Lucas Papademos: ECB Financial Stability Review June 2006

Opening remarks by Mr Lucas Papademos, Vice President of the European Central Bank, at the press briefing on the occasion of the publication of the June 2006 ECB Financial Stability Review, Frankfurt am Main, 1 June 2006.

The slides and charts for this speech can be found on the ECB website at www.ecb.int.

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Ladies and Gentlemen,

1. Introduction

Welcome to this press briefing on the occasion of the presentation of the June 2006 edition of the ECB's Financial Stability Review. As usual, the financial stability assessment contained in the Review reflects the input of a significant number of experts, and it builds on both inter-departmental work within the ECB and very close collaboration with the ESCB Banking Supervision Committee.

The report that has been made available to you follows the same overall structure as the previous Reviews which the ECB has been publishing semi-annually since December 2004. However, the scope of the analysis has been broadened to include dedicated sections on the euro area commercial property markets, credit risk transfer market issues and hedge funds. Specific themes of particular interest have been addressed in a total of 17 boxes. There are also three Special Feature articles, notably a discussion of macro-level stress testing practices across EU countries, an assessment of banking system risk using extreme value analysis, and an investigation of the driving forces behind EU banks' stock returns.

I should note that the Review uses data that was available up to 5 May 2006. In my presentation (some of the slides), I will refer to developments since this cut-off date. In presenting the main findings of the analysis, I will broadly follow the structure of the Review (as outlined on slide 2).

2. Overview of the main risks and vulnerabilities

I would like to begin with an overview of some pertinent developments in the euro area financial system and of the main sources of risk and vulnerabilities for euro area financial stability, in comparison to the assessment in the December 2005 Review.

Overall, the developments since last December lend support to the view that the euro area financial system is robust and well-capable of withstanding shocks. First, the pace of global economic activity has strengthened and it has become more evenly distributed. Second, the balance sheets of euro area banks and insurance companies have continued to strengthen.

At the same time, these positive developments are clouded by the fact that the risks and vulnerabilities we identified in the December 2005 Review remain and some of them have increased. Global imbalances have continued to grow. Moreover, it cannot be excluded that tightening liquidity conditions in the G3 economies could yet expose vulnerabilities in the pricing of assets following a protracted period of hunt for yield in a low interest rate environment. Particularly at risk are leveraged investors, especially hedge funds, and this could accentuate the risks of disorderly market corrections. Finally, there are some signs of a maturing of the global corporate sector credit cycle and this has the potential to generate tensions in global financial markets, especially credit derivatives.

3. Global macro-financial environment

Let me now illustrate the analysis behind our assessment in more detail, starting with the global macro-financial environment where the ever-expanding current account and financial imbalances and the high oil prices continue to feature as prominent sources of risk.

The Chart on the left draws your attention to the scale of global financial imbalances and to the fact that the United States remains the largest debtor country. However, there have been changes in the relative importance of global creditor countries. Indeed, the aggregate contribution of the Asian economies to financing the US deficit has broadly stabilised while the oil producing countries have surpassed them in importance. There have been concerns about the sustainability of global current account positions over the past six months as the cyclical support for the US dollar has been gradually waning. In this context, I would like to draw your attention to Box 1 of the Review that contains an overview of the recent debate on this topic.

Oil prices have been volatile and they have surged further since November last year, against a background of persistently strong demand and renewed geopolitical tensions. Financial stability risks arising from developments in commodity markets operate largely through indirect, or macroeconomic, channels as high and volatile oil prices can pose risks to economic activity and inflation and, thereby, contribute to financial sector stress. Speculative activity that has occasionally been blamed for fuelling the momentum in oil prices seems to have played again some role in driving the recent price developments (as shown in the chart on the right on slide 4). A comparison of the relative movements between oil prices and the net futures commitments of non-commercials – that is, entities not engaged in oil producing or refining – on the New York Mercantile exchange suggests the existence of a positive correlation.

In the global fixed income markets, it is apparent that the protracted period of low long-term interest rateshas been coming to an end since the spring of 2006 both in the US and in the euro area.

