Financial stability in Europe: what are the main emerging risks?

1. Navigating an uncertain and challenging environment

1.1 High public indebtedness remains a key vulnerability in the EMU

A Central Bank official stated that the large fiscal support during the pandemic and the recent energy crisis resulted in higher public indebtedness in more euro-area countries. It has also directly translated into higher interest rate costs of sovereigns, although its pass-through to the average cost of outstanding debt has been relatively slow due to the earlier lengthening of public debt maturity.

Debt service-to-income ratios are being pushed upward, and pressure could mount if downside risks to GDP materialise. Treasuries have been working on extending the average maturities of their debt. Public debt levels are projected to remain above the pre pandemic level in the medium term. But there are many challenges for debt sustainability on pensions, healthcare, defence spending and climate change mitigation. It is vital to start fiscal consolidation without any delay. A key aspect is the right balance around flexibility on fiscal discipline.

Debt sustainability is at the centre of the political discussion. Calibration of country specific issues is vital, because the new rules take public investment and structural reforms into consideration. The intermediate target is under the control of the authorities and can have countercyclical features. Realistic programmes to adjust public debt are needed.

1.2 The corporate sector remains resilient

1.2.1 The corporate sector has been able to absorb the deterioration of its interest coverage ratio

The Chair highlighted the clear message around less fiscal space. Corporate credit quality has slightly been obscured by the fiscal impulses that were given through Covid and the energy crisis.

A Central Bank official stated that UK corporates have generally entered this period of higher rates and weak growth in good shape; net debt to earnings is at the lowest level since 2003. Greater finance has been provided through markets, typically at fixed rates rather than floating rates, which gives companies time to adjust. Insolvencies are at a decade high in the UK but are still well below the levels seen in previous recessions. Companies with low interest coverage ratios are expected to stay below previous peaks, but small and medium-sized enterprises (SMEs) are an area of particular concern.

Leveraged loan defaults have increased from 2% to 6% in one year. Although that is below the levels seen in the global financial crisis (GFC), it is high. Despite some pickup in the second half of last year, headline default rates in high-yield bond markets remain low. Market based finance requires refinancing. A great deal of refinancing is due in 2024 and 2025, and economic stress could be seen if that refinancing is not available. Commercial real estate is also an area of concern.

1.2.2 Corporate bankruptcies rose in 2023 but remained below pre-pandemic average

A Central Bank official explained that default rates in the corporate sector have increased, although it is still below the pre-pandemic level. There has been a decline in the interest coverage ratio, but the cash buffer was also large. Corporate debt is about 78% of GDP in France but corporate cash is about 32% of GDP. The interest coverage ratio takes time to decrease due to the loans' long maturity. The increasing interest rate initially benefitted the corporate sector because their assets were more liquid than the liabilities.

1.3 Residential real estate and commercial real estate markets are vulnerable to higher interest rates

1.3.1 Worrying signs in the global real estate markets

An industry representative highlighted worrying signs in the global real estate markets. Europe is in a much better state than Japan was in the 1990s, as its banks have more capital, more liquidity, transparency, and adequate safety nets. A potential risk is the time lag between what is happening in the markets and becoming aware of the scale of the problem and acting to remedy the situation. Europe needs to reexamine its safety nets and closely monitor the real estate markets to prepare for what may be coming.

The Chair noted that many jurisdictions have tried to implement a proactive macroprudential policy. Macroprudential buffers are now in place in most European jurisdictions, which have built resilience in the system. Inaction bias has to be fought on a daily basis. There is a public sector with less fiscal space, corporates with increasing risks, and an increase in insolvencies off historic lows and problematic real estate markets.

1.3.2 Firms operating in the commercial real estate sector face financing and income challenges

The Chair emphasized that the commercial real estate markets are correctly at the top of the priority list. The more private the markets, the longer it takes for valuations to flow through the system. Banks will have a much tougher 2024 than 2023, when the interest rate margin had been maximised and the credit costs had not been flowing through to a major extent.

A Central Bank official observed that the focus is the commercial real estate sector. Non performing loans (NPLs) are being examined, which is vital in a situation with high interest rates. NPL levels are stable, but there is an increase in the consumer credit and commercial real estate areas at the same time as bankruptcies in the corporate sector are increasing. All in all it's probable that the asset quality in bank portfolios will deteriorate in 2024.

Commercial real estate borrowers have faced declining profitability, with higher interest rates reducing the income of specialised firms operating in this market and the value of their properties. The market is also adjusting to lower demand due to structural changes reinforced by the pandemic, such as shifts towards online shopping and working from home.

