

Financial Stability Review December 2007

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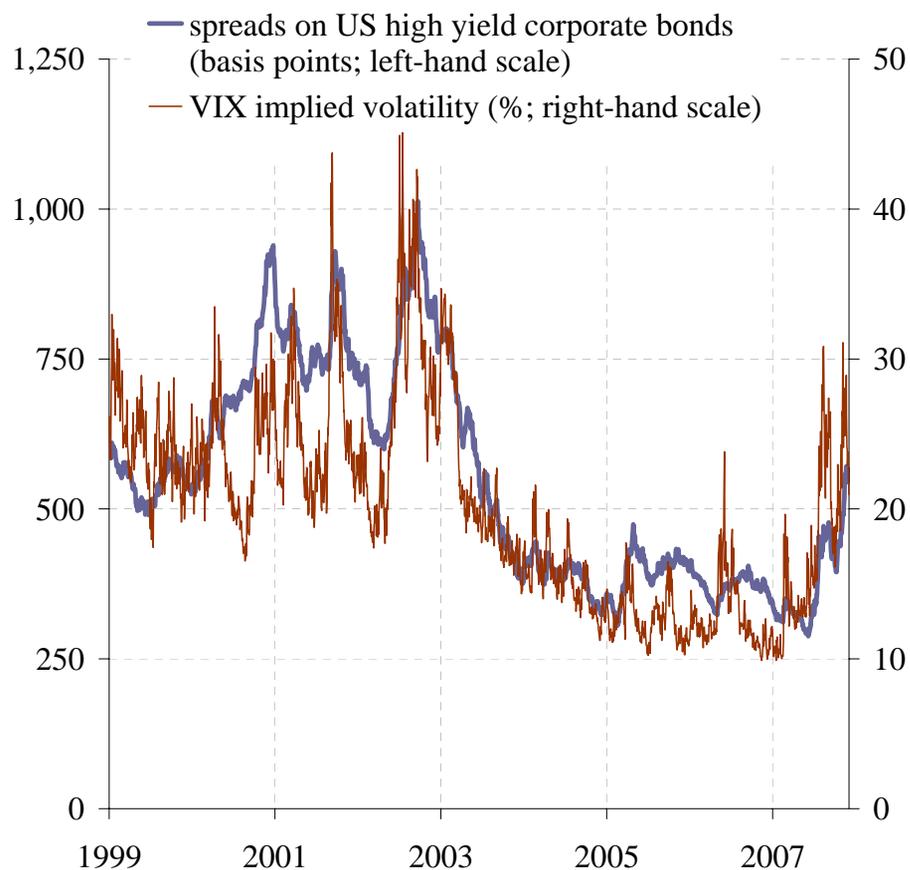
Frankfurt am Main, 12 December 2007

- **The financial market turmoil**
 - **Causes and propagation channels**
 - **Impact and lessons**
- **Other risks and vulnerabilities in:**
 - **The external macro-financial environment**
 - **The euro area corporate and household sectors**
 - **The euro area financial institutions**
- **Overall assessment**

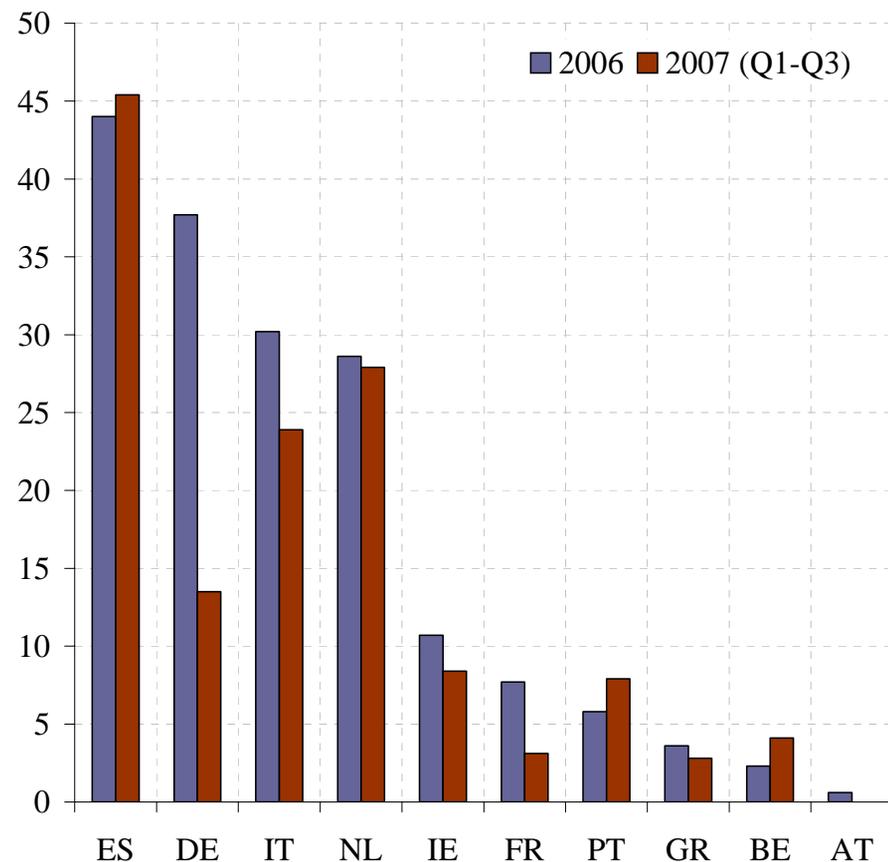
The financial market turmoil:

What were the vulnerabilities? The search for yield and the prevalence of the “originate and distribute” model

Spreads on US high yield corporate bonds and the implied volatility for the S&P 500 index



Loan securitisation issuance in the euro area (EUR billions)



The financial market turmoil:

Given vulnerabilities, what were the risks?

