EUROPEAN CENTRAL BANK

EUROSYSTEM

Financial Stability Review

May 2019

Main developments since the last FSR

The financial stability environment has become more challenging over the last 6 months

Persistent **downside risks** to euro area economic growth

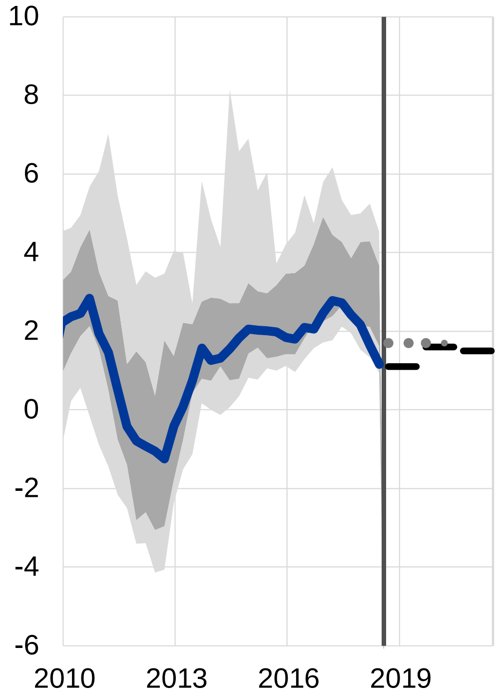
Return of **search for yield** after the December 2018 correction

Euro area banks struggling with **low return on equity** below 6% last year

Risks to euro area growth tilted to the downside

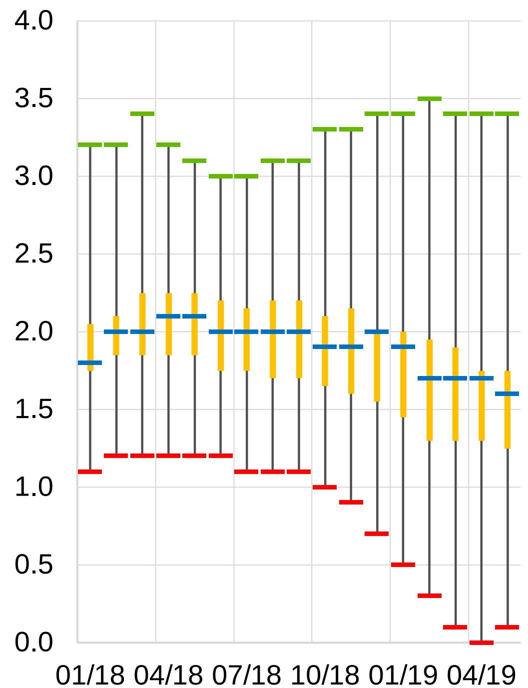
Annual real GDP growth for the euro area and ECB GDP growth forecast for 2019-2021

Euro area



2019 real GDP growth expectations across euro area countries

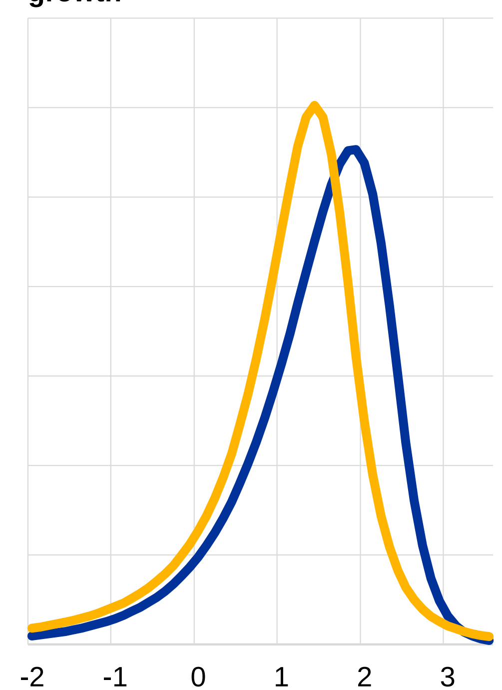
Minimum country value
Median country value
Maximum country value
Interquartile distribution



Future expected GDP distributions derived from the Financial Stability Risk Index

