Vítor Constâncio

November 2016
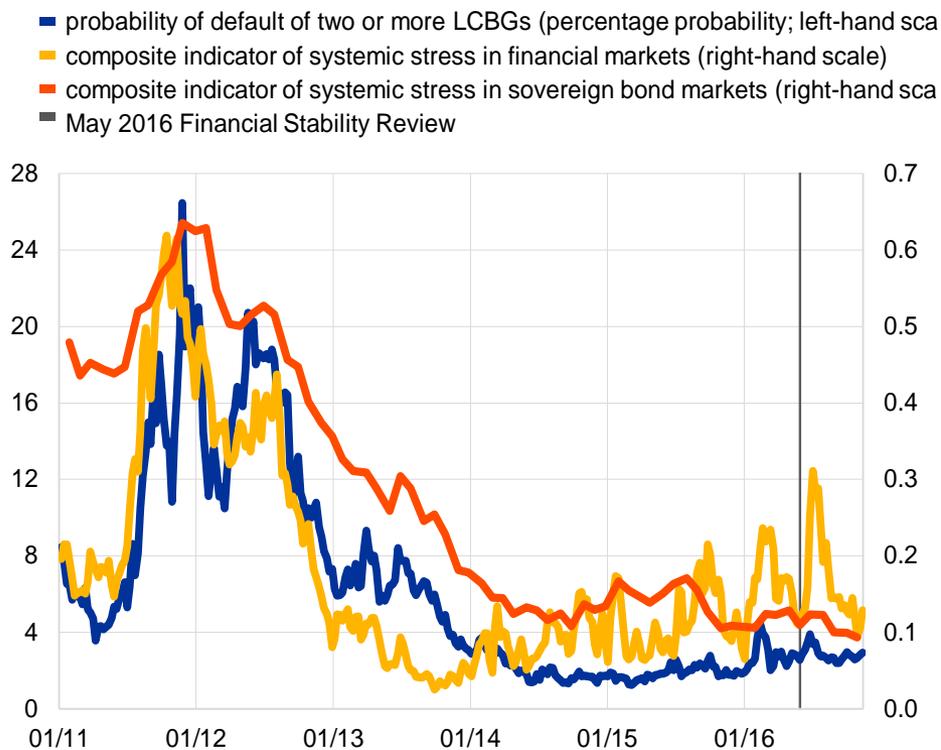# Financial Stability Review

Press Briefing

Frankfurt

24 November 2016

- **Euro area systemic stress has remained relatively low over the past six months, despite bouts of market turbulence**
- **CISS indicators have becoming highly correlated globally (see Box 1)**

Composite indicators of systemic stress
(Jan. 2011 – Nov. 2016)

- probability of default of two or more LCBGs (percentage probability; left-hand sca
- composite indicator of systemic stress in financial markets (right-hand scale)
- composite indicator of systemic stress in sovereign bond markets (right-hand sca
- May 2016 Financial Stability Review

Time-varying correlation coefficient between weekly changes in the CISS for each pair of countries
(Jan. 2004 – Oct. 2016)

- euro area-US
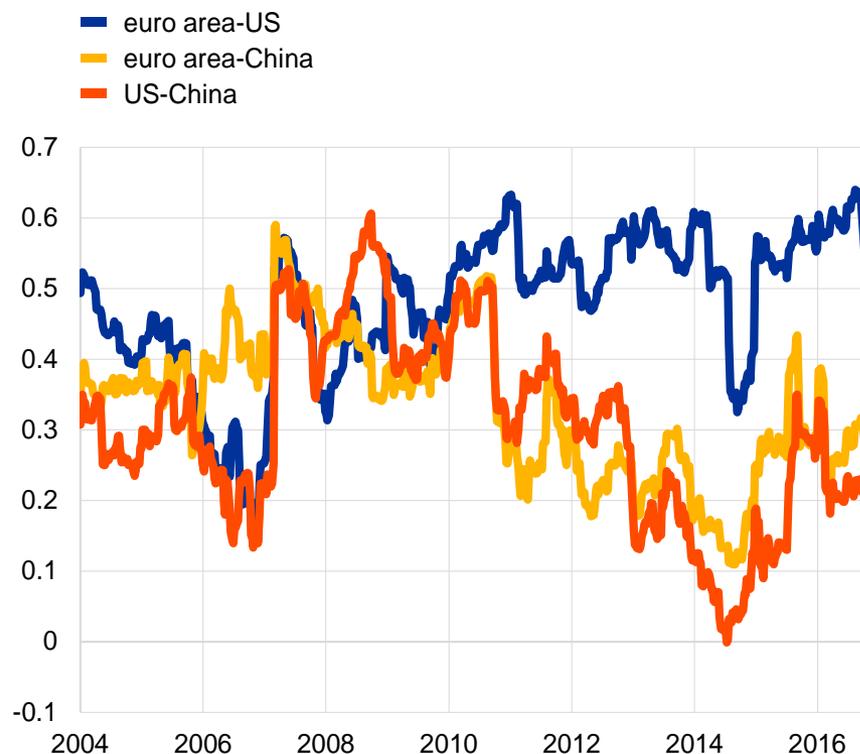- euro area-China
- US-China

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.

