EUROPEAN CENTRAL BANK

EUROSYSTEM

SUMMARY OF THE JUNE 2009 FINANCIAL STABILITY REVIEW

The primary objective of the ECB's Financial Stability Review (FSR) is to review the main sources of risk to, and vulnerability for, financial system stability and to provide a comprehensive assessment of the capacity of the euro area financial system to absorb adverse disturbances.

Many of the downside risks to euro area financial stability that were identified in the December 2008 issue of the FSR have crystallised.[1] In particular, the further significant deterioration of global macroeconomic conditions, as well as sizeable downward revisions to growth forecasts and expectations, have added to the stresses on global and euro area financial systems. The contraction of economic activity and the diminished growth prospects have resulted in a further erosion of the market values of a broad range of assets.

Large and complex banking groups (LCBGs) in the euro area have been responding to the challenging macro-financial environment by making efforts to de-leverage and de-risk their balance sheets, although this has been hindered by the illiquid and stressed conditions that have characterised many financial markets. The adjustment of bank balance sheets has entailed adverse feedback on the market pricing of assets and on banks' financial intermediation role of channelling funds from savers to investors. Moreover, increasing signs of an adverse feedback loop between the real economy and the financial sector have posed new challenges for the safeguarding of financial stability.

Because of the continued stresses and impaired liquidity of many financial markets, a range of remedial policy measures have been taken both by central banks and by governments, with the aim of preventing this adverse feedback and fostering the flow of credit. The significant narrowing of money market spreads over the past few months indicates that the central bank measures have contributed to improving the functioning of money markets. At the same time, hard-to-value assets have remained on bank balance sheets and the marked deterioration in the economic outlook has created concerns about the potential for sizeable loan losses. Reflecting this, uncertainty prevails about the shock-absorbtion capacity of the euro area banking system.

1 These risks included the possibility of: a further deterioration in the US and the euro area housing markets and the impact it could 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 economy that could cause a sharper and broader deterioration in borrowers' ability to service their debt; a more pronounced deleveraging 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 a surge in financial market volatility caused by a further unwinding of positions by hedge funds.

Looking forward, there is a concern that many of the risks identified in this issue of the FSR could materialise if the global economic downturn proves to be deeper and more prolonged than currently expected. In particular, the main risks identified within the euro area financial system include the possibility of:

- a further erosion of capital bases and the risk of a renewed loss of confidence in the financial condition of LCBGs;
- significant balance sheet strains emerging among insurers; and
- more widespread asset price declines coupled with high volatility.

Outside the euro area financial system, important risks include the possibility of:

- US house prices falling further than currently expected;
- the economic downturn in the euro area being even more severe than currently projected; and
- an intensification of the stresses already endured by central and eastern European countries.

All in all, and notwithstanding the measures that have been taken by the Eurosystem and governments in the euro area to stabilise the euro area financial system and the recent recovery of the equity prices of most LCBGs, policy-makers and market participants will have to be especially alert in the period ahead. There is no room for complacency because the risks for financial stability remain high, especially since the credit cycle has not yet reached a trough. Banks will, therefore, need to be especially careful in ensuring that they have adequate capital and liquidity buffers to cushion the risks that lie ahead, while providing an adequate flow of credit to the economy. Over the medium to longer term, banks should undertake the appropriate restructuring to strengthen their financial soundness and resilience to shocks. This may well include adapting their business models to the challenging operating environment. At the same time, banks should be alert in ensuring that risks are priced appropriately, but not excessively or prohibitively so. The commitments made by euro area governments to support the financial sector have been sizeable across a range of measures. Given the risks and challenges that lie ahead, banks should be encouraged to take full advantage of these commitments in order to improve and diversify their medium-term funding, enhance their shock-absorbtion capacities and protect sound business lines from the contagion risks connected with troubled assets.

