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SUERF
Key takeaways from the ECB's new Financial Stability Review

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The ECB Financial Stability Review

- **Very robust and comprehensive report**. High level of uncertainty reflected in bouts of volatility.
- Overall, the messages and **key findings align with the IMF's October GFSR.**
- The report effectively highlights and elaborates on the shift in risks and spillover effects over the EA from the external environment
- **Excellent analysis on rising sovereign vulnerabilities** with a thorough and detailed analysis amid geopolitical and policy uncertainty. Welcome the call for fiscal consolidation.
- **Very comprehensive analysis on the challenges in the corporate sector, including a deep dive into the CRE** facing structural challenges.
- **Balanced analysis on the banking sector**: resilient but also a call for caution in this uncertain environment with the expected deterioration in asset quality and moderate profitability from its multi-year highs.

The ECB Financial Stability Review

- **Vulnerabilities in the NBFIs sector**: in addition to liquidity, leverage and concentration risks, the FSR raises concerns about spillovers from shocks and volatility in global markets , especially the US as very well document in the dedicated section.
- **Macroprudential policies**: The call for an enhanced toolkit with ex-ante tools to mitigate risks in the NBFIs sector and build resilience is very welcome.
- **Insightful special features**:
  - Kudos for the special feature on the ECB framework.
  - FSRs adapted to a fast-changing world.
  - The special feature offers a snapshot of how priorities have evolved over time.
  - Expanding scope with a broader set of factors to capture systemic risks and the complexity of the financial system, particularly NBFIs risks given their increasing role in the global system.
  - Introduction of the macroprudential policy section to reflect the full ECB mandate and lessons learned from the GFC.

Additional Issues that May Warrant Attention

- **Geopolitical and fragmentation risks and direct or indirect spillover risks**:
  - The FSR acknowledges the risks stemming from policy trades and geopolitical fragmentation but also indicates that future market resilience cannot be guaranteed given the current headwinds.
    - **How can the EA buffer these risks?**:
      - Macroprudential tools?
- **Emerging risks in financial markets**:
  - The FSR mentions the role of AI in the equity market, especially in the recent volatile episode, and the underlying risks such as cyber threats.
    - Possible area for future work: AI and the role of the NBFIs sector.

