Financial Stability Review

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Outline

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II Risks in euro area non-financial sectors

III Risks in the euro area financial system

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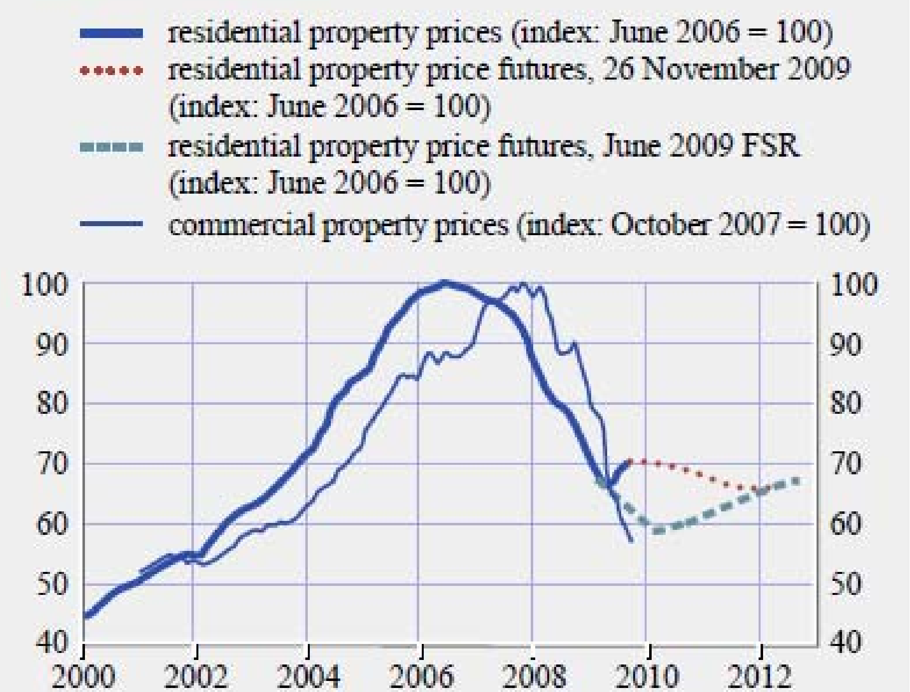
I Risks in the global macro-financial environment

The outlook for US residential property prices has improved over the past six months, although the stock of vacant homes remains large …

… while the decline in commercial property prices has been very sharp and the outlook remains negative.

Chart 1 US residential and commercial property prices and market expectations

(Jan. 2000 – Sep. 2012)



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

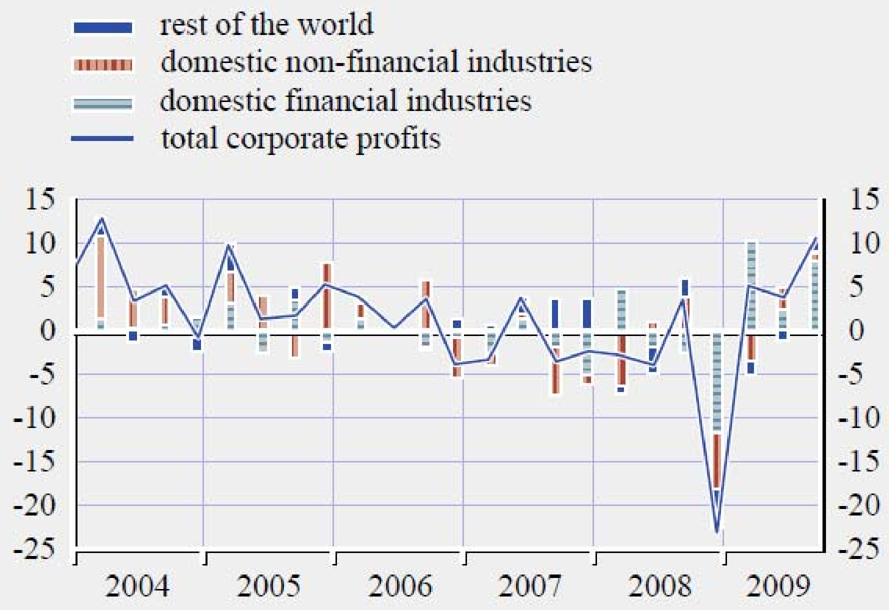
I Risks in the global macro-financial environment

After the slump in late 2008 and in early 2009 the profits of US non-financial corporations have improved …

… however, the main driver of the increase in profits has been cost-cutting, while revenues have been sluggish.