Sources: ECB and ECB calculations.

Note: Time-varying correlation coefficients estimated using a multivariate integrated GARCH(1,1) model for weekly changes in the CISS for the euro area, the United States and China.

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Key risks to euro area financial stability

■ (dark red) pronounced systemic risk

■ (orange) medium-level systemic risk

■ (yellow) potential systemic risk

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

Global risk repricing leading to financial contagion, triggered by heightened political uncertainty in advanced economies and continued fragilities in emerging markets

[orange box, up arrow]

Adverse feedback loop between weak bank profitability and low nominal growth, amid challenges in addressing high levels of non-performing loans in some countries

[orange box, right arrow]

Re-emerging sovereign and non-financial private sector debt sustainability concerns in a low nominal growth environment, if political uncertainty leads to stalling reforms at the national and European levels

[yellow box, up arrow]

Prospective stress in the investment fund sector amplifying liquidity risks and spillovers to the broader financial system

[yellow box, right arrow]

▪ RISK 1

Global risk repricing leading to financial contagion, triggered by heightened political uncertainty in advanced economies and continued fragilities in emerging markets

- **Euro area and US bond yields higher since early October …**
- **… which contributed to steeper yield curves**

10-year government bond yields in selected euro area countries and in the United States
(Daily data, 1 Oct. – 22 Nov. 2016)

Legend: Germany, Spain, Italy, United States
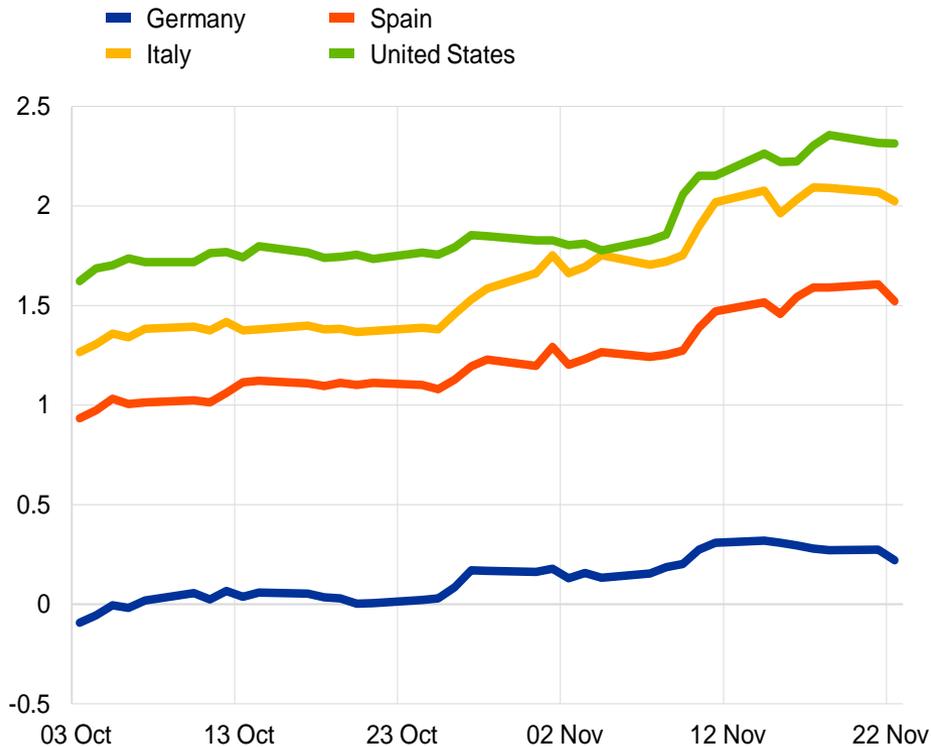
Sources: Bloomberg

Slope of the yield curve in selected euro area countries and in the United States
(Daily data, 1 Oct. – 22 Nov. 2016)

