I OVERVIEW

Continued fragilities since the last FSR…

The significant financial market turmoil experienced late last year gave way to some respite in the early months of 2012. This relative calm, however, has proven to be fragile and renewed pressures have again emerged since April. Volatility has continued to afflict the euro area financial system – inherent in several market-based indicators, such as bond yields and derivative prices, as well as in other more general measures of market volatility. Recent stress has differed, however, from that witnessed at the end of last year. In particular, concerns now appear to differ across entities depending on specific underlying fundamentals and have moved away from generalised self-fulfilling expectations that threatened an indiscriminate seizing up of liquidity with systemic consequences.

… notwithstanding two avenues of policy initiatives…

Two distinct avenues of policy action have been pivotal in attenuating financial stability strains within the euro area. On one hand, resolute Eurosystem measures have allayed notions of a funding-related liquidity squeeze for euro area financial institutions. On the other hand, cumulative political action is leading towards a comprehensive strategy to address the ultimate root causes of the euro area crisis. Critical within the latter set of measures has been the approval of several legislative initiatives that include changing the governance of the Stability and Growth Pact and introducing a new macroeconomic imbalances procedure, the approval of the so-called fiscal compact and the enhancement of the size and scope of the euro area's financial firewall to protect Member States. All of these reforms implied progress in policy-setting frameworks at the national level, accompanied by concrete policy measures in several Member States.

… with several risks still pressing

Continued turbulence related to specific markets and countries in the first half of 2012 confirms the remaining fragilities in the financial stability outlook. This, in turn, has demonstrated that there is no room for complacency, either on the part of governments or on that of banks. In particular, as described below, Member States should step up their initiatives to strengthen the fiscal and banking components of a robust monetary union.

KEY RISKS TO EURO AREA FINANCIAL STABILITY

Three key risks to euro area financial stability

Measures of systemic stress have been volatile, signalling some renewed tensions, but have nonetheless remained below their peaks – not least on account of the impact of policy action that averted the materialisation of widespread funding-based systemic stress. At the same time, several core risks identified in the December 2011 Financial Stability Review (FSR), and the interplay between these risks, have remained intact (see the table below).

Key risks to euro area financial stability

	Systemic attributes	Current level and evolution[1]
1. Potential aggravation of the debt crisis for euro area sovereigns	Unwinding of imbalances and contagion	→ (red)
2. Bank profitability risk stemming from weaker economic growth and associated higher credit and asset valuation losses	Aggregate shock	↑ (orange)
3. Excessive pace of deleveraging of the banking sector due to frontloaded changes to banks' business models	Unwinding of imbalances	↓ (orange)

1) The *colour* indicates the current level (with red representing considerable systemic risk, orange systemic risk and yellow potential systemic risk). The current level of risk is a combination of the probability of materialisation and an estimate of the likely systemic impact of the identified risk, based on the judgement of the ECB's staff. The *arrows* indicate the change since the previous FSR.

Key risk 1: Potential aggravation of the debt crisis for euro area sovereigns

Sovereign fragilities remain…

The first – and arguably most concerning – key risk to euro area financial stability relates to sovereign vulnerabilities at the heart of this stage of the financial crisis, the origins of which lie half a decade in the past. A resurgence in sovereign market tensions within some euro area countries has implied renewed increases in bond yields, along with signs of tension in bond markets. The containment and reversal of such trends rests upon action to address vulnerabilities that persist amongst several sovereigns. It is clear that several euro area countries need to repair both their fiscal positions and prospects, as do other major advanced economies.

… with the interplay of fiscal, economic and financial vulnerabilities

There are several reasons for investors' persistent risk aversion that relate to the main underlying factors influencing fiscal sustainability. First and foremost, reducing both fiscal stock and flow imbalances requires unwavering commitment, and a reactive approach to prevailing market pressure needs to be avoided. Second, a weak growth outlook plagues several euro area countries, along with uncertainty about the rigour of implementation of structural reforms and their effectiveness in terms of raising competitiveness and productivity. Third, uncertainty regarding contingent liabilities related to remaining financial adjustment, as well as uncertainty regarding the robustness of backstops, may reinforce negative feedback loops.

