EUROPEAN CENTRAL BANK

EUROSYSTEM

SUMMARY OF THE DECEMBER 2008 FINANCIAL STABILITY REVIEW

The central objective of the ECB Financial Stability Review is to identify the main sources of risk and vulnerability to financial system stability and to provide a comprehensive assessment of the capacity of the euro area financial system to absorb adverse disturbances.

Stresses on the financial systems in mature economies persisted over the summer months of 2008 as banks had to absorb further asset valuation write-downs in an environment where wholesale funding costs remained elevated. At the same time, uncertainty about the global economic outlook grew, risk aversion among financial market participants surged and the prices of most financial assets fell. Following the bankruptcy of Lehman Brothers, the persistent liquidity stresses eventually gave way to deeper concerns about the creditworthiness of even the largest financial institutions and the adequacy of their capital buffers. This left many key financial firms facing mounting challenges in accessing short-term funding and capital markets, which triggered sharp drops in their stock prices and ultimately threatened their liquidity and solvency positions.

The extraordinary remedial actions taken by central banks and governments, which are aimed at addressing liquidity stresses and strengthening capital positions, thus contributing to restoring confidence in, and improving, the resilience of financial systems, were successful in stabilising the euro area banking system. Over time, once fully implemented, these measures should lower the cost of bank credit and facilitate its provision to the economy. That said, in order to revive the process of efficient financial intermediation, financial institutions will need to play their part in the adjustment process by taking advantage of these measures.

Looking forward, a number of risks and vulnerabilities remain which the financial system may have to cope with, notably the possibility of:

- a further deterioration in the US and the euro area housing markets and the impact this may have on banks' loan quality and the value of securities backed by mortgage-related assets;
- a deeper and more prolonged slowdown in both the global and the euro area economy than currently expected that could cause a sharper and broader deterioration in borrowers' ability to service their debt;
- a more pronounced de-leveraging by banks, due to persistently high funding costs and concerns about the adequacy of capital buffers, which could negatively affect the flow of credit extended to the broader economy; and
- an increase in financial market volatility caused by a further unwinding of positions by hedge funds.

All in all, given the risks that lie ahead, banks will need to be especially watchful in ensuring that they have adequate capital and liquidity buffers in place to cushion the challenges ahead.

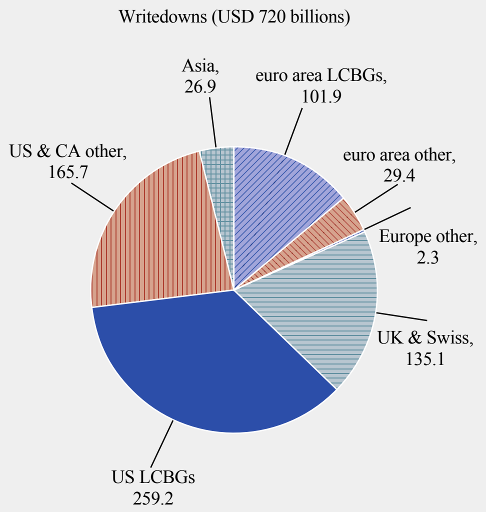
OVERVIEW

Between the beginning of the second quarter of 2007 and early December 2008, the total write-downs due to mark-to-market losses for the global banking system amounted to USD 720 billion ...

... with euro area banks accounting for USD 131 billion, or 18%, of the global amount

Chart 1 Turmoil-related bank writedowns by region

(Q2 2007 – 10 Dec. 2008)