Additional Issues that May Warrant Attention

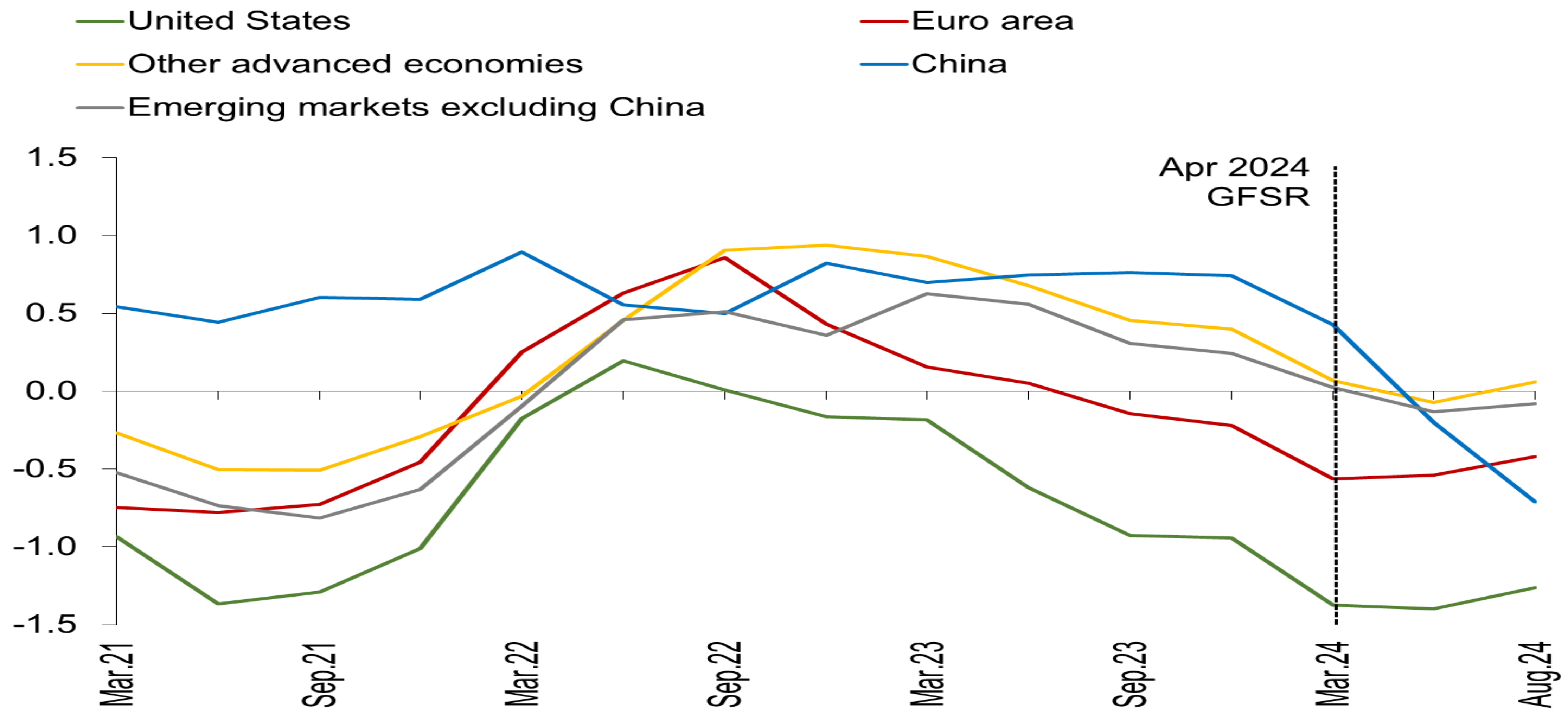
- **The impact of (global) quantitative tightening on markets**, together with higher fiscal issuance in some regions, may weigh further on sovereign spreads.
  - Moreover, as overall liquidity in the financial system decreases due to the QT, strains in some market segment may arise as we move from collateral scarcity to collateral abundance.
  - Shift in government bond buyers base towards more price-sensitive investors.
  - Re-emergence of the sovereign-bank nexus in some countries?

- **US dollar funding box**: An area of concern we should continue to monitor closely.
  - The box touches upon a very specific and critical topic, which is under-documented.
  - The analysis nicely highlights the interconnectedness between banks and non-banks and the complexity of the interlinkages across markets.
  - There is perhaps room to expand further the analysis on the role of NBFIs in the US funding market, data permitting.
  - Mitigation tools: Are central bank swap lines enough to mitigate the US funding shortage given not all financial institutions have access to these facilities?

Steadying the Course – Financial Markets Navigate Uncertainty

- Financial conditions remain accommodative, and market volatility subdued, but economic uncertainty and geopolitical risks are elevated.
- Medium-term vulnerabilities continue to mount:
    - High levels and rapid growth of sovereign debt
    - Debt servicing challenges for corporates and CRE remains a heightened risk.
- Widespread adoption of AI in capital market activities may increase financial fragilities

Financial Conditions Indices
(Number of standard deviations over the long-term average)



Sources: Bloomberg Finance L.P.; Dealogic; EUROPACE AG/Haver Analytics; national data sources; and IMF staff calculations.