Legend: Germany, Spain, Italy, United States
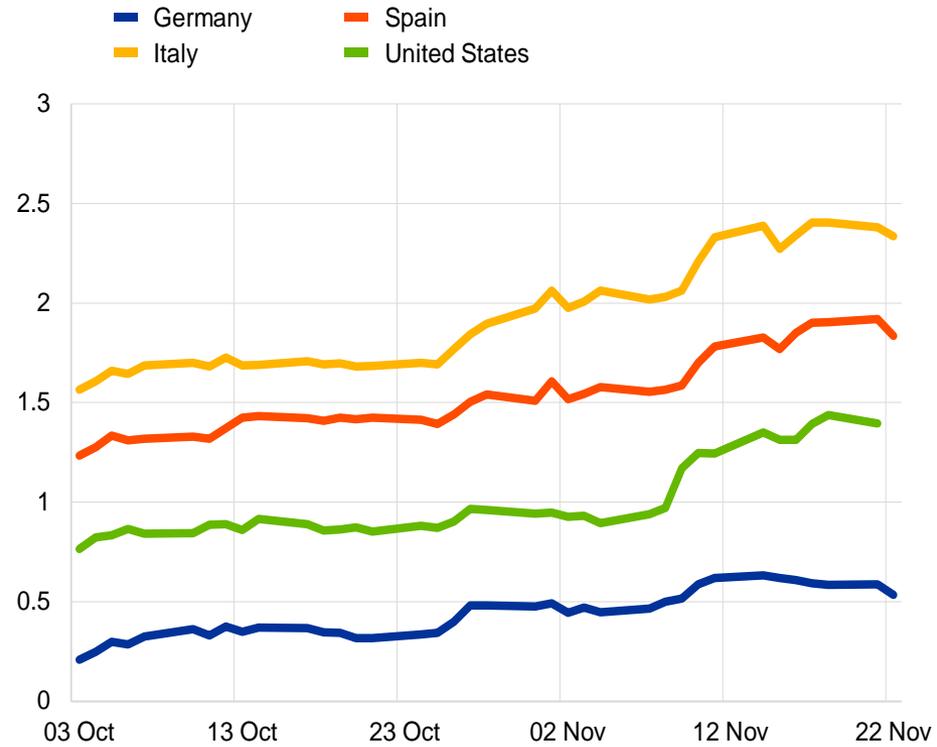
Sources: Bloomberg and ECB calculations

Note: The slope is computed as the difference between 10-year government bond yields and 3-month money market rates
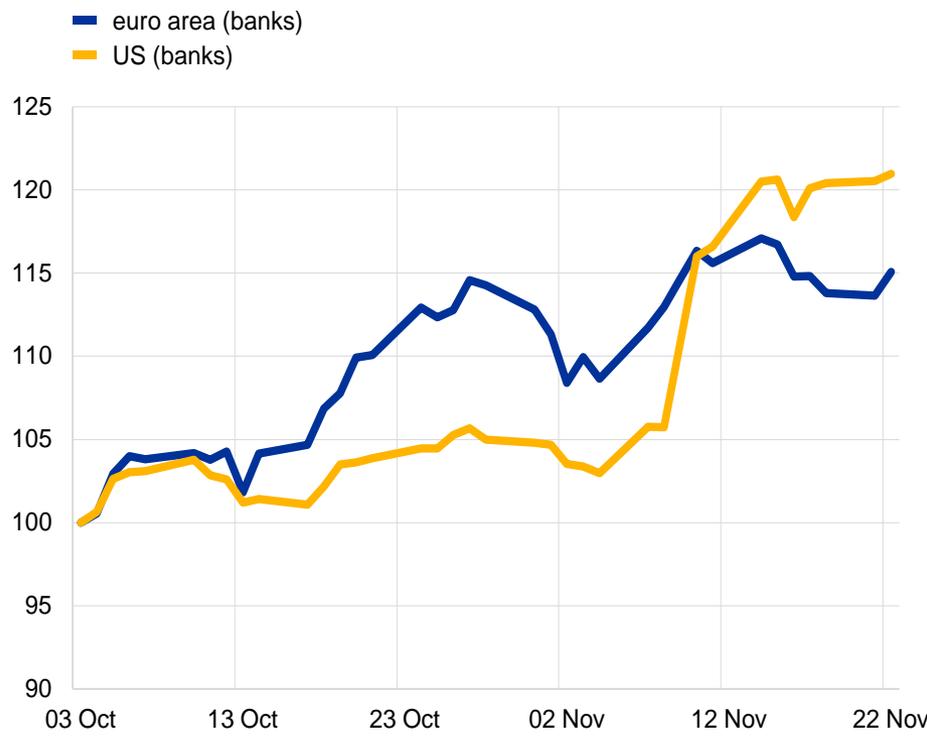
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US and euro area bank stock prices increased sharply in recent weeks

