Lucas Papademos: ECB Financial Stability Review June 2008 – opening remarks

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 2008 ECB Financial Stability Review, Frankfurt am Main, 9 June 2008.

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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 June 2008 edition of the ECB 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 for the most part based on information that was available up until 8 May, the "cut-off" date for this Review.

It is now ten months since the eruption of the market turmoil which was triggered by the surge in delinquencies on US subprime mortgages. The financial systems of the euro area and other advanced economies are still undergoing further adjustment as the processes of risk repricing and de-leveraging continue. The stresses on financial systems have persisted longer and they have become broader and deeper than anticipated six months ago.

Although there have been some signs of easing tensions in certain markets since mid-March, elevated pressures remain in others, notably in the term money markets of major currencies. Moreover, high uncertainty surrounds the future dynamics of property and other asset prices, the magnitude of possible further asset valuation write-downs by financial institutions and the effects of the market turmoil on the broader economy.

Let me recall that the primary objective of the ECB's Financial Stability Review is to identify the main sources of risk and vulnerability to financial system stability and to provide a comprehensive assessment of the capacity of the euro area financial system to absorb adverse disturbances. The June 2008 issue of the Review also examines in some detail the main trends and events that characterised the operating environment of the euro area financial system over the past six months and it contains 17 boxes and three special feature articles that address topical financial stability issues in a more focused and analytical manner.

I will start my presentation with a brief review of the current state of some parts of the global financial system that have been significantly affected by the ongoing financial market turmoil. I will then examine the risks and vulnerabilities in: (1) the global macro-financial environment; (2) the euro area corporate and household sectors and; (3) the euro area financial system. Finally, I will conclude with the overall assessment of risks to euro area financial stability in the period ahead.

II. The financial market turmoil: overview

Over the past two months, money, credit and other financial markets appear to be sending mixed signals. The term money market spreads between euro deposit and EONIA swap rates have remained high and close to record levels, for maturities from three to twelve months (as shown in the left chart of slide 3). There was a considerable easing of tensions in the money markets at the beginning of this year in the wake of extraordinary measures taken by central banks in the context of year-end concerns last December. But new strains emerged in advance of the first quarter of 2008 and money market spreads in the euro area and elsewhere reached record levels, especially during the Bear Stearns collapse and rescue. After that, an easing of counterparty credit risk worries has been observed but very large liquidity risk premia have remained in money market interest rates. Tensions in the term money market continue to be a global phenomenon. Currently, the spreads between three-month deposit and overnight-indexed swaps (OIS) rates are virtually the same in the euro, US dollar and pound sterling money markets, although pressures have somewhat eased in these latter two markets in recent weeks (as shown in the right chart of slide 3). In the credit markets, greater risk awareness by banks and increased bank funding costs have been reflected in the significant and general further tightening of lending standards in the euro area, the US and the UK.

At the same time, credit default swap (CDS) indices in Europe and the US have declined since mid-March (as shown in the left chart of slide 4), corporate bond spreads have narrowed across-the-board, and the availability of bank credit to households and non-financial corporations has not been significantly affected by the financial market turbulence. Moreover, the functioning of the leveraged loan market is showing some tentative signs of improvement.

The narrowing of the CDS spreads of financial institutions, which reflects an easing of concerns about counterparty credit risk, and, at the same time, the persisting high levels of term money market spreads may appear to be a puzzle at first sight. One way of reconciling these seemingly mixed messages is to examine the relative contributions of counterparty risk and liquidity risk factors to money market spreads. A decomposition of the one-month euro area term money market spread into counterparty credit risk and other components, mainly liquidity risk, is plotted in the chart on the right of slide 4. It shows that the role of credit risk seems to have diminished, while the contribution of other factors increased after mid-March, as liquidity concerns in money markets rose following the collapse of Bear Stearns, which induced banks to hoard more liquidity. Box 10 of the FSR elaborates on these issues.

With regard to the impact of the market correction on bank profits, you may recall that towards the end of last year, there was optimism that the extent of the size and spread of the costs of the turmoil across financial institutions and financial systems would be largely known once audited full-year 2007 financial statements had been published. As it turned out, the write-downs disclosed by many financial institutions went far beyond the expectations of late last year. The chart on the left of slide 5 shows that although major euro area banking groups did report large write-downs, these were significantly smaller than the income losses disclosed by their European peers from outside the euro area and by large US banking groups. After the disclosure of full-year 2007 financial statements, more write-downs were expected to be revealed over the following few quarters, and these expectations were broadly confirmed by the financial results for the first quarter of 2008.

This brings me to one key lesson from the turmoil, namely that full and meaningful disclosure of exposures and losses is desirable, in order to reduce market pressures and restore confidence in financial institutions globally. It was precisely the lack of knowledge about banks' exposures and the great uncertainty about the valuation of these exposures which were key factors with pronounced impact on market indicators throughout the episode thus far. To illustrate this point, the chart on the right of slide 5 shows the CDS spreads for global and euro area large and complex banking groups (LCGBs): they increased after the start of the turbulence, and further widened sharply towards the end of 2007 and in early 2008. Subsequently, they narrowed again significantly in conjunction with the more comprehensive reporting of banks' financial results, with the measures taken by the Federal Reserve in March and also with the indications that the financial institutions most hit by the turmoil were taking determined action to restore their balance sheets. That said, we should not overinterpret these positive developments in CDS spreads as signs of banks' improved creditworthiness. There are a number of risks with potentially adverse effects on banks' profitability and capital positions.