Chart 2 US corporate sector profits

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



Source: US Bureau of Economic Analysis.
Notes: Corporate profits include inventory valuation and capital consumption adjustments. Profits from the rest of the world (RoW) are receipts from the RoW less payments to the RoW.

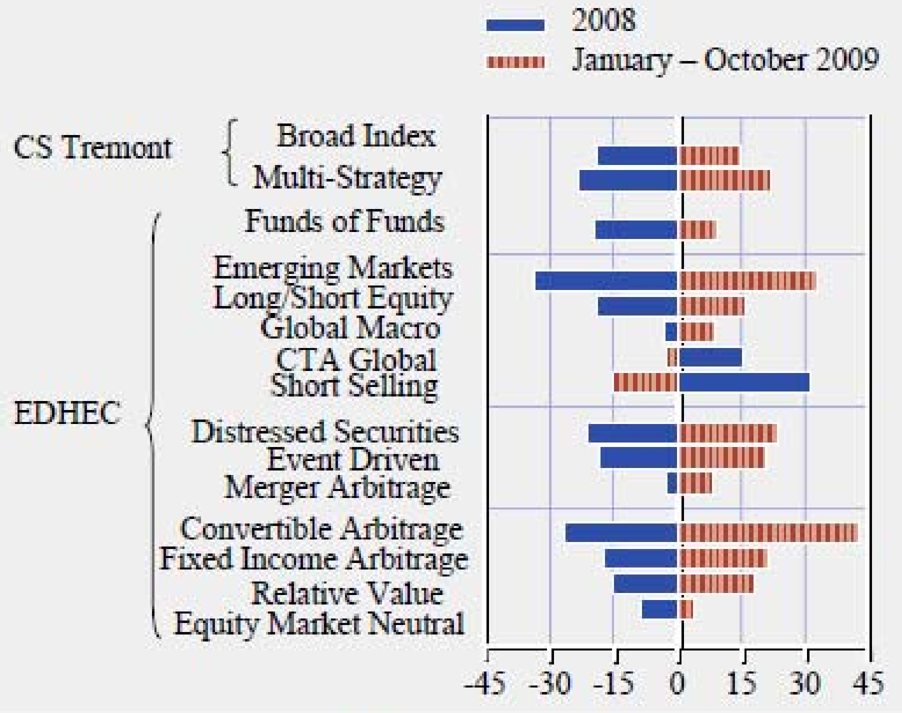
I Risks in the global macro-financial environment

The global financial markets rebounded after the first quarter of 2009, reflecting positive developments in investors' confidence …

**… and the global hedge fund sector has been one of the beneficiaries, with almost all of the broadly defined hedge fund investment strategies having
recouped much of the losses they had suffered in 2008.**

Chart 3 Global hedge fund returns

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



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

II Risks in euro area non-financial sectors

The decline in euro area economic activity was sharp, but quarterly real GDP growth rates recently turned positive …

… and the latest Eurosystem staff macroeconomic projections show a gradual recovery in 2010, although the recovery process is likely to be uneven.

Chart 4 Real GDP growth in the euro area

(Q1 1999 – Q3 2009; percentage change)

Sources: Eurostat and ECB calculations.

