

# **Financial Stability Review June 2008**

**Lucas Papademos**

Frankfurt am Main, 9 June 2008

## **I The financial market turmoil: overview**

## **II Sources of risk and vulnerability**

**II.1 the global macro-financial environment**

**II.2 the euro area corporate and household sectors**

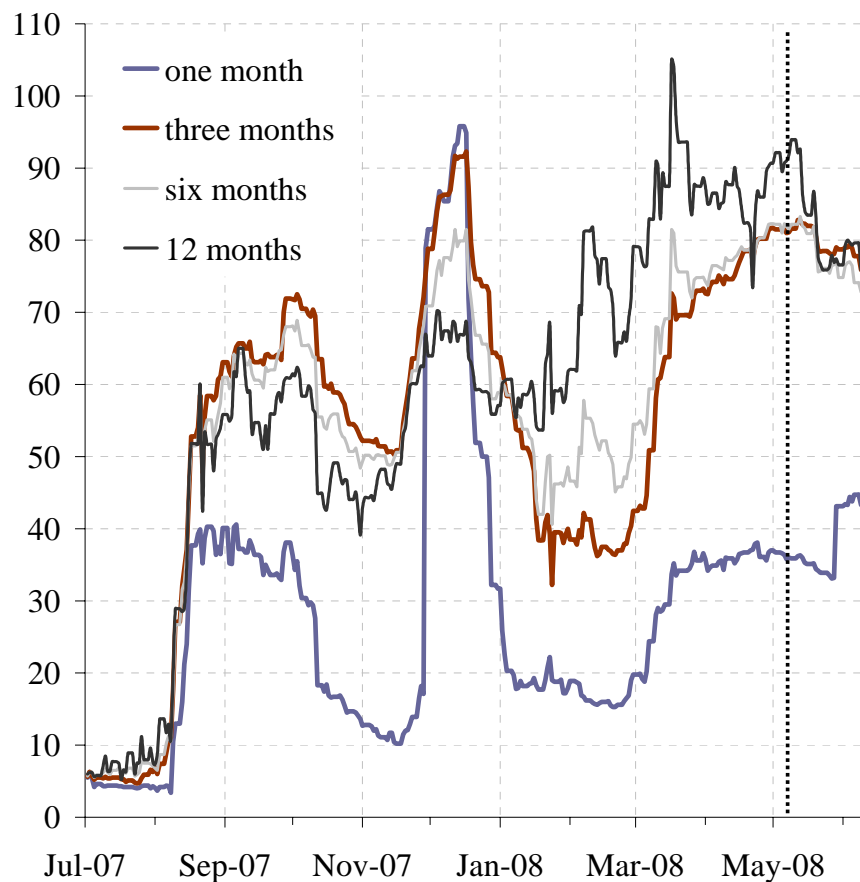
**II.3 the euro area financial system**

## **III Overall assessment**

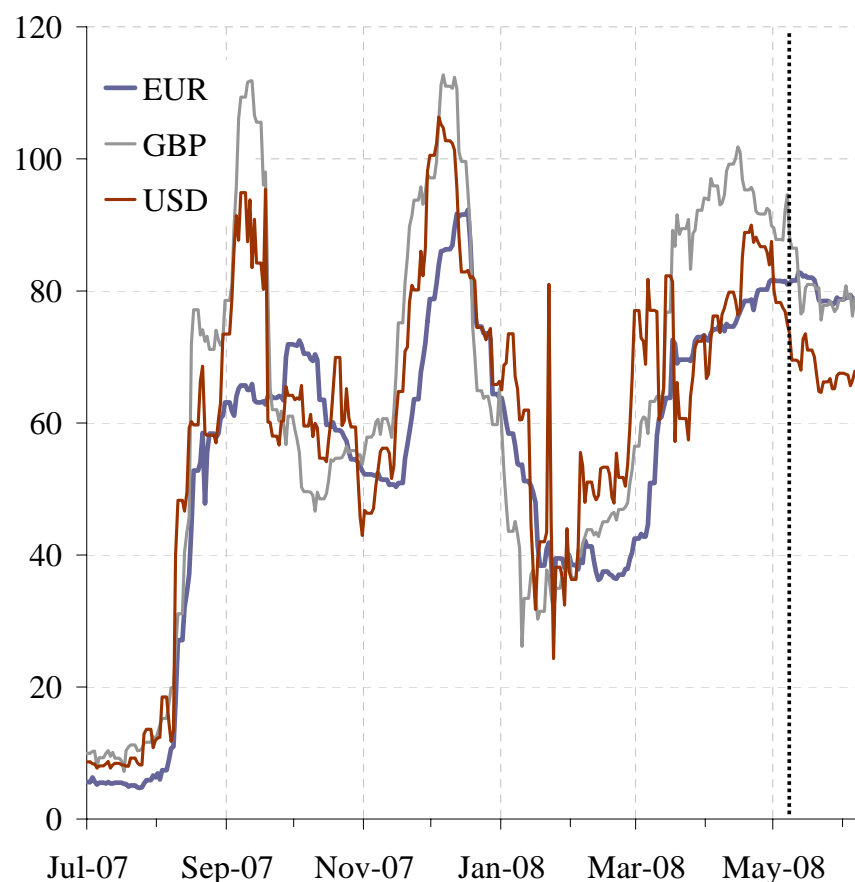
# I. The financial market turmoil: overview

Stress in the term money markets continues

## Spreads between euro deposit and EONIA swap rates (basis points)



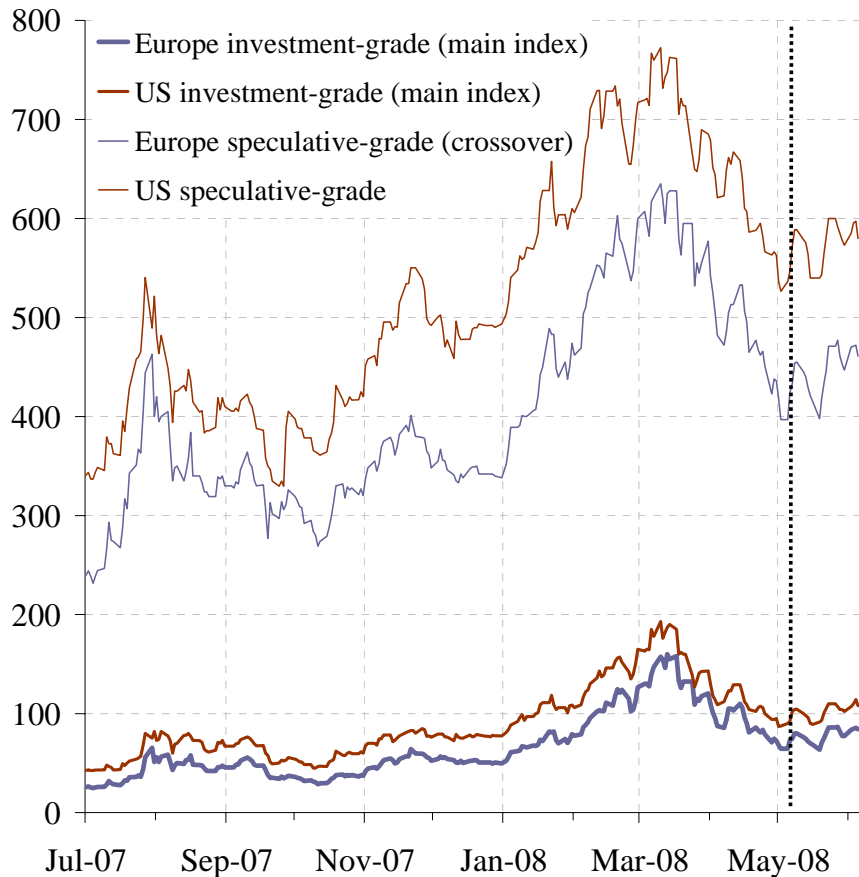
## Spreads between three-month deposit and overnight index swap rates (basis points)



