EUROPEAN CENTRAL BANK

EUROSYSTEM

May 2024
Financial Stability Review

Press briefing

16 May 2024

Euro area financial stability vulnerabilities have eased, but the outlook remains fragile

1. **A cohort of vulnerable households, corporates and sovereigns is being tested by rising debt service costs, while a property market downturn is challenging real estate firms.**

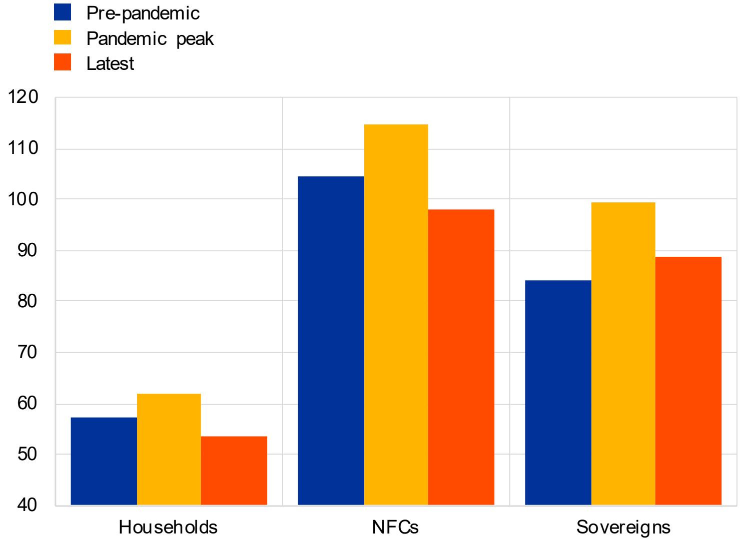
2. **Euro area banks have been a source of resilience, but low valuations suggest that current profitability may not be sustainable due to asset quality, funding and revenue headwinds.**

3. **Pricing-for-perfection in financial markets and non-bank liquidity fragilities are creating the potential for outsized market reactions to adverse shocks.**

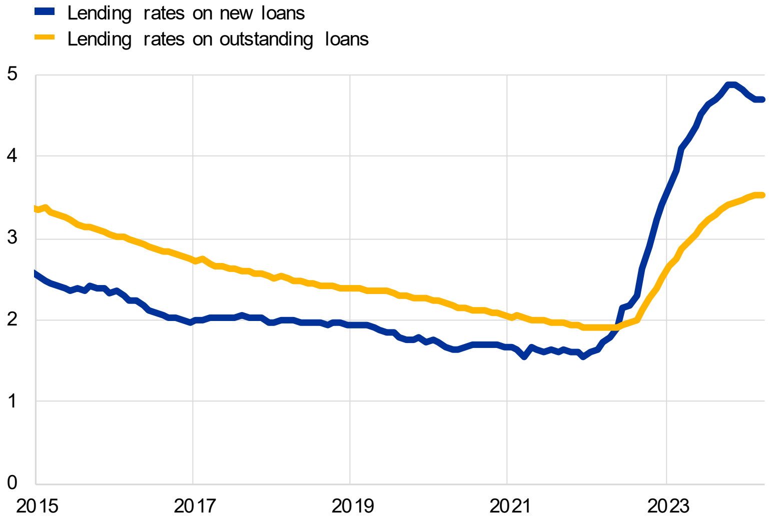
1st theme: *Vulnerable households, corporates and sovereigns tested by rising debt service costs*

- On average, non-financial sectors have remained resilient and seen their indebtedness decline, with only sovereign debt above pre-pandemic levels
- Debt service costs are likely to remain high and may continue creeping up for some, challenging vulnerable households, firms and sovereigns