II. Sources of risk and vulnerability

This leads me to the second part of my presentation, namely the main sources of risk and vulnerability that may affect the euro area financial stability outlook over the next six to twelve months.

II.1. The global macro-financial environment

Starting with the global macro-financial environment, future developments in the US housing market remain a crucial determinant of the financial stability outlook also for the euro area. Two interrelated factors are of relevance in this respect: first, the likelihood that delinquencies on residential mortgages and foreclosures may rise in the coming quarters and, second, the future trajectory of US house prices. The factors that will affect US house prices in the period ahead include an overhang of unsold homes, which is close to its highest level in decades and which could increase further because delinquencies are likely to rise in the course of 2008. That said, the uncertainty surrounding the future course of US house prices is considerable and there is a very wide range of estimates of the total losses that financial systems will eventually have to absorb. The chart on the left side of slide 6 shows that the futures prices for the S&P500/Case-Schiller index imply an expected significant further fall in US house prices during 2008 and 2009. These futures prices factor in a peak-to-trough decline of close to 30%.

Conditions in the US housing market could deteriorate further in the course of 2008 because around two-fifths of the outstanding stock of subprime adjustable rate mortgages (ARMs) are scheduled to reset to higher interest rates during the year and the credit quality of these mortgages is known to be inferior to the ARMs that were reset in 2007. Even though the Federal Reserve cut interest rates by a cumulative 3.25 percentage points since summer 2007, which has lowered the rates to which these mortgages will reset, repayment burdens are expected to increase and, hence, delinquencies and foreclosures are likely to rise in the period ahead. The chart on the right of slide 6 illustrates the paths of subprime mortgage rates under different money market rate assumptions. Box 1 of the Review elaborates on the relationships between money market rates, mortgage resets and delinquencies.

In assessing the potential implications of such future developments on the financial system, it is important to take into account that the affected related securities have already priced in a rather severe scenario for US house prices and that financial firms have taken much of the implied losses through their income statements.

A further source of risk to the financial stability outlook is the potential of a broadening of stresses in the credit markets, which could thereby amplify the deterioration in the credit cycle. The sources of potential pressure relate to both the household and the corporate sectors. Let me mention three:

- First, so-called charge-offs[1] and delinquencies on US consumer loans other than sub-prime mortgages continued to rise until the end of the fourth quarter of 2007 (the latest observation available) which indicates a deteriorating financial position of households and a declining capacity to service their debts.
- Second, there are signs that conditions in commercial real estate markets are weakening on both sides of the Atlantic. The significant tightening of lending standards especially for commercial real estate loans (as shown on the chart on the left of slide 7), can be expected to accelerate unfavourable developments in a sector to which bank exposures are relatively large.

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[1] Charge-offs are the value of losses removed from banks' books and charged against loss reserves; they are measured net of recoveries as a percentage (annualised) of average loans.

- Third, although the balance sheets of US firms are considerably stronger than they were before the last credit cycle downturn, the significantly tightened credit standards and financing conditions will cause firms that have very low profitability and are highly-leveraged to face debt-servicing problems. This, in turn, increases the probability of corporate defaults Indeed, rating agencies are predicting a surge in defaults by both US and euro area speculative-grade firms in the near term. Past experience also strongly suggests that the persistent and substantial rise in oil prices can further contribute to a higher probability of corporate defaults. All these developments and expectations have resulted in a widening of spreads on investment-grade corporate bonds since the turn of the year, as shown on the right side of slide 7. Although these spreads have narrowed considerably since mid-March, they have remained at high levels.

Finally, global financial imbalances, while still a matter for concern, seem to have diminished somewhat, reflecting macroeconomic developments especially in deficit countries. In particular, the US current account deficit narrowed to 5.3% of GDP in 2007 – the first decline since 2001 – and is projected to diminish further in 2008. Nevertheless, the prospect of a continued gradual correction remains fragile. Looking forward, the main source of uncertainty relates to the durability of current account developments, notably in deficit economies, and particularly when considering developments in oil prices and financial markets.

Turning to other risks in global financial markets, a significant factor behind the loss of market liquidity in the second half of 2007 was the rapid and substantial de-leveraging imposed on the hedge fund sector as prime brokers tightened margin requirements and terms on their lending for the funding of leveraged positions. Nevertheless, the hedge fund sector proved remarkably and unexpectedly resilient in the first phases of the turbulence. An important reason for this was that exposures of the sector to the sub-prime and related securities markets appear to have been more limited than initially feared. Other reasons put forward included, first, a much narrower, and therefore more specialised, investment scope than that of banks allowing more focused risk management approaches and, second, the alignment of hedge fund managers' incentives with those of investors due to the co-investment of their own money (see chart on the left of slide 8).

As growing uncertainties about possible adverse second-round effects of the market turmoil on real economic activity started to percolate into broader asset markets – especially high-grade corporate credit and equity markets – in early 2008, hedge fund performances began to suffer, as shown in the chart on the right of slide 8, and incidences of failure rose. Hedge fund losses have set in motion a further round of de-leveraging and prime brokers may further raise margin requirements on collateralised lending. Hence, at present, the risks to financial market stability related to growing balance sheet vulnerabilities within the hedge fund sector seem to have increased.

II.2. The euro area corporate and household sectors

After this review of the global aspects of our financial stability assessment, let me now turn to risks and vulnerabilities in the euro area non-financial sectors. The first – positive – observation is that most available financial market indicators suggest that the balance sheets of euro area firms have remained reasonably strong. Firms seem to have been able – so far – to weather the financial market tensions and deteriorating macroeconomic outlook that have continued to adversely affect the global economy. Looking ahead, however, corporations could face problems absorbing further shocks to their balance sheets as net income growth could be levelling off and financing costs and leverage have continued to edge up over the recent past.[2] In particular, also in the euro area a fringe of highly-leveraged firms with very low profitability are expected to face much higher refinancing costs than before. As already mentioned, rating agencies currently expect an increase in default rates by European speculative-grade firms in the period ahead as shown in the left chart of slide 9.

Another source of vulnerability stems from the euro area commercial property markets where the overall outlook remains uncertain. Downside risks have increased and may have started to materialise. Higher funding costs and stabilising or, in some cases, falling property prices have reduced investor demand which could further weaken (as shown in the chart on the right of slide 9). Demand has fallen most in those countries where investment volumes have grown rapidly during recent years and where property prices have started to stagnate or fall. Moreover, the deteriorating economic outlook in some parts of the euro area has the potential to negatively affect demand for rented commercial property, thus increasing vacancy rates and lowering rents. In addition, the market turmoil has had a sizeable impact on the issuance of commercial real estate-backed securities.

In our overall assessment, highly-leveraged firms and commercial real estate corporations may entail significant risks to euro area financial stability not only because of potential asset price reversals, but especially because several euro area large and complex banking groups have large lending and investment exposures to these corporations. Developments in these sectors therefore need to be closely monitored in the period ahead.

For euro area households, the property market is of particular relevance. Residential property prices in the euro area as a whole continued to rise at a moderating rate, as is shown in the chart on the left of slide 10. Despite the recent moderation in house price inflation in the euro area on average, there are still indications of increasing overvaluation in the residential property market in some member states during the past six months (as can be derived, for instance, from house price-to-rent ratios). In those countries where overvaluation appears to be most acute, the housing market represents a source of risk to household sector balance sheets. From a broader financial system perspective, lending to households – even though on a declining path – remains an important business for most euro area banks. For some of them, loans to households represent a sizeable proportion of their overall loan portfolios and total assets, as shown in the chart on the right of slide 10. Hence, household sector net worth and creditworthiness – which at the euro area level remain rather comfortable despite the existence of previously identified pockets of vulnerability – are important in assessing the overall risk profile of these institutions.[3]

II.3 The euro area financial system

For the assessment of the financial stability outlook, the euro area large and complex banking groups are of particular importance. The disclosure of their full-year 2007 financial results revealed that the subprime-related turmoil has had a material impact on their profitability. In fact, banks' profitability declined for the first time since 2003. The good news is that their capital buffers remained largely intact in 2007. Looking ahead, it can be expected that the profitability of these institutions will be adversely affected this year as the process of de-leveraging continues and as spillovers to asset markets and the real economy materialise. The expected slowdown in profit growth – which is shown in the chart on the left

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[2] Box 6 of the FSR contains an assessment of some differences between euro area and US firms with regard to their exposure to bank and market-based financing. It concludes that euro area firms are, on average, more leveraged than their US counterparts. But because euro area firms are less reliant on market-based funding then US corporations, the higher market-based financing costs relative to bank financing costs, if they are to persist, are likely to have a less marked impact on euro area corporations.

[3] Box 5 of the FSR examines the role of the macroeconomic environment as a potential source of risk for financial stability by looking at past banking crises in an attempt to identify a common set of fault lines during periods of financial distress.

of slide 11 – is a consequence of possible further valuation losses, increased funding costs, as well as declining non-interest income from securitisation and capital market activities.

Since the financial market turmoil has not led – thus far – to a material erosion of the capital buffers of euro area large and complex banking groups, there appears to be only a rather low risk of a significant shortage of credit in the economy as a result of de-leveraging on the part of these institutions. Up to now, banks have responded to the market turmoil and the resulting exceptionally challenging operating environment by retrenching from risk-taking. Banks have tightened their credit standards, as shown in the chart on the right of slide 11, either by limiting, or by even cutting, exposures to riskier business lines, such as commercial real estate lending, leveraged buy-out financing and the provision of prime brokerage services to hedge funds.

For euro area banks, the financial market turmoil has underlined the importance of an adequate management of funding liquidity risk. In particular, many euro area LCBGs continue to show a positive customer funding gap and the median funding gap even increased in 2007. Although there are wide differences across LCBGs, with some large banks maintaining a deposit surplus or a relatively narrow positive funding gap, overall large euro area banks have become more vulnerable to adverse changes in the cost of, and access to, market-based funding.

The sharp increase in the spreads of bonds issued by banks suggests that debt issuance could have become very expensive for many lower-rated banks. Moreover, the decline in banks' issuance of medium and long-term debt, as well as the significant decline in securitisation activities, may also result in a decrease in the average maturity of banks' liabilities, thereby possibly increasing rollover risk. The chart on the right of slide 12 shows that recent debt securities issuance activity by euro area MFIs indicates a slowdown in long-term debt issuance coupled with a rapid rise in short-term debt issuance. Overall, these developments in capital markets have accentuated the pressures towards tighter financing conditions for banks.

Finally, in the euro area insurance sector developments have been generally favourable . Insurance companies had relatively limited exposures to structured credit products associated to US sub-prime mortgages, and, as a result, most of them faced limited write-downs in the second half of 2007, especially when compared to those recorded by many euro area large and complex banking groups (as shown in the chart on the left of slide 13). Exposures to other, non-sub-prime, structured credit products are, however, in some cases large. They therefore constitute a source of vulnerability in the event that credit market problems were to spread further. Moreover, some euro area insurers could face losses from their links to the troubled US "monoline" financial guarantors, which are discussed in detail in Box 4 of the Review. As illustrated in the chart on the right of slide 13, some euro area insurers have (i) built up rather large exposures to securities insured by financial guarantors, (ii) invested in the guarantors themselves, or (iii) used the financial guarantors as a source of reinsurance.

III. Overall financial stability assessment

Let me conclude my presentation with the overall assessment of euro area financial stability, as we see it at the current juncture. The information which has become available since the December 2007 Financial Stability Review suggests that the global and euro area financial systems have undergone further substantial adjustment to the financial turmoil. In the euro area, asset valuation write-downs disclosed by large banking groups in 2007 materially impacted on their profitability, but their capital buffers have been maintained largely intact. Some of the risks to euro area financial system stability previously identified have materialised, and risks on balance have increased over the past six months, for several reasons, including:

1. conditions in the US housing market have further deteriorated;
2. the valuation losses endured by mature economy banking systems were larger than anticipated six months ago; and
3. banks have tightened their lending standards significantly.

The current financial stability outlook is highly uncertain and will depend, inter alia, mainly on the following three factors: first, how conditions in the US housing market develop; second, how banks respond to a much more challenging operating environment; and third, the extent to which initiatives and measures aimed at restoring confidence and strengthening financial system resilience are eventually implemented.

It is probable that the adjustment process within the financial system will be protracted as banks continue to strengthen their liquidity and capital positions. This means that balance sheet expansion is likely to be somewhat curtailed in the period ahead. In a negative scenario, the adjustment could risk perturbing the smooth intermediation of credit in the economy. So far, however, the availability of bank credit to households and non-financial corporations has not been significantly affected by the financial market turbulence. At the same time, the financial system may be more vulnerable than before to the crystallisation of other risks that have been identified in previous issues of the Review and that remain relevant.

Given the heightened uncertainty and an environment in which balance sheet conditions could change unexpectedly, vigilance by financial institutions and market participants is of the essence and those with relevant exposures will need to step up their efforts to effectively manage the risks that may lie ahead.

I would like to conclude on a positive note by recalling that the losses disclosed so far by the financial institutions affected by the turmoil are mostly mark-to-market losses on hard-to-value assets. If the outturns for implied credit losses ultimately prove less severe than currently expected, then it cannot be ruled out that those financial firms still holding these assets will see some offsetting valuation gains in their portfolios.

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

I. The financial market turmoil: overview

Stress in the term money markets continues

Spreads between euro deposit and EONIA swap rates
(basis points)

Spreads between three-month deposit and overnight index swap rates (basis points)

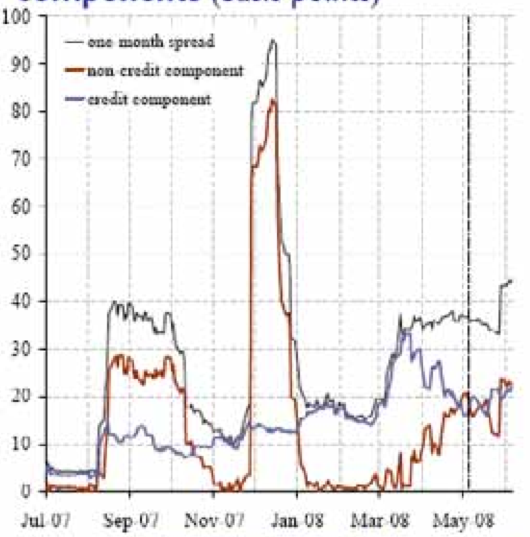
EUROPEAN CENTRAL BANK 3

I. The financial market turmoil: overview

Counterparty credit concerns may have decreased in importance

Credit default swap (CDS) indices in Europe and the US
(basis points)

One-month euro area deposit-OIS spread decomposition into credit and non-credit (mainly liquidity) components (basis points)

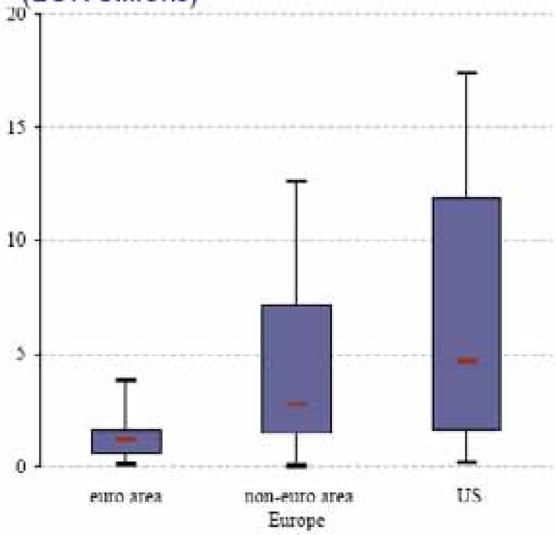


EUROPEAN CENTRAL BANK 4

I. The financial market turmoil: overview

Large and complex banking groups have reported unexpectedly large write-downs, but the risk of bank failures has fallen sharply

Turbulence-related loss in 2007 after-tax net income reported by large and complex banking groups (EUR billions)



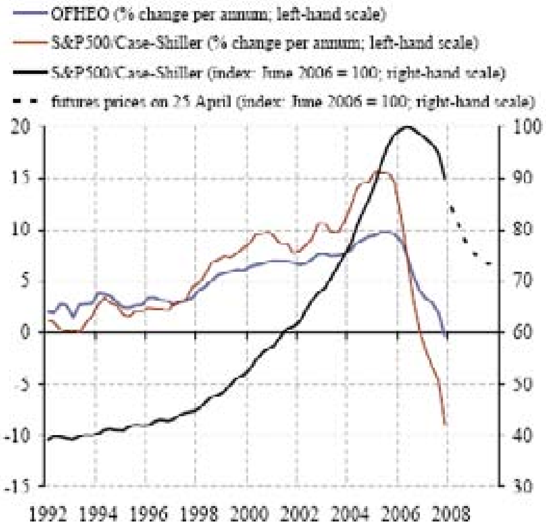
Credit default swap (CDS) spreads for large and complex banking groups (basis points)

EUROPEAN CENTRAL BANK 5

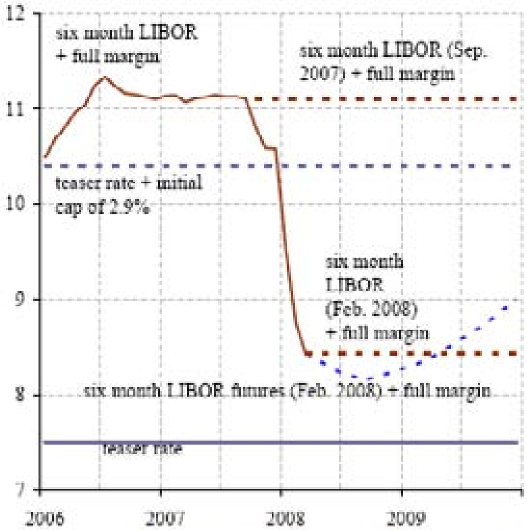
II.1. The global macro-financial environment

Developments in the US housing markets remain a key driver of the outlook for financial stability

US house price inflation



US sub-prime mortgage rate paths with different money market rate assumptions (%)

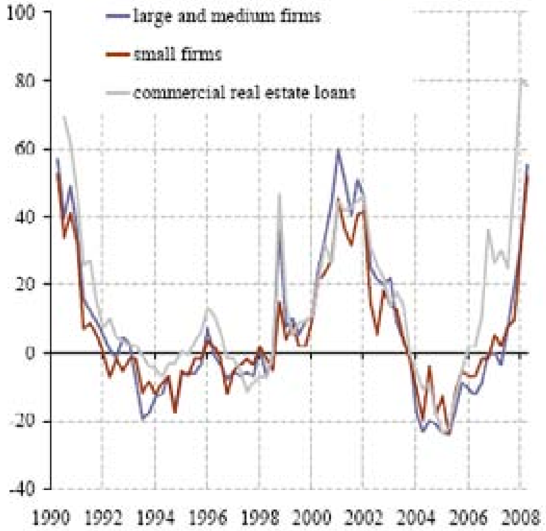


EUROPEAN CENTRAL BANK 6

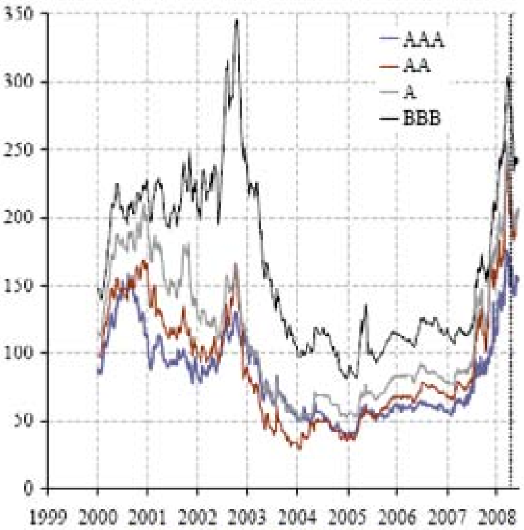
II.1. The global macro-financial environment

The risk of a corporate sector credit cycle downturn in the US has increased

US banks' credit standards on loans to firms
(% reporting net tightening)



US investment-grade corporate bond spreads
(basis points)

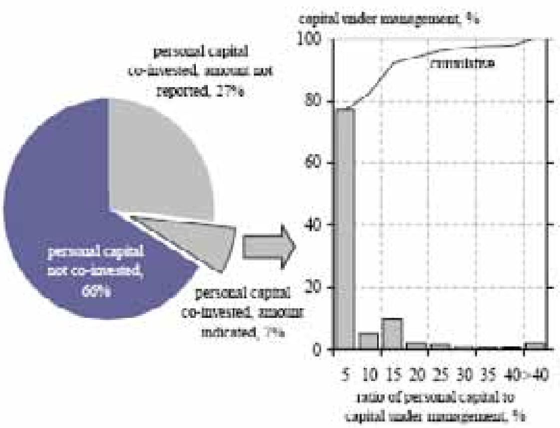


EUROPEAN CENTRAL BANK 7

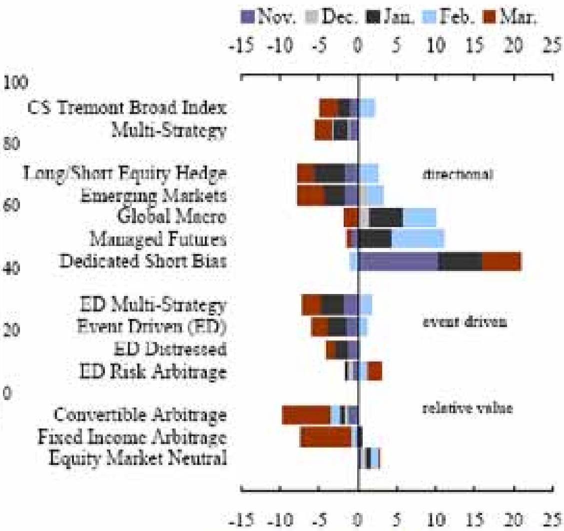
II.1. The global macro-financial environment

Hedge funds: incentive structures for managers could have fostered investment discipline but recently the risk of failures has grown

Co-investments of personal capital by hedge fund managers
(% of capital under management)



Global hedge fund monthly returns
(%, net of all fees)



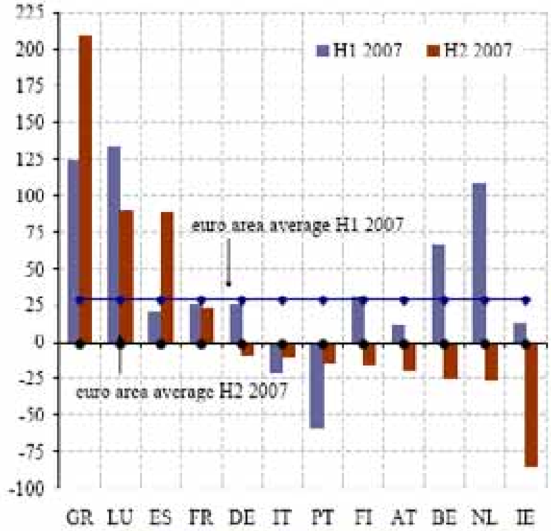
EUROPEAN CENTRAL BANK 8

II.2. The euro area corporate sector

Vulnerabilities related to highly leveraged firms and commercial real estate markets could contribute to rising credit risks

European and euro area speculative-grade rated corporations' default rates and forecast (%)

Growth in direct commercial property investment volumes in the euro area (% change per annum)

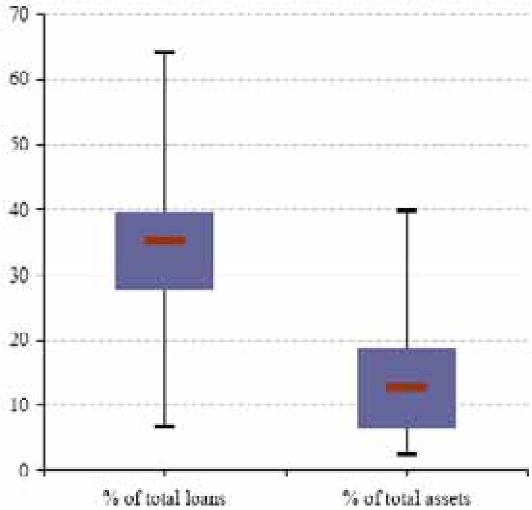


II.2. The euro area household sector

Pockets of vulnerability in the euro area household sector entail risks to parts of the financial system

Loans for house purchase and house prices in the euro area (% change per annum)

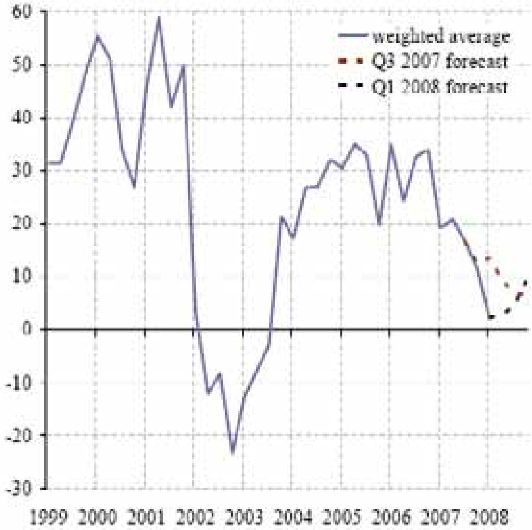
Distribution of large and complex banking groups' loan exposures to households (%)



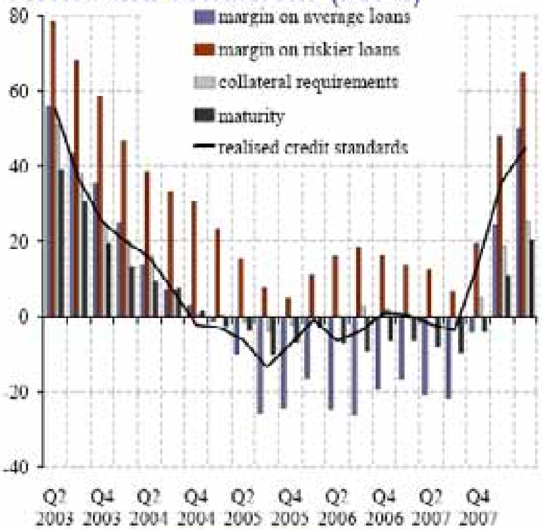
II.3. The euro area financial system

LCBGs' earnings growth is expected to be subdued and banks' willingness to take risks has decreased

Earnings and earnings forecasts for large and complex banking groups in the euro area (% change per annum)



Euro area banks' credit standards applied to loans and credit lines to non-financial corporations and terms and conditions (net %)

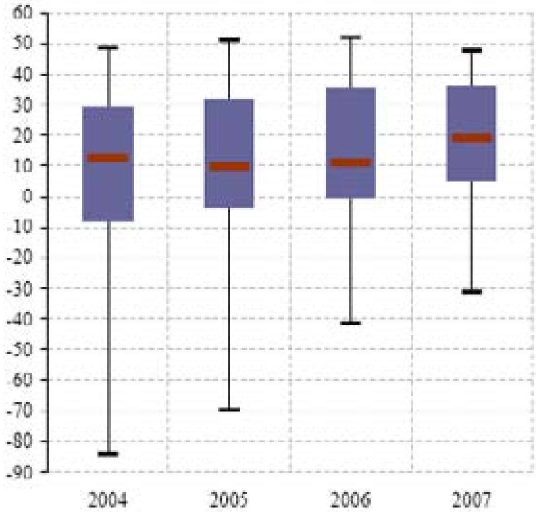


EUROPEAN CENTRAL BANK 11

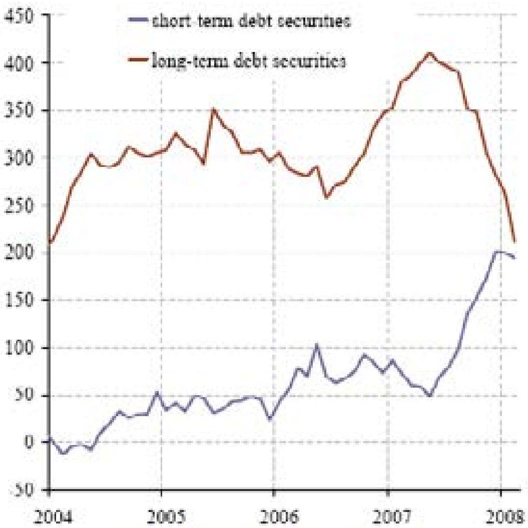
II.3. The euro area financial system

Some LCBGs could remain vulnerable to additional liquidity shocks

Customer funding gap of large and complex banking groups in the euro area (% of customer loans)



Net issuance of debt securities by euro area MFIs by maturity (EUR billions)



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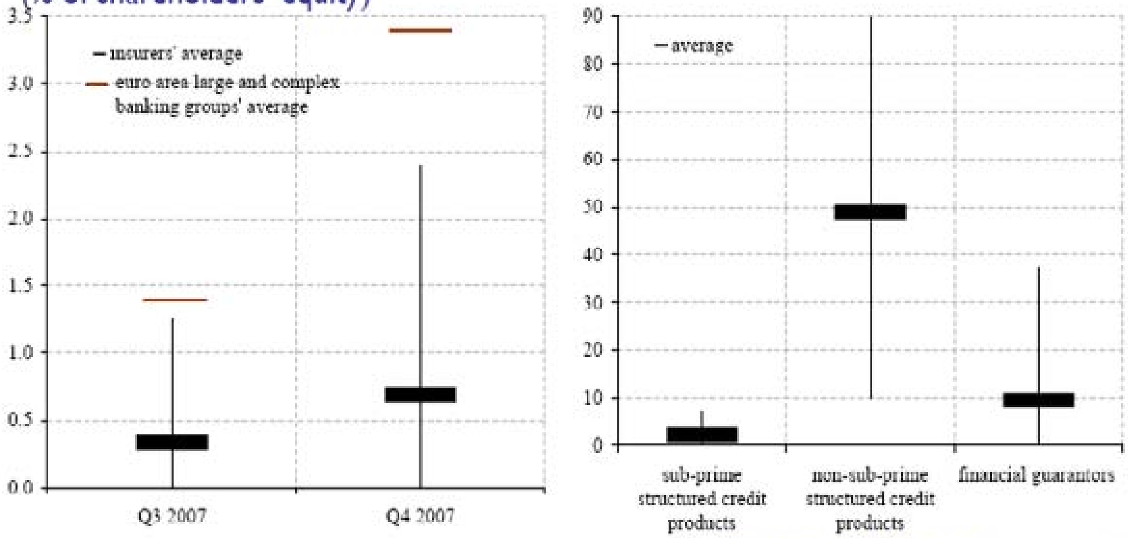
II.3. The euro area financial system

