Financial Stability Review December 2008

Lucas Papademos

Frankfurt am Main, 15 December 2008

Outline

I Overview

II Risks in the global macro-financial environment

III Risks in euro area non-financial sectors

IV Risks in the euro area financial system

V Overall assessment

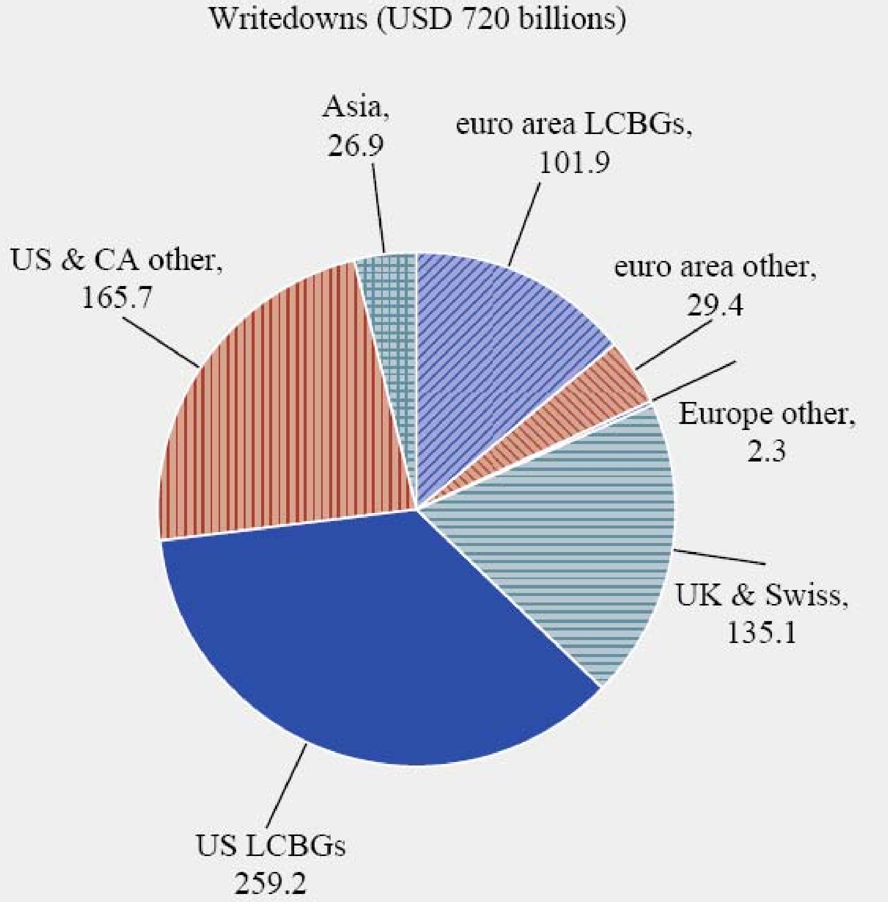
I Overview

Between the beginning of the second quarter of 2007 and early December 2008, the total write-downs due to mark-to-market losses for the global banking system amounted to USD 720 billion…

… with euro area banks accounting for USD 131 billion, or 18% of the global amount

Chart 1 Turmoil-related bank writedowns by region

(Q2 2007 – 10 Dec. 2008)



