# Lucas Papademos: ECB Financial Stability Review June 2009 – 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 2009 ECB Financial Stability Review, Frankfurt am Main, 15 June 2009.

*The original speech, which contains various charts to the speech can be found on the European Central Bank's website.*

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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 2009 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. The Review examines in detail the main trends and events that characterised the euro area financial system over the past six months[1] and it contains 15 boxes and five special feature articles that address topical financial stability issues in a more focused and analytical manner. As done for the first time last December, we have prepared a summary note that highlights some key messages of our analysis and assessment.

Many of the downside risks to euro area financial stability that were identified in the December 2008 issue of the FSR have crystallised.[2] In particular, the further significant deterioration in global macroeconomic conditions as well as sizeable downward revisions to growth forecasts and expectations have added to the stresses on global and euro area financial systems. The contraction of economic activity and the diminished growth prospects have resulted in a further erosion of the market values of a broad range of assets. The adjustment of bank balance sheets has adversely affected the market pricing of assets and the financial intermediation role of banks in channelling funds from savers to investors. Moreover, there have been increasing signs of an adverse feedback loop between the real economy and the financial sector which poses new challenges for the safeguarding of financial stability.

## II. Sources of risk and vulnerability

### *II.1. Risks in the global macro-financial environment*

The primary objective of the Financial Stability Review is to identify the main sources of risk to, and vulnerability for, the financial system stability in the euro area and to provide an assessment of the system's capacity to absorb adverse disturbances. As the global financial and economic turbulence is still ongoing, let me start by examining risks to euro area financial stability stemming from developments in the global macro-financial environment.

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[1] The analysis and assessment contained in the Review is for the most part based on information that was available until the "cut-off" date of 29 May 2009.

[2] These risks included the possibility of: a further deterioration in the US and the euro area housing markets and the impact it could have on banks' loan quality and the value of securities backed by mortgage-related assets; a deeper and more prolonged slowdown in both the global and the euro area economy that could cause a sharper and broader deterioration in borrowers' ability to service their debt; a more pronounced de-leveraging by banks, due to persistently high funding costs and concerns about the adequacy of capital buffers, which could negatively affect the flow of credit extended to the broader economy; and a surge in financial market volatility caused by a further unwinding of positions by hedge funds.

Over the past eight months, the crisis has broadened and affected most countries, including advanced, emerging and developing countries.

*US household sector*

Developments in the US economy, particularly in the household sector, continue to be central to the global financial stability outlook. There are two reasons for this: first, the important contribution of US consumer spending to global economic activity; and, second, the continuing high exposure of global financial institutions to securities backed by US mortgages and consumer loans. According to the IMF, these exposures amount to USD 1.3 trillion.

Since the end of 2008, private consumption in the US has recovered somewhat after a significant decline in the second part of 2008. This decline resulted from weak income growth, rising unemployment and a rapid deterioration in the balance sheets of US households. Total net household wealth in the US declined by USD 7.8 trillion (or 13%) in the second half of 2008. The outlook for household wealth in the US depends on many factors, amongst which the future evolution of US house prices is important. Chart 1 shows that, according to the Case-Shiller futures price index for 10 major US cities, prices are expected to fall by a further 14% from their current levels, before bottoming out by mid-2010. Moreover, delinquency rates on mortgages and on all other types of household loans have exceeded the peak rates recorded in the previous downturn in 2002-2003.

*US corporate sector*

The delinquency rates on US commercial and industrial loans also picked up but have remained lower than those on household loans and well below the levels reached during the 2002-2003 recession. This suggests that the US corporate sector has proven relatively resilient to the turmoil thus far. However, the outlook for the US non-financial corporate sector has deteriorated. As shown in Chart 2, US corporate profits fell further in the second half of 2008. Both domestic profits and those from the rest of the world contributed to the decline on a year-on-year basis. The turn in the corporate credit cycle has also been reflected in the rise of speculative-grade corporate default rates since the end of 2007, which over the course of the next 12 months are projected to reach levels far above the peaks in the early 1990s and in 2001. The expected sharp increase in US speculative-grade corporate defaults could cause a widening of credit spreads and exacerbate funding problems. Moreover, it could adversely affect the US labour market and consumer spending.