Household, corporate and sovereign indebtedness
Percentages of GDP



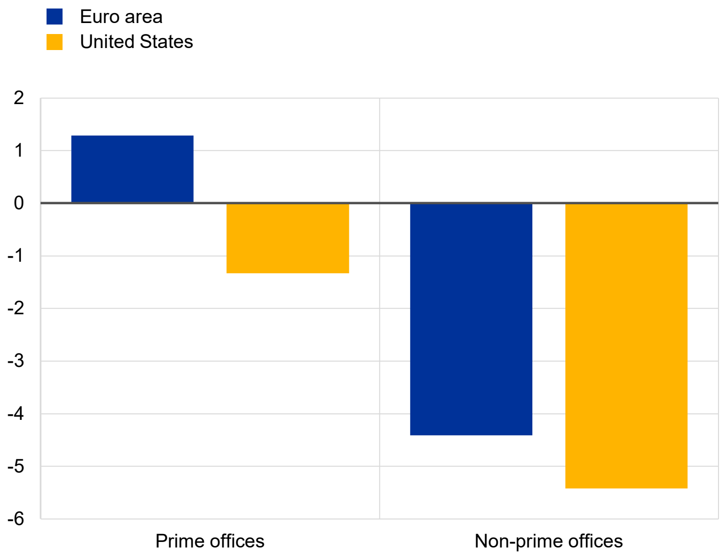
Lending rates to the euro area non-financial private sector
Jan. 2015-Mar. 2024, percentages



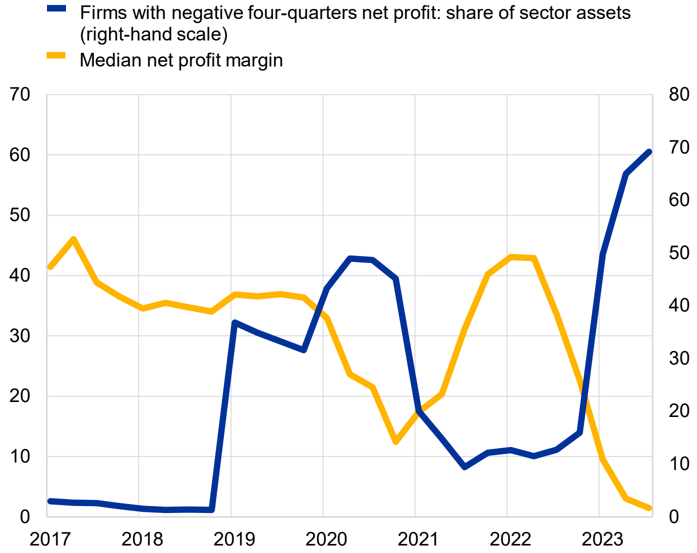
Sources: Eurostat and ECB (QSA), ECB (MFI, MIR) and ECB calculations.

- The outlook for commercial real estate markets continues to deteriorate…
- …with real estate firms facing increasing profitability pressure

Rent growth expectations for the office market over the next 12 months
Q4 2023, percentages



Median net profit margin and share of firms with negative net profit in the real estate sector
Q1 2017-Q3 2023, percentages

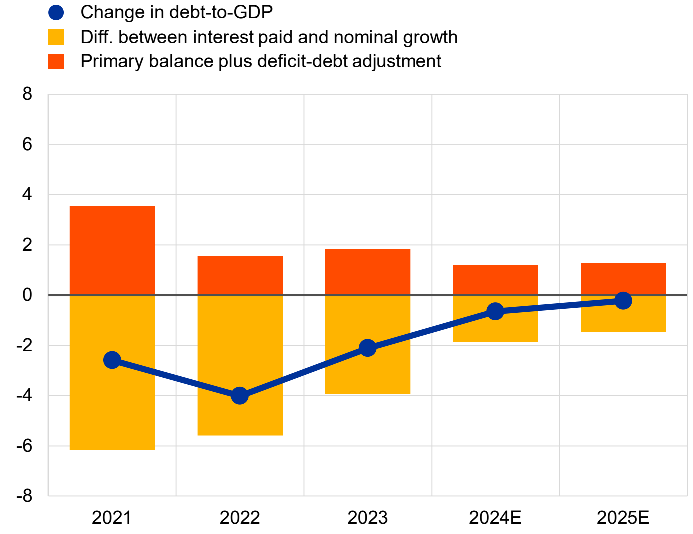


Sources: S&P Global Market Intelligence and ECB calculations.