Stock prices in the euro area and in the United States
(Daily data, 1 Oct. – 22 Nov. 2016, stock prices indexed to 100 on 1 Oct.)
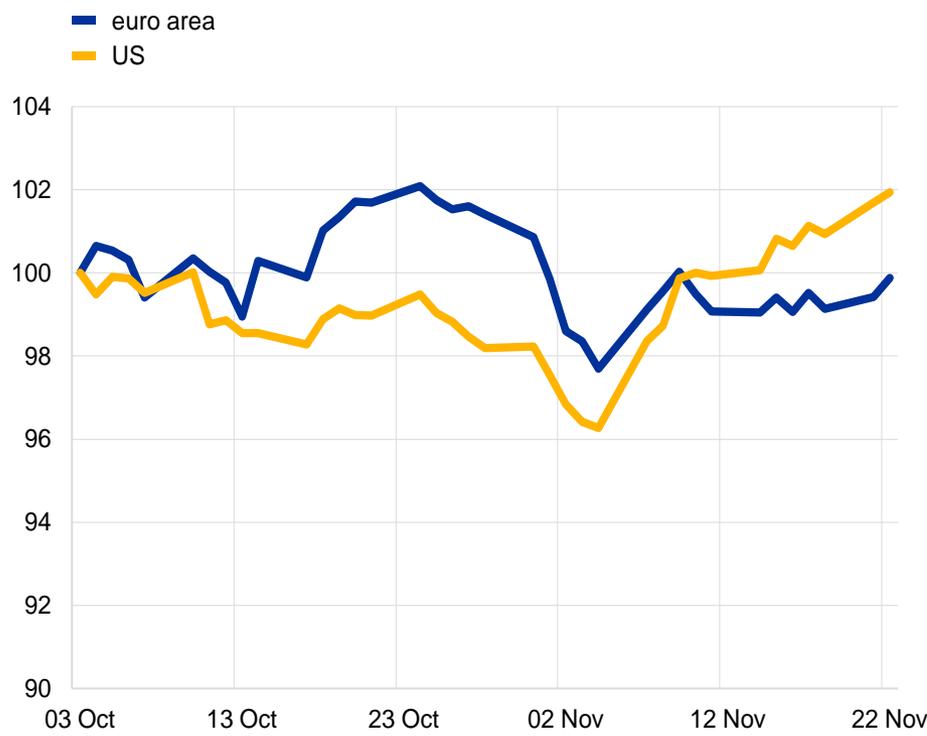
Bank stock prices in the euro area and in the United States
(Daily data, 1 Oct. – 22 Nov. 2016, stock prices indexed to 100 on 1 Oct.)

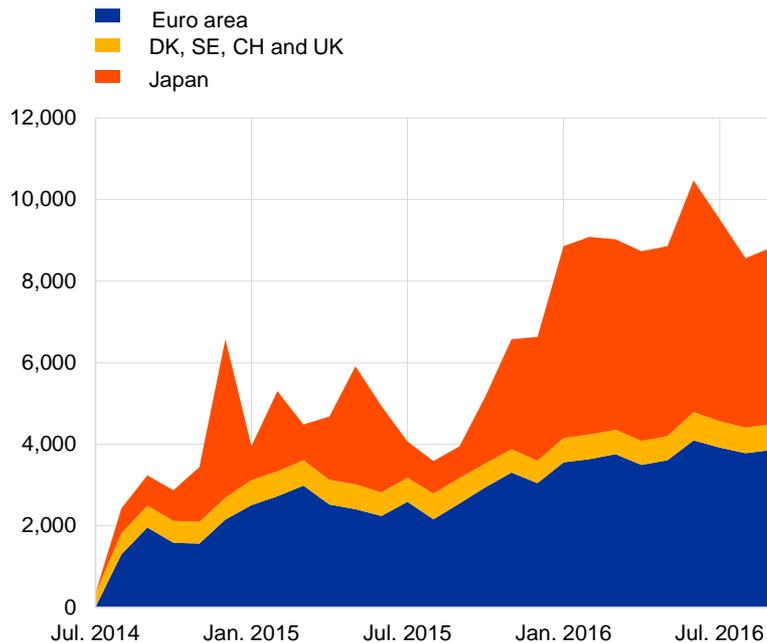Sources: Thomson Financial Datastream

Sources: Thomson Financial Datastream

- **Prices on most global bonds and stocks edged up over the past six months Share of bonds with negative yields are on the rise .**
- **Signs of inflated equity price valuations in some regions**

**Outstanding amount of sovereign bonds with negative yields**
(Jul. 2014 – Oct. 2016; monthly data, nominal amounts outstanding in USD billions)

October 2016 percentiles for the P/E ratio according to three different methods
(valuations as of October 2016 compared with history, current valuations normalised to a 0-1 scale)