Euro area insurance companies' write-downs have been modest, but some firms hav relatively large exposures to structured credit products and US financial guarantors

Profit and loss write-downs of selected euro area primary insurers and reinsurers (% of shareholders' equity)

Credit exposures of selected euro area primary insurers and reinsurers (% of shareholders' equity)



III. Overall assessment

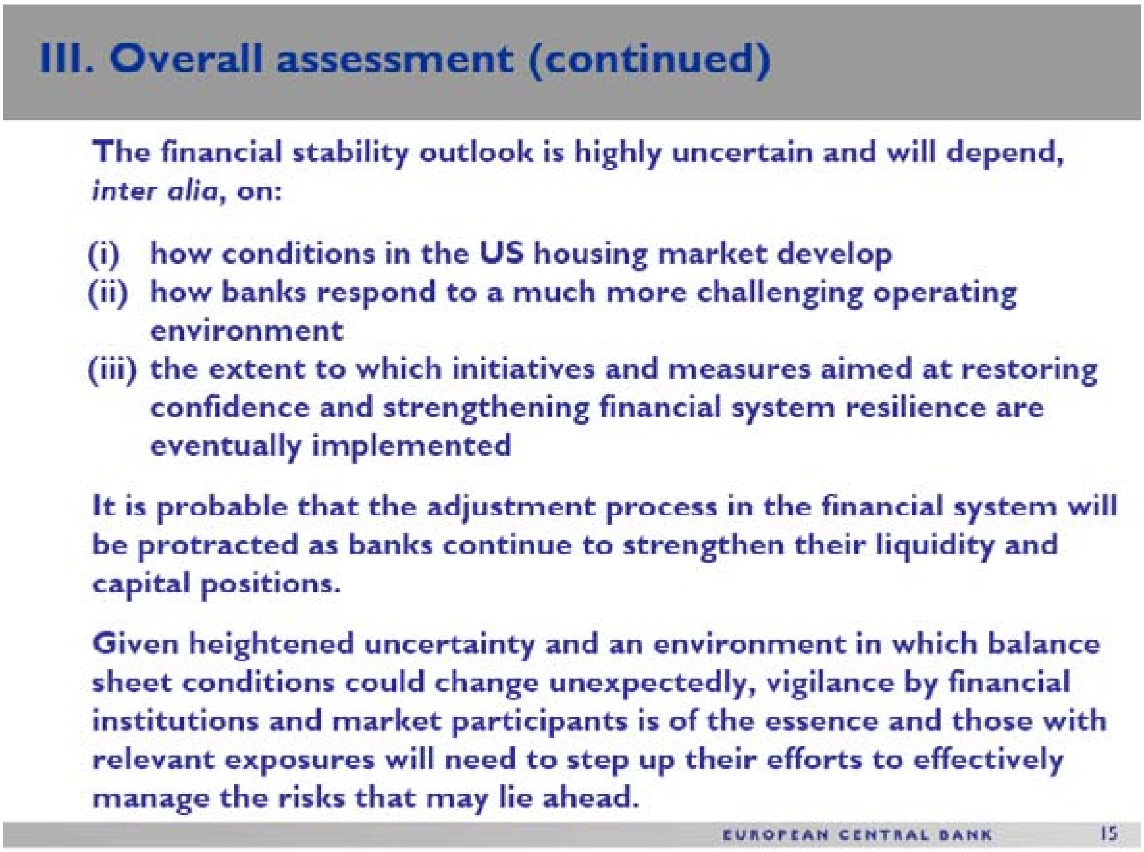
Since the last FSR, the global and euro area financial systems have undergone further substantial adjustment to the financial turmoil. In the euro area, asset valuation write-downs disclosed by LCBGs in 2007 materially impacted on their profitability, but their capital buffers have been maintained largely intact.

Some of the risks to euro area financial system stability previously identified have materialised, and risks on balance have increased over the past six months, for several reasons, including:

(i) Conditions in the US housing market have further deteriorated

(ii) The valuation losses endured by mature economy banking systems were larger than anticipated six months ago

(iii) Banks have tightened their lending standards significantly


III. Overall assessment (continued)
The financial stability outlook is highly uncertain and will depend, inter alia, on:
(i) how conditions in the US housing market develop
(ii) how banks respond to a much more challenging operating environment
(iii) the extent to which initiatives and measures aimed at restoring confidence and strengthening financial system resilience are eventually implemented
It is probable that the adjustment process in the financial system will be protracted as banks continue to strengthen their liquidity and capital positions.
Given heightened uncertainty and an environment in which balance sheet conditions could change unexpectedly, vigilance by financial institutions and market participants is of the essence and those with relevant exposures will need to step up their efforts to effectively manage the risks that may lie ahead.
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