- The drop in sovereign debt-to-GDP ratios has been driven by the post-pandemic recovery in nominal GDP
- Low growth potential and weak cyclically-adjusted primary balance imply that sovereign debt is likely to stabilise at higher levels than before the pandemic in several euro area countries

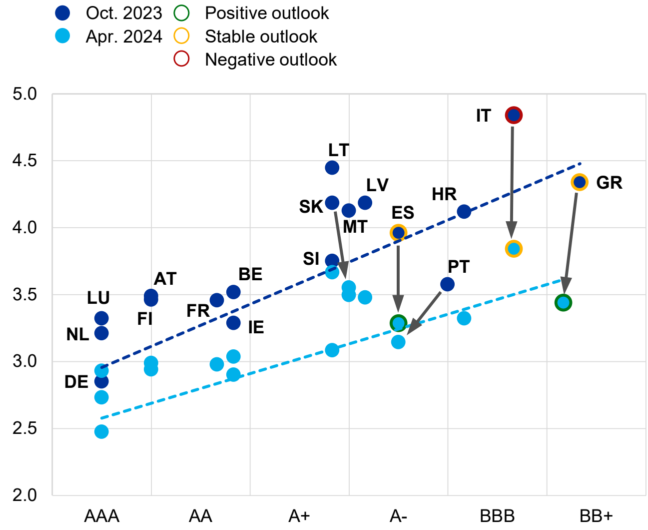
Changes in the euro area general government debt-to-GDP ratio and its drivers

2021-25, percentages of GDP and percentage point contributions



Ten-year government bond yields and sovereign credit ratings

31 Oct. 2023, 30 Apr. 2024, percentages, ratings



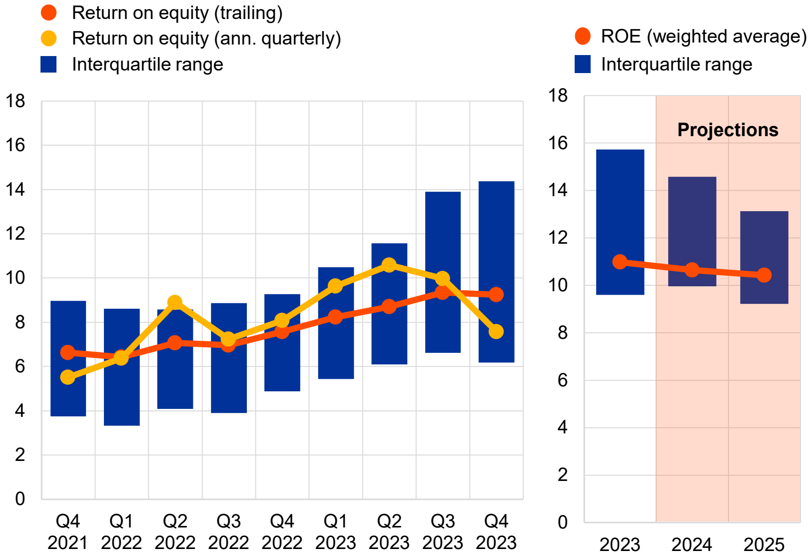
Sources: Bloomberg Finance L.P., LSEG, S&P, Moody's, Fitch Ratings and ECB calculations.