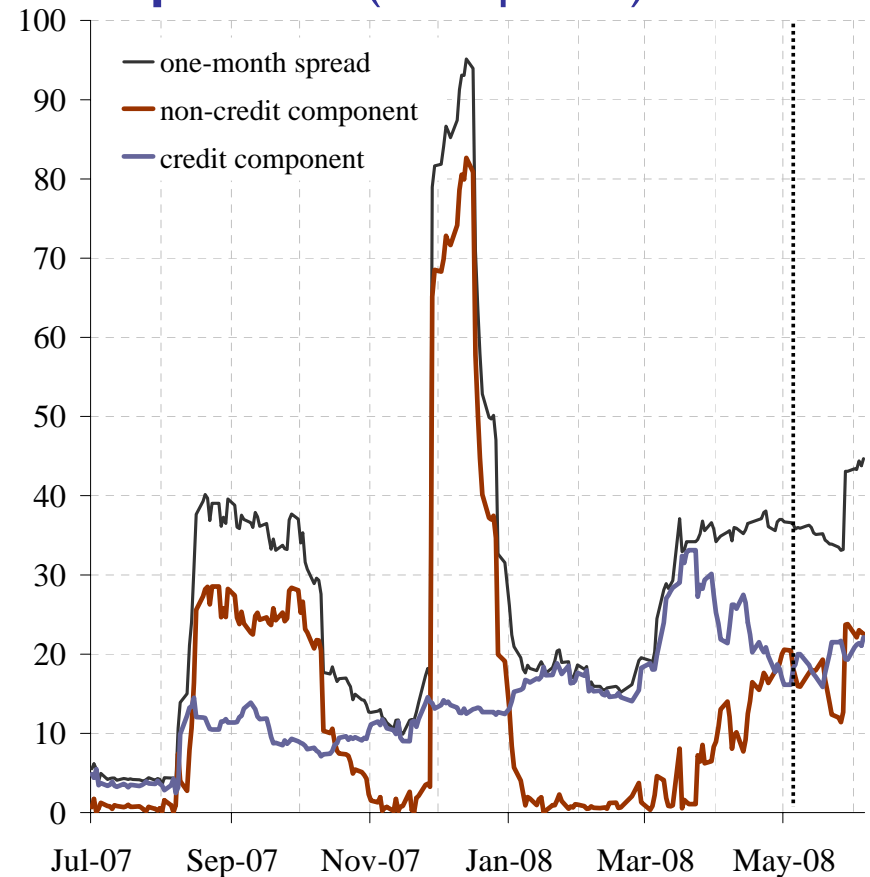
# I. The financial market turmoil: overview

Counterparty credit concerns may have decreased in importance

## Credit default swap (CDS) indices in Europe and the US (basis points)



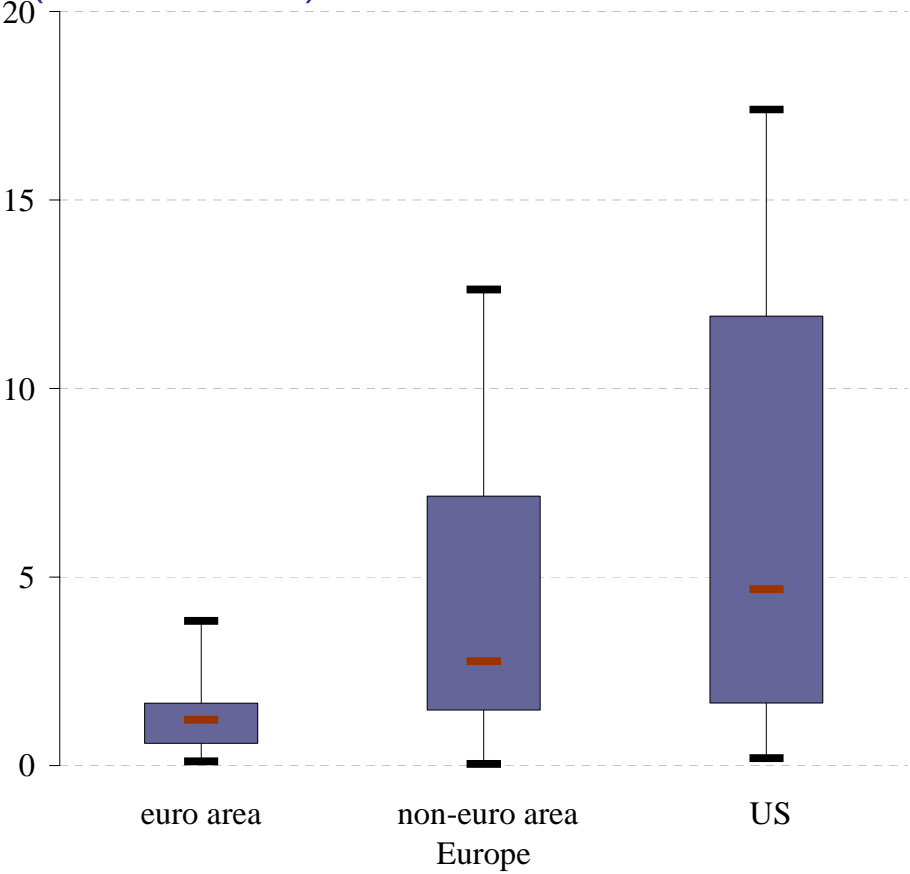
## One-month euro area deposit-OIS spread decomposition into credit and non-credit (mainly liquidity) components (basis points)



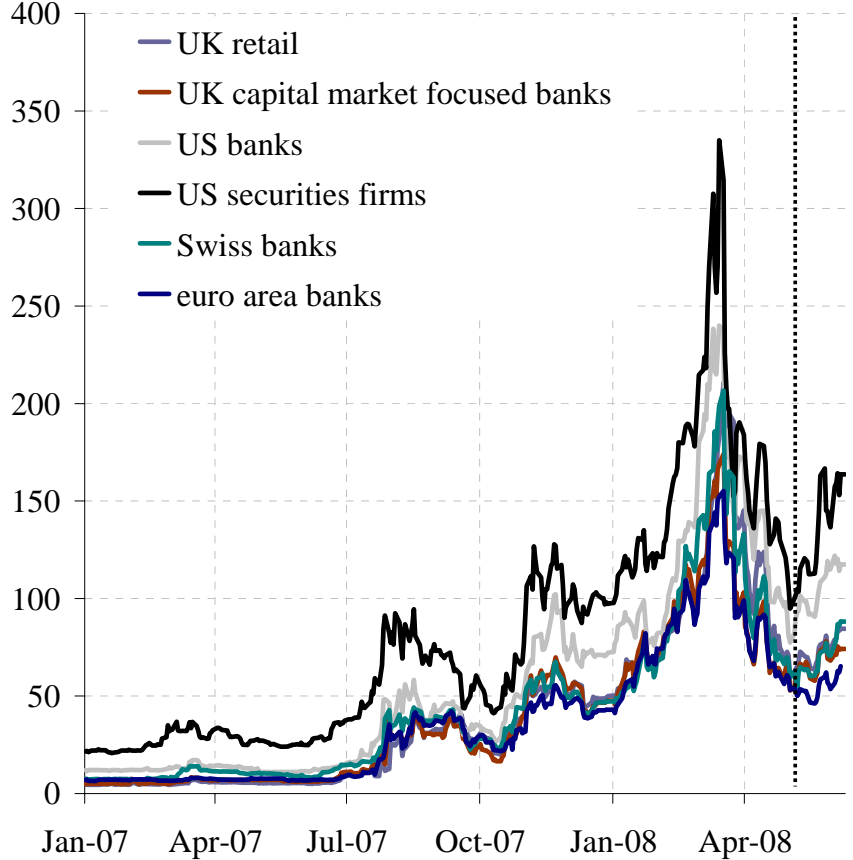
# I. The financial market turmoil: overview

