Financial Stability Review June 2007

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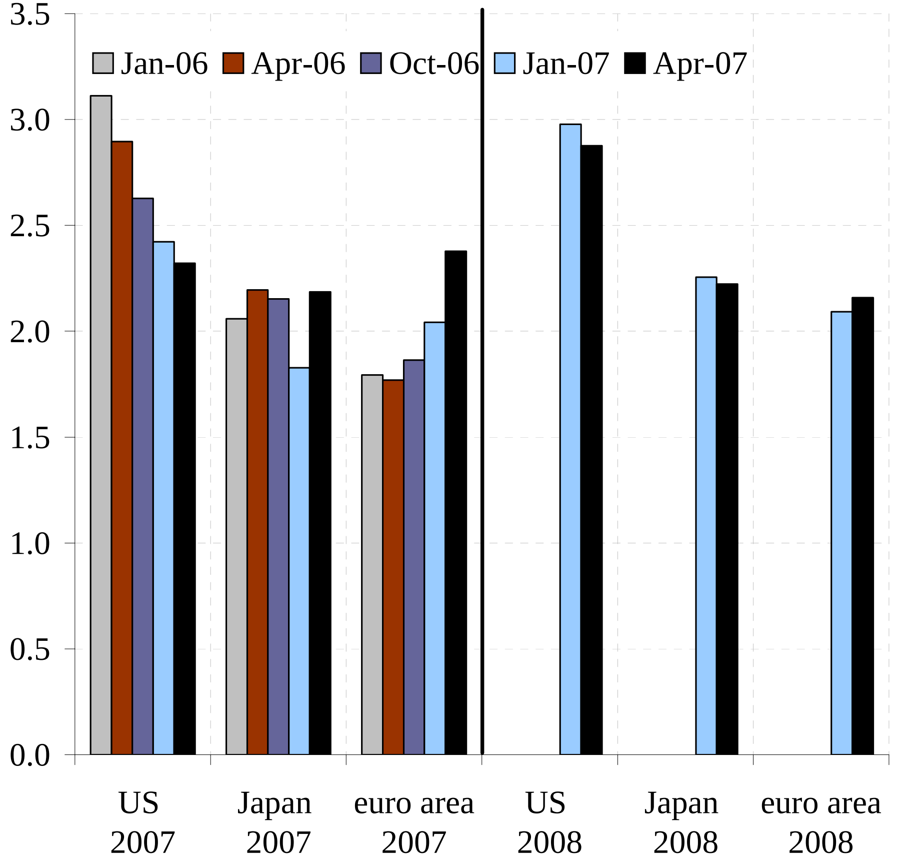
Outline

- Macro-financial developments and outlook
- Vulnerabilities
  - in the external environment
  - in global financial markets
  - in the euro area non-financial environment
- Condition of financial institutions
- Potential risk triggering factors
- Overall assessment

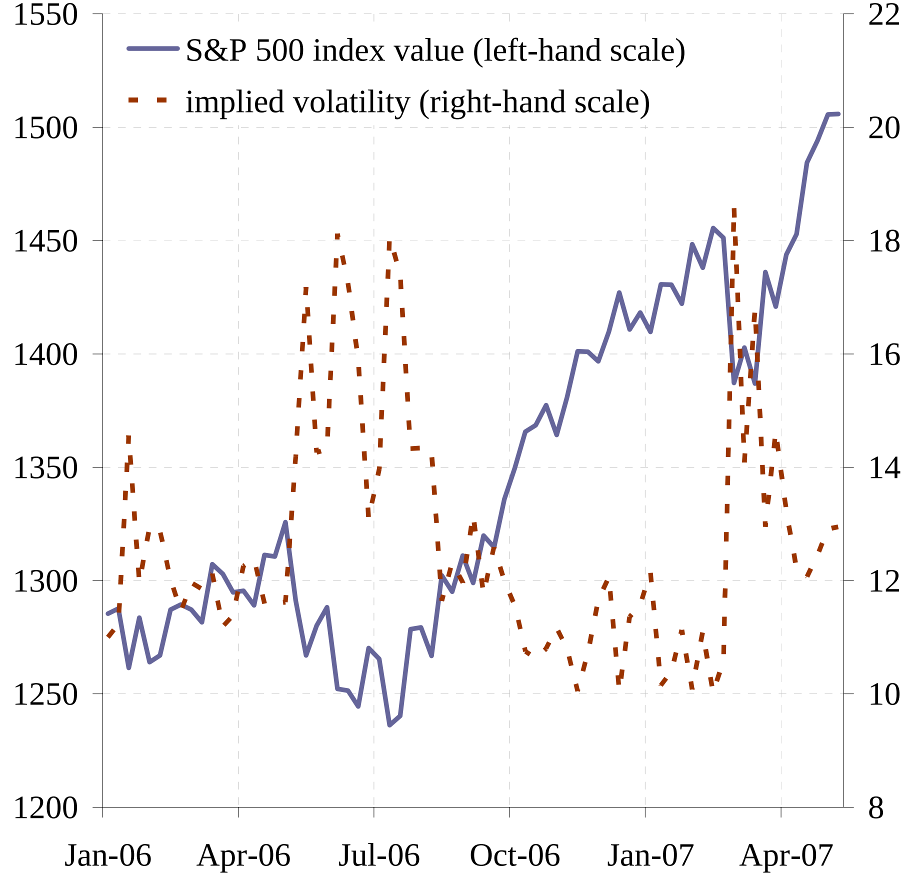
Global macro-financial developments:

Expected euro area growth revised up; volatility episodes weathered comfortably

Consensus forecasts for GDP growth for 2007 and 2008

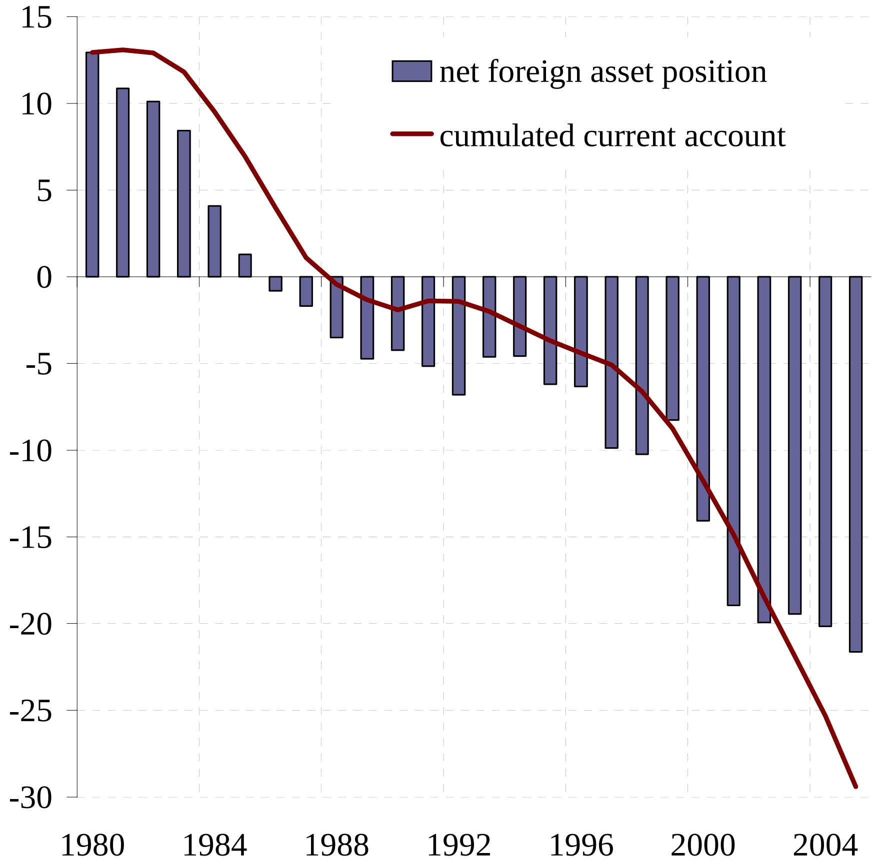


S&P 500 index and implied volatility

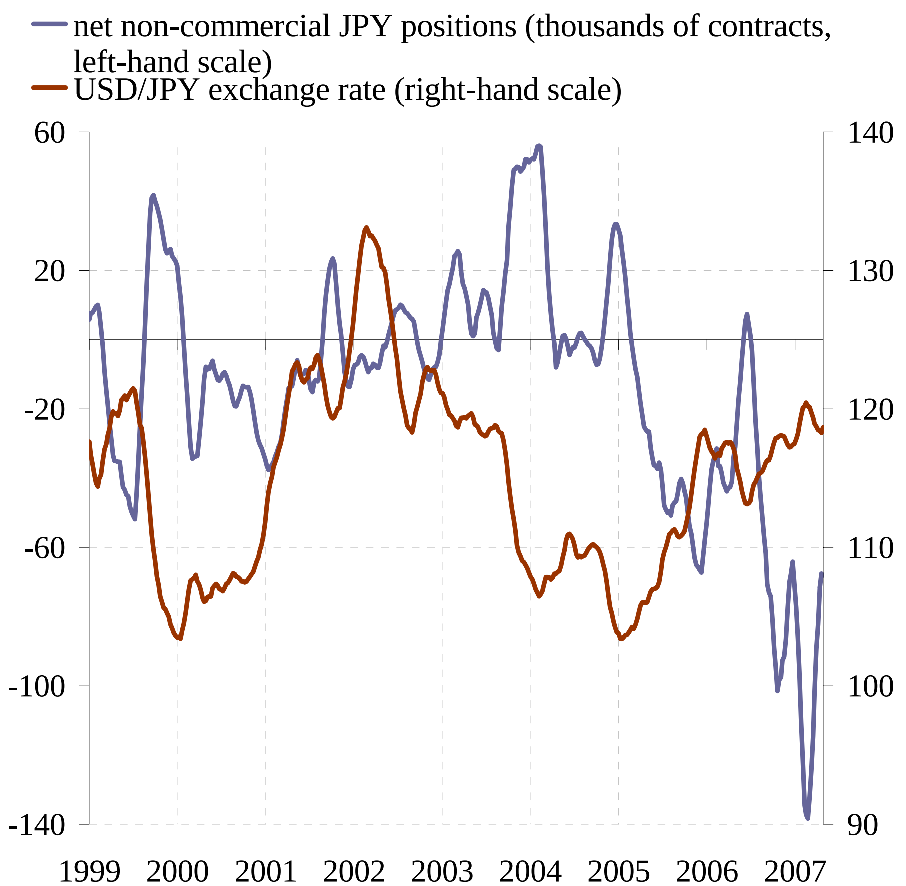


Vulnerabilities in the external environment:
Global imbalances remain wide; concerns surfaced about carry trades

US net foreign assets and cumulated current account balance (% of GDP)



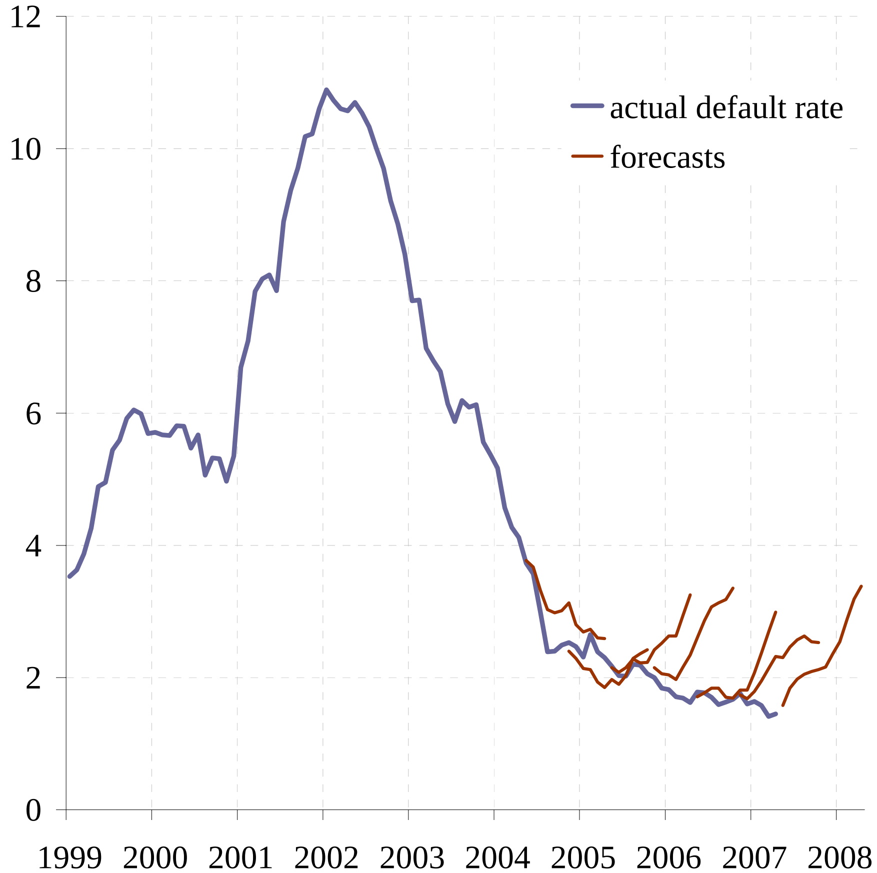
Net non-commercial Japanese yen positions and the USD/JPY exchange rate (2-months m.a.)