2nd theme: *Banks have remained resilient, but face headwinds from asset quality, funding and revenues*

- Decline in bank profits already visible in Q4 2023 (q-o-q), with mild additional declines expected
- Euro area bank valuations generally remain below those of international peers

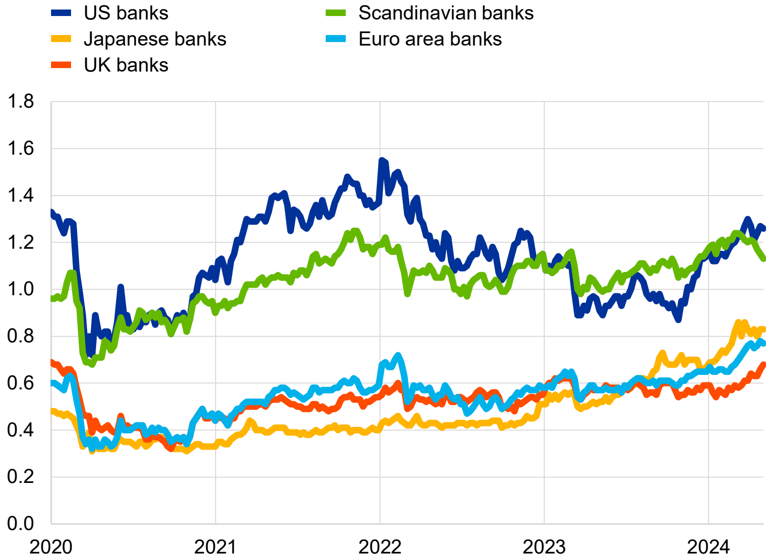
ROE and ROE outlook based on analyst expectations

Q4 2021-Q4 2023, percentages



Price-to-book ratios of euro area banks and global peers

3 Jan. 2020-3 May 2024, ratio

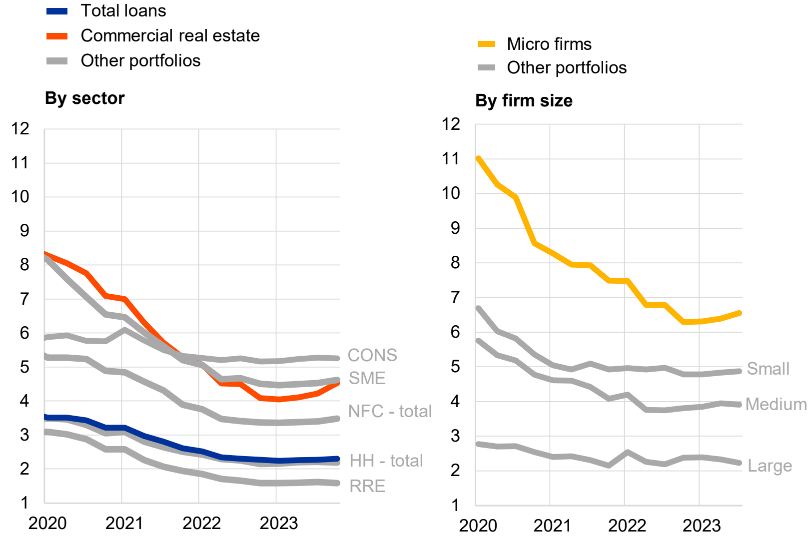


Sources: LSEG, Bloomberg Finance L.P. and ECB calculations.

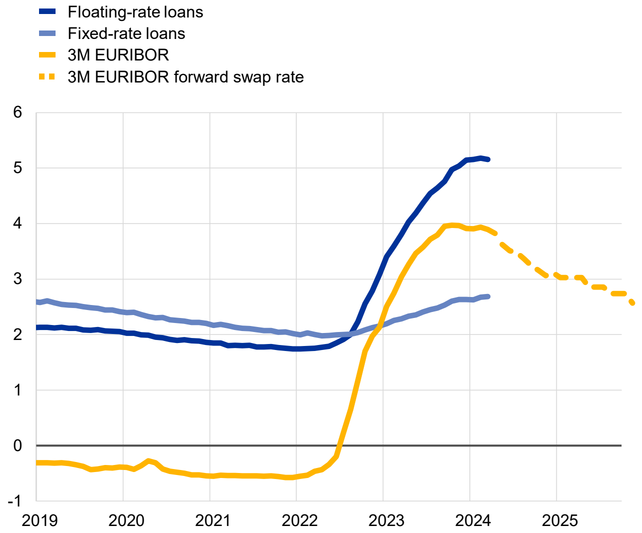
2nd theme: *Banks have remained resilient, but face headwinds from asset quality, funding and revenues*

