Lucas Papademos: Opening remarks at the press briefing on the occasion of the publication of the December 2009 ECB Financial Stability Review

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 2009 ECB Financial Stability Review, Frankfurt am Main, 18 December 2009.

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I. Introduction

My colleagues and I would like to welcome you to today's press briefing on the occasion of the publication of the December 2009 edition of the ECB Financial Stability Review.[1] The primary objective of the Review is to consider the main sources of risk to the stability of the euro area financial system and provide a comprehensive assessment of the capacity of the financial system to absorb adverse disturbances. As usual, the Review has integrated the interdepartmental work of the ECB with that of the Banking Supervision Committee (BSC) of the ESCB. It contains 14 boxes and five special feature articles that address topical financial stability issues in a more focused and analytical manner. As in the past, we have prepared a summary note that highlights some key messages of our analysis and assessment.

Over the past 12 months, the extraordinary policy measures taken by central banks and governments have succeeded in restoring confidence in, and strengthening the resilience of, financial systems around the world. In particular, financial system support measures have been addressing the funding problems of key financial institutions and have bolstered their capital positions. These measures, in combination with sizeable macroeconomic policy stimuli, have set in motion a mutually-reinforcing process between financial system conditions and real economic performance, fostering improving economic prospects and a fading of systemic risk.

One important reason for the lowered systemic risk has been an abatement of tail risk, which has been primarily due to the downside-protection by governments of financial institutions' balance sheets. A recovery of risk appetite, underpinned by the reduced systemic risk, has contributed to the remarkable turnaround in the financial markets since March 2009. The improved financial conditions and the steeper yield curves have sufficiently strengthened the profitability of many financial institutions, especially the large ones, to such an extent that they have been able to absorb considerable write-downs on securities and loans, while still, on average, reporting material improvements in profitability over three consecutive quarters.

In my presentation, I will highlight the main risks identified and assessed in the Review and the associated financial stability challenges. I will start with certain sources of risk stemming from the global macro-financial environment.

II. Risks in the global macro-financial environment

Over the past six months, the adjustment of global current account imbalances has continued, driven by the global economic slowdown and the overall fall in commodity prices, especially energy, from the peaks of mid-2008. The current account deficit of the US is now projected to fall to 2.6% of GDP in 2009, which is almost 2.3 percentage points lower than in the previous year. The major counterparts to the adjustment of the US current account balance have continued to be the surplus economies of eastern Asia and the oil-exporting

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[1] The cut-off date for data included in the December 2009 FSR was 27 November 2009.

countries. The current account surplus of Japan is projected to narrow to 1.9% of GDP in 2009, while China's current account surplus is forecast to decline by 2 percentage points to 7.8% GDP in 2009, as robust domestic demand has underpinned imports growth which has exceeded that of exports. However, this ongoing adjustment of global imbalances is rather fragile, as it remains largely driven by cyclical factors related to the financial crisis rather than by structural factors. Looking ahead, there is a risk of re-emergence of sizeable global imbalances stemming from various sources, including a possible widening of the US current account deficit as the economy recovers and if the substantial fiscal stimulus persists.

Turning to external risks stemming more directly from the US economy, there were some positive developments, but vulnerabilities also remain. The US housing market has shown some signs of stabilisation over recent months. Both home sales and housing construction appear to have bottomed out since earlier this year, while the decline in house prices ceased in July 2009. The Case-Shiller futures price index for ten major US cities now indicates that house prices are expected to remain broadly flat over the next three years (see Chart 1). Nevertheless, the risk of a renewed deterioration in the US housing market and, therefore, possible further losses for households' net worth in the US and the financial sector has not disappeared. While the pace of increase in delinquencies on mortgages and in foreclosures has been slowing down, the excess stock of vacant homes remains considerable and might continue to exert downward pressure on house prices. In addition, the demand for housing has been spurred by tax credits for first-time home buyers, but this incentive has a limited time horizon.

In the US commercial property sector, developments have lagged those in the residential property market, both with regard to prices and activity. The recent steep fall in prices raises risks both for banks and other financial institutions that are directly exposed to the commercial property market and for investors in US commercial mortgage-backed securities.

The outlook for US corporate sector has stabilised since May 2009, as quarter-on-quarter profit growth has turned positive in the first half of 2009. This has mainly been due to a turnaround in the profitability of domestic financial industries (See Chart 2). As a consequence, corporate sector default rates are expected to peak. Notwithstanding the improvement in total corporate profitability, there are risks: the increase in non-financial corporate profitability has been largely due to cost-cutting measures, which could not continue indefinitely, while weak demand prospects are expected to constrain revenue growth.

The macroeconomic outlook in the non-euro area EU countries has improved, although there is still an unusually high degree of uncertainty. In many of the Central and Eastern European (CEE) countries of the EU, vulnerabilities have been reduced since May, but the economic and financial situation remains fragile. In particular, further economic contraction is forecast for a number of these countries next year. In this environment, a combination of rising unemployment and falling household incomes could be expected to raise the credit risks on consumer loans and residential mortgages. Corporate default rates are likely to be high in such a context as well. Given these fragilities, the possibility of a resurfacing of risk aversion towards the region can not be excluded.