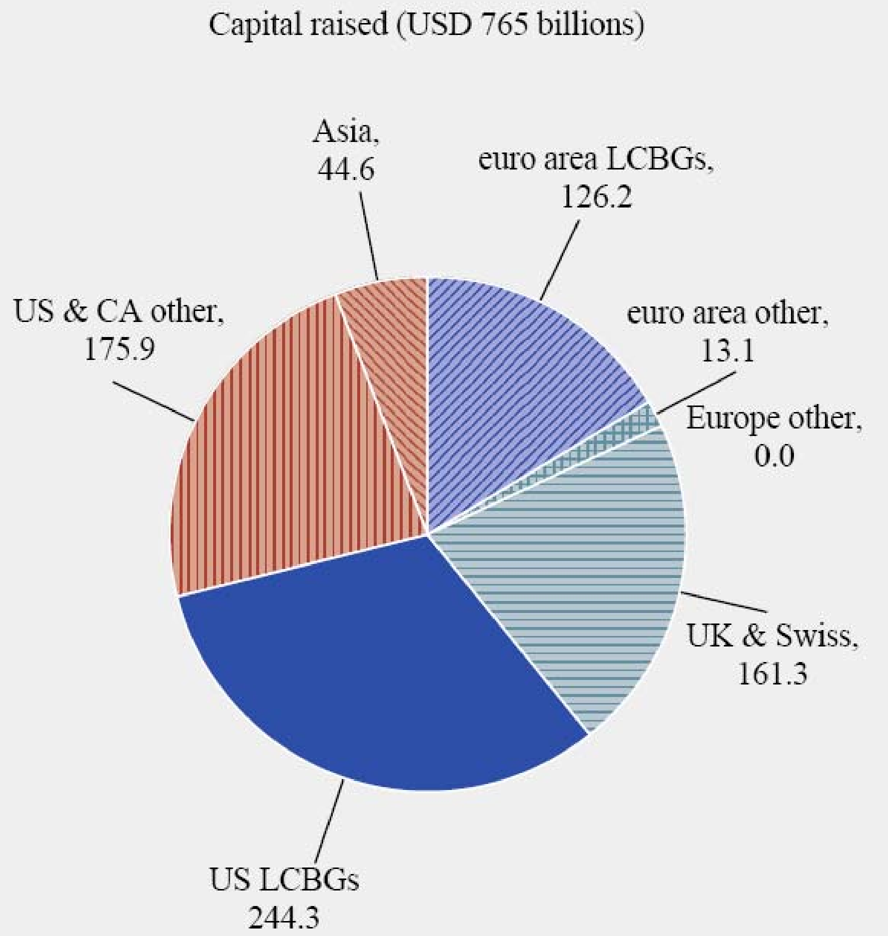
I Overview

Over the same period, banks raised USD 765 billion worth of new capital throughout the world, USD 139 billion, or 18%, of which was accounted for by euro area banks ...

... on aggregate, banking systems have consequently more than covered the losses they have reported thus far with fresh capital

Chart 2 Capital injections into banks by region

(Q2 2007 – 10 Dec. 2008)



I Overview

Credit losses of euro area banks generally remained low in 2008 …

… in the period ahead, a key risk for euro area financial system stability is the outlook for borrowers' credit quality and the possible adverse feedback of financial system stresses on the broader economy

Chart 3 Real GDP growth in the euro area and the Eurosystem staff macroeconomic projections for the euro area

(percent change per annum)

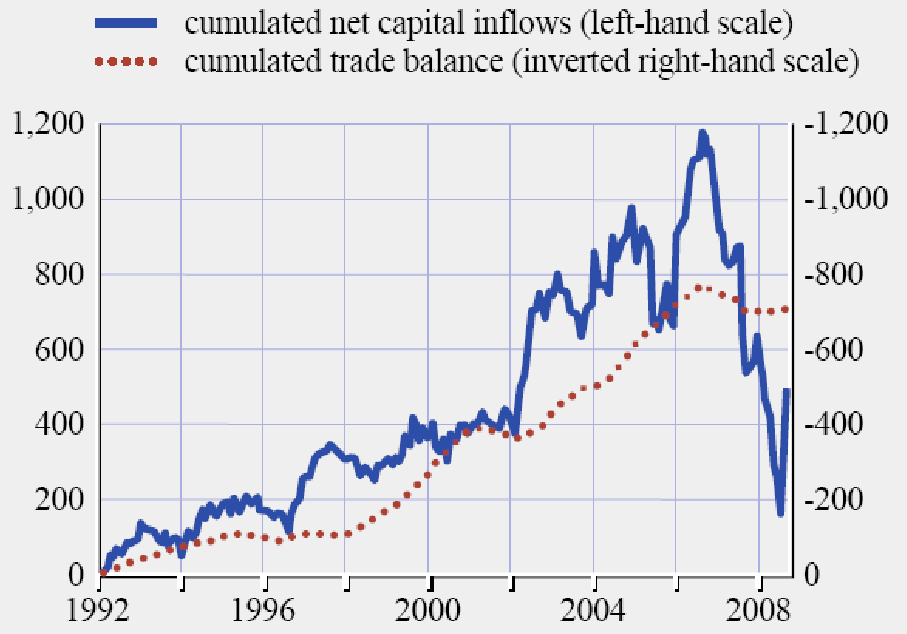
II Risks in the global macro-financial environment

The risk of a disorderly correction of global imbalances persists …

… the US trade deficit remains large and inflows of private capital from abroad have not been matching the trade balance

Chart 4 US trade balance and net capital inflows to the United States

(USD billions; 12-month moving sums)



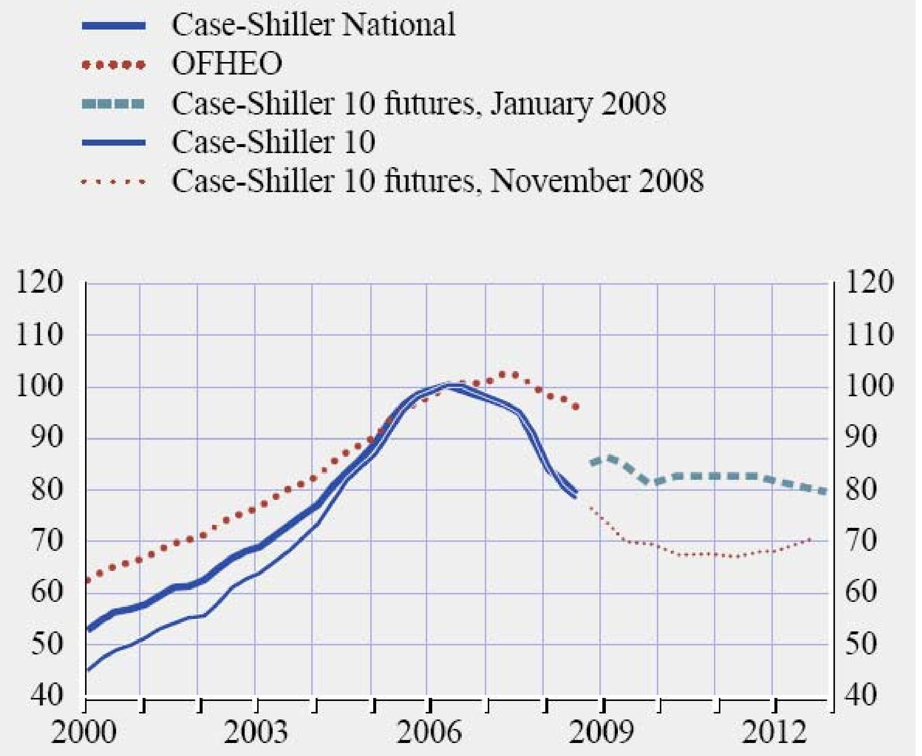
II Risks in the global macro-financial environment