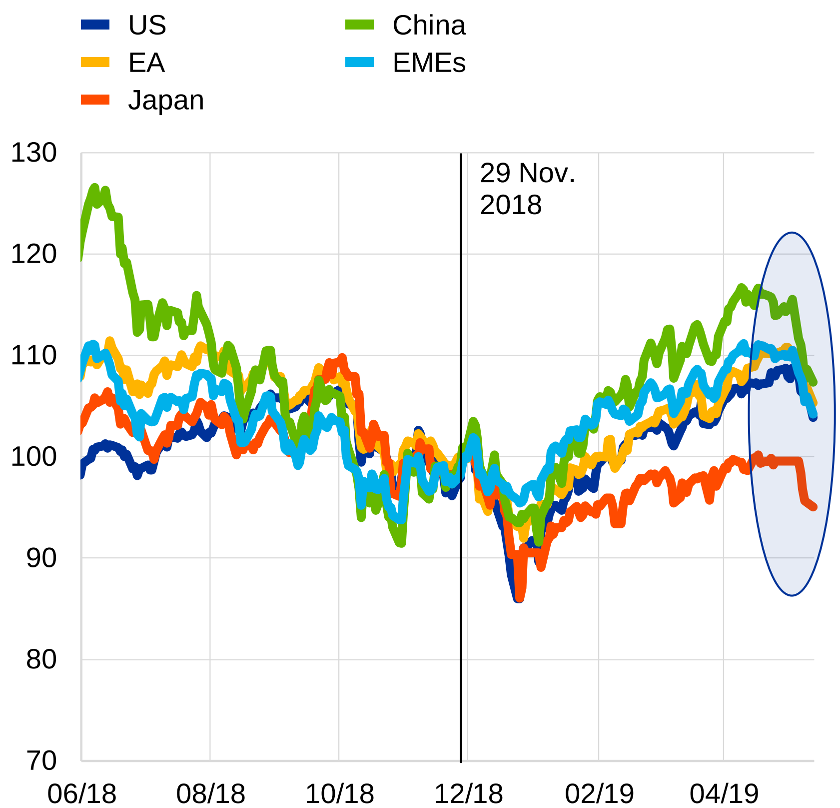
One-year-ahead forecast
As of Q2 2018
As of Q4 2018

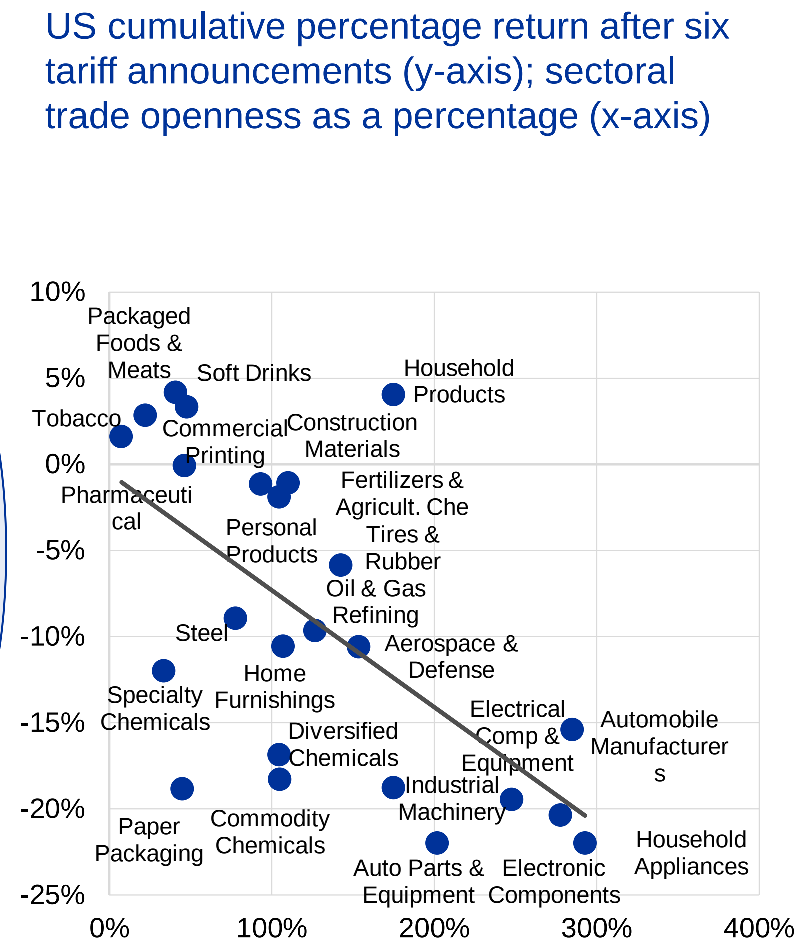
Pronounced downside risks to growth



Sources: Consensus Economics, Thomson Reuters Datastream, ECB and ECB calculations.
Notes: Left panel: the darker grey shaded area represents the range between the 25th and 75th percentiles, while the lighter grey shaded area displays the range between the 10th and 90th percentiles. For more details, see Chart 1 in the Overview.