Commercial real estate accounted for 9% of the loan books of significant banks in Q2 2023, and less than 4% of those loans were classified as NPL. A very negative shock will cause spillover effects to other sectors. Portfolios in the commercial real estate market segment have a higher likelihood of facing debt servicing challenges than those in other market segments.

Work has been ongoing in leveraged finance. Increased risk has been seen as a result of the increased interest rate. Refinancing risk is increasing, and a number of banks have had to do significant write-downs. A few years ago the ECB introduced a leveraged capital add on, and in 2023 there was an increase in the number of banks who had a capital add-on on leveraged finance.

The Chair observed that some banks are much more exposed than others on commercial real estate and noted that that uneven exposure could potentially cause problems in a stress scenario.

1.3.3 The residential real estate market in many parts of Europe is heavily dependent on the economic trajectory

A regulator stated that real estate markets are the most complex ones, as they are driven by behavioural aspects of society, migration and macroeconomic perspectives. There has not been pressure on residential real estate prices in the regulator's country. The commercial real estate market is more rational because interest rates have a direct impact on prices and occupancy rates. Price drops have not been seen in the residential space. Continued pressure on prices in the commercial real estate segment might lead to substantial losses, so the banking system should be well capitalised to absorb them.

In residential real estate the interest rate environment is increasing pressure on debt capacity servicing, especially on passing interest rate risk from banks to clients, as many clients have used flexible mortgage rates. What is good for the banking system in terms of interest rate in the banking book is bad on the credit side, because the default rates might increase with falling prices and pressure on households. In some areas there is fear of spillover risks coming from other markets, in particular from the non bank financial institution (NBFI) sector.

The Chair observed that the residential real estate market in many parts of Europe is heavily dependent on the economic trajectory. Avoiding deep recessions will avoid unusual amounts of default. A deep recessionary scenario is when the volume effect of the residential real estate markets can play an important role. Inflation is impacting households, but they are still benefitting from wage rises.

2. Addressing macroeconomic environment impact on banks and non-bank financial intermediation

2.1 The resilience of the EU banking sector

An industry representative highlighted that interest rates in the euro area have gone from -0.5% to 4%. Banks are well capitalised, liquid and able to lend. The origination spread for banks has never been tighter. The margin of banks is tight, which means there is competition, capacity to lend and liquidity to lend. The lending growth of eurozone banks had trended at 3-4% until 2022, but it has flatlined or declined. Certain sectors are continuing to increase but other sectors are facing challenges. The area where banks are very concerned is commercial real estate and the fact that they require refinancing.

A Central Bank official stated that supervisors have to be vigilant even if. Europe has resilient banks that are well capitalised, the liquidity buffers are at good levels, and the quality of the assets are good. Banks have also been through a number of external shocks in recent years and have been resilient.

A Central Bank official explained that French banks have been very resilient due to limited exposure of the sectors that are most vulnerable to an interest rate increase. French banks are diversified and have large capital and liquidity buffers that were accumulated prior to the interest rate shock. France has a sectoral systemic risk buffer for exposures to highly leveraged large companies. Borrower based measures are in place for house credit, which keep French default rates extremely low. If credit is extended it is based on the income of the borrower and on fixed rates, not on a loan-to-value (LTV) ratio. Net interest margins are quite small, and in France they have not yet benefitted from higher interest rates. There has also been a reallocation of deposits towards interest-bearing deposits.

The Chair observed that the message is 'so far, so good', but that relies on valuations which are going to be under pressure in certain sectors. The impression is that market valuation corrections are done quickly in the US but not so quickly in Europe.

2.2 It is challenging to mitigate financial stability risks in this deleveraging context

A Central Bank official pointed out that risks are difficult to translate into concrete actions. Indebtedness ratios in the Spanish private sector are at their lowest for more than 20 years. The private sector, households and corporates are deleveraging, but it is hard to understand what will follow that. Work is needed to understand the underlying revenue streams that will repay the loan. It is vital to be mindful of the situation of each country. Real salaries have increased and recovered in the eurozone. The profits of corporates are buoyant, so it is hard to see a significant accumulation of NPLs in the short term. It is important to strengthen the collaboration between the micro supervision and the macro authorities, and to cooperate with bankers, because they need to continue lending to the economy. Good underwriting standards need to be maintained.

The Chair agreed that the current resilience in banks is going to be tested.