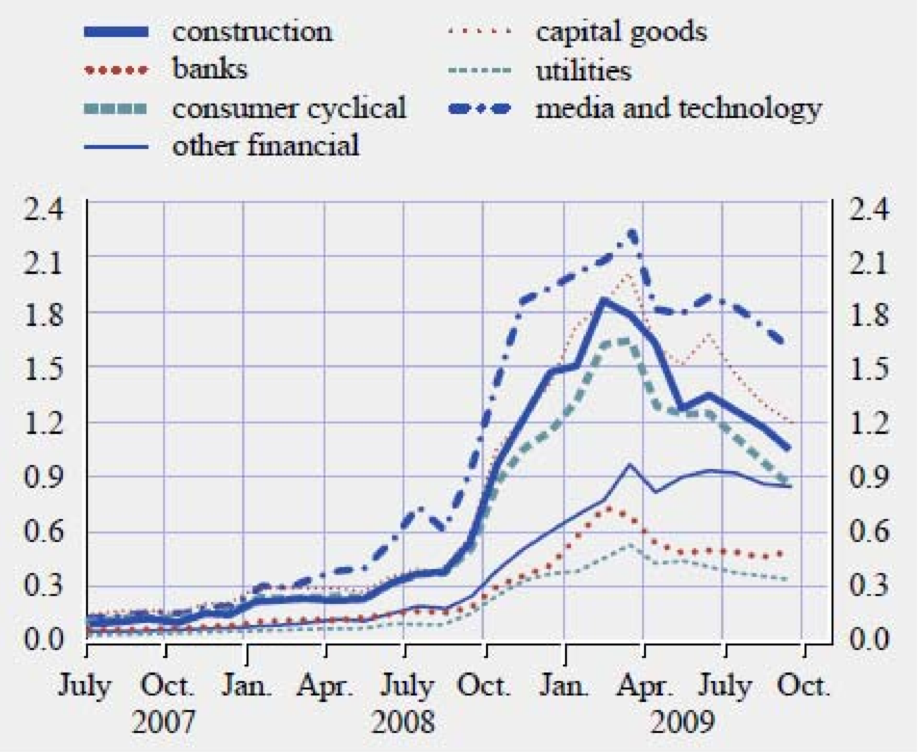
II Risks in euro area non-financial sectors

The expected default rates of euro area non-financial corporations have moderated somewhat from the peaks reached in early 2009 …

… but expected default rates remain elevated, reflecting high corporate sector leverage which is adding to the credit risks faced by euro area banks.

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

(July 2007 – Sep 2009; percentage; medians)



Sources: Moody's KMV and ECB calculations.

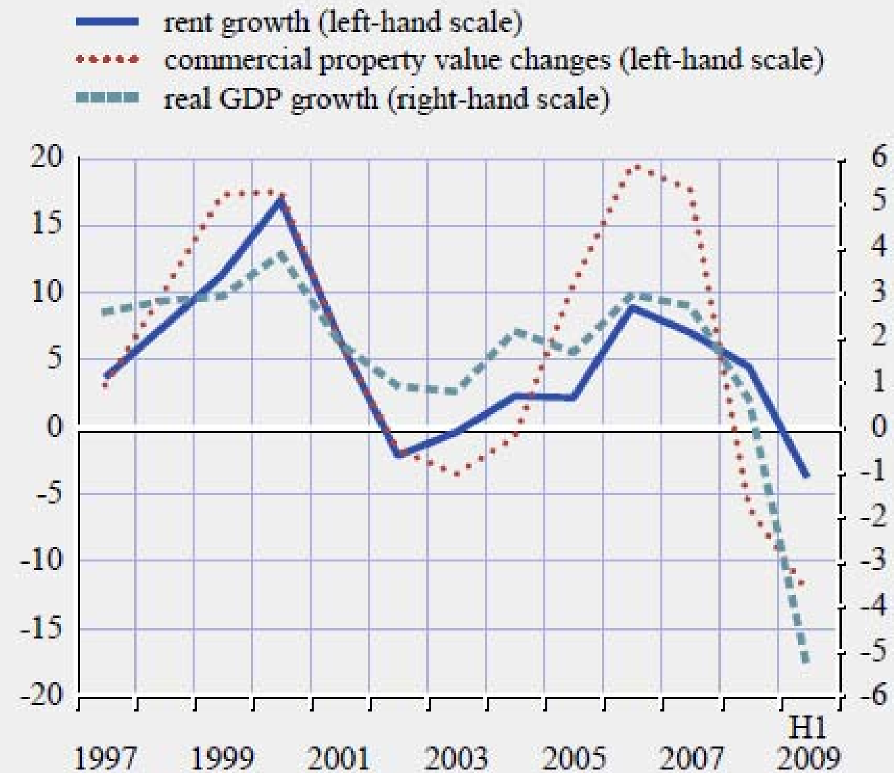
II Risks in euro area non-financial sectors

Conditions in the euro area commercial property markets have continued to deteriorate over the past six months …

… and they are expected to remain challenging until economic conditions improve and investors' appetite for commercial property assets returns.

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

(1997 – H1 2009; percentage change per annum)



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

II Risks in euro area non-financial sectors

The slowdown in residential property price inflation in most of the euro area countries continued in the first half of 2009, with prices falling in almost half of the countries …

… and this was accompanied by a fall in the growth rate of loans extended by banks for house purchase.