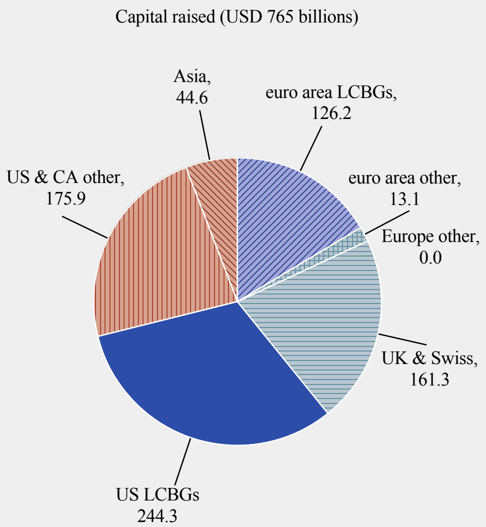
Sources: Bloomberg and ECB calculations.
Note: Write-downs include reductions in after-tax income due to valuation changes in sub-prime and structured credit securities, leveraged loans commitments, commercial mortgage backed securities, CDS guarantor contracts and new loan impairment charges. Figures are pre-tax and net of any relevant financial hedges and offsetting gains unless the firm does not report these factors. Capital raised also includes asset sales and divestitures.

Over the same period, banks raised USD 765 billion worth of new capital throughout the world, USD 139 billion, or 18%, of which was accounted for by euro area banks ...

... on aggregate, banking systems have consequently more than covered the losses they have reported thus far with fresh capital

Chart 2 Capital injections into banks by region

(Q2 2007 – 10 Dec. 2008)



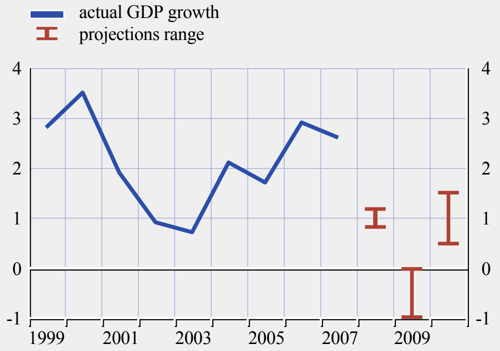
Sources: Bloomberg and ECB calculations.
Note: Capital raised also includes asset sales and divestitures.

Credit losses of euro area banks generally remained low in 2008 ...

... in the period ahead, a key risk for euro area financial system stability is the outlook for borrowers' credit quality and the possible adverse feedback of financial system stresses on the broader economy

Chart 3 Real GDP growth in the euro area and the Eurosystem staff macroeconomic projections for the euro area

(percent change per annum)



Source: ECB.

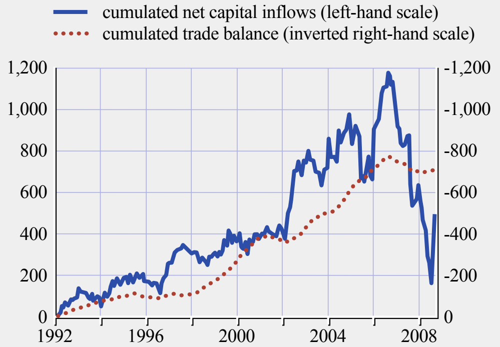
RISKS IN THE GLOBAL MACRO-FINANCIAL ENVIRONMENT

The risk of a disorderly correction of global imbalances persists ...

... the US trade deficit remains large and inflows of private capital from abroad have not been matching the trade balance

Chart 4 US trade balance and net capital inflows to the United States

(USD billions; 12-month moving sums)



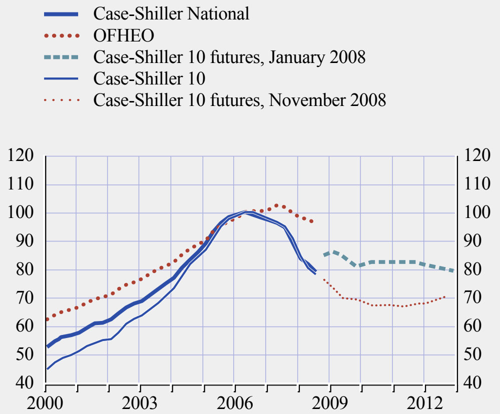
Source: US Bureau of Economic Analysis and US Treasury International Capital System.

Since June 2008, US household sector balance sheet conditions have deteriorated somewhat further ...