- Weaker asset quality for commercial real estate loans, consumer credit and loans to micro firms
- Floating rate assets could turn into a headwind for interest income as market reference rates are expected to fall
- Funding costs likely to remain high as maturing liabilities reprice at higher levels and the composition of bank funding shifts towards a higher share of term deposits and bonds

NPL ratios by sector and corporate NPL ratios by firm size
Q1 2020-Q4 2023, percentages



Lending rates on loans to the non-financial private sector
Jan. 2019-Nov. 2025, percentages



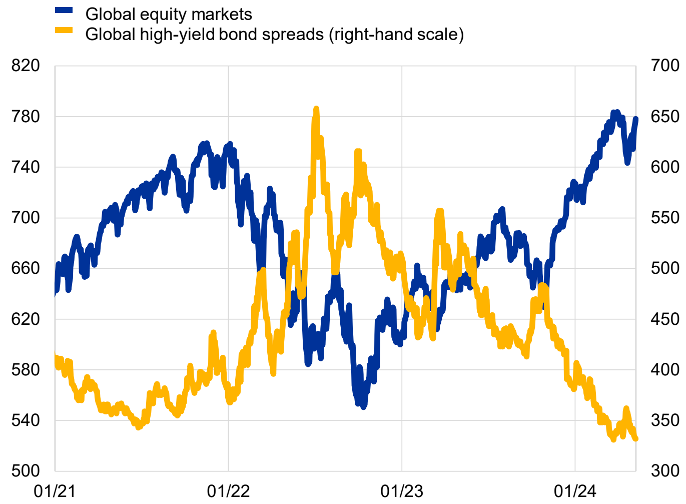
Sources: Bloomberg Finance L.P., ECB (MIR, BSI, AnaCredit) and ECB calculations.

3rd theme: *Risk of outsized financial market reactions to disappointing news*

- Stock markets close to record highs, high-yield corporate bond spreads near record lows
- A return of financial risk-taking, with particularly risky assets showing very strong performance

Global equity markets and high-yield corporate bond spreads

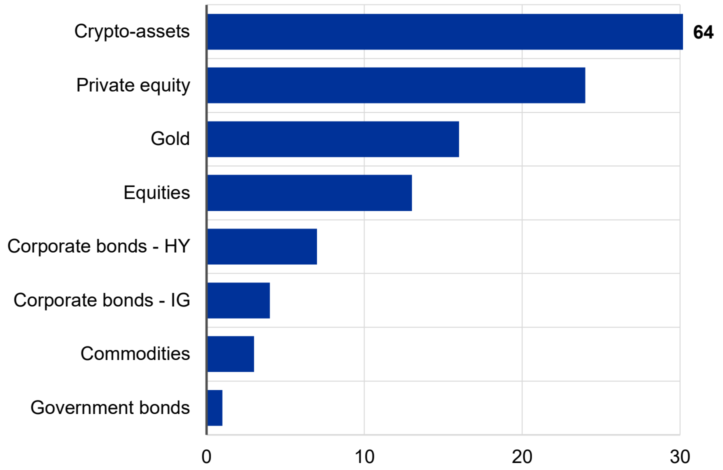
1 Jan. 2021-7 May 2024, index, basis points



Bloomberg Finance L.P.