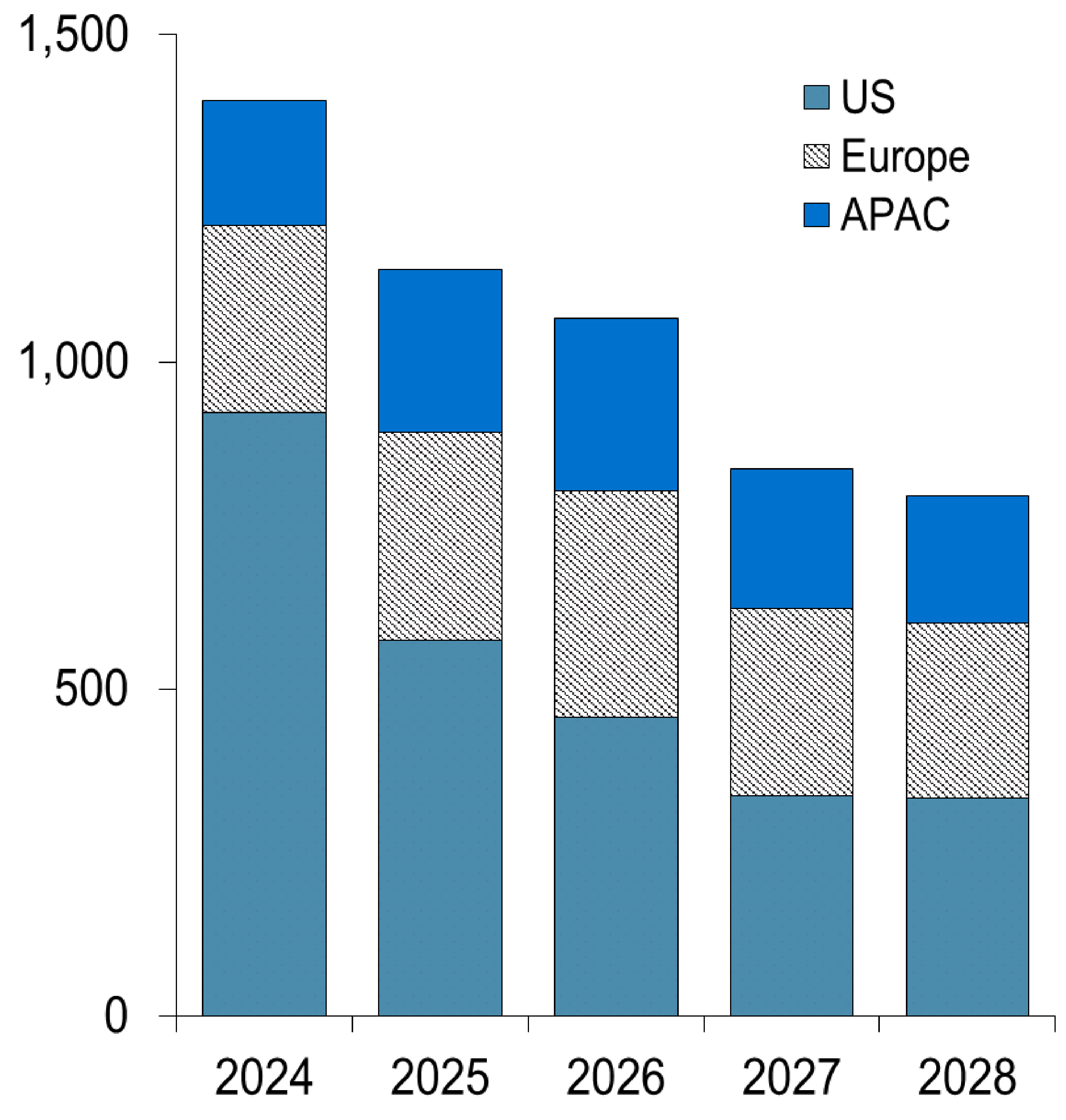
Note: The IMF's Financial Conditions Index is designed to capture the pricing of risk. It incorporates various pricing indicators, including real house prices, but does not include balance sheet or credit growth metrics. For details, see Online Annex 1.1 in the October 2018 GFSR. Panel 2 shows the key drivers of financial conditions indices in terms of the contribution of underlying components, which is the weighted average of the *z*-scores of these components. "Aggregate" represents the sum of these contributions, and its values are similar, but not identical, to Financial Conditions Index values shown in panel 1. AEs = advanced economies; EMs ex-China = emerging markets excluding China; GFSR = *Global Financial Stability Report*.

