# Financial Stability Review
## June 2010

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# Outline

I. Summary of main risks and vulnerabilities

II. Main risks identified outside the euro area financial system

III. Main risks identified within the euro area financial system

IV. Overall assessment

# I. Summary of main risks and vulnerabilities

**The main risks for euro area financial system include the possibility of:**

- **Concerns about the sustainability of public finances persisting or even increasing with an associated crowding-out of private investment**
- **Adverse feedback between the financial sector and public finances continuing**

**Other, albeit less material risks, identified outside the euro area financial system include the possibility of:**

- **Vulnerabilities being revealed in euro area non-financial corporations' balance sheets, because of high leverage, low profitability and tight financing conditions**
- **Greater-than-expected euro area household sector credit losses if unemployment rises by more than expected**

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

- **A setback to the recent recovery of the profitability of large and complex banking groups and of adverse feedback with the provision of credit to the economy**
- **Vulnerabilities of financial institutions associated with concentrations of lending exposures to commercial property markets and to central and eastern European countries**
- **Heightened financial market volatility if macroeconomic outcomes fail to live up to expectations**

# II. Main risks identified outside the euro area financial system

# Concerns about the sustainability of public finances persisting or even increasing with an associated crowding-out of private investment

**Public finances in the euro area have deteriorated rapidly, primarily on account of the activation of automatic stabilisers and discretionary fiscal measures in many countries …**

**… by early May, the concerns about sovereign credit risk contributed to adverse market dynamics which, ultimately, hampered the monetary policy transmission mechanism. To help restore the normal transmission of monetary policy, the ECB decided on several remedial measures.**

**Chart 1 Intra-euro area yield spreads on ten-year government bonds**

(Jan. 2008 – May 2010; basis points)


Sources: Thomson Financial Datastream and ECB calculations.
Note: The chart shows ten-year yield spreads relative to Germany.

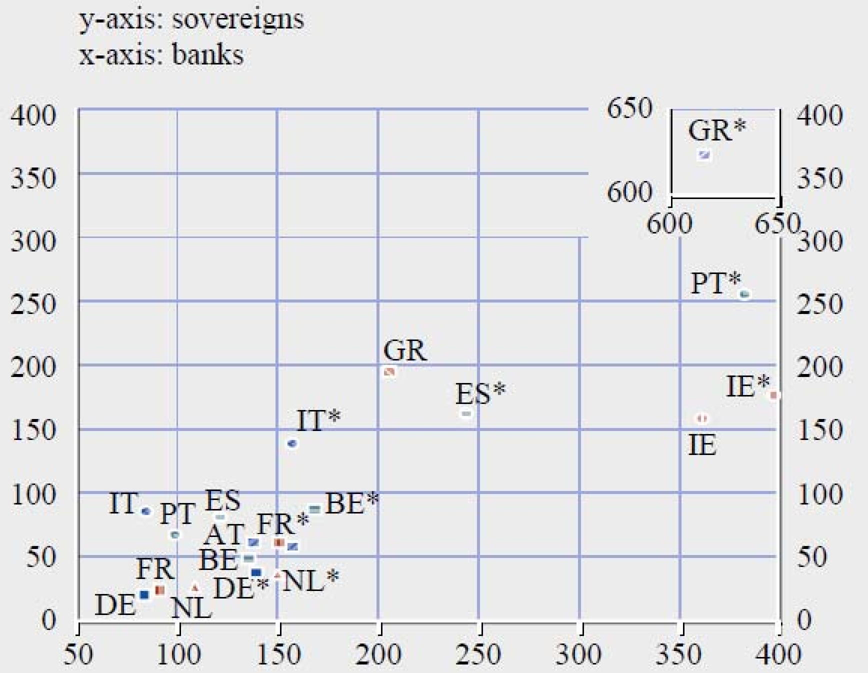
# Adverse feedback between the financial sector and public finances continuing

**The rise in sovereign credit risk premia was passed through to private sector funding costs …**

**… which resulted in increased correlation between credit default swap (CDS) spreads for large banks and sovereign CDS spreads for the governments of the countries where the banks have their headquarters.**

**Chart 2 Sovereign and bank CDS spreads in selected euro area countries**

(first snapshot: 26 Nov. 2009; second snapshot (*): 19 May 2010; basis points)




Sources: Bloomberg and ECB calculations.
Notes: For each country, the CDS spreads of the five largest banks for which CDS quotes were available were used to calculate the average CDS spread of banks in that country. For some countries there were less than five banks with quoted CDSs.