Global asset class performance since the previous FSR was published

22 Nov. 2023-7 May 2024, percentages



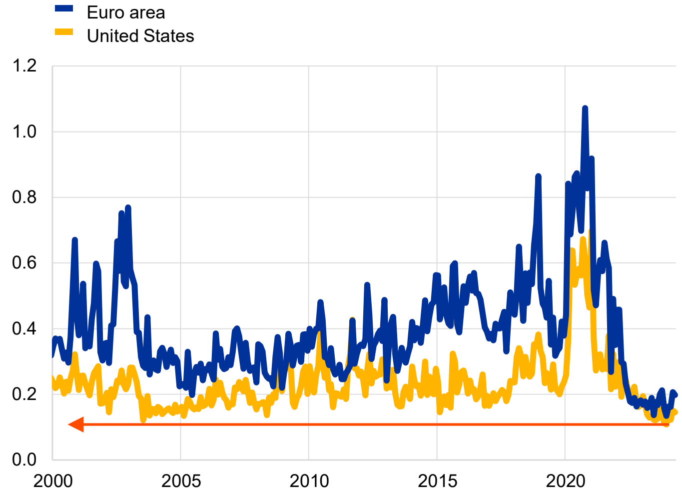
Sources: Bloomberg Finance L.P. and ECB calculations.

Risk of outsized financial market reactions to disappointing news

- Low volatility can lead to a substantial compression of risk premia
- …and incentivize additional risk-taking

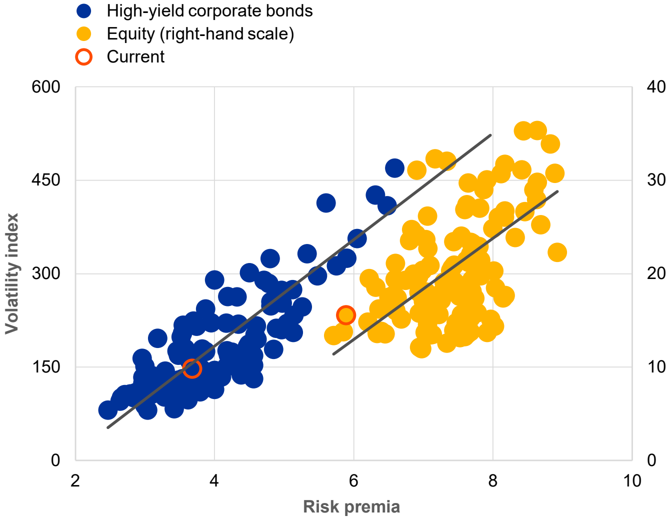
Implied equity market volatility relative to interest rate volatility

Jan. 2000-Apr. 2024, ratio



Risk premia versus implied volatility indices for euro area risky assets

Mar. 2014-Apr. 2024, percentages



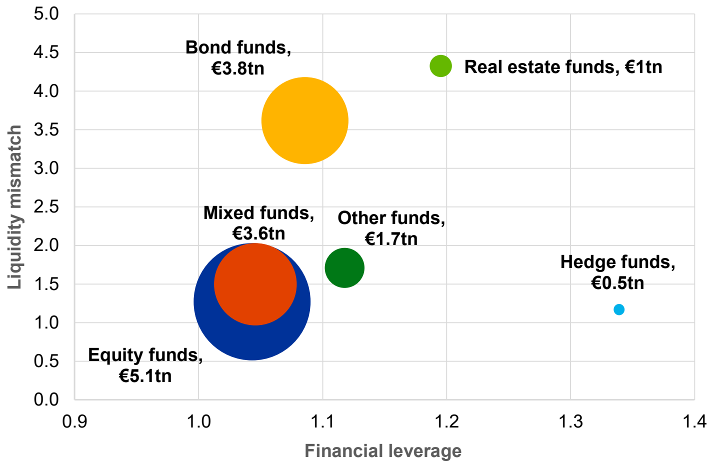
Sources: Bloomberg Finance L.P. and ECB calculations.