Until early May, the increase in long-term interest rates in the major economic areas (shown in the chart on the left on slide 5) has had relatively little impact on global asset prices or on asset allocation. But, there have been some signs that the “search for yield” which began in 2003 could be ending. The recent increase in financial market volatility, after the Review was finalised, and the flight-to-safety into government bonds suggests that a process of re-pricing of risk could be starting in financial markets. The key question from a financial stability perspective is whether this process will proceed in an orderly manner.

A major destination of funds searching for yield, namely emerging market bonds, were particularly exposed to increased volatility over the recent weeks (as shown in the chart on the right on slide 5). While spreads widened, they still remained very narrow. While the longer-term narrowing of spreads on emerging market bonds over the past couple of years has to a considerable extent reflected the improved fundamentals, including substantially reduced indebtedness in emerging market economies, it cannot be excluded that some mis-pricing of risk will be exposed when capital inflows are reversed. The turbulence in March in the Icelandic financial markets, although contained, reminds us that vulnerabilities exist in parts of the world financial system.

4. Euro area macro-financial environment

Let me now turn to the euro area macro-financial environment, focusing on developments in the corporate and household sectors that are of particular relevance for the outlook for financial intermediaries’ credit portfolios. The balance sheet of the euro area non-financial corporate sector has strengthened significantly over recent years following notable improvements in profitability as well as debt restructuring efforts. Looking forward, however, a number of risks could be looming.

The chart on the left on slide 6 shows that after several years of decline, corporate sector borrowing in the euro area has picked up considerably over the past year. The fact that non-financial corporations have started to re-leverage their balance sheets can be interpreted as a positive indicator for investment activity. At the same time, increased leverage is augmenting a significantly higher level of indebtedness than witnessed in past recoveries.

It cannot be excluded that corporate sector credit quality could deteriorate somewhat in the future, especially if the macroeconomic environment turns out less benign than currently foreseen. The chart on the right of slide 6 shows the ratio of credit-rating upgrades-to-downgrades for euro area firms. This ratio has exhibited a general upward movement over the past year. However, more firms have been placed on review for a downgrade than for an upgrade by rating agencies.

In the euro area household sector, the size of balance sheets continued to expand, a development closely related to borrowing for house purchases. While vulnerabilities in the sector are still assessed as being low, risks are unambiguously rising, not least because of the significant increase in indebtedness in several euro area countries. In the euro area as a whole, lending for house purchases grew at a rapid pace, and both nominal and real residential property prices continued to rise. The chart on the left on slide 7 plots nominal house price-to-rent ratios in the largest euro area countries. It shows that residential property markets have shown no sign of cooling down. The chart also illustrates that there have been large differences in the rates of house price increases across euro area countries. Spain, France and Italy have experienced the most rapid growth rates, but in Germany further declines or only moderate increases in prices have been reported.

An evaluation of the risks to euro area financial stability stemming from the household sector depends on the balance sheet situation of households as this determines their resilience to adverse financial shocks. Both the households' debt-to-financial assets ratio and the debt-to-liquid financial assets ratio have continued to grow, but more moderately compared with the rapid increase at the beginning of the current millennium. Although this implies a further deterioration of households' financial position, the household sector's liquid assets still exceed its debts.

5. Euro area financial system

5.1. Euro area financial markets

Let me now briefly turn to the euro area stock and corporate bond markets, both of which continued to develop dynamically until very recently. The Review points out that despite the favourable economic outlook, a risk of a slowdown in market dynamics cannot be excluded if risk-free interest rates continue to edge upwards and credit ratings and/or earnings growth surprise to the downside. On the positive side, structural developments in euro money markets, described in Box 6 of the Review, and the increased use of collateral in borrowing and lending transactions, discussed in Box 7, suggest an overall strengthening of the financial system's resilience to a systemic shock.

The price-earnings ratio of the euro area stock market (shown on the left of slide 8) indicates that despite the rather elevated level, this valuation measure remains well below its peaks reached in 2000. However, should corporate earnings growth unexpectedly slow down, the consequent rise in price-earnings ratios could make stocks look relatively expensive to other assets.

The chart on the right plots the implied volatility of euro area stock prices and corporate bond spreads which both gradually declined throughout the first five months of the current year, despite rising long-term bond yields. The rather sharp jump in these indicators during the last two weeks, suggests that there was room for adjustment to a higher pricing of risk in the context of changing views regarding the future macro-financial environment.

