I OVERVIEW[1]

The further significant deterioration of global macroeconomic conditions since the finalisation of the December 2008 Financial Stability Review 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. Connected with this, there has been a significant increase in the range of estimates of potential future write-downs and losses that banks will have to absorb before the credit cycle reaches a trough. Although there are great uncertainties surrounding such estimates of probable losses and of the outlook for banking sector profitability, the scale of estimates of potential write-downs has weighed on investors' confidence in the resilience of already-weakened financial institutions. Reflecting the challenges confronting the euro area banking sector, funding costs have remained elevated, the market price of insuring against bank credit risk has continued to be very high and the market value of many banks' equity has remained significantly below book value.

Large and complex banking groups (LCBGs) in the euro area have been responding to the challenging macro-financial environment by making efforts to de-leverage and de-risk balance sheets, although this has been hindered by the illiquid and stressed conditions that have characterised many financial markets. Banks have also been cutting costs and tightening credit standards on new lending. Recent surveys of bank lending practices indicate that those making lending decisions have been tightening their standards not only because of expectations of a further deterioration in the pace of economic activity, but also because of costs relating to the capital positions of their banks and difficulties in accessing wholesale funding markets.

The adjustment of bank balance sheets has entailed adverse feed-back on the market pricing of assets and on banks' financial intermediation role of channelling funds from savers to investors. The access of non-financial sectors to funding appears to have been hampered as a consequence, meaning that some investments and purchases either could not be undertaken or have been postponed, and economic output is incurring knock-on losses and declines. At the same time, in view of expectations of lower aggregate demand, credit growth has slowed, reflecting cut-backs in the perceived funding requirements of non-financial sectors. As revenue garnered from the provision of financial intermediation services is being eroded, this is adding to the stresses in the financial sector. Moreover, increasing signs of an adverse feedback loop between the real economy and the financial sector have posed new challenges for the safeguarding of financial stability.

Because of the continued stresses and impaired liquidity of many financial markets, a range of remedial policy measures have been taken both by central banks and by governments with the aim of preventing this adverse feedback and fostering the flow of credit. Central banks have taken numerous steps to meet the liquidity needs of financial institutions, including that of fully allotting all bids received in liquidity providing operations at preset policy rates, and widening of the lists of assets that are accepted as collateral for the provision of central bank liquidity. Central banks have also reduced policy interest rates to unprecedented lows, and have deployed unconventional monetary policy tools. At the same time, governments have created schemes to support depositor confidence and to ensure that banks can meet their funding requirements in capital markets. They have done this through a range of measures, including through the guaranteeing of bank liabilities, the injection of capital and, more recently, by relieving banks from the risks embedded in troubled assets, either through insurance schemes or by setting up dedicated asset management companies – also known as "bad banks".

1 This issue of the Financial Stability Review (FSR) describes the main endogenous and exogenous trends and events that characterised the operating environment of the euro area financial system over the period from 28 November 2008 (when the December 2008 FSR was finalised) until 29 May 2009.

There is a broad consensus that the remedial policy measures taken in the autumn of 2008 were successful in alleviating the exceptional stresses on financial systems that were triggered by the failure of Lehman Brothers. The significant narrowing of money market spreads over the past few months indicates that the central bank measures have contributed to improving the functioning of money markets. It is too early, however, to accurately assess the impact of the government measures on the longer-term funding and capital needs of the banks or, importantly, the extent to which they have contributed to fostering bank lending to the private sector. This is partly because the measures are taking time to implement and because euro area banks have been relatively slow to take up the support offered by governments. At the same time, hard-to-value assets have remained on bank balance sheets and the significant deterioration in the economic outlook has created concerns about the potential for sizeable loan losses. Reflecting this, uncertainty prevails about the shock-absorbing capacity of the banking system.

The next part of this section reviews the main sources of risk and vulnerability that are particular to the euro area financial system, and it discusses the remedial measures that have been taken both by the ECB and by national governments to stabilise the euro area financial system. This is followed by an examination of the main sources of risk and vulnerability that are present in the macro-financial environment. The section concludes with an overall assessment of the euro area financial stability outlook.