Gap Between Financial Volatility, Economic Uncertainty and Geopolitical Risk

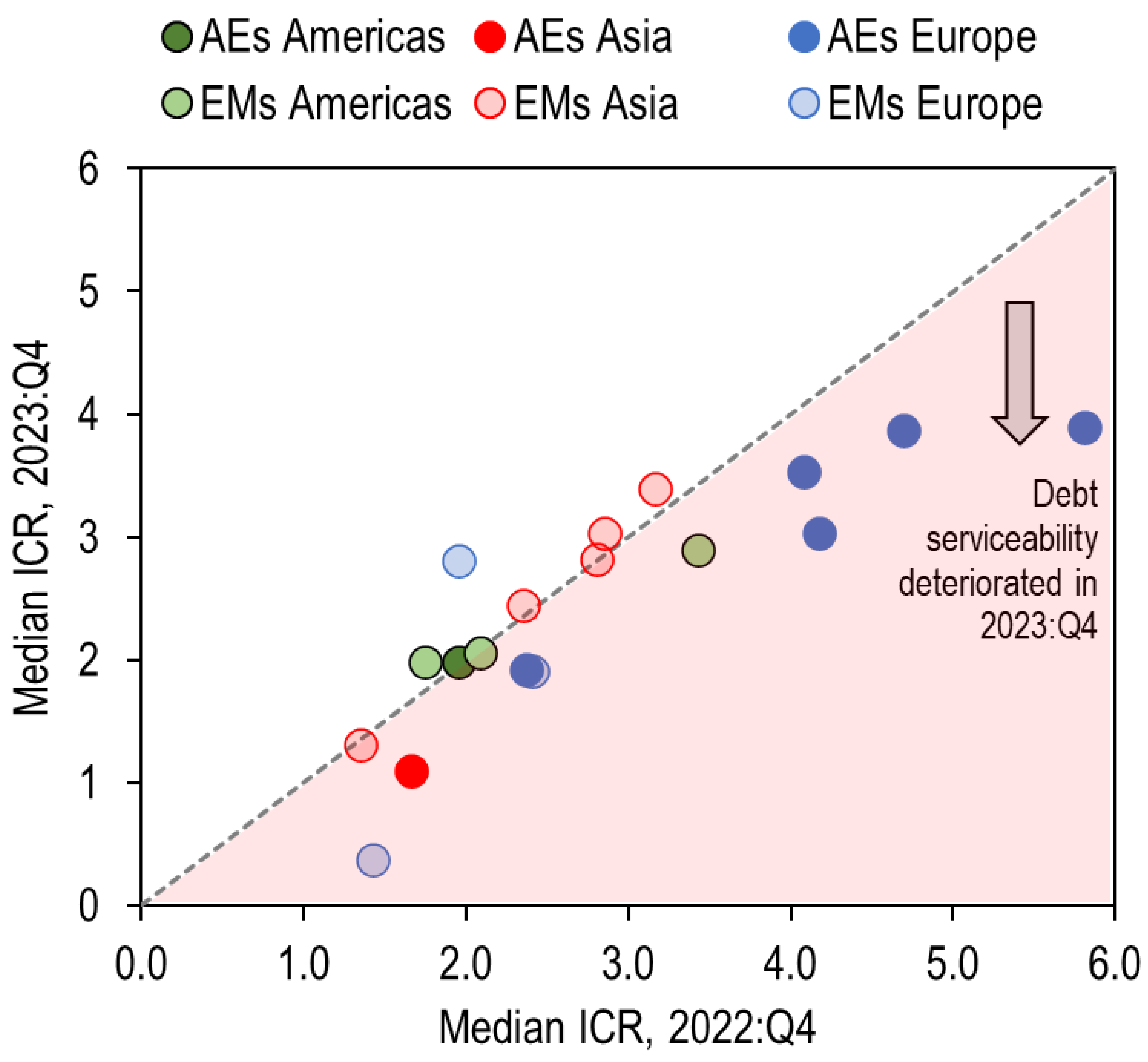
Source: Bloomberg Finance L.P.