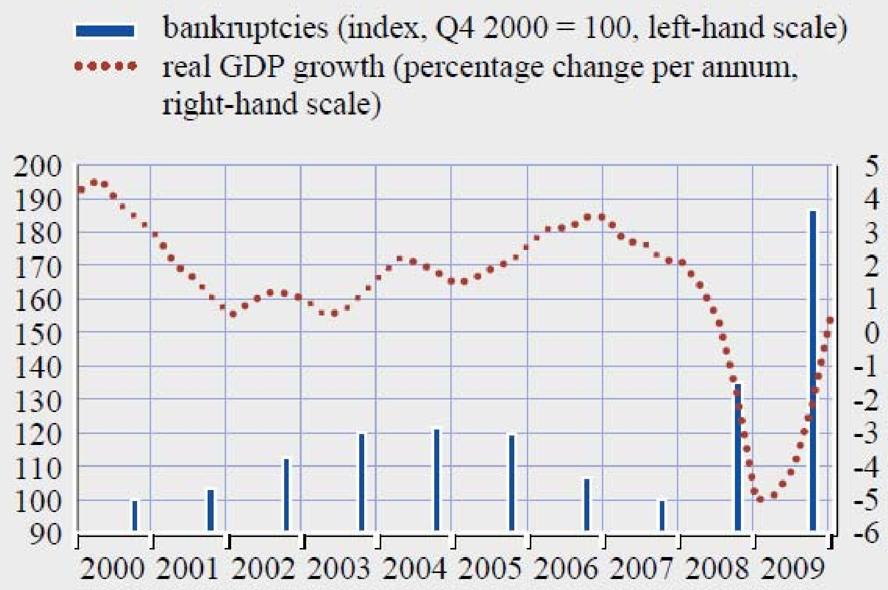
# Vulnerabilities being revealed in euro area non-financial corporations' balance sheets, because of high leverage, low profitability and tight financing conditions

**For the euro area non-financial corporate sector, balance sheet conditions have improved slightly since the last issue of the FSR …**

**… but the high leverage of non-financial corporations, coupled with very low profitability in both 2008 and 2009 and persistently tight lending standards, has translated into high default rates for non-financial firms.**

**Chart 3 Bankruptcies and real GDP growth in the euro area**

(Q1 2000 – Q1 2010)




Sources: National central banks, national statistical offices, Euler Hermes ("Insolvency Outlook", 2/2009) and ECB calculations.
Notes: GDP growth refers to total euro area, while data for bankruptcies only refers to 12 euro area countries (Cyprus, Malta, Slovakia and Slovenia not included). The index is weighted by GDP. Bankruptcies in 2009 are partly estimated.