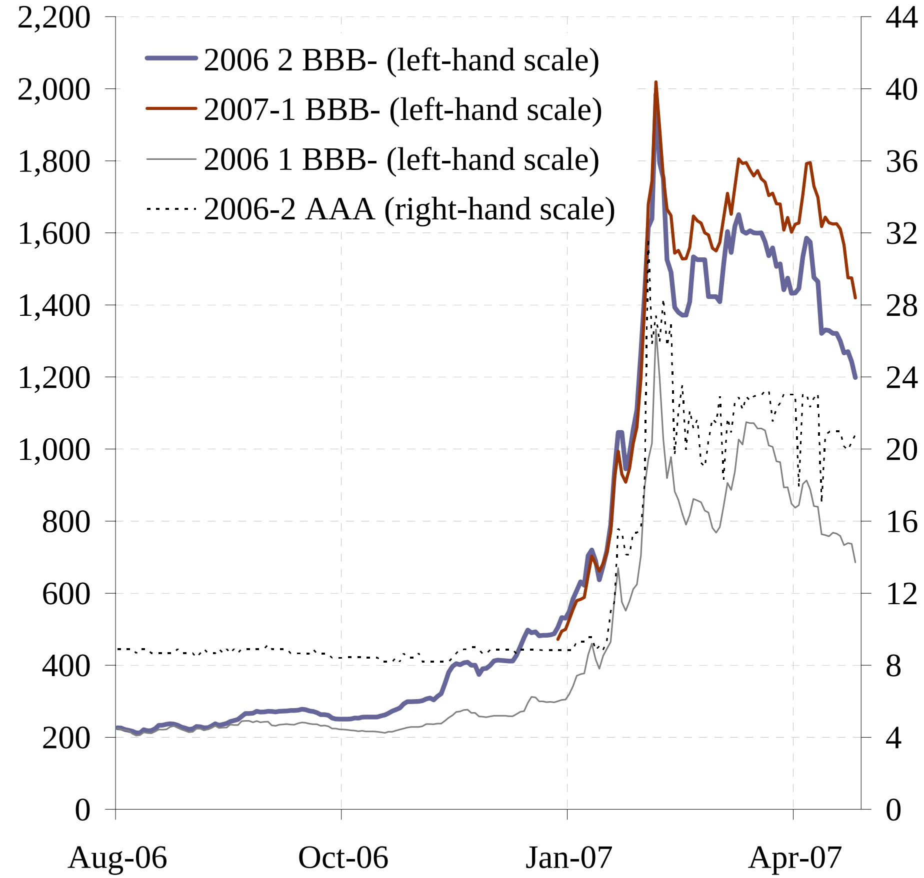
Vulnerabilities in the external environment:

Turbulence in the US mortgage market; no firm signs of a turn in the credit cycle

Global speculative-grade default rates and forecasts (%)



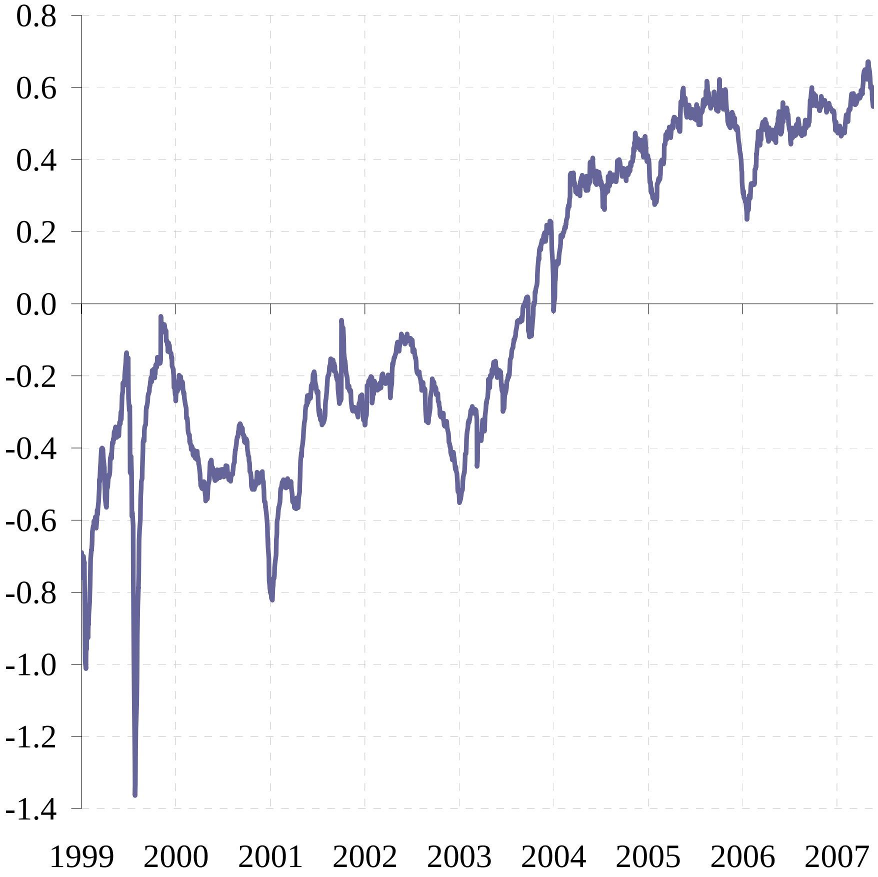
Spreads of high and low-rated index tranches over risk free rate in the US (basis points)



Vulnerabilities in global financial markets:

Market liquidity: causes, measures and risks

Euro area financial market liquidity indicator



Abundant financial market liquidity:

- Structural changes in financial markets
- Search for yield and confidence in smooth market functioning

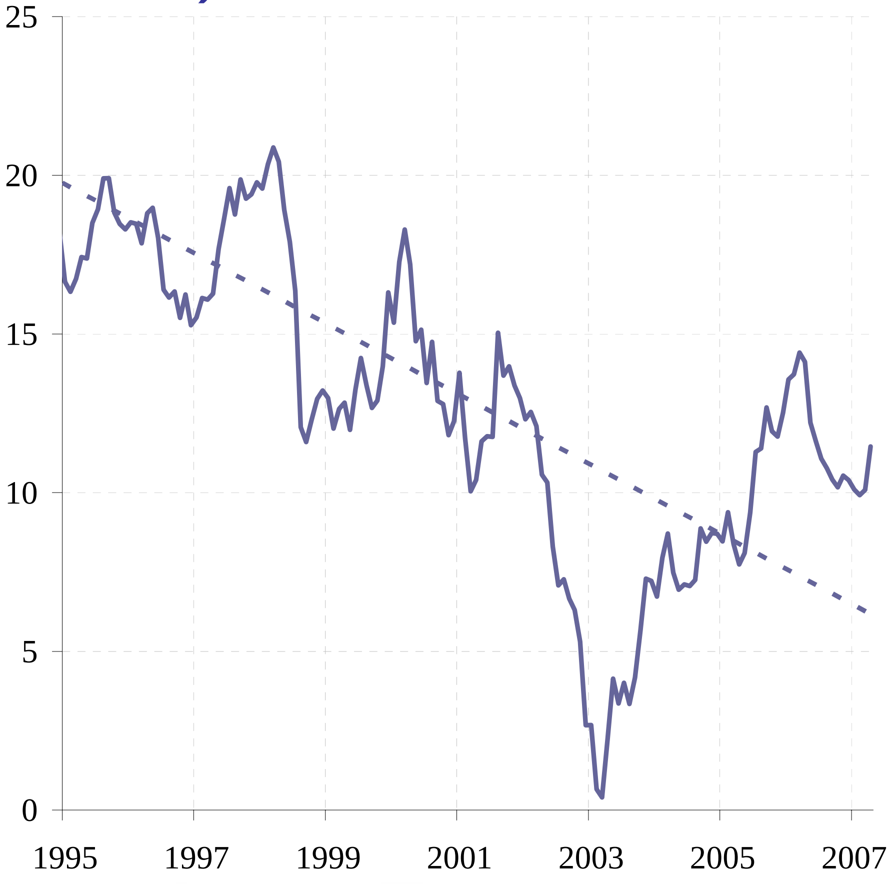
A composite indicator combining information across foreign exchange, equity, fixed income and credit markets and constructed to gauge three different dimensions of market liquidity:

- Tightness
- Depth + resiliency
- Liquidity premium

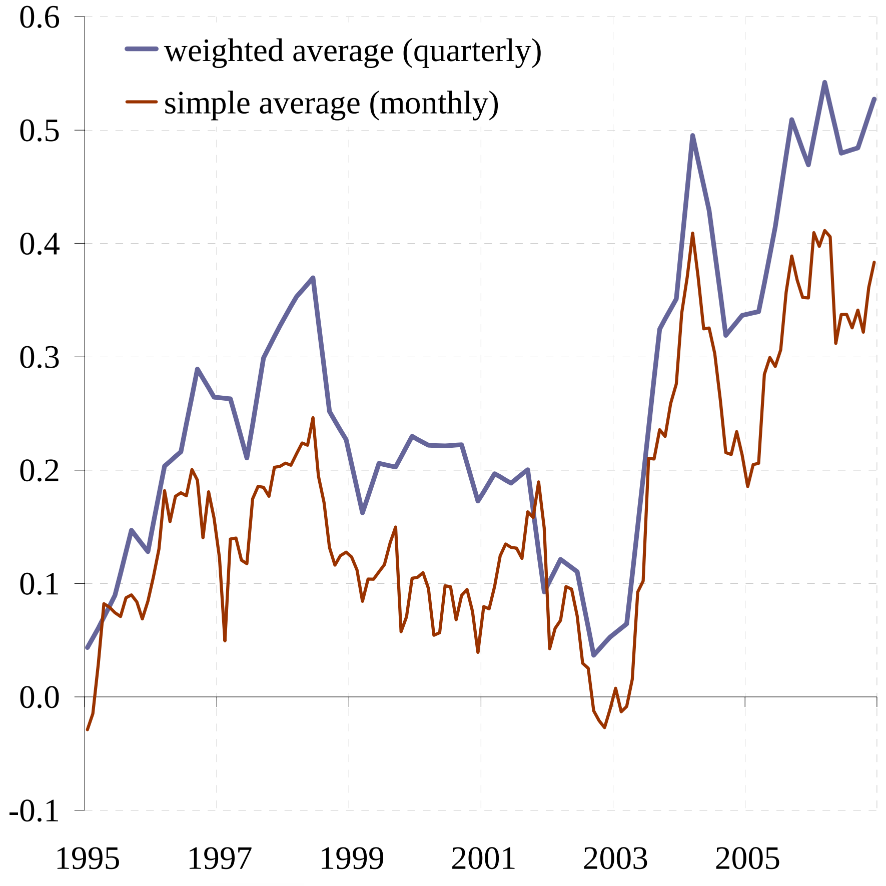
Risks: A loss of confidence or an increase in risk aversion could lead to a decline in market liquidity and expose underlying vulnerabilities

