Lucas Papademos: ECB Financial Stability Review December 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 December 2006 ECB Financial Stability Review, Frankfurt am Main, 11 December 2006.

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I. Introduction

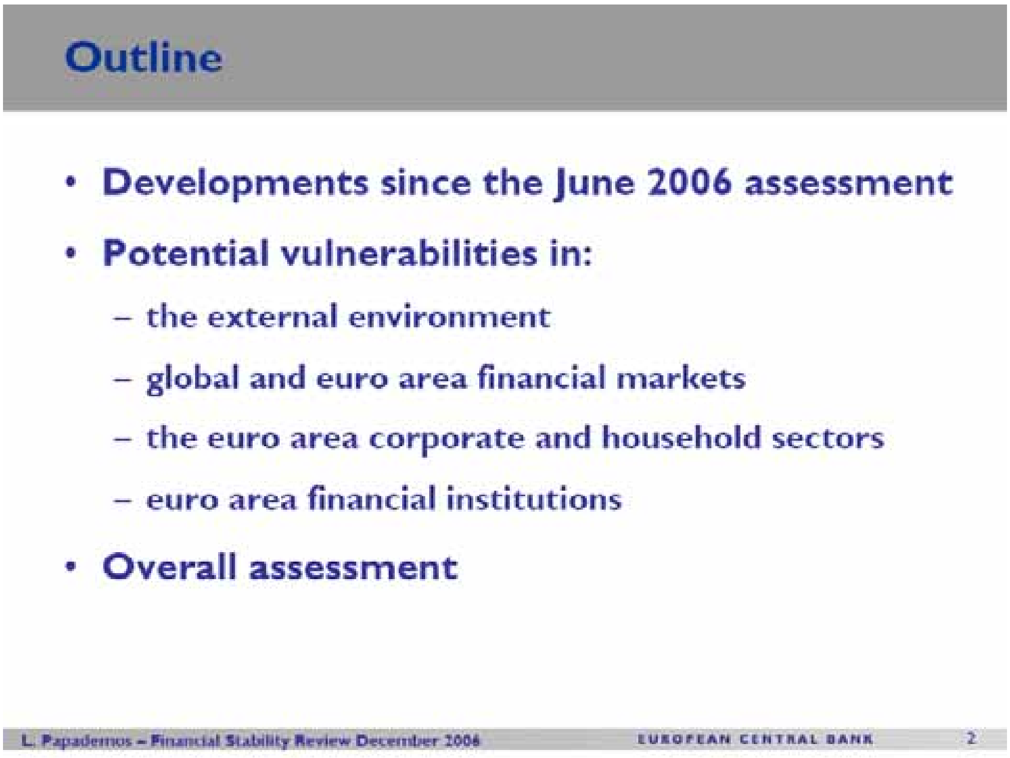
Welcome to this press conference for the fifth issue of the ECB's semi-annual Financial Stability Review which is being published today.

The financial stability assessment contained in the December 2006 issue of the Review is based on close collaboration between ECB staff and the ESCB Banking Supervision Committee. In addition, this particular issue draws upon information that was obtained from a series of informal discussions that were held with investment banks, hedge funds and credit rating agencies. It reflects information that was available up to 3 November 2006.

This issue of the Review broadly follows the structure that was adopted in previous issues, although the assessment of the hedge fund sector is now included in the first Chapter in an expanded section on global financial institutions.

Some thematic financial stability topics are addressed in a total of 16 boxes and there are also five Special Feature articles in this issue. These are concerned with the following topics: (i) a methodology for identifying a set of large and complex banking groups for financial system stability assessment; (ii) an analysis of the information content of credit default swap index tranches for financial stability assessment; (iii) a methodology for analysing episodes of dynamic credit growth in Central and Eastern Europe; (iv) an assessment of systemic risk in the insurance sector and (v) a review of the EU arrangements for financial crisis management.

In presenting the main findings of the analysis, I will broadly follow the structure of the Review – as outlined on slide 2. In particular, I will discuss the main sources of risk and vulnerability for euro area financial stability we have identified in: (i) the external environment; (ii) global and euro area financial markets; (iii) the euro area corporate and household sectors and (iv) euro area financial institutions. Then I will conclude with an overall assessment of the outlook.



II. Developments since the June 2006 assessment

Before doing this, let me start by recalling our assessment of last May when the June FSR was finalised and what has happened since then. In May, several vulnerabilities had been assessed as being capable of posing material risks to the euro area financial system. Given these vulnerabilities, there had been some concern that the shift to less accommodative monetary policies in the major economies and the occurrence of a number of shocks could have resulted in disorderly adjustments in asset prices by exposing "stretched" asset valuations in some markets and "overextended" balance sheets. This did not happen.

The gradual shift to less accommodative monetary policies in all major economies proceeded smoothly. The system endured several shocks over the past six months. For instance, there was a bout of volatility across a broad range of financial markets during May and June but the markets comfortably absorbed the disturbances and no major financial institution was significantly impacted by the event.

It should also be recalled that there had been some anxiety that disruptive asset price dynamics could have been triggered by an idiosyncratic collapse of a large hedge fund. However, the plunge into financial distress in September 2006 of Amaranth Advisors had little discernible impact on markets.

Against this background, in the euro area over the past six months, conditions for raising funds in the credit and equity markets remained favourable, there was a further and broad-based improvement in the profitability of banks, and the balance sheets of insurance companies were strengthened further. In addition, key financial infrastructures – including payment systems such as TARGET, and securities clearing and settlement systems – remained robust and continued operating smoothly.

III. Overview of the main risks and vulnerabilities

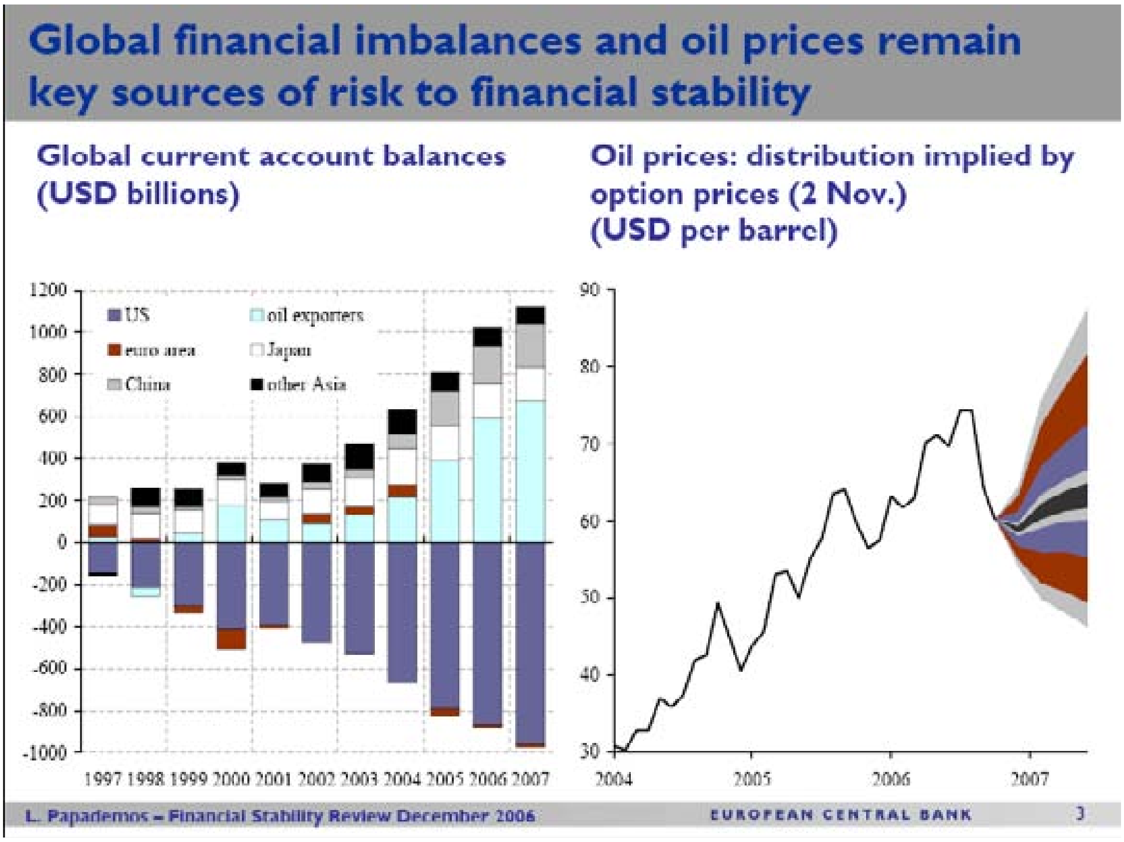
III.1 External environment

Turning to the current assessment and starting with the **external environment**, a global source of medium-term risk for the stability of financial systems continues to be the large global financial imbalances, despite some rebalancing of global growth patterns and recent declines in oil prices [see slide 3].

While there are indications that global financial imbalances have been widening at a slower pace than before, they are not expected to narrow significantly in the short term. The prolonged accumulation of expanding US current account deficits has been a source of unease because the financing of these deficits relies on the continuation of capital inflows from surplus emerging market economies and oil-producing countries [see chart on the left of slide 3].

Commodity price swings, especially in the oil markets, can also pose risks for financial stability through various channels both indirectly and directly. Indirect effects pass through macroeconomic channels as high and volatile oil price levels pose risks for economic growth and inflation with potential adverse effects on asset prices. As regards direct effects, there are indications that speculative activity in the markets for derivatives on oil as well as in other non-oil commodities has been increasing. An example of the risks that can be posed by such activity in non-oil commodities markets was the episode involving the Amaranth Advisors hedge fund that collapsed in September. The fund ran into difficulties after its leveraged bets in the natural gas futures market – which had been predicated on expectations of hurricane frequency and intensity that did not materialise – suddenly turned sour.

Regarding oil spot prices, after reaching new historical highs in early August, they subsequently declined substantially but have remained at high levels. The decline was mainly attributable to a reduction in geopolitical tensions, a receding threat of hurricanes in the Gulf of Mexico and an easing of petrol market tightness. All of these factors led to a decline in speculative positions which contributed to the rather abrupt downward adjustment in the price of oil. Looking forward, the implied probability distribution of future oil prices, extracted from options contracts, indicates that considerable uncertainty surrounds near-term oil futures prices, with very wide confidence intervals. Moreover, the balance of risks is tilted towards the upside [see chart on the right of slide 3].