Large and complex banking groups have reported unexpectedly large write-downs, but the risk of bank failures has fallen sharply

**Turbulence-related loss in 2007 after-tax net income reported by large and complex banking groups (EUR billions)**



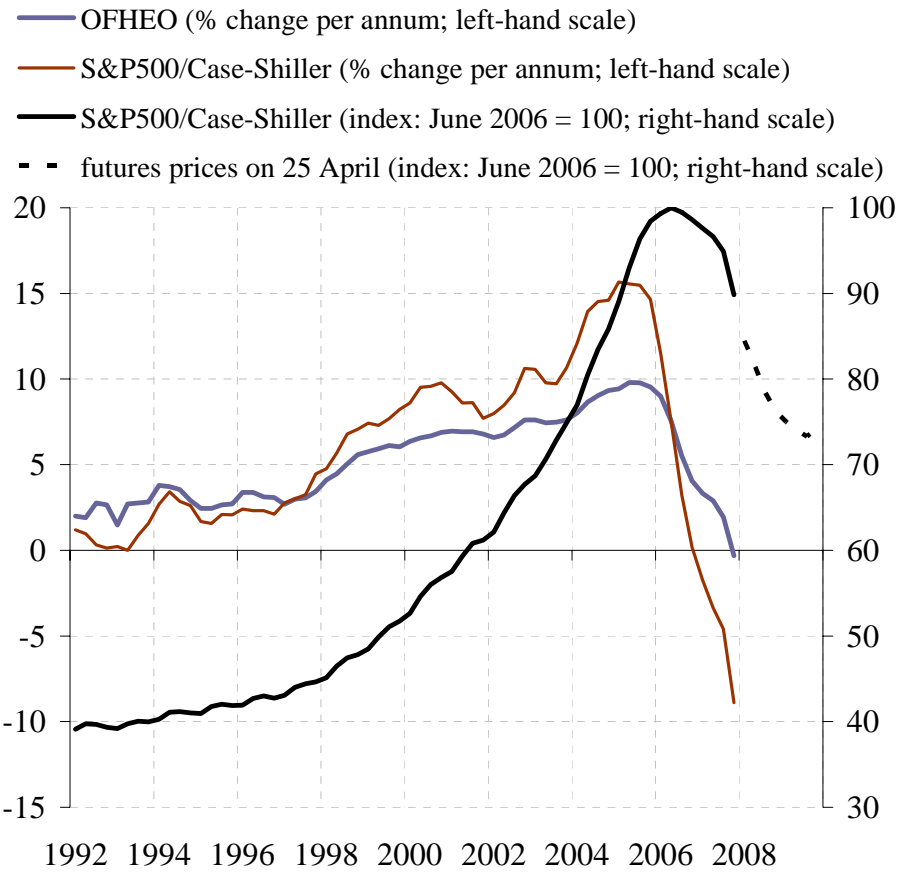
**Credit default swap (CDS) spreads for large and complex banking groups (basis points)**



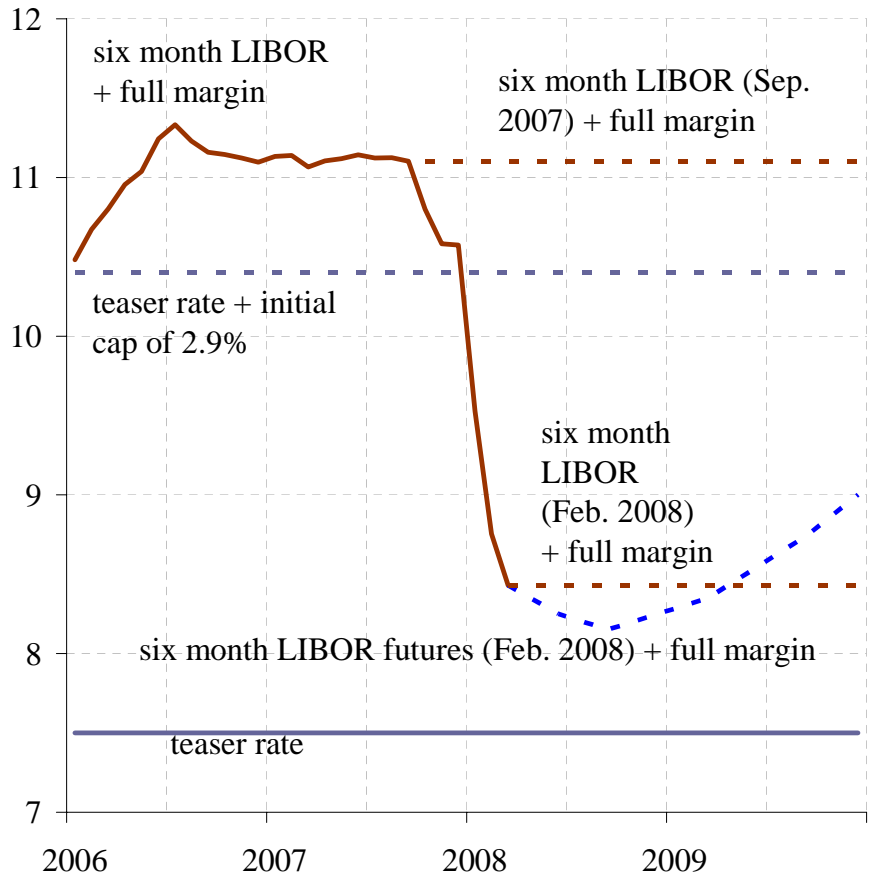
# II.1. The global macro-financial environment

Developments in the US housing markets remain a key driver of the outlook for financial stability