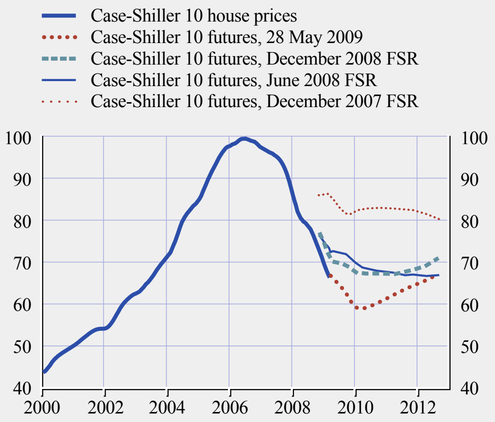
RISKS IN THE GLOBAL MACRO-FINANCIAL ENVIRONMENT

The outlook for US house prices remains crucial for the recovery of the global financial system ...

... and futures markets currently indicate expectations of further falls in house prices in the ten largest US cities, before they start to stabilise in 2010

Chart 1 US house prices and market expectations

(Jan. 2000 – Sep. 2012; index: June 2006 = 100)



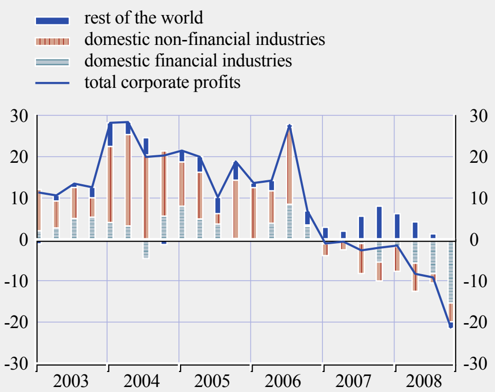
Sources: S&P/Case-Shiller and Bloomberg.

Overall, the US corporate sector has so far proven relatively resilient to the turmoil, with bankruptcy rates remaining at low levels ...

... but there has been a broad-based and steady deterioration of corporate profits, triggering expectations for a sharp rise in corporate default rates

Chart 2 US corporate sector profits

(Q1 2003 – Q4 2008; percentage point contribution to year-on-year growth)



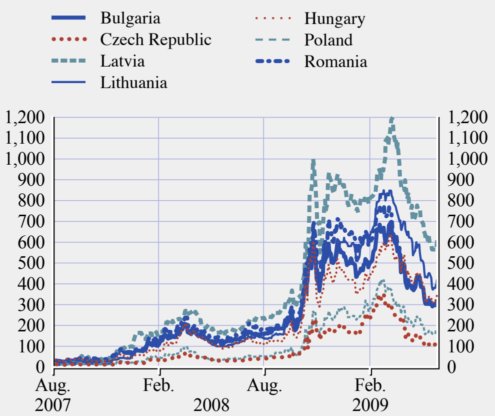
Source: US Bureau of Economic Analysis.
Notes: Corporate profits include inventory valuation and capital consumption adjustments. Profits from the rest of the world (RoW) are receipts from the RoW less payments to the RoW.

Macro-financial conditions in many central and eastern European economies have weakened significantly on account of slowing global demand and waning capital inflows ...

... and credit spreads widened, especially in those countries where demand has weakened significantly and where current account deficits are wide, but have narrowed more recently

Chart 3 Sovereign credit default swap spreads of Central and Eastern European economies

(Aug. 2007 – May 2009; basis points, five year maturity)



Source: Thomson Financial Datastream.

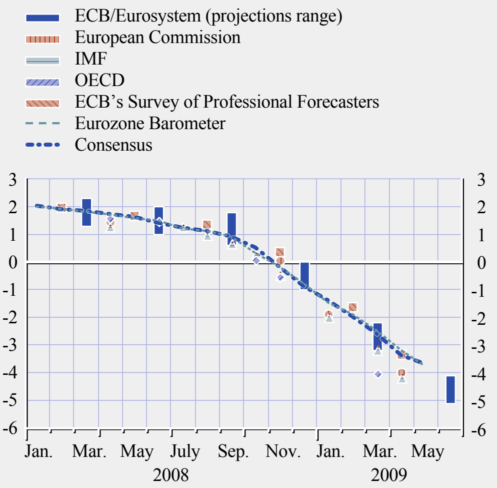
RISKS IN EURO AREA NON-FINANCIAL SECTORS

The euro area endured a substantial and broad-based contraction in economic activity in the first quarter of 2009 …

… but recently there have been signs that the pace of deterioration in economic activity may be moderating both globally and in the euro area