Since June 2008, US household sector balance sheet conditions have deteriorated somewhat further …

… and futures markets are pricing in another year of declines in house prices, suggesting that further credit losses could yet crystallise

Chart 5 US house prices and outlook

(index: Q2 2006 = 100; nominal prices)



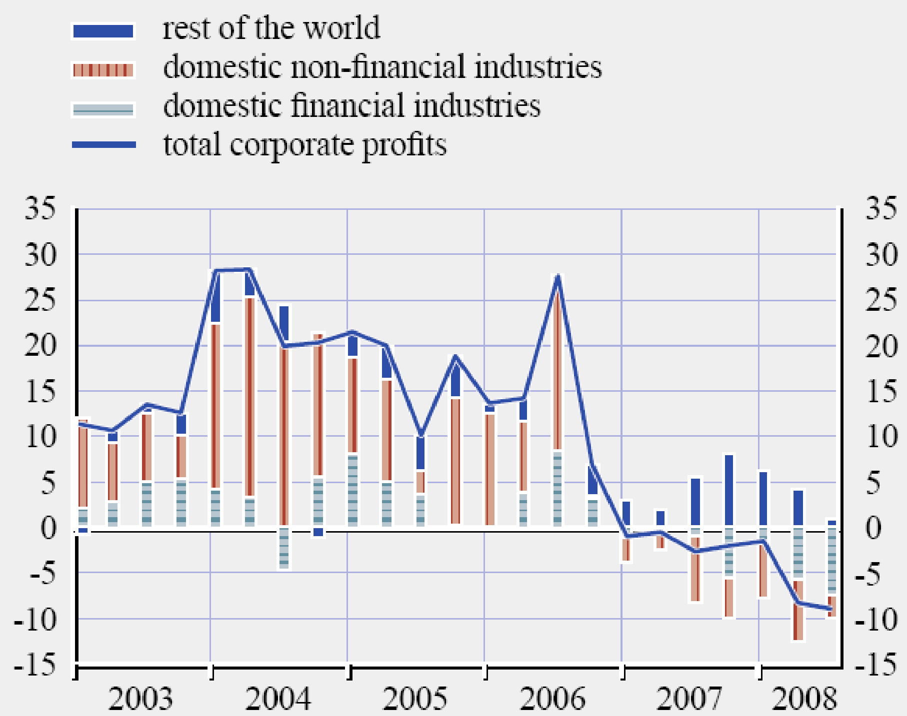
II Risks in the global macro-financial environment

The outlook for the US corporate sector has weakened substantially amid slowing economic growth …

… with profits from the rest of the world the only positive contributor to profit growth in 2007 and 2008

Chart 6 US corporate sector profits

(percentage point contribution to year-on-year growth; seasonally adjusted)



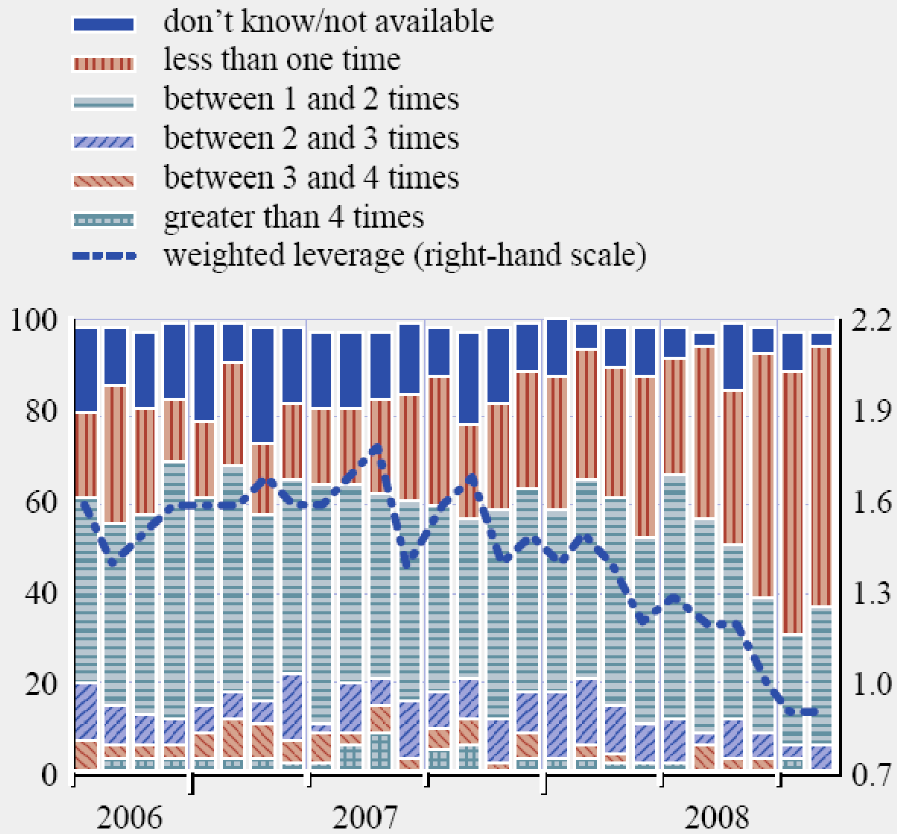
II Risks in the global macro-financial environment