Before discussing the developments in euro area financial institutions, let me first highlight an important dimension of the market-based intermediation process: the rapid development of structured finance products. Although the risk-transfer that this market has facilitated has very likely led to efficiency gains and a better management of risks within the financial systems, there are several concerns which mostly arise from the fact that relatively little is known about how this market has effectively spread risk and how it would function in a situation of extreme stress.

Since June 2002, the size of the global credit default swaps market has increased nearly exponentially (see chart on the right on slide 9). While the use of credit derivatives has substantially contributed to enhanced risk-sharing and is expected to have improved the resilience of the financial system, questions can be asked about the sustainability of the pace of growth in these markets as well as about their implications for the emergence of other forms of risk.

Two issues in particular have surfaced in the course of the past year. First, the sheer complexity of many of the structured products introduced in the credit derivatives markets implies that there are potentially large risks for end-users who might not fully understand the time-varying risk profiles of such instruments. Indeed, as illustrated in several episodes of recent large corporate downgrades, the pricing of structured credit products might not adequately account for unanticipated changes in correlation structures among the assets incorporated in the underlying pools. Second, the rapid increase in trading volumes has stretched banks' and dealers' settlement systems and caused backlogs that could contribute to liquidity problems in a situation of increased trading activity. These problems could be particularly relevant for the European market, given the larger discrepancy in size between the cash bond market and the derivatives market than in the US. There are signs that, in accordance with the recommendations of the Counterparty Risk Management Group II report, many global banks have successfully worked towards solutions to these problems. However, it is rather widely acknowledged that pockets of vulnerability remain in these markets. Box 8 of the Review discusses recent market initiatives for improving the functioning of the credit derivatives market.

As shown by the chart on the right, the structure of market participants on the two sides of the credit derivatives market has changed over the past three years. Among the buyers of credit protection, the share of banks has declined in favour of hedge funds and other investors, such as private equity firms. Among the sellers of protection, insurance companies have increased their share at the expense of banks. It is worth noting, however, that hedge funds have been active also on the issuing side of the credit derivatives markets which is a business typically characterised by lucrative fees.

5.2. Euro area banking sector

With regard to the financial situation of large euro area banks, the financial results, overall, paint a picture of a very profitable banking sector with rather comfortable solvency ratios. In most euro area countries, bank profits were driven by continuing cost control and volume growth in mortgage lending that more than compensated for the narrowing of interest rate margins. Moreover, banks have also benefited from a recovery in lending to the non-financial corporate sector, as well as from the buoyant growth in fees and commissions. It should also be kept in mind, however, that the introduction of new international accounting standards might have had an impact on banks' profitability.

The frequency distribution of the return on equity of large euro area banks (see chart on the left on slide 10) shows that the degree of dispersion among banks narrowed considerably in 2005. The banks with the lowest returns on equity managed to improve their performance, shifting the overall distribution to the right. Banks' profits were also supported by the fact that the frequency distribution of loan impairment charges of large euro area banks, previously referred to as provisioning, shifted substantially to lower levels between 2004 and 2005 (as shown on the right-hand side of slide 10). Although this is an indication of an overall improvement in the quality of large euro area banks' loan books, questions can be asked about the sufficiency of banks' charges for expected loan losses should the credit environment deteriorate from the current very benign conditions. Regarding banks' buffers for unexpected losses, on the other hand, the capital ratios for the same (large euro area) banks show that, in general, a greater proportion of banks exhibited higher capital ratios in 2005 relative to the previous year.

The generally positive assessment of large euro area banks is complemented by a thorough analysis of risks related to interlinkages between banks. Special features B and C look at two different aspects of the relationships between banks: those running through extreme contagion channels and through earnings expectations. On both accounts, lessons learned suggest the need for continued and careful monitoring of banks with large and cross-border operations, as these appear to account for a disproportionate share of the systemic risk in the sector. With this in mind, Special Feature A takes stock of various conceptual aspects of designing macro-stress tests for the banking sector, with a focus on credit risk.

Judging from market-based forward-looking indicators, the central outlook for the banking sector remains positive. Market participants' perceptions of banks' risks have continued to diminish, also recognising banks' greater ability to manage and shed risks in their balance sheets. However, the increasing reliance of large euro area banks on non-interest income, and in trading income in particular, could imply increased risks in the future. As a reappraisal of market risk could take place in connection with an abrupt unwinding of the search for yield, banks could be exposed to greater market risks directly or indirectly through their exposure to counterparties.