CRE Risk and Corporates Debt Sustainability Challenge

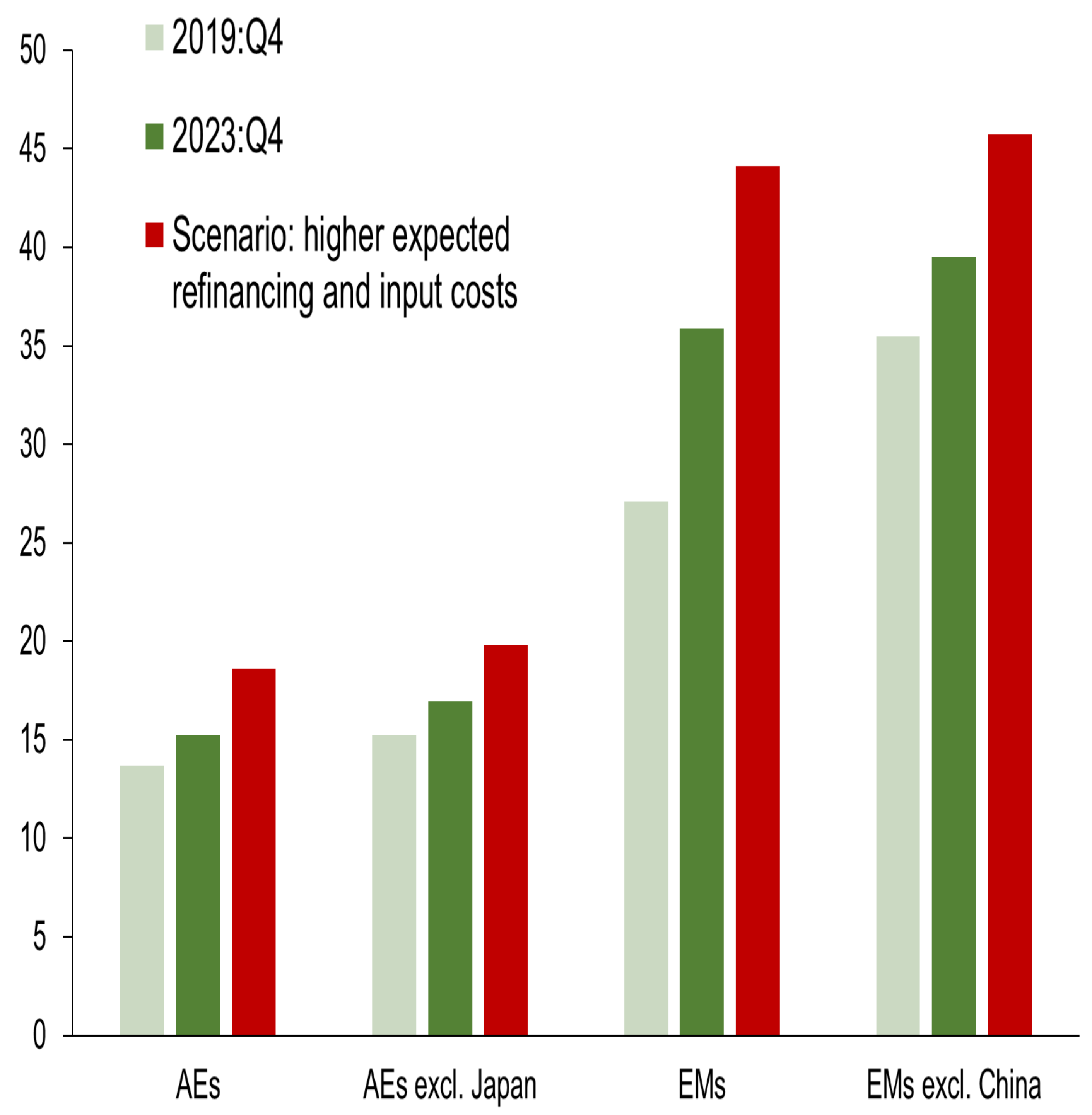
CRE Maturing Debt and Funding Gap
(Billions of US dollars)



Interest Coverage Ratio across regions and over time
(Times)



Share of Corporate Debt in Total with ICR below 1
(Percent)



Note: The scenario depicted by the red bars is calibrated to reflect higher expected marginal financing cost based on the current market yield, and potential upward pressures on input costs, due to factors like recalibration of international trade policies or supply chain disruptions caused by geopolitical events. Green bars are realized ratios, as of the time indicated.