... and futures markets are pricing in another year of declines in house prices, suggesting that further credit losses could yet crystallise

Chart 5 US house prices and outlook

(index: Q2 2006 = 100; nominal prices)



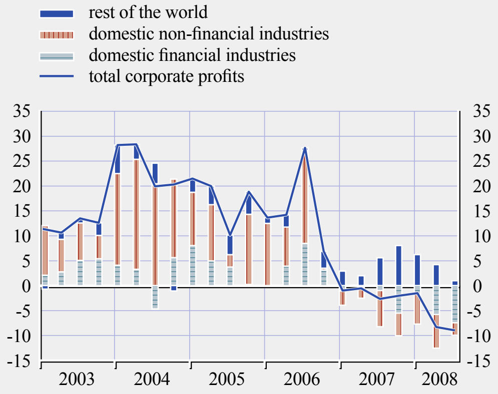
Source: S&P/Case-Shiller, OFHEO, US Bureau of Labour Statistics and ECB calculations.

The outlook for the US corporate sector has weakened substantially amid slowing economic growth ...

... with profits from the rest of the world the only positive contributor to profit growth in 2007 and 2008

Chart 6 US corporate sector profits

(percentage point contribution to year-on-year growth; seasonally adjusted)



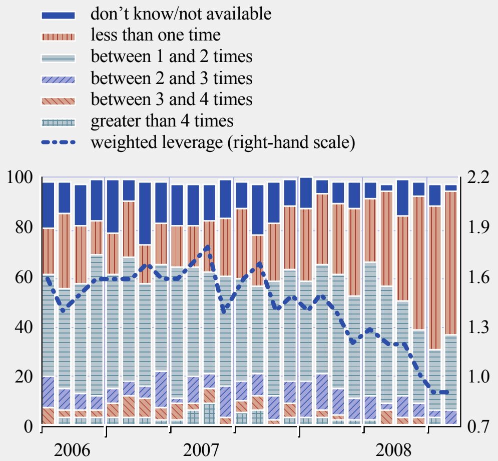
Source: US Bureau of Economic Analysis.
Note: Corporate profits include inventory valuation and capital consumption adjustments. Profits from the rest of the world (RoW) are receipts from the RoW less payments to the RoW.

Hedge funds have been deleveraging sharply in order to preserve capital ...

... the process has been partly voluntary, but forced liquidations have also increased in response to investor withdrawals

Chart 7 Hedge fund leverage

(percentage of responses and weighted average leverage)



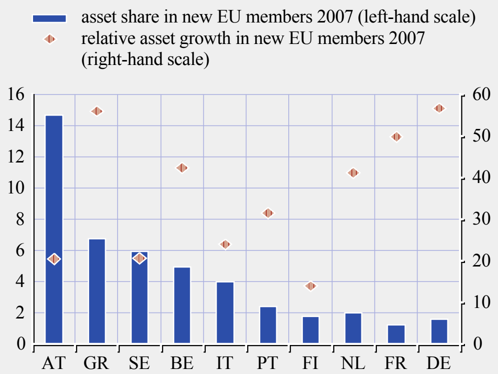
Source: Merrill Lynch Global Fund Manager Survey.
Note: Leverage is defined as a ratio of gross assets to capital. The number of responses varied from 32 to 45.

The presence of euro area financial institutions in central and eastern European countries has continued to grow rapidly ...

... but the economic slowdown in these countries implies that risks originating from EU banks' exposures to the new EU Member States have grown

Chart 8 Asset share of EU banks' subsidiaries in new EU Member States and relative asset growth in 2007

(percentage)



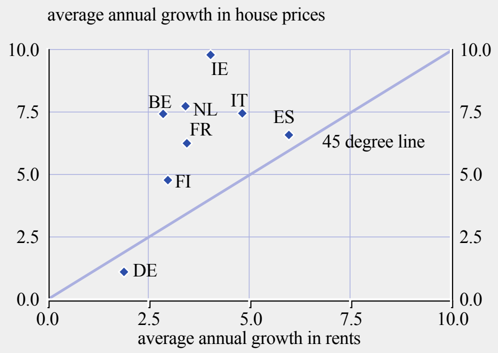
Sources: BIS, BSC and ECB calculations.

