EUROPEAN CENTRAL BANK

1 June 2006

Transmission embargo until
4 p.m. ECB time (CET) on Thursday, 1 June 2006

PRESS RELEASE

PUBLICATION OF THE JUNE 2006 ECB FINANCIAL STABILITY REVIEW

The European Central Bank (ECB) today publishes its June 2006 **Financial Stability Review**.

The review, which has been published semi-annually since December 2004, assesses the stability of the euro area financial system with regard to both the role it plays in facilitating economic processes and its ability to absorb adverse shocks and prevent them from having an inordinately disruptive impact.

The purpose of publishing this review is to promote awareness in the financial industry and among the public of issues relevant to safeguarding the stability of the euro area financial system. By providing an overview of sources of risk and vulnerability with regard to financial stability, the review also seeks to play a role in preventing financial crises.

The production of a comprehensive assessment of financial stability involves three important elements. The first entails forming a judgement about the individual and collective strength and robustness of the constituent parts of the financial system – institutions, markets and infrastructures. The second involves systematically identifying the plausible and systemically important sources of risks and vulnerabilities that could pose challenges to financial stability in the future. The third is an appraisal of the potential costs – that is, the ability of the financial system to cope – should some combination of these identified risks and vulnerabilities materialise.

It should be stressed that calling attention to such sources of risk and vulnerability does not mean seeking to identify the most probable outcome. Rather, it merely entails highlighting potential and plausible sources of downside risk, even if the probability of their realisation is relatively low.

The analysis contained in the review has been prepared with the close involvement of the Banking Supervision Committee, which is a forum for cooperation between the ECB and the national central banks and supervisory authorities of the EU.

The main points of the overall assessment of the stability of the euro area financial system contained in the review can be summarised as follows:

The strength and resilience of the euro area financial system continued to improve over the six months to early May 2006. Despite further oil price rises, the growth of global economic activity was sustained and became more broadly based. This, together with the continued strength of euro area corporate sector balance sheets, meant that the operating environment for euro area financial institutions and markets was favourable, mirroring the conditions in most mature economies' financial systems. Although liquidity conditions were tightened in the G3 economies, conditions for raising funds in mature economies' credit and equity markets remained favourable, and market volatility continued to be very low across most asset classes until very recently. In this environment, there was a further, broad-based improvement in the profitability of euro area banks, and the balance sheets of euro area insurance companies strengthened. In addition, key financial infrastructures – including payment systems such as TARGET and securities clearing and settlement systems – continued to operate smoothly.

However, over the same period risks and vulnerabilities for euro area financial stability remained, with some growing in importance. Within the euro area financial system, the main source of vulnerability in the period ahead continues to centre around concerns that a global search for yield may have led investors in the euro area to underestimate or take on an excessive level of risk. Very low long-term risk-free rates of return and ample liquidity in global financial markets were key factors in driving investors to seek higher expected returns in riskier markets, possibly raising asset prices in the euro area beyond intrinsic values, especially in corporate bond and credit risk transfer markets. As regards sources of risk and vulnerability outside the euro area financial system, financial imbalances continued to expand. While primarily observed at the global level, these were also seen in the euro area. Global financial imbalances continue to pose medium-term risks to the stability of financial markets. By raising energy costs, the further surge in oil prices over the six months to early May 2006 could dent future corporate sector profits if it proves to be as persistent as futures prices currently suggest. At the euro area level, concerns remain regarding the implications that rising household sector indebtedness and house prices observed in some euro area countries will have for credit risk and wealth. In addition, there are some concerns that the period of balance sheet consolidation in the euro area corporate sector may have come to an end, and that the risk of an adverse turn in the corporate credit cycle may have increased.

Looking ahead, the durability of euro area banking sector profitability could, despite its current strength, be tested in the period ahead. Declining loan impairment charges could adversely affect the ability of banks to cope with an unforeseen deterioration in credit quality. Moreover, given their risk exposures, concerns about financial asset price misalignments have left some euro area financial markets and institutions vulnerable to changes in global liquidity conditions and unexpected credit developments.

All in all, although the shock absorption capacities of euro area financial institutions have been improving, the fact that risks and vulnerabilities have remained, with some increasing further, means that there is no room for complacency: the financial stability outlook still rests upon a delicate balance. While a positive outcome remains the most likely prospect in the period ahead, the possibility that the risk management systems and loss-absorption capacities of financial institutions may be severely tested, while still small, cannot be excluded.

Further information

The review can be downloaded from the "Publications" section of the ECB's website (http://www.ecb.int/pub). Printed copies are also available free of charge from the ECB's Press and Information Division at the address given below.

European Central Bank:
Directorate Communications
Press and Information Division
Kaiserstrasse 29, D-60311 Frankfurt am Main
Tel.: +49 69 1344 7455, Fax: +49 69 1344 7404
Internet: http://www.ecb.int