Until such time as these risks to fiscal sustainability have been convincingly addressed – and the associated backstops for the banking sector strengthened – the risk of a potential aggravation of the sovereign debt crisis remains key to euro area financial stability.

Key risk 2: Bank profitability risk stemming from weaker economic growth and associated higher credit and asset valuation losses

Credit risk still abounds in several countries…

Weakened economic prospects can imply increasing vulnerabilities in the non-financial sector, particularly in those jurisdictions in which leverage is high. Systemic risks stem from an adverse impact on the credit risks confronting banks and from possible balance sheet effects, with the most pronounced consequences having the potential to affect those countries with a legacy of property excesses.

… with associated vulnerabilities for banks…

… and a key role for macroeconomic prospects

While specific vulnerabilities faced by euro area financial institutions in the sphere of credit are quite heterogeneous across euro area countries, the main aspects can be broken down into three broad categories. First, a high degree of non-financial private sector leverage in several euro area countries implies fragilities in their debt-servicing capacities, albeit mitigated by the current low interest rate environment. Second, declining property prices in several countries may yet entail a prospective need for eventual further mark-downs on the value of banks' commercial and residential property loan portfolios – notwithstanding the mark-downs that have already taken place – with forbearance a key issue to be monitored in this context. Third, a deterioration of the euro area and/or global economic outlook could not only create asset price volatility, but also more generally weaken both banks' asset quality and borrowers' collateral values, thereby prompting restrictions in credit availability and amplifying the financial and macroeconomic downturn. Such a downturn could be triggered by exogenous factors, such as an oil price shock as a consequence of an escalation of geopolitical tensions or a hard landing of a key emerging market economy. Furthermore, interaction with the sovereign key risk mentioned above is a particular concern: in order to help contain any contractionary impact of the (necessary) aggressive frontloading of fiscal consolidation measures, appropriate policies for economic growth are needed, including, notably, growth-enhancing structural measures in euro area countries.

Key risk 3: Excessive pace of deleveraging of the banking sector due to frontloaded changes to banks' business models

Adjustment to a more resilient model continues…

Many euro area banks face a structural need to deleverage and enhance their resilience by improving their capital bases and changing their funding structures. As indicated in this FSR, the cumulative medium-term reduction in leverage within the euro area banking sector could exceed €1 trillion – although it must be acknowledged that there are many uncertainties surrounding estimates of the overall extent of adjustment. Irrespective of the quantitative aspects of such adjustment, in qualitative terms, it represents an integral part of bringing the economy back to a more sustainable post-crisis equilibrium when considered alongside re-optimised business models. Along the path to this new equilibrium, however, there remain risks of a pro-cyclical adjustment that is detrimental to financial stability, risks that require close monitoring.

… timely ECB action supports (but does not replace) needed adjustment…

The funding certainty provided by the wide-ranging liquidity support measures taken by the Eurosystem have significantly attenuated pro-cyclical deleveraging pressures on euro area banks. Funding challenges nonetheless remain in view of the need for fundamental changes to business models. In this respect, central bank actions support, but cannot replace, the necessary steps to be undertaken by banks to create stable funding structures that are suitable for a post-crisis environment. Concrete changes in this regard include closing significant funding gaps (loans minus non-financial private sector deposits), as well as reducing any excessive reliance on volatile funding sources. Liability-side vulnerabilities more generally relate to the role of unsecured funding in the post-crisis liability structure as a consequence of the increased use of secured funding and the resulting higher asset encumbrance. While unsecured funding may not resume the role it played in financing prior to the crisis, secured financing too has clear limitations. In particular, investors' concerns about the increasing subordination of unsecured bank debt, also associated with forthcoming regulatory initiatives on "bail-ins", could place a limit on the rolling-over of unsecured funding.

… to eliminate remaining vulnerabilities

Throughout the crisis, funding fragilities have plagued euro area financial institutions with intermittent threats of widespread asset "fire sales" or a curtailment of financial intermediation for (and associated lending to) the real economy. Addressing such vulnerabilities would not only reduce perceptions of counterparty risk, but could also support a return to an effective euro area interbank market that is free of segmentation and, at the same time, free of reliance on the provision of extraordinary central bank liquidity.

