



EUROPEAN CENTRAL BANK

Financial Stability Review

June 2006

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Frankfurt am Main, 1 June 2006

Outline

- **Overview of main risks and vulnerabilities**
- **Global macro-financial environment**
- **Euro area economic environment**
- **Euro area financial system**
- **Overall assessment**

Outlook for financial stability - overview

Since the December 2005 Financial Stability Review, the outlook for financial stability has remained broadly favourable:

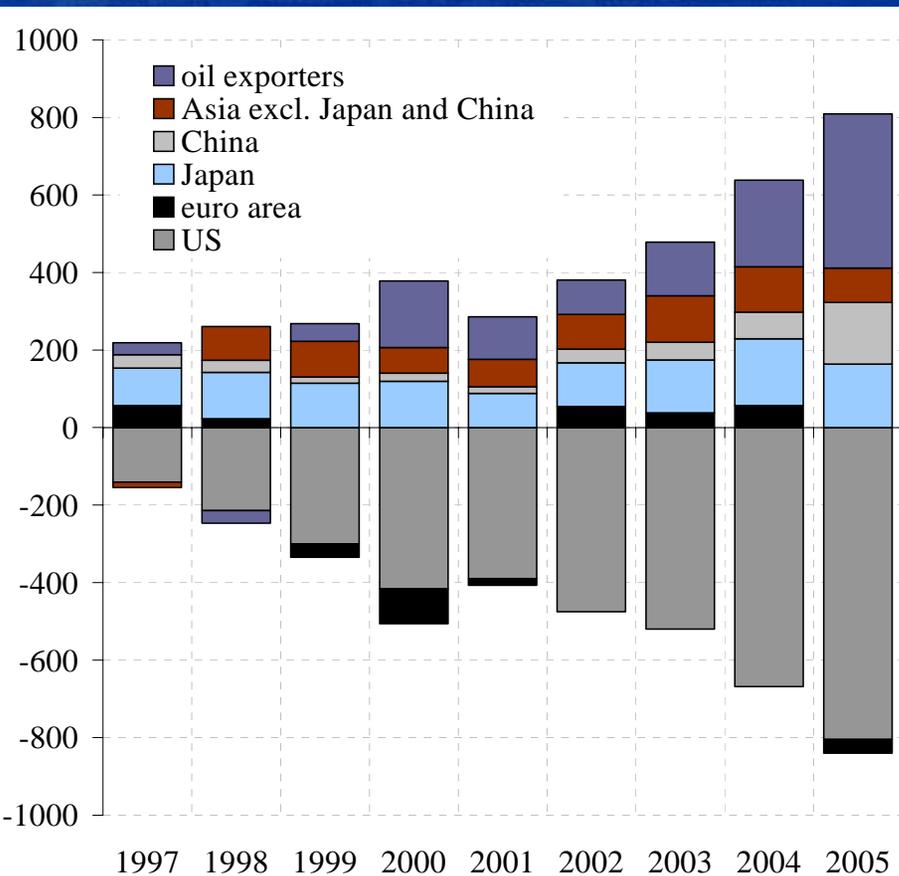
- Global economic activity continues to be buoyant and has become more evenly distributed
- Profitability of global and euro area banks has been strong and solvency ratios are comfortable

But risks and vulnerabilities remain, and some have grown further, including:

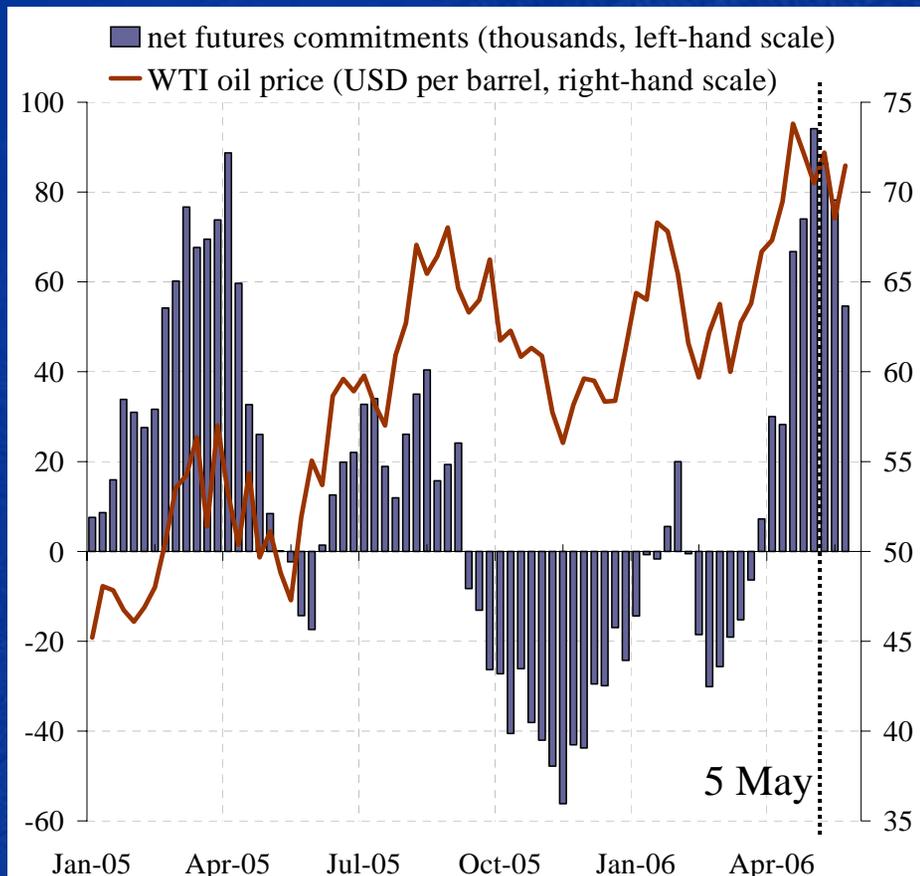
- A further widening of global imbalances, posing medium-term risks of disorderly correction
- A tightening of liquidity conditions in the G3 economies could expose vulnerabilities in asset pricing following a protracted period of hunt for yield
- A maturing global corporate sector credit cycle has the potential to generate tensions in global financial markets, especially credit derivatives

Global financial imbalances and oil prices remain key external risks to financial stability

US current account deficit and its counterparts (USD billions)