Vulnerabilities in global financial markets:
Hedge fund sector showing signs of over-capacity

Global hedge fund returns (%, rolling three-year annualised compound rate of return, net of all fees)



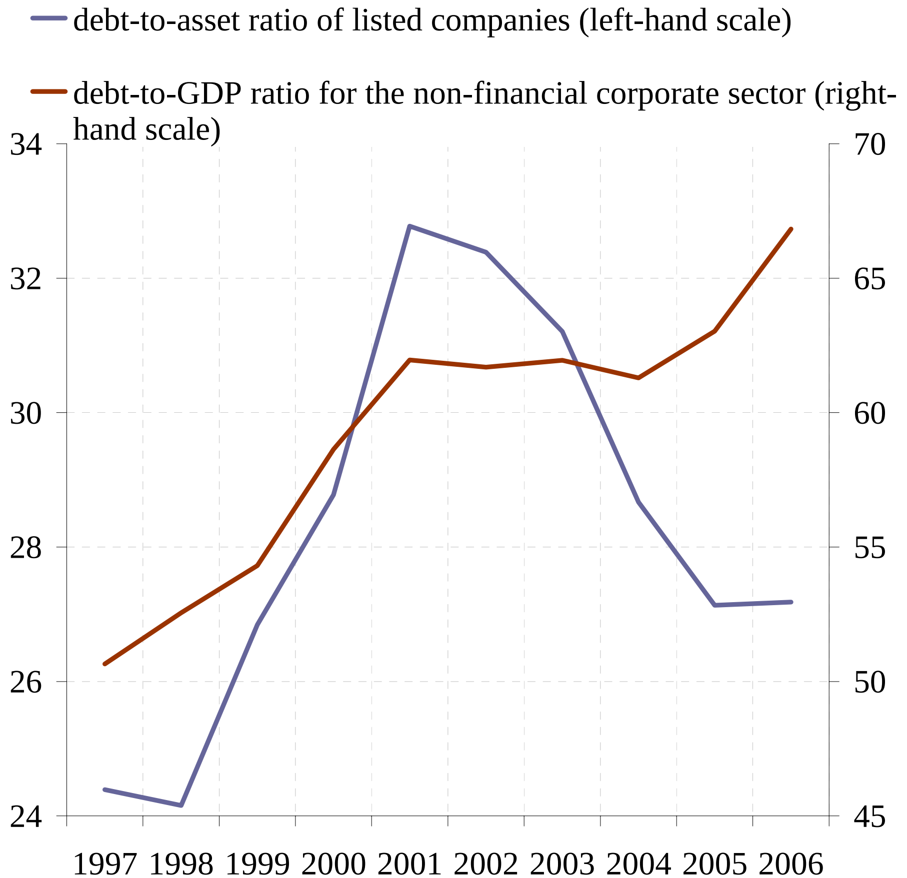
Return correlations across hedge fund strategies



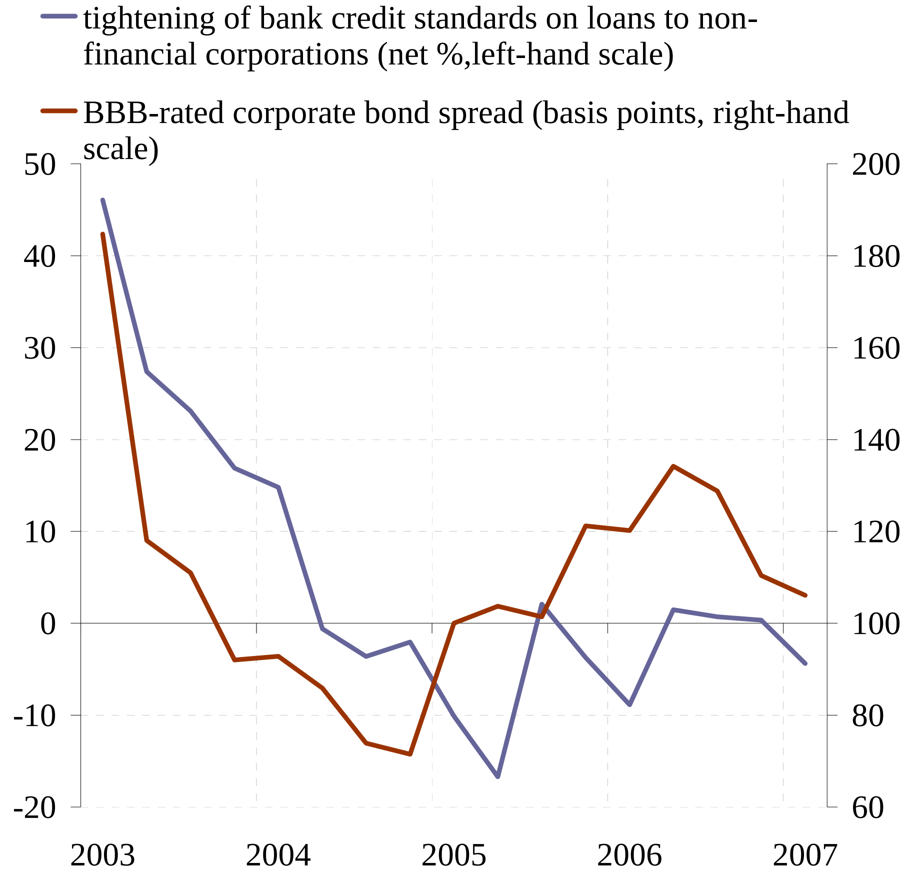
Vulnerabilities in the euro area non-financial sector:

Rising leverage of unlisted corporations but no firm signs of a turn in the credit cycle

Debt ratios of euro area non-financial corporations (%)