Euro area households' income and employment expectations have deteriorated further …

… while risks of house price declines remain in some parts of the euro area, contributing to growing credit risks for banks

Chart 9 House prices and rents in selected euro area countries

(average percentage changes over 1985-2007)



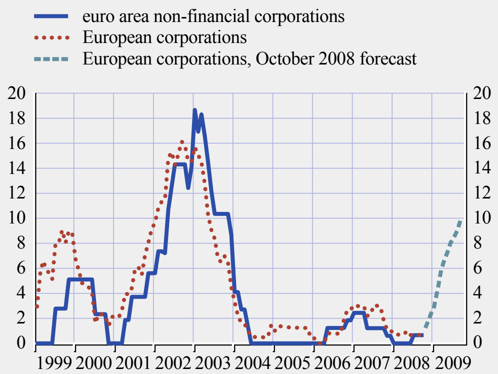
Sources: National data and ECB calculations.
Note: Rents reflect the HICP component of rent extended back using national data.

Euro area non-financial corporate sector balance sheets are relatively sound …

… but the slowdown in demand has contributed to an increase in expected distress among lower-rated firms

Chart 10 Euro area and European speculative-grade-rated corporations' default rates and forecast

(percentage; 12-month trailing sum)

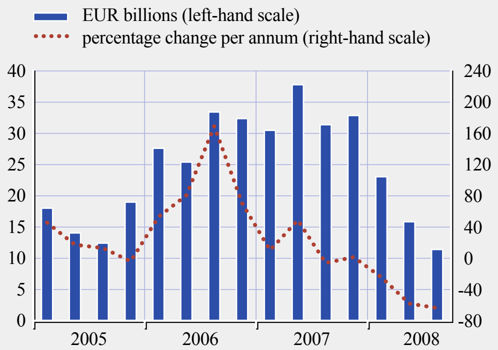


Source: Moody's.

The decline in direct investment volumes contributed to stabilising or even falling prices in the commercial real estate sector …

… to which many euro area banks have large financing and/or investment exposures

Chart 11 Direct commercial property investment volumes in the euro area



Source: Jones Lang LaSalle.
Note: Data for Cyprus, Malta and Slovenia are not available.

The failure of Lehman Brothers triggered a further increase in counterparty risk in global money markets ...

... with the widening of term money market spreads driven by uncertainty about the creditworthiness of counterparties and banks' own liquidity needs

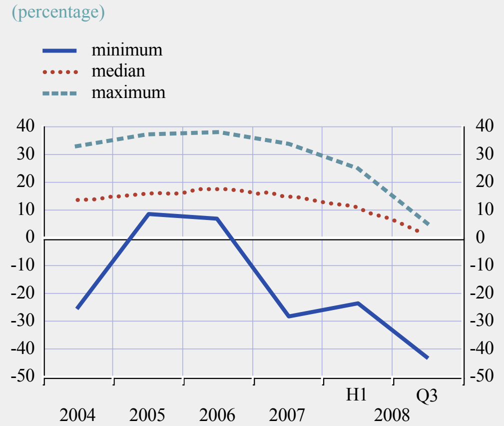
Chart 12 Spreads between EURIBOR and EONIA swap rates

Source: Bloomberg.

For euro area large and complex banking groups (LCBGs), persistent funding problems, as well as sizeable write-downs on securities, contributed to falling profits ...

... although performance measures have shown a rather wide dispersion across institutions since the beginning of the turmoil

Chart 13 Dispersion in return on equity (ROE) for euro area large and complex banking groups

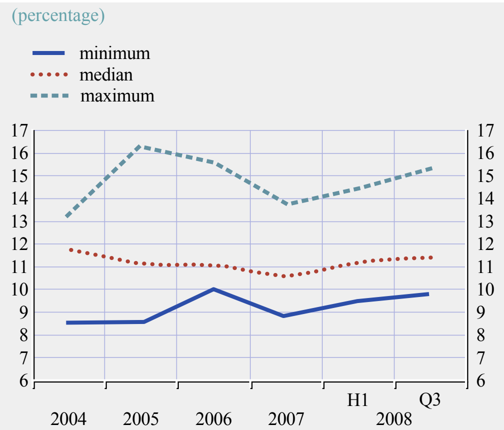


Sources: Individual institutions' financial reports and ECB calculations.
Note: Q3 2008 figures are available for 11 of 22 LCBGs.

