

Financial Stability Review December 2006

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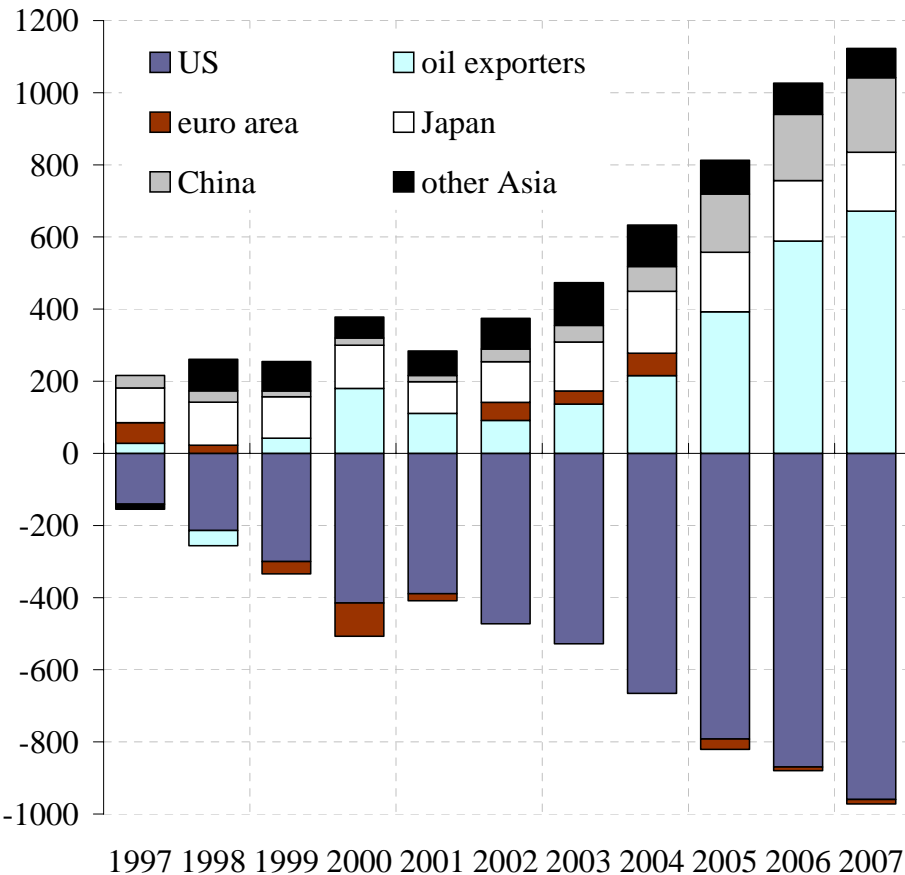
Frankfurt am Main, 11 December 2006

Outline

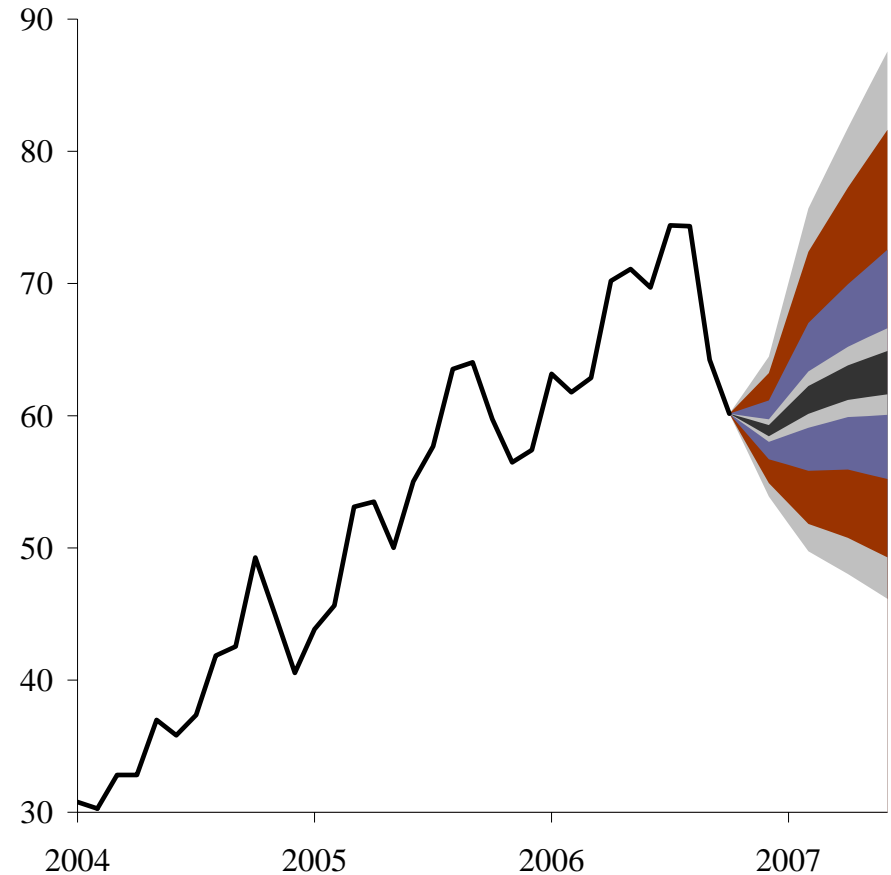
- **Developments since the June 2006 assessment**
- **Potential vulnerabilities in:**
 - the external environment
 - global and euro area financial markets
 - the euro area corporate and household sectors
 - euro area financial institutions
- **Overall assessment**

Global financial imbalances and oil prices remain key sources of risk to financial stability

Global current account balances (USD billions)

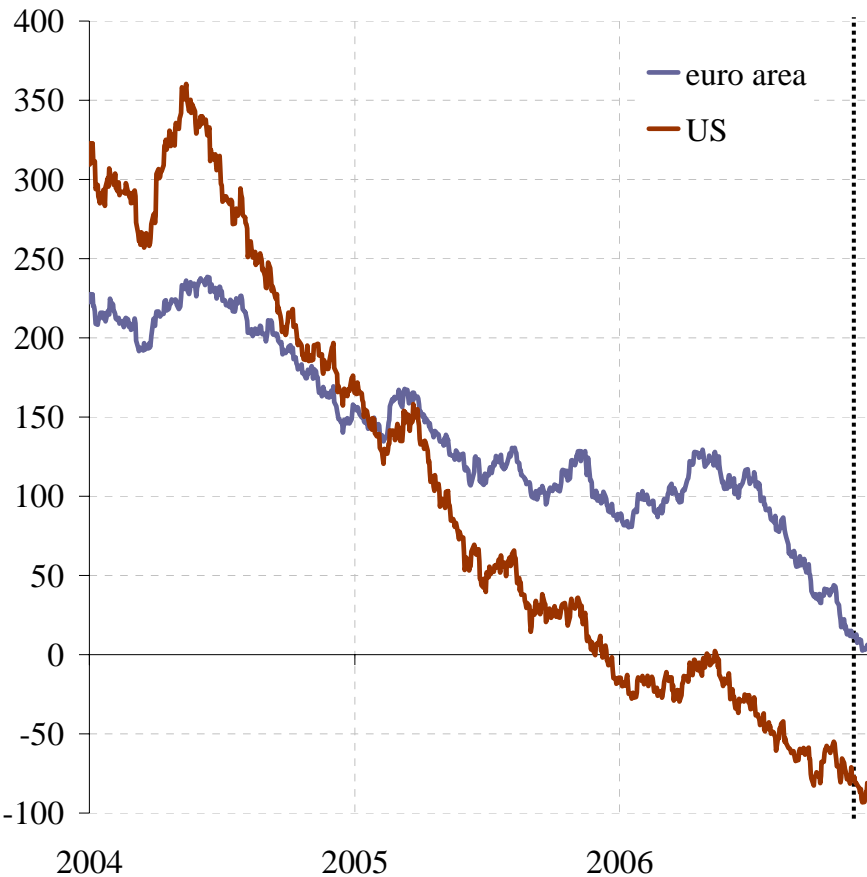


Oil prices: distribution implied by option prices (2 Nov.) (USD per barrel)

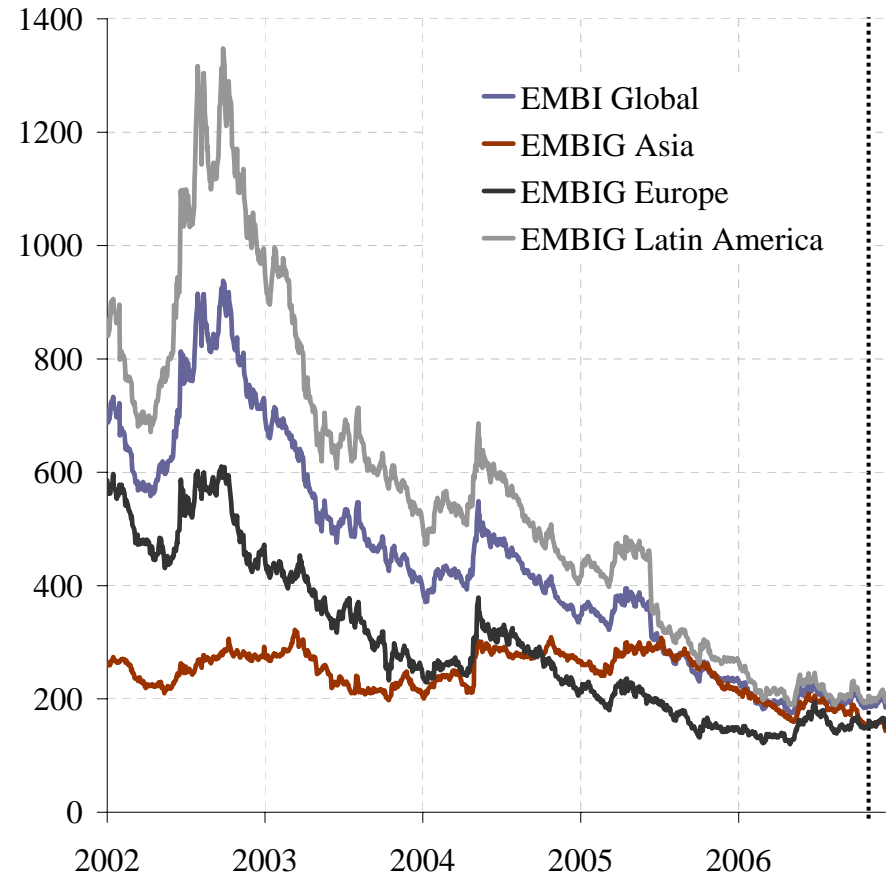


Bond yield “conundrum” persists and emerging market bond spreads remain unusually low

Yield curve slope in the euro area and US (10-yr govt. bond yield less 3-month T-bill yield, basis points)

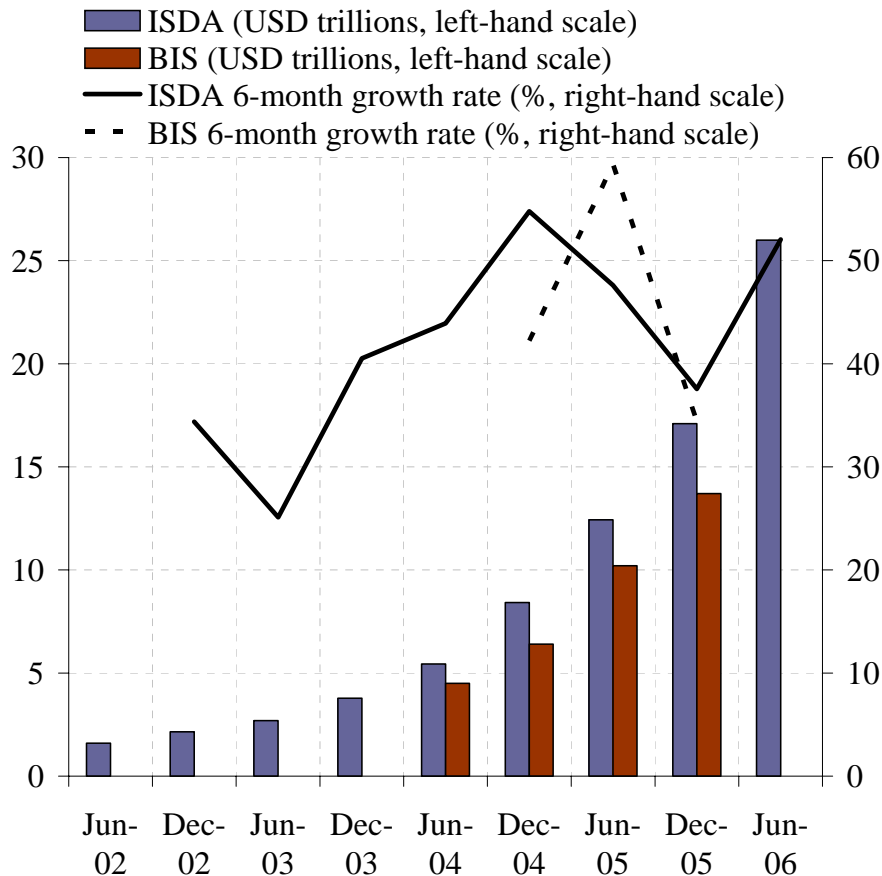


Emerging market sovereign bond spreads (basis points)