Hedge funds have been deleveraging sharply in order to preserve capital …

… the process has been partly voluntary, but forced liquidations have also increased in response to investor withdrawals

Chart 7 Hedge fund leverage

(percentage of responses and weighted average leverage)



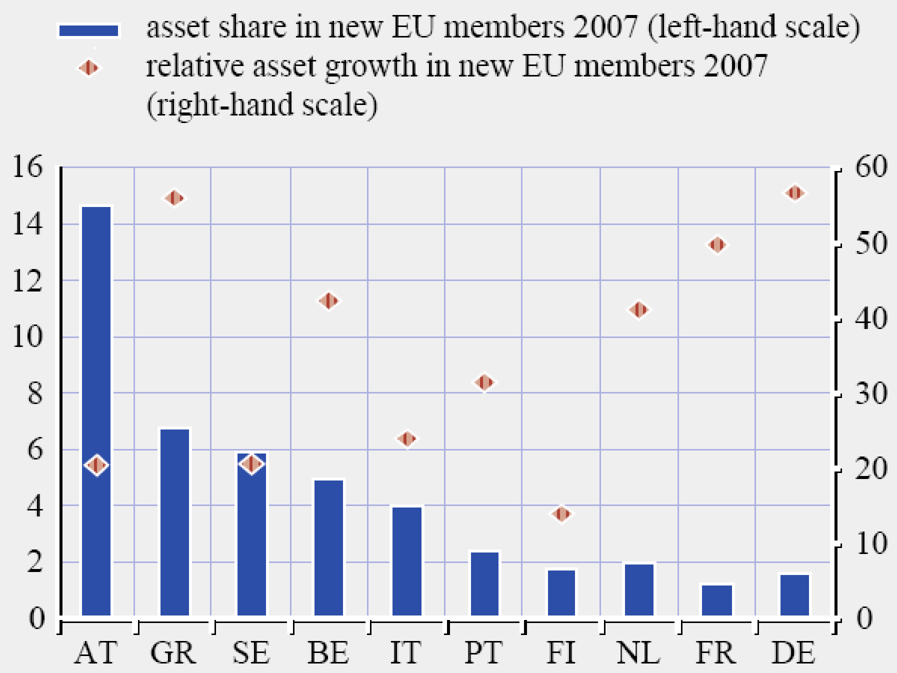
II Risks in the global macro-financial environment

The presence of euro area financial institutions in Central and Eastern European countries has continued to grow rapidly …

… but the economic slowdown in these countries implies that risks originating from EU banks' exposures to the new EU Member States have grown

Chart 8 Asset share of EU banks' subsidiaries in new EU Member States and relative asset growth in 2007

(percentage)



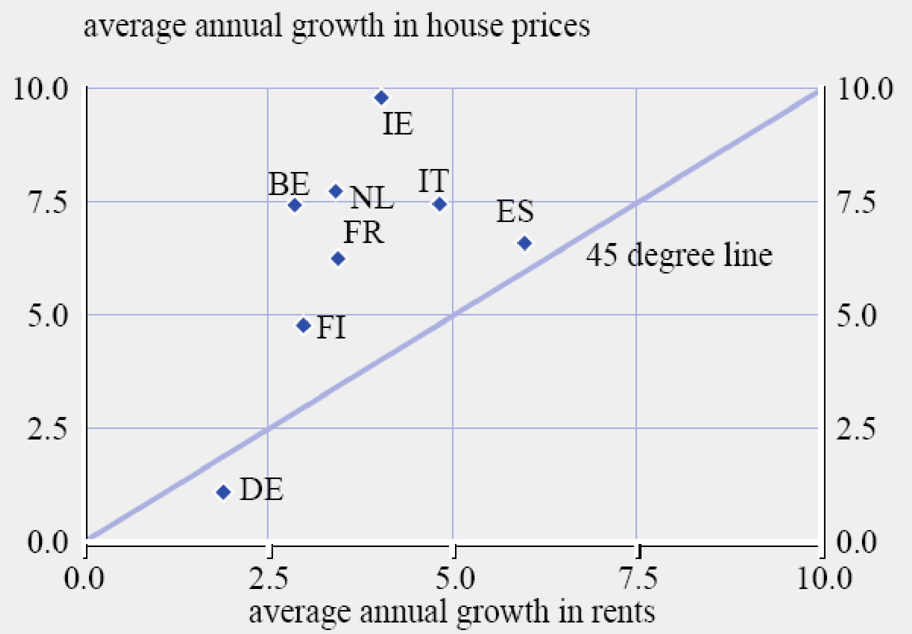
III Risks in the euro area non-financial sectors