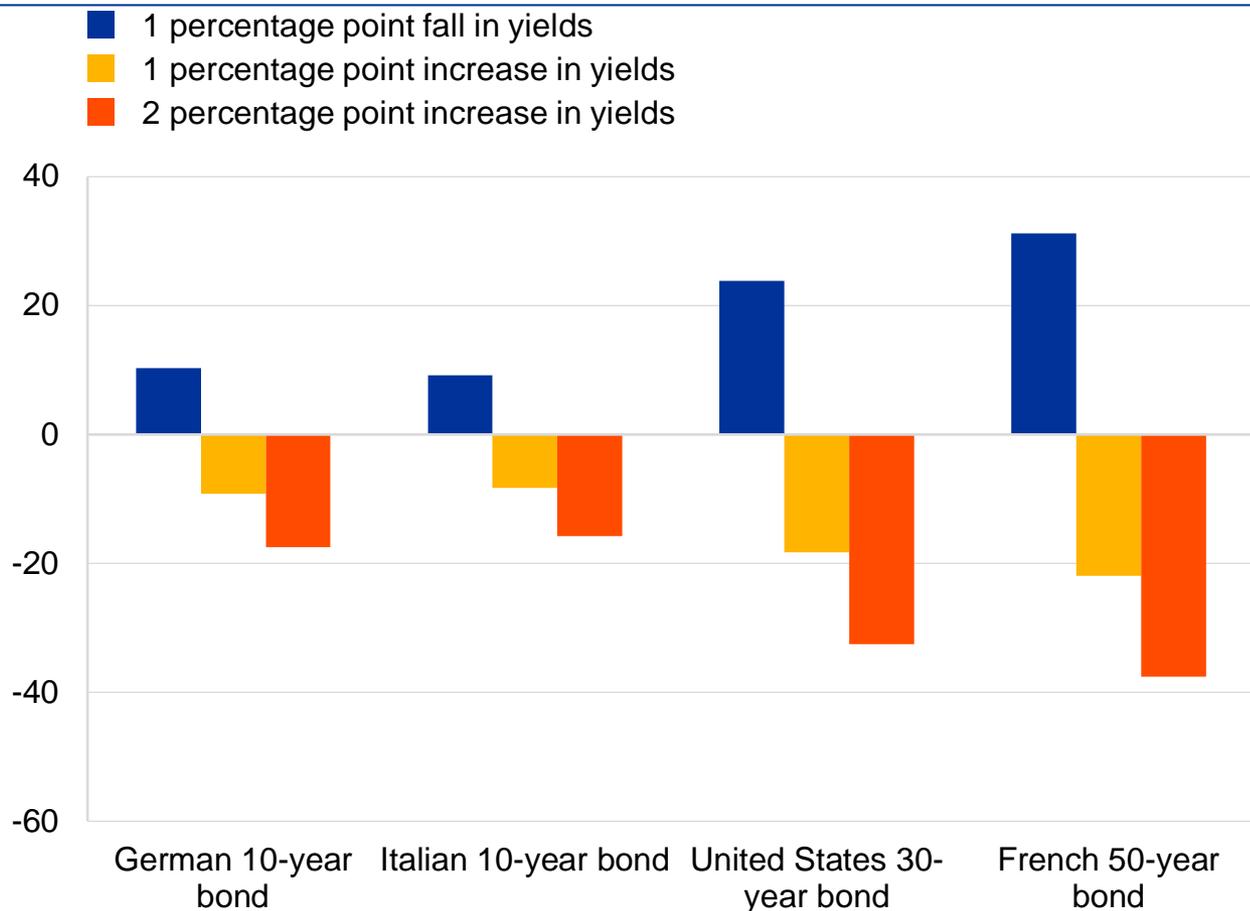
Source: Dealogic, Bloomberg and ECB calculations
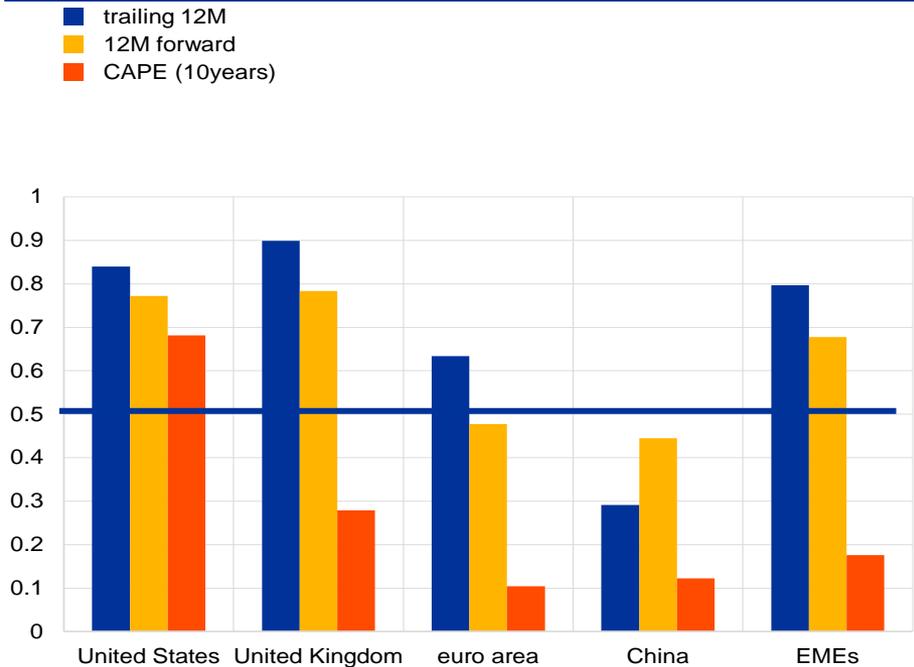
Source: Thomson Reuters Datastream.

Note: "Trailing 12M" is a P/E ratio based on the last year's reported earnings (sample starts in 1985, for EMEs in 1995), "12M forward" is a P/E ratio based on earnings forecasts a year ahead (sample starts in 1990) and the "CAPE (10 years)"is a cyclically adjusted P/E ratio with a ten-year moving average of reported earnings in the denominator (sample starts in 1985, for EMEs in 2005).

- **Capital losses for low yielding/high duration portfolios can be substantial if sentiment would reverse**

Capital gains/losses following 1 and 2 percentages changes in bond yields
(Capital gains/losses as of 15 Nov., percentage)

- 1 percentage point fall in yields
- 1 percentage point increase in yields
- 2 percentage point increase in yields

Source: Bloomberg

- # RISK 2

Adverse feedback loop between weak bank profitability and low nominal growth, amid challenges in addressing high levels of non-performing loans in some countries

- **Weak bank profitability in advanced economies during and after the global financial crisis**
- **In the euro area, banks' profitability remained at low levels in the first half of 2016, lower earnings expectations drove stock prices lower**

Median bank RoE in major advanced economic regions
(2006 – 2016, annual percentages)

Legend:
- euro area
- United States
- UK
- Japan
- Nordics
- Switzerland
- Global
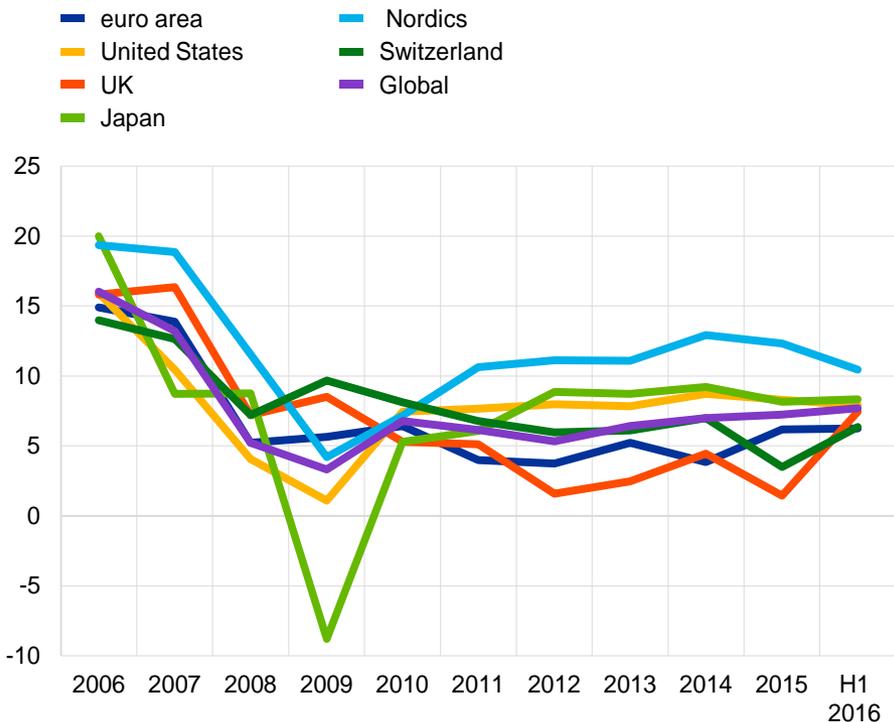
Sources: SNL and ECB calculations.

Note: Data for 2016 refer to the first half of the year.

Changes in bank stock prices and changes in 2017 net income expectations since January 2016
(annual percentages between 1 Jan. and 15 Nov. 2016)

y-axis: % changes in earnings expectations

x-axis: % changes in stock prices
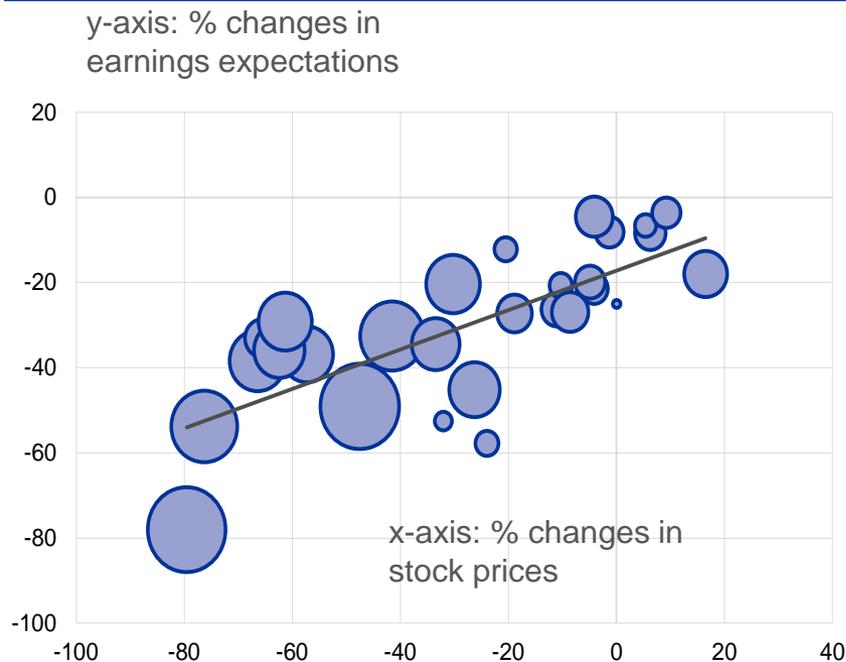
Sources: Bloomberg and ECB calculations

Note: Sample consists of banks included in Euro STOXX bank index. The bubble sizes are proportional to NPL ratios as of Q4 2015.

