

Annex 1

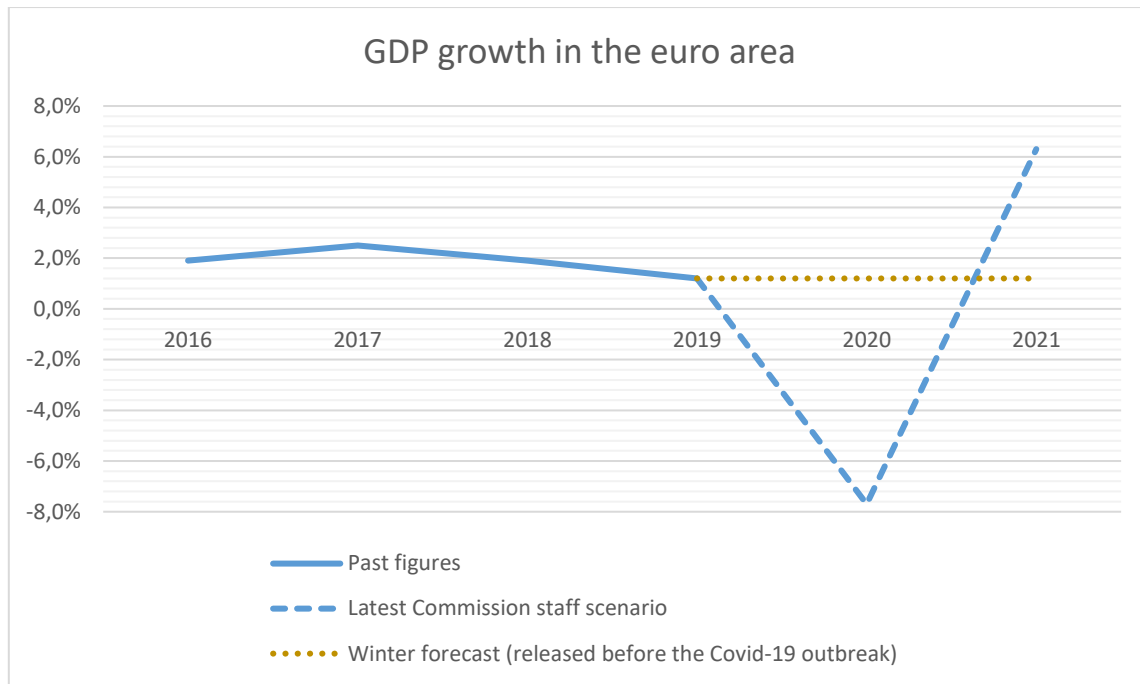
Assessment of risks to the financial stability of the euro area (in preparation of the assessment pursuant to Article 13(1) ESM Treaty)

Having assessed at technical level the risks to the financial stability of the euro area, the European Commission services have reached the following preliminary conclusions:

1. The Covid-19 epidemic has generated major recessive impacts, which will last for several months, and has caused severe turmoil in the financial markets.
2. Member States and European Institutions reacted swiftly to address risks of an imminent downward spiral toward a major economic, financial and social crisis, and to stabilise markets and economies. Nevertheless, there is still a risk to the financial stability of the euro area as a whole. Averting severe and lasting damage to citizens, firms, public institutions and to the Economic and Monetary Union may require additional and substantial efforts.
3. Financial assistance by the ESM to the benefit of its members, in particular under precautionary arrangements, would contribute to instilling confidence, would help to stabilise financial markets and would reduce risks to the financial stability of the euro area as a whole and of the euro area Member States.