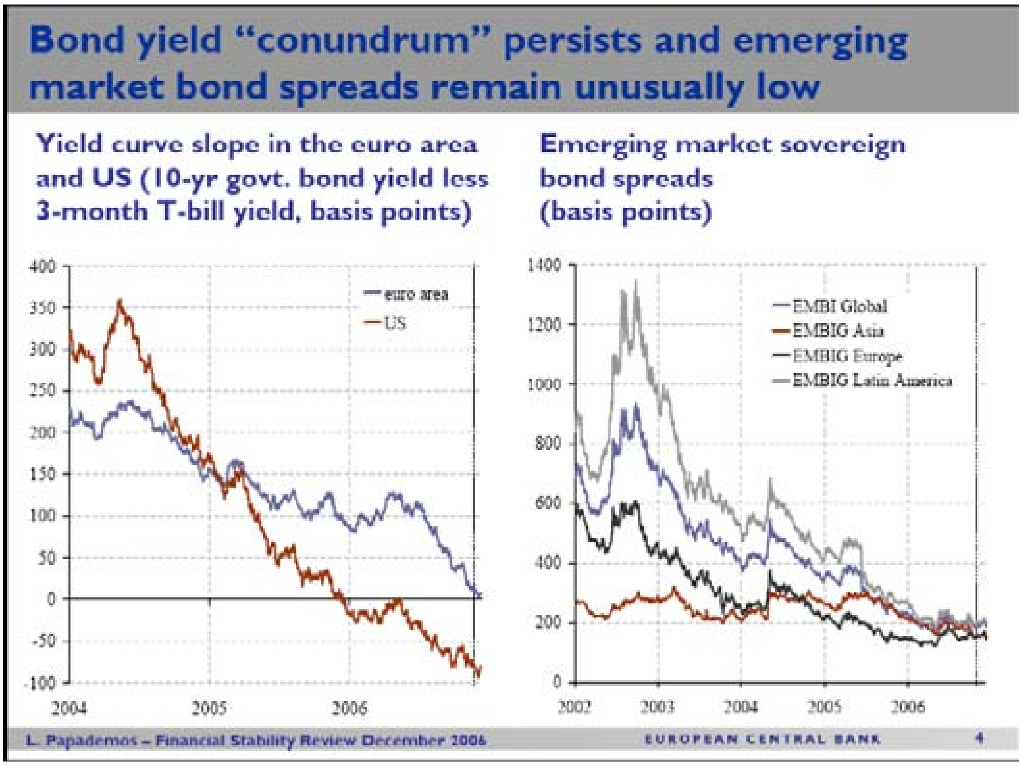


III.2 Global and euro area financial markets

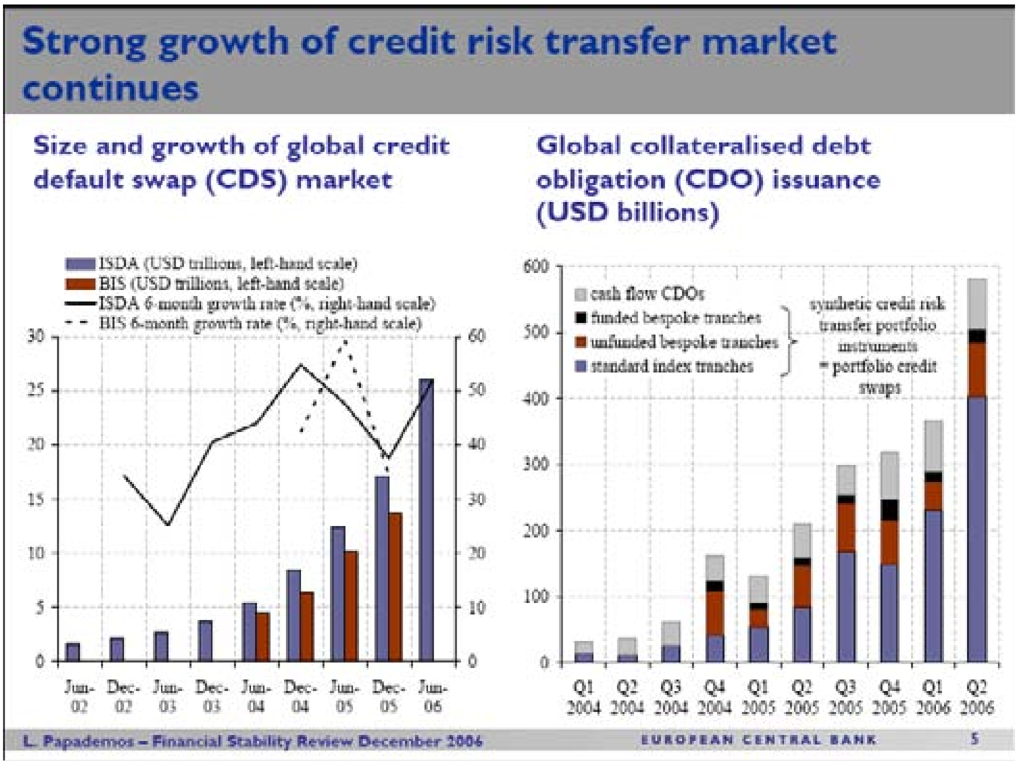
When assessing the potential risks in the **global and euro area financial markets**, two main sources of vulnerability can be identified. The first concerns the persistently low levels of long-term interest rates and credit spreads which have been associated with a “pricing for perfection” in corporate sector capital (credit) markets and emerging economy debt markets in the sense that valuations in these markets appear to be based on very favourable expectations regarding future economic outcomes and low risk premia. The second concerns the growth in the volume and complexity of credit derivatives markets, coupled with the increasing presence of hedge funds in these markets.

An abundance of liquidity in global financial markets, although its rate of growth has moderated, together with very high saving rates in some emerging market regions relative to domestic investment opportunities partly explain why long-term interest rates and credit spreads have been remarkably unperturbed by the shift to less accommodative monetary policies in the G3 economies and the resulting withdrawal of global liquidity. Rising short-term interest rates have instead produced flatter, or inverted, market yield curves in the six months following the finalisation of the June 2006 FSR. [see chart on the left of slide 4] The renewed “conundrum” of low long-term government bond yields seems, in part, related to very low risk premia. It should also be noted that several demand-related factors, such as bond purchases by euro area insurance corporations and pension funds, might have played some role in keeping long-term bond yields at low levels, although it is difficult to quantify the impact with precision.

As already noted, the bout of volatility across a broad range of financial markets during May and June 2006 was comfortably absorbed both by markets and institutions. However, to the extent that the “search for yield” in a low interest rate environment has led to this “pricing for perfection” in other financial markets, long-term rates and risk premia could have been driven too low especially in credit markets and those of emerging market economies [see chart on the right of slide 4]. This means that valuations in these markets could prove vulnerable to several potential unanticipated adverse disturbances including a renewed spike in oil prices, a pick-up in the demand by non-financial firms for external funds should profitability weaken, or a change in global asset allocation. Such triggering events could have the potential to bring about possible abrupt increases in bond yields, spreads and risk premia across mature and emerging capital markets.



If a triggering event of sufficient severity were to occur, it could bring about an abrupt increase in long-term yields, and credit and equity risk premia across mature capital markets and emerging market economies. This would imply significant asset portfolio losses for banks and other financial institutions. More importantly, it could also raise the counterparty risks some banks face vis-à-vis hedge funds in case it would trigger a cluster of hedge fund failures.



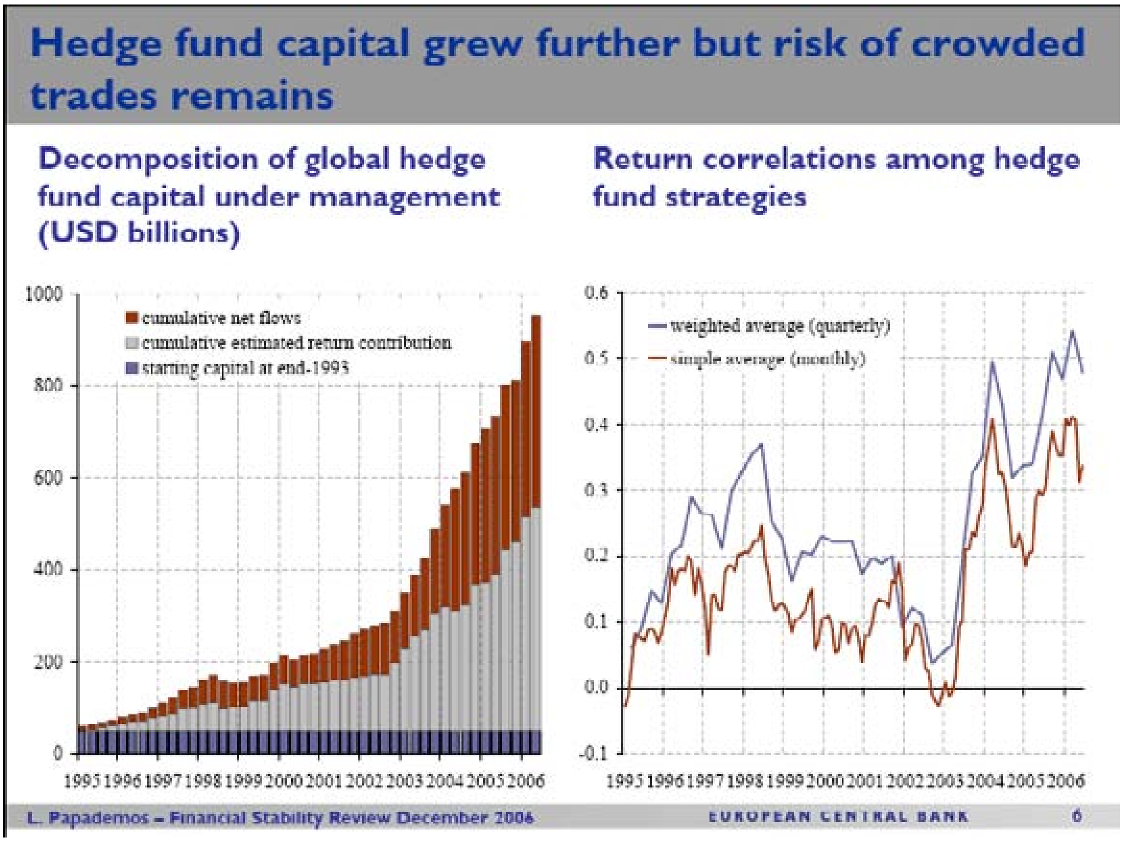
As to the second issue for financial markets, credit derivatives markets have been growing at an exponential rate over recent years, not only in terms of size but also in terms of the complexity of products. [see slide 5] The development of these markets is undoubtedly contributing to the efficiency and stability of the financial system by allowing financial intermediaries to measure and manage their credit risks more efficiently and effectively, primarily by buying protection in the credit default swaps (CDS) market.