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- # RISK 3

Re-emerging sovereign and non-financial private sector debt sustainability concerns in a low nominal growth environment, if political uncertainty leads to stalling reforms at the national and European levels

- **Economic recovery in the euro area still uneven. High sovereign indebtedness in some countries.**
- **Debt sustainability concerns could arise also in the non-financial private sector**

**Gross general government debt in 2015 and average GDP growth forecasts for 2016-17**
(2015; 2016-17; percentage change; percentage of GDP; x-axis: gross general government debt; y-axis: average GDP growth forecasts for 2016-17)

Household indebtedness (x-axis) and non-financial corporate indebtedness (y-axis)
(Q2 2016; percentage of GDP)
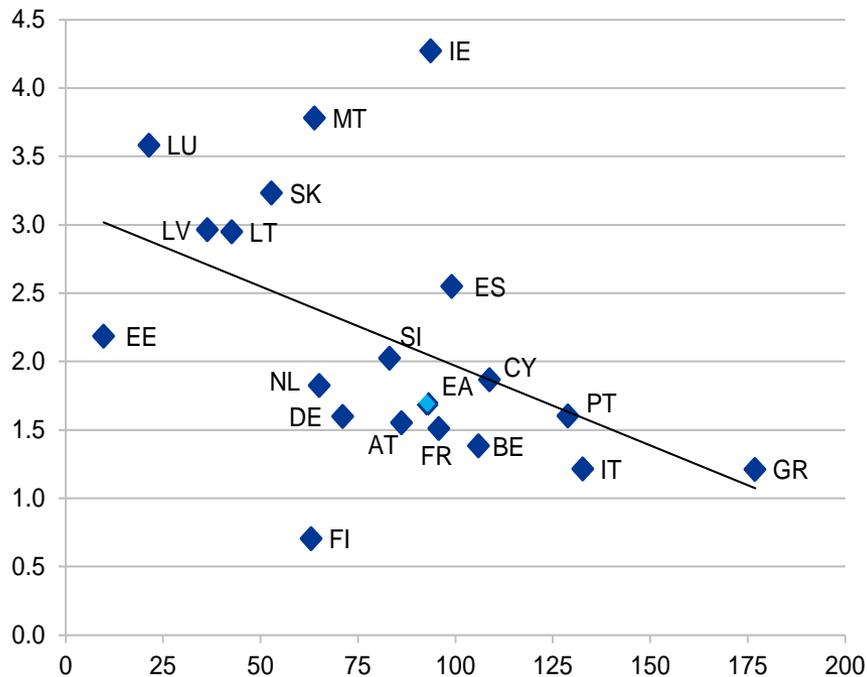
Sources: European Commission and ECB calculations.
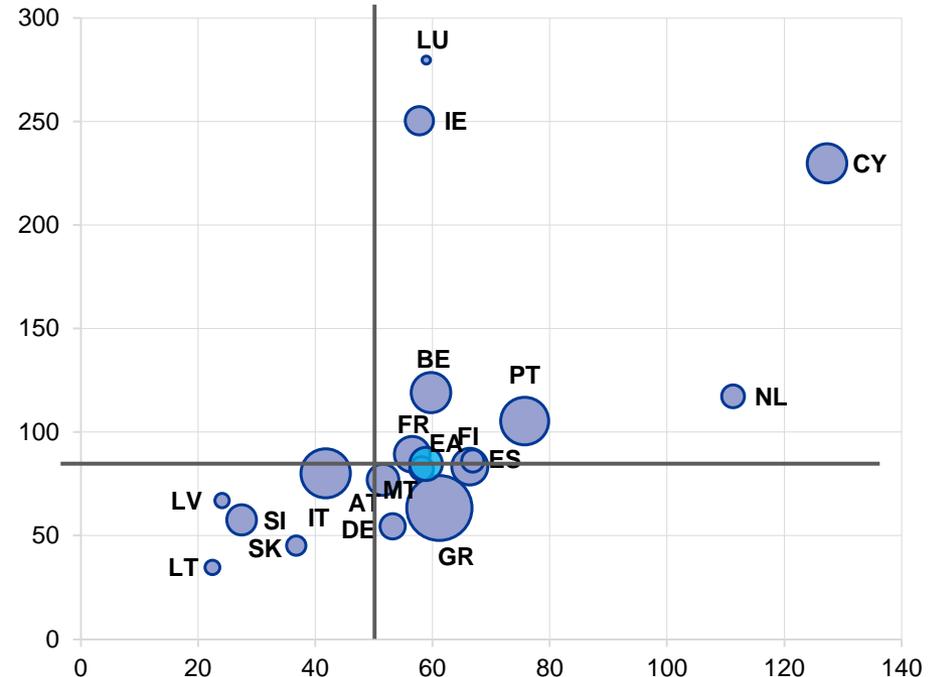
Sources: European Commission and ECB

Notes: The size of the bubble reflects the level of general government debt as a share of GDP. Non-financial corporate debt is consolidated. The horizontal and vertical lines represent the estimated macroeconomic imbalance procedure (MIP) benchmarks of 80% of GDP for consolidated non-financial corporate debt and 53% of GDP for household debt.