In several CEE economies, vulnerabilities stem from the fact that a sizeable proportion of outstanding bank loans are denominated in currencies other than the currency in which the borrower's income is denominated. Such mismatched foreign exchange currency positions mostly affect households. In countries with flexible exchange rates, currency depreciations earlier this year have meant that households would have to repay larger amounts than they expected. Recent developments serve to underline the risks that exist when large stocks of foreign currency credit are outstanding. The share of foreign currency lending in many of these countries has been rising, owing to wide interest rate differentials. This has left them increasingly vulnerable to a renewed weakening of their currencies, which could trigger a significant further deterioration in banks' asset quality.

The general recovery of risk appetite has benefited the hedge fund sector. By the end of October 2009, most hedge fund investment strategies have already recouped a substantial part, or even all, of the losses they suffered in 2008. Cumulative average year-to-date investment returns at the end of October 2009 of all hedge fund investment strategies had almost all signs opposite to those reported for the whole of 2008 (See Chart 3). At the same time, after significant investor outflows in earlier quarters, preliminary estimates for the third quarter of 2009 suggest that the second quarter of 2009 may have marked the end of sector-wide investor outflows.

III. Risks in the euro area non-financial sectors

Let me now focus on risks and vulnerabilities that we have identified in the non-financial sectors of the euro area economy. Despite the considerable heterogeneity at the country level, the overall macroeconomic environment in the euro area has improved over the past six months. The decline in euro area economic activity has been sharp by historical standards since the third quarter of last year, but quarterly real GDP growth has recently turned positive (see Chart 4). In addition, the latest Eurosystem staff macroeconomic projections show a gradual recovery in 2010, although the road ahead is likely to be uneven. Among the risks stemming from the euro area non-financial sectors, I will highlight the main vulnerabilities in the corporate sector, specific fragilities in the commercial property market, and certain risks associated with the household sector.

Over the past six months, corporate profitability has remained very low and leverage ratios have generally increased, intensifying the balance sheet vulnerabilities of the non-financial corporate sector. In addition, banks have continued to apply conservative lending standards, albeit at a moderating degree. Improvements in financial market conditions have allowed larger firms to partly substitute bank loans with market-based debt or equity. Looking forward over the next few months, the overall balance sheet conditions are expected to remain challenging, as firms' access to external finance is not likely to improve significantly in the coming months, while profitability is likely to remain low. Low profitability and high leverage are putting a severe strain on firms, making them less resilient to adverse shocks. As a consequence, some measures of corporate credit risk, such as unconditional expected default frequencies, remain high for most industries although they had declined recently for most sectors. (See Chart 5).

Conditions in the euro area commercial property markets have deteriorated further during the past six months and continue to be a potential source of risk to many financial institutions. Capital values – i.e. commercial property prices adjusted for capital expenditure, maintenance and depreciation – for prime property had declined by an average of 12% (year-on-year) in the third quarter of 2009. All euro area countries had recorded declining capital values compared with the third quarter of 2008. The outlook for commercial property prices and rents is uncertain because it largely depends on the future path of economic activity as developments in commercial property markets follow the business cycle rather closely (See Chart 6). Some forecasters expect continued decreases in capital values and rents throughout 2009 and 2010.

Turning next to the household sector, although household indebtedness has stabilised over the past six months, the balance sheets of this sector remain a potential source of risk to financial stability. A relatively negative outlook for the labour market and household income is expected to offset, at least partly, the ongoing positive effect of the past declines in interest rates on the ability of households to service their debts.

The annual rate of growth in loans to the household sector, especially for house purchase, has further moderated, in line with the weakness of economic activity, the uncertain income prospects and the marked slowdown in house prices (See Chart 7). Indeed, several euro area countries have recorded declines in house prices in the first half of 2009.

IV. Risks in the euro area financial system

Let me now turn to the main sources of risk in the euro area financial system. Investor appetite for risk has begun to return after the first quarter of this year, bringing with it an improvement in market liquidity and a decline in asset price volatility. The turnaround has been underpinned by government-provided downside protection of financial institutions' balance sheets, which has reduced tail risk, improving macroeconomic news and better than expected earnings, especially by financial institutions. Against this background, the equity markets have rebounded, led by financial stocks. At the same time, historically low levels of money market interest rates have induced a hunt for yield among investors, triggering outflows from bank deposits and money market funds into riskier assets, including corporate bonds issued by lower-rated borrowers.

Euro area bond and equity markets

Over the past six months, euro area long-term bond yields have declined. However, in late November 2009, the slope of the euro area yield curve remained steeper than at any point in time since the launch of the euro, due to the past declines in short-term market rates (See Chart 8). Intra-euro area sovereign spreads, as well as euro area sovereign CDS spreads, have narrowed further, in some cases to pre-Lehman levels, until very recently, when a few have widened again.