Euro area households' income and employment expectations have deteriorated further …

… while risks of house price declines remain in some parts of the euro area, thus contributing to growing credit risks for banks

Chart 9 House prices and rents in selected euro area countries

(average percentage changes over 1985-2007)



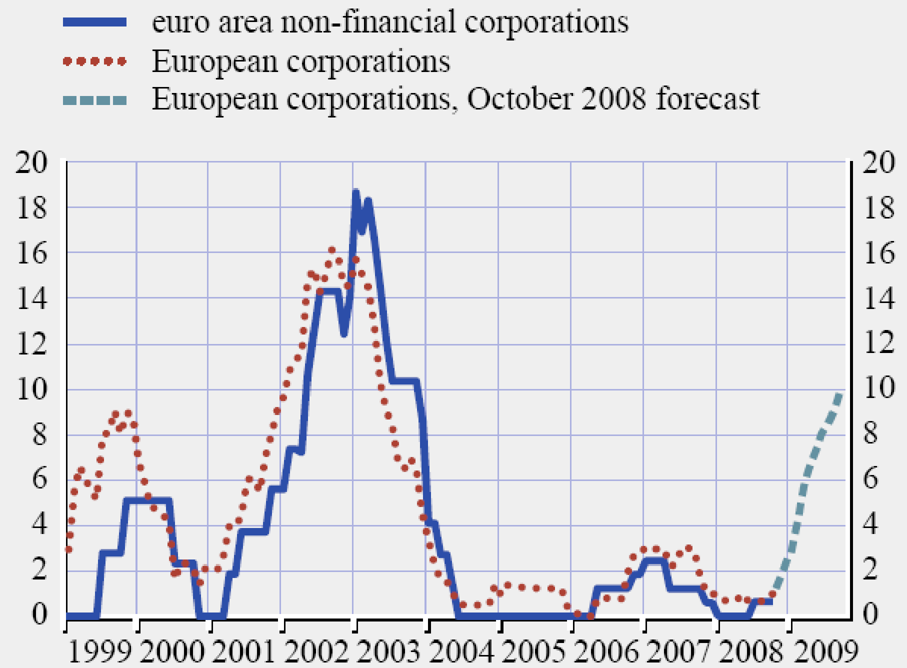
III Risks in the euro area non-financial sectors

Euro area non-financial corporate sector balance sheets are relatively sound …

… but the slowdown in demand has contributed to an increase in expected distress among lower-rated firms

Chart 10 Euro area and European speculative-grade-rated corporations' default rates and forecast

(percentage; 12-month trailing sum)

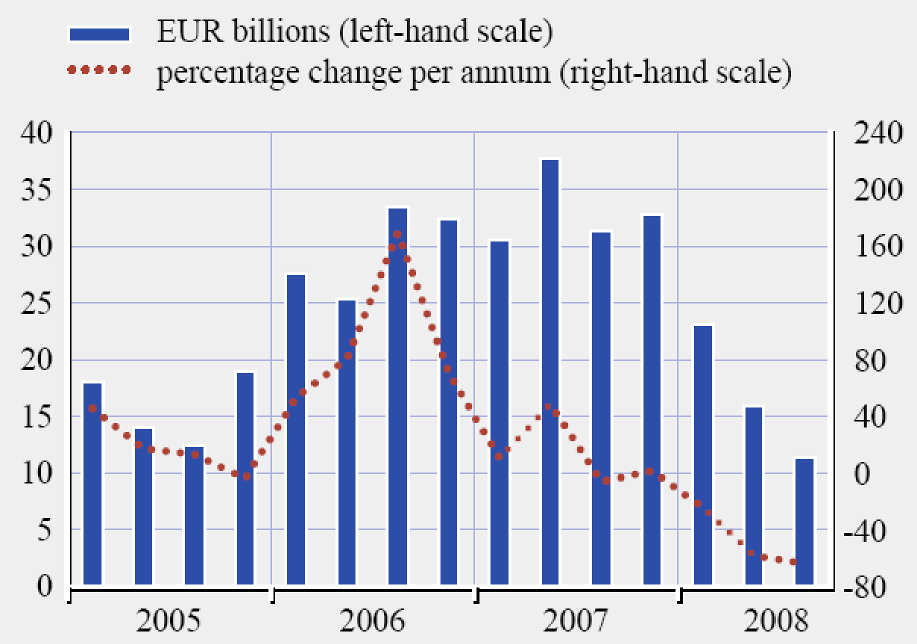


III Risks in the euro area non-financial sectors

The decline in direct investment volumes contributed to stabilising or even falling prices in the commercial real estate sector…

… to which many euro area banks have large financing and/or investment exposures

Chart 11 Direct commercial property investment volumes in the euro area

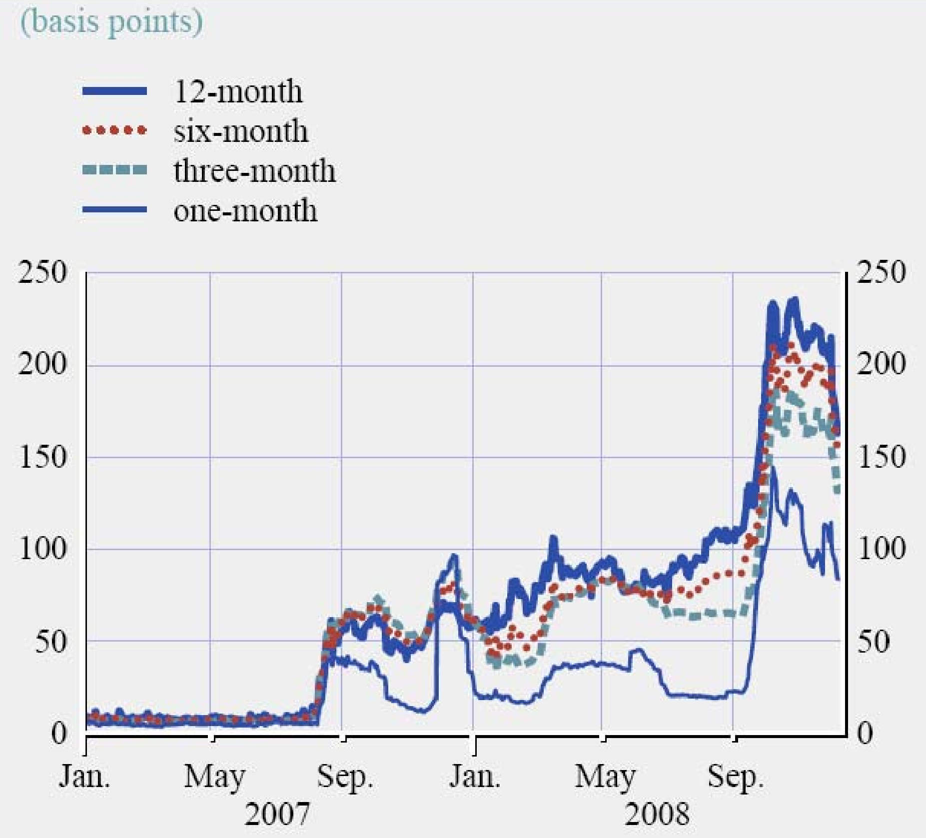


IV Risks in the euro area financial system

The failure of Lehman Brothers triggered a further increase in counterparty risk in global money markets …

… with the widening of term spreads driven by uncertainty about the creditworthiness of counterparties and banks' own liquidity needs

Chart 12 Spreads between EURIBOR and EONIA swap rates



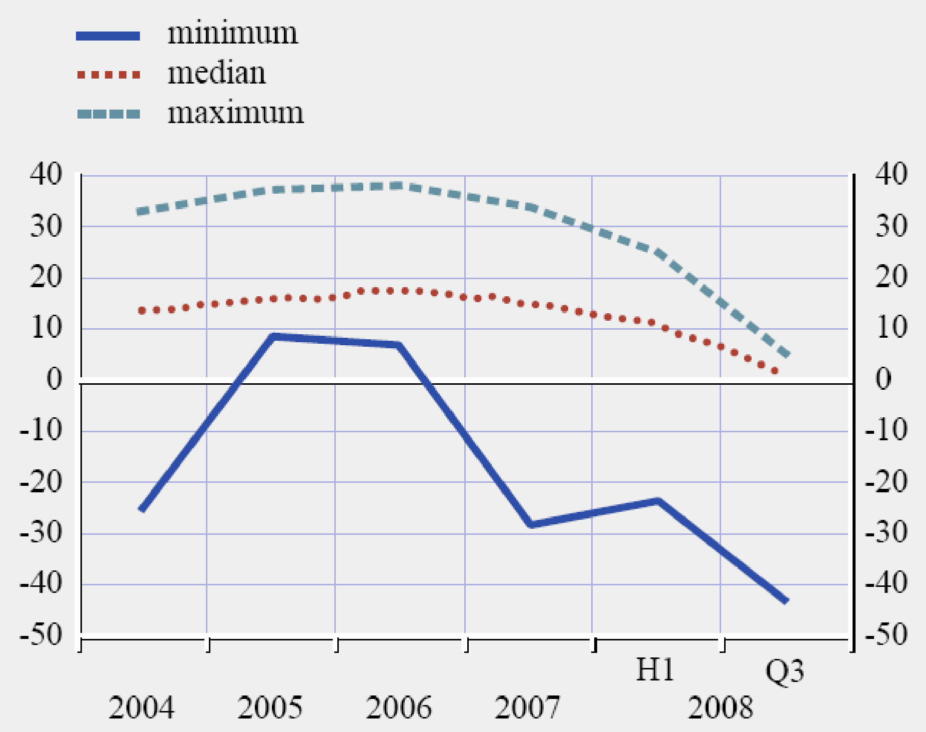
IV Risks in the euro area financial system

For euro area large and complex banking groups (LCBGs), persistent funding problems, as well as sizeable write-downs on securities, contributed to falling profits …

… although performance measures have shown a rather wide dispersion across institutions since the beginning of the turmoil

Chart 13 Dispersion in return on equity (ROE) for euro area large and complex banking groups

(percentage)



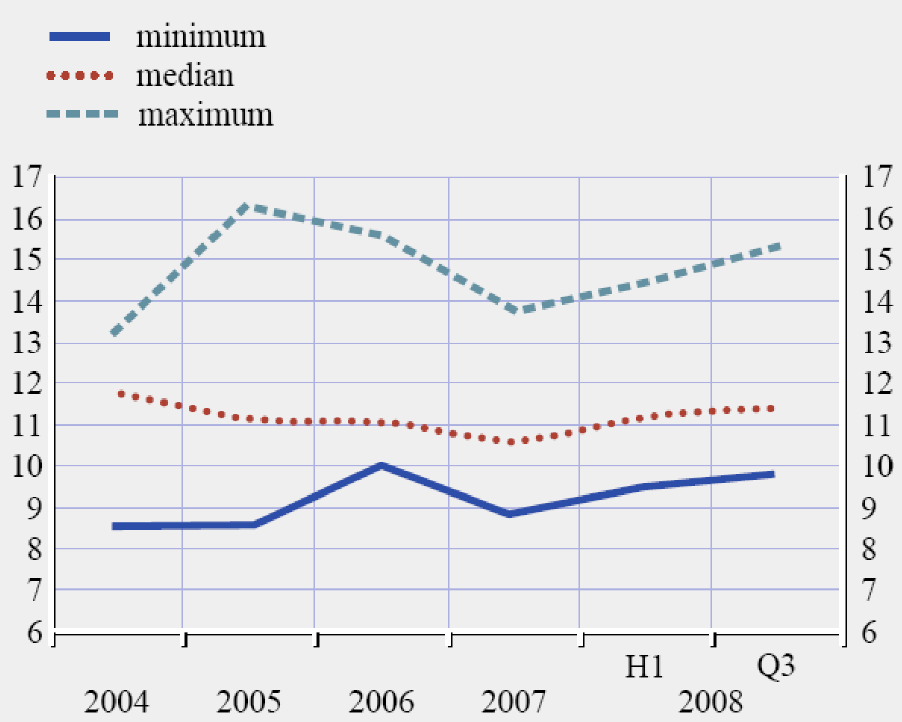
IV Risks in the euro area financial system

Declining growth of risk-weighted assets and new capital raised contributed to improving solvency ratios …

… but further risks ahead imply that banks should use all means at their disposal to bolster their capital buffers in order to minimise the risk of a slowdown in lending to the broader economy

Chart 14 Overall solvency ratios for euro area large and complex banking groups

(percentage)



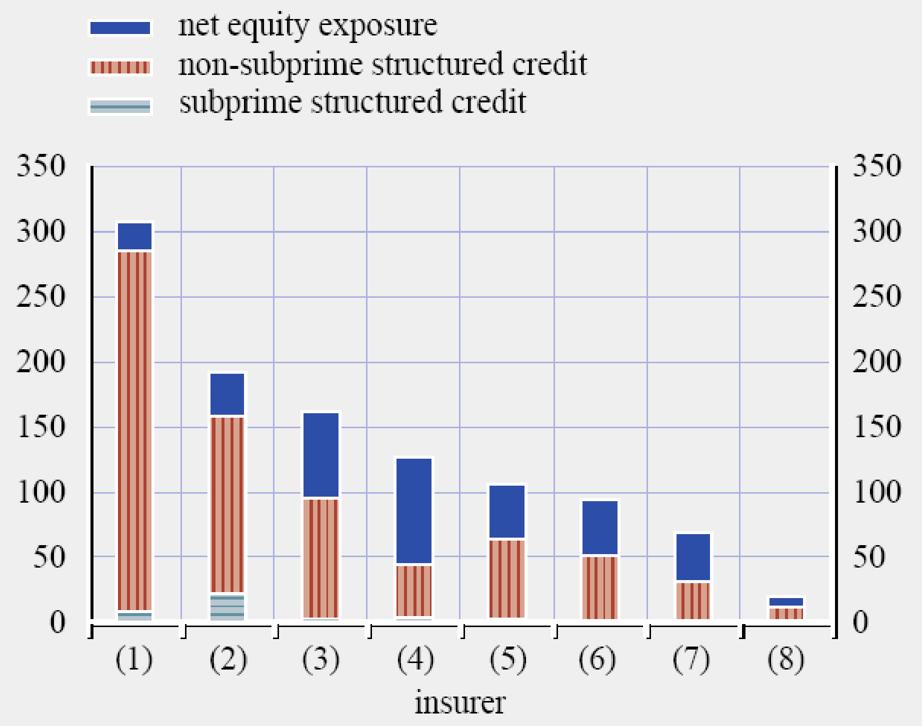
IV Risks in the euro area financial system