Trade tensions weighed on global equities in May

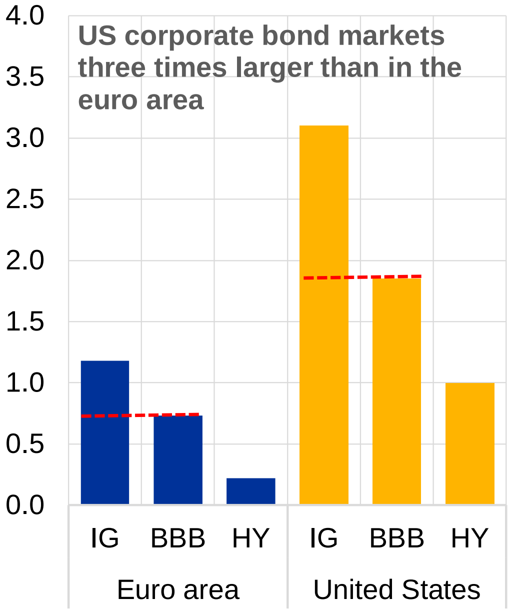




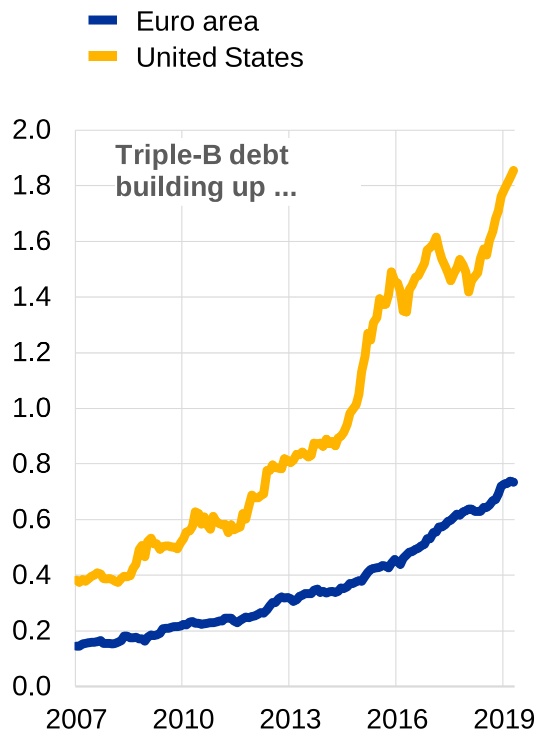
Sources: MSCI, Bloomberg, Haver Analytics, Thomson Reuters and ECB calculations.
Notes: Left panel: June 2018-May 2019; index: 29 Nov. 2018 = 100; right panel: y-axis: cumulative percentage return after six tariff announcements; x-axis: sectoral trade openness as a percentage based on gross value added.

Expansion in US and euro area corporate debt, but low expected default rates (so far)

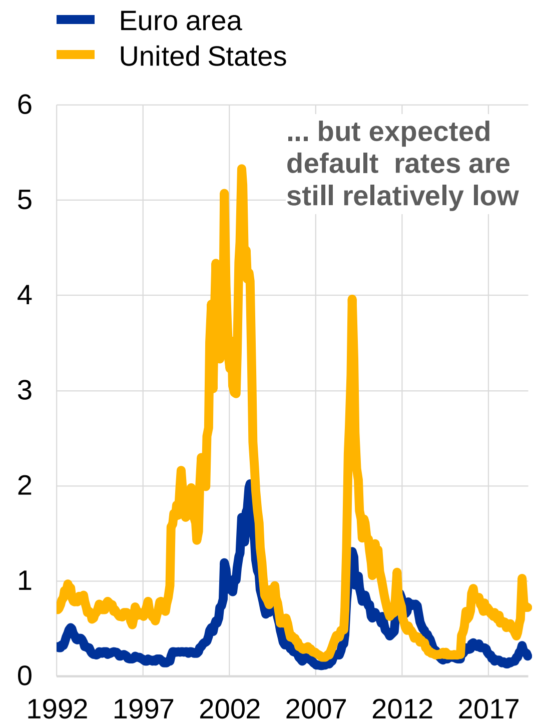
Size of euro area and US corporate bond markets