Looking ahead, the prospects for euro area government bonds continue to be surrounded by persistent uncertainty about future macro-financial developments. Upward risks to yields could stem from a further unwinding of flight-to-safety and flight-to-liquidity flows. In addition, slower than expected growth might increase the financing needs of euro area governments and bond markets might face difficulties in absorbing higher government bond issuance.

Euro area equity markets continue to recover from the severe decline experienced during the financial crisis, supported by market optimism about the economic recovery and diminishing risk aversion. Valuation measures based on price/earnings ratios using long-term trailing earnings figures suggest that the markets are not particularly overvalued (see Chart 9). Alternative valuation measures, based on expectations of future earnings, provide different signals. Moreover, risks for stock market prices remain, in particular those associated with an economic recovery that could turn out to be weaker than expected by markets.

The euro area banking sector

Let me now turn to euro area financial institutions, starting with the large and complex banking groups. Conditions in the euro area banking sector have improved markedly in the first three quarters of 2009, on account of better-than-expected macroeconomic news and the concomitant rebound in the financial markets. The euro area banking sector has also benefited from the various financial system support measures and the macroeconomic policy stimulus.

The earnings and profitability of euro area major banks have recovered significantly, and across the board, in the first three quarters of 2009, after a dismal performance in the second half of 2008. Nevertheless, the dispersion of profitability across LCBGs continues to be wide (see the left side of Chart 10).

The examination of individual revenue categories sheds more light on the factors explaining euro area LCBGs' recent favourable performance (see the right side of Chart 10). Net interest income has been an important driver of the improved bank performance, on account of the steeper yield curve and wider operating margins. The tightening of credit standards, the gradual pass-through of lower policy rates to lending rates and declining competitive pressures in the credit market have all contributed to higher revenues from core banking business. Trading income has increased even more strongly as the financial markets recovered after the first quarter of 2009 and has been the main contributor, on average, to the increase in revenues as a percentage of assets.

With regard to bank capital positions and loan-loss provisions, I would like to highlight the following points. The recovery in major banks' earnings, the slowdown in the growth rate of both risk-weighted and total assets and increases in capital have contributed to a slight increase in the regulatory capital ratios of the median institutions. Even those institutions with the lowest regulatory capital ratios comfortably exceed at present the minimum requirements (see the left side of Chart 11).

Provisions on impaired assets had been a serious drag on euro area LCBGs' incomes in 2007 and 2008. To a large extent these provisions still related to securitised loans, although the share of loan impairments had started to grow. Most institutions have reported sharply higher provisions for loan losses (see the right side of Chart 11). Moreover, expressed as a percentage of total loans, loan-loss provisions were the highest in the third quarter compared to the five preceding years.

Funding liquidity problems continue to bring pressure on the major banks' operations. While the conditions have improved substantially in most funding segments throughout 2009, including the money markets, some of these institutions and parts of the broader euro area banking system, remain reliant on temporary support measures extended by the Eurosystem and governments.

Box 11 summarises the government measures to support the banking sector and discusses their implications for fiscal balances. Regarding the implementation of the measures, several conclusions can be drawn: First, the take-up rate has been generally low across all measures, but there are substantial variations: the use of recapitalisation measures has been relatively widespread, while the take-up rate for the issuance of bank bonds with government guarantees has been considerably lower than expected. Second, the largest part of the financial support has been provided to a relatively small number of institutions (See Chart 12). Indeed, about half of the extended support has been absorbed by the largest three recipient institutions in each category of support.

The various measures to support the financial sector amount to considerable actual and contingent liabilities for euro area governments. Although they are expected to have only a small direct impact on government deficits in the short to medium term, potential fiscal risks in the form of higher refinancing costs are sizeable for all countries that have provided significant financial system support, as these measures seem to have had a negative effect on market perceptions of the creditworthiness of the respective governments.

A closer look at LCBGs' financial results in the first three quarters of 2009 shows that risks of future substantial write-downs, and related liquidity and solvency concerns, remained and might have increased somewhat. While the LCBGs seem to be gradually getting over the valuation losses they have suffered on their securities holdings, the sizeable provisions for loan losses seen lately underscore the significant challenges for banks in managing their distressed loan portfolios.

Using the same methodology as in the June 2009 Review, and benefiting from more detailed data on loan and securities exposures of euro area banks, Box 10 presents an update of the estimate and assesses the magnitude of potential write-downs that might be suffered by banks by the end of 2010. The results show that euro area banks could face cumulative total losses of EUR 198 billion on their exposures to securities and losses of EUR 355 billion on their loan book exposures over the period 2007–2010. The total potential write-downs on securities and loans is thus currently estimated at EUR 553 billion over the same period. This figure is EUR 65 billion higher than the June 2009 estimate. The increase is mainly be explained by a further deterioration in the commercial property market, which contributed to a higher estimate of potential write-downs on banks' commercial property mortgages and commercial mortgage-backed securities, and also by the inclusion of an estimate of write-downs on securities originated in Central and Eastern Europe. Taking into account the write-downs on loans and securities recorded until end-October 2009 and the loan loss provisions until end-June 2009, the potential further write-downs of euro area banks until end-2010 could reach EUR 187 billion.