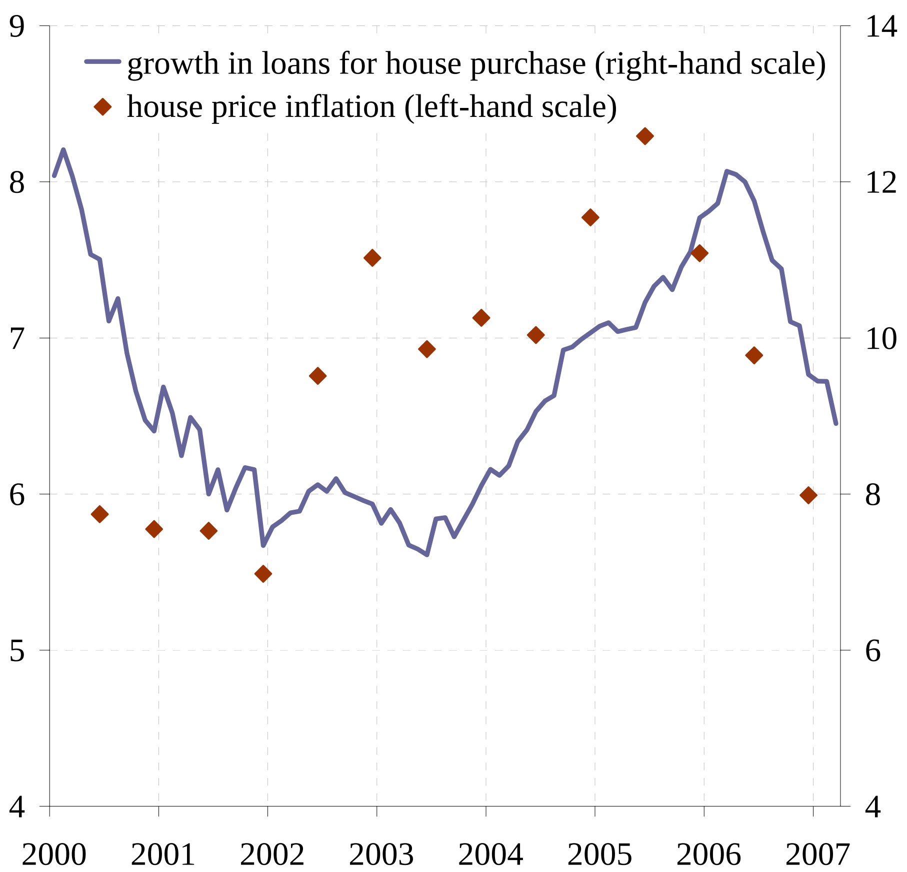
Euro area banks' credit standards applied on loans to non-financial corporations, and BBB-rated corporate bond spread



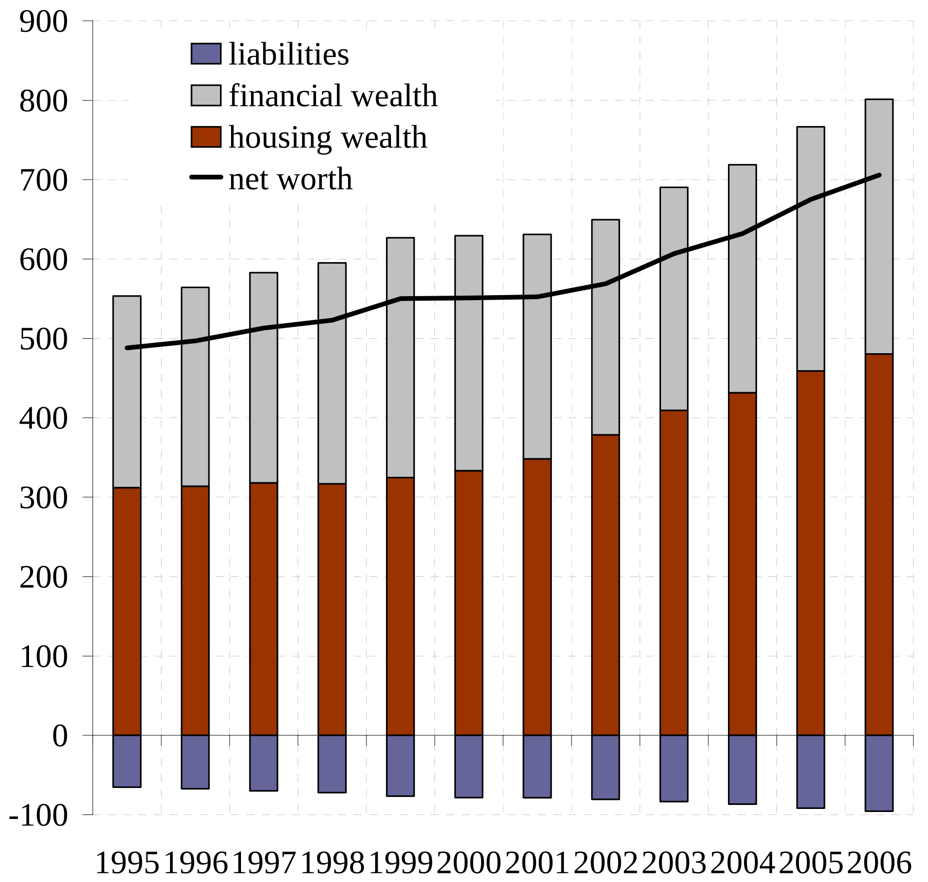
Vulnerabilities in the euro area non-financial sector:

Household borrowing slowing and house price inflation decelerating

Growth of MFI loans for house purchase and house price inflation in the euro area (%)