A. A symmetric macroeconomic shock of an extraordinary magnitude

4. Since the beginning of 2020, the euro area has been facing an unprecedented shock caused by the pandemic. Since January, international supply chains have been severely disrupted. “Lockdown” measures initiated in February-March 2020 to protect the population of each Member State and of the EU as a whole have caused a severe reduction in the production of goods and services and a sudden stop of some activities such as tourism and travel. The pandemic is clearly an exogenous and common shock that affects all countries and sectors, although its impact differs among Member States given differences in the structure of their economies.
5. All economic indicators are confirming a sudden and exceptional contraction of the economy.
6. As a result, the Commission staff has revised substantially downwards the growth scenario for 2020, compared to the forecast released in February. In its *Spring forecast*, the Commission staff anticipates negative real growth at -7.7% instead of +1.2% for euro area GDP. Other forecasters such as the IMF (World Economic Outlook, 6 April 2020) anticipate contractions in economic activity of a similar magnitude. The recovery is projected to start in the second half of 2020. However, the real GDP level of all but two euro area Member States is expected to be lower in 2021 than it was in 2019.



Source: European Commission services

B. Exceptional turmoil on the financial markets

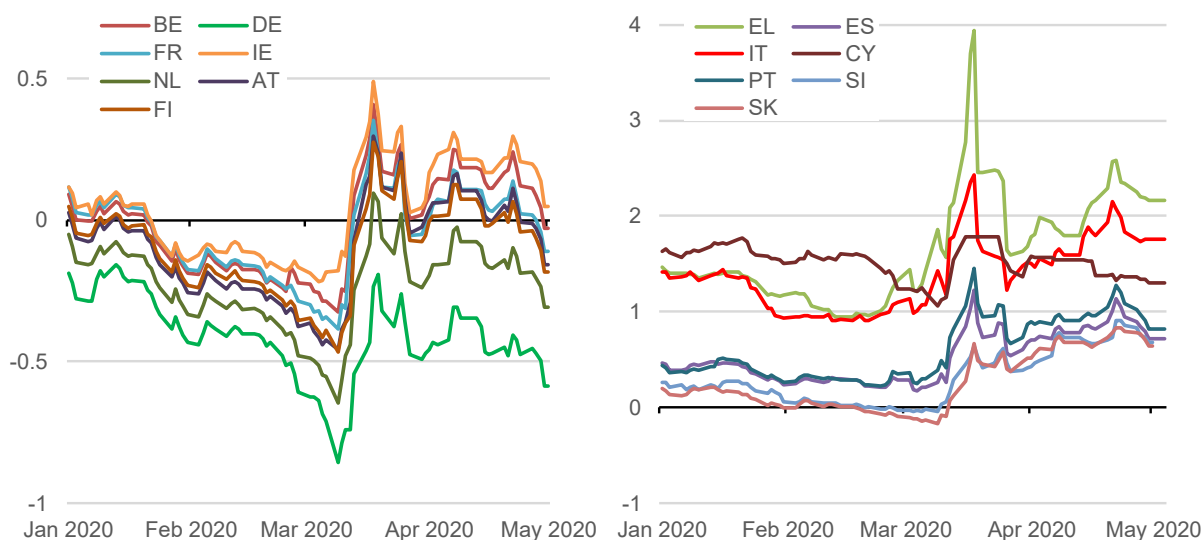
a. Market developments since the crisis outbreak

7. Because of the general worsening of the economic situation and of the uncertainty about the pace of the return to normality, financial markets in the euro area and more globally experienced severe downward price corrections and increased volatility. Public policies, including by the ECB and other monetary authorities across the globe, have reduced but not fully offset the price corrections and volatility.

8. The stock market and the commodities markets have been severely affected. In the first quarter of 2020, the Eurostoxx 50 fell by almost 27% and the price of Brent oil lost about 60% of its USD value. The correction in asset prices was extremely rapid by historical standards and volatility on the European stock market as measured by the STOXX index reached an all-time high at 86 on 16 March 2020 and has engaged in April in a slowly decreasing trend between 50 and 45, a level comparable to the peaks reached during 2010-2011.

9. Sovereign bond markets have also suffered from the deteriorating economic conditions and the higher uncertainty level. Until the ECB announcements of 18 March 2020¹, the spreads of some area Member States had widened and market liquidity had sharply reduced. Forceful policy action by the ECB has been effective in preventing a fragmentation of financial markets that could have blunted the transmission of monetary policy. Although this policy has been effective in avoiding a further widening of spreads, spreads on the euro area sovereign bond market remain significantly above their level at the beginning of the year.

¹ https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200318_1~3949d6f266.en.html

Euro area Member States: 10-year benchmark government bond yields (% p.a.); latest value: 1 May

Source: Bloomberg

10. Corporate sector funding conditions tightened even more considerably. Corporate bond spreads widened noticeably for investment grade issuers and surged in the high-yield segment while corporate bond issuance almost stalled in the wake of the coronavirus outbreak.

11. Tensions on euro area money markets have remained limited so far. This reflects the still very high excess liquidity in the euro area banking system as well as recent ECB measures, which ensured ample liquidity support. Nonetheless, the recent increases in euro area sovereign spreads are likely to have exacerbated somewhat the fragmentation of secured euro area money markets, with some divergence in rates on different general collateral baskets emerging since mid-March, in addition to ongoing differences on special collateral markets. Furthermore, there are signs of USD shortages on global financial markets affecting also euro area market participants. The ECB and other central banks have reacted by installing USD swap lines with the US Fed, which has also significantly stepped up its Treasury purchases and repo operations to provide USD liquidity to markets.

b. Market access of Member States during the last 12 months

12. All euro-area Member States experienced a complete and solid access to sovereign debt markets over the past 12 months, including after the crisis outbreak. All countries issued medium- or long-term debt², including all former programme Member States. The maturity of the issuances and the monthly average number of bond issues (ranging from 0 to 8 per month, including regular auctions and syndication) reflected funding strategies and revealed no market access constraint.

13. The average funding costs³ for the past 12 months have been below historical averages, reflecting good conditions in the market access. The average funding costs for the past 12-

² Except one Member State issued only short-term bills due to the very limited size of its debt in absolute and relative terms.

³ As measured by the [ECB](#), percentage per annum yield, based on the issues in the last 12 months, weighted by face value of each issue.

months declined to 0.1% in March 2020 from 0.4% in early 2019. Deviations from this average are limited: the average funding cost was 1.4% in the member state with the highest value.

14. Secondary market indicators showed signs of severe stress in February and March and of milder but persistent tensions in April. Despite the stress on markets, countries demonstrated good market access with successful issuances, although the issue premium was higher than normal amid volatile market conditions. Most of the member states had more than average volume of issuances in March. The number of auctions broadly increased, as the pre-announced regular auctions remained intact and some countries successfully launched extra syndications to raise additional financing.

C. A large increase of the gross financing needs of all governments in the euro area during the crisis

15. Member States' governments have to face simultaneously the medical costs of the pandemic, the impact of automatic stabilisers and the cost of discretionary measures to protect jobs, support the income of vulnerable households and, more generally, support the economy. Measures have also been taken by the Member States to preserve liquidity to the several sectors of their economies. Exceptional actions undertaken by euro area Member States with a direct budgetary impact represent, as estimated by the Commission by 29 April 2020, 3.2% of GDP. Liquidity support schemes for firms and workers have been scaled up to almost 24% of GDP.

16. Short-term financing needs of sovereigns are expected to be particularly high due to the interim measures during the lockdown and subsequent quarters. The Commission *Spring forecast* estimates a rise of the gross financing needs of euro area Member States (and subsequently of expected issuances) by more than two thirds in 2020 compared to 2019. Long-term financing will be required to absorb part of the fiscal cost of the crisis and smoothen its impact over the next cycle.

17. Potentially all public entities in Member States bearing exceptional costs due to the current crisis may have to rely on exceptional financing. This includes national social security and unemployment schemes and local governments.

18. According to the latest scenario from the Commission staff, the aggregated government debt ratio of the euro area may increase from 86% of GDP at the end-2019 to 102.7% of GDP at the end-2020. For twelve euro area Member States, the increase in the government debt-to-GDP ratio from 2019 to 2020 may exceed 10 percentage points.

19. The contraction in economic activity leads to an increase in the household and corporate debts by percentage points of GDP despite a decrease of 1% in nominal values. This increase in the private sector debts, and the extension of guarantees and other support mechanisms by the government generates contingent risks for the public sector.

D. A sizeable direct and indirect impact on the financial sector

20. The banking sector of the euro area has considerably enhanced its resilience during the last decade and entered the recent crisis with significant capital and liquidity buffers.

Importantly, from the inception of the Single Supervisory Mechanism in 2014 to end-2019⁴, banks in the euro area have increased their own funds (the average CET1 ratio has risen from 13% to 14.8%), their funding structure has become more resilient and the stocks of non-performing loans in the euro area have declined (from 8.1% of gross loans to 3.3%).

21. Since the start of the crisis, efforts have been made to preserve bank lending to the economy. The ECB, the EBA the SSM and the SRB have announced exceptional temporary measures to help the banking sector to keep financing households and firms to bridge their loss in revenues in the past weeks and the coming months.

22. The ECB has further supported liquidity provisions to euro area banks by introducing temporary additional weekly long-term refinancing operations, raised the maximum amount that counterparties can borrow in existing targeted long-term refinancing operations and has eased the collateral framework, thus complementing the existing liquidity-providing instruments in place. Moreover, the ECB has announced additional purchases of public and private sector assets (via the Pandemic Emergency Purchase Programme and an increase of the Asset Purchase Programme) which will increase its balance sheet by an additional EUR 1 trillion (8.5% of euro area GDP).

23. Following EBA and supervisory decisions, banks will be allowed to operate temporarily below Pillar 2 Guidance, the Capital Conservation Buffer and the minimum required level of the Liquidity Coverage Ratio (LCR). Some Member States released the Countercyclical Capital Buffer and reduced the Systemic Risk Buffers, where they were in place, to be in better position to absorb losses and support the economic recovery with credit. Supervisory actions have been taken to mitigate the impact of the crisis on the potential rise in non-performing loans and on the provisioning requirements of banks and to allow banks to fully benefit from generalised moratoria and guarantees put in place by public authorities⁵. The Commission interpretative communication COM(2020)169 of 28.04.2020⁶ and other decisions allowed banks to hold lower capital to cover market risks in order to maintain banks' market making activities and market liquidity⁷.

24. The resilience built during the last years has safeguarded the solvency of the euro area banking system, as confirmed by the ECB-Banking Supervision in the solvency assessment of the euro area credit institutions attached to its letter sent to the Commission on 24 April 2020. However, many banks have already been struggling with low profitability in an environment of persistently low interest rates. Banks will now be affected also by the fall in economic activity and of asset prices and the increasing economic strain of their borrowers or policyholders, and, accordingly, higher credit risk, higher wholesale funding costs due to more adverse market conditions and credit downgrades. Credit risk is only partially and temporarily mitigated by the official measures taken and by increased regulatory flexibility. The solvency of insurers also remains robust, but the sector has also faced problems of profitability in the low-interest rate environment. Insurers will now also be affected by declining levels of economic activity, volatility in asset valuations and a need to absorb an increased number of damage claims for 2020 linked to the direct and indirect effects of the pandemic.

⁴ Figures of this paragraph are quoted from the [2019 ECB Annual Report on Supervisory Activities](#)

⁵ <https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200320~4cdbbcf466.en.html>

⁶ <https://ec.europa.eu/transparency/regdoc/rep/1/2020/EN/COM-2020-169-F1-EN-MAIN-PART-1.PDF>

⁷ <https://www.bankingsupervision.europa.eu/press/pr/date/2020/html/ssm.pr200416~ecf270bca8.en.html>

25. These challenges ahead for financial institutions have not only been reflected by the very large drop in their share prices, but also in a series of negative ratings outlooks published by rating agencies. They may trigger in turn knock on effects on market and credit risk and capital losses (all euro area G-SII have been placed on negative surveillance by one or more of the three main agencies).