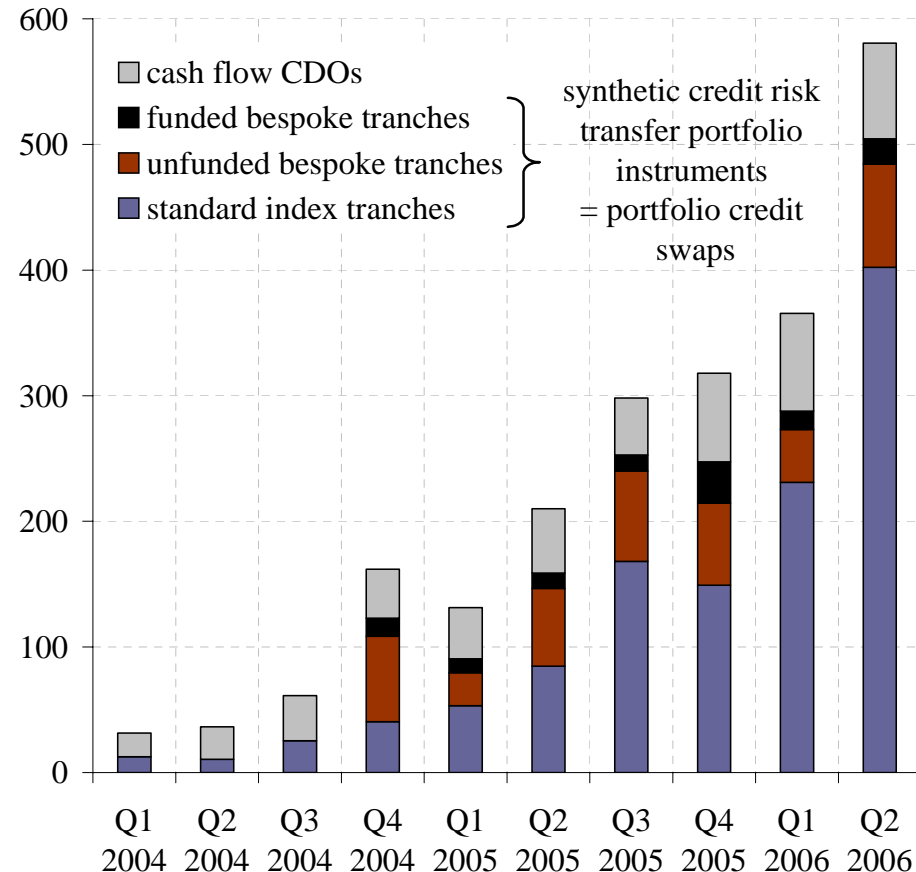


Strong growth of credit risk transfer market continues

Size and growth of global credit default swap (CDS) market

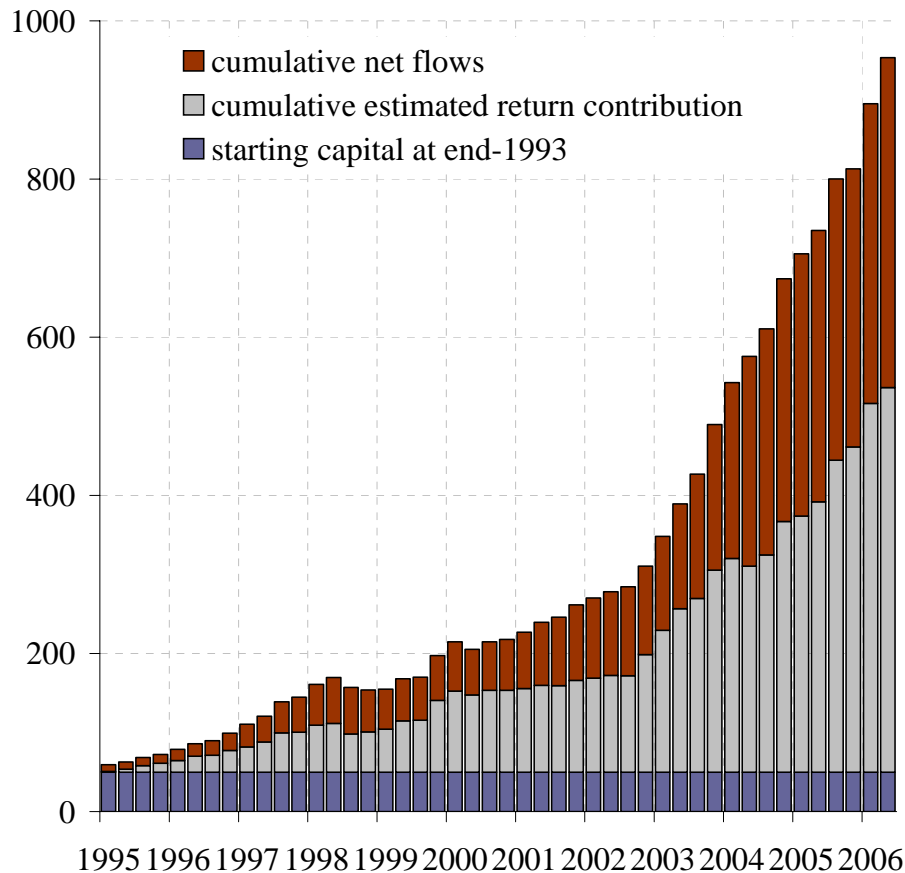


Global collateralised debt obligation (CDO) issuance (USD billions)

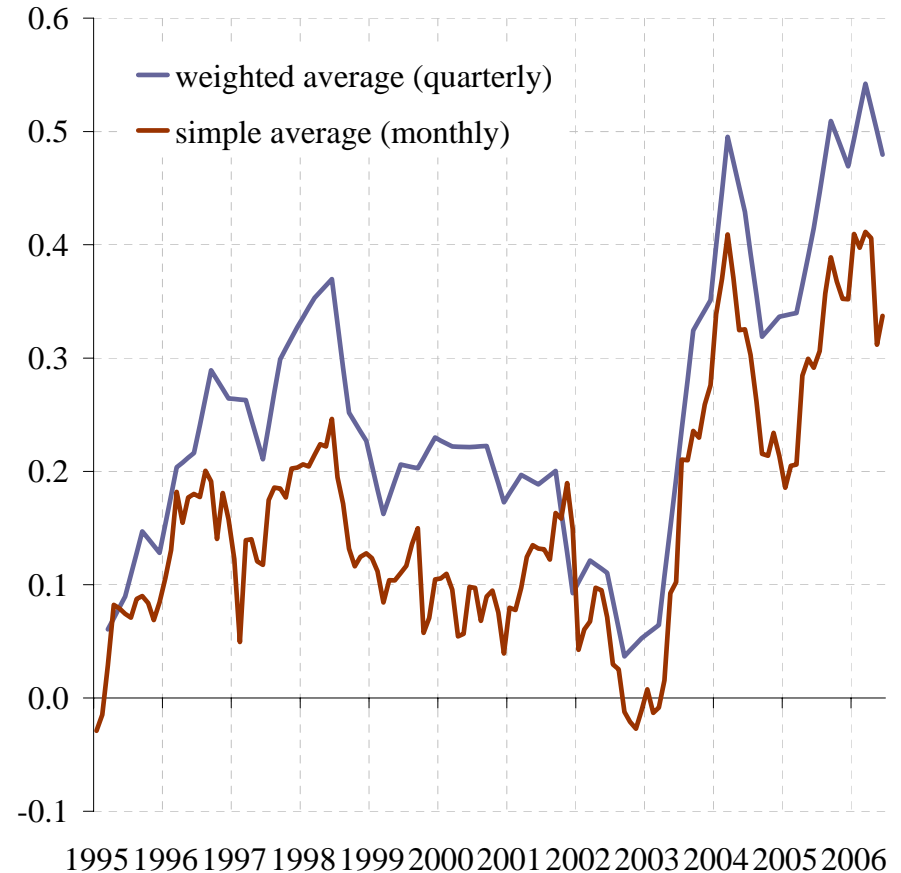


Hedge fund capital grew further but risk of crowded trades remains

Decomposition of global hedge fund capital under management (USD billions)



