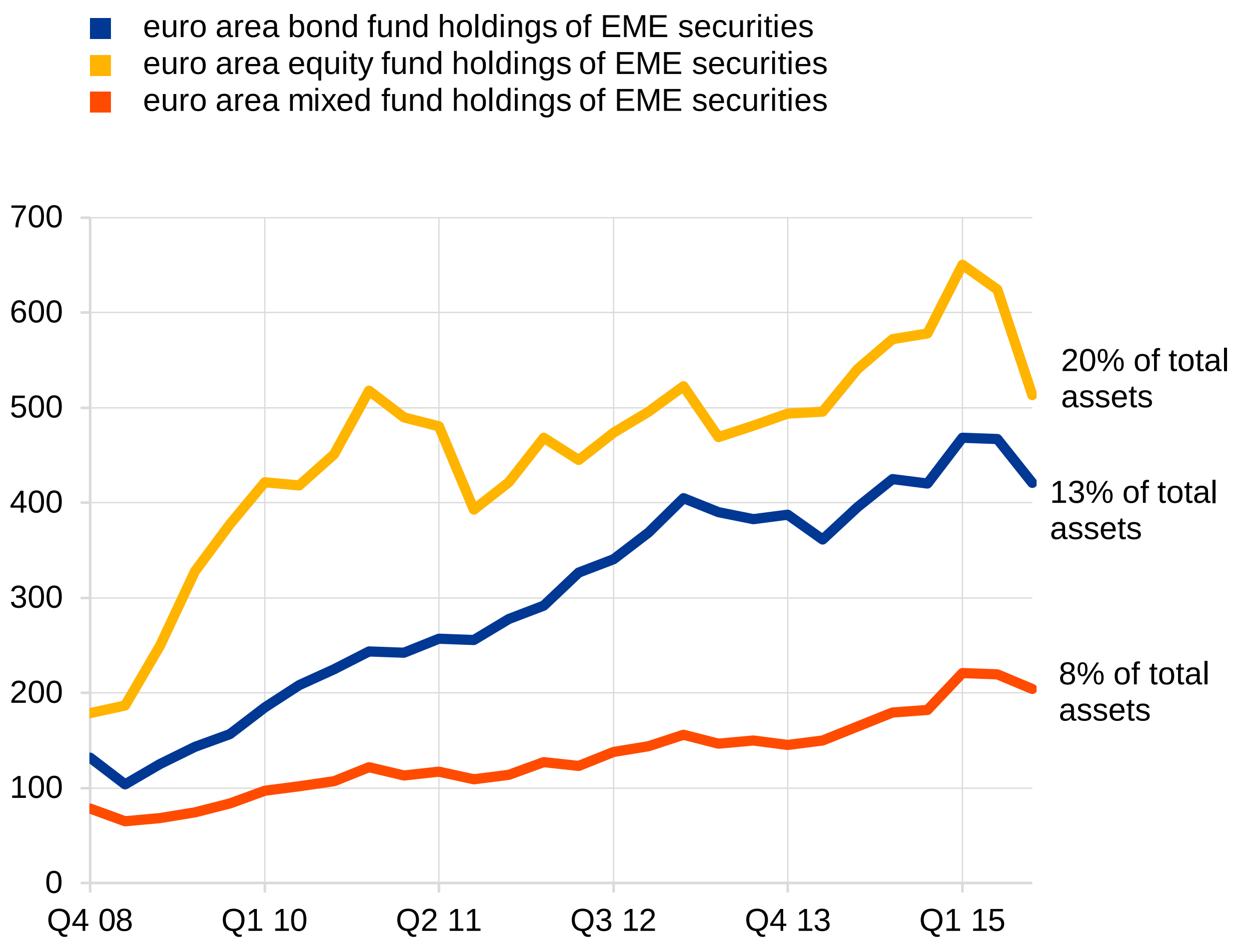
Notes: The size of the bubble reflects the indebtedness of the general government. Data on non-financial corporations are consolidated. The horizontal and vertical lines represent the euro area averages.