*Risks in the Emerging Market Economies and in new EU member states*

In emerging market economies, macroeconomic conditions have continued to worsen significantly, reflecting the confluence of weaker external demand, tighter financing constraints and falling commodity prices. In Central and Eastern Europe, economic and financial conditions deteriorated sharply, as a consequence of reduced capital inflows, the collapse of international trade and declining domestic demand. Although the economies of these countries are heterogeneous, many were highly vulnerable to a reduction in capital flows because their economic expansions had been financed to a considerable extent by external borrowing. Reduced external demand has also had a significant impact on several countries in the region. As a result, credit growth to the private sector has decelerated rapidly, and there is an emerging risk of a vicious circle between weakening economic activity and deteriorating asset quality. Against this background, as shown in Chart 3, sovereign credit default swap (CDS) spreads increased sharply in early 2009, especially in those economies with a large fiscal deficit and a wide current account deficit, and where domestic demand has weakened significantly. The CDS spreads have narrowed substantially since March 2009, but they remain at levels well above those in the first half of 2007. The risk to the euro area economy relates both to the close economic links with these countries as well as to the large exposures of a number of euro area banks to the region.

### *II.2. 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. The intensification of the strains in the financial sector in the last quarter of 2008 has set in motion a negative interplay between the financial sector and the real economy which emerged more clearly at the beginning of 2009.

*Euro area macroeconomic environment*

The pace of economic activity has slowed significantly since October 2008. Especially in the first quarter of 2009, we witnessed a substantial and broad-based contraction of euro area activity. Both external and domestic demand are expected to decline further in 2009 and gradually recover in 2010. As shown in Chart 4, private sector forecasters and international institutions have been revising downwards their estimates of real GDP growth for 2009 and 2010.

This assessment is broadly in line with the June 2009 Eurosystem staff macroeconomic projections for the euro area published on 4 June, according to which annual real GDP growth will range between -5.1% and -4.1% in 2009 and between -1.0% and 0.4% in 2010, that revised downwards the ranges of projected GDP growth, particularly for 2009, compared with the March 2009 ECB staff macroeconomic projections. The projected gradual recovery next year, with rates of growth returning to positive levels by mid-2010, reflects the effects of the significant macroeconomic stimulus under way as well as of the measures taken so far to restore the functioning of the financial system both inside and outside the euro area. Box 5 of the Review provides a comparison of the amplitude and time profile of "normal" economic cycles with those observed during past episodes of banking crises. The latter were characterised by a more protracted U-shaped recession, while the former involved a sharp decline in activity followed by a swift recovery.

Nevertheless, in recent weeks, there have been signs – both within and outside the euro area – that the pace of deterioration in activity is moderating and that consumer and business sentiment is improving though still remaining at low levels. In addition, there may be stronger than anticipated effects on activity stemming from the extensive macroeconomic stimulus under way and from other policy measures taken. Confidence may also improve more quickly than currently expected. At the same time, concerns remain about the following potential downside risks: a stronger impact on the real economy from the financial market turmoil, more unfavourable developments in labour markets, the intensification of protectionist pressures and adverse developments in the world economy stemming from a disorderly correction of global imbalances.

*Euro area non-financial corporate sector*

Concentrating on the euro area non-financial corporate sector, lower sales volumes and profit margins have caused a substantial weakening of corporate profitability which is expected to persist in 2010. Firms in the euro area entered the economic downturn with a relatively high leverage ratio. Reduced profits hamper firms' ability to generate internal financing while, at the same time, external financing conditions are likely to remain tight, as long as banks continue to de-leverage and other funding markets remain under stress.