Return correlations among hedge fund strategies



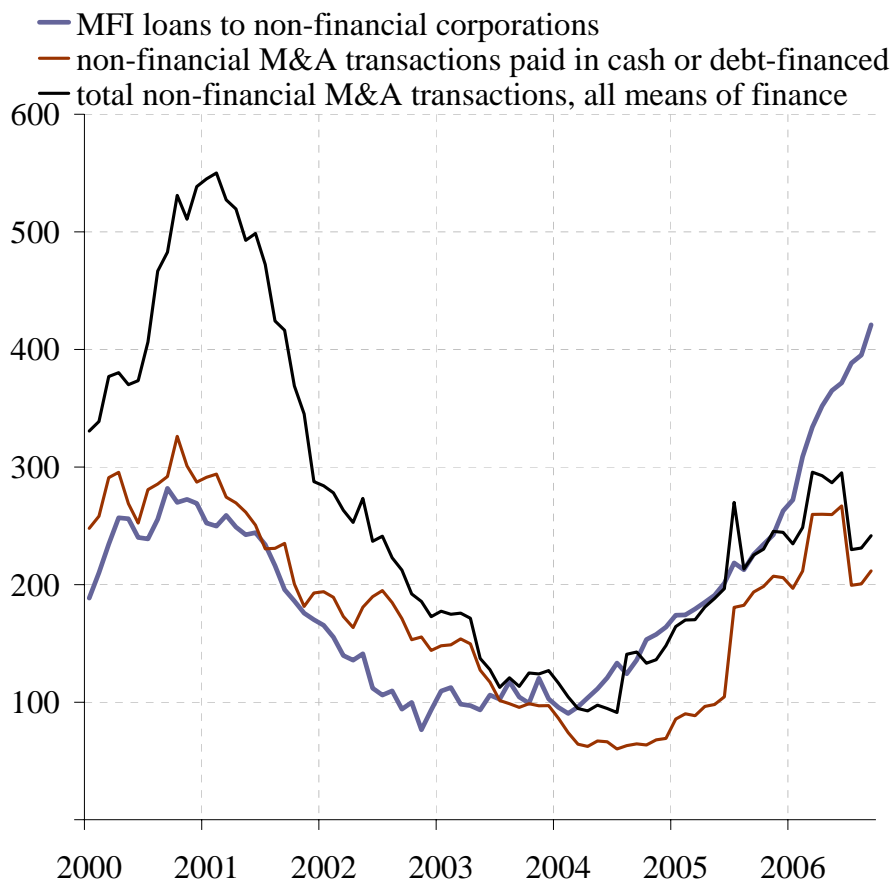
A “triangle” of vulnerability

- 1) Credit cycle deterioration, possibly aggravated by leveraged lending
- 2) Credit derivatives – uncertainties about the way credit risk has been spread in the financial system
- 3) Hedge funds – limited transparency and risk of crowded trades

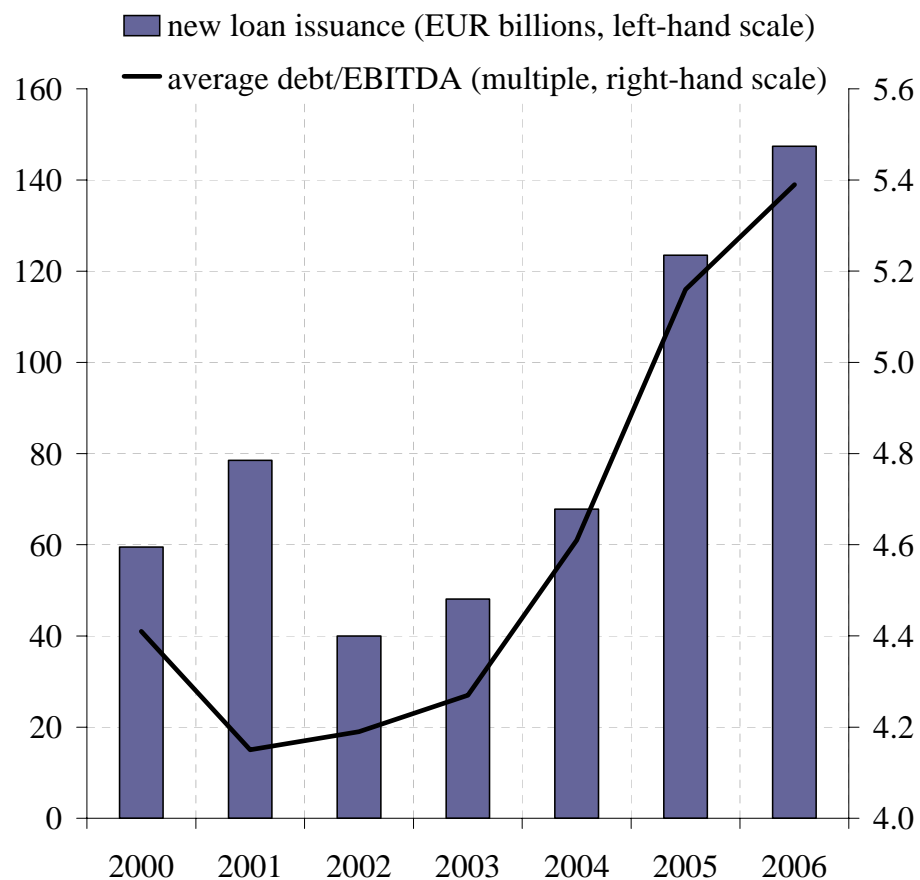
Possible scenarios: An adverse turn of the credit cycle, credit event(s), or an increase in market volatility resulting in impaired functioning of the credit derivatives market could trigger correction of vulnerabilities

Euro area corporate sector: Borrowing is rising as takeovers and leveraged lending surge

Loans to firms and M&A deal values where euro area firms act as acquirer (EUR billions)

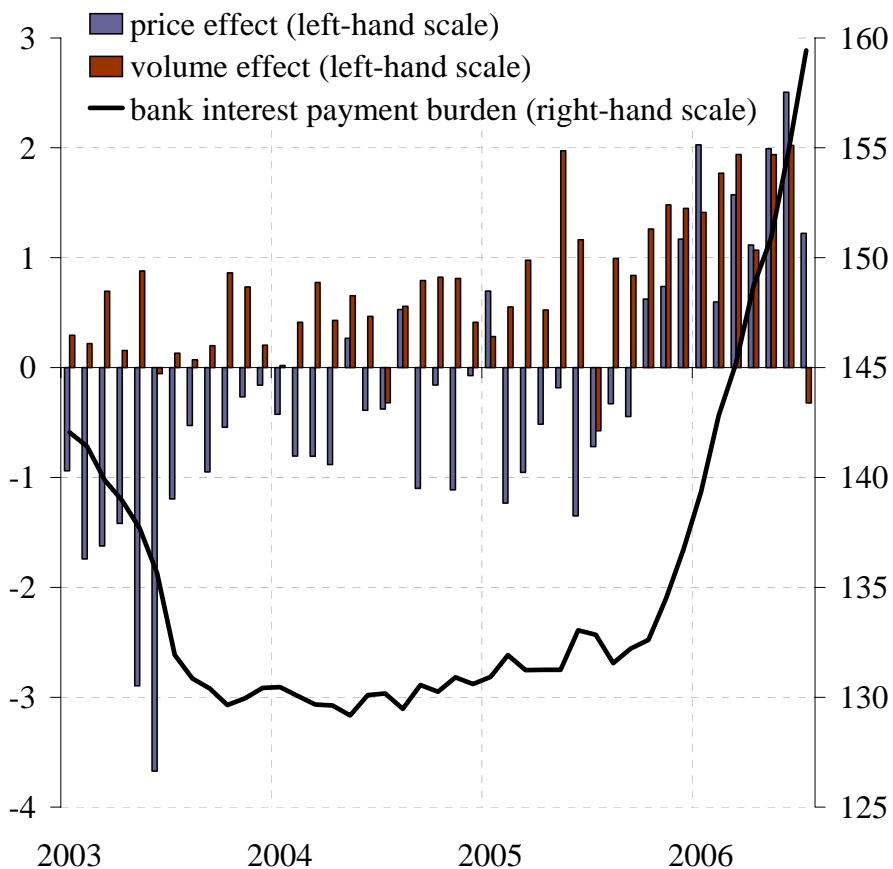


EU new leveraged loan issuance and average degree of leverage

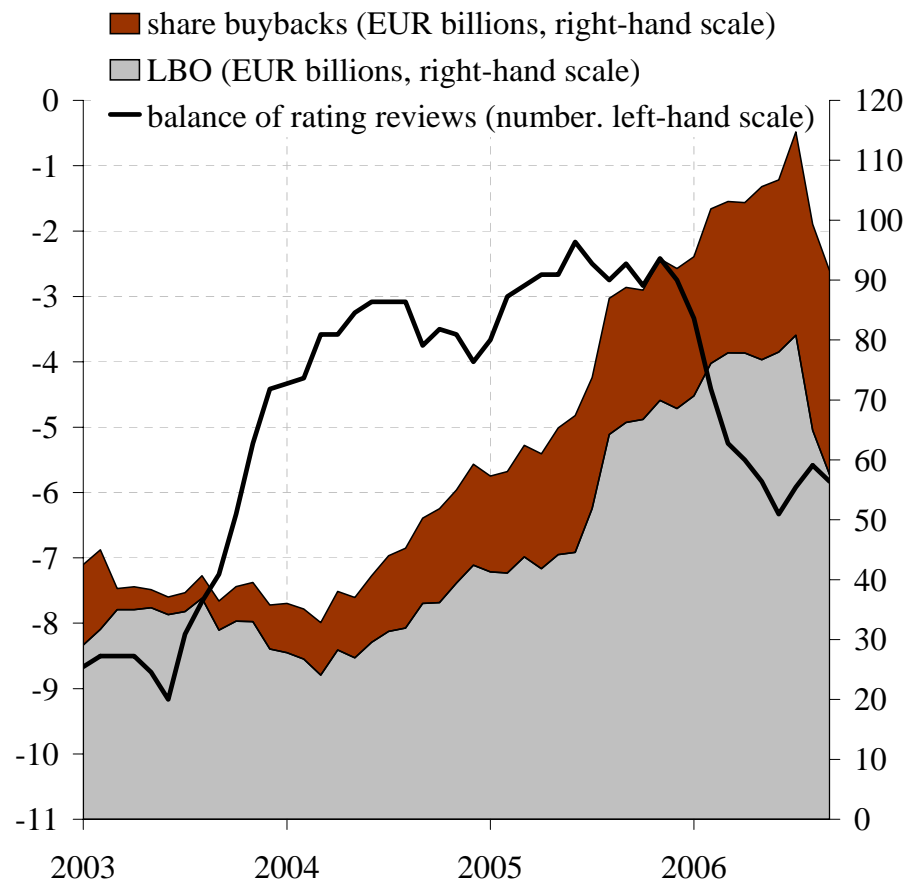


Euro area corporate sector: Credit quality deteriorating as leverage and interest payment burden rise

Bank loan interest payment burden of firms, including changes due to price and volume effects (EUR billions)