OTHER RISKS

Monitoring to detect incipient risks…

While many relevant factors are captured by the three key risks to euro area financial stability highlighted above, this list – as holds true for any succinct set of risks – cannot capture all prospective sources of financial instability. Financial stability monitoring is much broader in scope – as is clear from the broad sweep of macro-financial issues covered in this Review – requiring attentiveness to signs of emerging risk that is not yet fully formed, but has a destabilising potential.

… including mispricing in the hunt for (safe) yield…

In prioritising numerous potential additional risks to euro area financial stability, one of the issues warranting close monitoring, in fact, stems from the broader financial crisis itself. This refers to pricing distortions created by, in particular, the hunt for perceived "safe" assets that has emerged as a result of the crisis on multiple grounds. First, a perceived erosion of the use of sovereign bonds of several countries as risk-free assets by investors may give way to a search for alternative assets that offer a comparable risk-adjusted return – for instance, sovereign holdings of different geographical

origin or a complete replacement of sovereign holdings by other assets altogether, such as those in the non-financial corporate sphere. Second, the increased asset encumbrance associated with persistently high perceptions of counterparty risk has led to a dwindling supply of assets that are acceptable in the wide-ranging world of securities financing and repo transactions – activities often considered part of the so-called "shadow banking" sector. While these two examples need not necessarily give rise to systemic risks, any under-pricing of risk as a result of shifting patterns of demand against the background of a limited supply may sow the seeds for the emergence of price bubbles that are subject to sudden and/or unruly unwinding.

… and improved data to avoid "unknown unknowns"

Not least with this in mind, initiatives aimed at shedding more light on certain areas of the financial system must be fostered. Progress continues to be made in improving transparency and the capacity for effective monitoring, particularly in areas where detailed or even basic information is currently lacking – as in the case of, in particular, indicators for monitoring non-bank activity. This is vital for financial stability, given the large size of the shadow banking sector in the euro area that, as the ECB has recently estimated, accounts for around half of all banking system assets. This is becoming all the more crucial in an environment where an enhanced regulation of banks cannot be allowed to give rise to a shifting of activities that embed systemic risk to less regulated areas of the financial system. Beyond this, efforts to obtain more information on financial innovation would also be warranted – including details of those developments that have altered market microstructures, such as exchange-traded funds, as well as algorithmic and high-frequency trading.

POLICY INITIATIVES TO ADDRESS THE CRISIS AND STRENGTHEN THE EURO AREA

Root causes of the crisis must be addressed

While the worst market manifestations of crisis may have passed, there remains a clear need for a continued focus on tackling its root causes. Indeed, a recent resurgence in financial market concerns serves as a timely reminder that market pressure cannot – and should not – be a requisite factor for sustained policy efforts that foster enduring financial stability, which had suffered from deficiencies at both the national and the euro area level.

The role (and limits) of ECB support

Exceptional ECB action has played a crucial role in bringing market stress down from the heights reached at the end of last year. Within the broad toolkit of non-standard monetary policy actions, the three-year longer-term refinancing operations (LTROs) had a clear purpose, namely to prevent a disorderly deleveraging that could have led to a credit crunch. In this sense, a "tail event" involving a collapse in lending activity was prevented. Clear evidence of this is provided by the comparison of the most recent ECB bank lending survey for the first quarter of 2012 with that for the preceding quarter, which indicates a marked fall in credit supply restrictions by banks. More generally, apart from the fact that data on aggregate loan developments do not fully distinguish the loan supply from loan demand, such data must be evaluated against this counterfactual scenario of a credit crunch. And, importantly, it is clear that liquidity should now be more accessible to small and medium-sized enterprises, as evidenced by the several hundreds of smaller banks participating in Eurosystem operations. Aside from this, the operations appear to have had more wide-ranging impacts, including reduced liquidity stress in the interbank market. Ultimately, this action has mitigated liquidity-induced solvency strains in otherwise viable financial entities – while apparently leading to a general reduction of risk aversion in conjunction with lower funding costs for many banks. The ECB's non-standard measures, which were designed to combat exceptional stress, have not of course left the preferences of banks and investors unaffected, as holds true for any other policy measure. Close monitoring is therefore required to assess the risks associated with any undue strengthening of the links between

financial entities and sovereigns, as well as any undue reliance on central bank funding observed, for instance, in aggregate monetary flows and asset encumbrance.