## US house price inflation



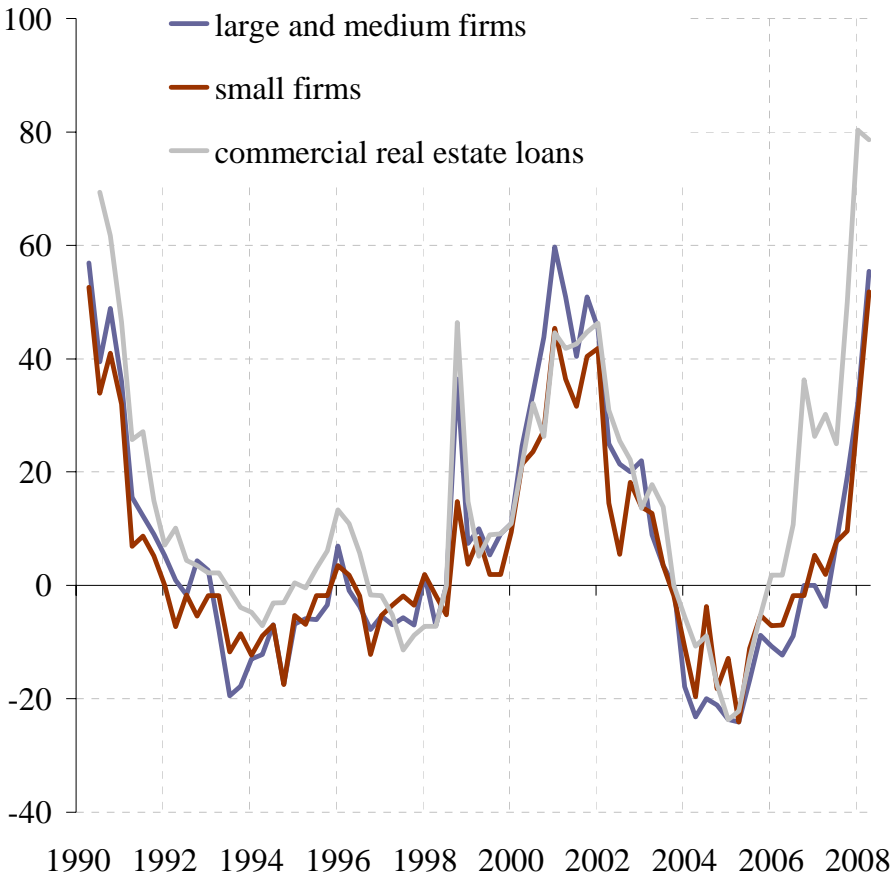
## US sub-prime mortgage rate paths with different money market rate assumptions (%)



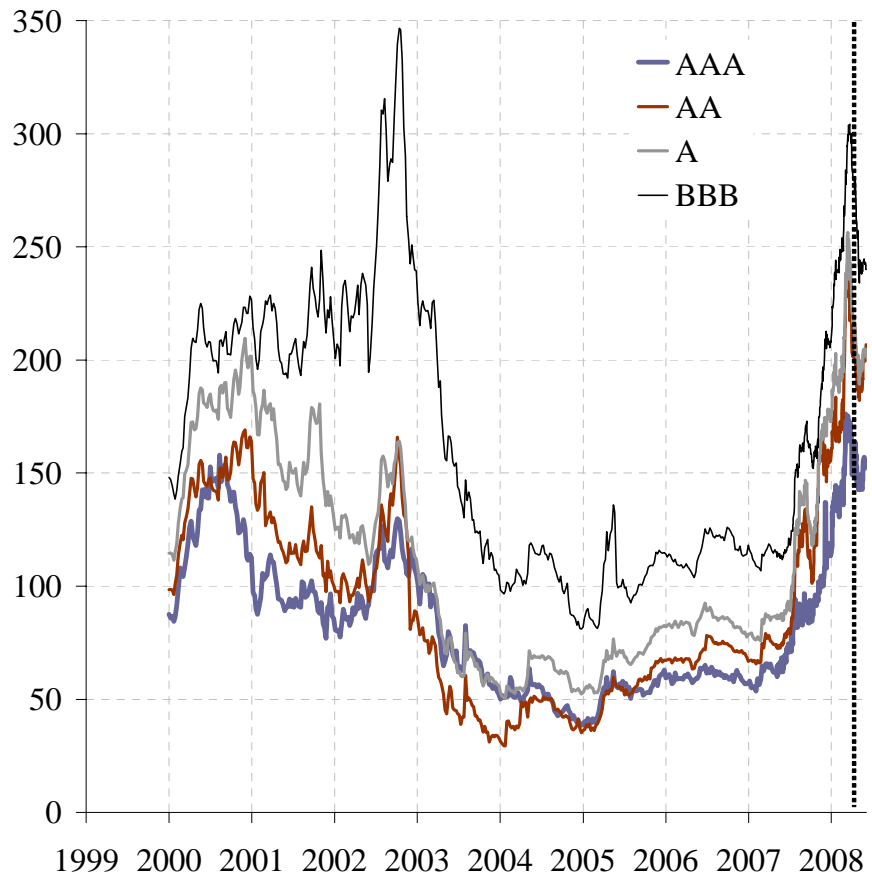
# II.1. The global macro-financial environment

The risk of a corporate sector credit cycle downturn in the US has increased

### US banks' credit standards on loans to firms (% reporting net tightening)



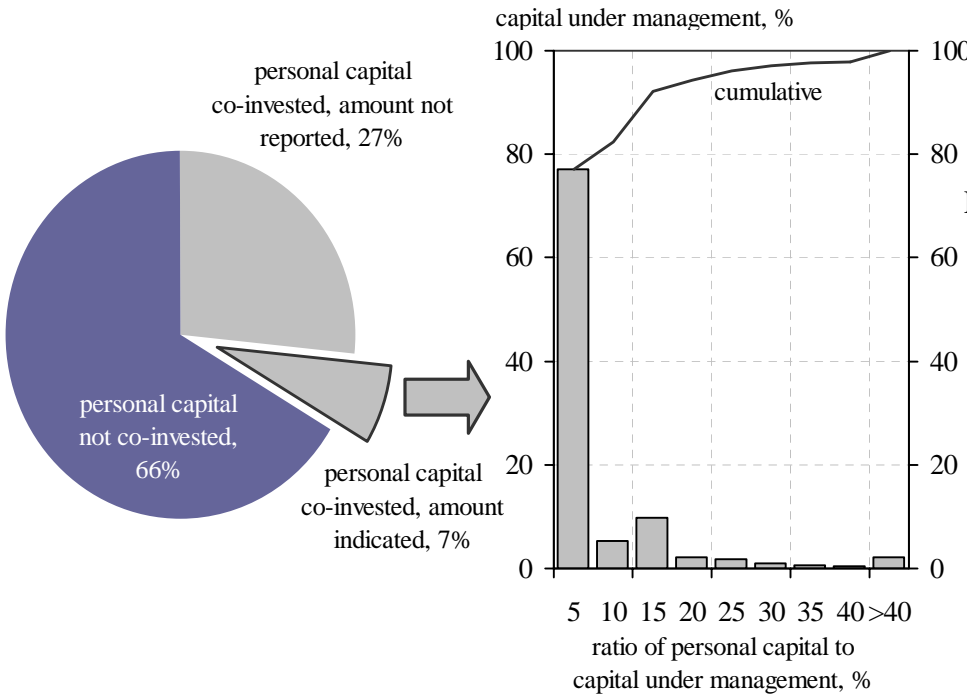
### US investment-grade corporate bond spreads (basis points)



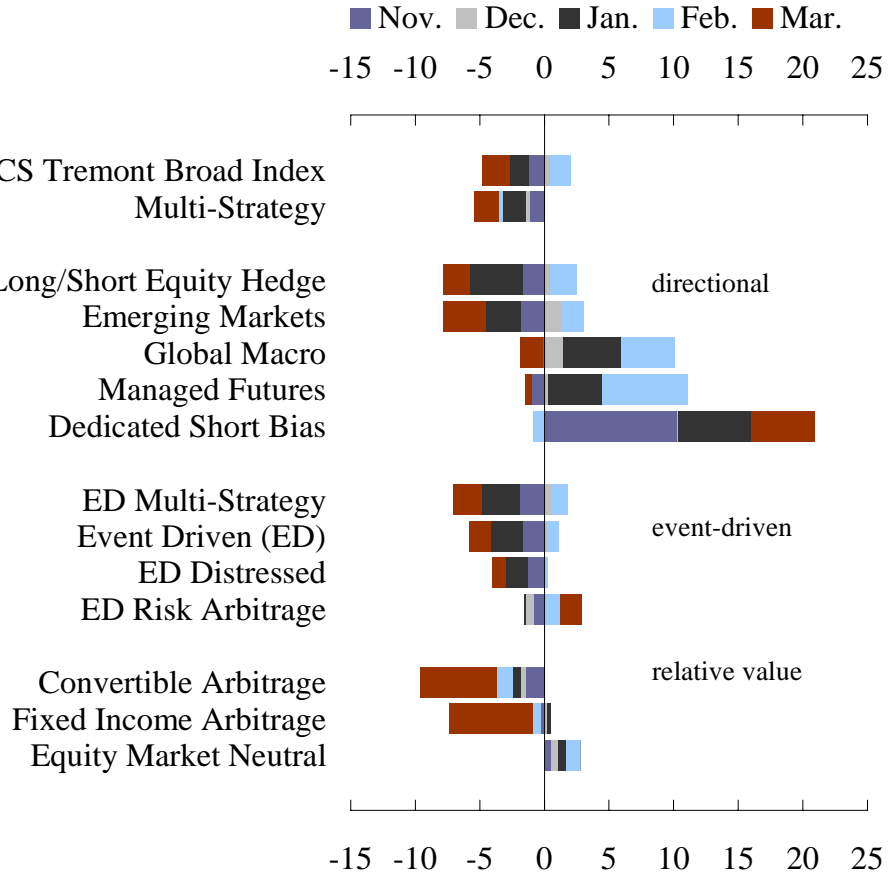
# II.1. The global macro-financial environment

Hedge funds: incentive structures for managers could have fostered investment discipline but recently the risk of failures has grown

## Co-investments of personal capital by hedge fund managers (% of capital under management)



## Global hedge fund monthly returns (%, net of all fees)

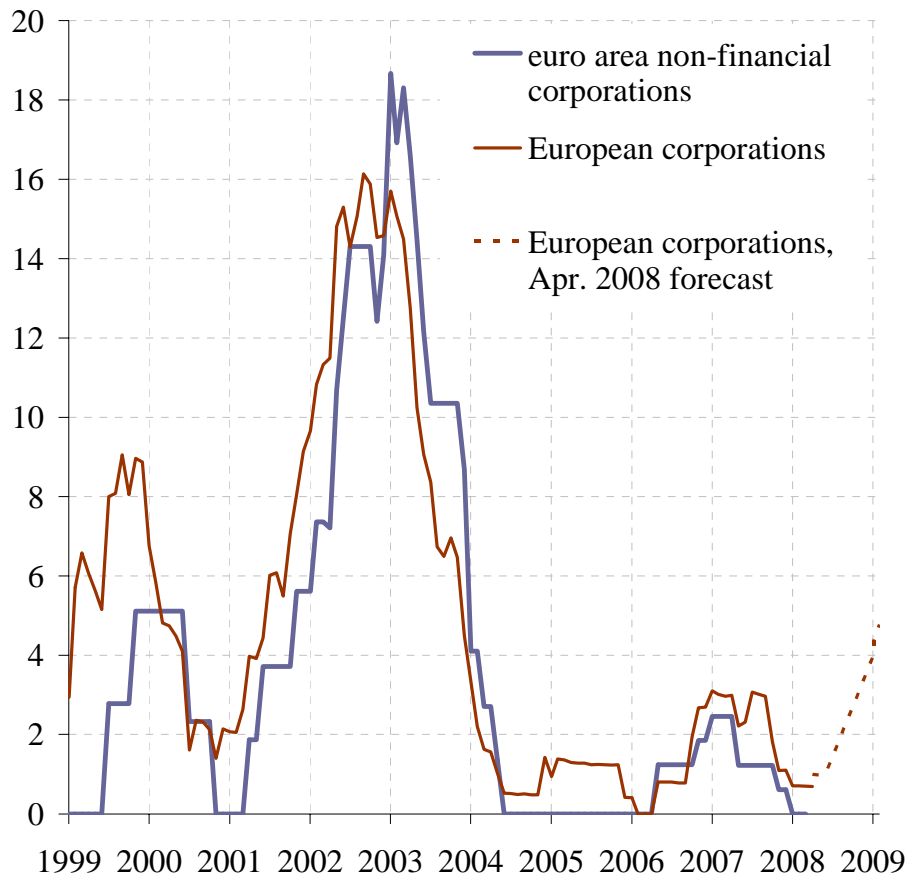




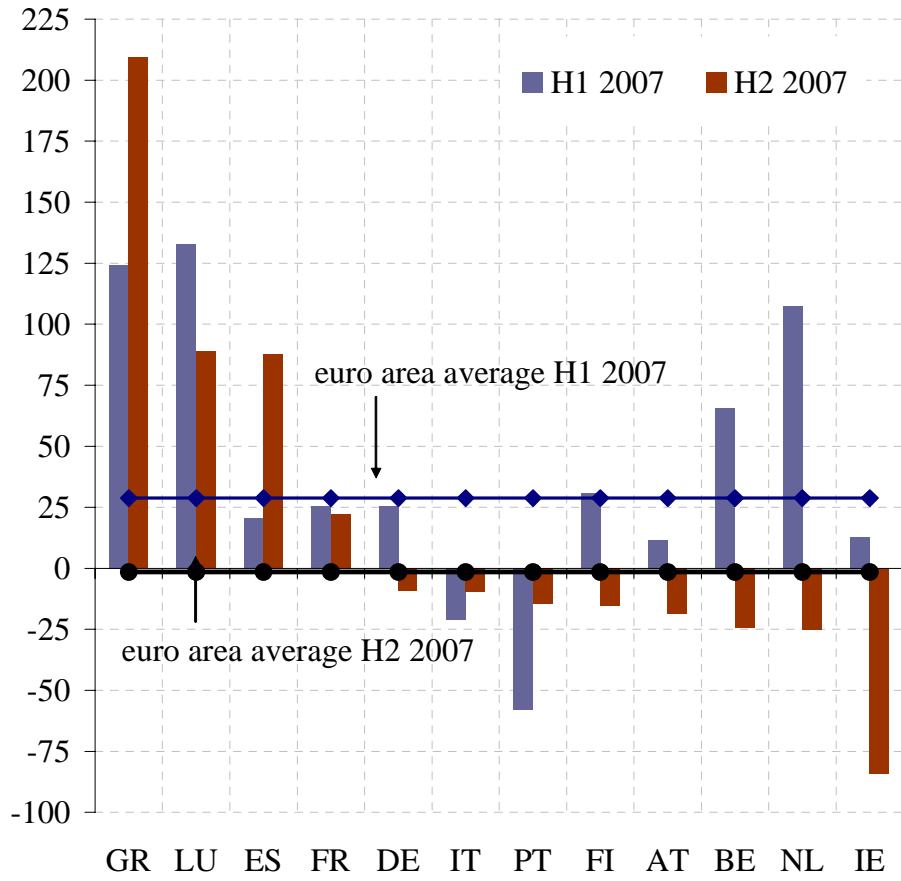
# II.2. The euro area corporate sector

Vulnerabilities related to highly leveraged firms and commercial real estate markets could contribute to rising credit risks

### European and euro area speculative-grade rated corporations' default rates and forecast (%)



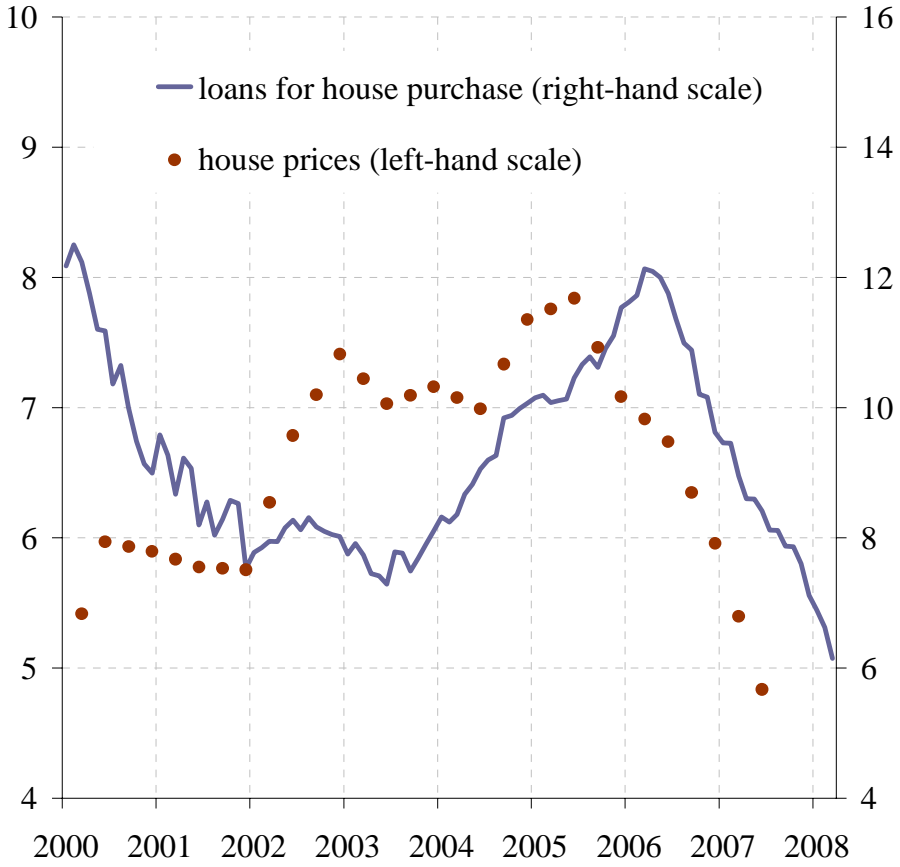
### Growth in direct commercial property investment volumes in the euro area (% change per annum)



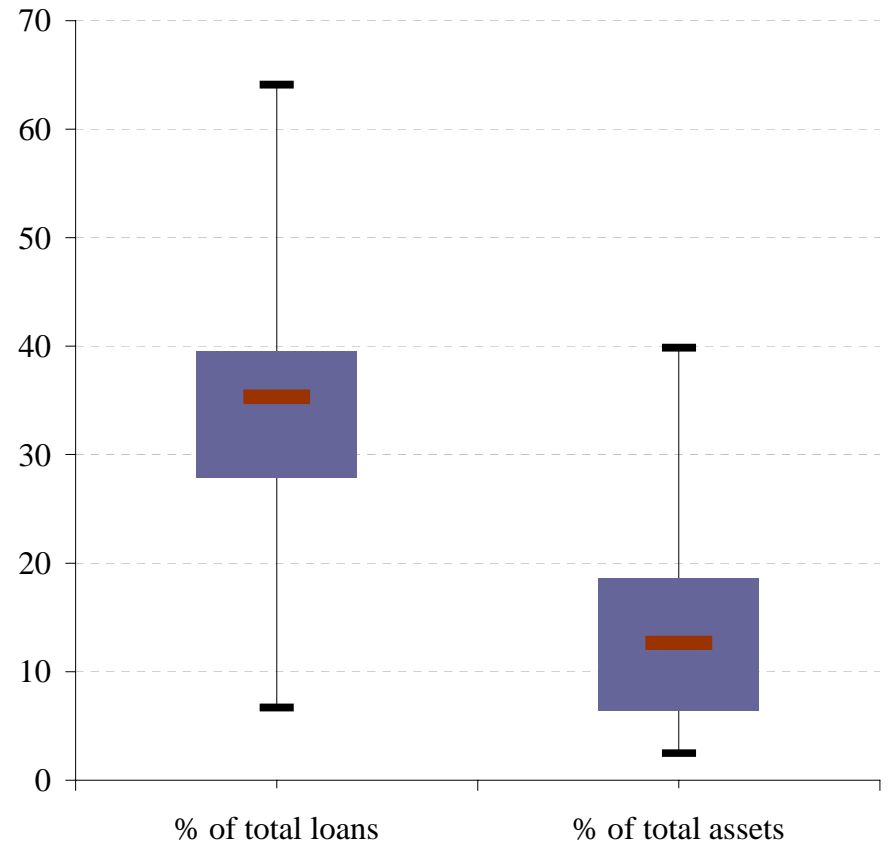
# II.2. The euro area household sector

Pockets of vulnerability in the euro area household sector entail risks to parts of the financial system

### Loans for house purchase and house prices in the euro area (% change per annum)



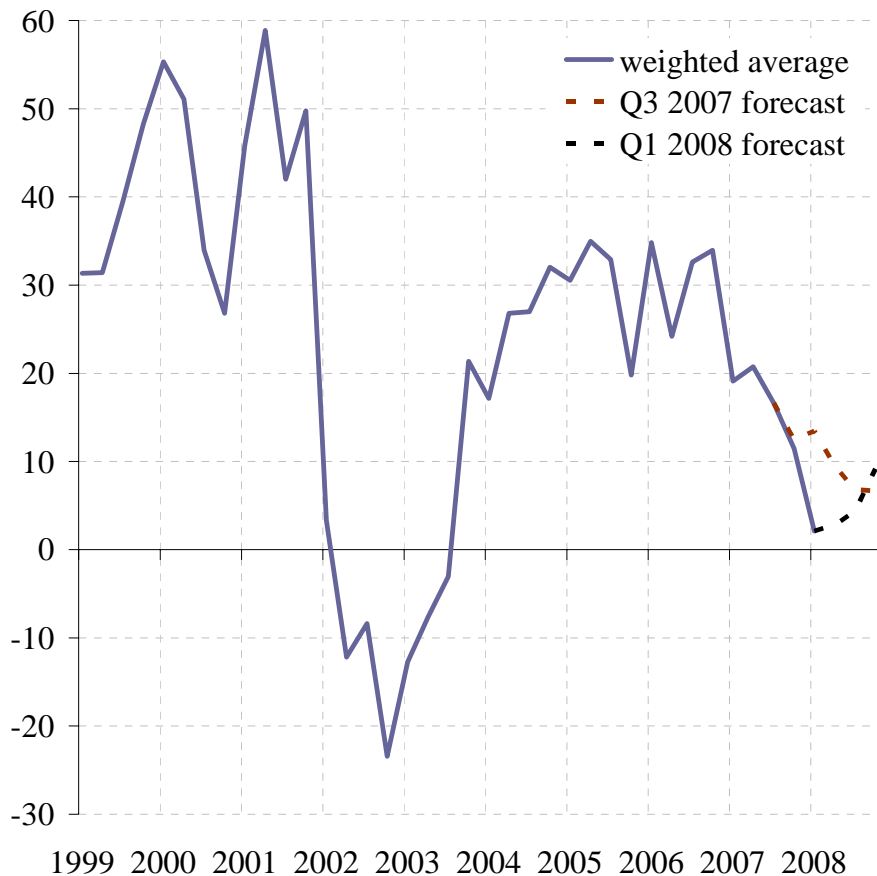
### Distribution of large and complex banking groups' loan exposures to households (%)



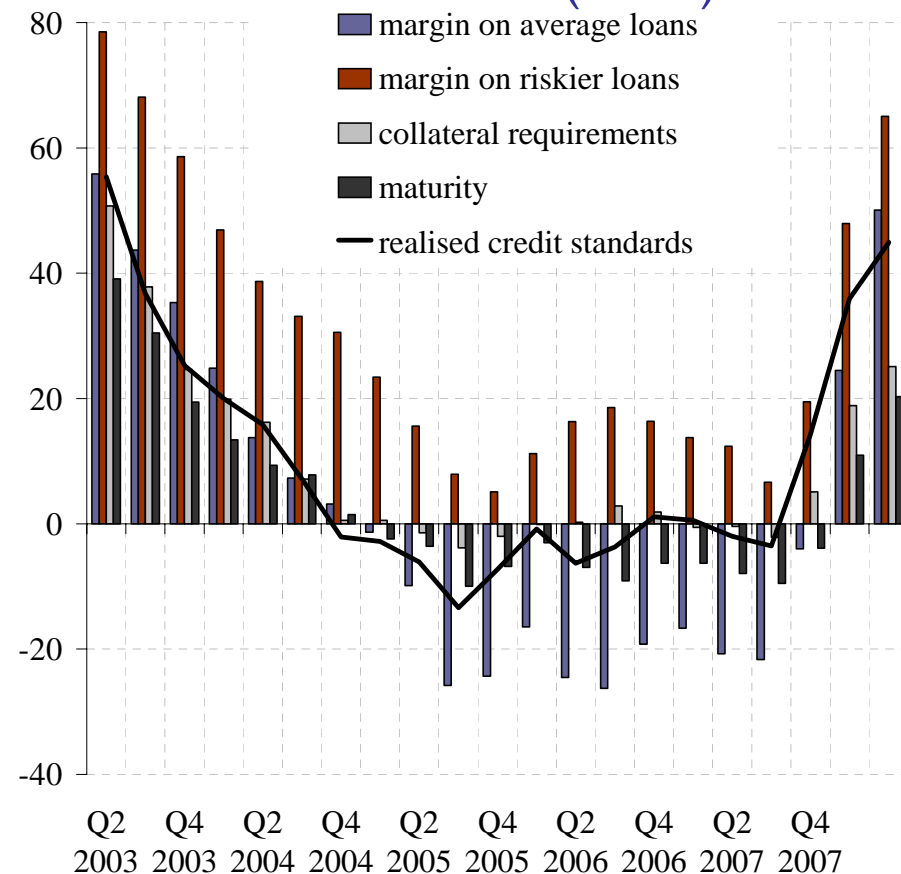
# 11.3. The euro area financial system

LCBGs' earnings growth is expected to be subdued and banks' willingness to take risks has decreased

## Earnings and earnings forecasts for large and complex banking groups in the euro area (% change per annum)



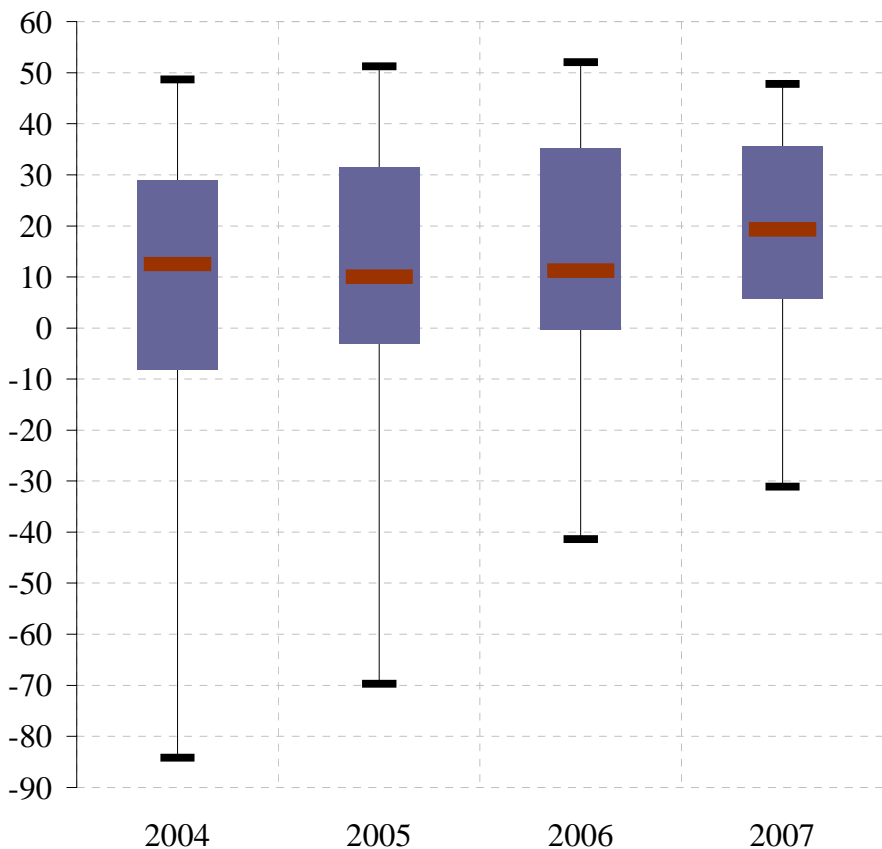
## Euro area banks' credit standards applied to loans and credit lines to non-financial corporations and terms and conditions (net %)



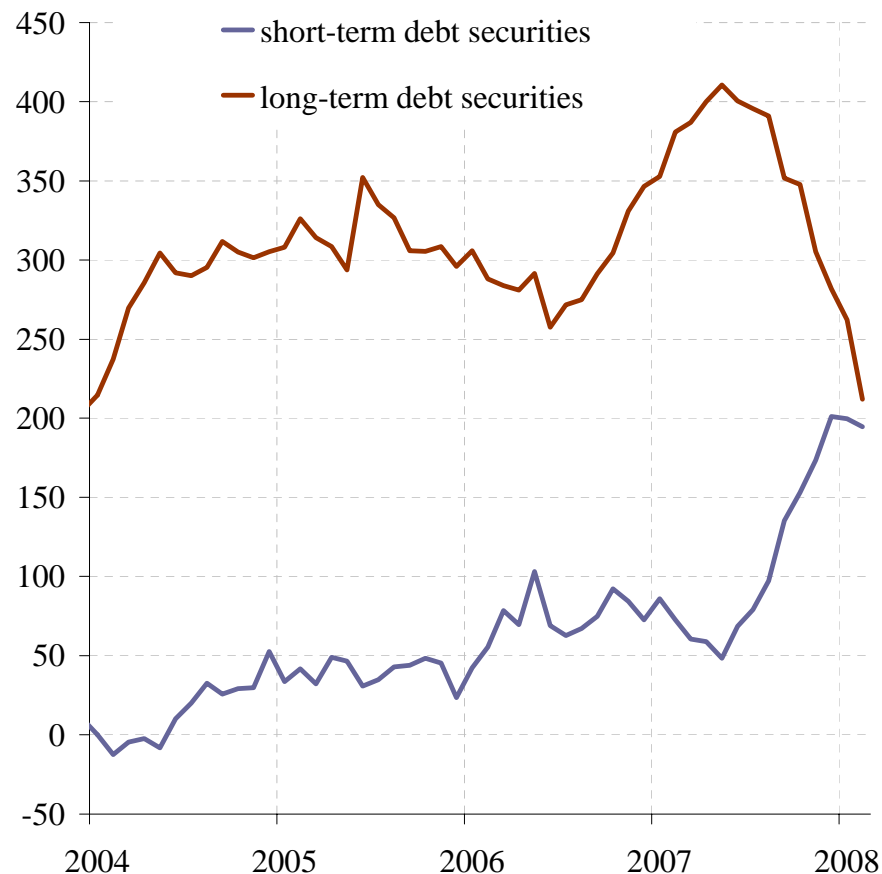
# II.3. The euro area financial system

Some LCBGs could remain vulnerable to additional liquidity shocks

### Customer funding gap of large and complex banking groups in the euro area (% of customer loans)



### Net issuance of debt securities by euro area MFIs by maturity (EUR billions)

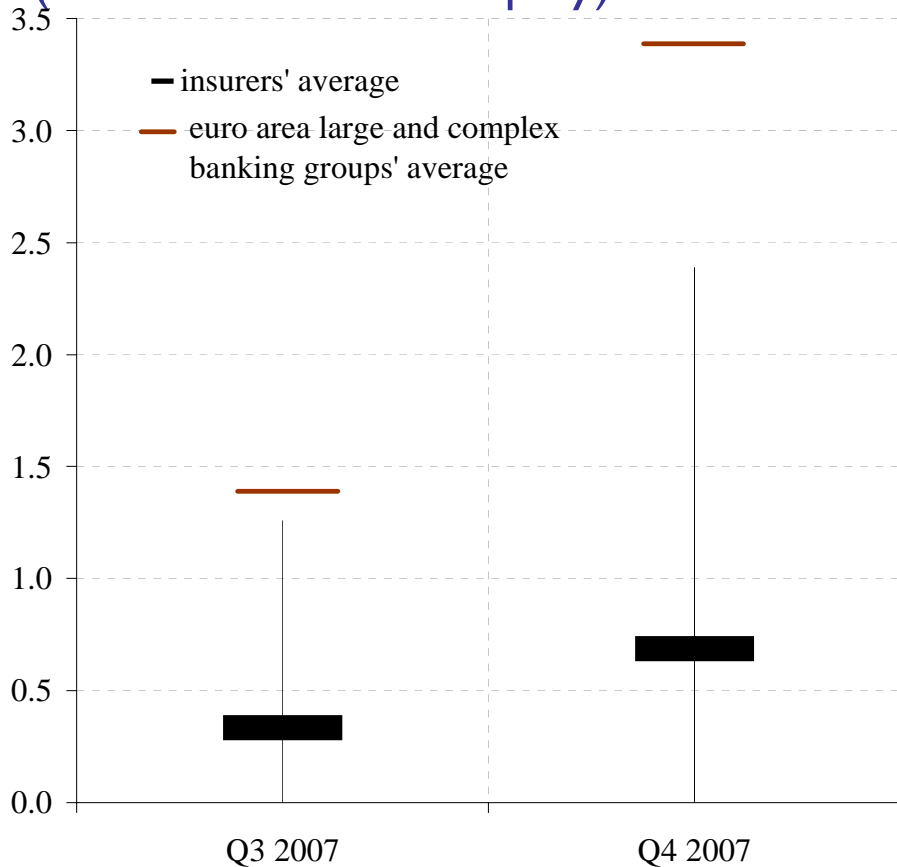


# 11.3. The euro area financial system

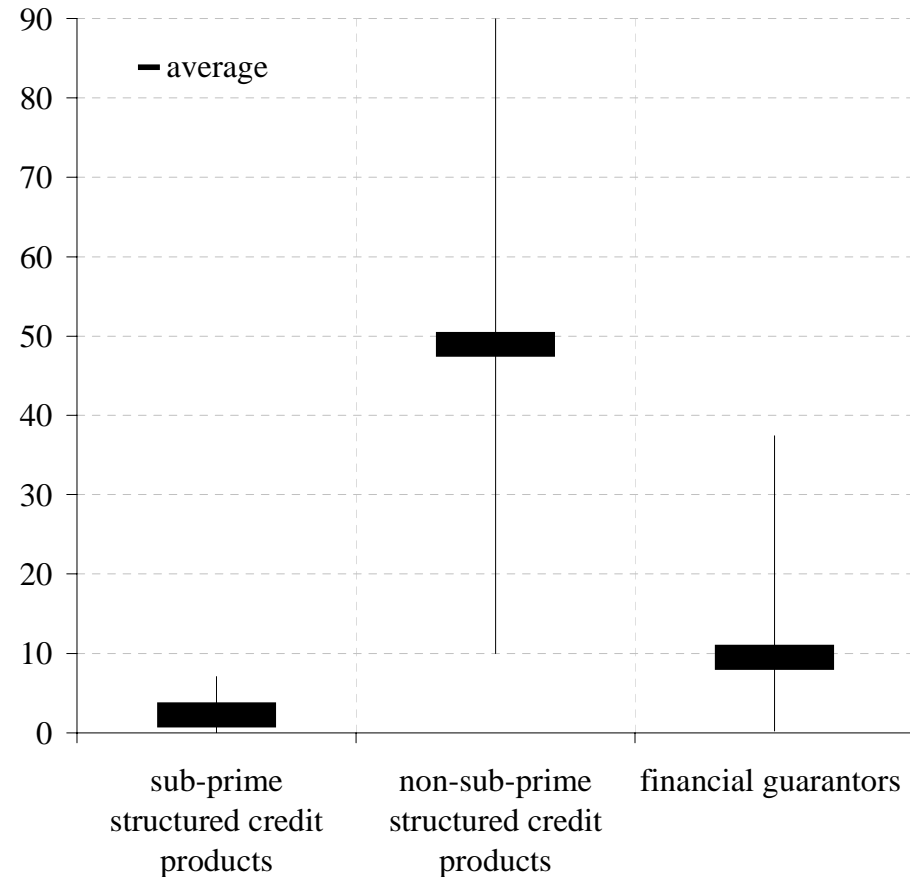
Euro area insurance companies' write-downs have been modest, but some firms have relatively large exposures to structured credit products and US financial guarantors

## Profit and loss write-downs of selected euro area primary insurers and reinsurers

(% of shareholders' equity)



## Credit exposures of selected euro area primary insurers and reinsurers (% of shareholders' equity)



### III. Overall assessment

Since the last FSR, the global and euro area financial systems have undergone further substantial adjustment to the financial turmoil. In the euro area, asset valuation write-downs disclosed by LCBGs in 2007 materially impacted on their profitability, but their capital buffers have been maintained largely intact.

Some of the risks to euro area financial system stability previously identified have materialised, and risks on balance have increased over the past six months, for several reasons, including:

- (i) Conditions in the US housing market have further deteriorated
- (ii) The valuation losses endured by mature economy banking systems were larger than anticipated six months ago
- (iii) Banks have tightened their lending standards significantly

### III. Overall assessment (continued)

The financial stability outlook is highly uncertain and will depend, *inter alia*, on:

- (i) how conditions in the US housing market develop
- (ii) how banks respond to a much more challenging operating environment
- (iii) the extent to which initiatives and measures aimed at restoring confidence and strengthening financial system resilience are eventually implemented

It is probable that the adjustment process in the financial system will be protracted as banks continue to strengthen their liquidity and capital positions.

Given heightened uncertainty and an environment in which balance sheet conditions could change unexpectedly, vigilance by financial institutions and market participants is of the essence and those with relevant exposures will need to step up their efforts to effectively manage the risks that may lie ahead.