At the same time, there have been concerns that rapidly increasing credit risk transfer (CRT) activity may be leading to concentrations of risk among agents who might not be able to bear it in a more challenging environment, particularly in the case of the more complex structured credit products where investors may have been attracted by high short-term returns.

In 2003, the Banking Supervision Committee undertook an important survey on CRT activity. But so much has happened since then – especially in terms of the substantial growth of the market and the increasing participation of hedge funds in taking on credit risk exposures – that at the current juncture, the available data are insufficient to make a sound assessment of these risks. Should current trends continue, they will imply fundamental changes in the methods for assessing the ability of the financial system to cope with unexpected credit cycle deterioration.

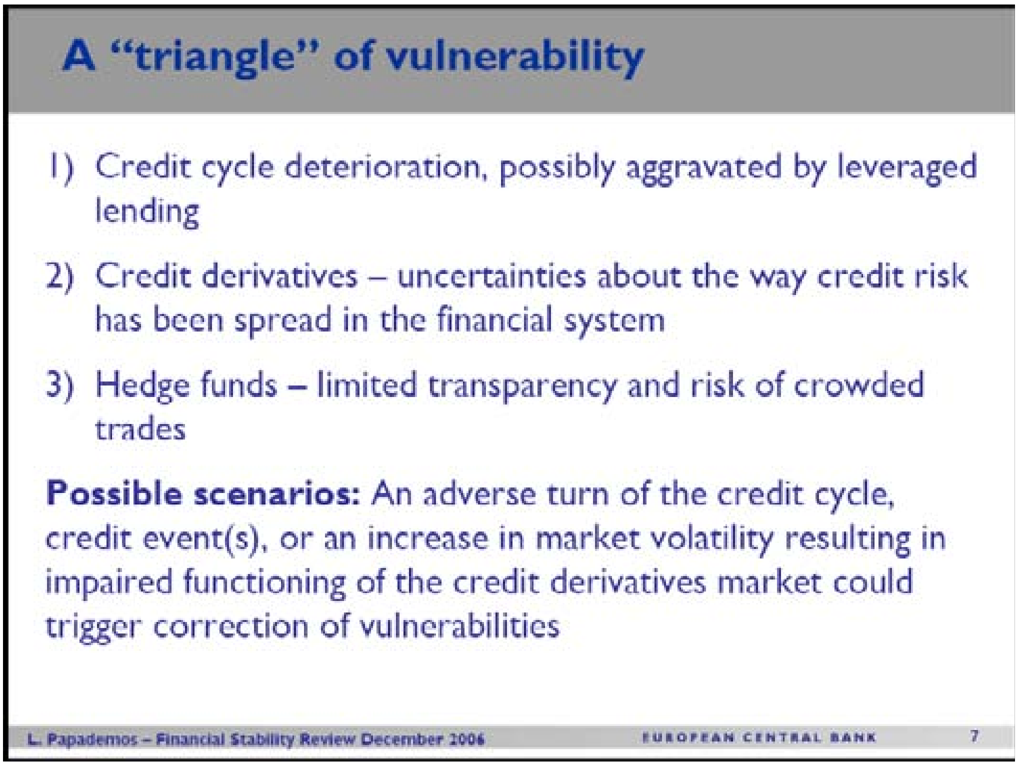
After the finalisation of the June 2006 FSR, some hedge funds endured financial losses, mainly as a consequence of turbulence in financial markets during May and June. Subsequently, there were some highly publicised adverse developments in the hedge fund sector related to the collapse of Amaranth Advisors, a large multi-strategy fund. Nevertheless, the hedge fund sector continued to benefit from steadily increasing investor demand. [see slide 6]

Capital under management by hedge funds has been growing very rapidly and has reached close to one trillion US dollars. [see chart on the left of slide 6] Given this size of the sector, a growing concern is that trades are becoming increasingly crowded. Higher correlation of hedge fund returns could be an indication of this. During the first half of 2006, correlations among and within hedge fund strategies remained relatively stable.



It is noteworthy that the collapse of Amaranth Advisors in September did not lead to wider turbulence, despite the fact that the total loss experienced by the fund was much larger than that incurred by LTCM in 1998. The ability of the system to absorb the shock demonstrated that the hedge fund sector has become more mature and has the ability to repair itself in the event of idiosyncratic distress. However, it should also be recalled that this event occurred against a backdrop of rather benign market conditions, and it cannot be excluded that in a more challenging market environment, such as that which characterised markets after the Russian crisis in August 1998, the impact of such an event could have been more disruptive.

New risks have emerged related to what could be called a “triangle” of vulnerability connecting the state of the credit cycle (which could deteriorate in the future), credit derivatives and hedge funds [see slide 7]. On the one hand, a marked adverse turn in the credit cycle, triggered either by a large and unexpected credit event, such as the collapse of a large corporation, or by a cluster of defaults by smaller and highly leveraged low-quality corporations, could lead to substantial payment obligations for counterparties which have provided credit risk protection. If these counterparties were found not to be in a position to sustain the losses, credit risk “insurance” might not be available when claims are ultimately made. On the other hand, if the functioning of the credit risk transfer market were impaired, for instance if financial market volatility rose unexpectedly, this could have an adverse impact as banks might not then be able to lay-off their credit risk in the way they have become accustomed which could, in turn, induce greater caution in their lending to lower quality borrowers in particular.



III.3 Euro area corporate and household sectors

Turning to developments in the euro area corporate sector, over the past six months there have been mounting signs that an adverse turn in the credit cycle seems increasingly likely, driven by factors such as rising leverage ratios, a further tightening of monetary conditions and expectations of a future slowdown in the pace of profit growth.

A favourable economic environment together with the persistently low cost of issuing corporate sector debt and greater investor appetite for lower quality credit have created conditions that have been conducive to a surge in global merger and acquisition (M&A) activity [see chart on the left of slide 8], and in particular of leveraged buy-outs (LBOs). Such transactions have become an important source of growth in leveraged loans.[1] [see chart on the right of slide 8] The rapid growth in the value of LBO transactions has taken European leveraged loan issuance beyond levels last seen at the height of the telecom boom of the late 1990s. At the same time, the average degree of leverage in these loans – measured by debt-to-EBITDA ratios[2] – has increased substantially. As a result, the credit quality of

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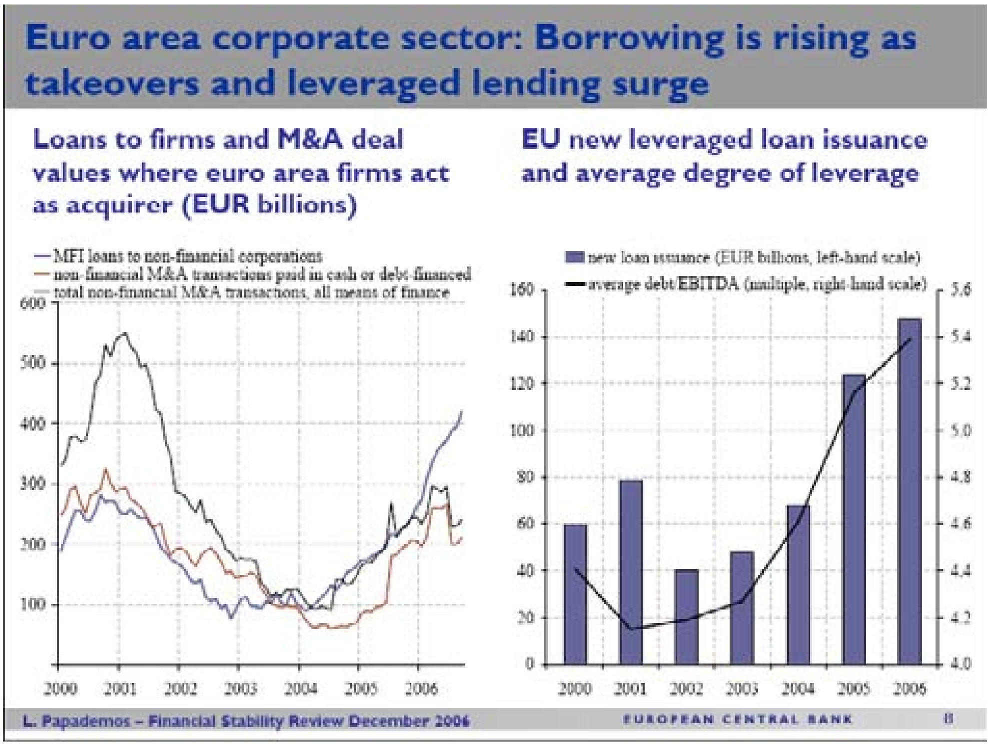
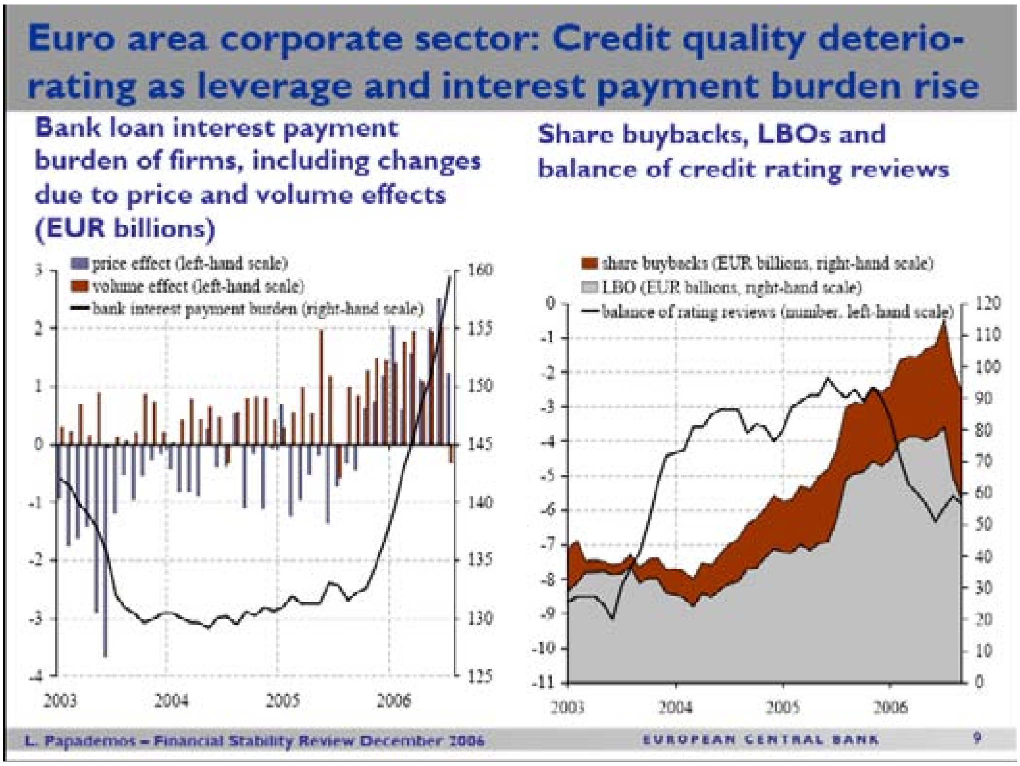
[1] Different market organizations and lenders define leveraged loans in different ways; however there are two broad ways to classify loans as leveraged or nonleveraged. The first is based on credit ratings, and the second is based on a loan’s initial interest rate spread over LIBOR. The extent to which a credit is leveraged reflects, other things being equal, the leverage ratios of a borrower with higher ratios resulting in higher spreads or lower credit ratings.

[2] EBITDA stands foe Earnings before Interest, Taxes, Depreciation, and Amortization.

issuing companies has deteriorated. It cannot be excluded that certain features of the leveraged loan markets, such as debtor-friendly re-payment structures and an increasing tendency by lenders to accept breaches of loan covenants, could have contributed to a perpetuation of the benign credit cycle, while at the same time increasing the risk of clusters of defaults in the event that liquidity conditions deteriorate.



Because of the high yields they offer, leveraged loans have become popular assets for inclusion in complex structured credit derivatives products and the riskiest parts of them are often sold to hedge funds. Disturbances in the leveraged loan market could therefore also trigger spill-over effects via the aforementioned "triangle".



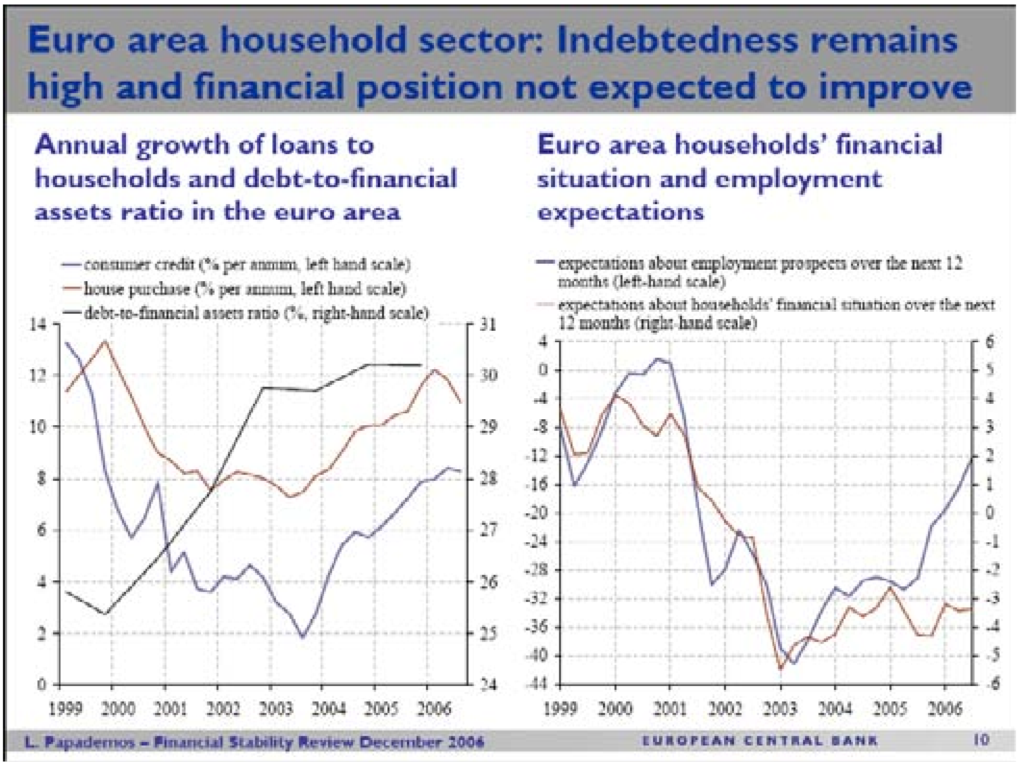
Looking ahead, rapidly rising leverage, the increasing recourse to short-term funding and the surging interest payment burden have left firms' balance sheets vulnerable to adverse disturbances. [see slide 9] Although the increase in euro area corporate sector leverage should be considered in conjunction with the continued strength of profitability, it seems nevertheless to have contributed to deterioration in some yardsticks of credit quality. These include a higher proportion of rating agency downgrade actions than upgrades and a rising number of firms being placed on review for a rating downgrade vis-à-vis firms facing a possible rating upgrade. This seems to be at least partly related to the aforementioned growing LBO, as well as share buyback, activity both of which can weaken the position of existing corporate debt holders and increase the affected firms' vulnerability to changes in financing conditions.

A significant deterioration in corporate sector credit quality would not only imply greater loan losses for banks, but could also trigger an asset price adjustment in credit markets, especially if the frequency of unexpected idiosyncratic corporate defaults were to rise.

Euro area household sector leverage has reached unprecedented heights. Thus, past experience is not relevant for assessing its sustainability. Although household sector debt ratios in the euro area on average have remained lower than those in other mature economies, risks are not evenly spread across the euro area. Indeed, there are continuing concerns regarding balance sheet vulnerabilities in countries where debt-ratios are well above the euro area average, especially if debt is predominantly financed at variable interest rates. [see chart on the left of slide 10]

Regarding risks to household income, survey evidence reveals that euro area households have become less pessimistic concerning their future employment prospects but have remained pessimistic about their financial outlook. [see chart on the right of slide 10] All in all, however, considering the outlook for economic growth, the likelihood of a decrease in household income in the near term is judged to be low.

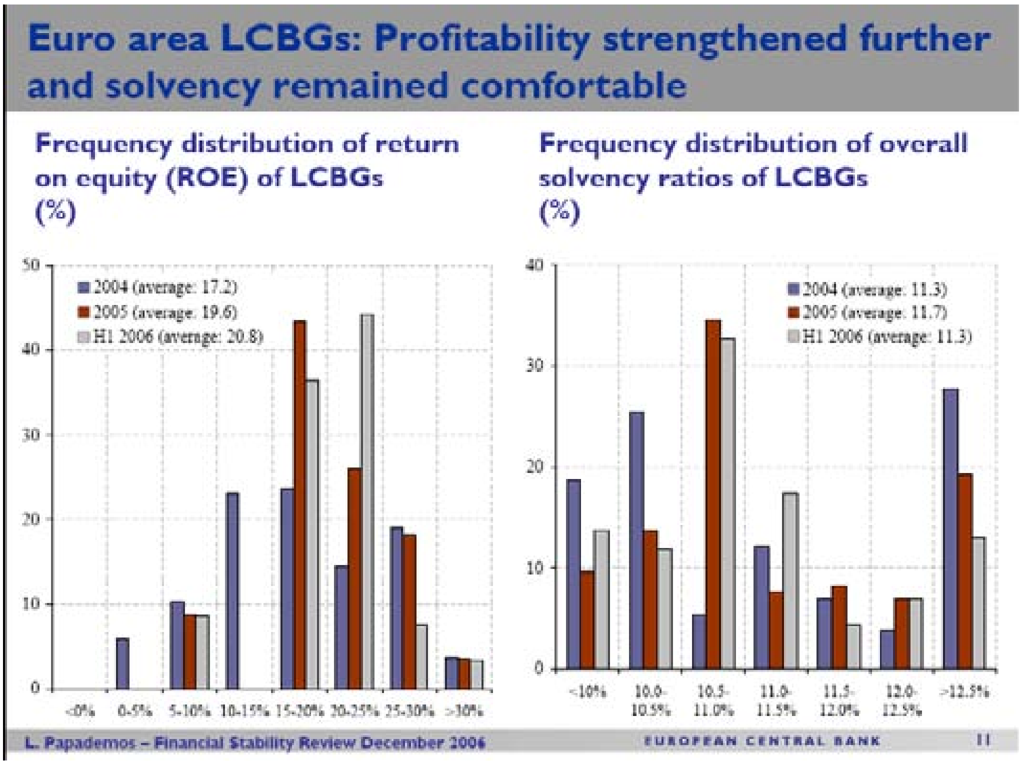
On the asset side of euro area household sector balance sheets, price-to-rent ratios in some countries suggest that a slowdown in the pace of future house price inflation, or even a correction, cannot be excluded. Banks in many Member States appear, by and large, to have carefully managed the risks inherent in the collateral used to secure mortgages, even though signs of intensifying competition may have led to a loosening of credit standards. This means that euro area households would probably have to bear the brunt of any property price reversal.



III.4 *Euro area financial institutions*

Turning to developments in the **euro area banking sector**, the analysis of the sector in this issue of the Review focuses on the performance of, and outlook for, a set of large and complex banking groups (LCBGs). The methodology used to identify these institutions, which is far more rigorous than the methods used in the past, is explained in detail in Special Feature A.

The latest data show that the financial condition of euro area LCBGs continued to improve in 2005 and the first half of 2006 consolidating the already steady improvement that had been underway since 2003. [see slide 11] The broad-based strengthening of profitability was driven by lending growth, which compensated for the further erosion in lending margins as a result of intense competition. Non-interest sources of income also contributed to bottom-line. At the same time, cost-containment continued and loan impairment charges declined further. Solvency ratios of euro area LCBGs remained comfortable despite declining slightly in the first half of 2006, which was due to a rise in risk-weighted assets. From a financial stability perspective, it is encouraging that those institutions with the lowest capital ratios in the past also improved in the first six months of 2006.