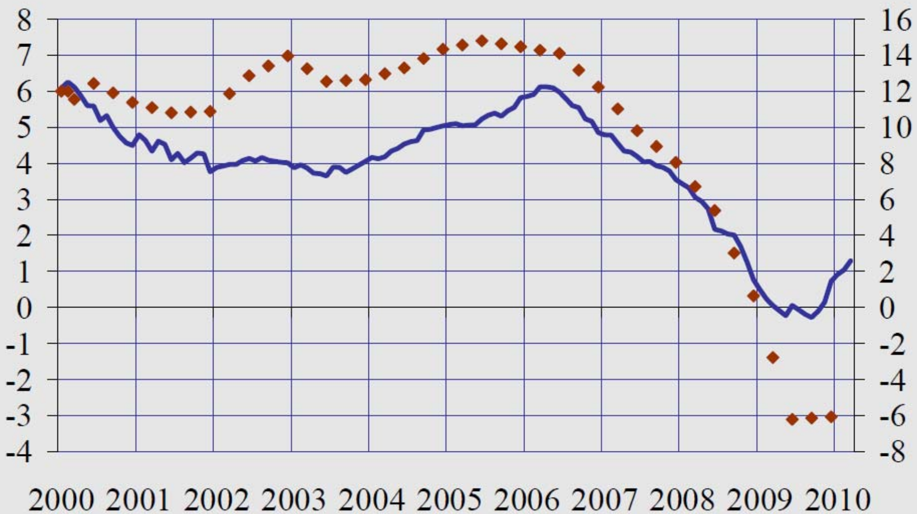
# Greater-than-expected euro area household sector credit losses if unemployment rises by more than expected

**The condition of euro area household balance sheets has changed little, but there are downside income risks if unemployment in the euro area were to remain at high levels for longer than expected …**

**… however, there are signs that the sharp fall in house prices, together with low interest rates, has improved housing affordability, which, in part, helps to explain the recent turnaround in the extension of new loans to households for house purchases.**

Chart 4 Loans for house purchase and house prices in the euro area

(Jan. 2000 – Mar. 2010; percentage change per annum)




Source: ECB.

# III. Main risks identified within the euro area financial system

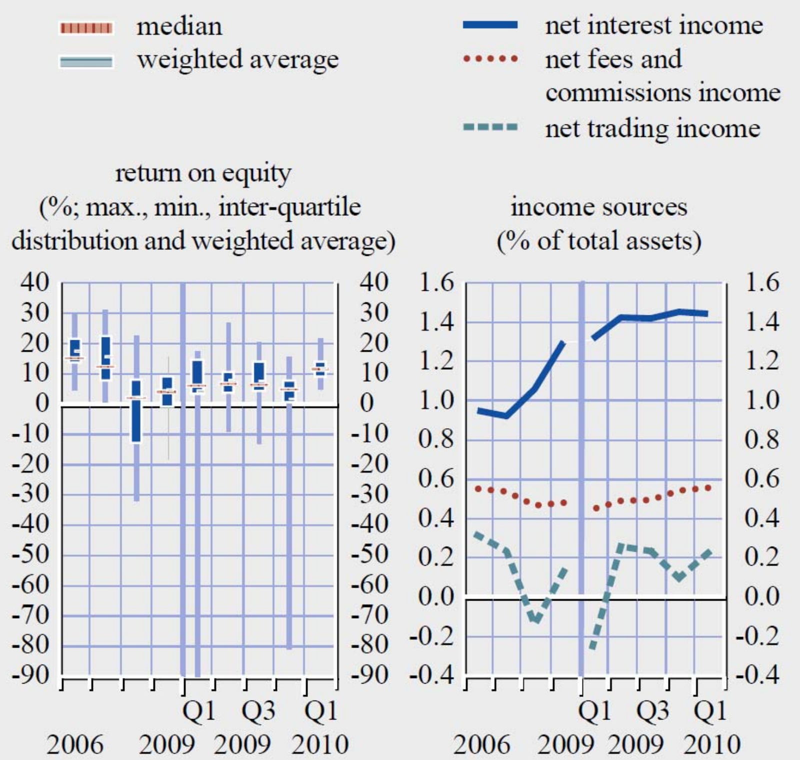
# A setback to the recent recovery of the profitability of large and complex banking groups and of adverse feedback with the provision of credit to the economy

**Many euro area large and complex banking groups (LCBGs) returned to modest profitability in the course of 2009, and their financial performances strengthened further in the first quarter of 2010 …**

**… net interest income continued to be the most important profitability driver among this group of banks throughout 2009. Also, the capital ratios of euro area LCBGs improved substantially.**

**Chart 5 Euro area large and complex banking groups' profitability and breakdown of income sources**

(2006 – Q1 2010; maximum, minimum and inter-quartile distribution)




Sources: Individual institutions' financial reports and ECB calculations.
Notes: The left-hand chart is based on the Tier 1 measure of equity. Quarterly returns have been annualised.