Potential write-downs on securities and loans for the euro area banking sector over the period from 2007 to 2010

(EUR billions)

	June 2009 FSR	December 2009 FSR
Securities	164	198
Loans	324	355
Total potential write-downs on securities and loans from 2007 to 2010	488	553
Write-downs reported to end-May 2009 (June 2009 FSR) and end-October 2009 (December 2009 FSR)	162	180
Loan-loss provisions 2007-2008 [1]	113	121
Estimate of loan-loss provisions in H1 2009	-	65
Potential further write-downs on securities and loans	214	187

Sources: Association for Financial Markets in Europe, Banking Supervision Committee, national central banks, ECB and ECB calculations.
1) Loan-loss provisions made by banks in 2007-2008 are somewhat higher than those published in the June 2009 FSR due to revisions to the consolidated banking statistics that were made after the finalisation of the June 2009 FSR.

The euro area insurance sector

Turning to the euro area insurance sector, it continues to be confronted with challenging conditions. The results for the second and third quarters of the year remained rather subdued, as premiums written declined on average. Reduced demand for life insurance products, in particular unit-linked products – where the investment risk was borne by the policyholder – have contributed to lower premiums written. Premiums written growth in the non-life segments has been hampered by the weak economic environment, which kept demand from households and firms muted. However, investment income, which has benefited from the improvements in the capital markets after mid-March 2009, was on average higher than in previous periods. The improvement in investment income has, however, not been enough to avoid a broad-based decline in profitability.

Large euro area insurers have continued to increase their investment exposure to government and corporate bonds during the first half of 2009, as they have continued to shift their investment strategies away from equities in an attempt to de-risk their investment exposures At the end of the first half of 2009, a sample of large euro area insurers had about 70% of their investments in bonds, up from about 50% at the end of 2007 (See Chart 13).

Overall, looking forward, euro area insurers continue to face challenges mainly due to the subdued economic activity, which is reflected in the uncertainty of their earnings prospects (see Chart 14). At the same time, the disclosed solvency positions of euro area insurers indicate a reasonable amount of remaining shock-absorption capacity to weather the materialisation of the risks they currently face.

V. Overall assessment

Let me now conclude by providing an overall assessment of the identified risks to euro area financial system stability.

As mentioned at the beginning of my presentation, the extraordinary policy measures taken by central banks and governments since late last year have been successful in restoring confidence in, and improving the resilience of, financial systems around the world. A recovery of risk appetite, underpinned by lowered systemic risk, has contributed to the turnaround in financial markets since March 2009 and supported the trading income of large and complex banking groups. Many of these institutions also benefited from a considerable boost to net interest income on account of very steep yield curves. The significant strengthening of the profitability of many LCBGs enabled them to absorb considerable write-downs on securities and loans while still, on average, reporting profits. Some were even able to return the capital they had received from governments, thus exiting from financial support.

Despite the recovery in financial markets and improved financial performance of euro area LCBGs, there are several grounds for caution in assessing the outlook for financial stability in the euro area.

Let me be elaborate on these key risks and vulnerabilities: The main risks identified outside the euro area financial system include the possibility of:

- vulnerabilities being revealed in non-financial corporations' balance sheets, because of high leverage, low profitability and tight financing conditions;
- greater-than-expected household sector credit losses if unemployment rises by more than expected;
- the surge of government indebtedness raising concerns about the sustainability of the public finances, as well as the crowding out of private investment; and
- an adverse feed-back between the financial sector and public finances as a result of government financial system support measures, fiscal stimuli and weak economic activity.

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

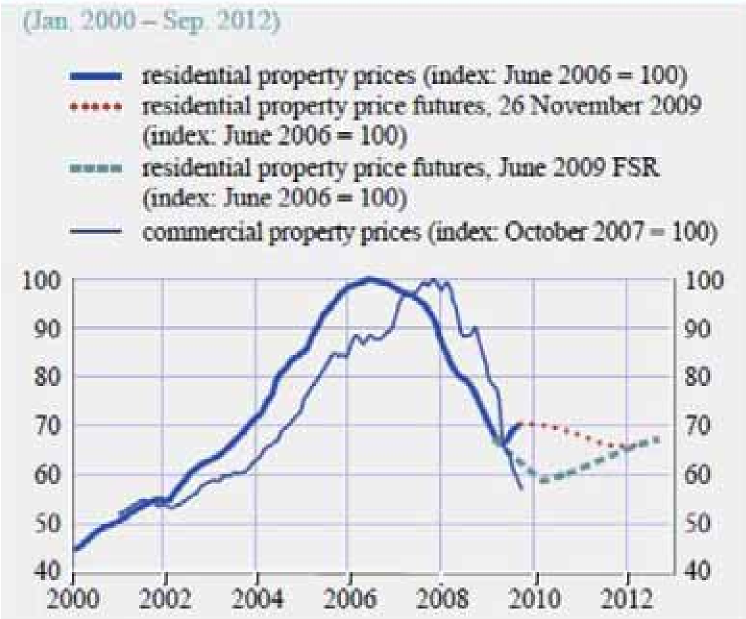
- renewed financial strains and that the recent recovery of bank profitability will not prove durable;
- vulnerabilities of financial institutions associated with concentrations of lending exposures to commercial property markets and to central and eastern European countries being unearthed; and
- a setback for the recent recovery of financial markets, if macroeconomic outcomes fail to live up to optimistic expectations.

All in all, the challenges facing the euro area banking sector in the period ahead call for caution in avoiding timing errors in disengaging from public support. In particular, exit decisions by governments will need to carefully balance the risks of exiting too early against those of exiting too late. Exiting before the underlying strength of key financial institutions is sufficiently well established runs the risk of leaving some of them vulnerable to adverse disturbances, possibly even triggering renewed financial system stresses. Late exits, on the other hand, can entail the risk of distorting competition, creating moral hazard risks that come with downside protection – including the possibility of excessive risk-taking – as well as exacerbating risks for public finances.

To cushion the risks that lie ahead, banks will need to be especially mindful in ensuring that they have adequate capital and liquidity buffers in place. If the circumstances require it, some banks may need to raise new and high-quality capital. In addition, some banks, especially those which have received state support, may need fundamental restructuring in order to confirm their long-term viability when such support is no longer available. This could involve the shrinking of balance sheets through the shedding of unviable businesses with a view to enhancing their profit-generating capacities. At the same time, banks should take full advantage of the recent recovery in their profitability to strengthen their capital positions, so that the necessary restructuring of businesses and the enhancement of shock-absorbing capacities do not impinge materially on the provision of credit to the economy.

Thank you very much for your attention. I am now at your disposal for questions.

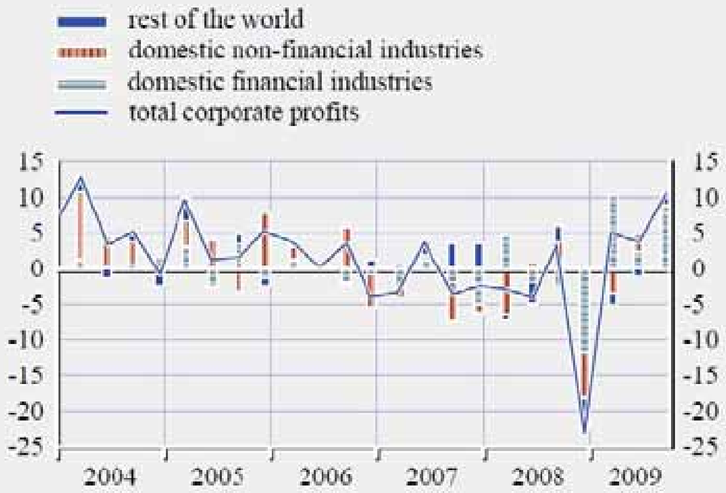
Chart 1 US residential and commercial property prices and market expectations



Source: Bloomberg.
Note: The residential property price index is the S&P/Case-Shiller 10 home price index.

Chart 2 US corporate sector profits

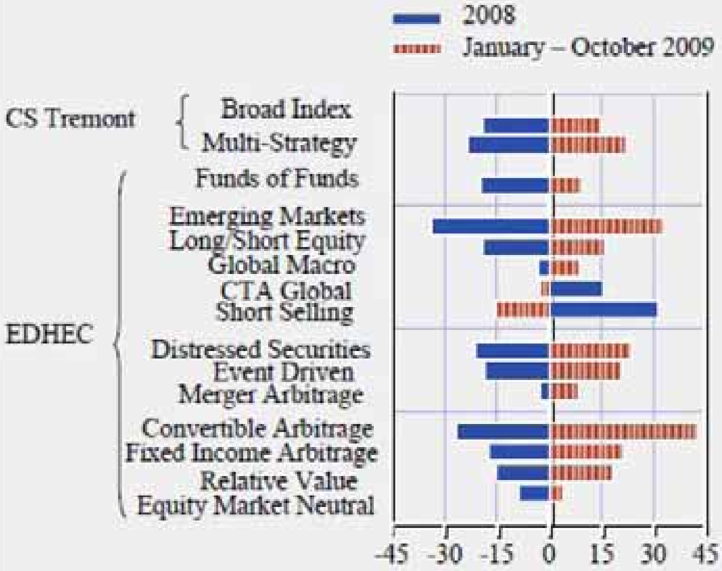
(Q1 2004 – Q3 2009; percentage-point contribution to quarter-on-quarter growth; seasonally adjusted)



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.

Chart 3 Global hedge fund returns

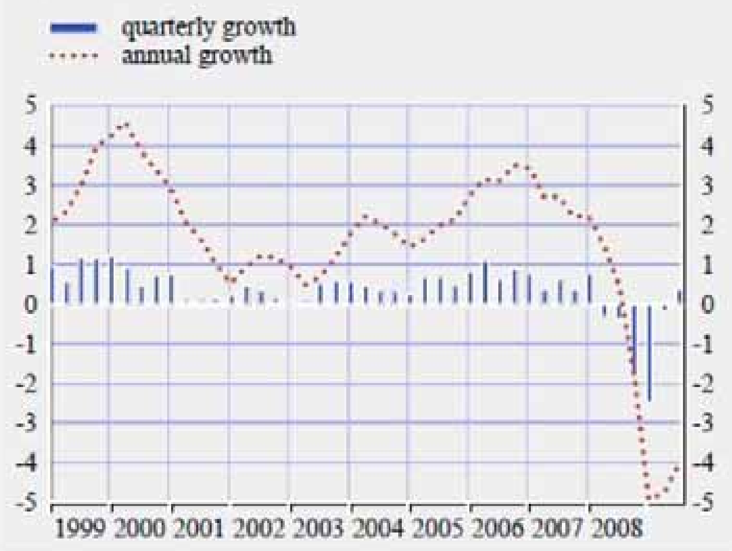
(2008 and Jan. 2009 – Oct. 2009; percentage cumulative returns net of all fees; in USD)



Sources: Bloomberg and EDHEC Risk and Asset Management Research Centre.

Chart 4 Real GDP growth in the euro area

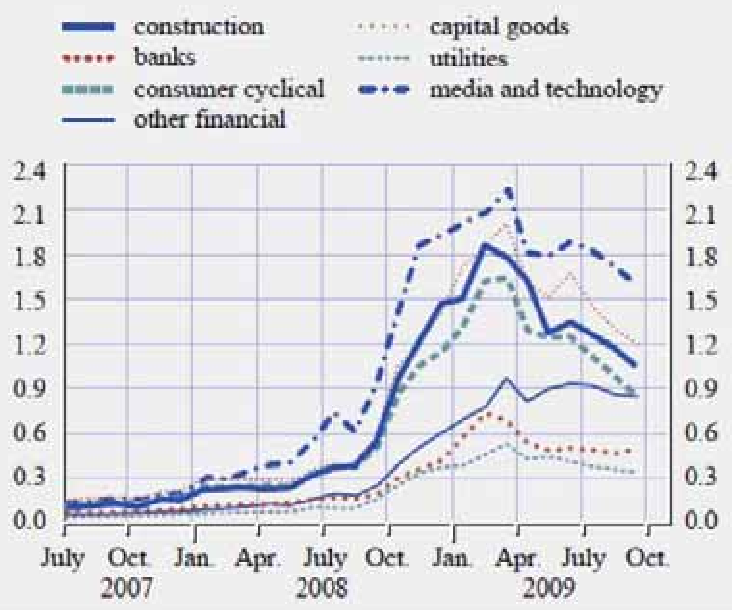
(Q1 1999 – Q3 2009; percentage change)



Sources: Eurostat and ECB calculations.

Chart 5 Unconditional expected default frequencies (EDFs) for selected sectors in the euro area

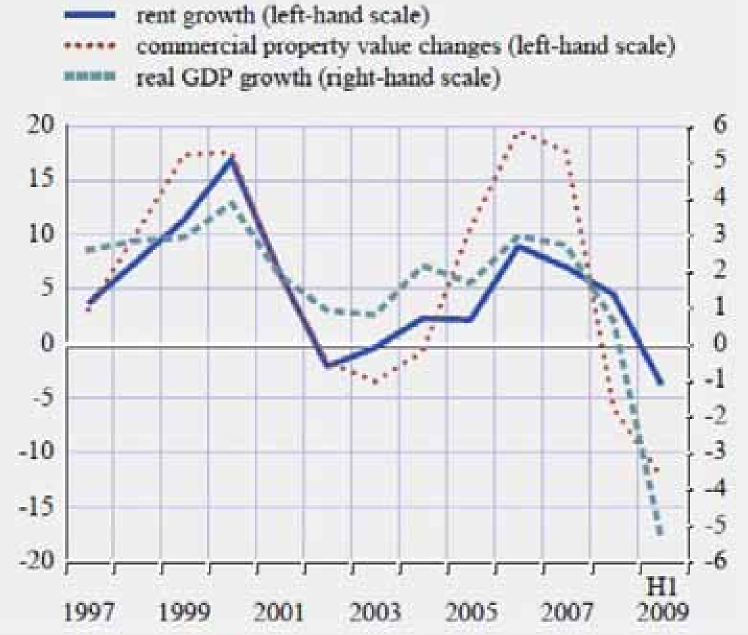
(July 2007 – Sep 2009; percentage; medians)



Sources: Moody's KMV and ECB calculations.