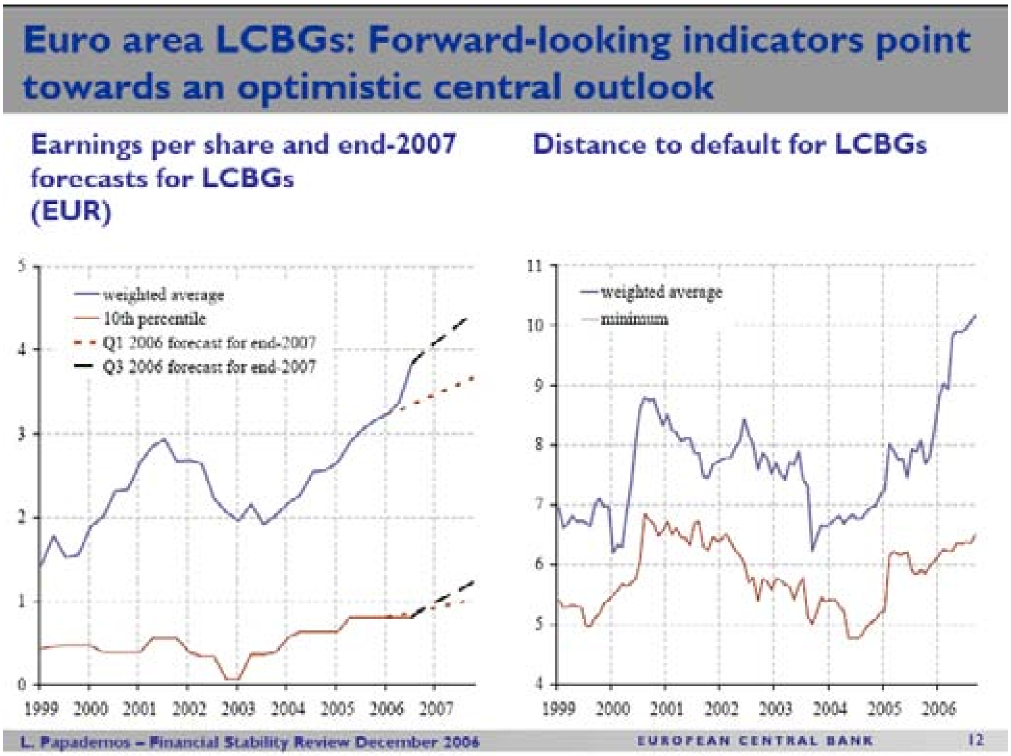


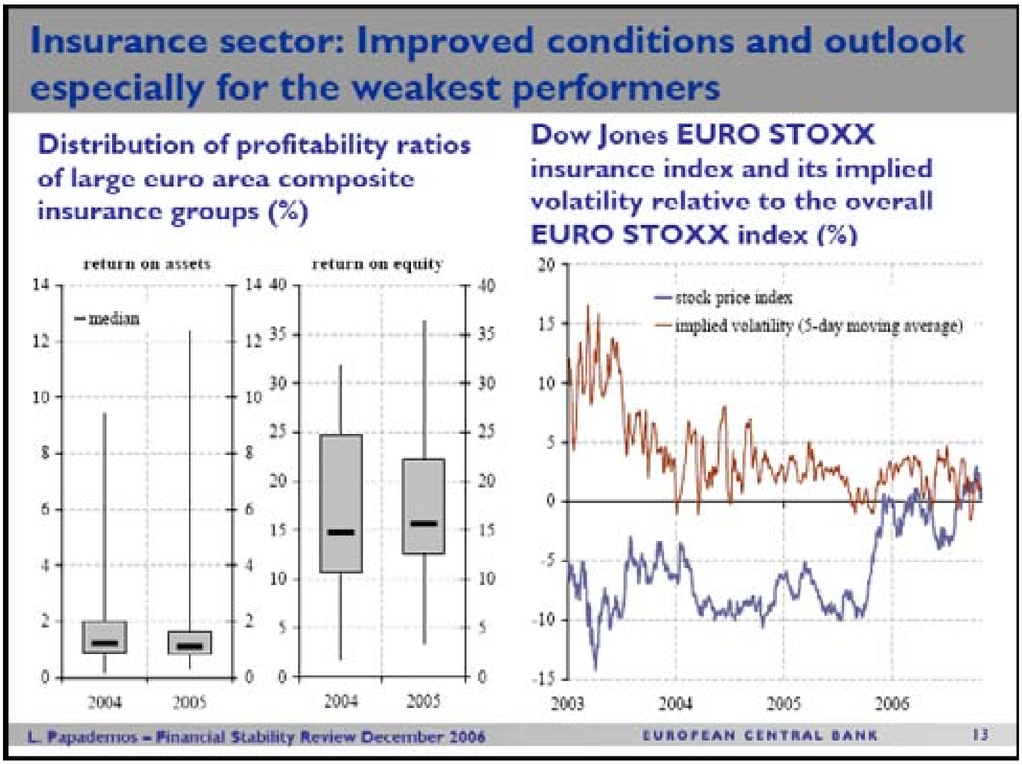
The assessment of credit risks is becoming complicated by recourse to CRT markets. For instance, the impact of a potential turn in the credit cycle on banks might be more muted than in earlier downturns, albeit not necessarily on other parts of the financial system since the risks themselves do not disappear. Other risks facing the banking sector mainly relate to interest rate risks, where the flat yield curve environment limits banks returns in their core business. There is a concern that this could encourage them to seek more risky ventures in an effort to boost profits, resulting in increased operational and counterparty risks from their growing exposure to unregulated financial institutions.

Notwithstanding the risks identified, market analysts are expecting that the profitability of euro area LCBGs is likely to strengthen further in the short term, underpinned by a favourable economic outlook and benign credit conditions. [see slide 12]

Forward-looking market indicators for the credit risk of euro area LCBGs reflect this broadly positive assessment. For instance, the distance-to-default indicator continued to rise, including for the weakest banks. While this may reflect the low probability assigned by market participants to the materialisation of the risks and vulnerabilities identified by our analysis, it could also signify a favourable assessment of the shock-absorbing capacity of the banking system, supported by comfortable solvency ratios and improved risk management.

Euro area insurance firms have placed greater focus on risk management, risk-adjusted pricing and core profitability, all of which have continued to support a positive outlook for the sector, especially for large firms. Ongoing improvements in asset liability management, together with an overall optimisation of the capital structure have underpinned a generally positive assessment by market participants, as witnessed by the recent moderate over-performance of the insurance index relative to the broad stock index. [see slide 13]





However, there are a number of risks facing the industry in the period ahead. For the non-life insurance sub-sector, increased competition is likely to weigh further on underwriting income, which could drive further consolidation within the sub-sector. For the life insurance sub-sector, ongoing challenges include the closing of balance sheet mismatches in an environment of persistently low long-term interest rates and the effective management of longevity risk.