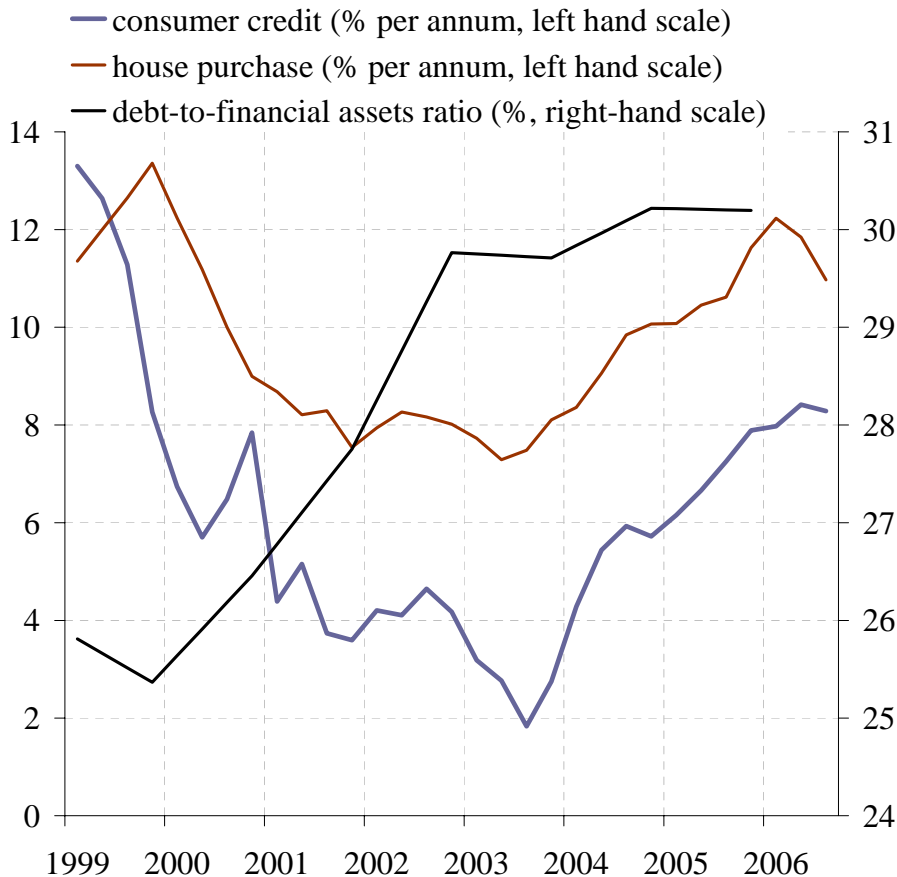


Share buybacks, LBOs and balance of credit rating reviews

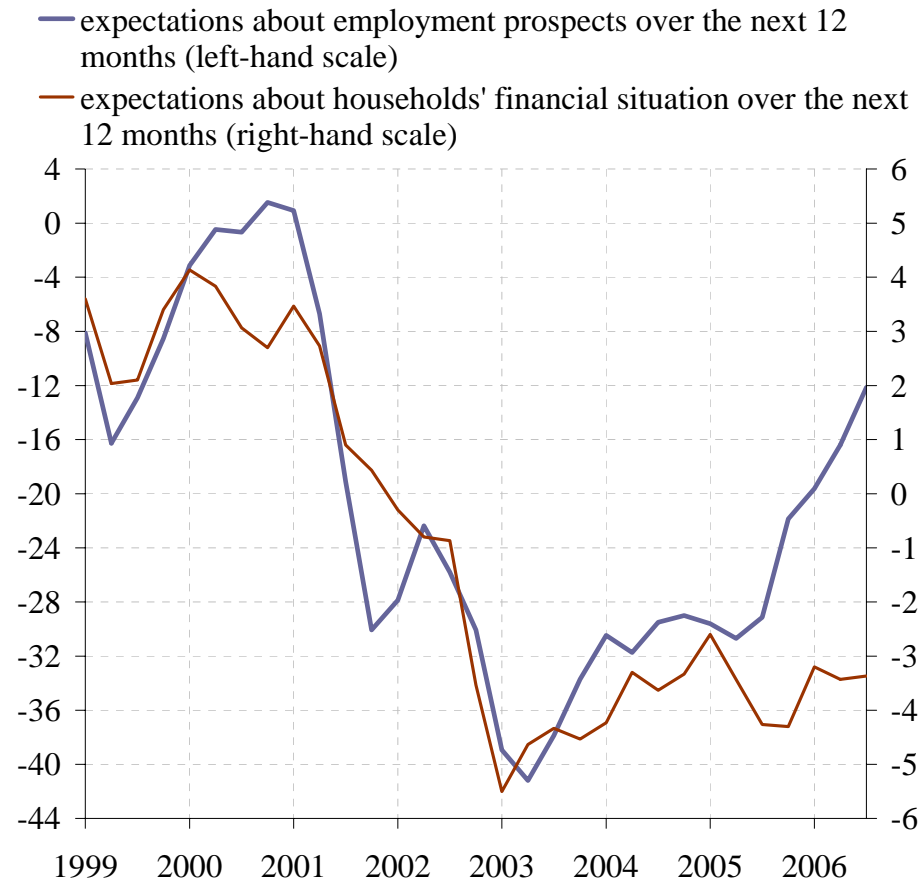


Euro area household sector: Indebtedness remains high and financial position not expected to improve

Annual growth of loans to households and debt-to-financial assets ratio in the euro area

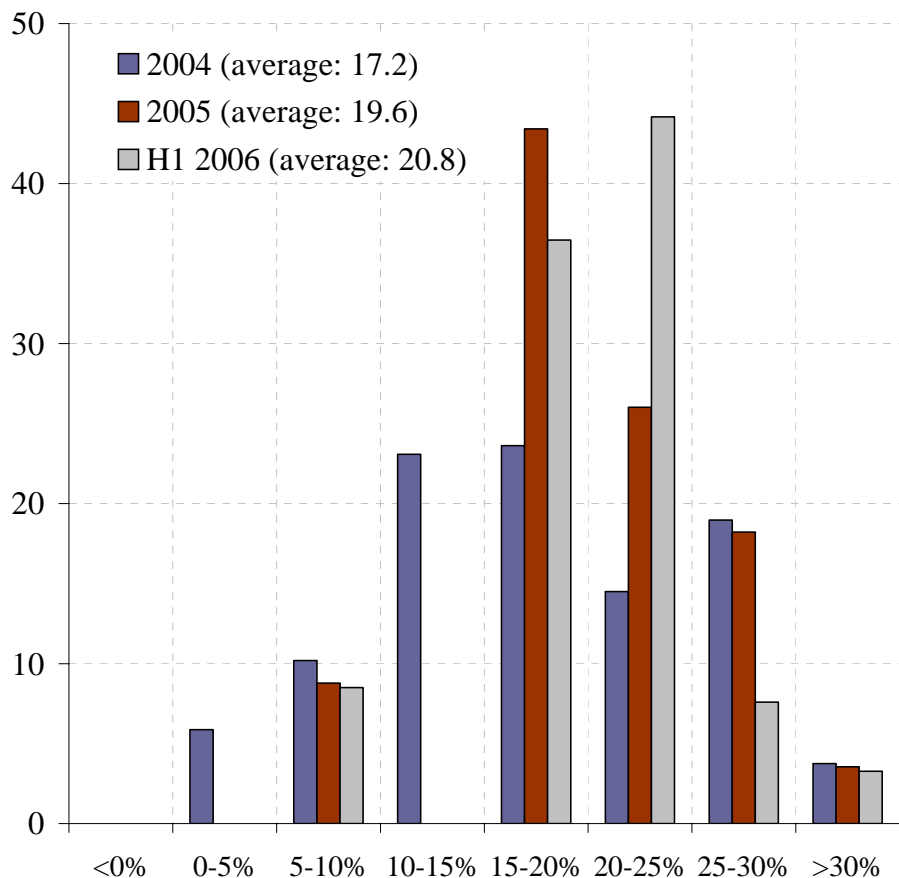


Euro area households' financial situation and employment expectations

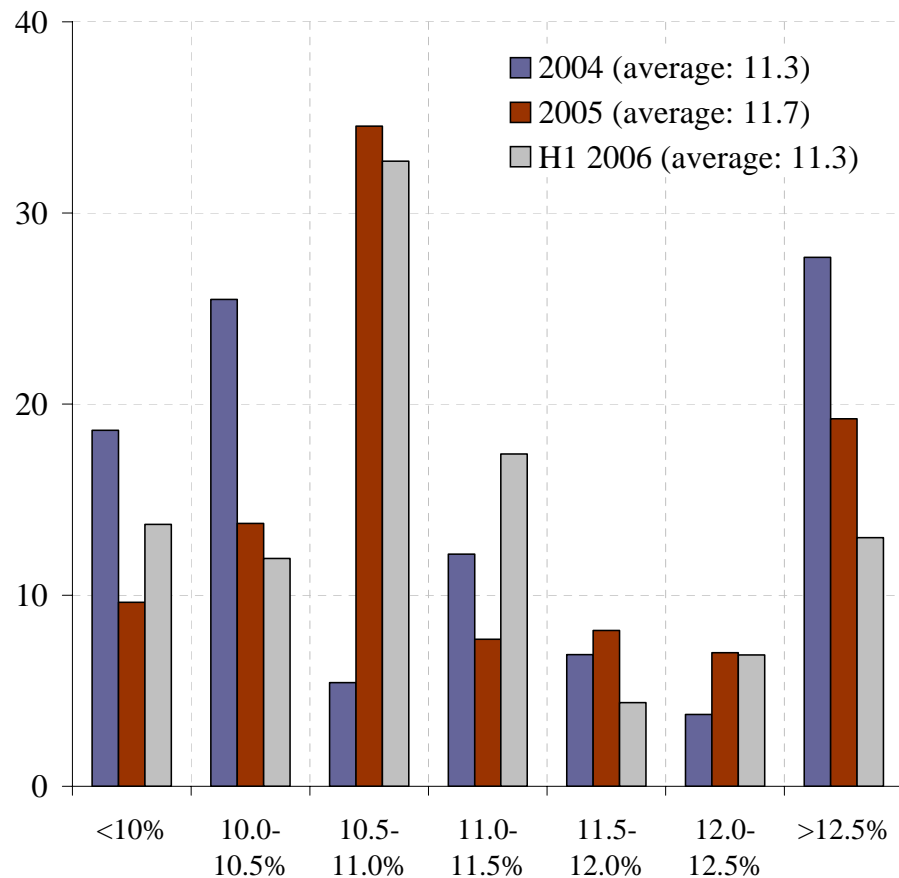


Euro area LCBGs: Profitability strengthened further and solvency remained comfortable

Frequency distribution of return on equity (ROE) of LCBGs (%)

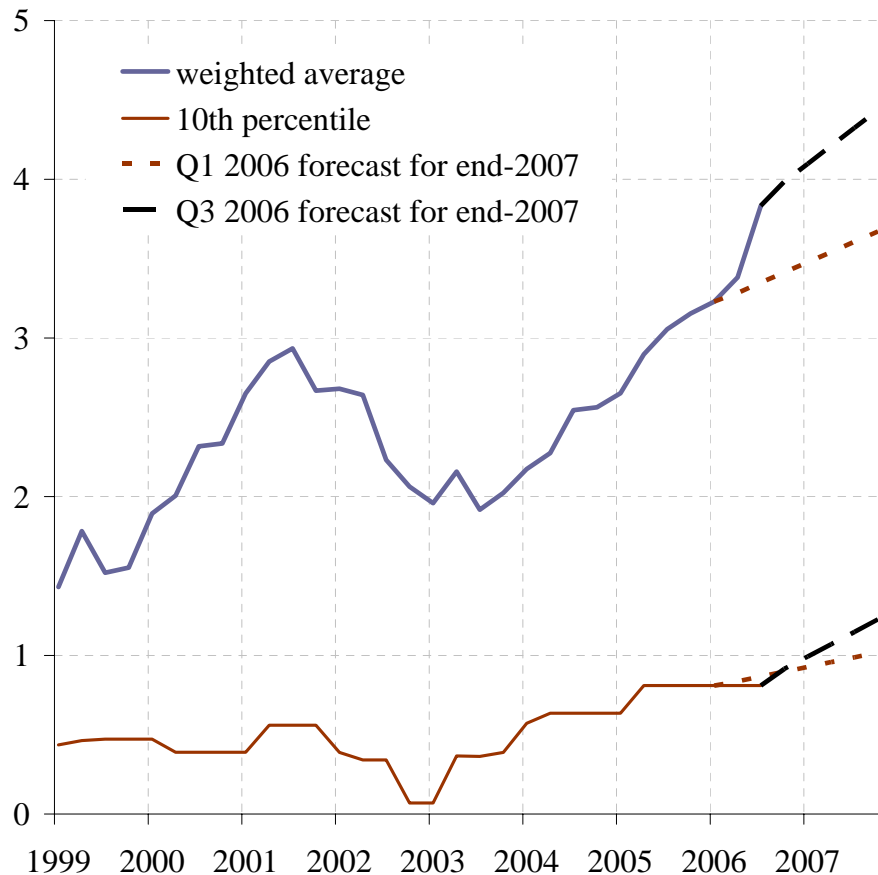


Frequency distribution of overall solvency ratios of LCBGs (%)

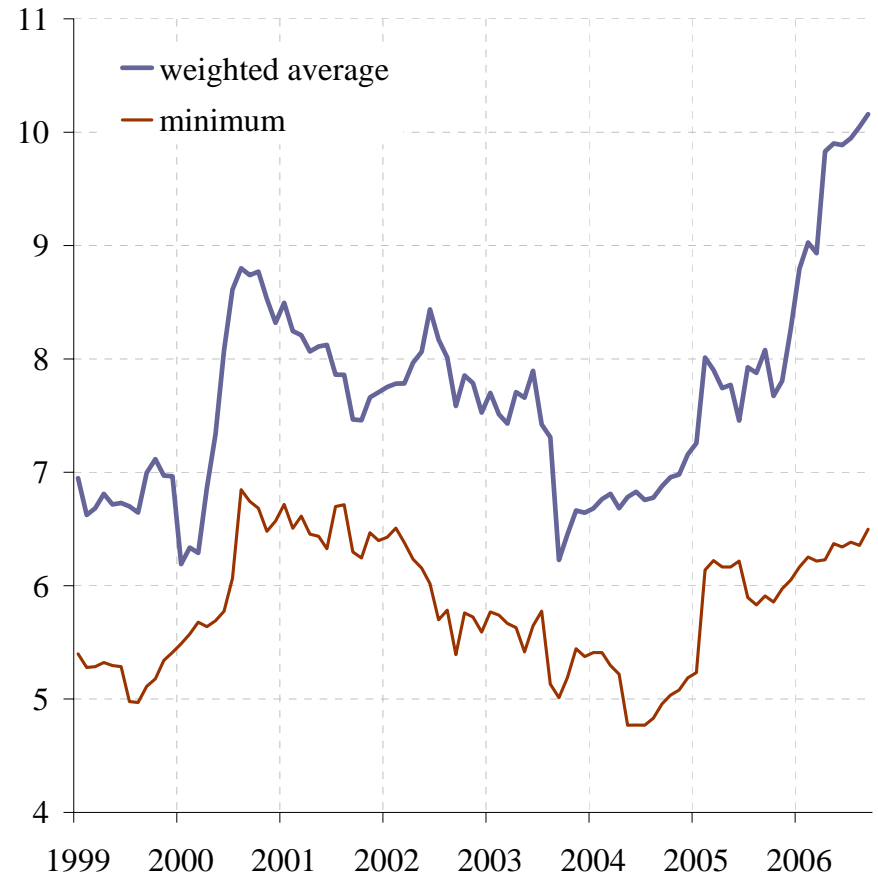


Euro area LCBGs: Forward-looking indicators point towards an optimistic central outlook