Chart 6 Changes in euro area capital value of prime commercial property, commercial property rent growth and euro area real GDP growth

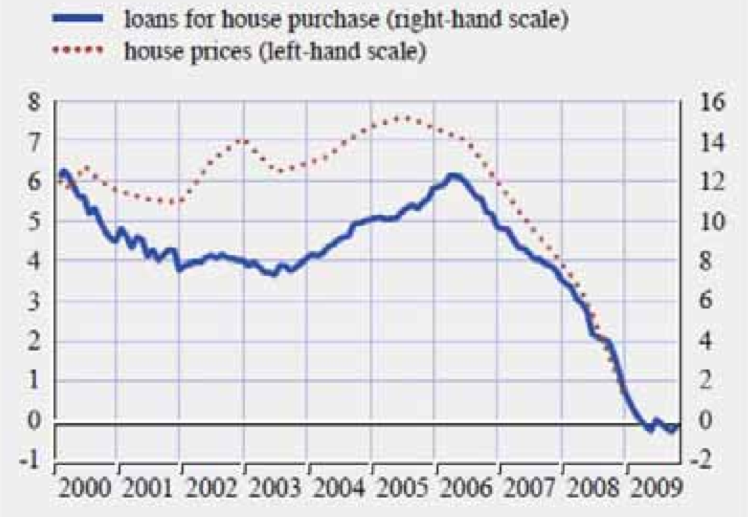
(1997 – H1 2009; percentage change per annum)



Sources: ECB and Jones Lang LaSalle.
Notes: Commercial property data for Cyprus, Malta, Slovakia and Slovenia are not available.

Chart 7 Loans for house purchase and house prices in the euro area

(Jan. 2000 – Oct. 2009; percentage change per annum)



Source: ECB.

Chart 8 Euro area yield curve

(percentage)

Source: ECB.

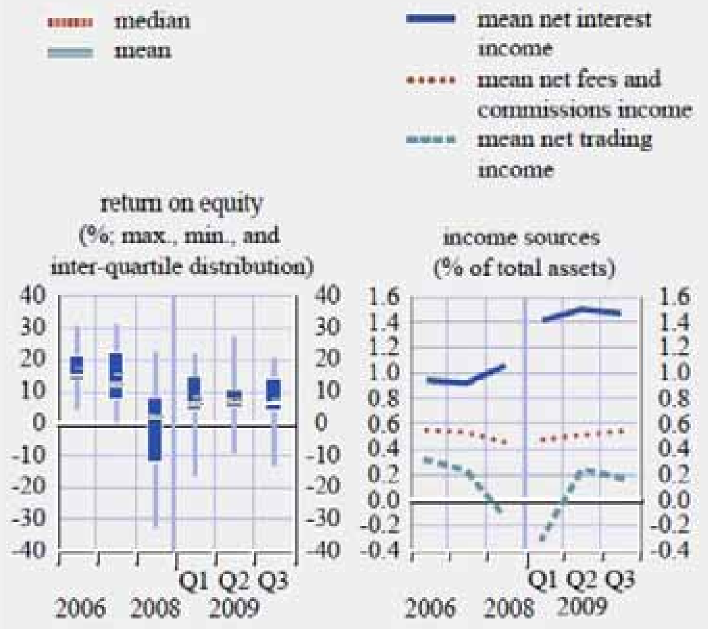
Chart 9 Price-earnings (P/E) ratio for the euro area stock market

(Jan. 1985 – Oct. 2009; ten-year trailing earnings)

Sources: Thomson Reuters Datastream and ECB calculations.
Note: The P/E ratio is based on prevailing stock prices relative to an average of the previous ten years of earnings.

Chart 10 Euro area large and complex banking groups' return on equity and income sources

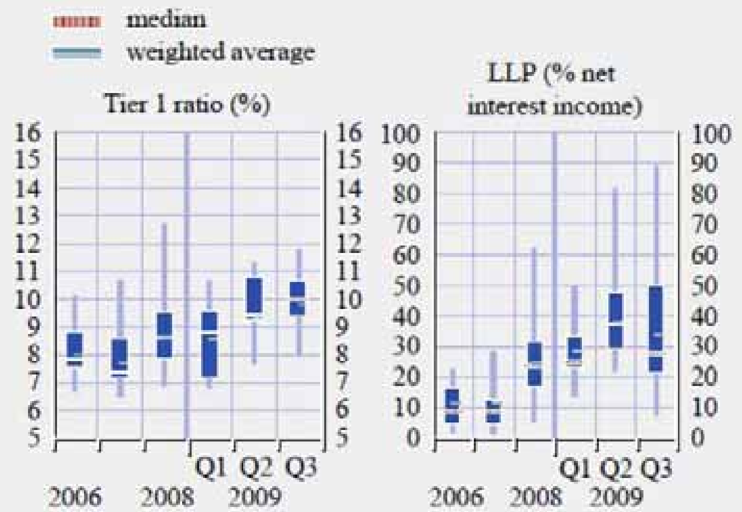
(2006 – Q3 2009)



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.

Chart 11 Euro area large and complex banking groups' Tier 1 and loan loss provisions ratios

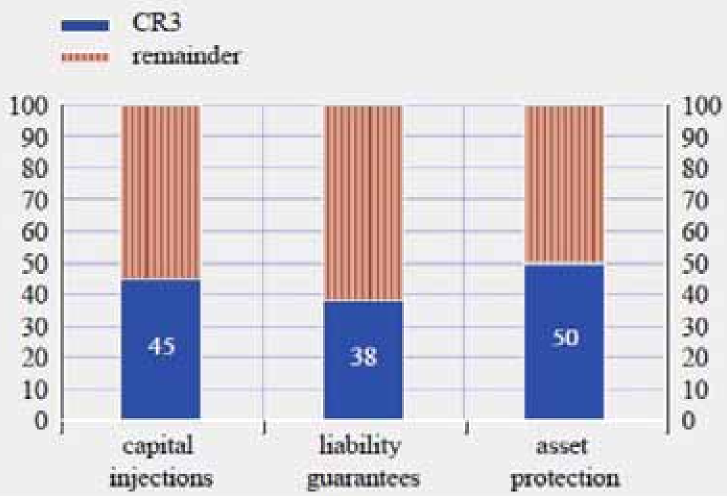
(2006 – Q3 2009; maximum, minimum and inter-quartile distribution)



Sources: Individual institutions' financial reports and ECB calculations.

Chart 12 Concentration ratio of implemented public support measures in the euro area

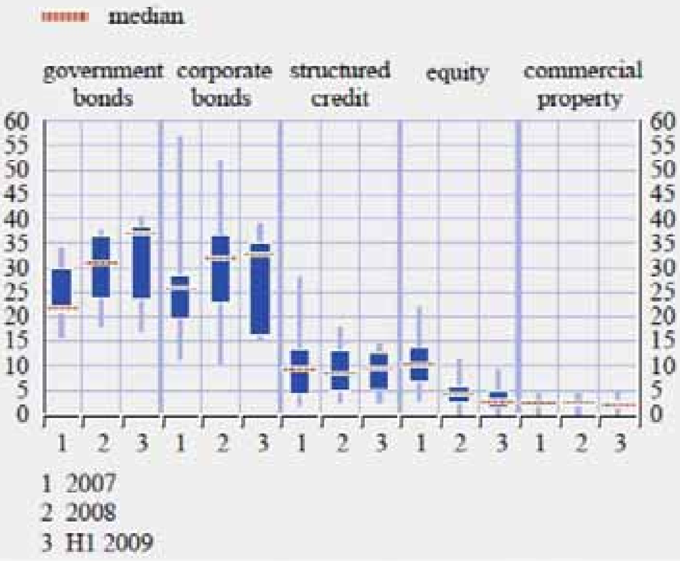
(Oct. 2008 – Nov. 2009; percentage of total)



Sources: National authorities, Bloomberg and ECB calculations.
Note: The CR3 ratio shows the share of support that is dispensed to the largest three recipient institutions.

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

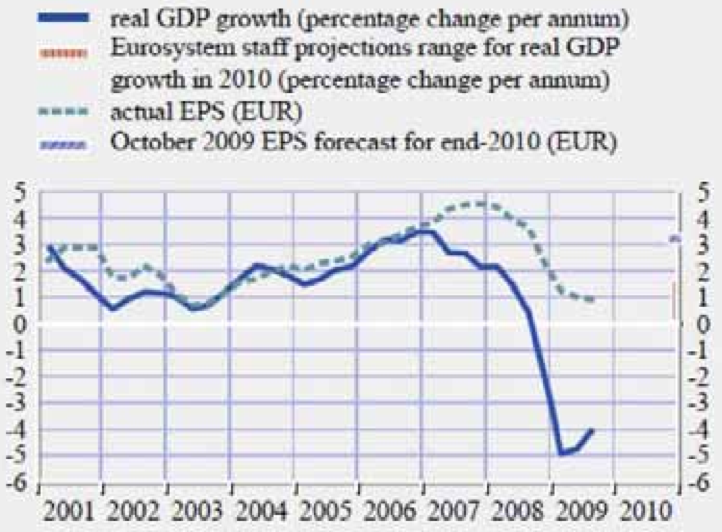
(2007 – H1 2009; percentage of total investments; maximum, minimum and inter-quartile distribution)



Sources: Individual institutions' financial reports and ECB calculations.
Note: The equity exposure data exclude investment in unit trusts.

Chart 14 Earnings per share (EPS) and the forecast 12 months ahead for a sample of large euro area insurers, and euro area real GDP growth

(Q1 2001 – Q4 2010)



Sources: ECB, Thomson Reuters Datastream and ECB calculations.