IV. Overall assessment

Let me now turn to the **overall assessment**. [see slide 14] The central scenario for euro area financial stability remains broadly favourable. This is assessment is based on the following four factors:

First, the resilience of the system was confirmed by its ability to comfortably absorb some adverse disturbances;

Second, global economic activity is becoming more evenly balanced and the gradual shift to less accommodative monetary policies is proceeding smoothly;

Third, the credit quality of the key counterparties of banks – households and firms – generally remains high and;

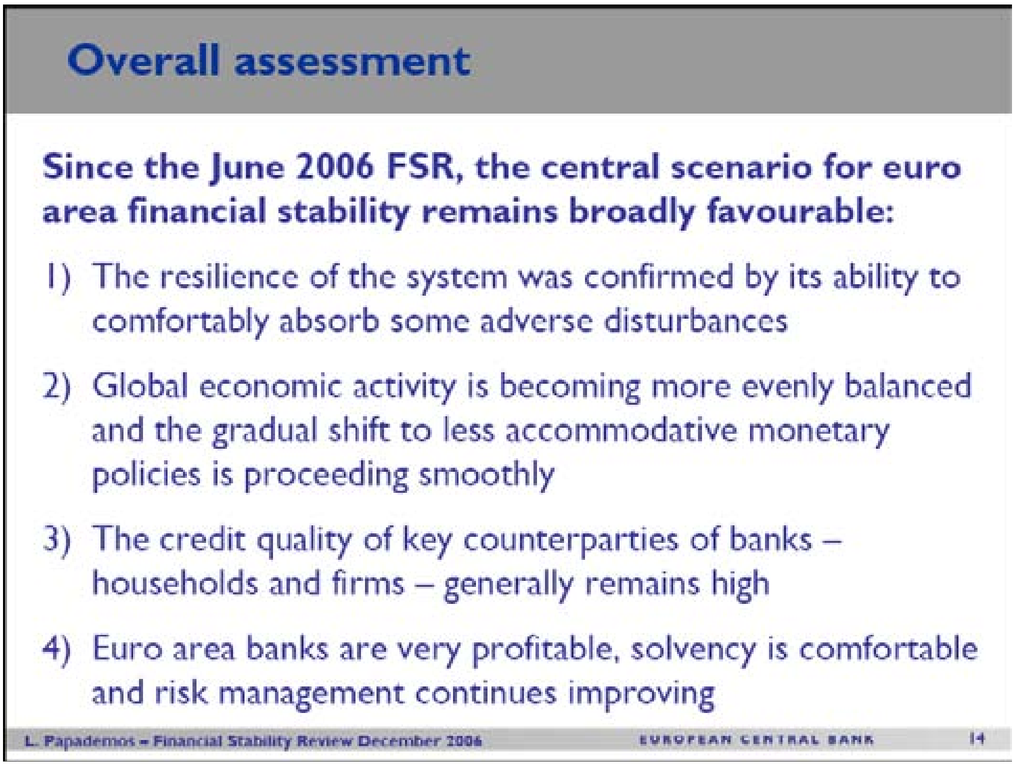
Fourth, euro area banks (LCBGs) are very profitable, their solvency ratios are comfortable and risk management continues to improve.

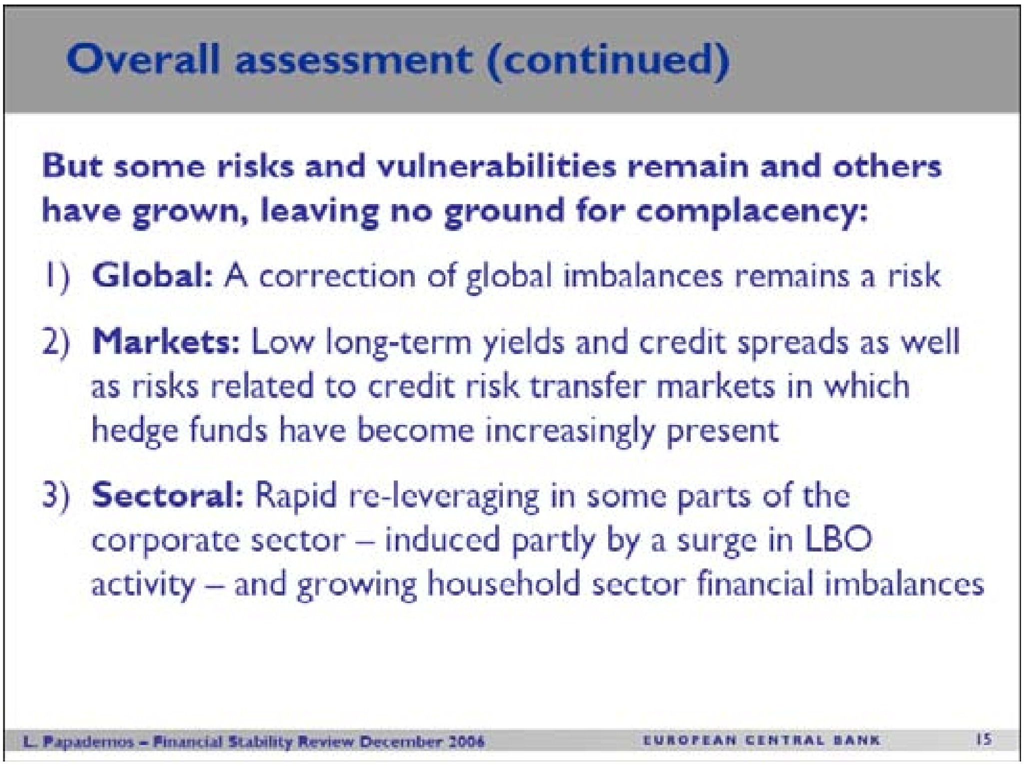
Nevertheless, some previously identified sources of risk and vulnerability have grown, and their relative likelihood could have changed. [see slide 15]

First, a global source of medium-term risk for the stability of the financial system continues to be the large global financial imbalances, despite some rebalancing of global growth patterns and recent declines in oil prices.

Second, in global and euro area financial markets long-term yields and credit spreads remain very low, and thus vulnerable to a reappraisal of risk. At the same time, important risks may be developing – although they are extremely difficult to quantify – related to credit risk transfer markets in which hedge funds have become increasingly present.

Third, concerning sectoral risks in the euro area, there has been rapid re-leveraging in some parts of the corporate sector, induced in part by a surge in LBO activity, and household sector financial imbalances continue to grow and are especially sizeable in a number of countries.





For these reasons, the comforting central outlook for financial stability should not give rise to complacency because there are several possible low-probability but potentially high-impact events that could occur and that would, if they were to crystallise, create material risks for financial stability.

Thank you very much for your attention.