Breathing space for governments and banks…

The three-year LTROs were never meant to be a substitute for other forms of policy action. Exceptional and temporary non-standard central bank monetary policy measures have created breathing space that must be used wisely and effectively. First and foremost, banks must adjust towards viable business models at a reasonable pace in order to maintain the intermediation function for the economy. In the near term, this includes their retaining profits, as well as robust efforts to foster a stronger capital base in order to facilitate their regaining access to market funding. Moreover, prudent risk management needs to be a cornerstone of balance sheet management, and this requires the avoidance of temptations to search for yield on the basis of temporary enhanced public support measures. Second, governments must use the time gained by these LTROs in a decisive manner to enact reforms and lay the political foundations for a stable economic (as well as monetary) union. In this respect, it is useful to recall the fundamental reasons behind this stage of the five-year-old global financial crisis: a deficit bias and a problem of competitiveness that require the problem of real imbalances to be addressed at the euro area level.

… for rigorous implementation of five-point strategy…

Concretely, a proactive (and not reactive) rigorous policy implementation in the five areas presented last year as a comprehensive response to the crisis remains key to decisively ending a spiral of systemic risk augmentation. First, continued action is needed to substantiate commitments at the national level to *both* ensure fiscal discipline *and* accelerate structural reforms for growth and employment. Second, a strong and credible backstop is needed to halt the downward spiral of self-fulfilling dynamics in the pernicious interplay between sovereign, banking and macroeconomic forces – building upon a consolidated fiscal position of the euro area that is strong in comparison with the situation in other developed economies. Third, durable changes to banking models must complement temporary Eurosystem support and provide *lasting* funding certainty, to accompany the strengthening of the capital base of European banks in the first half of 2012. Fourth, continued progress is needed to eliminate political and economic uncertainty not only to stem the forces of contagion but also to provide a more solid basis for markets to manage risk. Fifth, measures to strengthen economic and fiscal surveillance, and to enhance governance, must be taken and not remain contingent on market-driven pressure – thereby providing credible reassurance that the crisis that has engulfed the euro area over the last few years will never be permitted to recur.

… alongside steps towards a banking union as a complement to Monetary Union

While these five areas provide the necessary critical foundations upon which a sustainable monetary union must be based, there is a need to go beyond these areas and conceive a *banking union* as an integral counterpart of *Monetary Union*. Such a banking union would be predicated upon three main objectives. First, strengthening the euro area-wide supervision of the banking sector in order to reinforce financial integration, mitigate macroeconomic imbalances and, therefore, improve the smooth conduct of the single monetary policy. Second, breaking the link between banks and sovereigns – which significantly exacerbates the impact of any financial disturbance – also by establishing a European deposit guarantee scheme and EU-wide crisis resolution arrangements. And, last but not least, minimising the risks for taxpayers through adequate contributions by the financial industry. These reforms will certainly take time to implement and may require substantive legal changes, including in primary legislation.

REGULATORY INITIATIVES TO BUILD A SAFER GLOBAL AND EUROPEAN FINANCIAL SYSTEM

Post-crisis regulatory model…

Alongside the aforementioned measures that would strengthen the foundations of Monetary Union, numerous supervisory and regulatory initiatives taken in response to the broader financial crisis have been proceeding steadily. This agenda, necessary to strengthen the resilience of the financial sector, consists of many key elements that form a post-crisis architecture, which also fits into the broader context of the ongoing strengthening of the regulatory environment at the global level. Indeed, an international coordination of these endeavours is critical to bolster global financial stability in a world of internationally mobile capital.

… including Basel III liquidity and capital standards…

Of the various regulatory initiatives under way, the implementation of the new Basel III capital and liquidity standards must continue to be given high priority – indeed, G20 jurisdictions have been called upon to deliver on their commitment to implement these standards by the end of 2012. To this end, the Basel Committee on Banking Supervision has proposed a three-stage implementation review. In the first stage, countries will carry out a self-assessment of their domestic rule-making processes. In the second stage, the Basel Committee will review the consistency of national rules or regulations with Basel III. Finally, in the third stage, the consistency of the measurement of risk-weighted assets across both banks and jurisdictions will be reviewed. The first review is already under way, covering the EU, the United States and Japan.