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RISK 4

Prospective stress in the investment fund sector amplifying liquidity risks and spillovers to the broader financial system

- **Exposures to credit and interest rate risk increased in the investment fund sector**
- **Abrupt withdrawals are possible as illustrated by the UK referendum**

Euro area financial institutions' holdings of debt securities by rating and sector
(Q4 2013 – Q2 2016; percentages)
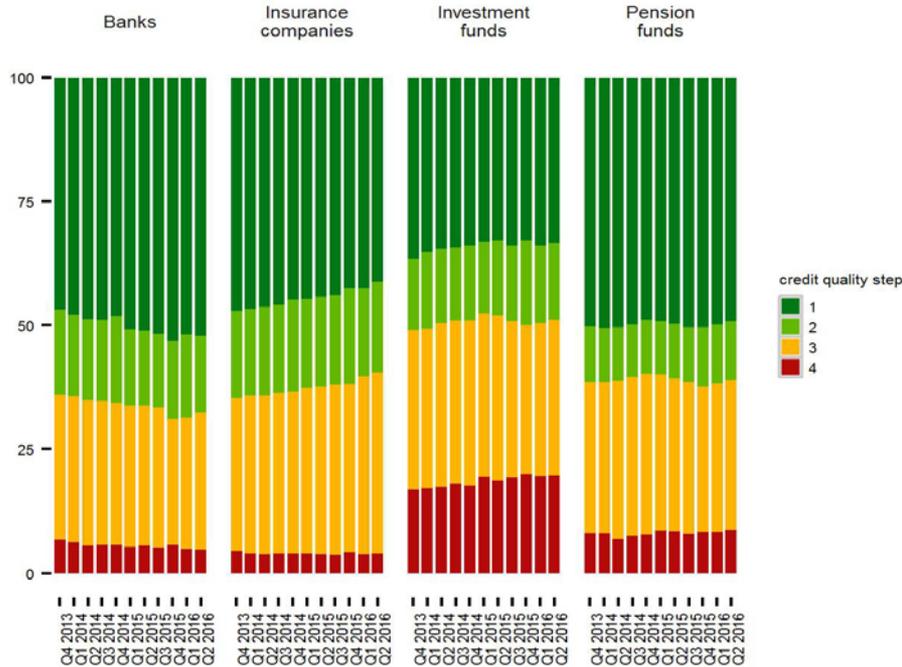
Sources: ECB and ECB calculations.

Note: Credit quality steps are defined in accordance with the Eurosystem credit assessment framework (ECAF), which provides a harmonised rating scale classifying ratings into three credit quality steps. The first category includes securities rated from AAA to AA-, the second from A+ to A- and the third from BBB+ to BBB-. A fourth category is added which includes all rated securities with a rating below credit quality step three. The analysis is based on the nominal amounts of euro and foreign currency-denominated securities, including "alive" and "non-alive" securities. The investment fund sector excludes money market funds.

UK investment fund flows
(Oct. 2015 – Sep. 2016, monthly net flow, GBP billions)
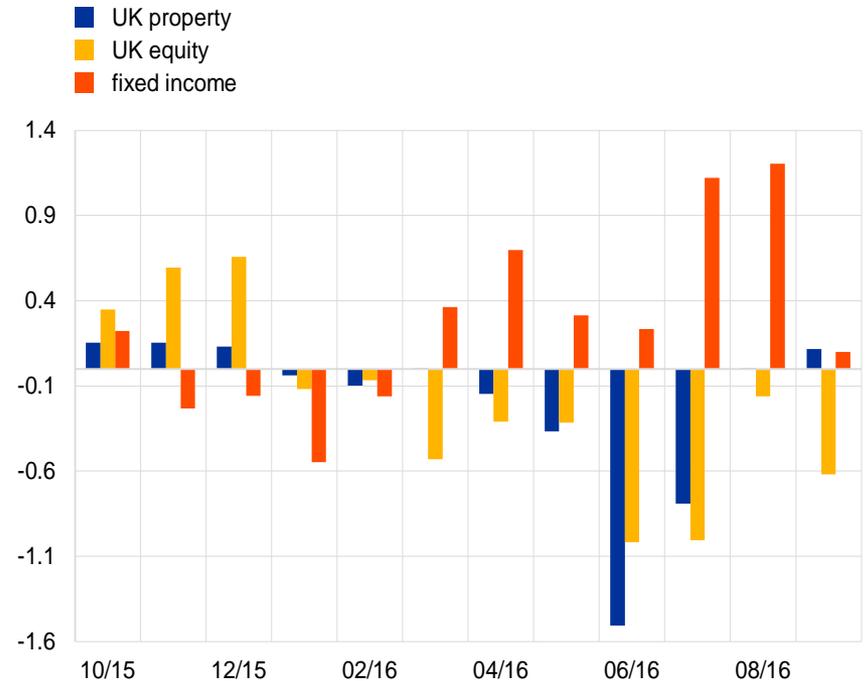
Sources: The Investment Association and ECB calculations.

Note: Funds domiciled in the United Kingdom invested in UK property, UK equity, and fixed income globally, respectively.