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

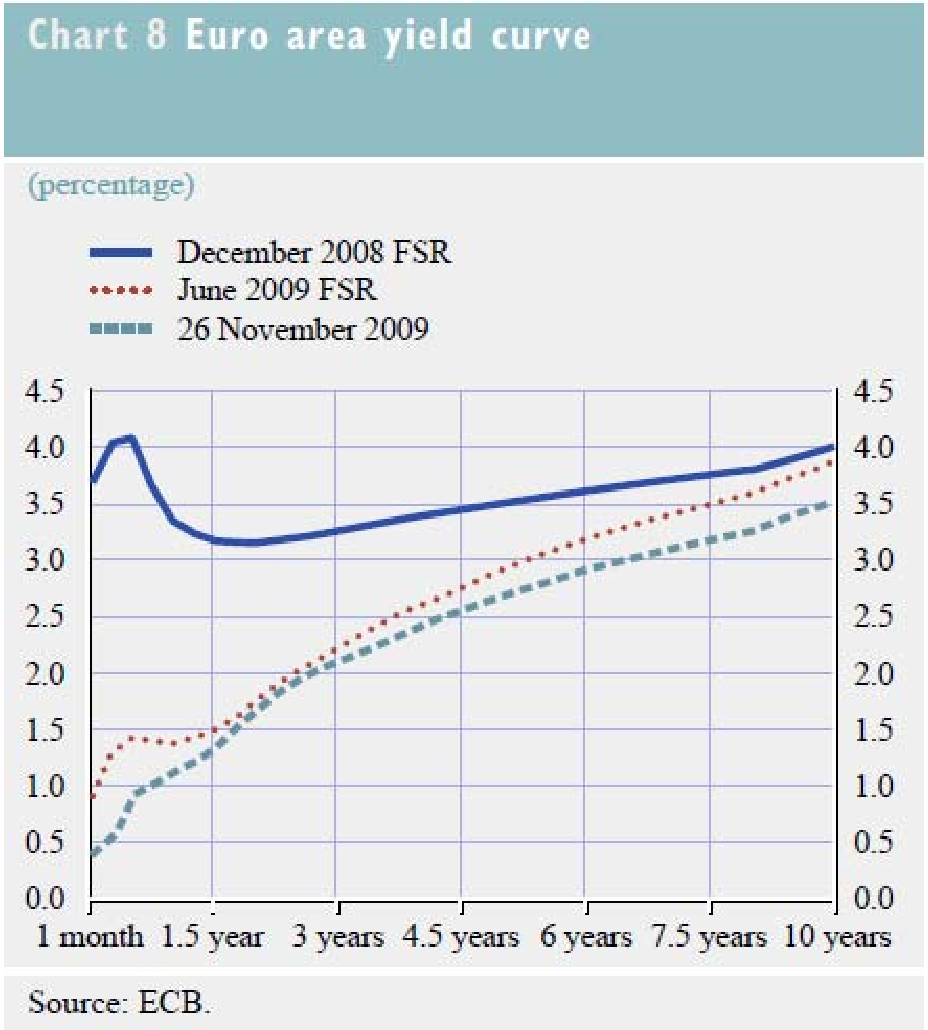
(Jan. 2000 – Oct. 2009; percentage change per annum)

Source: ECB.

III Risks in the euro area financial system

**Partly as a consequence of past reductions in policy interest rates, the slope of the euro area
yield curve is steeper than it has ever been since the launch of the euro in 1999 …**

… and this has supported the earnings of those euro area large and complex banking groups (LCBGs) that are engaged in maturity transformation activities (i.e. borrowing short-term and lending long-term).



III Risks in the euro area financial system

The recovery in euro area equity prices has contributed to easier corporate financing conditions and to a strengthening of the trading revenues of LCBGs …

… while long term (cyclically adjusted) valuation measures suggest that equity prices are not particularly high by historical standards.