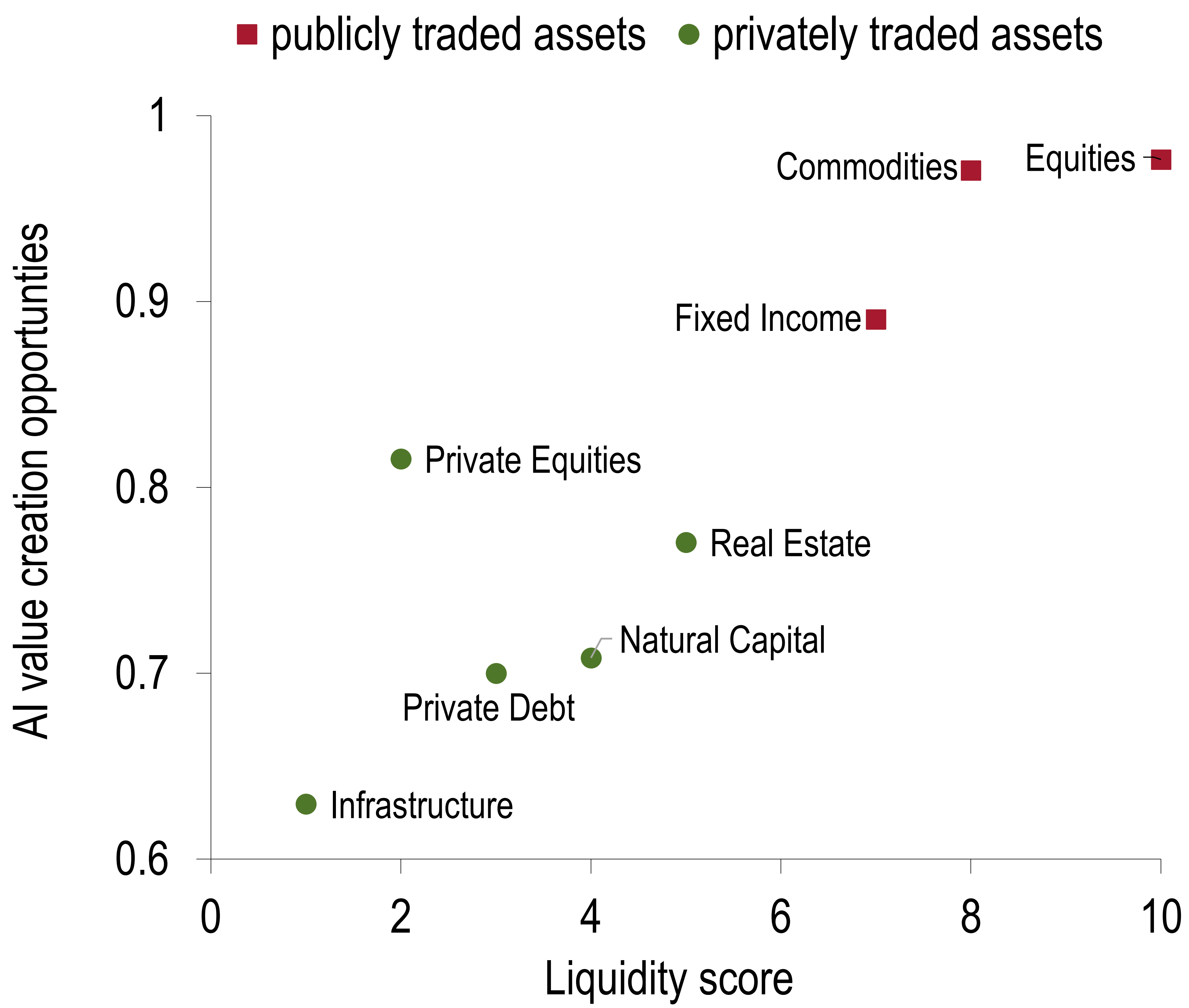
Sources: Bloomberg; Bond Radar; CapitalIQ; Dealogic; IMF's World Economic Outlook; and IMF staff calculations

AI Can Provide Benefits But Also Introduces Risks In Markets

AI opportunities: liquid and publicly traded assets stand out due to transaction volumes and data availability