2.3 Supervisor and regulator concern around NBFI

A Central Bank official stated that supervisors and regulators are concerned about NBFI because the combination of leverage, liquidity and interconnectedness is toxic. The Banque de France has conducted risk mapping for the banking sector from NBFI. Direct risk is currently quite limited; NBFI in France is smaller than in other countries, but due to data gaps the cross border exposure is not precisely known. NBFI is about 10% of French bank assets and about 17% of their liabilities. Fire sales would have an impact on market valuations and is the trigger for derivative markets, margin calls and risks through the real economy.

So far there has mostly been microprudential regulation in terms of liquidity buffers or liquidity management tools. The system wide stress test that is carried out in the UK is a useful innovation. There could be examination of macroprudential entitlement to activate liquidity management tools and to fill data gaps, but those gaps will not be filled if there is no pressure of regulation.

The Chair agreed that there are unknowns in that space, and some underestimated 'knowns'.

A Central Bank official agreed that the combination of leverage, liquidity and correlations leads to stress. When looking at data on individual entities there is no sense of how there might be a market wide stress. The UK is conducting a system-wide exploratory exercise, which is designed to stress test in the good times to see the potential for where resilience needs to be built in advance of the bad times. Market based finance is half of the financial system and has led to the extra financing that the corporate sector has seen since the global financial crisis (GFC).

The Chair observed that in the credit crunch there had been a lack of availability of market finance, which is going to turn on and off quicker than relationship lending out of the banking sector.

An industry representative stated that NBFIs play an important part in the financing of the economy. The industry needs to obtain more data around NBFIs. It is important to recognise the benefits such as diversification and business opportunities that NBFIs could bring to the financial ecosystem; any regulatory efforts need to strike the right balance between those potential benefits and risks. It would be appropriate to adopt an activities-based approach to non-bank risks, rather than an entities-based approach.

If regulators and policymakers are to take steps to address the risks, they should not surprise the markets. Predictability is needed. For example, a number of decisions have been unpredictable, such as taxing banks on an ad-hoc basis and reducing their ability to generate capital.

2.4 Addressing deficiencies in the frameworks that banks have in place for internal governance, managing credit risk and for operational resilience

A Central Bank official observed that work needs to commence with the macroprudential authorities, because 60% of the commercial real estate sector is financed by investment funds. More data and more cooperation is needed. The ECB published its priorities at the end of December. The near perspective is very important, in order to ensure that banks identify issues early and measure their risk and provision. Banks need to be able to manage the present economic downturn and the uncertainty around geopolitical risks. There is a focus on credit risk, liquidity, funding and interest rates in the banking book.

The ECB's second priority is governance. Risk aggregation has been a Basel core principle for 10 years but banks are still not fulfilling it. The ECB is also focusing on climate and environmental risk. If banks are not fulfilling supervisory expectations the ECB will use its escalation ladder and potentially proceed to enforcement. The ECB's third priority is operational resilience. Third country providers are important, in order to ensure that banks understand the risk. Most banks are digitally transforming their business models, which will lead to sustainable business models in the future.

The Chair noted that there is an increasing stability risk in the IT environment.

A regulator stated that capital is at the centre of the stress test and the Pillar 2 requirements, but there are areas of activity on a microprudential level, especially with regards to internal ratings based (IRB) banks. The regulator's organisation wants to look at what capital levels they produce, add multipliers to those Pillar 2 requirements, and correct the outcomes of the models, if needed. Much can also be done in the governance area by monitoring exceptions to policies and challenging banks on deviation from those policies.

A consistent implementation of Basel III is needed. The regulator's organisation appreciates the more stringent guidance on loan-to-values and debt service capacities requirements. When Basel III is introduced there will be more risk sensitivity in the system.

The Chair agreed that a consistent and stringent implementation of Basel III is needed.

An industry representative disagreed with the Chair's assertion that too much has been distributed out of the banking industry in good times, as the market will adjust as long as the frameworks are clear. The cost of equity for banks remains extremely high due to the predictability of regulations.

An industry representative noted that there is a problem with indirect exposure. The world is so interconnected that there are bound to be blind spots such as derivatives or structured products. Preventing regulatory arbitrage is vital, particularly in benign times. Housing loans made by NBFIs or any other type of finance are innovative, but previously, regulatory arbitrage has always produced gaps and blind spots.

Thought is needed about how to replenish liquidity before it is too late. It is vital that central bank liquidity is available for solvent banks with sufficient qualified collateral. The other task is to replenish capital; Japan has coped with public funds, but other things can be done to facilitate it. Additional Tier 1 (AT1) instruments could be used, with a caution around investor suitability.