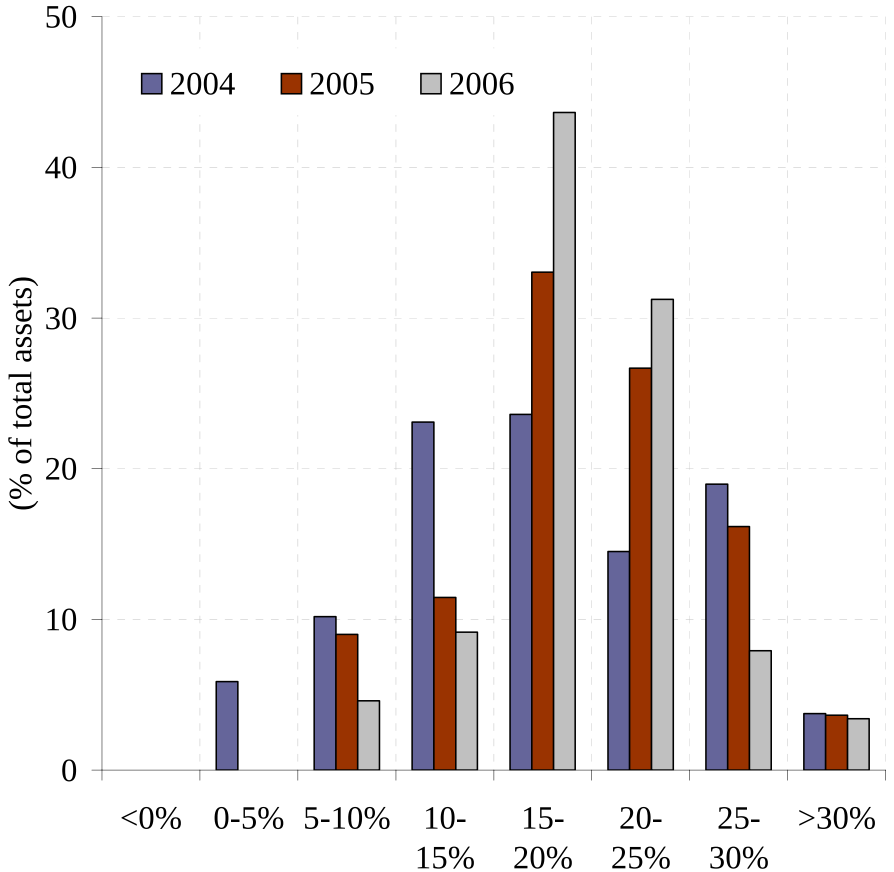
Households' net worth in the euro area (% of gross disposable income)



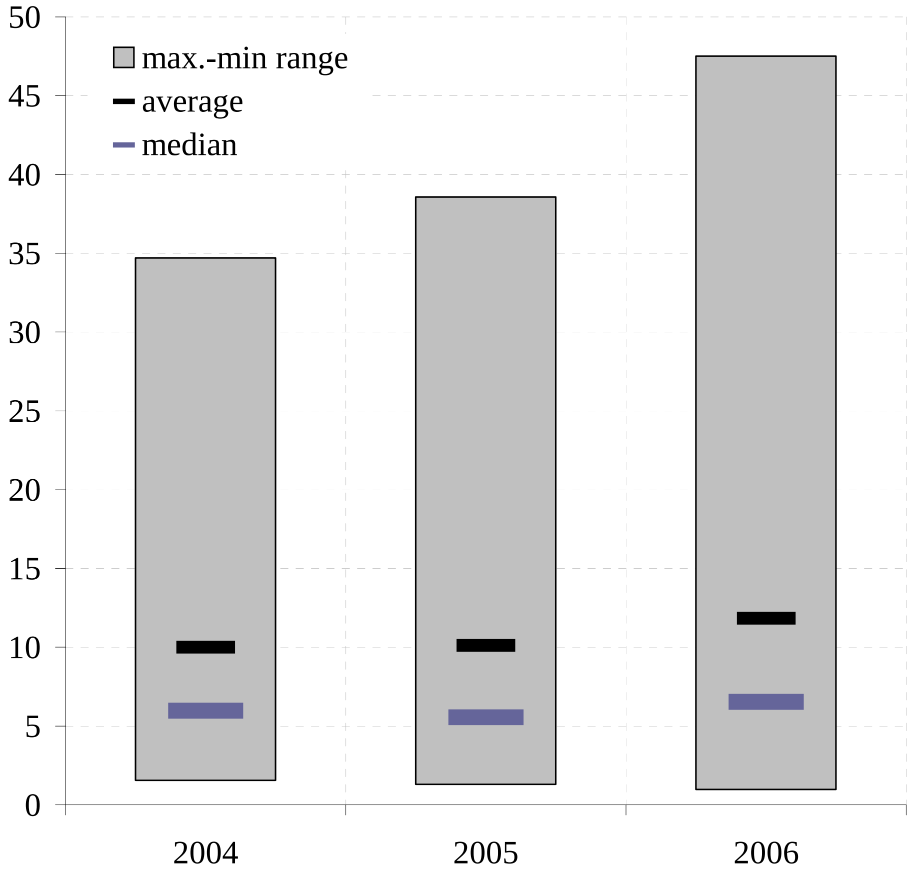
Condition of euro area financial institutions:

Euro area banks; Profitability strengthened further, driven by non-interest income

Frequency distribution of return on equity (ROE) for LCBGs in the euro area (%)