Non-financial corporations' default rates for both euro area and European firms have started to increase. The European speculative grade-rated corporations' default rate is expected to jump to almost 20% by the end of 2009, as shown in Chart 5. Furthermore, credit rating agencies began revising downwards their ratings of non-financial corporations in December 2008. Box 6 of the Review takes a closer look at the outlook for corporate defaults. It concludes that given the extraordinary nature of recent developments in the financial markets, current forecasts could prove too pessimistic despite the sharp decline in economic activity. The prospect of global and European speculative-grade corporations' default rates increasing substantially implies a significant risk to the financial system.

Another source of risk is the commercial property market where conditions continued to deteriorate over the past six months. In the first quarter of 2009, commercial property prices actually fell in all 13 euro area countries for which data are available. The outlook will remain unfavourable until economic and financial conditions improve and investor appetite for commercial property returns. Potential further losses constitute a significant risk for many banks since commercial property loans in the euro area on average account for about 10% of total loans and, in many cases, exposures are even much larger.

*Euro area household sector*

Turning to the household sector, euro area house price increases continued to ease in 2008, as shown on Chart 6. In at least six euro area countries house prices have declined on an annual basis. These developments have been associated with a moderation of both housing demand and supply, but the balance of the changes in demand and supply has been putting downward pressure on prices.

The annual rate of growth of loans to the household sector declined sharply in the final quarter of 2008 and in the first quarter of 2009, reflecting the deterioration in housing markets, weakening economic conditions and prospects, and the ongoing tightening in credit standards. According to the results of the April 2009 ECB bank lending survey, a further dampening of households' demand for housing loans is expected due to worsened housing market prospects and low consumer confidence.

### *II.3. Risks in the euro area financial system*

*Euro area money markets*

Let me now focus on the euro area financial system. Over the past few months, developments in several financial markets give rise to some optimism. Although market liquidity in the euro area is still tight, it has improved appreciably, especially in the interbank money market.

Since mid-February, conditions in the euro money markets improved. This is reflected in the lower utilisation of the ECB deposit facility and in higher overnight unsecured interbank transaction volumes. More importantly, money market rates have declined substantially and the spreads between Euribor rates and EONIA swap rates have continued to narrow, as shown in Chart 7. In late May 2009, the spread between the 3-month Euribor and the EONIA swap rate had fallen below 50 basis points for the first time since the collapse of Lehman Brothers in September 2008. In shorter maturities, money market spreads have narrowed even further. These positive developments are a consequence of the extensive provision of liquidity and other policy measures taken by the Eurosystem. Forward Euribor-EONIA swap spreads in the three-month maturity indicate that these spreads are expected to continue narrowing in the coming months.

*Euro area government finances*

An important development in financial markets was the marked increase in the net issuance of euro area government debt securities at the end of 2008 and early 2009, as shown in Chart 8. New debt issuance has mainly been in the form of short-term debt, partly because the steeper yield curve has made short-term financing relatively cheaper. The national bank support schemes, which were announced in October 2008, were perceived by investors as a credit risk transfer from the private to the public sector. This is reflected in the widening of government bond spreads relative to Germany and the increasing divergence in CDS spreads in the first quarter of 2009, especially in those countries with a weaker public finance position and a relatively large financial sector. Since March 2009, however, a narrowing of bond and CDS spreads indicates some improvement in investors' confidence in the euro area sovereign bond markets.

*Euro area equity markets*

In mature economies, stock market valuations have steadily improved since early March of this year and the major equity indices both in the euro area and globally have more than recovered the losses of the first two months of the year, while volatility has also declined. As shown on Chart 9, several equity valuation measures, including the ratio of equity prices to long-term past corporate earnings, indicate that despite the recent recovery in prices, equity market valuations in the euro area are still substantially lower than the peaks reached in October 2007 and in March 2000, and also below the long-term average level.

*Euro area LCBGs' earnings and solvency developments*

Turning next to the euro area financial institutions, large and complex banking groups (LCBGs) remained under intense financial stress in the last quarter of 2008. Profits and (the weighted average) return on equity (ROE) declined sharply, as shown in the left panel of Chart 10. This performance reflects partly further write-downs on structured product portfolios and increasingly the deterioration in the macroeconomic environment, which resulted in an increase in loan losses and a decline in non-interest revenue. In the first quarter of 2009, euro area banks' ROE improved somewhat, albeit at a very low level, thanks to a more favourable trading environment and better non-interest revenues. The asset quality of banks' loan portfolios will remain a crucial determinant of their performance in the rest of the year.

At the same time, the efforts of euro area LCBGs to bolster their capital buffers have contributed to maintaining their current regulatory capital ratios at levels that conform to the regulatory minimum requirements. Both the median and the weighted average Tier 1 ratios increased in 2008 compared with 2007 (from 7.76% to 8.15%, and from 7.7% to 8.6%, respectively). The total capital ratio followed a broadly similar pattern. However, part of the recovery in regulatory capital is also due to a reduction in risk-weighted assets and to asset shedding at a majority of LCBGs.

*Write-downs and new capital raised*

Since the turmoil erupted, the total reduction in net income attributable to write-downs of global banks on their assets has amounted to just under USD 1 trillion so far. The left panel on Chart 11 shows that US banks have accounted for the bulk of the income losses – about 60% of the overall figure. A further 20% of the global losses was incurred by UK and Swiss banks and euro area banks' write-downs also corresponded to 20% of the total. To compensate for the large write-downs, euro area LCBGs successfully raised capital in 2008 – both from private and from public sources. By late-May 2009, euro area banks had received relatively more capital than their US peers in relation to the recorded write-downs, as private and public capital injections were equivalent to 119% of the write-downs in the euro area versus 88.5% in the United States.

*Availability of public bank support*

Since October 2008, EU governments have implemented support measures to alleviate strains on the European banking system. These measures complement the extensive liquidity support that has been provided by the ECB/Eurosystem and have been implemented in accordance with specific guidance from the ECB and the European Commission. The bank support measures taken, which include equity re-capitalisations, guarantees of new bank debt and asset relief schemes, are summarised in Box 11 and a tentative assessment of their effectiveness is provided. The main conclusion is that the measures have been successful in stabilising the banking system and in bolstering confidence.

The take-up rates of the government committed support to banking systems has varied across countries and across types of measures. Overall, the take-up rates are considered satisfactory taking into account banks' needs so far. In particular, the use of government guarantees on new bank debt issuance has been indispensable in providing banks with access to medium-term funding when needed, as shown in Chart 12. Looking forward, banks should be encouraged to take advantage of the governments' commitments for support and strengthen their capital buffers. This is especially important in order to restore the provision of credit to the economy and also because the current ample liquidity provided by the ECB will not remain permanently in place.

*Estimated future banking sector losses in the euro area*

A key issue for bank performance and financial system stability is the amount of potential further write-downs that could be faced by global and euro area financial institutions and the additional capital that should be raised by them in order to safeguard their solvency. Box 14 of the FSR presents the ECB staff estimates of potential write-downs on the securities and loans of euro area banks which, for the sake of comparability and transparency, are calculated following the approach used by the IMF in its Global Financial Stability Report published in April 2009. However, the ECB staff calculations have been based on certain parameters that can be estimated on the basis of euro area data. Table 1 on Slide 15 shows the estimated potential write-downs facing the euro area banking sector.

The ECB staff estimates suggest that the total amount of potential write-downs of euro area banks on their securities and loans over the period 2007-2010 could amount to around USD 649 billion. Taking into account the write-downs on banks' securities reported by late May 2009 and the banks' loan loss provisions for 2007 and 2008, the potential future losses of euro area banks, largely concentrated on their loan exposures, could be around USD 283 billion until the end of 2010. These potential losses would be cushioned by provisions and retained earnings over the next two years.

I want to stress that estimates of potential future write-downs on banks' securities and loans depend crucially on the assumptions made and the methodology used and they are subject to a considerable margin of error. Bearing in mind the significant uncertainty surrounding all available estimates, further efforts are needed to obtain as accurate figures as possible because the magnitude of the expected potential write-downs has weighed heavily on investor confidence and has affected already-weakened financial institutions.

*Euro area insurers' investment exposures*

Finally, allow me to make a few points with regard to euro area insurance companies. Large euro area insurers suffered a deterioration in their financial conditions in the second half of 2008 and the first quarter of 2009. Most of them reported declines in premium income, as falling equity prices and widening credit spreads lowered the demand for life insurance products. At the same time, non-life insurance business lines were challenged by the deterioration in the economic environment which adversely affected the demand of households and firms for their products. In addition, insurers endured a significant erosion of their investment income because of stresses in many of the financial markets in which they mainly invest, especially corporate bonds and equities.

As can be seen in Chart 14, the biggest investment exposure of euro area insurers relates to corporate and government bonds, on average about 60% of total investment in 2008 for a sample of large insurers, up from 46% in 2007. In addition, many insurers have investment exposures to structured credit products. Continued high yields on corporate bond and structured credit products have led to large unrealised losses in many insurers' "available for sale" bond portfolios. Insurers may have to sell such securities and realise losses if the ratings of the securities they hold are downgraded or in the event of liquidity shortages. In addition, realised losses for insurers are likely to increase as corporate bond default rates are expected to rise in the period ahead.

*Euro area insurers' outlook*

The main challenge that the euro area insurer sector is currently confronted with is a synchronised deterioration in both underwriting and investment income. This is illustrated in Chart 14. Insurance underwriting is usually supported by a favourable economic environment and the slowdown in economic activity is weighing on the underwriting performance of euro area insurers. At the same time, the turmoil in the financial markets continues to weigh on insurers in their attempts to generate investment income.

## III. Overall assessment

In conclusion, I will summarise our overall assessment of the risks to euro area financial stability. Over the past six months, the deterioration in the macro-financial environment has continued to test the shock-absorption capacity of the euro area financial system. The profitability of euro area major banks has been eroded and the prospects for a significant turnaround in the short term are not promising. These prospects weighed on investor confidence in the resilience of already-weakened financial institutions. Importantly, however, capital buffers have been rebuilt through mitigating actions taken by the major banks themselves, as well as through the injection of capital by governments, and the securities prices of these institutions have responded positively. Because capital buffers have been maintained well above the minimum regulatory requirements, overall euro area LCBGs appear to be sufficiently well capitalised to withstand severe but plausible downside scenarios.

The main risks identified within the euro area financial system include the possibility of:

- a further erosion of capital bases and a renewed loss of confidence in the financial condition of LCBGs;
- significant balance sheet strains emerging among insurers; and
- more widespread asset price declines coupled with high volatility.

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

- US house prices falling further than currently expected;
- an even more severe than currently projected economic downturn in the euro area; and
- an intensification of the stresses already endured by Central and Eastern European countries.

It cannot be excluded that many of these risks could materialise simultaneously. Indeed, this could happen if the global economic downturn proves to be deeper and more prolonged than currently expected.

All in all, notwithstanding the measures that have been taken by the Eurosystem and governments to stabilise the euro area financial system and in spite of the recent recovery in the equity prices of most major banks, policy-makers and market participants will have to be very alert in the period ahead. There is no room for complacency because the risks for financial stability remain high, also bearing in mind that the credit cycle had not yet reached a trough.

Banks, in particular, will therefore need to be especially careful in ensuring that they have sufficient capital and liquidity buffers to cushion the risks that lie ahead while providing an adequate flow of credit to the economy. Over the medium to longer term, banks should undertake the appropriate restructuring to strengthen their financial soundness and resilience to shocks. This may include adapting their business models to the new financial environment.

The commitments made by euro area governments to support the financial sector have been sizeable across a range of measures. Given the risks and challenges that lie ahead, banks should be encouraged to take full advantage of these commitments, in order to improve and diversify their medium-term funding, enhance their shock-absorbing capacity and protect sound business lines from the contagion risks connected with troubled assets.

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