Chart 4 Evolution of euro area real GDP growth forecasts for 2009

(Jan. 2008 – June 2009; percentage change per annum)



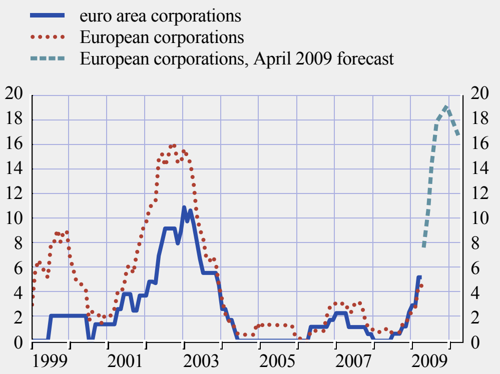
Sources: ECB, European Commission, IMF, OECD, Eurozone Barometer and Consensus Economics.
Notes: The dates on the x-axis correspond to the release dates of the various estimates. The time span between the cut-off date for information used and the actual publication date varies across projections.

The default rates of lower-rated euro area non-financial corporations have started to increase and are forecast to rise substantially more…

… which, together with lower expected recovery rates, implies substantial risks for those parts of the financial system which have sizeable exposures

Chart 5 Euro area and European speculative-grade-rated corporations' default rates and forecast

(Jan. 1999 – Apr. 2010; percentage; 12-month trailing sum)



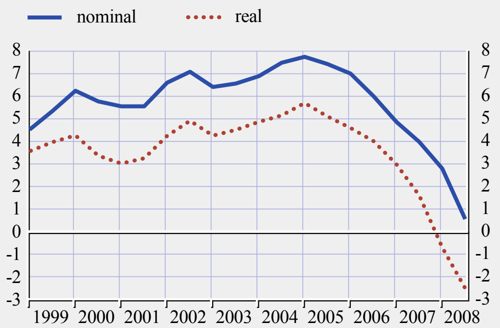
Source: Moody's.

A marked slowdown in residential property price inflation continued in most euro area countries in 2008…

… this development has also been reflected in a further decline in the growth rate of loans extended by banks for house purchases

Chart 6 Residential property price changes in the euro area

(H1 1999 – H2 2008; percentage change per annum)



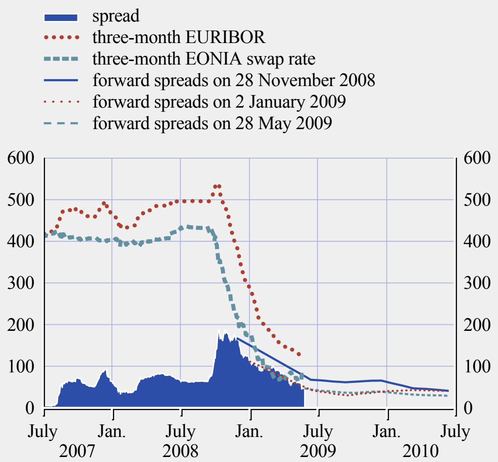
Sources: Eurostat and ECB calculations based on national sources.
Note: The real price series has been deflated by the Harmonised Index of Consumer Prices (HICP).

Owing to the ample provision of liquidity by the ECB, money market spreads in the euro area have significantly narrowed …

… and market participants expect that three-month maturity spreads will continue narrowing in the coming months

Chart 7 Contemporaneous and forward spreads between EURIBOR and EONIA swap rates

(July 2007 – July 2010; basis points)



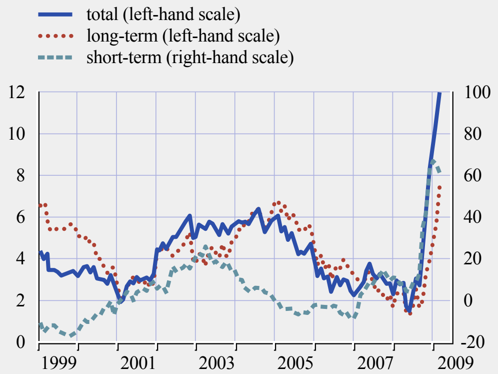
Source: Bloomberg.