… and their EU counterpart, CRD IV

At the EU level, the transposition of Basel III into EU law through an appropriate directive and a regulation on capital requirements – the new *Capital Requirements Directive* (CRD IV) – has shown the willingness in Europe to implement the newly agreed standards in a timely manner. The ECB's Opinion on this proposal, published in January 2012, expressed support for the establishment of a single European rulebook for all financial institutions, while also providing national authorities with the necessary flexibility to adopt stricter requirements in order to address country-specific financial stability concerns that reflect structural and cyclical differences across domestic financial systems. This includes scope to impose tighter quantitative requirements, while not compromising common definitions for capital ratios and for limits on large exposures, as well as for liquidity and leverage ratios. The European Systemic Risk Board is ideally placed to assume a monitoring and coordinating role in ensuring consistency and in assessing where departures from harmonised regulatory levels give rise to any financial stability concerns, including possible spillovers to other Member States. This will also require an environment of high transparency on the part of all authorities responsible for both macro and micro-prudential supervision.

Complementary efforts to identify systemically important entities…

In parallel to Basel III, work has continued on identifying systemically important financial institutions (SIFIs), which is crucial for addressing the negative externalities and moral hazard issues linked to the problem of their being "too big to fail", a problem that has to be resolved or mitigated. The Financial Stability Board (FSB) has continued to focus on developing a comprehensive policy approach to address the risks associated with SIFIs. In November 2011, specific measures were announced for global systemically important banks (G-SIBs), including a common equity capital surcharge. In the first half of 2012, in line with the G20 mandate, work was under way to appropriately extend this framework to cover other SIFIs, in particular domestic systemically important banks (D-SIBs) as well as other non-bank entities. This agenda needs to see progress in a way that addresses the key role such entities play with respect to financial stability.

… and to improve the regulation of the "shadow banking" sector

The regulatory agenda has not been restricted solely to the banking sector. There have also been substantial efforts to prepare policy recommendations addressing the "shadow banking" sector – or activities related to credit intermediation, liquidity and maturity transformation that take place

outside the regulated banking system. Given the breadth and inherent complexity of these activities, this is being concretely addressed by the FSB through five different work streams, while also relying on the support of international standard-setters. Two of these work streams address specific regulatory issues, including the regulatory treatment of money market funds and securitisation. The other work streams assess broader issues, such as the banks' interactions with shadow banking entities, the need for new regulation on shadow banking entities, and systemic risks stemming from practices in securities financing and repo markets.

These initiatives represent only a sub-set of the ambitious and comprehensive regulatory reforms that are under way, albeit an important one. Ultimately, this broad regulatory reform agenda will significantly strengthen the resilience of the international financial sector.

RECENT DEVELOPMENTS

Recent developments underscore continued fragilities…

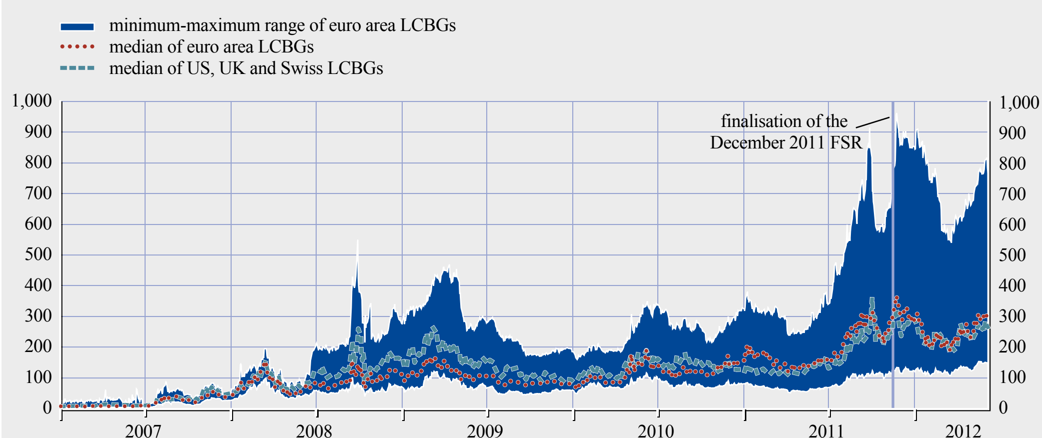
Since the cut-off date for this FSR in mid-May, fragilities in some euro area sovereigns and banks have contributed to continued volatility in financial markets.