Box 13 in the Review analyses the downside risks in euro area banks' stock prices. The chart on the left on slide 11 shows that the tail risk of portfolios consisting of stocks of banks from three different size categories (large, medium-sized and small listed banks) behave rather differently under different market conditions. Indeed, while the risks of investing in different types of banks do not differ substantially under low volatility conditions, such as the one that prevailed until recently, the risks from investing in large euro area banks increase considerably when market volatility goes up.

Overall, however, forward-looking market indicators provide a positive assessment of the outlook for the euro area banking sector, although the uncertainty surrounding this assessment has increased since the publication of the December 2005 Review. The chart on the right on slide 11 depicts the broadly based contraction of a standard measure of credit risk – the expected default frequency –

across banks with different levels of risk. Notable in this regard is the substantial improvement in this indicator for the most risky banks.

5.3 Other euro area financial institutions – insurance companies and hedge funds

Allow me now to turn to non-bank financial institutions, focusing on insurance companies and hedge funds, two sectors that have been at the centre of attention during the past year. Despite significant losses incurred by the reinsurance sector following the damage caused by natural catastrophes, the financial performance of the euro area insurance sector as a whole improved in 2005, owing to stronger investment income, improving underwriting income and rising equity prices. Market-based indicators suggest that the outlook for the sector remains favourable in the immediate future. However, there are a number of risks facing the industry in the period ahead. These include the possibility of premium competition in the non-life sector, longevity risk in the life sector, and the possibility, albeit diminishing, of an influenza pandemic.

The chart on the left on slide 12 portrays the performance of the insurance sub-sectors relative to the Dow Jones EURO STOXX. Whilst the impact on the reinsurance sub-sector of the damage caused by natural catastrophes is evident, other sub-sectors appear more resilient. The chart on the right on slide 12 shows the median expected default frequency and average subordinated debt spread for euro area insurance companies. Both measures of risk in the sector have reached new lows since 2001, indicating that market participants see an improving resilience in the sector.

The current Review contains for the first time a specific section dedicated to assessing developments in the global hedge funds sector. The pace of growth of the capital under management of global hedge funds, which had moderated in the course of 2005, fluctuated rather sharply in the first months of 2006, partly due to the mixed performance of most strategies in the last quarter of 2005 and improved results in the first quarter of 2006. After several quarters of reduced inflows into the hedge fund sector, and an outflow in the last quarter of 2005, inflows re-bounded in the first quarter of 2006 as shown by the chart on the left on slide 13. Looking forward, however, the possibility of tighter global liquidity conditions has raised investor redemption risk for hedge fund managers, particularly as the share of less liquid assets has reportedly been increasing.

At the same time, correlations of returns within some hedge fund investment strategies and among strategies remained high or even increased, raising the risk of disorderly synchronous exists from similar trades in an environment of unexpected market turbulence. This is illustrated in the chart on the right on slide 13.

6. Overall assessment

Having reviewed the developments in the key parts of the financial system, I will now turn to the overall assessment of risks to euro area financial stability. Let me first remind you of the scope and the nature of our financial stability analysis. In particular, drawing attention to sources of risks and vulnerability to financial stability does not seek to identify the most probable outcome, but it rather entails highlighting potential and plausible sources of downside risks, even if the probability of their realisation is relatively low.

Let me now conclude by stressing that in June 2006, the financial stability outlook rests upon a delicate balance. On the one hand, the global economic activity is expected to remain robust and the shock-absorption capacity of euro area financial institutions has improved. But, on the other hand, risks and vulnerabilities remain and some have grown further. Overall, while a positive outcome remains the most likely prospect, the possibilities that the risk-management systems and loss-absorption capacities of financial institutions may be severely tested, while still small, cannot be excluded.

Finally, I would like to remark that many of the risks discussed in my presentation today have already been identified some time ago. The fact that they have not materialised to any significant extent does not mean that these risks have diminished. Therefore, we should not be complacent in the face of what might currently appear to be a reassuring stability in the euro area financial system. Continuing vigilance is required to safeguard financial stability in the euro area.

I am now at your disposal to answer questions on the Review.