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

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

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

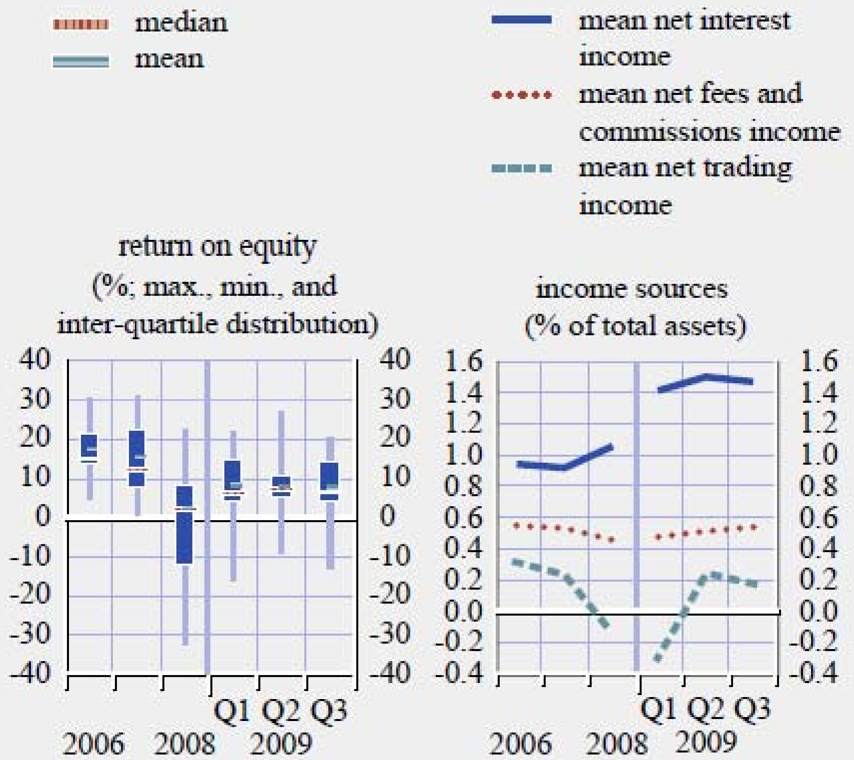
III Risks in the euro area financial system

Euro area LCBGs' earnings improved after the dismal performances of 2008, but some institutions still reported net losses …

… the main contributors to the recovery in earnings were trading income, owing to the buoyant market conditions, and net interest income, owing to the steep yield curve and wider lending margins.

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

(2006 – Q3 2009)



Sources: Individual institutions' financial reports and ECB calculations.
Notes: The left-hand chart is based on the Tier 1 measure of equity. Quarterly returns have been annualised.

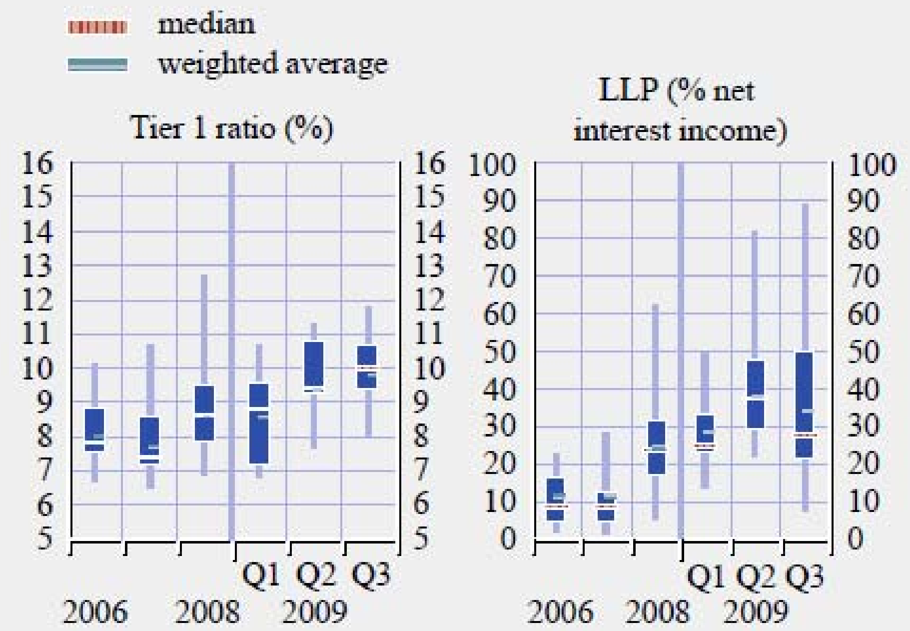
III Risks in the euro area financial system

Capital raised on financial markets, a reduction in risk-weighted assets and government support contributed to a broad-based improvement in the capital ratios of LCBGs …

… but the loan-loss provisions of euro area LCBGs have increased, with some institutions having to cope with particularly large provisions.

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

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



Sources: Individual institutions' financial reports and ECB calculations.

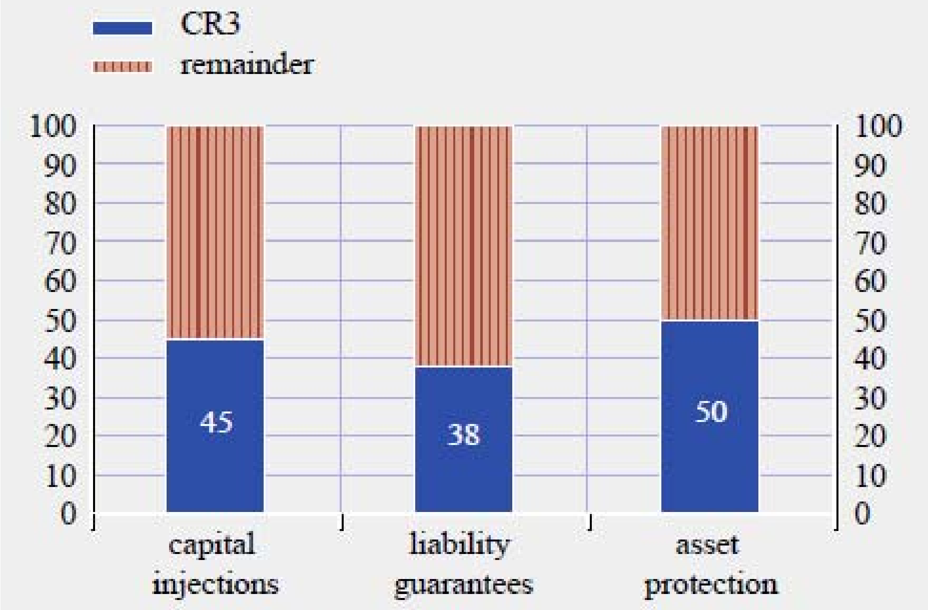
III Risks in the euro area financial system

Better wholesale market funding conditions have contributed to a stabilisation in the take-up rates of funds committed by governments to support banking systems …

… while measures of concentration show that, for each support category for the euro area as whole, the share of the three largest recipient institutions represents around half of all funds tapped by euro area banks.

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

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



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

III Risks in the euro area financial system

The latest estimate of the potential cumulative write-downs for the euro area banking sector is €553 billion for the period from 2007 to 2010, which is higher than the estimate published in the June 2009 FSR because of increasing write-downs on exposures to commercial property and the inclusion of write-downs on securities issued by central and eastern European countries …

… the latest ECB estimates put the potential further write-downs on assets for the euro area banking sector up to the end of 2010 at €187 billion.

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

(EUR billions)

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

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

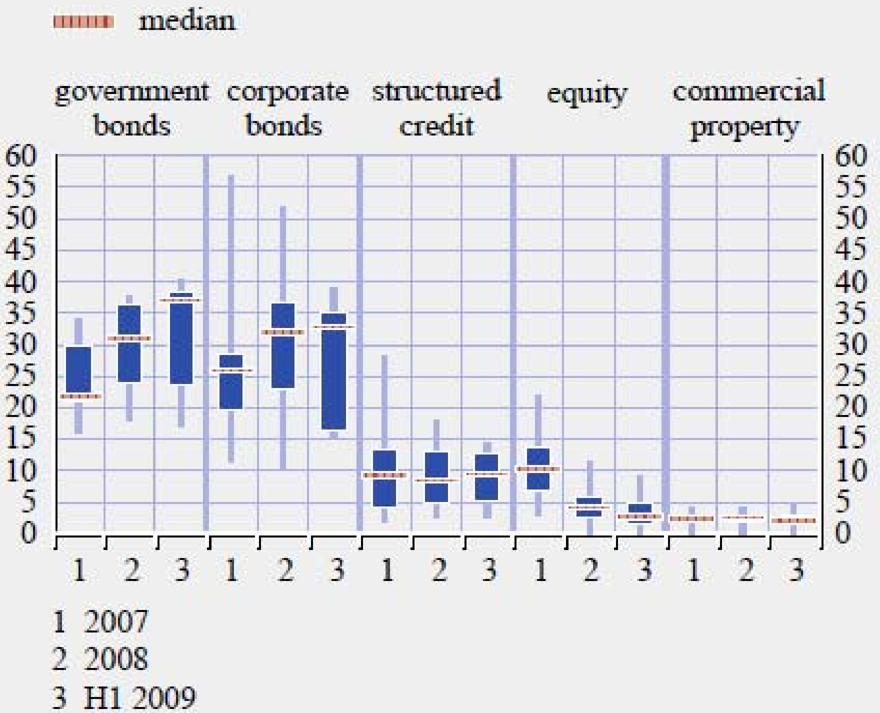
III Risks in the euro area financial system

The financial performance of large euro area insurers remained rather subdued in the second and third quarters of 2009, although investment income improved …

… and insurers further increased their investment exposures to corporate and government bonds.