3rd theme: *Risk of outsized financial market reactions to disappointing news*

- Risk that non-banks with liquidity fragilities could amplify market corrections and transmit stress to the wider financial system
- Real estate funds with unrealised losses also face liquidity mismatches and rising redemptions could increase the potential for forced sales

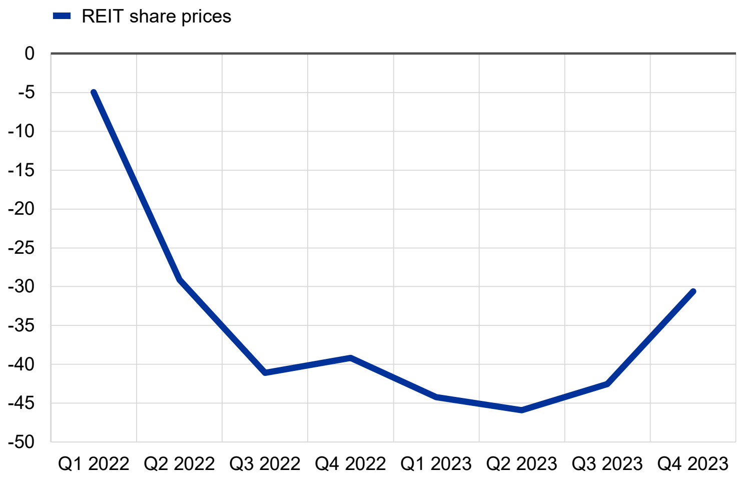
Liquidity mismatch and leverage among euro area investment funds

Q4 2023, ratios, bubble size: total assets, € trillions



Cumulative changes in share prices of euro area REITs

Q1 2022-Q4 2023, cumulative percentage change in share prices



Sources: Bloomberg Finance L.P., ECB (IVF) and ECB calculations.

Note: REITs stands for real estate investment trusts.

Preserve banking sector resilience and enhance the macroprudential framework for banks

Maintain existing capital buffers and borrower-based measures to ensure resilience

Further **enhance macroprudential space** in the medium term

Continue to make the **regulatory framework for banks** more effective

A strong capital markets union requires a solid institutional and policy framework for non-banks

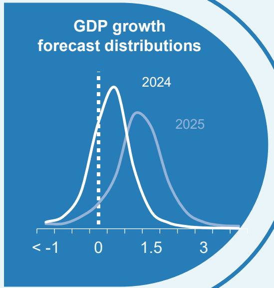
EU-wide supervision and a macroprudential framework for non-banks is key for financial stability

Implementing FSB recommendations in the EU should be a top priority

A stable and resilient NBFI sector would support **the broader objectives of the capital markets union**

Risks to the economic outlook may threaten private sector debt service

- Economic and geopolitical uncertainty ahead
- Financing conditions remain tight for firms
- Rising share of vulnerable households
- Outlook for commercial real estate remains fragile

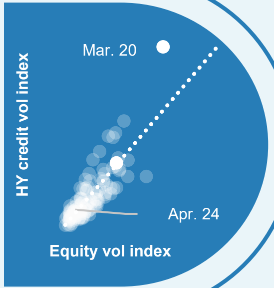


Euro area banks face headwinds from weaker asset quality, lower revenues and cost of funding

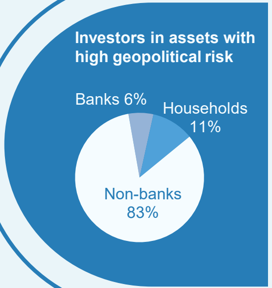
- Market valuations of banks remain subdued
- Deteriorating commercial real estate asset quality
- Rollover of bank funding at higher interest rates
- Lower income from variable-rate loans expected

Low risk pricing can mask vulnerabilities and lead to excessive risk taking

- Lower volatility supports tighter spreads
- Total bond funding costs might rise further
- "AI rally" raises concentration risk
- Markets price in higher geopolitical risk



Non-banks remain vulnerable to shocks amid low liquidity buffers



- Rising concentration risk in equity portfolios
- Persistent liquidity mismatches in funds
- Risk of losses on real estate exposures
- Uncertain profitability outlook for insurers

The euro area banking system is resilient and well-placed to face higher risks thanks to active prudential policy in recent years.

Enhanced macroprudential policy space, regulatory reform and faithful implementation of the final parts of Basel III can help to ensure durable resilience.

Structural vulnerabilities in non-banks continue to require a comprehensive policy response.