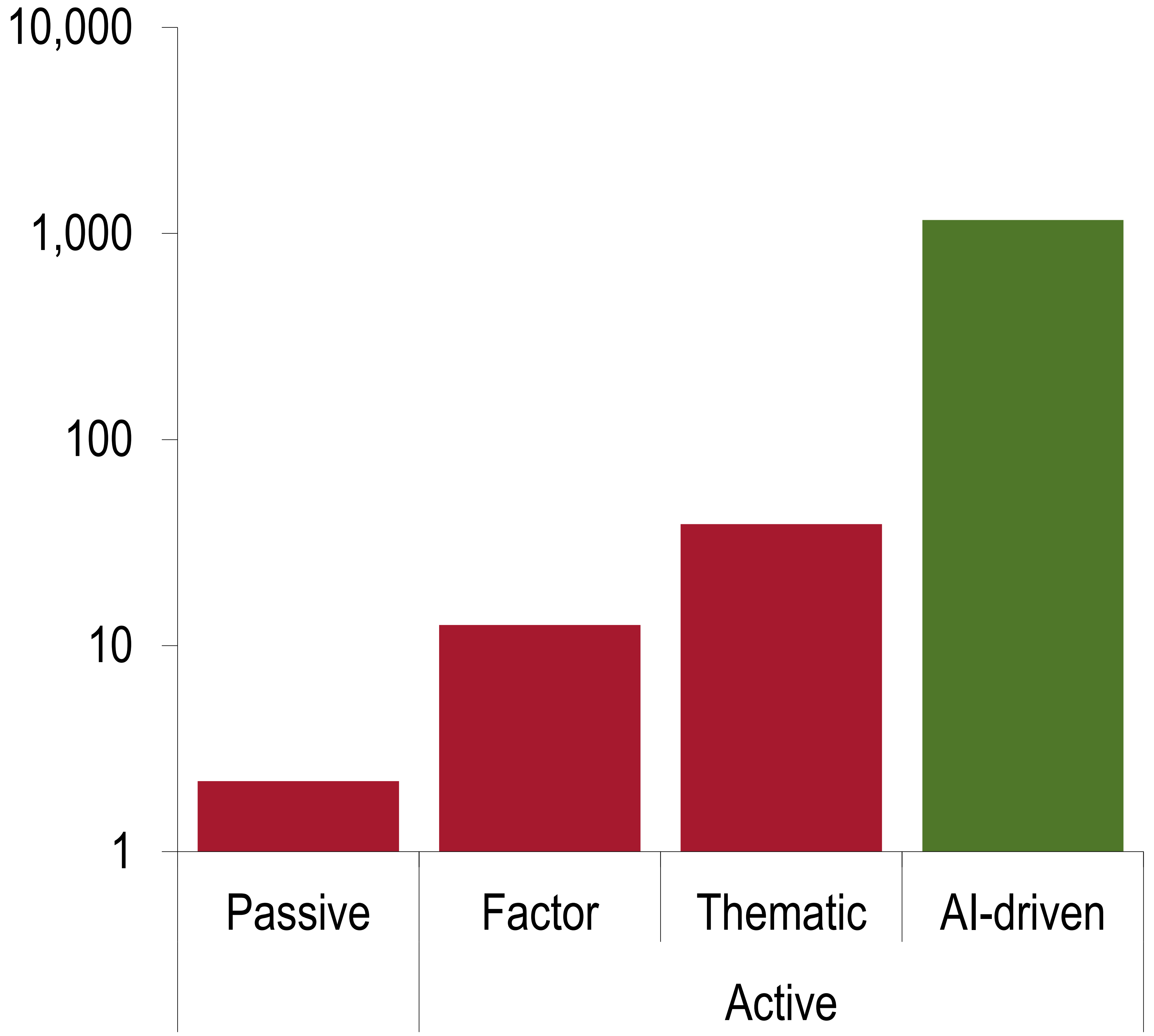
AI-driven investment strategies can lead to higher trading volumes and a higher market adjustment speed

AI Opportunities and Asset Class Liquidity
(Value creation opportunity index; liquidity score)



Sources: SEC Filings, IMF staff calculations
Note: Value opportunities according to Mercer, AI integration in investment management (2024) global manager survey, which included 150 asset management managers

Portfolio Turnover of ETFs
(Percent of assets under management)



Note: Portfolio turnover as of fiscal year 2023. Turnover ratios are expressed on a logarithmic axis