Net issuance of short-term government debt securities increased sharply in late 2008 and in early 2009, partly on account of commitments by governments to support financial sectors …

… reflecting this and expectations of widening deficits, government bond spreads widened, especially in those countries with large financial sectors or relatively weaker public finance positions, but have narrowed more recently

Chart 8 Annual growth of euro area governments' outstanding debt securities

(Jan. 1999 – Mar. 2009; percentage change per annum)



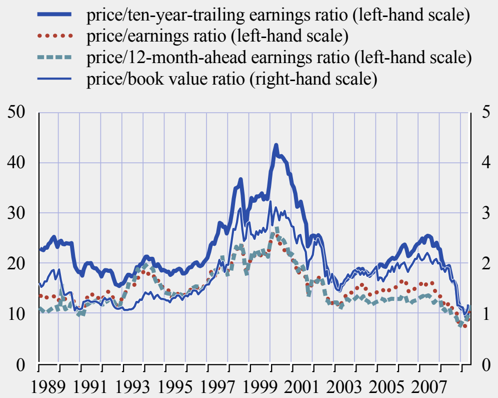
Source: ECB.

Signs that the pace of deterioration in economic activity may be moderating, both globally and in the euro area, led to some reversal of the sharp declines in equity prices and equity price volatility has declined …

… but long-term valuation measures suggest that equity prices still remain low by historical standards.

Chart 9 Equity valuation ratios for the euro area

(Jan. 1989 – May 2009; ratio)



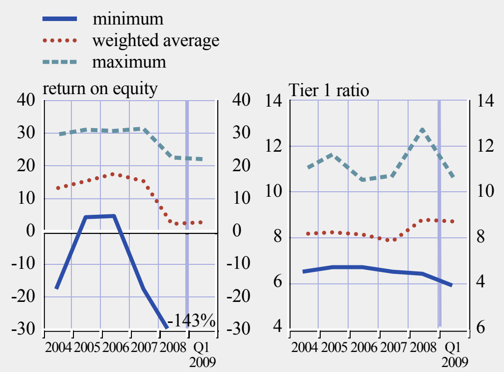
Sources: Thomson Financial Datastream and ECB calculations.

Euro area large and complex banking groups (LCBGs) remained under stress in 2008, with profits falling sharply …

… and although the financial performance of LCBGs improved somewhat in the first quarter of 2009, the sustainability of the recovery is uncertain because of risks of rising loan losses

Chart 10 Return on equity and Tier 1 capital ratios of euro area large and complex banking groups

(2004 – Q1 2009; percentage)



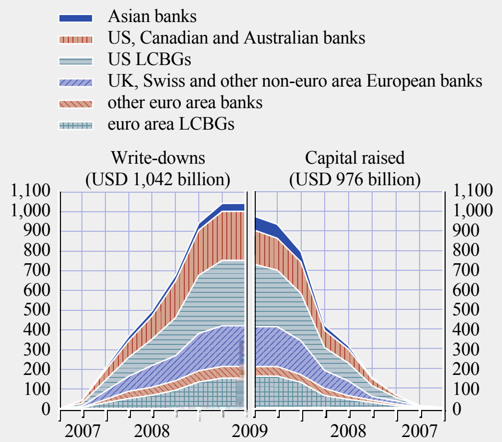
Sources: Individual institutions' financial reports and ECB calculations.
Note: The chart uses Tier 1 capital as a measure of equity capital. Data for Q1 2009 are for a subset of 16 LCBGs that reported quarterly results in the first quarter of 2009.

Write-downs on banks' assets surged in 2008, both globally and in the euro area, but have been moderating in 2009 …

… at the same time, banks have been successful in raising fresh capital from private sources, while capital injections by governments have also helped to shore up their solvency

Chart 11 Turmoil-related bank write-downs and capital raised by region

(as at 28 May 2009; USD billions)



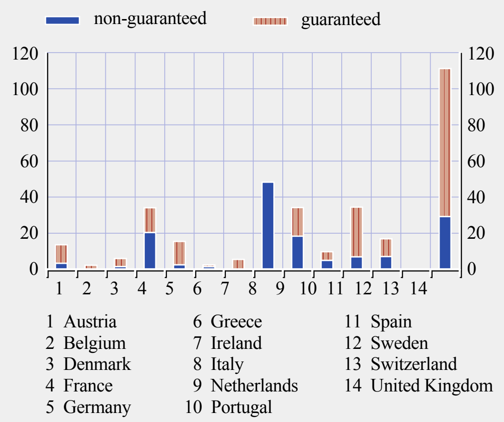
Sources: Bloomberg and ECB calculations.
Note: The data do not cover all banks in the euro area, nor do they cover all banks across the globe.