RISK 4

Prospective stress in a rapidly growing shadow banking sector, amplified by spillovers and liquidity risk

Risk 4: Euro area investment funds have gradually increased their exposure to emerging markets

Euro area bond and equity funds' exposure to emerging markets
(Q4 2008 – Q3 2015; EUR billions)



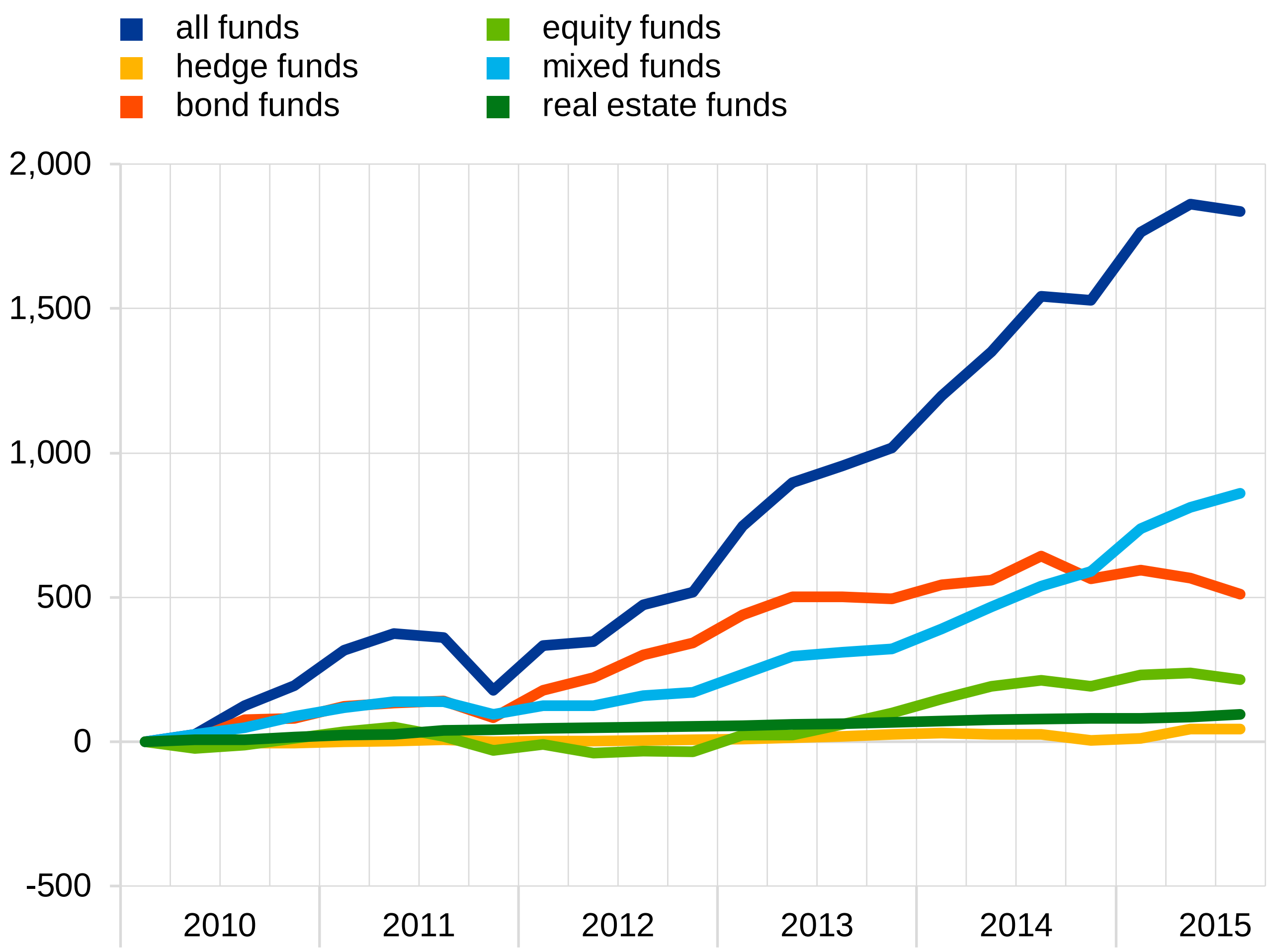
- Euro area investment funds have continued to increase their exposure to emerging markets over the few past years, although a decline in valuations and some outflows led to a reduction in exposures in the recent past

Source: ECB and ECB calculations.

Note: EME debt securities and shares are proxied by debt securities and shares issued in countries outside the European Union, the United States and Japan.

Risk 4: The shadow banking sector has continued to grow

Cumulated net flows into euro area investment funds
(Q1 2010 – Q3 2015; EUR billions)



- Net flows in euro area investment funds continued to be strong during the first half of 2015

Source: ECB and ECB calculations.