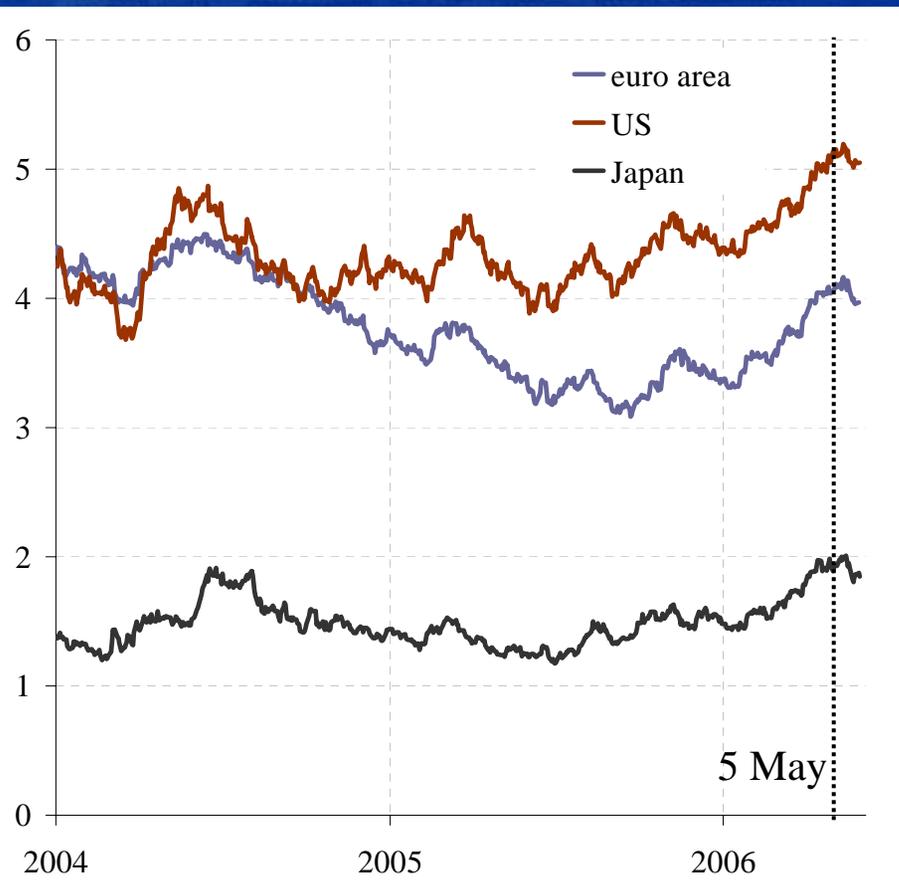


Speculative positions on oil futures and oil prices

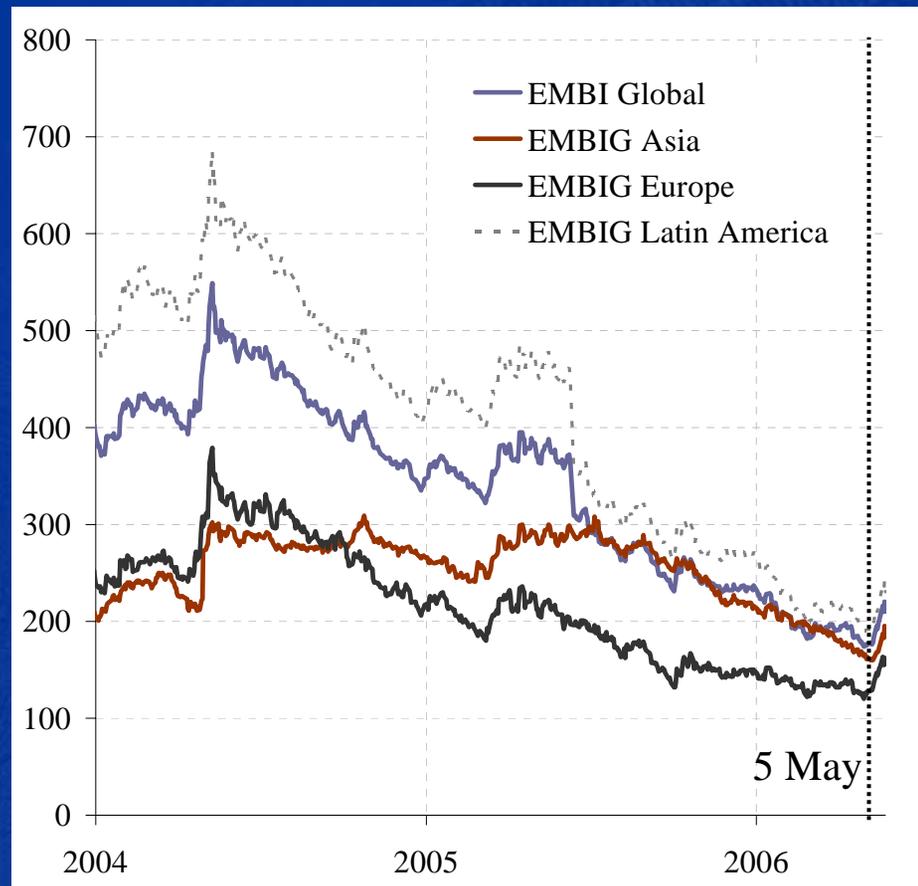


Increased awareness of risks may have triggered a start in the unwinding of the global hunt for yield

Ten-year government bond yields (%)

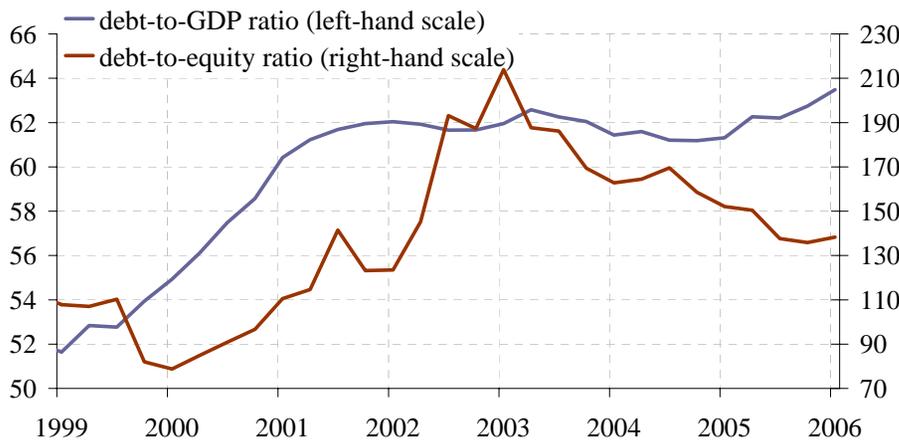
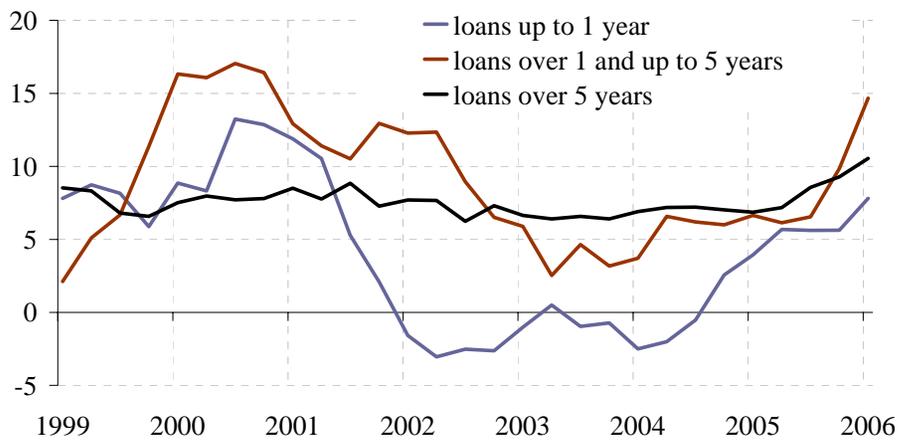


Emerging market sovereign bond spreads (basis points)

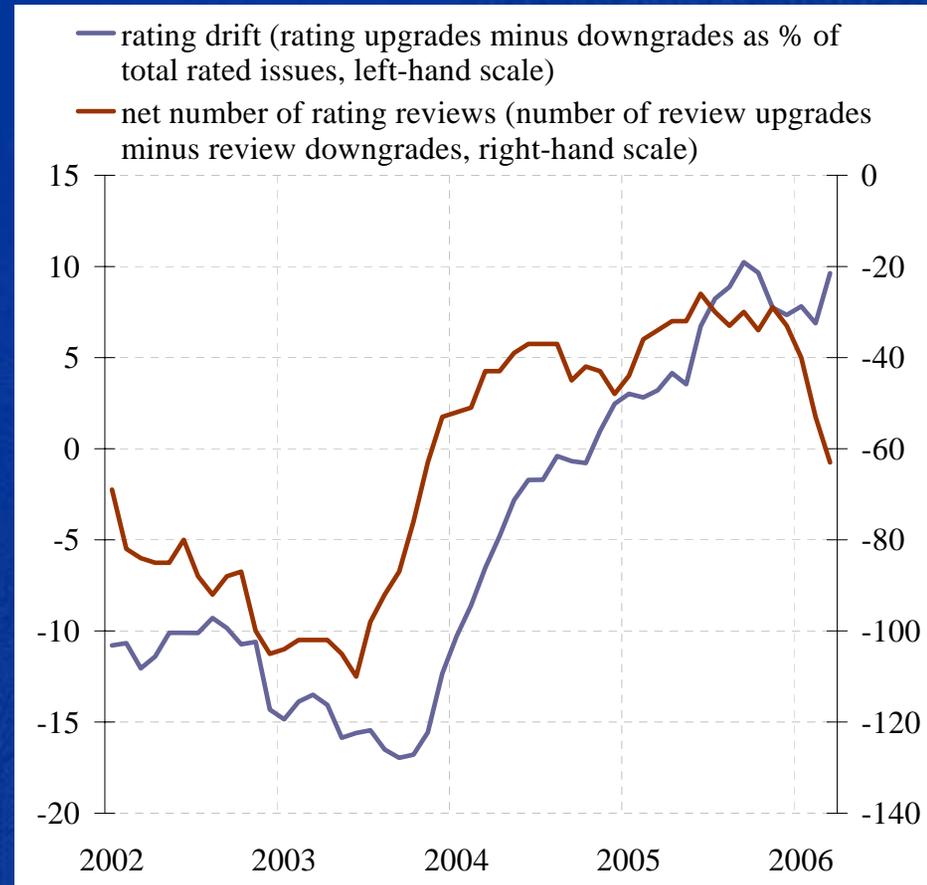


Euro area corporate sector re-leveraging may imply credit risks going forward

Annual growth in loans to and total debt of non-financial corporations in the euro area

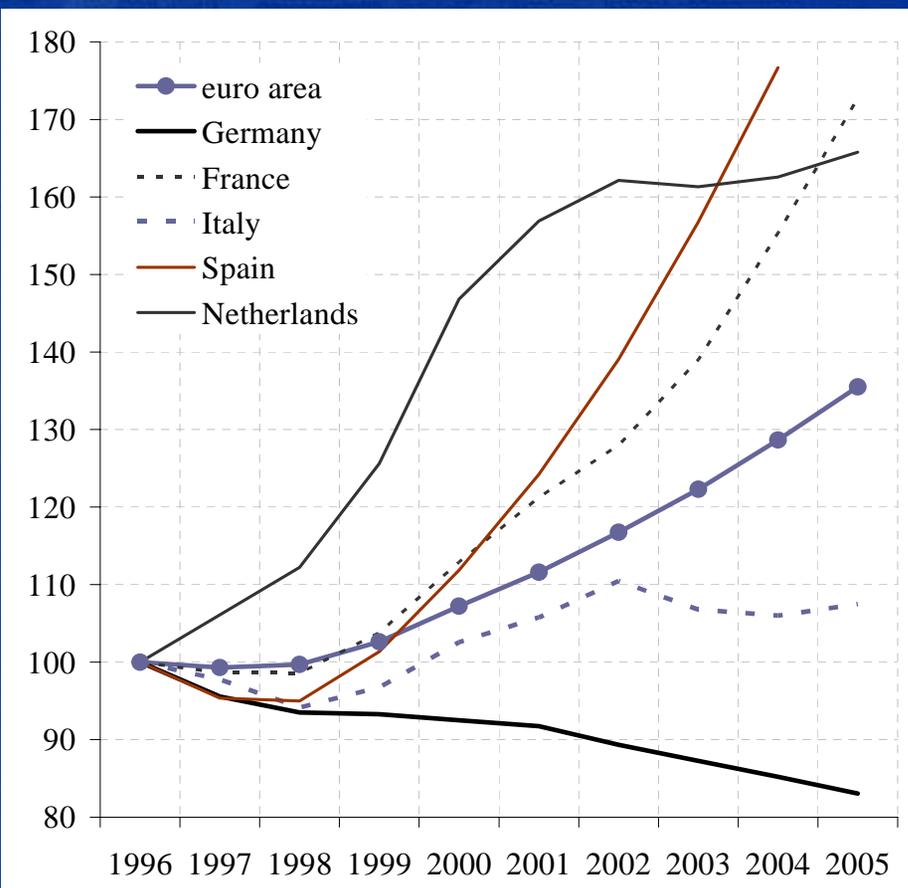


Credit rating drift and net number of issuers placed under rating review

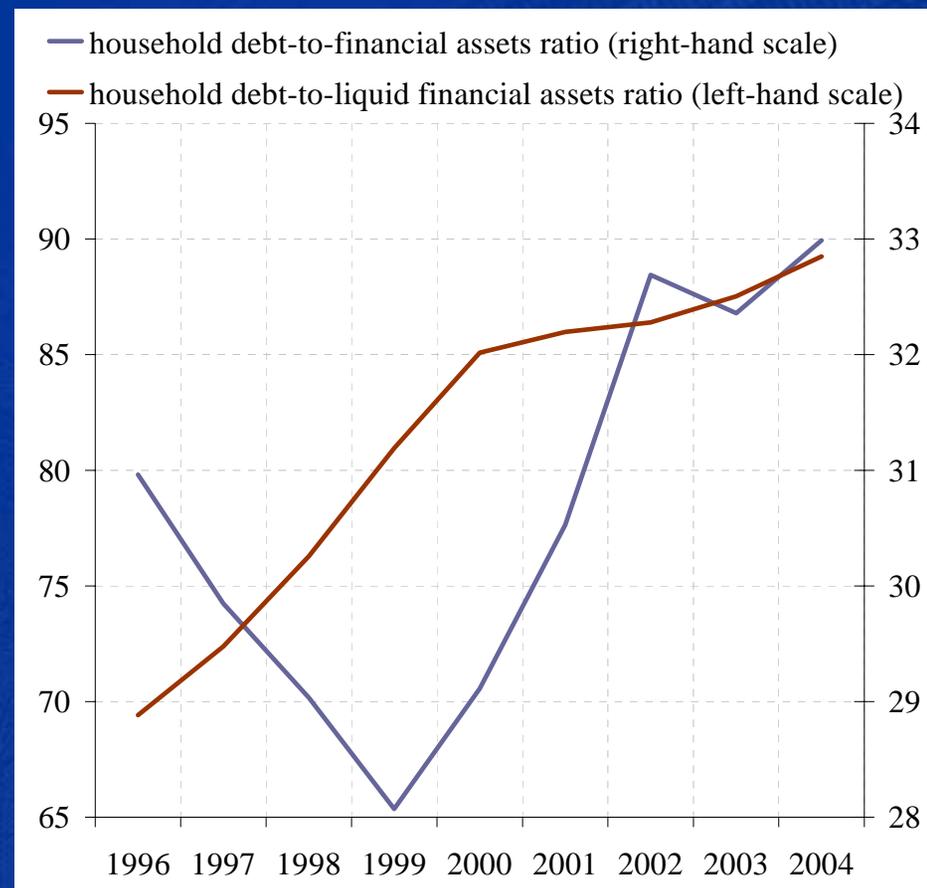


Euro area household sector balance sheets expand further and risks increase

House price-to-rent ratio for the euro area (index: 1996 = 100)

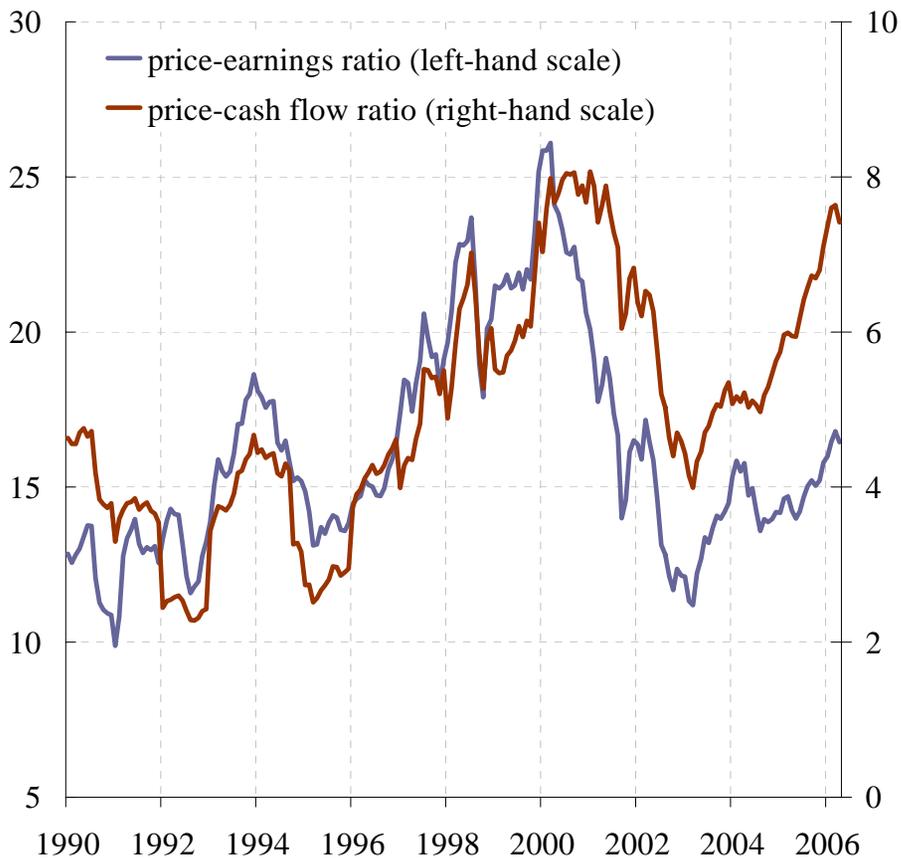


Ratios of household debt to financial assets and liquid financial assets in the euro area (%)

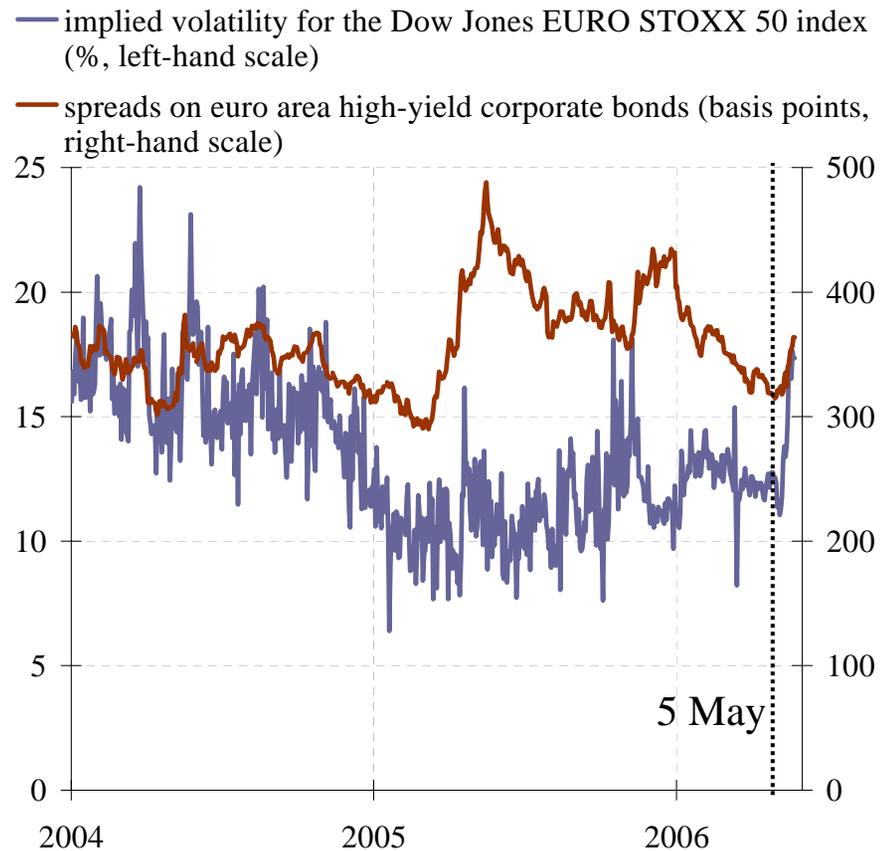


Developments in euro area equity valuations – uncertainty on the rise

MSCI euro area price-earnings and price-cash flow ratios (%)

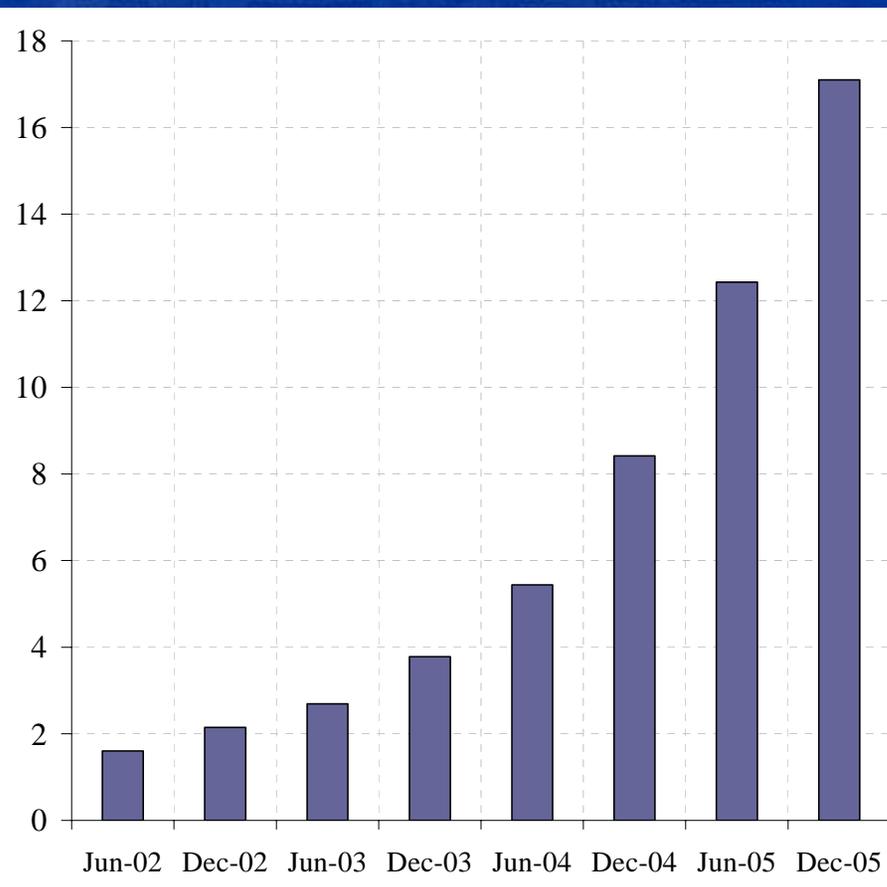


Euro area stock market implied volatility and spreads on high-yield bonds

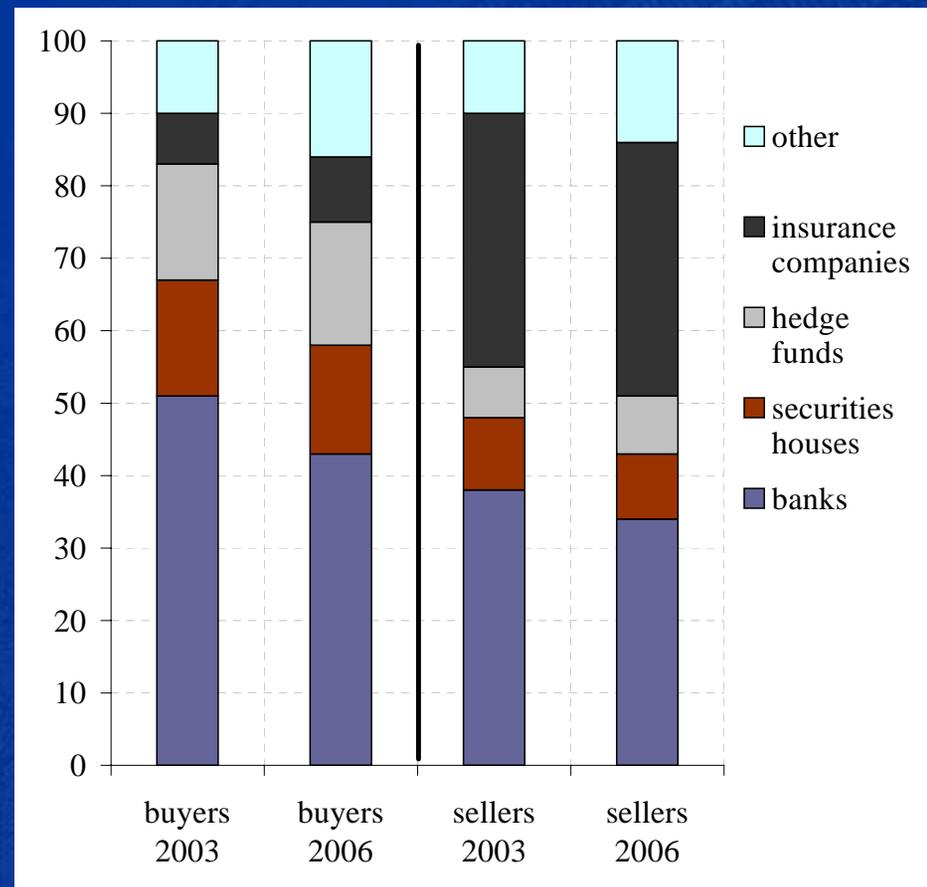


Rapid growth in credit risk transfer markets may have brought new risks

Notional principal outstanding in the global credit default swap (CDS) market (USD trillion)



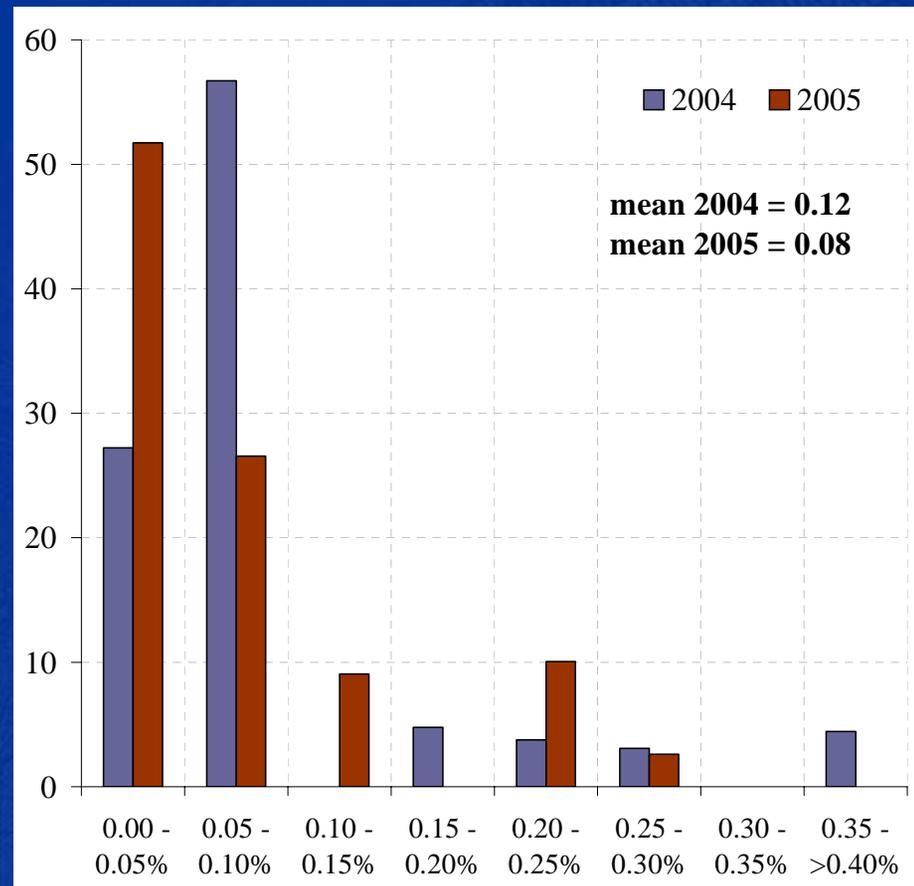
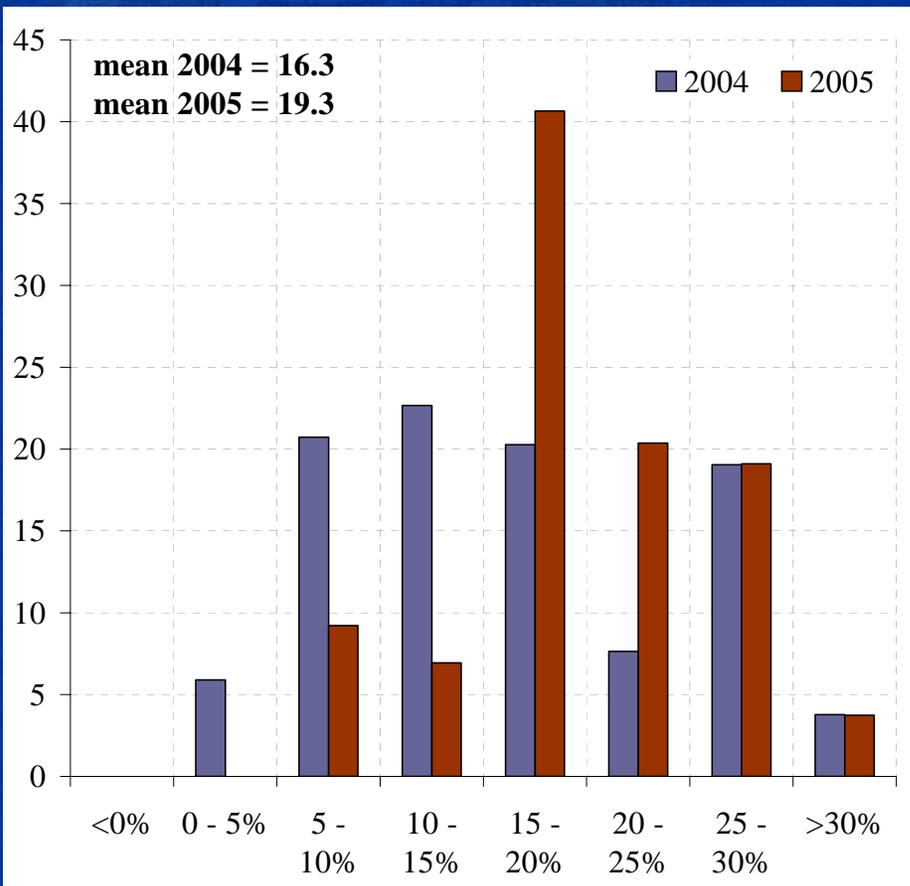
Market participants in credit derivatives markets (% of total)



Euro area banks' profits improved further but impairment charges provide thin buffers

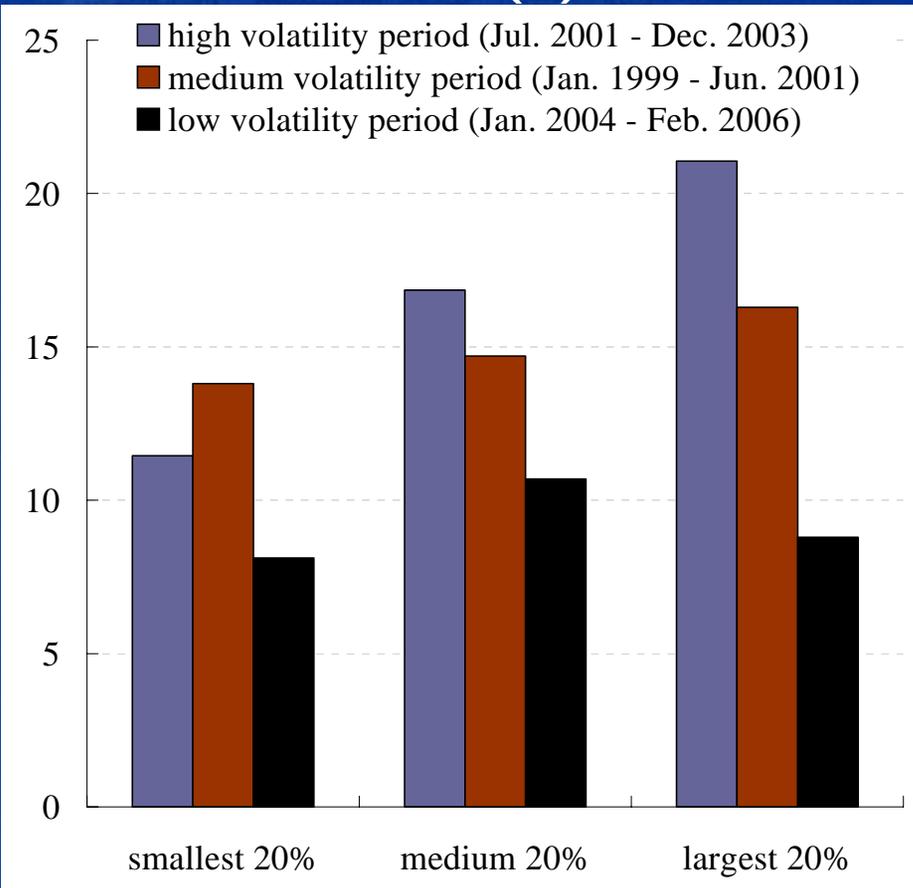
Frequency distribution of return on equity (ROE) of large euro area banks (%)

Frequency distribution of loan impairment charges of large euro area banks (% of total assets)

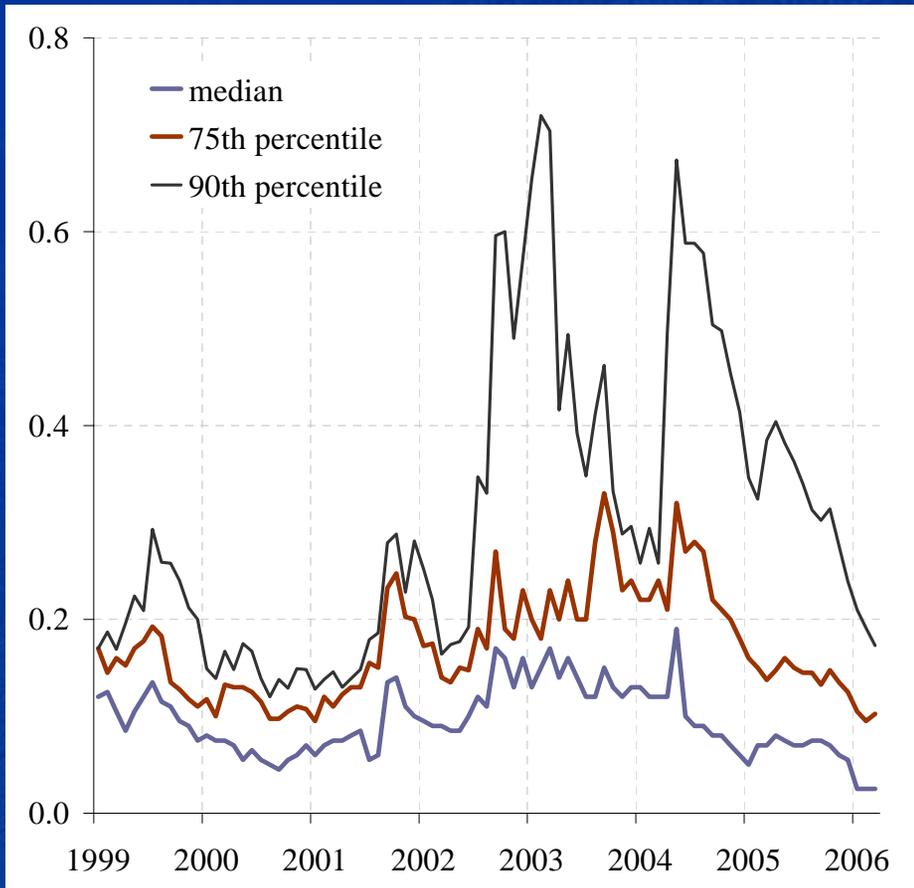


Banks' market risks are rising but indicators suggest comfortable shock-absorption capacity

Tail risk of stocks on Dow Jones EURO STOXX bank index in size clusters and under different market conditions (%)

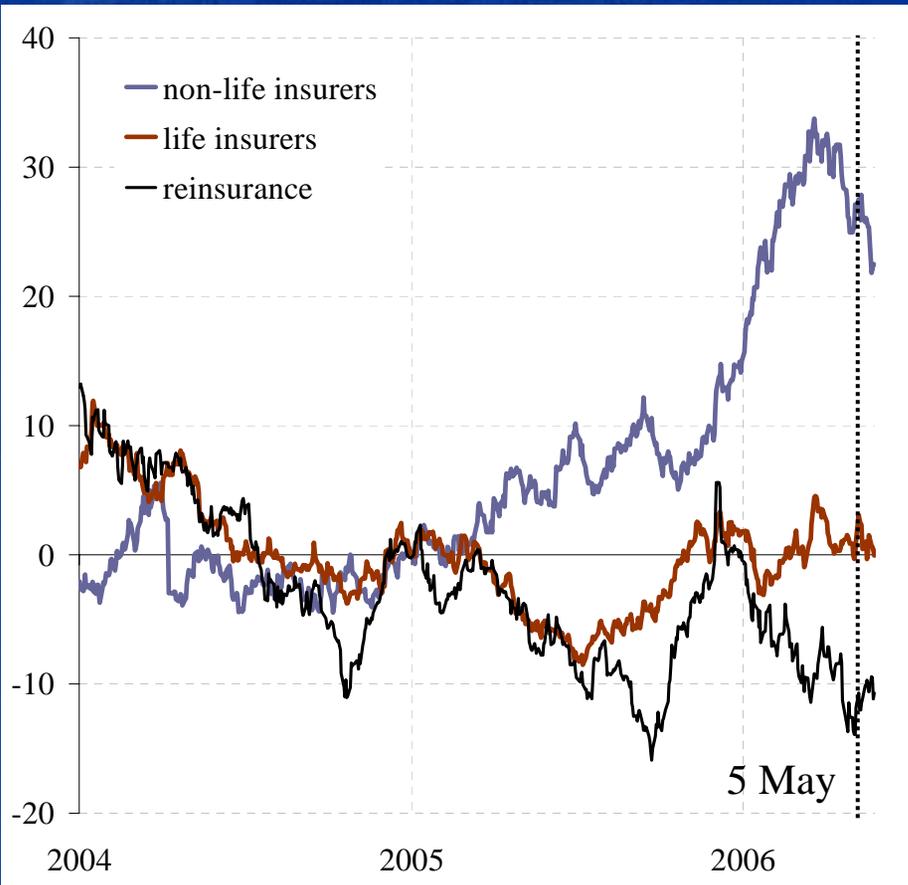


Expected default frequencies (EDF) for large euro area banks (% probability)

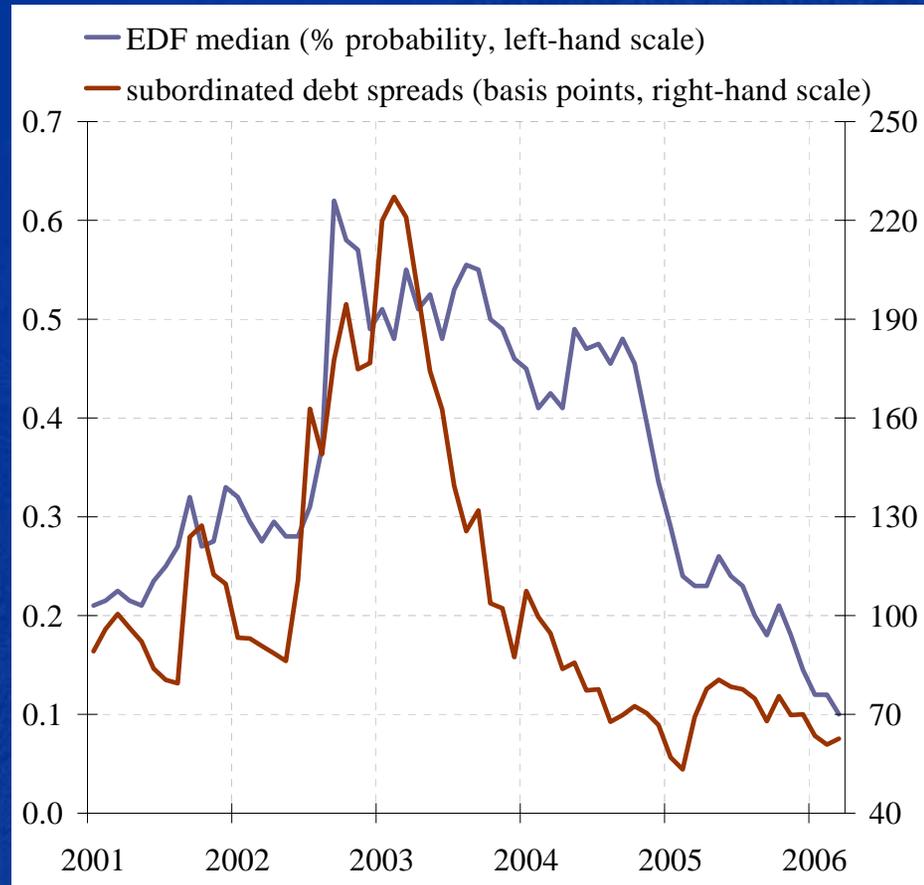


Euro area insurance sector shows further improvement and signs of resiliency

Euro area insurance sector stock indices relative to the Dow Jones EURO STOXX
(percentage points; Jan. 2005 = 0)

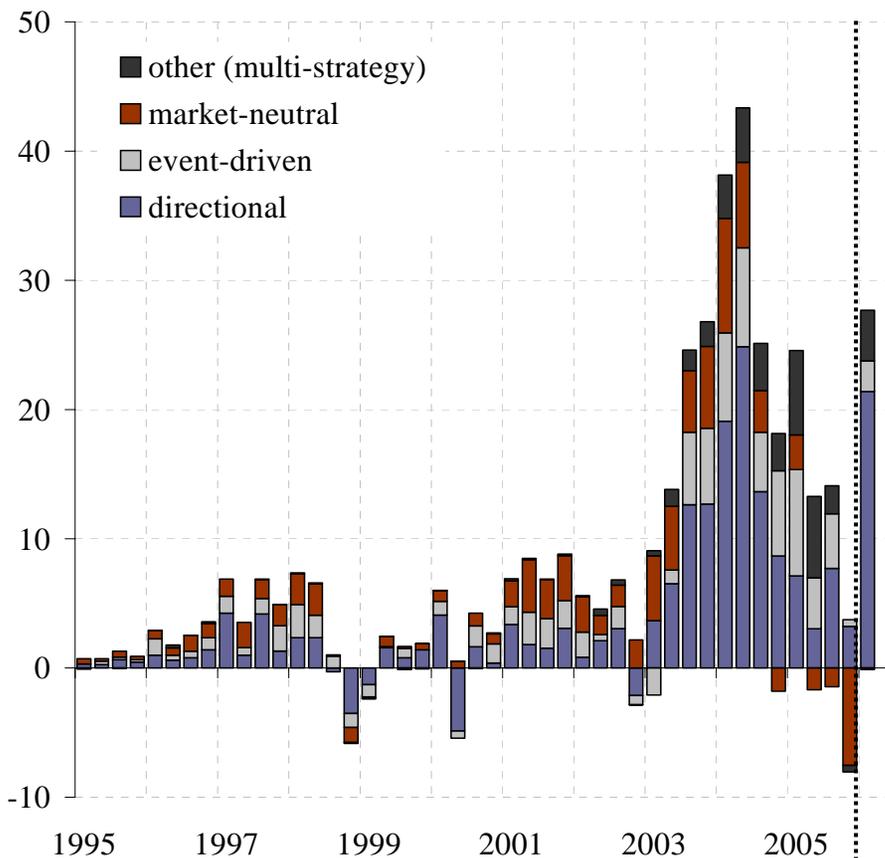


Subordinated bond spreads and expected default frequencies for the euro area insurance industry

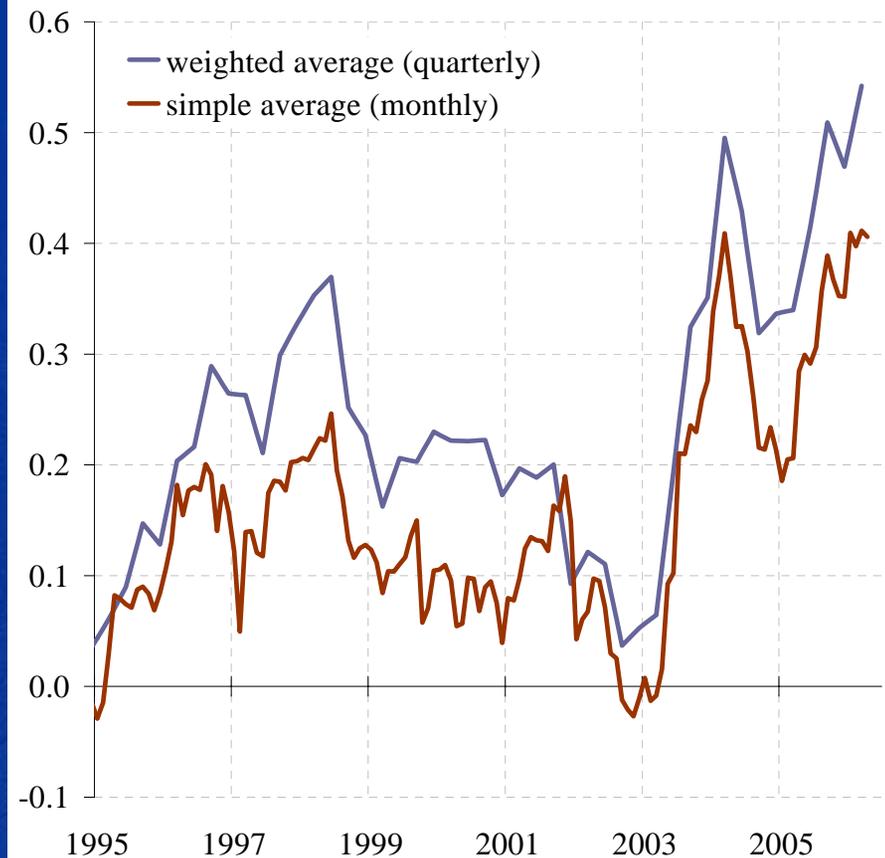


Global hedge funds: fluctuations in inflows and further convergence with regard to returns

Global hedge fund net flows (USD billions)



Correlations of returns among hedge fund strategies



Overall assessment: the scope of financial stability analysis

Drawing attention to sources of risks and vulnerability to financial stability does not seek to identify the most probable outcome.

It rather entails highlighting potential and plausible sources of downside risks, even if the probability of their realisation is relatively low.

Overall assessment in June 2006:

The euro area financial stability outlook rests upon a delicate balance:

- Global economic activity is expected to remain robust and the shock-absorption capacity of euro area financial institutions has improved, but
- Risks and vulnerabilities remain and some have grown further.

Therefore, there is no room for complacency.

While a positive outcome remains the most likely prospect, the possibility that the risk-management systems and loss-absorption capacities of financial institutions may be severely tested, while still small, cannot be excluded.