Investment losses have also contributed to a deterioration in the profit outlook of the euro area insurance sector …

… but the magnitude of the exposures to structured credit products and equities differs across institutions

Chart 15 Credit and equity exposures of selected euro area primary insurers and reinsurers

(percentage of shareholders' equity)



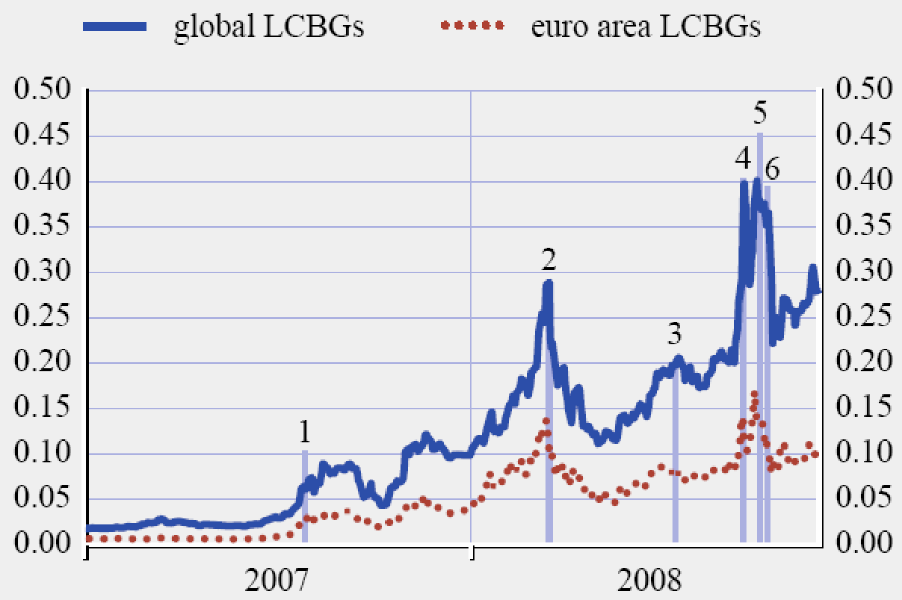
IV Risks in the euro area financial system

The financial sector turmoil intensified sharply after September 2008 …

… coordinated actions by central banks and governments contributed to a decline in systemic risk …

… but indicators remain at elevated levels, suggesting that further stress cannot be ruled out

Chart 16 Systemic risk indicator for large and complex banking groups



1. Turmoil begins
2. Bear Stearns rescue take-over
3. Rescue plan of US Fannie Mae and Freddie Mac announced
4. Lehman Brothers defaults
5. US Senate approves Paulson plan
6. Coordinated central bank and government actions

IV Risks in the euro area financial system

The extraordinary measures taken by the public sector to support financial institutions include liquidity and capital support, debt guarantees and asset purchases … but it is important that the financial sector plays its part in the adjustment process by taking advantage of these measures

Measures taken globally to support financial system stability

	Euro area	Other Europe	US
Liquidity	Extensive longer term refinancing, expanded collateral frameworks, joint efforts to provide USD liquidity		
	Joint efforts to provide liquidity outside the euro area between the ECB and the central banks of Denmark, Hungary, Switzerland		
Capital injections	EUR 92 billion injected out of EUR 201 billion of explicit commitments	EUR 64 billion injected out of EUR 68 billion of explicit commitments	USD 242 billion of the USD 700 billion TARP injected + USD 200 billion into 2 GSEs
Guarantees	Temporary rise of deposit insurance limits. Guarantees on new bank debt established		
	Wider – even blanket – guarantees of bank liabilities set up in some countries		
Asset purchases	EUR 30-50 billion fund in Spain. Swapping bank assets against government bonds in Greece (EUR 8 billion) and Italy (EUR 40 billion)	EUR 42 billion fund in Switzerland to purchase illiquid assets.	Not included in the TARP anymore. Several other programs to purchase whole loans, MBSs, ABCP
Regulation changes	Temporary bans for short-selling of financial stocks		
	Allowing for reclassifying financial assets out of trading portfolio in the IFRS (IASB)		Clarification of the application of fair value accounting under US GAAP in a market that is not active (FASB)

V Overall assessment (I)

The euro area financial system has undergone a further significant test of its shock-absorbing capacity since the finalisation of the June 2008 Financial Stability Review.

At the same time, there are a number of risks and vulnerabilities lying ahead which the financial system may have to cope with, notably the possibility of:

V Overall assessment (II)

- a further deterioration in the US and the euro area housing markets and the impact this may have on banks' loan quality and the value of securities backed by mortgage-related assets;
- a deeper and more prolonged slowdown in both the global and the euro area economies than currently expected that could cause a sharper and broader deterioration in borrowers' ability to service their debt;
- a more pronounced de-leveraging by banks, due to persistently high funding costs and concerns about the adequacy of capital buffers, which could negatively affect the flow of credit extended to the broader economy; and
- an increase in financial market volatility caused by a further unwinding of positions by hedge funds.