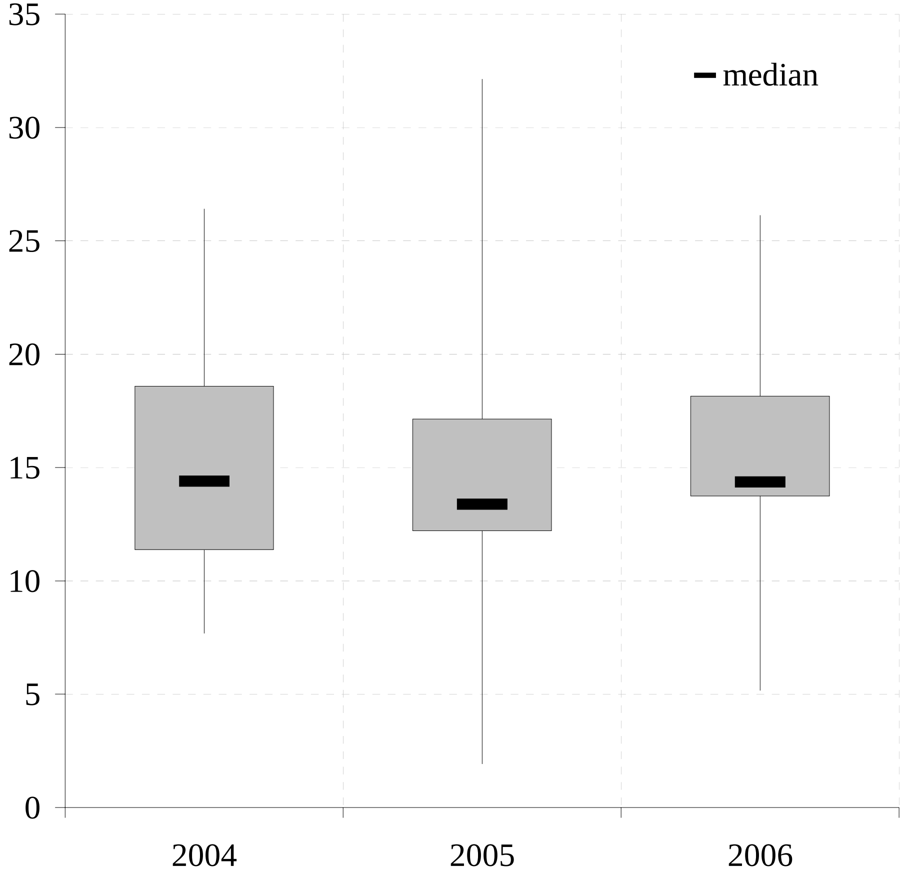


Distribution of trading income for LCBGs in the euro area (% of Tier 1 capital)

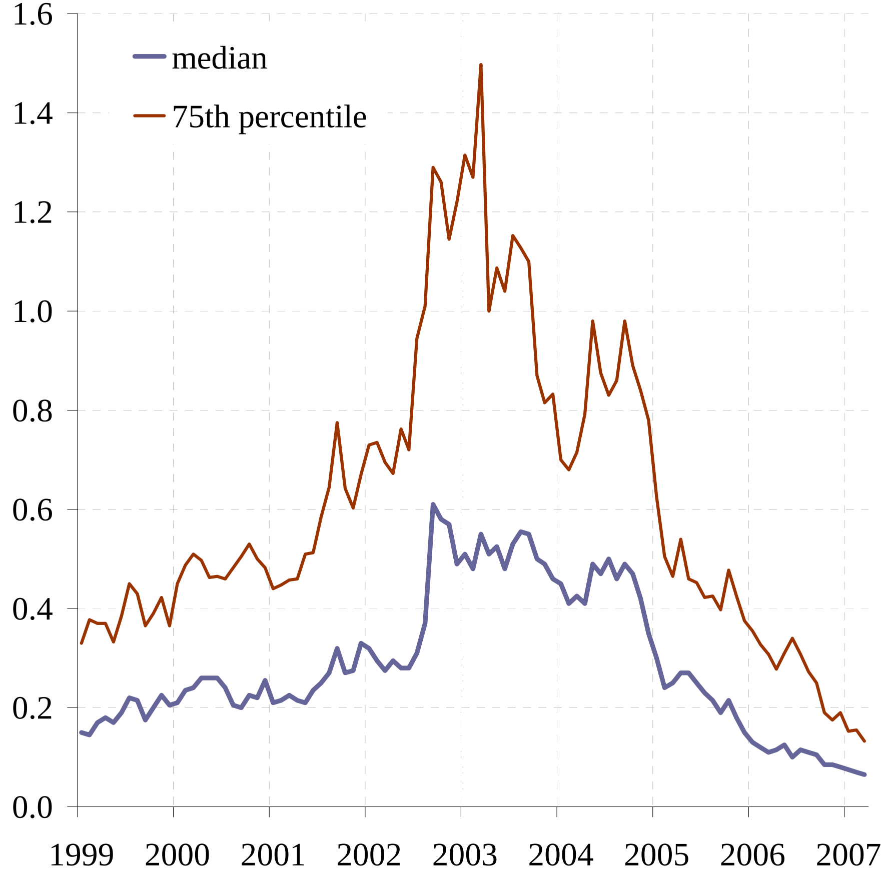


Condition of euro area financial institutions:
Profitability of, and outlook for, the insurance sector improves further

Distribution of return on equity (ROE) for a sample of large euro area insurers (%)



Expected default frequencies (EDFs) for the euro area insurance sector (% probability)



Vulnerabilities and potential risk triggering factors

An abrupt and lasting increase in risk aversion and/or a loss of confidence would most likely lead to a substantial decline in financial market liquidity, expose several underlying vulnerabilities and trigger an adverse scenario, possibly involving:

- **Funding liquidity challenges for highly leveraged financial institutions**
- **Unwinding of carry trades and global imbalances**
- **Increasing credit spreads across the credit quality spectrum**
- **Increased volatility in financial markets more generally**
- **Reduced bank profitability as a result of lower trading revenues**

Vulnerabilities and potential risk triggering factors (continued)

A turn of the credit cycle or a large credit event could trigger an unraveling of vulnerabilities in the corporate and household sectors and in credit markets, involving:

- **Defaults of low credit-quality, high-leveraged households and firms**
- **Significant challenges in the structured credit and CRT markets**
- **Hedge fund losses and potential failures**
- **Counterparty risks for banks**

In summary, this constitutes a potential triangle of vulnerabilities involving hedge funds, CRT and the credit cycle

Overall assessment

Since the December 2006 FSR, the main scenario for euro area financial stability remains broadly favourable:

- Global and euro area economic activity are expected to remain robust
- In February and March 2007 the resilience of the financial system was tested by the third significant bout of market volatility in two years, which it comfortably weathered
- Euro area credit quality overall remains high and should be underpinned by a favourable economic outlook
- Pockets of vulnerability in the household and corporate sectors have most likely increased, but on average financial positions remain sound
- Profitability of euro area financial institutions further improved and solvency is comfortable relative to regulatory requirements

Overall assessment (continued)

But pre-existing sources of risk and vulnerability remain and some have grown:

- **Recent market jitters confirmed concerns regarding previously identified risks and vulnerabilities and revealed the relevance of some risk exposures**
- **Vulnerabilities could be quickly unearthed if financial market liquidity were to abruptly and sharply decline**
- **Re-leveraging in the corporate sector and the process of credit risk transfer from the banking system could constitute vulnerabilities in a less benign market environment**
- **In addition, global imbalances remain a medium-term low-probability but potentially high impact risk for financial stability**
- **All in all, despite the strong performance of the euro area financial sector, there is no room for complacency**