… where banks are concerned…

Where *banks* are concerned, the equity prices of euro area financials have exhibited some volatility while generally continuing on the declining path highlighted in this FSR (see Chart 3.17). This development underscores not only strong interlinkages, but also severe headwinds – both macro-financial and regulatory – to be found along the path to more sustainable post-crisis models. This equity market pricing has been mirrored by increasing concern in the derivatives market about the health of large and complex banking groups (LCBGs) – similarly in the euro area and at the global level (see Chart 1). The dynamics of market pricing have reflected the headwinds encountered by banking sector profitability, as revealed in the results for the first quarter of this year – albeit with improved regulatory capital ratios.

Chart 1 CDS spreads of euro area and global LCBGs

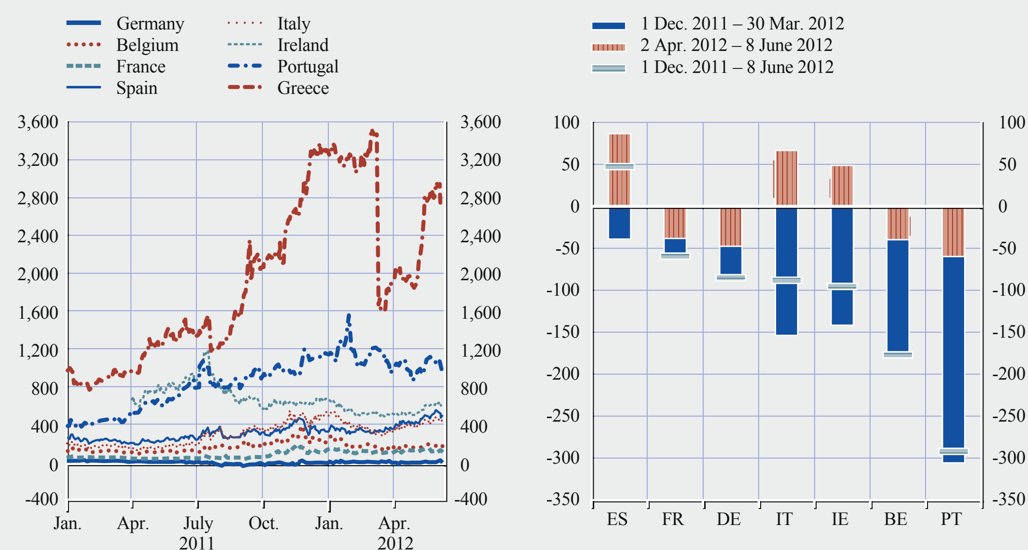
(Jan. 2007 – 8 June 2012; basis points; senior debt; five-year maturity)



Sources: Bloomberg and ECB calculations.

Chart 2 Spread between ten-year euro area sovereign bond yields and the ten-year overnight index swap rate

(Jan. 2011 – 8 June 2012; basis points)



Sources: Bloomberg and ECB calculations.
Note: The euro overnight index swap rate, rather than German government bond yields, was used in order to account for the impact of flight-to-safety flows into German government bonds.

… and where sovereigns are concerned

Where euro area *sovereigns* are concerned, bond spreads have continued to be highly volatile, most notably in Greece where political uncertainty has continued to contribute to the observed renewed sharp increase (see Chart 2, left-hand panel). Recent developments in the bond spreads of other euro area countries, however, have been more muted. Indeed, when put in a broader recent historical context, these movements represent only a partial reversal of the marked decline in sovereign risk premia seen at the beginning of the year for most countries (see Chart 2, right-hand panel).

Request by Spanish authorities

Turning to specific recent policy developments, the Eurogroup was informed on 9 June that the Spanish authorities will present a formal request for recapitalisation of financial institutions. The financial assistance will cover all possible capital requirements to be estimated by the diagnostic exercise which the Spanish authorities have commissioned to external evaluators and international auditors. The amount of the assistance will cover such capital requirements with an additional safety margin, estimated as summing up to €100 billion in total. This development will make an important contribution to ease existing banking vulnerabilities in the euro area.