Euro area and US BBB-rated debt



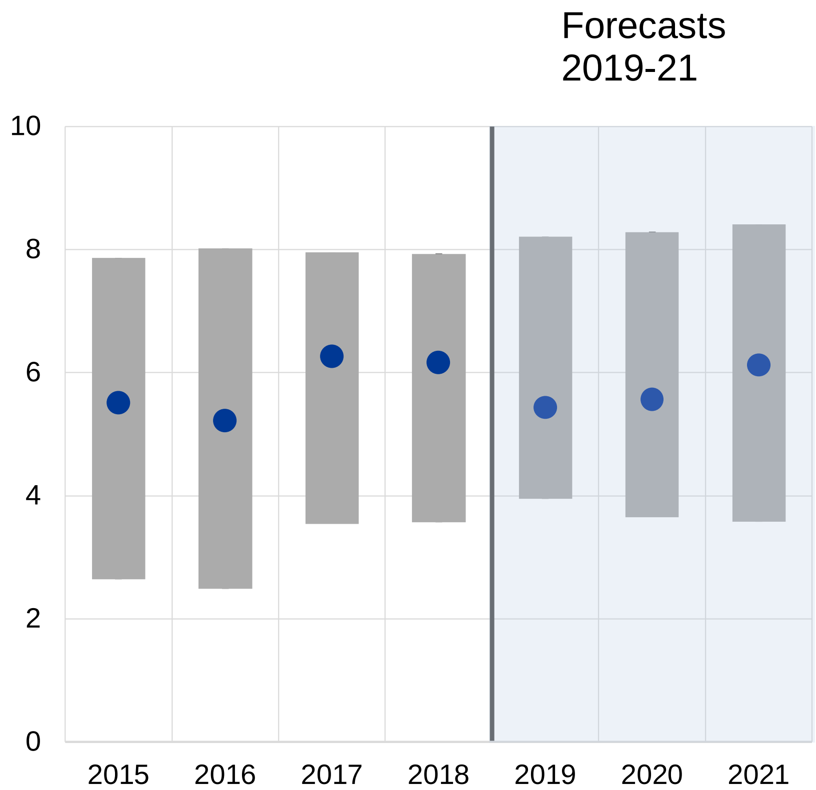
Expected default frequencies for European and US non-financial corporates



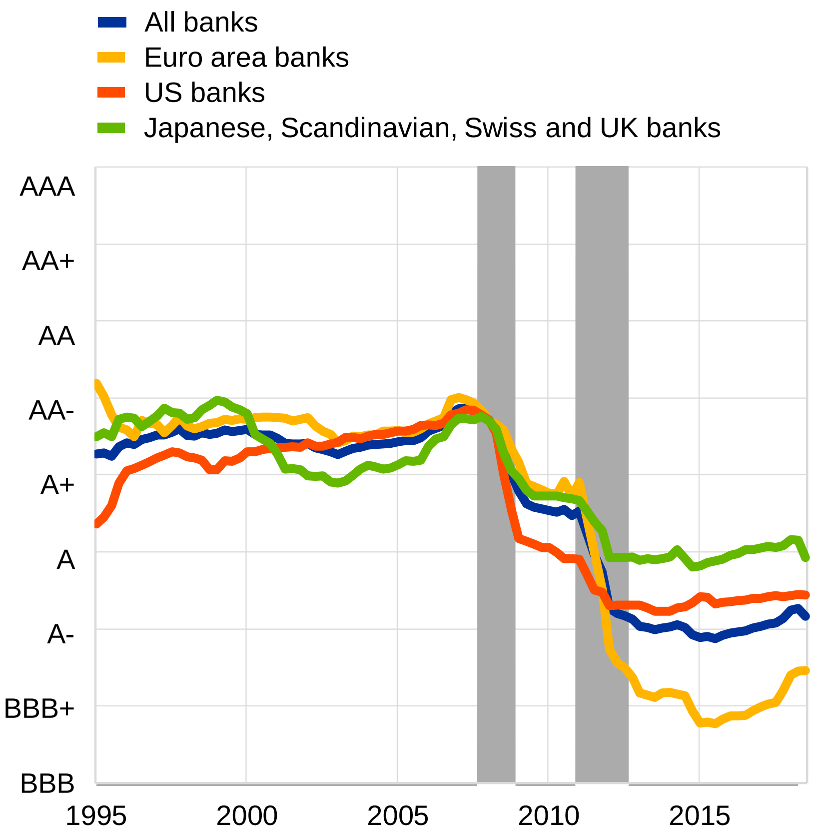
Sources: Bloomberg, Barclays Live, Moody's KMV and ECB calculations.
Notes: IG refers to investment-grade bonds and HY to high-yield bonds. The outstanding amounts in the left and middle panels refer to bonds denominated in euro for the euro area and US dollars for the United States. For more details, see Chart 4 in the Overview.

Subdued profit outlook and creditworthiness of euro area banks below international peers

Euro area banks’ actual (2015-18) and expected (2019-21) return on equity



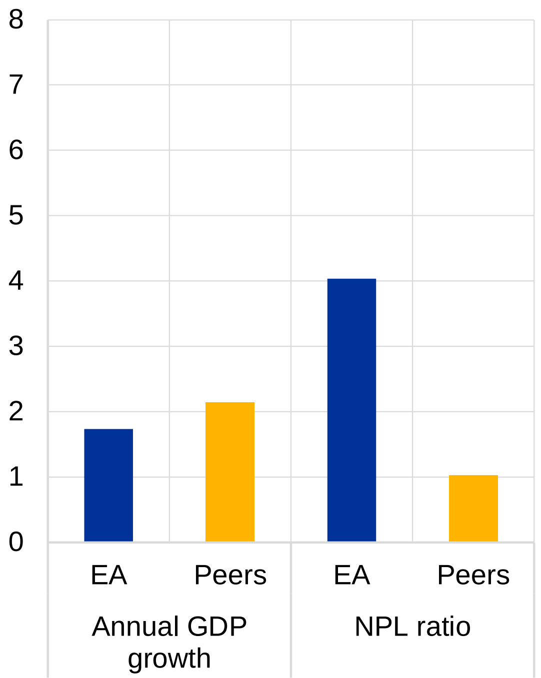
Median ratings for large global listed banks



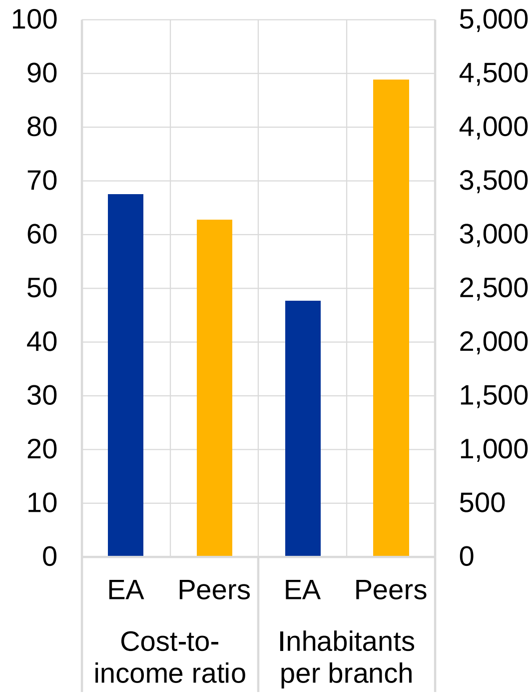
Sources: Standard & Poor’s, Moody’s, Fitch Group, Centre for Economic Policy Research (CEPR) and ECB calculations.
Notes: Left panel: the sample consists of euro area significant institutions. Right panel: the grey shaded areas represent periods of euro area recessions as defined by the CEPR. Sample: 22 euro area banks, 16 US banks and 16 Japanese, Scandinavian, Swiss and UK banks. For more details, see Chart 6 in the Overview.

Structural challenges facing the euro area banking sector

Euro area bank profitability dampened by low growth and high NPLs ...



... amid low cost-efficiency, partly attributed to overcapacity



Euro area banks' profitability lower than for their international peers given:

- weak growth environment
- still high non-performing loans (NPLs) in some regions
- low cost-efficiency, partly attributed to overcapacity

Sources: Standard & Poor's, IMF Financial Stability Indicators, IMF World Economic Outlook, Federal Deposit Insurance Corporation, national central banks, ECB and ECB calculations.
Notes: Peers are a weighted average of large banks in Denmark, Norway, Sweden, the United Kingdom and the United States. For more details, see Chart 7 in the Overview.

Climate change-related risks require structural monitoring, given their potential to become systemic

Climate change could have an impact on financial institutions through two channels:

- *Physical risks*: The impact that more frequent and severe natural disasters have on financial institutions’ balance sheets
- *Transition risks*: Financial institutions can be negatively affected by an abrupt transition to a low-carbon economy

Assessing these risks is difficult, as there is uncertainty about their size and timing

Looking ahead, risks remain:

Disorderly increase in risk premia

Global corporate bond spreads at pre-crisis lows and high US equity valuations

Debt sustainability concerns

High sovereign indebtedness, alongside a doubling of lower-rated corporate debt over the past five years

Hampered bank intermediation capacity

A crowded euro area banking sector confronted with high operating costs

Increased risk-taking in the non-bank financial sector

Search for yield, liquidity risk and leverage could amplify the wider financial cycle