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

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



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

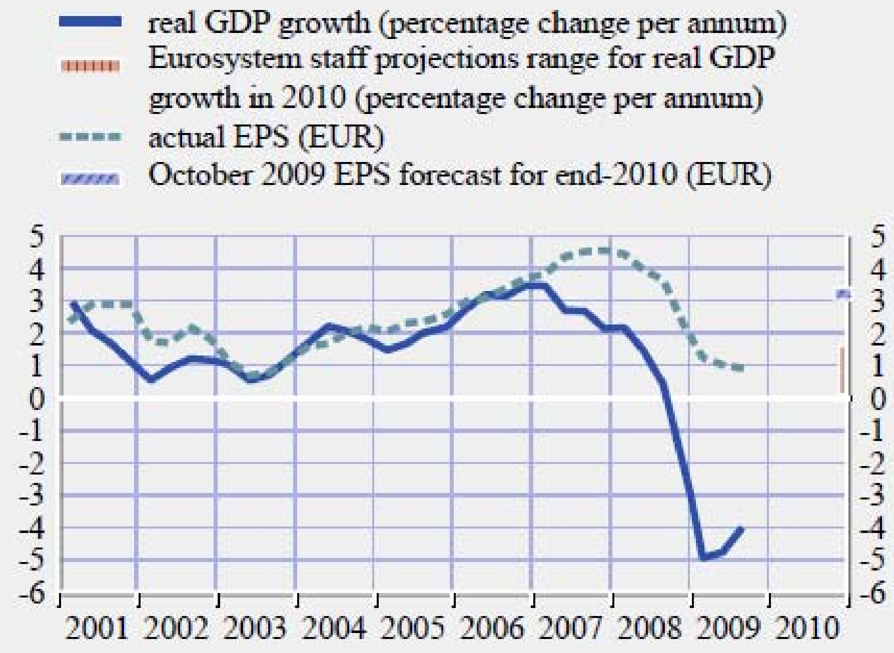
III Risks in the euro area financial system

Weak economic activity has continued to weigh adversely on the underwriting performances of euro area insurers …

… and the uncertainty in financial markets remains a challenge for the stability of insurers' investment income.

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

(Q1 2001 – Q4 2010)



Sources: ECB, Thomson Reuters Datastream and ECB calculations.

IV Overall assessment (I)

- The extraordinary remedial actions taken by central banks and governments since late last year have been successful in restoring confidence in, and improving the resilience of, financial systems around the world.

- Better financial conditions strengthened the profitability of many LCBGs to such an extent that they were able to absorb considerable write-downs on securities and loans while still, on average, reporting material improvements in profitability over three consecutive quarters.

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

IV Overall assessment (II)

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

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

IV Overall assessment (III)

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

- **renewed financial strains and that the recent recovery of bank profitability will not prove durable;**

- **vulnerabilities of financial institutions associated with concentrations of lending exposures to commercial property markets and to central and eastern European countries being unearthed; and**

- **a setback for the recent recovery of financial markets, if macroeconomic outcomes fail to live up to optimistic expectations.**

IV Overall assessment (IV)

- All in all, the challenges facing the euro area banking sector in the period ahead call for caution in avoiding timing errors in disengaging from public support. In particular, exit decisions by governments will need to carefully balance the risks of exiting too early against those of exiting too late.
- To cushion the risks that lie ahead, banks will need to be especially mindful in ensuring that they have adequate capital and liquidity buffers in place.
- If the circumstances require it, some banks may need to raise new and high-quality capital. In addition, some banks, especially those which have received state support, may need fundamental restructuring in order to confirm their long-term viability when such support is no longer available.
- At the same time, banks should take full advantage of the recent recovery in their profitability to strengthen their capital positions, so that the necessary restructuring of businesses and the enhancement of shock-absorbing capacities do not impinge materially on the provision of credit to the economy.