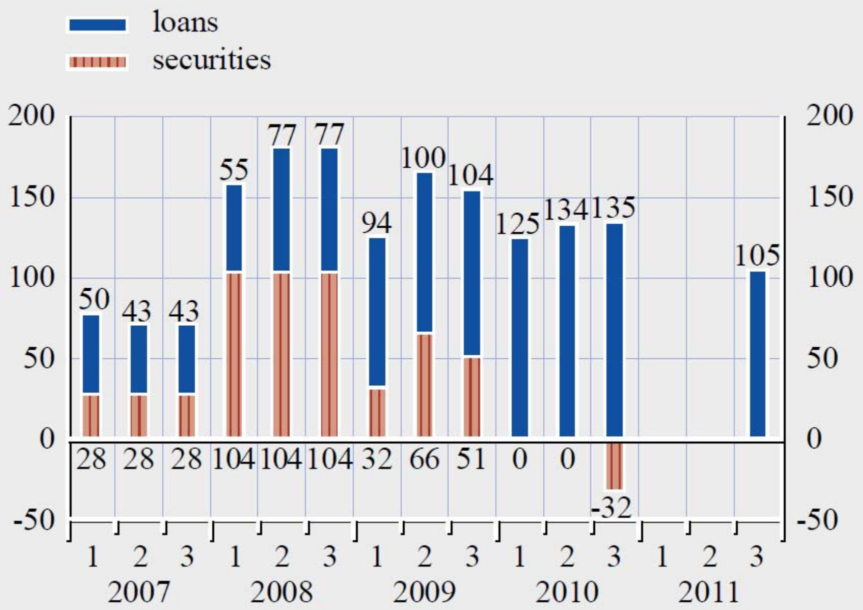
# A setback to the recent recovery of the profitability of large and complex banking groups and adverse feedback with the provision of credit to the economy

**The latest estimate of the potential cumulative write-downs on securities and loans for the euro area banking sector is €515 billion over the period from 2007 to 2010, which is lower than the estimate published in the December 2009 FSR, owing to a recovery in securities prices in 2009 and in early 2010 …**

**… at the same time, the total estimate of potential write-downs on loans for the period from 2007 to 2010 has increased slightly and further loan write-downs are likely during 2011.**

**Chart 6 Potential write-downs on securities and loans facing the euro area banking sector**

(EUR billions)




1 June 2009 FSR
2 December 2009 FSR
3 June 2010 FSR

Sources: Association for Financial Markets in Europe, Banking Supervision Committee, national central banks, ECB and ECB calculations.

# Vulnerabilities of financial institutions associated with concentrations of lending exposures to commercial property markets and to central and eastern European countries

**Commercial property prices and rents have continued to fall in most countries in the euro area, albeit at a more moderate rate …**

**… estimates of losses facing banks on their commercial property loan portfolios have been revised upwards by almost 50% over the past six months. This more than offset the recovery in the valuations of commercial mortgage backed securities held by banks in the euro area.**

**Chart 7 Potential write-downs on commercial mortgage-backed securities (CMBSs) and commercial property mortgages facing the euro area banking sector over the period from 2007 to 2010**


Sources: Association for Financial Markets in Europe, Banking Supervision Committee, national central banks, ECB and ECB calculations.