Declining growth of risk-weighted assets and new capital raised contributed to improving solvency ratios ...

... but further risks ahead imply that banks should use all means at their disposal to bolster their capital buffers in order to minimise the risk of a slowdown in lending to the broader economy

Chart 14 Overall solvency ratios for euro area large and complex banking groups



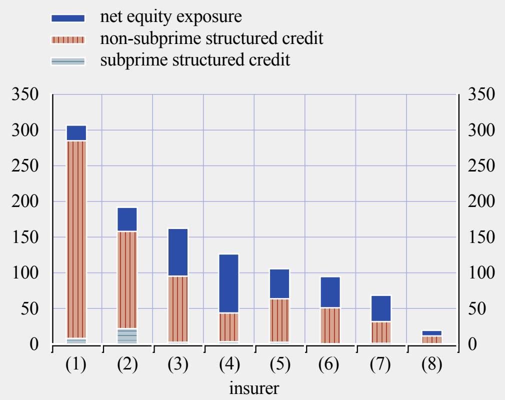
Sources: Bureau van Dijk (Bankscope), individual institutions' financial reports and ECB calculations.
Note: Q3 2008 figures are available for 13 out of 22 LCBGs.

Investment losses have also contributed to a deterioration in the profit outlook of the euro area insurance sector ...

... but the magnitude of the exposures to structured credit products and equities differs across institutions

Chart 15 Credit and equity exposures of selected euro area primary insurers and reinsurers

(percentage of shareholders' equity)



Sources: JPMorgan Chase & Co., institutions' financial disclosures and ECB calculations.
Note: Data also include exposures of some insurers' banking activities.

The financial sector turmoil intensified sharply in September 2008 ...

... coordinated actions by central banks and governments contributed to a decline in systemic risk ...

... but indicators remain at elevated levels, suggesting that further stress cannot be ruled out

Chart 16 Systemic risk indicator for large and complex banking groups

1. Turmoil begins
2. Bear Stearns rescue take-over
3. Rescue plan of US Fannie Mae and Freddie Mac announced
4. Lehman Brothers defaults
5. US Senate approves Paulson plan
6. Coordinated central bank and government actions

Sources: Bloomberg and ECB calculations.
Note: Implied probability of two or more LCBGs defaulting simultaneously within the next two years.

The extraordinary measures taken by the public sector to support financial institutions include liquidity and capital support, debt guarantees and asset purchases …

… but it is important that the financial sector plays its part in the adjustment process by taking advantage of these measures

Measures taken globally to support financial system stability

	Euro area	Other Europe	US
Liquidity	Extensive longer term refinancing, expanded collateral frameworks, joint efforts to provide USD liquidity		
	Joint efforts to provide liquidity outside the euro area between the ECB and the central banks of Denmark, Hungary, Switzerland		
Capital injections	EUR 92 billion injected out of EUR 201 billion of explicit commitments	EUR 64 billion injected out of EUR 68 billion of explicit commitments	USD 242 billion of the USD 700 billion TARP injected + USD 200 billion into 2 GSEs
Guarantees	Temporary rise of deposit insurance limits. Guarantees on new bank debt established		
	Wider – even blanket – guarantees of bank liabilities set up in some countries		
Asset purchases	EUR 30-50 billion fund in Spain. Swapping bank assets against government bonds in Greece (EUR 8 billion) and Italy (EUR 40 billion)	EUR 42 billion fund in Switzerland to purchase illiquid assets.	Not included in the TARP anymore. Several other programs to purchase whole loans, MBSs, ABCP
Regulation changes	Temporary bans for short-selling of financial stocks		
	Allowing for reclassifying financial assets out of trading portfolio in the IFRS (IASB)		Clarification of the application of fair value accounting under US GAAP in a market that is not active (FASB)

Source: ECB.

THIS ISSUE OF THE FINANCIAL STABILITY REVIEW ALSO CONTAINS THE FOLLOWING SPECIAL FEATURE ARTICLES: