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Despite improving global and euro area economic and financial conditions, the overall outlook for financial stability has remained very challenging in the euro area. In particular, important decisions to introduce concrete policy measures at the EU level to strengthen backstop mechanisms aimed at mitigating financial vulnerabilities have not been sufficient to overcome all difficulties. For the third successive year since the intensification of the financial turmoil in the autumn of 2008, risks are still prevailing across major sectors of the euro area economy, which poses challenges not dissimilar to those in many other advanced economies. In particular, concerns of financial market participants regarding the interplay between sovereign and financial sector risk remain elevated. In view of challenges related to the implementation of the consolidation programme in Greece, which have grown since the publication of the last FSR in December 2010, market concerns have risen as evidenced, for example, by an inversion of its sovereign credit default swap curve. In light of the potentially very dangerous implications of sovereign debt restructuring for the debtor country, including its banking, a determined and unwavering focus on improving fundamentals through both macroeconomic and structural policy reforms in vulnerable countries is required and within reach. In fact, programmes of adjustment, negotiated with the European authorities and the IMF, are now in place and should be rigorously implemented.

Five key risks to euro area financial stability

1. The interplay between the vulnerabilities of public finances and the financial sector with their potential for adverse contagion effects

2. Bank funding vulnerabilities and risks related to the volatility of banks' funding costs

3. Losses for banks stemming from persistently subdued levels of, or further decline in, commercial and residential property prices in some euro area countries

4. Risk of a market-driven unexpected rise in global long-term interest rates, with

possible adverse implications for the profitability of vulnerable financial institutions

5. Tensions related to international capital flows, asset price growth in emerging countries and the risks associated with a re-emergence of global imbalances

More generally, however, tensions in countries that have culminated in requests for EU/IMF support contrast with a positive development in the form of indications that sovereign risk can be contained. Confidence is being strengthened, in particular in other euro area countries that had been exhibiting high government bond yields, reflecting not only efforts made to push forward bank restructuring and transparency with respect to the state of the banking system as a whole, but also efforts undertaken to strengthen fiscal and macroeconomic fundamentals. Such efforts are crucial for the effective containment and mitigation of risks relating to sovereign debt in the euro area. Another positive element is the improving fundamentals of the aggregate euro area banking sector, evident in the evolution of key profitability indicators and solvency statistics for numerous large and complex banking groups (LCBGs) in the euro area – which should contribute to increased general resilience in terms of absorbing any prospective future losses. The latest available data for LCBGs indicate that all main income sources improved in 2010 and in early 2011, while a reduction of loan loss provisions had a major impact on profits. Regulatory (Tier 1) capital ratios amounted to 11.4% on average at the end of 2010, up from 7.7% in 2007. The results of the stress tests undertaken by the European Banking Authority (EBA) should yield further insights into the health of the euro area banking system and will, in particular, shed further light on banks' shock-absorption capacity. Despite the beneficial developments in banking sector resilience, notably the fact that banks' reliance on wholesale funding decreased further in 2010 and in early 2011, funding vulnerabilities continue to be an Achilles heel for many euro area banks, in particular those resident in countries facing acute fiscal challenges. At the same time, the heterogenous impact of the crisis has, in turn, led to divergent macroeconomic recovery and expansion paths across countries not only within the euro area, but also at the global level. These divergences contribute to a further exacerbation of the risks emanating from large international capital flows, global imbalances and their root causes.

Overall, there has been a broad-based improvement in banking sector resilience since the last FSR, evident, for instance, in the evolution of profitability and solvency indicators such as those reported above, while the transparency of euro area banking sector vulnerabilities will be enhanced through EU-wide stress tests. At the same time, several pockets of risk for euro area financial stability remain, ranging from macroeconomic and credit risks to liquidity and solvency issues for the euro area banking and insurance sectors. While such pockets of risk are manifold, some key aspects can be singled out in view of their clear generalised and systemic nature. First and foremost, the interplay between the vulnerabilities of public finances and the financial sector, with their potential for adverse contagion effects, arguably remains the most pressing concern for euro area financial stability at the moment, despite several encouraging signs of containment. But other key risks with strong systemic implications prevail as well. These relate to bank funding vulnerabilities, property price developments, the prospect of an unexpected and sudden, market-driven rise in long-term interest rates, and a disorderly unwinding of global imbalances. All these risks are closely intertwined and, indeed, could even reinforce one another in many ways.

Notwithstanding the varying probability of a materialisation of these key risks, any assessment of their prospective impact would need to take into account the improving robustness of the euro area financial system and its related shock-absorption capacity. In this respect, numerous policy initiatives, macro and micro-prudential in nature, have contributed to an enhanced resilience of the euro area financial sector. In this vein, it must be acknowledged that the financial crisis, in addition to the wide-ranging effects that are still being felt, has also brought forth a strengthened commitment to effective macro and micro-prudential oversight within the EU, which will make a decisive contribution to safeguarding current and future financial stability in the euro area.

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