SOURCES OF RISK AND VULNERABILITY WITHIN THE EURO AREA FINANCIAL SYSTEM AND REMEDIAL ACTIONS THAT HAVE BEEN TAKEN TO ADDRESS THEM

Stresses on euro area LCBGs intensified in the last quarter of 2008, with many of these key financial institutions reporting substantial losses for the period. Coming from record median returns on equity (ROE) of close to 20% in 2005 and 2006, the financial market turmoil steadily eroded their profits from the second half of 2007 onwards, to the point where they collectively reported a median ROE of close to zero for the full year 2008. Moreover, some of them reported heavy full-year losses. At the time of finalisation of this issue of the FSR, most euro area LCBGs had published statements on their first quarter 2009 financial performances. While the median ROE of this set of institutions was somewhat higher than in 2008, a number of institutions suffered sizeable losses.

As the impact of the financial market turmoil has been felt across a broadening range of economic sectors and economies, an increasing number of euro area LCBG business lines have suffered. Notwithstanding higher funding costs in the initial phases of the turmoil, the net interest income of euro area LCBGs held up reasonably well. This was also the case in 2008. However, in the course of last year and early 2009, the relative stability of this source of income became increasingly attributable to a widening of lending margins, which compensated for slower lending volume growth as lending standards were tightened. At the same time, fee and commission income suffered a dent in 2008, but it held up reasonably well in that year and in the first quarter of 2009. The turmoil initially had its greatest impact in the wearing down of LCBG profits through a continuous flow of write-downs of the values of portfolios containing complex credit products as their market or economic values sank. By end-May 2009, the accumulated portfolio losses absorbed by euro area LCBGs since the start of the turmoil had reached just over €100 billion, of which about €65 billion was reported in 2008. This was most visible in the collapse of trading income. At the same time, as the macro-financial environment took a turn for the worse in the latter part of 2008, a broad base of these institutions also began to see surging loan losses, which continued in the first quarter of 2009.

As the turmoil persisted and went through several waves of intensity, its impact was also felt in the cost and availability of a broadening range of LCBG funding sources. Challenges

surfaced first in raising new or rolling-over existing short-term unsecured debt in money markets, and in asset-backed commercial paper markets, as participants in these markets became increasingly worried about counterparty and credit risks in collateral. While swift action taken by the ECB to promote the orderly functioning of the money markets was largely successful in ensuring that counterparties were able to satisfy their short-term funding needs, it was not long before the costs and availability of longer and more durable sources of funding were adversely affected by credit risk concerns. The effective closure of asset-backed securities markets rendered securitisation of assets an unfeasible market financing option, although these securities could still be used in ECB refinancing operations.

Challenges confronting banks in accessing long-term wholesale funding were also quickly reflected in a shift of the maturity profile of new debt issuance towards shorter maturities. With an already relatively large stock of bank debt due to be rolled over in the next 18 months, this shift made some LCBGs increasingly vulnerable to the risk that they could be faced with stressed market conditions at the time of planned roll-over. In order to contain this risk, some institutions focused their funding strategies on increasing retail deposits, usually the most stable source of funding after equity finance. Indeed, a notable narrowing of the so-called customer funding gap – i.e. the difference between how much banks take in deposits and how much they lend out – for the euro area banking sector became evident after September 2008 when such risks became especially acute.

The erosion of LCBG profitability also meant that these institutions were unable to sufficiently increase their capital through the retention of earnings in order to alleviate the concerns of investors about their shock-absorbing capacities. This meant that they were forced to raise fresh equity capital in relatively challenging market conditions, characterised by sharply rising required rates of return on bank equity. While euro area LCBGs did manage to raise around €46 billion in new capital from private investors after the start of the financial market turmoil, this fell short of the amount they had to absorb from write-downs on portfolios containing structured credit products. However, taking account of the capital injected into euro area LCBGs by various governments, which has amounted to around €64 billion since the start of the turmoil, these institutions had, by the time of finalisation of this issue of the FSR, still raised slightly more capital than the losses they had absorbed.

The challenges banks were faced with in ensuring that their funding bases remained stable and diverse enough to cope with adverse disturbances caused EU governments to agree in October 2008 to implement measures designed to alleviate strains on their banking sectors. The main objectives of these public support schemes included the safeguarding of financial stability, the restoration of the provision of credit to the economy, the promotion of a timely return to normal market conditions, the restoration of the long-term viability of banks and the containment of the impact on the public finances, as well as the protection of taxpayers' interests, while preserving a level playing field in the single market. The forms these government support schemes have taken so far have included the guaranteeing of bank debt liabilities, recapitalisation measures and measures designed to relieve banks from the risks embedded in troubled assets.

In contrast to those in the United States, most of the government schemes in the euro area to support the financial sector have been voluntary. The take-up rate by financial institutions relative to the commitments made by governments has been diverse across all three types of measures and across countries. The schemes should be seen in a context where banks have been striving to improve their leverage ratios, which, all else being equal, would tend to favour new equity over debt issuance. Moreover, because banks are de-leveraging partly by scaling back on their lending, this implies a lower need for bond financing. On the positive side, the fact that bank issuance of bonds without such guarantees

has been very limited would tend to suggest that the availability of guarantees on bonds has been helpful for securing access to medium-term funding when needed. That said, market intelligence has revealed concerns among some banks about the high premium on guaranteed bank debt over government debt, possible stigma effects, as well as about the conditions sometimes attached to such guarantees.

The functioning of euro area money markets improved after the finalisation of the December 2008 FSR. This has been evident in a broad range of indicators, including that of a significant narrowing of spreads between short-term unsecured deposit rates and overnight index swap rates, a progressive lowering of the utilisation of the ECB's deposit facility by counterparties and a rise of overnight unsecured interbank transaction volumes. The improvement owed much to a range of measures taken by the Eurosystem that were aimed at restoring the functioning of the money market after the failure of Lehman Brothers in mid-September 2008. These measures included the introduction of a fixed rate tender procedure for the main refinancing operations, meaning that the Eurosystem fully allotted all bids received in the euro liquidity providing operations at a preset policy rate, the narrowing of the corridor between the standing facilities and an expansion of the list of assets eligible as collateral in Eurosystem credit operations. The significant compression of interest rate spreads in the euro area money markets would appear to suggest that market participants see short-term counterparty credit risks as having decreased considerably, possibly also on account of the government measures that have been taken. This notwithstanding, some banks have remained heavily dependent on central bank funding.

On 7 May 2009, a further set of measures, aimed at enhanced credit support, were announced. These measures encompassed (i) the introduction of liquidity providing longer-term refinancing operations with a maturity of 12 months, (ii) purchases of euro-denominated covered bonds issued in the euro area and (iii) granting the European Investment Bank counterparty status for the Eurosystem's monetary policy operations. Aimed at promoting a recovery in the term money and other funding markets, the announcement of these measures provided additional impetus to gradually improving conditions at the longer end of the money market maturity spectrum, whereas spreads narrowed in the covered bond market. Furthermore, the main ECB policy interest rate was reduced to 1% and the interest rate corridor between the standing facility rates was narrowed to ±75 basis points.

All in all, the efforts being made by banks to de-leverage and de-risk their balance sheets, as well as the measures that have been taken by the ECB and national governments of euro area countries, should, all else being equal, enhance the shock-absorbing capacities of euro area banks and lessen their funding risks. Indeed, the median leverage ratio – measured as the weighted average of assets relative to Tier 1 capital – of euro area LCBGs declined from 37 in 2007 to 33 in 2008, while the median Tier 1 and total capital ratios edged up slightly from 7.8% and 10.5% respectively in 2007 to 8.2% and 12.2% in 2008. Moreover, the quality of capital also improved and lending margins widened. Against this background, the stock prices of euro area LCBGs rebounded from March onwards, and their CDS spreads narrowed substantially, which brought these securities prices back to the levels prevailing at the time of finalisation of the December 2008 FSR.

That said, a number of sources of risk and vulnerability that are internal to the banking system can be identified. Among these vulnerabilities are capital buffers that do not appear to be sufficiently large in the eyes of market participants, hard-to-value assets that have remained on balance sheets and challenging prospects for improving profitability, as well as funding structures that have become increasingly and possibly too reliant on short-term borrowing via central bank liquidity operations. A number of these vulnerabilities could be revealed by a credit cycle downturn that proved to be more severe than currently expected.

Turning to large euro area insurers, these institutions also suffered a deterioration in their financial conditions in the second half of 2008 and the first quarter of 2009. Most of them reported drops in premium income, as falling equity prices and widening credit spreads lowered demand for life insurance products. At the same time, non-life insurance business lines were challenged by the deterioration of the economic environment, which lowered 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. Insurers also reported write-downs on portfolios containing complex credit products. However, the scale of the reported losses was much smaller than that of LCBGs, thanks partly to the fact that insurers often retain such exposures over lengthy periods and classify them as "available for sale" in their balance sheets. This classification means that insurers do not have to report unrealised losses that are considered to be temporary through their profit and loss accounts. Instead, the losses result in commensurate declines in the value of shareholders' equity, and most insurers have thus far managed to avoid outright realised losses on their investment portfolios. That said, losses that have not been realised so far may have to be acknowledged in the period ahead if asset prices remain low for a prolonged period of time or if the credit cycle downturn triggers significant rating downgrades on the securities that insurers hold, which could force them to sell these assets, and thus realise the losses.

As did banks, albeit to a more limited extent, some insurers took action to mitigate the risks created by the challenging macro-financial environment. Capital positions were bolstered, also by cutting dividends, in some cases to zero. Some euro area insurers received capital injections from governments. In addition, hedging of equity and credit exposures was continued, and some insurers carried out significant outright sales of equities. Although some euro area insurers have reported lower solvency positions in recent quarters, available information suggests that, on average, their shock-absorption capacities are sufficient to weather the possible materialisation of the risks they currently face. Apart from the risks associated with the possibility of having to realise losses on their asset holdings, the main challenge confronting euro area insurers at present continues to be the combination of weaker economic activity, which is weighing on their underwriting performance, and the stresses in financial markets, which are inhibiting their capacity to generate investment income.

In euro area capital markets, long-term government bond markets were characterised by increased discrimination among investors towards different euro area sovereign issuers, in large part brought about by the intensified concerns about fiscal sustainability that were raised by substantial national financial rescue and economic stimulus packages. In particular, spreads widened most in those countries where government indebtedness was already relatively high or where the size of troubled financial sectors was large relative to the size of the economy concerned.

While there were some signs of an improved functioning of the corporate bond markets – including narrowing spreads and greater issuance of investment-grade corporate bonds – market liquidity remained impaired. This was indicated, for instance, by persistently wide so-called basis spreads – i.e. the spread between a corporate bond and the credit default swap premium on the corresponding entity – which were progressively wider the further down the issuer was in the credit quality spectrum. Although equity markets recovered some of the losses suffered in late 2008, valuations remained very low and volatility, while reduced, still remained relatively high. This continued to make it difficult and expensive for non-financial firms to issue equity. All in all, many indicators of market risk remained higher than at the time just before the demise of Lehman brothers. The persistence of these stresses in financial markets has left them vulnerable to the possibility of continued forced investment

portfolio unwindings by leveraged investors such as hedge funds, events which could be triggered by further investor redemptions from the sector and/or closures of hedge funds as a result of insufficiency in the scale of remaining capital under management following sizeable investment losses in 2008 and lacklustre investment performances in early 2009.

SOURCES OF RISK AND VULNERABILITY OUTSIDE THE EURO AREA FINANCIAL SYSTEM

A broad-based and comprehensive financial stability assessment needs to be cognisant of sources of potential risks and vulnerabilities that are outside the control of participants in the euro area financial system. In this vein, a key source of concern is that downside risks to the global growth outlook increased significantly after the finalisation of the December 2008 FSR. Persistent economic weakness in the United States has added to the stresses on the US banking system that began with write-downs of the values of portfolios containing complex credit products, but have increasingly become related to losses on lending across a broadening range of exposures. While the rate of US house price declines appears, on the basis of futures prices, to be nearing a bottom, price declines and foreclosures might continue for some time to come. Furthermore, a significant upturn in default rates on corporate bonds is expected in the period ahead. If this credit cycle downturn in the United States were to prove more severe than currently expected, euro area banks could yet face additional losses on exposures to asset-backed securities. In addition, the possibility of further adverse feed-back between the US financial system and the real economy would most likely contribute to depressing confidence and private sector demand in the euro area.

From a euro area financial stability perspective, increasing stresses in some of the central and eastern European countries have become an additional area of concern. The overall exposure of the euro area financial system to the region is not particularly large. However, the distribution of exposures to the region is wide, with some euro area LCBGs having a significant share of their assets and profits connected with this region. This exposes them to the risk of a potential further deterioration in the economic situation there.

As regards the euro area non-financial sectors, risks to financial stability stemming from the euro area household sector have increased since the autumn of 2008, as households' capacity to service their debt may have weakened. In particular, households are facing higher income risks in a macroeconomic environment where downside risks to disposable income and unemployment have risen. At the same time, risks stemming from the likelihood of adverse house price developments remain significant, especially in those countries where house prices had previously been overvalued and where economic activity has been contracting. That said, the financial position of households in countries where borrowing takes place primarily at floating rates is likely to have improved. For the euro area non-financial corporate sector, the operating environment is expected to remain challenging for at least the remainder of this year. This has translated into expectations of sharply rising default rates. At the same time, conditions in the euro area commercial property markets are expected to remain weak until economic conditions improve and investor appetite for commercial property returns. Further losses on banks' exposures to commercial property lending and investment are therefore likely in the period ahead.

The vulnerabilities created by relatively high leverage among some euro area non-financial firms and in some parts of the household sector could be revealed by an economic downturn that is more severe than currently expected. Such developments, if they were to crystallise, could contribute to an increase in insolvencies, leading to losses on securities backed by European corporate loans and mortgage assets, as well as to an increase of loan losses for banks. In addition, the public finances in some countries appear to be vulnerable to the possibility of

spill-overs of stresses in both the financial and non-financial sectors.

OVERALL ASSESSMENT OF THE EURO AREA FINANCIAL STABILITY OUTLOOK

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 LCBGs 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 after the finalisation of the December 2008 FSR. Importantly, however, capital buffers have been rebuilt through mitigating actions taken by these LCBGs themselves, as well as through the injection of capital by governments, and the securities prices of these institutions have responded positively. However, the rebounds of these securities prices only brought bank share prices and CDS spreads back to the levels prevailing at the end of November 2008. At the time of the finalisation of this issue of the FSR, a number of market indicators continued to suggest that markets were not fully convinced that the buffers LCBGs have in place will prove sufficient to cope with the challenges and risks that lie ahead. This may well reflect persistently excessive risk aversion on the part of market participants, while it is also important to bear in mind that the impairment of liquidity across a range of financial markets has undoubtedly weakened their indicator properties.

Because capital buffers have been maintained well above the minimum regulatory requirements, most euro area LCBGs appear to be sufficiently well capitalised to withstand severe but plausible downside scenarios. However, there is a concern that many of the risks identified in this issue of the FSR could materialise if the global economic downturn proves to be deeper and more prolonged than currently expected. In particular, 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, the possibility of significant balance sheet strains emerging among insurers and the possibility of 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, the possibility of an even more severe than currently projected economic downturn in the euro area and the possibility of an intensification of the stresses already endured by central and eastern European countries.

All in all, notwithstanding the measures that have been taken by the Eurosystem and governments in the euro area to stabilise the euro area financial system and the recent recovery of the equity prices of most LCBGs, policy-makers and market participants will have to be especially alert in the period ahead. There is no room for complacency because the risks for financial stability remain high, especially since the credit cycle has not yet reached a trough. Banks will therefore need to be especially careful in ensuring that they have adequate 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 well include adapting their business models to the challenging operating environment. At the same time, banks should be alert in ensuring that risks are priced appropriately, but not excessively or prohibitively so. 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 capacities and protect sound business lines from the contagion risks connected with troubled assets.