Some extracts from the June 2007 FSR:

... the crisis in the US sub-prime mortgage market could deepen and spread to other markets, potentially affecting higher quality structured mortgage and corporate credit markets to which euro area financial institutions may have exposures.

If history is any guide, liquidity can vanish abruptly from financial markets when investor uncertainty and risk aversion rise... vulnerabilities could be quickly unearthed if financial market liquidity were to abruptly and sharply decline.

... There is some unease that the delegation of credit risk monitoring to rating agencies... could have led to some slippage in credit risk assessment and pricing.

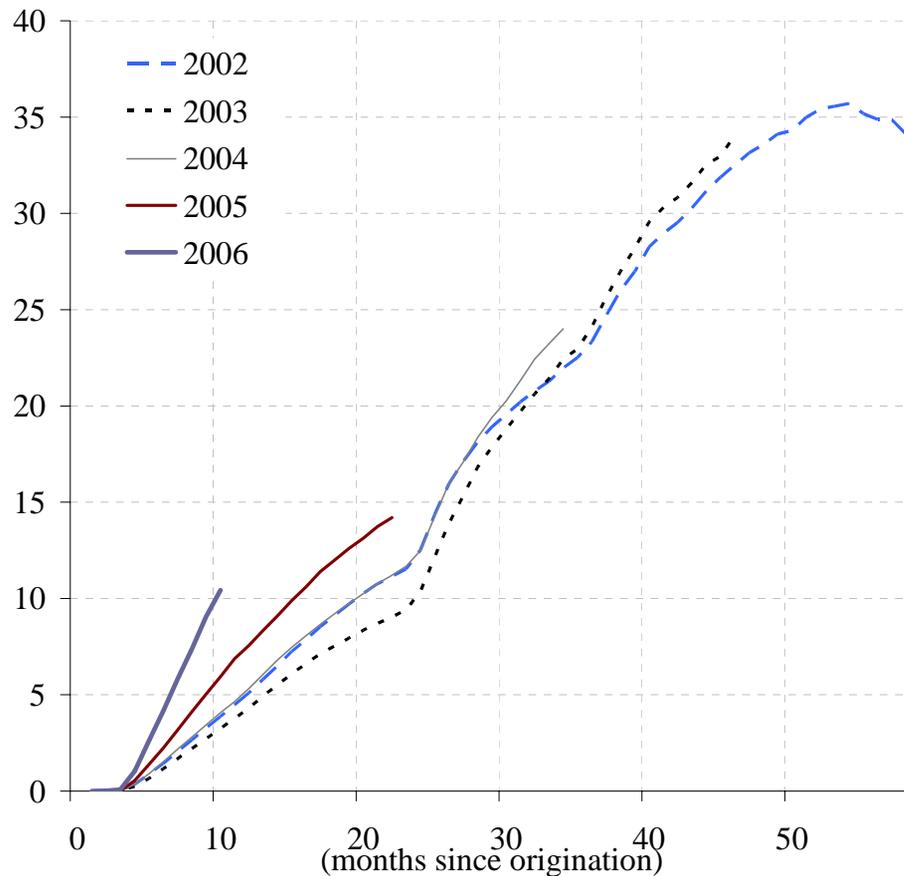
While counterparty risk management practices are known to be improving, it is unclear whether intensifying competition... may have compromised standards at the margin, especially for medium-sized banks.

Given the reliance of private equity-sponsored leveraged buyout (LBO) deals on smoothly functioning CRT markets... a loss of market liquidity could significantly impair this activity and, through the materialisation of underwriting risk, leave some banks holding unplanned credit risk exposures ...

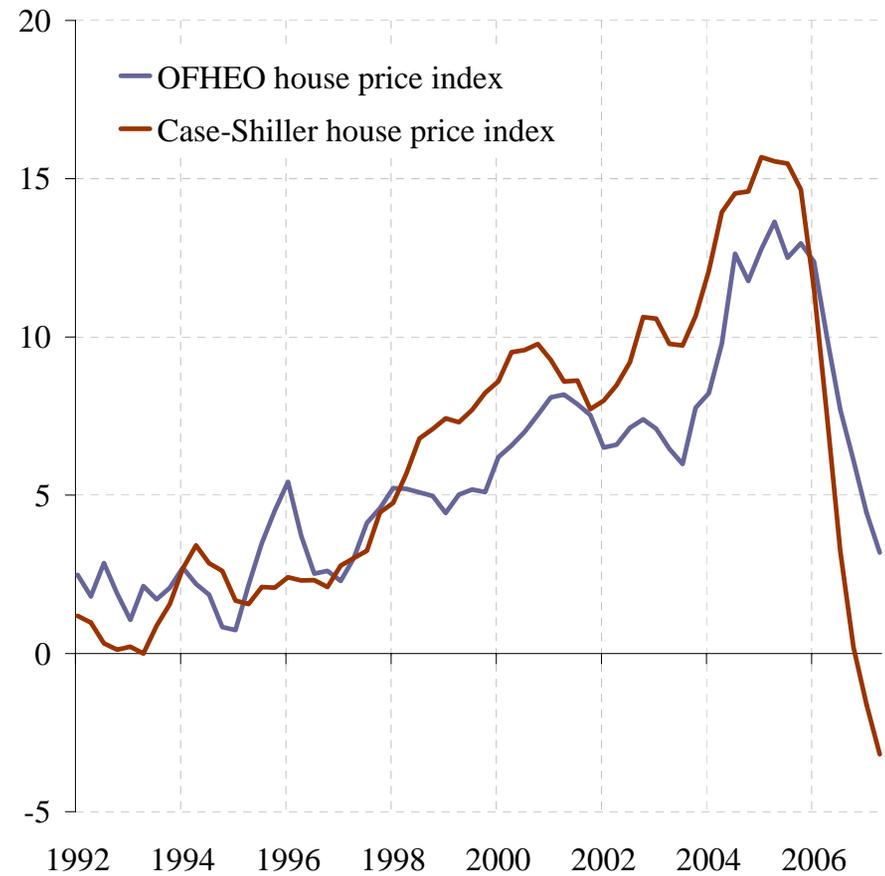
The financial market turmoil:

Sub-prime related liquidity squeeze: what triggered it?

Delinquency indices for sub-prime RMBS rated by Fitch Ratings (vintages 2002-2006, %)



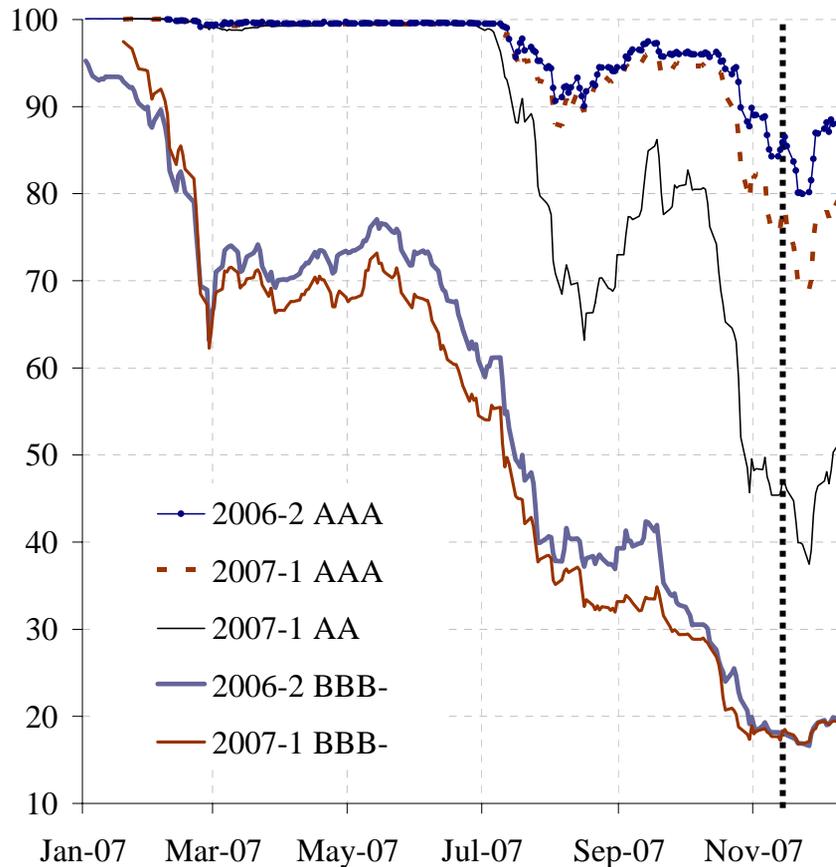
US house price inflation (% change per annum)



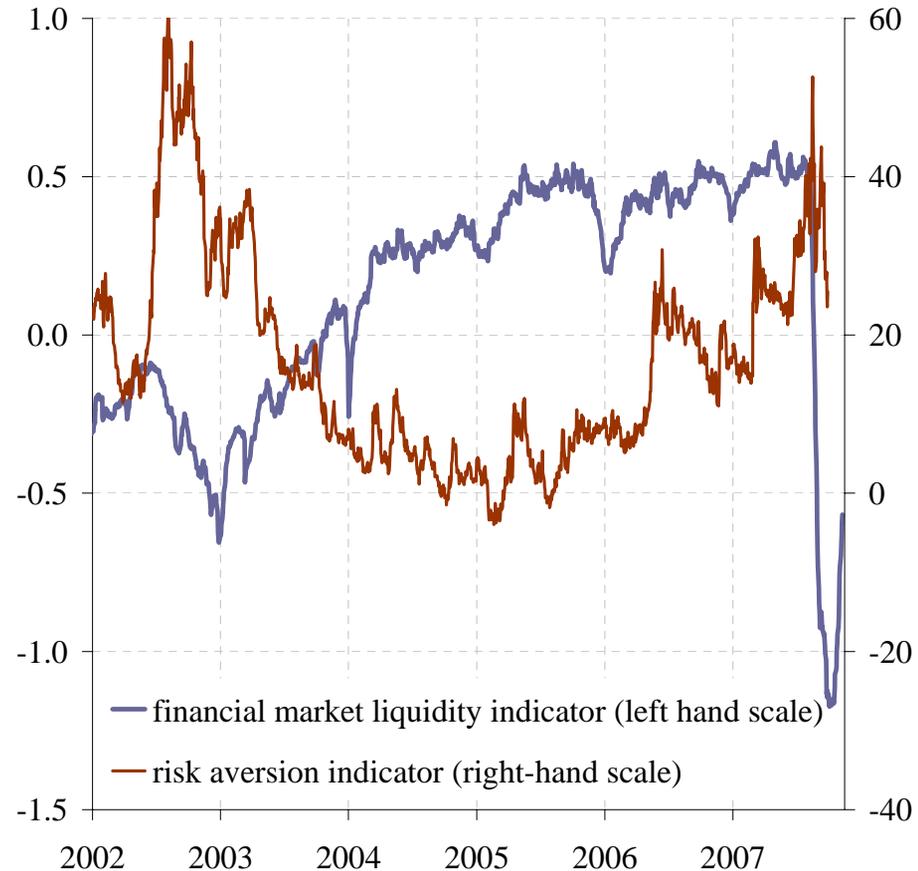
The financial market turmoil:

Sub-prime related liquidity squeeze: what were the effects?

Value index of CDSs on US non-agency sub-prime mortgage backed securities (different vintages and ratings; par value = 100)



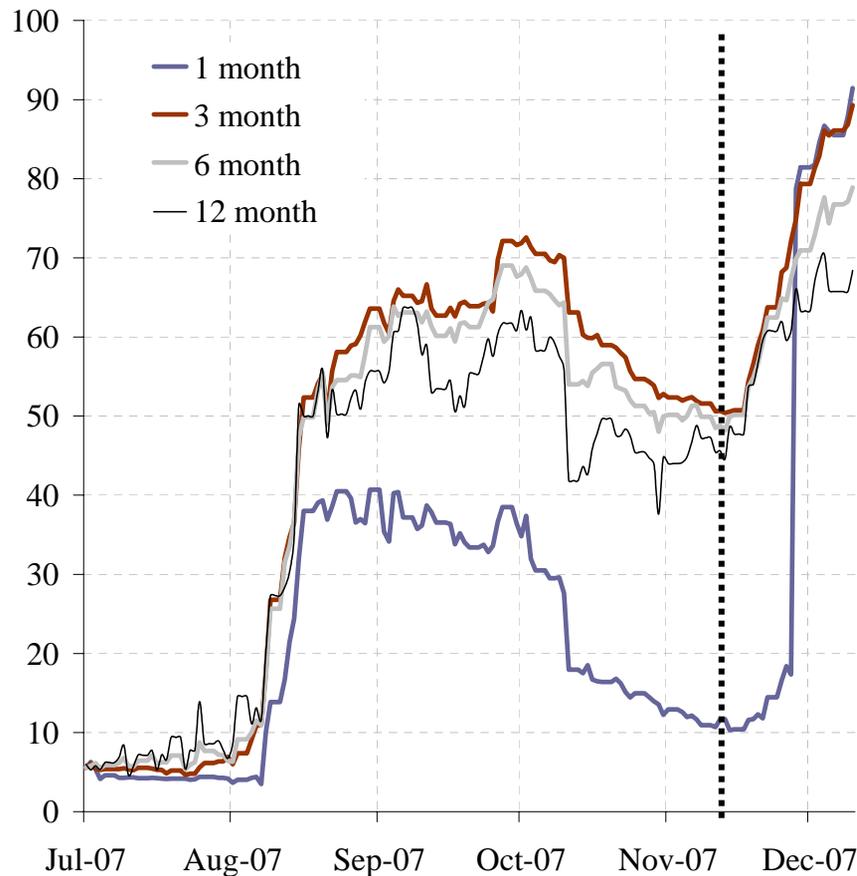
Financial market liquidity and risk appetite



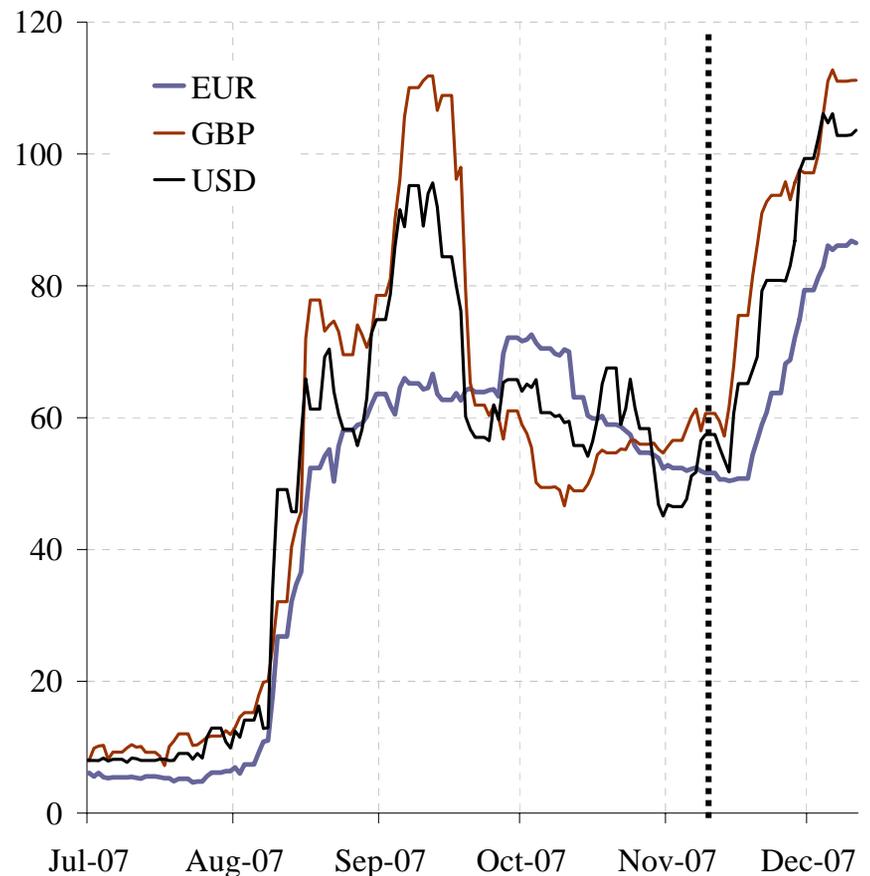
The financial market turmoil:

Sub-prime related liquidity squeeze: what were the effects?

Spreads between euro deposit and EONIA swap rates (%)



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



The financial market turmoil:

Sub-prime related liquidity squeeze: some lessons

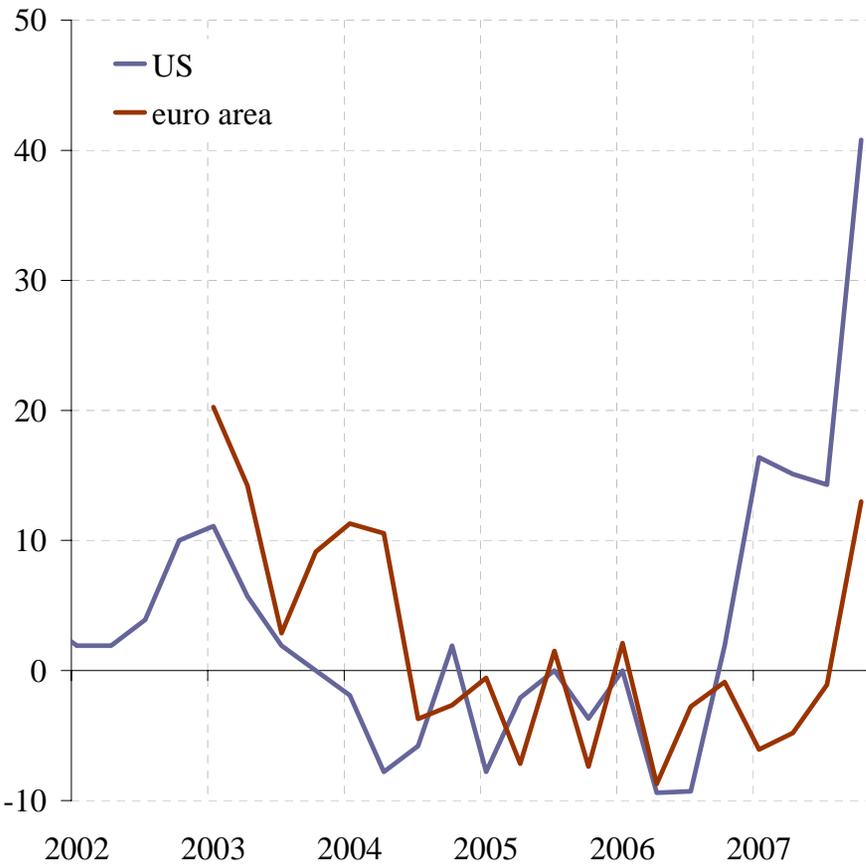
The market turmoil has highlighted weaknesses in risk management, which concern:

- (1) The monitoring, assessment and management of credit risk
- (2) The management and pricing of funding liquidity risk
- (3) The assessment of counterparty risk and
- (4) The role of conduits and structured investment vehicles

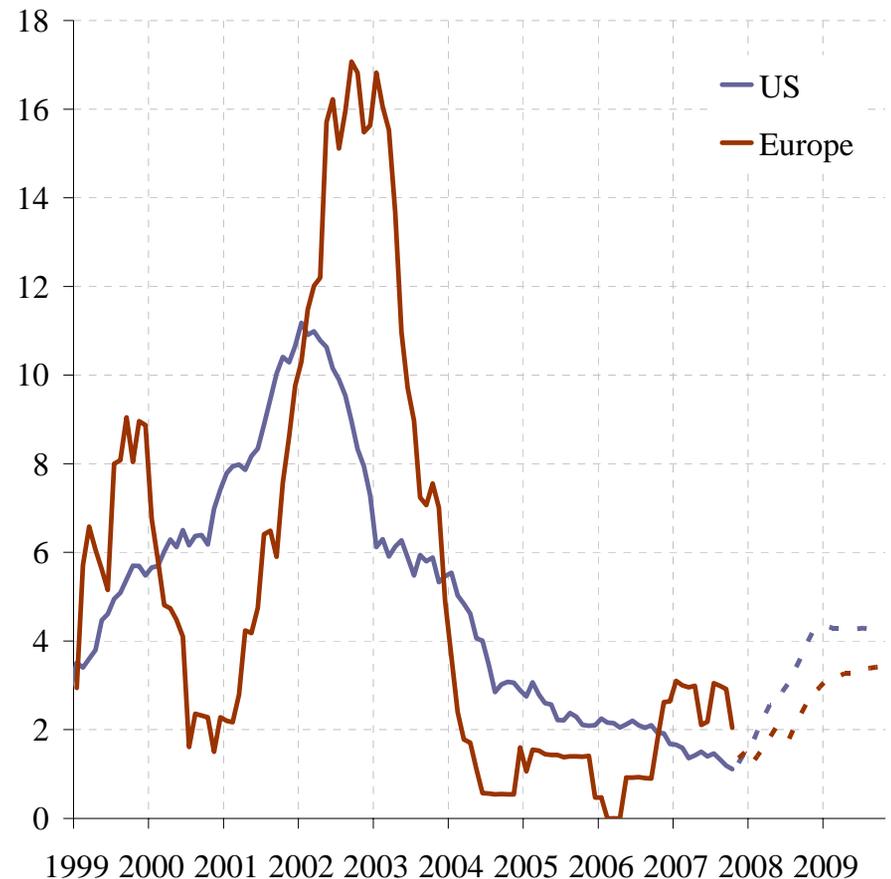
The financial market turmoil:

Sub-prime related liquidity squeeze: where do we go from here?

US and euro area banks' credit standards on mortgages (net % of banks reporting tightening)



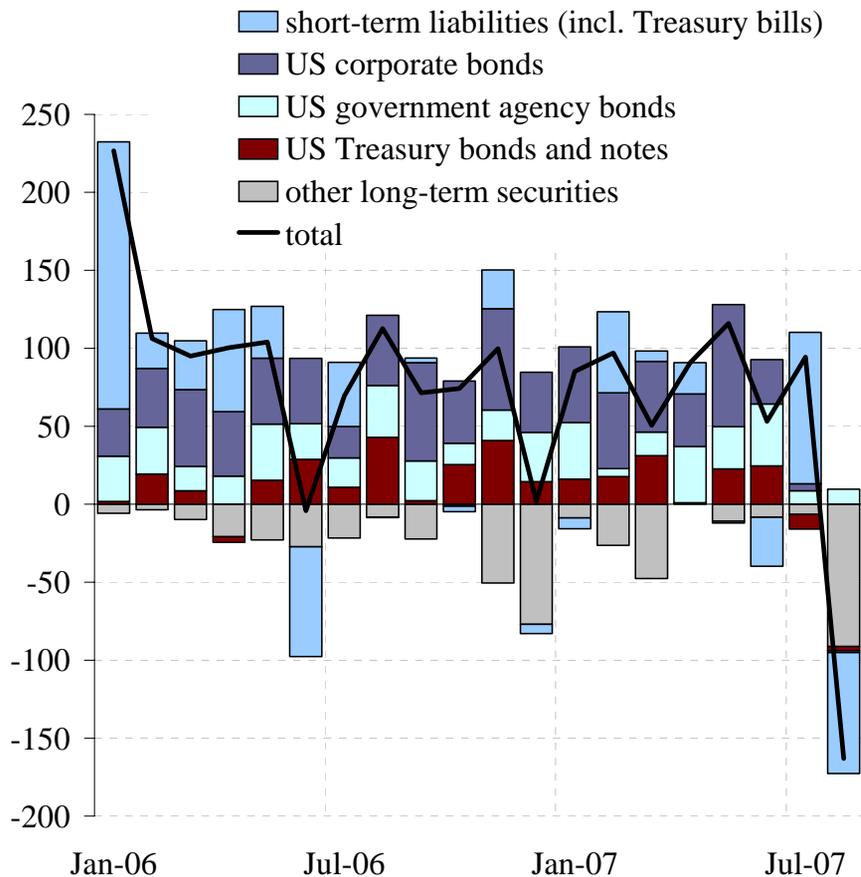
US and European speculative grade corporate default rates and forecasts (%)



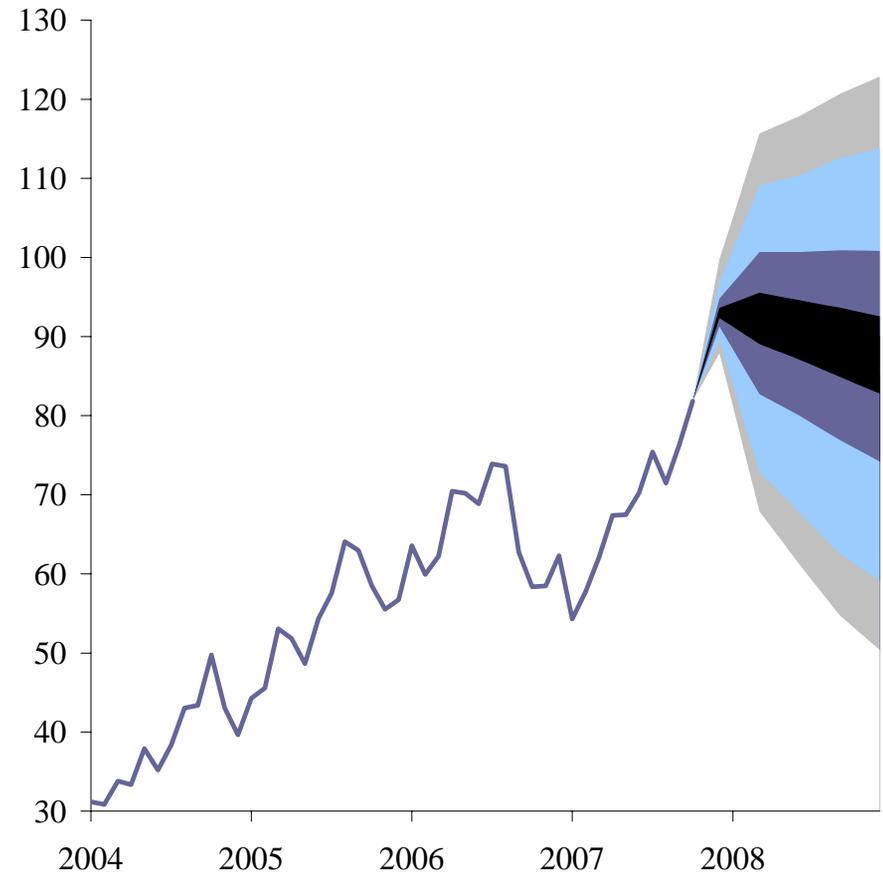
Vulnerabilities in the external environment:

Global imbalances and oil prices

Cross-border financial flows to the US (USD billions)



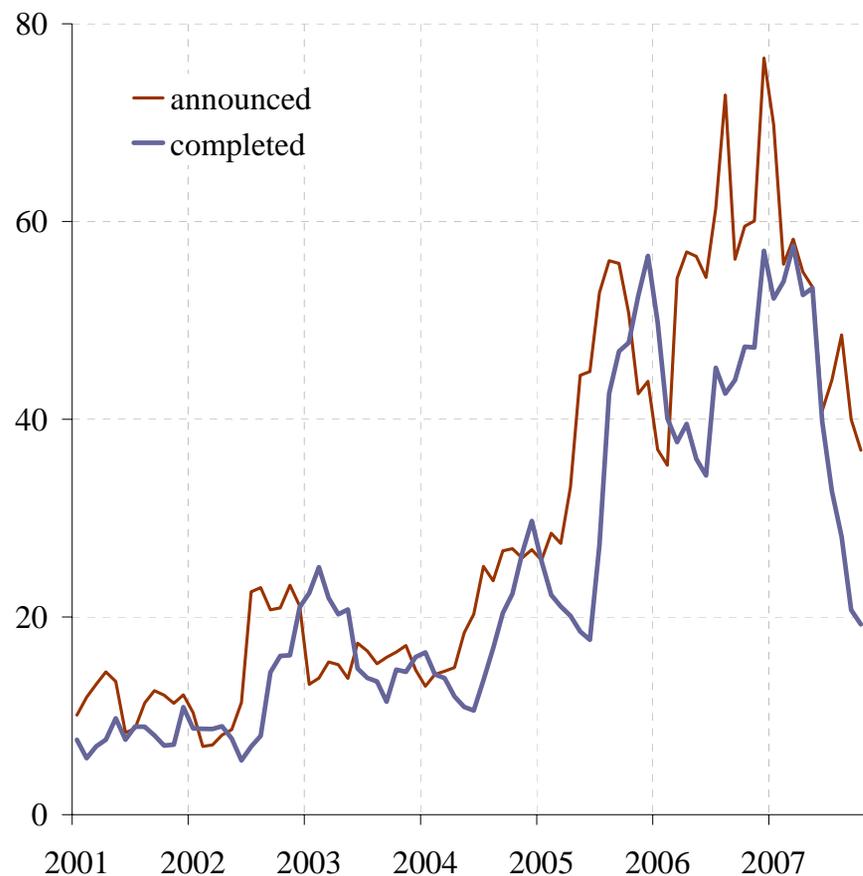
Option-implied risk-neutral densities of oil prices (USD per barrel)



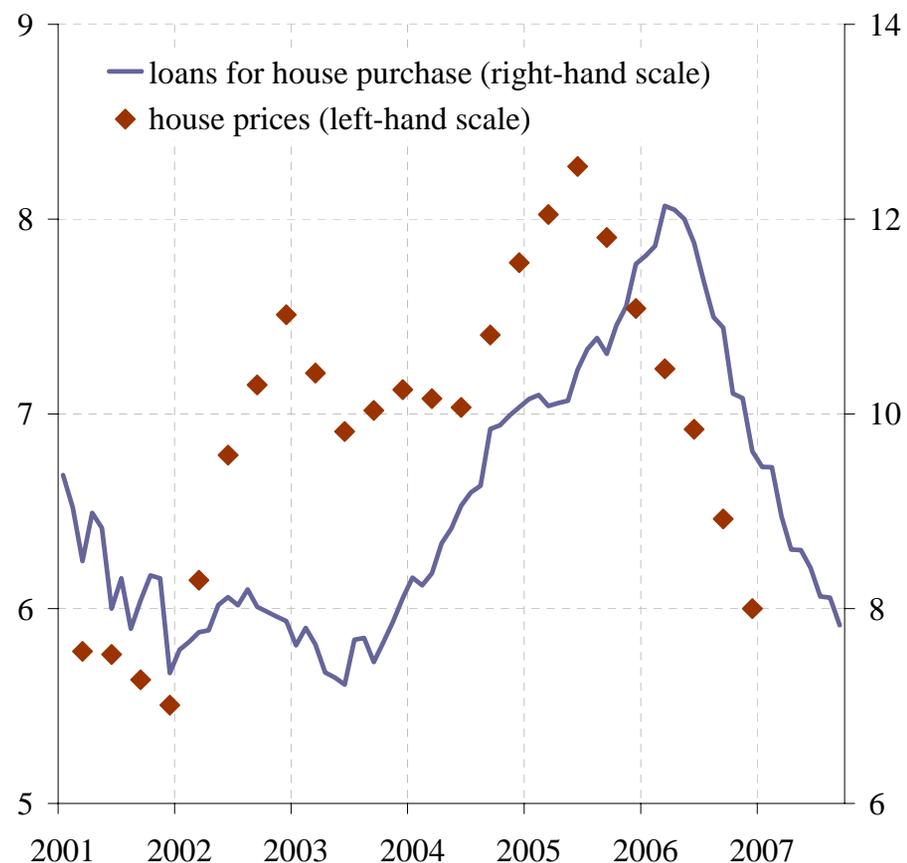
Vulnerabilities in the euro area non-financial sectors:

Risks remain among the highly leveraged firms; household sector balance sheet expansion has slowed down

Leveraged loan agreements in the euro area (EUR billions)