Take-up rates of government support to banking systems has varied, both across countries and across types of measures …

… the availability of government support has been indispensable in ensuring that banks have access to medium-term funding

Chart 12 Cumulative volume of gross issuance of bank bonds in Europe

(Oct. 2008 – May 2009; EUR billions)



Sources: Dealogic and ECB calculations.

There has been a significant increase in the range of estimates for potential bank losses before the credit cycle reaches a trough ...

... ECB estimates put further losses for the euro area banking sector at USD 283 billion

Table 1 Estimated potential write-downs for the euro area banking sector

(USD billions)

+ Total estimated losses from securities holdings 2007-10	218
+ Total estimated losses from loan exposures 2007-10	431
= Total estimated cumulative losses 2007-10	649
- Securities write-downs 2007 - May 2009	215
- Loan loss provisions and write-offs in 2007-08	150
= Potential further losses in 2009-10	283

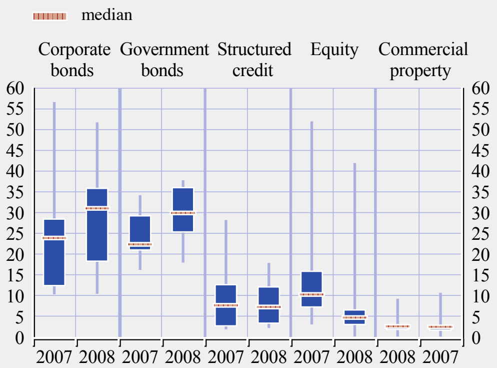
Sources: Individual banks' disclosures, European Securitisation Forum, IMF, ECB and ECB calculations.

Large euro area insurers suffered a deterioration in their financial conditions in the second half of 2008 and in the first quarter of 2009...

... while insurers have large investment exposures to corporate and government bonds, they have attempted to de-risk their balance sheets by reducing exposures to equities

Chart 13 Distribution of bond, structured credit, equity and commercial property investment for a sample of large euro area insurers

(2007 – 2008; percentage of total investments; maximum, minimum and interquartile distribution)



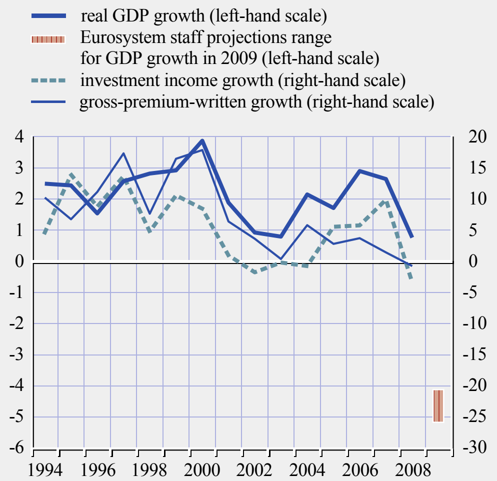
Sources: Individual institutions' financial reports and ECB calculations.

The slowdown in economic activity is weighing on the underwriting performance of euro area insurers...

...and stresses in financial markets continue to pose challenges for the stability of insurers' investment income

Chart 14 Gross premiums written and investment income for a sample of large euro area insurers, and euro area real GDP growth

(1994 – 2009; percentage change per annum)



Sources: ECB, Consensus Economics, Thomson Financial Datastream and ECB calculations.

THIS ISSUE OF THE FINANCIAL STABILITY REVIEW ALSO CONTAINS THE FOLLOWING SPECIAL FEATURE ARTICLES:

- **A Determinants of bank lending standards and the impact of the financial turmoil**
- **B Liquidity hoarding and interbank market spreads**
- **C Balance sheet contagion and transmission of risk in the euro area financial system**
- **D Estimating probabilities of hedge fund liquidation**
- **E Some lessons from the financial market turmoil for the use of market indicators in financial stability analysis**