Earnings per share and end-2007 forecasts for LCBGs (EUR)

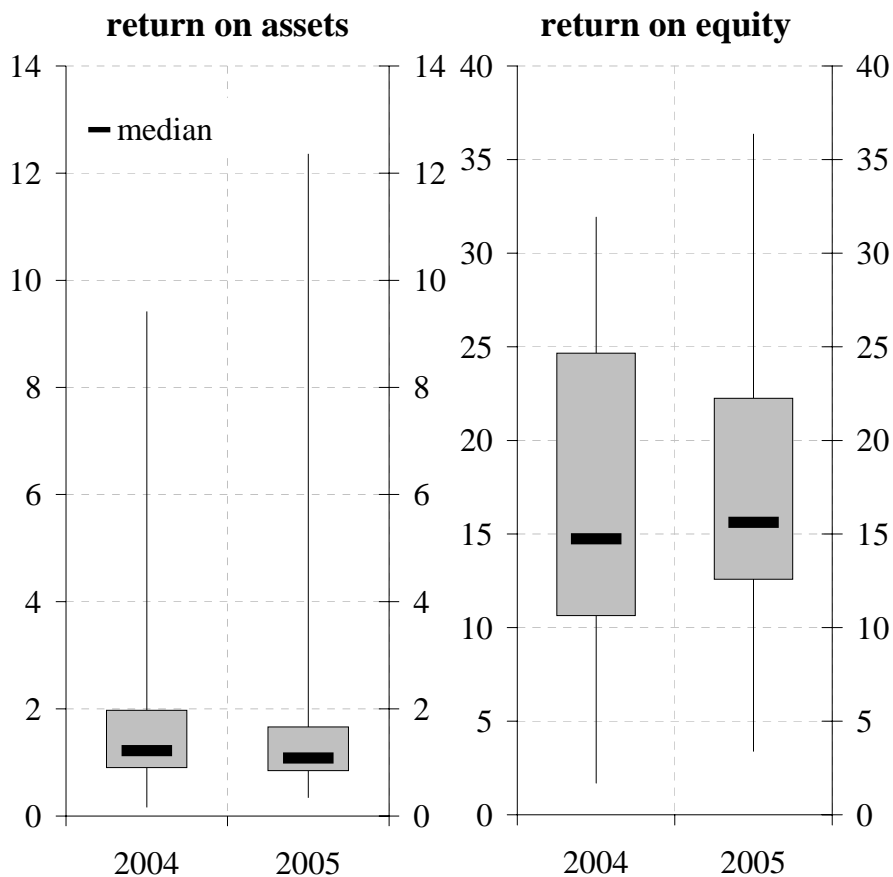


Distance to default for LCBGs

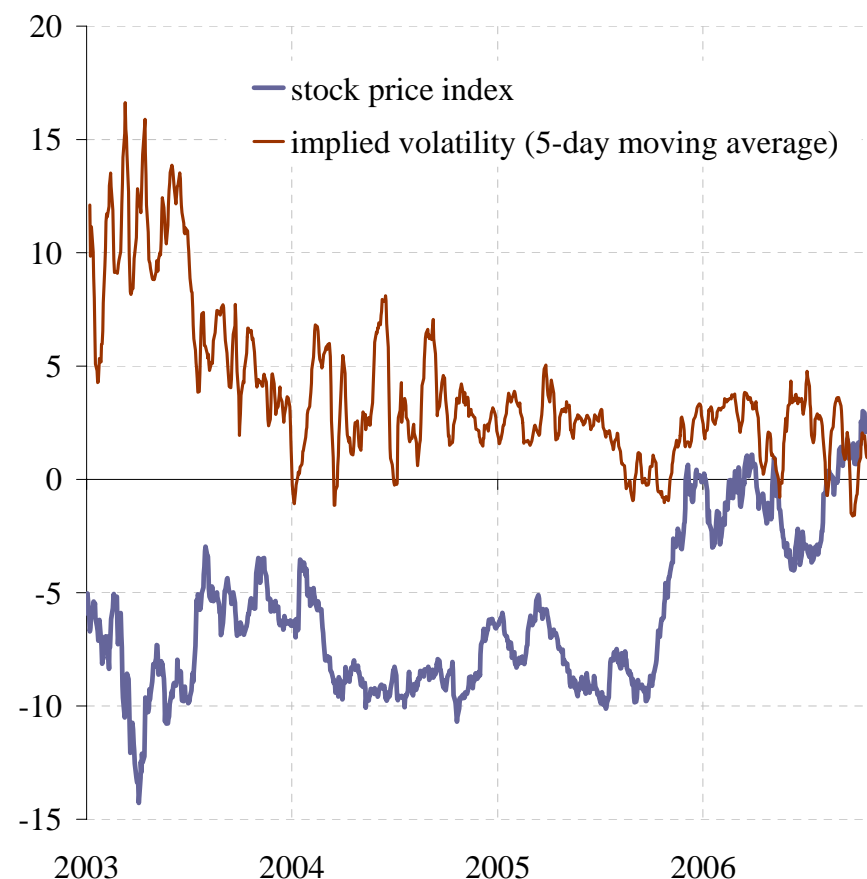


Insurance sector: Improved conditions and outlook especially for the weakest performers

Distribution of profitability ratios of large euro area composite insurance groups (%)



Dow Jones EURO STOXX insurance index and its implied volatility relative to the overall EURO STOXX index (%)



Overall assessment

Since the June 2006 FSR, the central scenario for euro area financial stability remains broadly favourable:

- 1) The resilience of the system was confirmed by its ability to comfortably absorb some adverse disturbances
- 2) Global economic activity is becoming more evenly balanced and the gradual shift to less accommodative monetary policies is proceeding smoothly
- 3) The credit quality of key counterparties of banks – households and firms – generally remains high
- 4) Euro area banks are very profitable, solvency is comfortable and risk management continues improving

Overall assessment (continued)

But some risks and vulnerabilities remain and others have grown, leaving no ground for complacency:

- 1) **Global:** A correction of global imbalances remains a risk
- 2) **Markets:** Low long-term yields and credit spreads as well as risks related to credit risk transfer markets in which hedge funds have become increasingly present
- 3) **Sectoral:** Rapid re-leveraging in some parts of the corporate sector – induced partly by a surge in LBO activity – and growing household sector financial imbalances