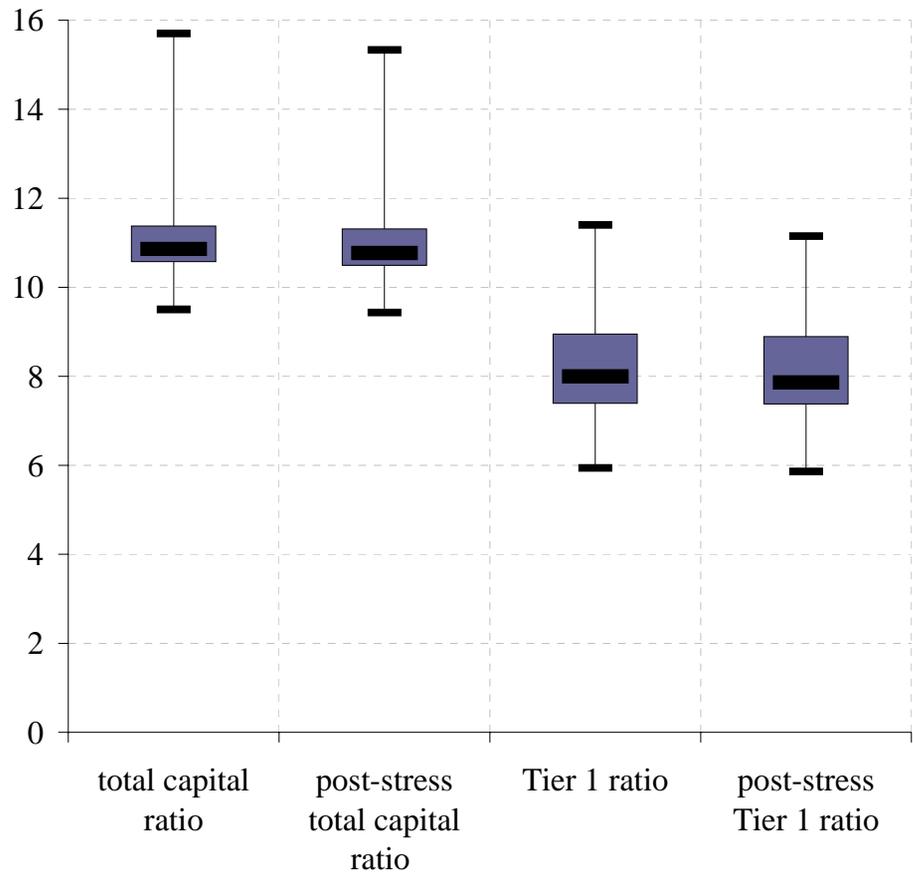


Loans for house purchase and house price inflation in the euro area (% change per annum)

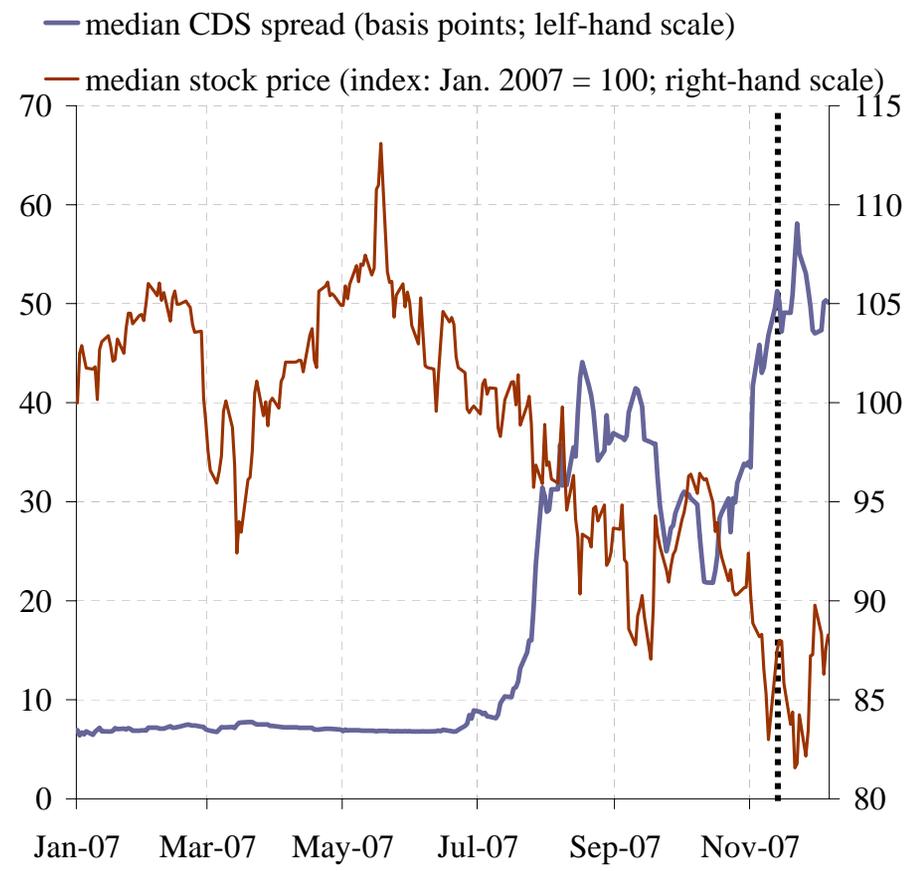


Vulnerabilities in the large and complex banking groups: Re-intermediation of illiquid assets may pose risks for capital and forward-looking indicators suggest near-term challenges

Distribution of capital ratio levels of euro area large and complex banking groups before and after stress (%)



Medians of euro area large and complex banking groups' credit default swap (CDS) spreads and share prices



Overall assessment

With financial systems currently undergoing a process of de-leveraging and re-intermediation, the uncertainty surrounding the financial stability outlook for the euro area has heightened

As the adjustment process in the financial sector over the coming months is likely to prove challenging, the system could be more vulnerable than before to the crystallisation of other risks that have been identified in the FSR and which remain relevant

All in all, the risks to the euro area financial system stability have materially increased over the past six months

Overall assessment (continued)

There are, however, several mitigating factors:

- The economic outlook remains broadly favourable
- Although pockets of vulnerability can be identified, the balance sheets of households and firms remain largely in good shape supporting the overall creditworthiness of the non-financial sector
- The capital positions of core financial institutions are also generally sound

This overall positive assessment of shock-absorbing capacity should not provide any grounds for complacency given the heightened uncertainties facing the financial system

Vigilance is of the essence and financial institutions in particular should step up their efforts to effectively manage the risks that may lie ahead

Initiatives and measures that are being taken, both by policy-makers and by the financial industry, aimed at restoring confidence and addressing the weaknesses that have been unearthed by the recent market turmoil should contribute to strengthening the resilience of the financial system