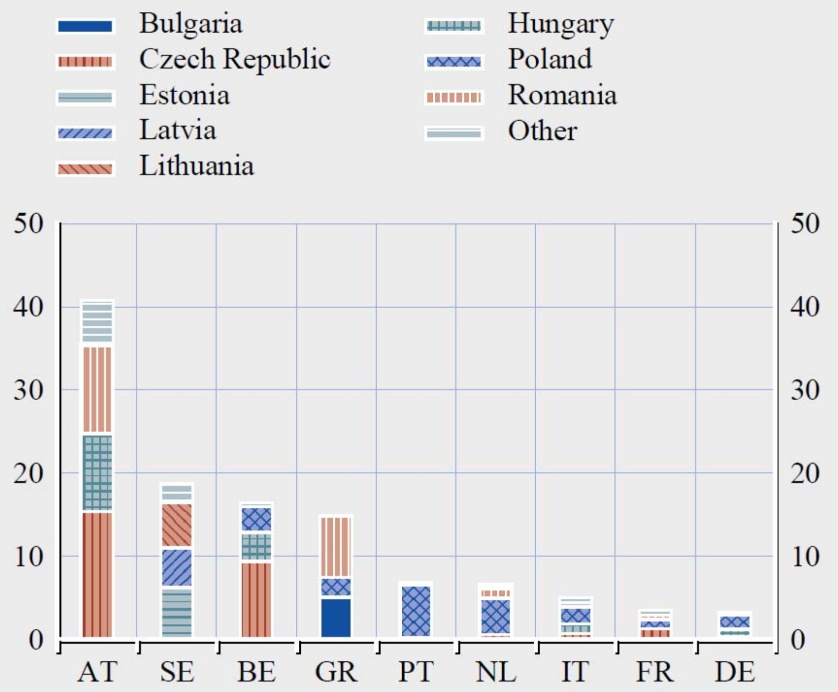
# Vulnerabilities of financial institutions associated with concentrations of lending exposures to commercial property markets and to central and eastern European countries

**The economic outlook in central and eastern European (CEE) countries has improved, but new vulnerabilities have emerged, especially a broad-based deterioration in the fiscal positions of these countries …**

**… given that the exposures to the CEE region are rather concentrated among some euro area Member States' banking sectors, the risks remain material in these cases.**

**Chart 8 Consolidated lending exposures of selected EU banking systems to selected non-euro area EU countries**

(2009; percentage of GDP, per lending country)




Sources: BIS and Eurostat.
Notes: BIS statistics on consolidated foreign claims of domestically owned banks in lending countries on individual non-euro area EU countries on an immediate borrower basis. The largest three exposures to each particular country are shown in the chart, while smaller exposures are combined under other countries.

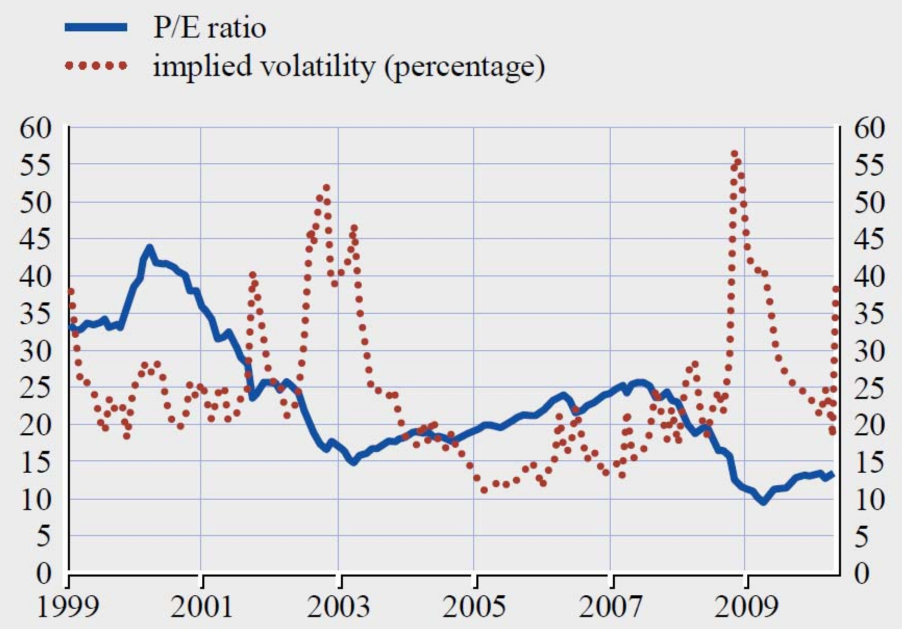
# Heightened financial market volatility if macroeconomic outcomes fail to live up to expectations

**Long-term (cyclically adjusted) valuation measures suggest that equity prices are not particularly high by historical standards …**

**… but there is a risk of a heightened financial market volatility, if macroeconomic outcomes fail to live up to expectations.**

**Chart 9 Implied volatility and price/earnings ratios (based on ten-year trailing earnings) for the euro area stock markets**

(Jan. 1999 – May 2010)




Sources: Thomson Reuters Datastream and Bloomberg.
Note: The last observation for the implied volatility is 19 May 2010.

# IV. Overall assessment (I)

- Although the main risks to euro area financial stability essentially remain the same as those to which attention was drawn in the last issue of the FSR, their relative importance has changed significantly over the past six months.

- The two most important risks for euro area financial stability at the current juncture are: the possibility of concerns about the sustainability of public finances persisting or even increasing with an associated crowding-out of private investment; and the possibility that adverse feedback between the financial sector and public finances continues.

- Other, albeit less material, risks identified outside the euro area financial system include the possibility of vulnerabilities being revealed in non-financial corporations' balance sheets and of greater-than-expected household sector credit losses, if unemployment rises by more than expected.

# IV. Overall assessment (II)

- Within the financial system, the central scenario is for modest banking sector profitability in the short to medium term, given the prospect of continued loan losses, lasting pressure on the sector to reduce leverage and market expectations of higher funding costs. The possibility of a setback to the recent recovery of bank profitability and of adverse feedback with the provision of credit to the economy are important risks.

- There is also a risk of heightened financial market volatility if macroeconomic outcomes fail to live up to expectations.

- A key concern is that many of the vulnerabilities highlighted in this FSR could be unearthed by a scenario involving weaker-than-expected economic growth.

# IV. Overall assessment (III)

- The measures taken by the ECB to stabilise markets and restore their functioning as well as the establishment of the European Financial Stabilisation Mechanism have considerably lowered tail and contagion risks.

- However, sizeable fiscal imbalances remain, and the responsibility rests on governments to frontload and accelerate fiscal consolidation so as to ensure the sustainability of public finances, not least to avoid the risk of a crowding-out of private investment while establishing conditions conducive to durable economic growth.

- With pressure on governments to consolidate their balance sheets, disengagement from financial sector intervention means that banks will need to be especially mindful of the risks that lie ahead. In particular, they should ensure that they have adequate capital and liquidity buffers in place to cushion the risks should they materialise.

- The problems of those financial institutions that remain overly reliant on enhanced credit measures and government support will have to be tackled decisively.

- Swift completion of the process of calibration and implementation of regulatory reforms should remove related uncertainties and allow banks to optimise their capital planning and, where necessary, adjust their business models.

# Background slides

## Chart 4.19 Systemic risk indicator and joint probability of distress of euro area LCBGs

(Jan. 2007 – May 2010; probability; percentages)

- systemic risk indicator (left-hand scale)
- joint probability of distress (right-hand scale)


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 T. Geithner announces Financial Stability Plan
7 Greek fiscal problems gain media attention
8 Establishing a European Financial Stabilisation Mechanism

Sources: Bloomberg and ECB calculations.
Notes: Both indicators are based on the information embedded in the spreads of five-year CDS contracts for euro area LCBGs. See the box "Measuring the time-varying risk to banking sector stability" in ECB, Financial Stability Review, December 2008, and the box "A market-based indicator of the probability of adverse systemic events involving large and complex banking groups" in ECB, Financial Stability Review, December 2007, for details.