Lucas Papademos: ECB Financial Stability Review June 2007

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 2007 ECB Financial Stability Review, Frankfurt am Main, 15 June 2007.

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I. Introduction

My colleagues and I welcome you to today's press conference on the occasion of the publication of the June 2007 edition of the ECB's Financial Stability Review. The financial stability assessment contained in the Review has been prepared with the close involvement of the ESCB Banking Supervision Committee. It is based on information that was available up until 11 May 2007, the "cut-off" date for this Review.

The primary objective of the semi-annual ECB Financial Stability Review is to review the main sources of risk and vulnerability for euro area financial system stability and to provide a comprehensive assessment of the capacity of the euro area financial system to absorb adverse disturbances. In addition to the financial stability assessment, the June 2007 edition of the Review addresses several topical issues in 17 boxes and it also includes five Special Feature articles. In my introduction, I will first focus on risks and vulnerabilities we have identified in: (i) the external environment; (ii) global financial markets; (iii) the euro area corporate and household sectors; and (iv) the euro area financial institutions. I will then discuss some potential risk triggering factors and will conclude with an overall assessment of the outlook for financial stability.

2. Overview of the main developments since December 2006

Let me start by recalling some of the key developments since our previous assessment in December 2006. Overall, the macroeconomic environment has continued to be favourable. Global growth has remained robust and some rebalancing of activity among the main economic areas has occurred. In the euro area, economic growth has exceeded expectations, leading to upwards revisions to our own growth projections and to the Consensus GDP forecasts (as shown in the chart on the left of slide 3).

In both the banking and insurance sectors, profitability continued improving. Moreover, global financial markets have, for the most part, been characterised by unusually subdued volatility, while credit spreads have remained low.

Notwithstanding this favourable background, between late February and early March 2007, the shock-absorbing capacity of the global and euro area financial systems was again tested by the third significant burst of market volatility in the past two years. This was comfortably weathered and the stock market recovered quickly (seen on the right chart of slide 3). Improvements in the risk management practices of financial firms appear to have contributed to ensuring that higher financial market volatility did not prevent capital markets from facilitating the intermediation of capital.

The fact that the global and euro area financial systems have so far proved resilient to a series of adverse disturbances is comforting, but it does not provide any ground for complacency. The episodes of market volatility were triggered by relatively small and transitory disturbances in an environment of strong macroeconomic fundamentals and abundant financial market liquidity. Therefore, these episodes do not provide sufficient guidance on how the financial system would perform in the event of a larger shock that could trigger a more material and longer-lasting reappraisal of risks at a less favourable stage of the credit cycle. However, they have served to reaffirm concerns about pre-existing vulnerabilities and potential risks.

3. External environment

Let me now turn to the vulnerabilities we have identified in the external environment. Overall, risks stemming from global imbalances have remained broadly unchanged over the past six months. The chart on the left of slide 4 shows that persistently large US current account deficits have not fully accumulated into the net foreign asset position of the US, largely because of exchange rate and asset price changes. Valuation effects – primarily a weaker US dollar – have played some role in containing

US external indebtedness. Nevertheless, the negative US net foreign asset position still remains very large in historical terms by comparison.

Since the previous assessment, concerns have increased about the possible implications of carry trades in the foreign exchange markets, driven by relatively low short-term interest rates in Japan and in Switzerland and very low exchange rate volatility. An indicator commonly used to highlight speculative pressures on exchange rates is the net short non-commercial positions in currency futures. As shown in the chart on the right of slide 4, this indicator reached unprecedented levels in early 2007 for the Japanese yen, suggesting that carry trading has grown significantly since the beginning of 2006.

In Box 4 of the FSR, a close look is taken at the evolution of the foreign exchange carry trades. The conclusion is that, from a financial stability perspective, large outstanding carry trade positions may be a concern if they make the targeted financial markets vulnerable to unexpected changes either in short-term interest rates in the funding currency or exchange rate volatility.

A pertinent issue for the outlook for financial stability is whether there have been signs of a turn in the US credit cycle. The assessment of the markets and banks appears, on the face of it, to be somewhat divided. For example, credit spreads on sub-investment grade bonds have narrowed further, but US banks are no longer easing their credit standards on loans granted to firms. The fundamentals of US firms have overall remained strong. Although rating downgrades have outpaced upgrades in the US credit market, this deterioration of credit quality has not translated into higher default rates. It has been suggested that the existence of abundant market liquidity is one of the reasons why rating agencies have, since late 2004, consistently revised their forecasts of rising global default rates, pushing them further into the future (see the chart on the left of slide 5). In particular, due to the growing presence of new participants in credit markets with greater risk tolerances, it seems that firms with lower creditworthiness (credit ratings) may have found it easier to refinance and restructure their debt. This refinancing activity has included the greater use of weaker loan covenants than in the past. Thus, to a certain extent, firms may only be deferring their financial difficulties into the future. When the credit cycle finally turns, the consequences could be more abrupt and severe than past experience might suggest.

In this context, the recent episode of re-appraisal of credit risk pricing in the US sub-prime mortgage market may provide some guidance on how the credit market could behave in a broader downturn. Since mid-2005, the combined effect of resets of initial borrowing terms to higher interest rates and reduced abilities of borrowers to avoid such resets through house sales or to carry out cash-out refinancing, has been associated with rising delinquency rates on securitised sub-prime mortgage loans. The impact of sub-prime mortgage delinquencies on the lower-quality-end of the credit risk transfer (CRT) market has been substantial. Early this year, the concern of market participants about deteriorating sub-prime credit quality led to a significant and, so far, persistent increase in the cost of credit protection associated with sub-prime non-agency residential mortgage-backed securities (RMBS), as shown in the chart on the right of slide 5.

Box 2 of the Review contains a more detailed assessment of the potential risks of the sub-prime episode. It concludes that there is some concern that the deteriorating performance of sub-prime RMBS could affect the broader market for structured credit instruments, due to the fact that the concentration of sub-prime mortgage loans as collateral for collateralised debt obligations (CDOs) is very high. It cannot be ruled out that further poor performance of this type of collateral could trigger rating downgrades of CDO tranches themselves and lead to a reassessment of risk in other segments of structured credit markets.

Financial market liquidity

An overarching theme, pertaining to several sources of risk and vulnerability in the financial markets, is the abundant liquidity characterising global markets. Indeed, there appears to be a consensus among market participants that market liquidity has reached unprecedented levels. Financial market liquidity is a measure of the ability of market participants to undertake securities transactions without triggering large changes in their prices. The concept of financial market liquidity is distinct from the concept of monetary liquidity, but there can be links between the two. Although the measurement of market liquidity is rather complex, symptoms of the abundance of liquidity include high leverage, low yields, low market volatility, narrow credit spreads, and high market turnover. Overall, abundant liquidity seems to be intertwined with the "search for yield" which has been discussed in past issues of the FSR and it appears to be dependent on confidence remaining in the smooth functioning of the market.

The chart on the left of slide 6 introduces a composite indicator of financial market liquidity in the euro area equity, bond, foreign exchange and credit markets. It is constructed to gauge three different dimensions of market liquidity. The first dimension is tightness , that is the magnitude of risk premiums required by market-makers for holding inventories of securities, and it is measured by the bid-ask spread. The second dimension is depth and resiliency , that is the degree to which the volume of transactions impacts on asset prices, and it is measured by using ratios of asset price movements to transactions. The third dimension relates to liquidity risk premia, that is, the compensation required by investors for the risk that attempts to unwind positions could be challenged by uncertain market conditions in the future. This is measured using yield spreads between securities which are known to have varying degrees of liquidity.

The evolution of this indicator over time confirms that financial market liquidity has increased significantly since 2001. It rose sharply in 2003 and 2004 and markets have remained very liquid since then. The increase in market liquidity may reflect structural changes in financial markets; for example, the liberalisation of international flows of capital, the securitisation of loans, the development of new financial instruments, and the rapidly growing market presence of highly active financial market participants, such as hedge funds.

However, buoyant market liquidity could also reflect excessive risk appetite, indicating that liquidity risk could be under-priced, as well as high leverage. To the extent that high risk appetite is an important determinant of market liquidity, the current favourable liquidity conditions could suddenly, and unexpectedly, fade away, if there were a loss of confidence or an abrupt and lasting increase in risk aversion. This could expose several underlying vulnerabilities in the financial system on which I will elaborate later on.

Global financial institutions

Turning to global financial institutions, with the exception of the fact that the hedge fund industry has grown further in size, all other backward-looking indicators suggest that potential risks to financial stability posed by hedge funds have not changed materially since the December 2006 FSR.

However, market risks posed by hedge funds remain. They arise largely from information which suggests that over-capacity, and indeed over-crowding, could be taking place in the sector after a simultaneous increase in the number of funds and a reduction of profitable trading opportunities over the last couple of years. On the one hand, as illustrated in the chart on the left of slide 7, average hedge fund returns have been on a downward trend since the early 1990s. This trend could point to overcapacity and to a consequent lowering of the amount of profitable investment opportunities available, although other explanations are also possible. At the same time, the degree of correlation between hedge fund returns across different strategies, shown in the chart on the right of slide 7, remained around the same relatively high level as in mid-2006. There are concerns about the implications for market dynamics if there was to be an event which would prompt many funds into “rushing towards the exit” at the same time due to the crowding of trades, i.e. that many funds are positioned similarly.

4. Euro area financial system

Euro area corporate sector

Let me now focus on the euro area corporate sector. Against a background of strong economic conditions, low financing costs and abundant market liquidity, the rate of borrowing by the euro area corporate sector began to quicken after mid-2005. As a result, key indicators of the leverage of the sector had reached unprecedented heights. However, as analysed in Box 7, the recent re-leveraging in the euro area corporate sector has not been broad-based, but rather it has been concentrated among unlisted firms – including not only small and medium-sized enterprises, but also firms which have been de-listed through private equity deals. Data is obviously lacking on unlisted firms, but comparing trends in the debt-to-asset ratio for listed non-financial corporations and the debt-to-GDP ratio for the non-financial corporate sector suggests that a sharp rise has taken place in the debt-to-asset ratio of unlisted firms in the period since 2004 (see chart on the left of slide 8).

Increasing corporate sector leverage in the euro area has also begun to raise questions about the likelihood of an adverse turn in the credit cycle and its possible consequences for the financial system.

Although closely related to business cycles, credit cycles are also driven by the criteria applied by banks and other investors when extending credit. By this yardstick, a long period of inertia in bank lending standards since mid-2004 and the persistent tightness of credit spreads suggest that euro area firms have not been facing financing constraints (as shown in the chart on the right of slide 8). On the contrary, as banks placed greater emphasis on the so-called “originate and distribute” business model, new opportunities have emerged for other financial institutions to acquire exposures to credit. This development has further improved firms’ access to bank credit.

Euro area household sector

Turning to the euro area household sector, the pace of net borrowing by the household sector has slowed since spring 2006, but has remained at high levels (see the chart on the left of slide 9). There have also been signs of moderation of house price inflation in a number of euro area housing markets. The risk of potentially disruptive property price declines in the future appears limited in the euro area as a whole, although differences continue to exist among individual Member States. However, concerns remain about the sustainability of unprecedented levels of mortgage-related leverage in those parts of the euro area where, ceteris paribus, housing valuations appear stretched, where the debt build-up has been pronounced, and where the majority of debt is financed at variable interest rates.

While measures of leverage compared to income can provide a rough indication of the ability to service debt, it is also important to evaluate the sustainability vis-à-vis assets, as this can provide an indication of the capacity of households to repay their debts in full at an aggregate level. The value of household assets – which is much larger than that of their debt – has grown more than their liabilities, especially after 2002, as the stock market has recovered the losses from the bursting of the high-tech bubble and as house prices have also risen. As a result, as shown in the chart on the right of slide 9, households have seen a notable rise in their net wealth over this period, driven in particular by the housing wealth component, which accounted for about 60% of total household wealth in 2006.

Euro area large and complex banking groups

The financial soundness of large and complex banking groups (LCBGs) in the euro area strengthened further in the second half of 2006, consolidating on the steady and broad-based improvement from 2003 onwards. Profitability continued to rise, underpinned by favourable macroeconomic conditions and, for the most part, very low levels of financial market volatility. The chart on the left of side 10 shows that compared to the situation in 2005, the distribution of returns on equity for large and complex banking groups (LCBGs) has become more compressed around the mean with the profitability of the institutions in the lower quantiles remaining unchanged or increasing slightly. At the same time, Tier 1 capital bases comfortably exceeded the regulatory minima for solvency ratios, pointing to a reassuring shock-absorbing capacity. Risk management among LCBGs is expected to improve further as the Basel II capital rules are being implemented in the course of the current year.

Special Feature articles B and C in this edition of the FSR introduce a model for stress-testing the resilience of euro area LCBGs in the face of a wide range of adverse shocks to the global macro-financial environment. The results suggest that the corporate credit quality of LCBGs tends to deteriorate following negative shocks to GDP and oil prices as well as an appreciation of the euro against the US dollar. The worsening credit quality, in turn, can have a rather marked negative impact on banks’ solvency as measures by Tier 1 capital ratios.

In recent years, euro area LCBGs have faced challenges in increasing, or at least maintaining, interest income as a share of total income, but they have enjoyed further improvements in fee, commission and especially trading income. Indeed, the share of banks’ trading income in net operating income rose significantly in 2006. For some LCBGs with sizeable capital market operations, the share of trading income accounted for nearly half of net operating income in 2006 and corresponded to more than 45% of their Tier 1 capital, as shown in the chart on the right of slide 10.

Special Feature article A looks at the relationship between bank income diversity and systemic risk. It finds that a measure of systemic risk is positively correlated with bank size and the share of trading income, while it is negatively correlated with revenues from (traditional) interest income sources.

Euro area insurance sector

In the euro area insurance sector, there was a broad-based improvement in profitability in 2006 (see the chart on the left of slide 11). The positive assessment is further supported by the fact that the profitability of the weaker performers in 2005 also improved in 2006. Underlying this improvement was a strengthening of investment income, mainly owing to buoyant stock markets and higher interest rates.

Moreover, favourable developments in the financial conditions of primary insurers and reinsurers in 2006, together with a greater focus on risk management and risk-adjusted prices, support a positive outlook for the euro area insurance sector as a whole. These positive developments continued to be priced into expected default frequencies (as shown in the chart on the right of slide 11). However, risks and challenges for the sector remain, as greater financial market risks could pose a challenge to the life insurance and non-life insurance sectors.

5. Triggering factors for the materialisation of risks and the exposure of vulnerabilities

I will now consider some possible factors that could trigger the materialisation of certain risks and the exposure of identified vulnerabilities. An important issue highlighted in the FSR relates to the existing ample financial market liquidity and the prevailing very low risk premia. One possibility is that an abrupt and sharp increase in risk aversion and a loss of confidence could lead to a substantial reduction in financial market liquidity which, as stressed, is currently abundant. Such a decline could expose several underlying vulnerabilities and trigger an adverse scenario which could involve:

- Funding liquidity challenges for highly leveraged financial institutions;
- Unwinding of carry trades and possible unwinding of global imbalances;
- Increasing credit spreads across the credit quality spectrum;
- Increased asset price volatility in financial markets more generally; and
- Reduced bank profitability as a result of lower trading revenues.

A second adverse scenario could be triggered by a turn in the credit cycle or by a large credit event. This could lead to an unravelling of vulnerabilities in the corporate and household sectors and in credit markets that could involve:

- defaults of low credit-quality, high-leveraged households and firms;
- significant challenges in the structured credit and CRT markets;
- losses and potential failures of high leveraged financial institutions; and
- counterparty risks for banks.

In this context, the “triangle of vulnerability”, identified in the December 2006 FSR, connecting the state of the credit cycle, credit derivatives and highly leveraged institutions, could have grown in relevance in the recent period. A shock involving any element of this triangle could have implications for the other two. For example, a sharp turn in the credit cycle could mean that credit risk protection-sellers, such as hedge funds, would have to make payments to banks which are protection-buyers, but hedge funds might not be capable of paying. Although many hedge funds have attempted to extend their investor lock-up periods, their positions are typically marked-to-market, implying that their funding remains vulnerable to any losses suffered because it could significantly impact on the willingness of banks to continue to grant credit. At the same time, a turn in the credit cycle could represent a challenging test for the functioning of the credit derivatives markets. Similarly, if widespread problems were to emerge in hedge funds active in credit risk transfer markets, this could spark a downturn in the credit cycle itself, as it could impair the “originate and distribute” business model upon which large banks have become reliant.

6. Overall assessment of the financial stability outlook

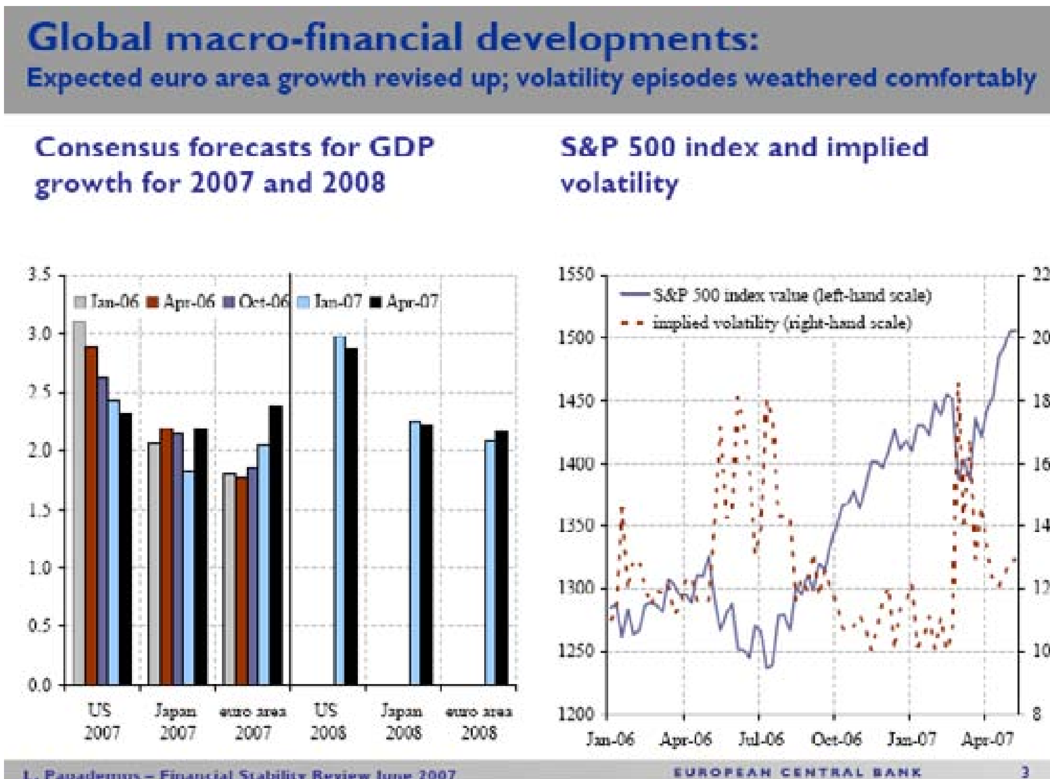
Let me now conclude with the overall assessment of the financial stability outlook. Comparing the current assessment with that presented in the December 2006 FSR, the main scenario for euro area financial stability remains broadly favourable:

- The current macroeconomic environment is benign and global and euro area economic activity it is expected to remain robust;
- In February and March 2007, the resilience of the financial system was tested by the third significant burst of market volatility in two years, which it comfortably weathered;
- Euro area credit quality, overall, remains high and should be underpinned by a favourable economic outlook;
- Pockets of vulnerability in the euro area household and corporate sectors have most likely increased, but, on average, financial positions remain sound;
- The profitability of euro area financial institutions further improved and solvency is comfortable relative to regulatory requirements.

However, pre-existing sources of risk and vulnerability remain and some have grown:

- The recent market jitters have confirmed concerns regarding previously identified risks and vulnerabilities and have revealed the relevance of some new risk exposures;
- Vulnerabilities could be quickly unearthed if market liquidity were to abruptly and sharply decline, possibly triggered by a wane in risk appetite caused by a change in risk perceptions;
- Re-leveraging in the corporate sector and the process of credit risk transfer from the banking system to other financial institutions and market participants which is associated with a greater emphasis on the "originate and distribute" business model by banks, could constitute vulnerabilities in a less benign market environment.
- In addition, global imbalances remain a medium-term, low-probability but potentially high impact risk for financial stability.

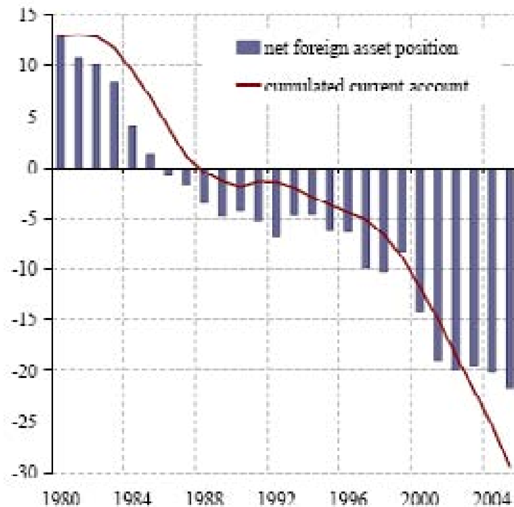
Therefore, despite the strong performance of the financial sector and the benign macroeconomic outlook, there is no room for complacency, given the potential risks and the identified vulnerabilities. This conclusion also reflects the fact that the materialisation of risks and the triggers that could expose vulnerabilities can not be predicted with any degree of certainty. The main message for the financial institutions is to prepare to mitigate potential disturbances through appropriate risk management arrangements including through stress-testing and vigilant monitoring of the financial soundness of their counterparties.



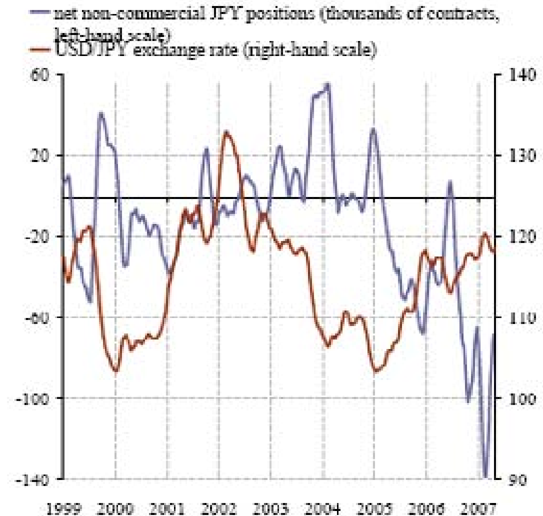
Vulnerabilities in the external environment:

Global imbalances remain wide; concerns surfaced about carry trades

US net foreign assets and cumulated current account balance (% of GDP)



Net non-commercial Japanese yen positions and the USD/JPY exchange rate (2-months m.a.)



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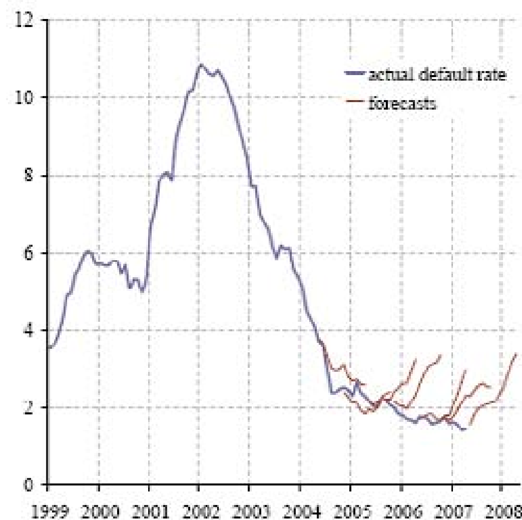
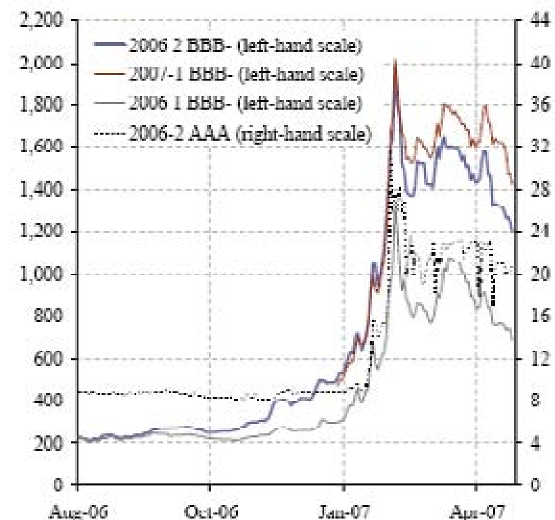
Vulnerabilities in the external environment:

Turbulence in the US mortgage market; no firm signs of a turn in the credit cycle

Global speculative-grade default rates and forecasts (%)



Spreads of high and low-rated index tranches over risk free rate in the US (basis points)



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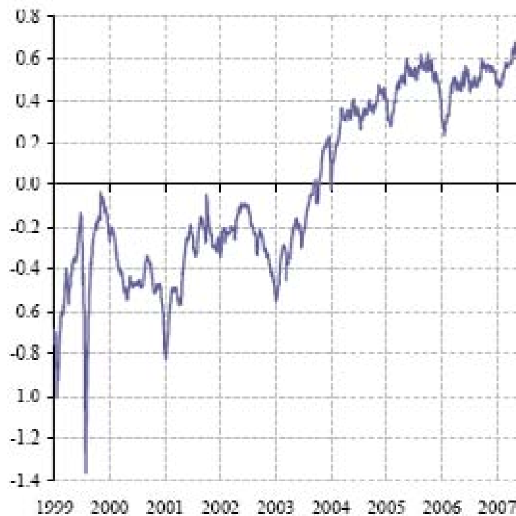
Vulnerabilities in global financial markets:
Market liquidity: causes, measures and risks

Euro area financial market liquidity indicator



Abundant financial market liquidity:

- Structural changes in financial markets
- Search for yield and confidence in smooth market functioning

A composite indicator combining information across foreign exchange, equity, fixed income and credit markets and constructed to gauge three different dimensions of market liquidity:

- Tightness
- Depth + resiliency
- Liquidity premium

Risks: A loss of confidence or an increase in risk aversion could lead to a decline in market liquidity and expose underlying vulnerabilities

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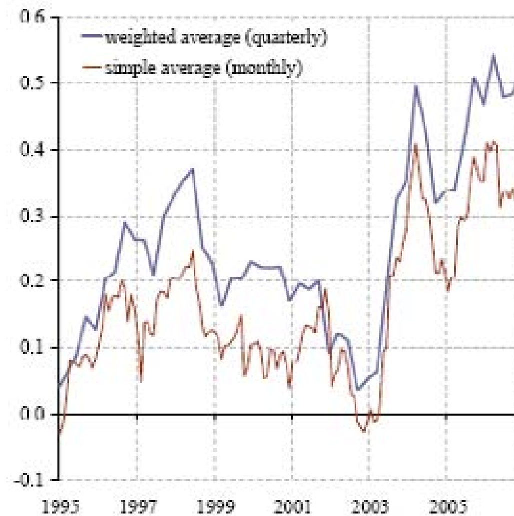
Vulnerabilities in global financial markets:
Hedge fund sector showing signs of over-capacity

Global hedge fund returns (%, rolling three-year annualised compound rate of return, net of all fees)

Return correlations across hedge fund strategies



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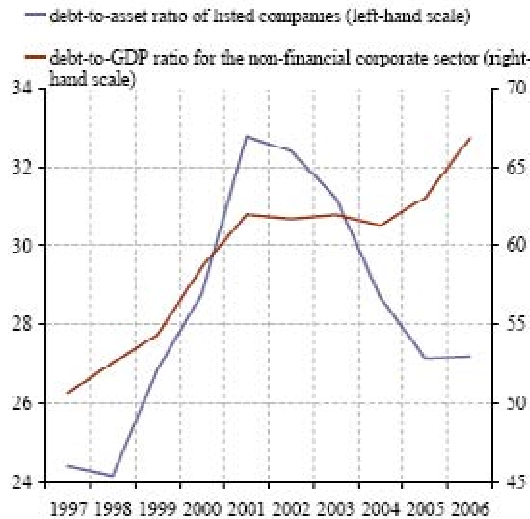
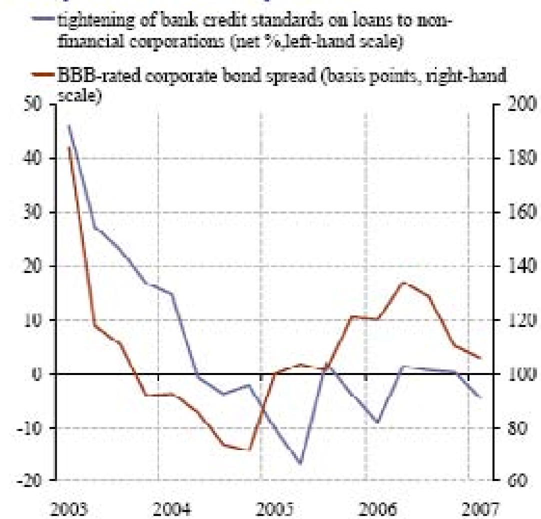
Vulnerabilities in the euro area non-financial sector:
Rising leverage of unlisted corporations but no firm signs of a turn in the credit cycle

Debt ratios of euro area non-financial corporations (%)



Euro area banks' credit standards applied on loans to non-financial corporations, and BBB-rated corporate bond spread



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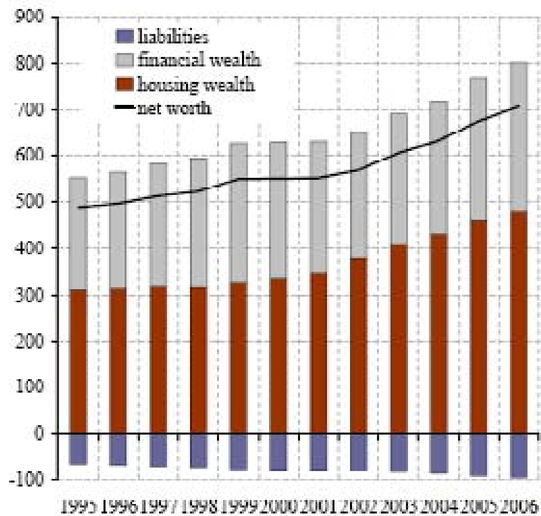
Vulnerabilities in the euro area non-financial sector:
Household borrowing slowing and house price inflation decelerating

Growth of MFI loans for house purchase and house price inflation in the euro area (%)

Households' net worth in the euro area (% of gross disposable income)



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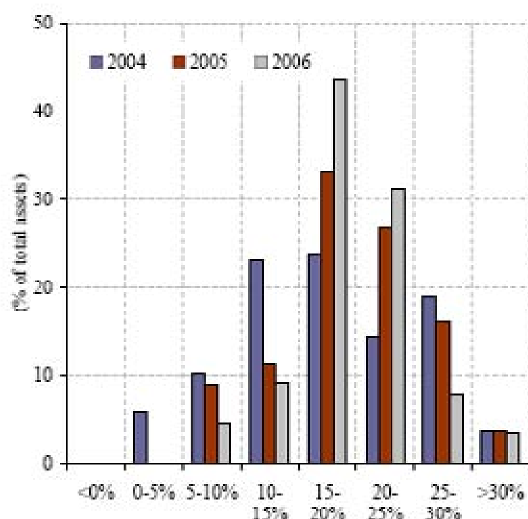
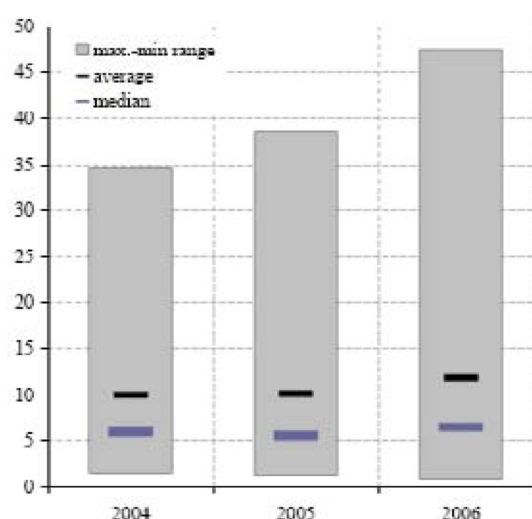
Condition of euro area financial institutions:

Euro area banks; Profitability strengthened further, driven by non-interest income

Frequency distribution of return on equity (ROE) for LCBGs in the euro area (%)



Distribution of trading income for LCBGs in the euro area (% of Tier 1 capital)



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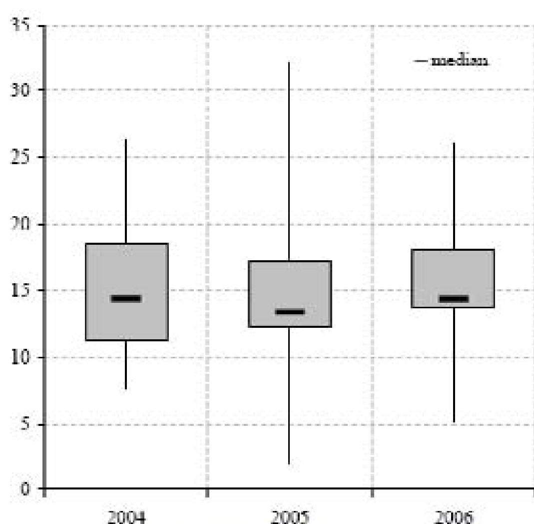
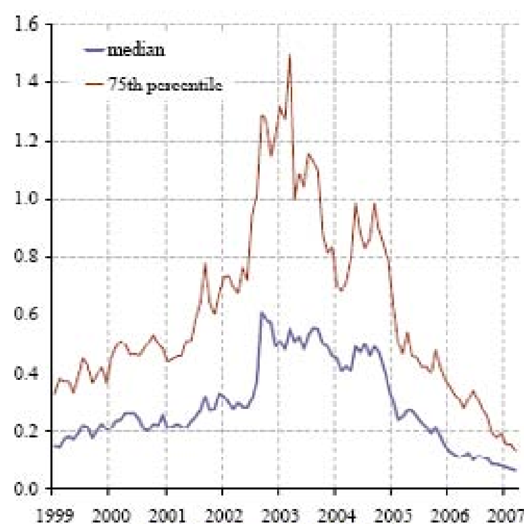
Condition of euro area financial institutions:

Profitability of, and outlook for, the insurance sector improves further

Distribution of return on equity (ROE) for a sample of large euro area insurers (%)



Expected default frequencies (EDFs) for the euro area insurance sector (% probability)



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Vulnerabilities and potential risk triggering factors

An abrupt and lasting increase in risk aversion and/or a loss of confidence would most likely lead to a substantial decline in financial market liquidity, expose several underlying vulnerabilities and trigger an adverse scenario, possibly involving:

- Funding liquidity challenges for highly leveraged financial institutions
- Unwinding of carry trades and global imbalances
- Increasing credit spreads across the credit quality spectrum
- Increased volatility in financial markets more generally
- Reduced bank profitability as a result of lower trading revenues

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Vulnerabilities and potential risk triggering factors (continued)

A turn of the credit cycle or a large credit event could trigger an unraveling of vulnerabilities in the corporate and household sectors and in credit markets, involving:

- Defaults of low credit-quality, high-leveraged households and firms
- Significant challenges in the structured credit and CRT markets
- Hedge fund losses and potential failures
- Counterparty risks for banks

In summary, this constitutes a potential triangle of vulnerabilities involving hedge funds, CRT and the credit cycle

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Overall assessment

Since the December 2006 FSR, the main scenario for euro area financial stability remains broadly favourable:

- Global and euro area economic activity are expected to remain robust
- In February and March 2007 the resilience of the financial system was tested by the third significant bout of market volatility in two years, which it comfortably weathered
- Euro area credit quality overall remains high and should be underpinned by a favourable economic outlook
- Pockets of vulnerability in the household and corporate sectors have most likely increased, but on average financial positions remain sound
- Profitability of euro area financial institutions further improved and solvency is comfortable relative to regulatory requirements

Overall assessment (continued)

But pre-existing sources of risk and vulnerability remain and some have grown:

- Recent market jitters confirmed concerns regarding previously identified risks and vulnerabilities and revealed the relevance of some risk exposures
- Vulnerabilities could be quickly unearthed if financial market liquidity were to abruptly and sharply decline
- Re-leveraging in the corporate sector and the process of credit risk transfer from the banking system could constitute vulnerabilities in a less benign market environment
- In addition, global imbalances remain a medium-term low-probability but potentially high impact risk for financial stability
- All in all, despite the strong performance of the euro area financial sector, there is no room for complacency