EUROPEAN CENTRAL BANK

EU BANKING SECTOR STABILITY

NOVEMBER 2004

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TABLE OF CONTENTS

LIST OF EU COUNTRIES

EU	European Union (EU-15 plus NMSs)
EU-15:	
Belgium	BE
Denmark	DK
Germany	DE
Greece	GR
Spain	ES
France	FR
Ireland	IE
Italy	IT
Luxembourg	LU
Netherlands	NL
Austria	AT
Portugal	PT
Finland	FI
Sweden	SE
United Kingdom	UK
NMSs:	
Czech Republic	CZ
Estonia	EE
Cyprus	CY
Latvia	LV
Lithuania	LT
Hungary	HU
Malta	MT
Poland	PL
Slovenia	SI
Slovakia	SK

EXECUTIVE SUMMARY

FINANCIAL CONDITIONS OF EU-15 BANKS IMPROVED IN 2003 AND THE FIRST HALF OF 2004

Following two consecutive years of decline, the aggregate profitability of EU-15 banks recovered in 2003. This improvement occurred against the background of a better operating environment in which the profitability of large firms started to improve and equity markets recovered. The main sources of profit improvement were non-interest income, further cost-cutting and reduced provisioning. At the same time, banks increased their solvency buffers, thereby enhancing their ability to absorb unexpected adverse developments.

Indications are that the improvement in banking profitability broadened in the first half of 2004 with also the weakest banking sectors beginning to show signs of improved profitability following aggressive restructuring.

POCKETS OF FRAGILITY MAY REMAIN WITHIN EU-15 BANKING SECTORS

Looking ahead, the general outlook for the EU-15 banking sectors is cautiously positive. The main factors underpinning this assessment are expectations of growth in net interest income and of improvements in asset quality. However, some pockets of fragility may remain within the sectors, while outside the EU banking sectors there are also some important external risks.

Banks may be exposed to risks from financial markets in the period ahead. In 2003, a search for yield spread wide across numerous fixed income markets, including corporate bond and emerging economy debt markets. This also continued in 2004. Hence, there are some indications that banks took on more interest rate risk in a low long-term yield environment. To the extent that this search for yield took asset prices above their intrinsic values, it may have left some banks vulnerable to a reappraisal of risk. Banks could be affected not only via direct market exposures, but also indirectly through existing interlinkages to other financial institutions through income and/or counterparty credit risks. These risks warrant close monitoring and stress testing by banks and supervisors.

Persistently wide global imbalances continue to pose medium-term risks for banks. While the crystallisation of these risks would potentially have a direct effect on banks – through foreign exchange markets, as well as other financial market segments – the indirect effects might be more significant. Furthermore, the surge in oil prices during 2004 may pose a risk for banks if it proves to be lasting through its indirect effects on the corporate sector. Transmission might take place through deteriorating sectoral balance sheets, and could feed through to the banking sector via second-round effects on income generation and asset quality.

As for the sources of risk to banks stemming from the non-financial corporate sector, banks' exposures to small and medium enterprises (SMEs) may be significant in several countries. The financial conditions of SMEs, which continue to lag behind larger corporations, could be weakened if economic growth were to prove slower than currently expected. Banks in some countries may also face risks from their exposures to specific subsectors, such as the commercial real estate firms and the construction industry. In this light, it remains uncertain whether banks' provisioning for loan losses has been adequate over recent years, given relatively slow economic growth and a high level of insolvencies. If banks unexpectedly needed to increase provisioning in the period ahead, this could imply weaker than currently envisaged profitability.

In countries where house prices have risen rapidly, perhaps beyond their intrinsic values, a reversal of this trend could pose problems by lowering household wealth and collateral values. Nevertheless, the setting of loan-to-value ratios at comfortable levels on aggregate

should leave banks relatively well-cushioned, and it seems that households would bear the brunt of any property market reversal. The implications for the banking sector would therefore ultimately depend upon the severity of any wealth effect on household consumption. Under these conditions, banks could be impacted negatively through reduced income from the household sector.

STABLE CONDITIONS IN THE NEW MEMBER STATE BANKING SECTORS

There have been wide differences in the performance and condition of banks in the new Member States (NMSs). On aggregate, the condition of these banking sectors was generally favourable in 2003 and the first half of 2004. Buoyant lending to households compensated for a narrowing of lending margins, and contributed positively to net interest income. At the same time, there were no clear improvements in the cost efficiency of banks in the NMSs. However, banks did benefit from enhanced asset quality, with reduced provisioning further boosting profitability. Capital ratios remained high, despite pressures exerted on the capital adequacy of banks in some countries by rapid lending growth.

RAPID LENDING GROWTH AND FOREIGN EXCHANGE MARKET RISKS REQUIRE MONITORING IN THE NMSs

Rapid credit growth may pose challenges for banks going forward. In addition, exchange rate risks may be of greater importance in the NMSs than in the EU-15 countries. In particular, given that the share of foreign currency lending to firms and households is significant in some NMSs, banking sectors could be vulnerable to credit risk, were these borrowers to suffer losses from unexpectedly rapid exchange rate movements.

Finally, while strong links between the EU-15 and NMS banking sectors could provide possible channels of contagion, they equally contribute to enhancing diversification and risk-sharing between systems. For instance, EU-15 banks have benefited from the strength of profitability in their subsidiaries in the NMSs. At the same time, EU-15 subsidiaries located in the NMSs have been able to enhance their risk management via knowledge transfer from their parents.

OVERALL ASSESSMENT IS CAUTIOUSLY POSITIVE FOR THE EU-25 BANKING SECTORS

The overall assessment of the EU banking sectors is cautiously positive conditional on the growth momentum of the first half of 2004 to be broadly maintained in the coming quarters. In the course of 2003 and the first half of 2004, banks were able to build up their capital buffers, thereby enhancing their ability to deal with future adverse disturbances.

Market indicators confirm the assessment that conditions improved after 2002 for most large banks in the EU. Moreover, since the risks identified in this report should also be priced into these indicators, this suggests that either the likelihood of these risks crystallising is perceived to be low, or that banks are generally considered to be well-positioned to deal with them.

INTRODUCTION

This report summarises the main findings of the regular annual macro-prudential analysis of EU banking sector stability conducted within the Banking Supervision Committee (BSC) of the European System of Central Banks (ESCB). The BSC consists of representatives of banking supervisory authorities and central banks of EU countries and the ECB.

This report reviews the financial condition of EU banks, their resilience and the potential risks to their stability. This is the third publication of this kind since February 2003.

The analysis draws on a large set of indicators based on data from national supervisors and the ECB. It has been further enriched by the exchange of information among the member organisations of the BSC. The key set of data underlying the report is the consolidated banking data collected by the BSC for 2003 and 2002 (see Statistical Annex, Table 1). These data are more timely than other sources, covering virtually the whole EU banking industry. Publicly available data for large EU banks are used to complement this analysis for the first half of 2004.

In May 2004, the macro-prudential analysis of the EU banking sectors was widened to include banks in the new Member States (NMSs). Owing to the important links between banks in EU-15 countries and the NMSs, this report provides an in-depth analysis of the financial condition of these banks as well as of the key risks they face in a separate chapter.

The report is structured as follows. The first section discusses the key developments in EU-15 banks' financial condition in 2003 and the first half of 2004. It analyses banks' income, cost and provisioning as well as their solvency and liquidity conditions. The sources of risk and vulnerability faced by EU-15 banks are discussed in the second section. These include credit, interest, foreign exchange and equity risks, as well as risks from exposures to hedge funds and emerging markets. The third section considers the market assessment of the condition of EU-15 banks in the near future. The fourth section covers income, profitability and cost developments in NMS banks, as well as the risks faced by the NMS banking sector. The report concludes with an overall assessment of the stability of the EU banking sector.

I EU-15 BANKS' PERFORMANCE IN 2003 AND THE FIRST HALF OF 2004

BANKS' PROFITABILITY IMPROVED

The profitability of EU-15 banks improved in 2003 (see Chart 1). Despite subdued economic growth, which continued to put pressure on banks' traditional income sources in many countries (see Chart 2),[1] banks succeeded in improving their performance. The major driving factors were benign `onditions in financial markets, further restructuring and cost-cutting as well as reduced provisioning by banks.

The average return on equity (ROE) of EU-15 banks increased in 2003, after falling for two consecutive years. ROE rose from 8.8% in 2002 to 9.9% in 2003. Profitability also improved in terms of return on assets (ROA) in 2003 (see Statistical Annex, Table 2).

Underlying the improvement was an increase in the profitability of the weakest performing banks. The percentage of EU-15 banks with an ROE of less than 5% fell significantly between 2002 and 2003 (see Chart 3).

Notwithstanding these positive developments, differences in profitability across countries in the EU-15 remained significant. In at least one large national banking sector, ROE for 2003 declined further from already low levels.

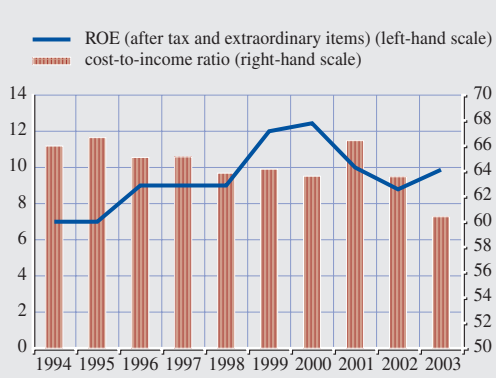
The average ROE of large EU-15 banks improved significantly in 2003, rising by 1.5 percentage points to reach 10.9%.[2] The medium-sized banks were somewhat less successful in improving their profitability, as their ROE increased by only 0.1 percentage points in 2003, resulting in an average ROE of 8.7%. Although the ROE of small banks remained lower than that of the other two groups, at 6.2%, they were able to reduce the gap with the medium-sized bank with a 1.5 percentage points increase in ROE. The difference in the level of ROEs between large or medium-sized and small banks can at least partly be attributed to the higher level of equity that small banks in general hold to cushion themselves against unexpected losses. (see Statistical Annex, Table 2).

1 In 2003 the annual real GDP growth rate in Denmark and Sweden reached 0.5% and 1.6% respectively. The October consensus forecasts for 2004 are 2.2% (Denmark) and 3.6% (Sweden). The annual real GDP growth rate in the United Kingdom was 2.2% in 2003. The October consensus forecast for 2004 stood at 3.3%. For the euro-area, 2003 annual real GDP growth was 0.4% and the October consensus forecast for 2004 was 1.9%.

2 See the Box in the Statistical Annex for the definition of the size groups for domestic banks.

Chart 1 Profitability and cost-to-income ratio of EU-15 banks

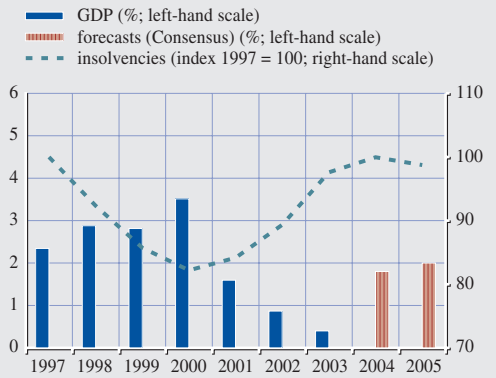
(1994-2003; all domestic banks; %)



Source: BSC.
Note: A break in the series took place in 2002. See the Box in the Statistical Annex.

Chart 2 Annual GDP growth and corporate insolvencies in the euro area

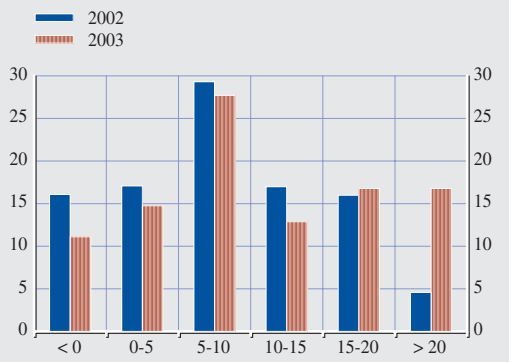
(1997-2005)



Sources: ECB, Euler Hermes and Consensus Economics.

Chart 3 Frequency distribution of ROE for EU-15 banks (after tax and extraordinary items)

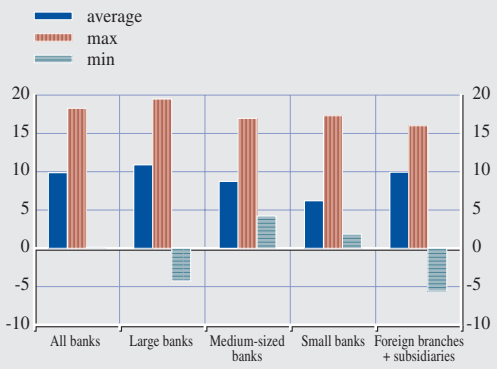
(2002-2003; %)



Source: BSC.

Chart 4 EU-15 banks' ROE (after tax and extraordinary items): average, maximum and minimum

(2003; %)



Source: BSC.

With regard to developments in foreign owned banks, their ROE increased by 3 percentage points, to 9.9% in 2003.

Comparisons in the dispersion of ROE across different categories of banks for 2003 indicate that differences were greatest for large domestic banks (see Chart 4). This calls for caution in assessing the overall strength of the EU-15 banking sector. Similarly, the group of foreign banks recorded negative ROEs in some countries although, given the smaller aggregate share (around 13%) in terms of total assets of foreign than large domestic banks in the sample, they are likely to be less relevant for the stability of the EU-15 banking sector (see Statistical Annex, Table 1). In those countries where the share of foreign-owned banks is quite large, their profitability was generally favourable in 2003.

Regarding 2004 performances, available data on first-half results from a sample of 50 large EU-15 banks (see Box 1 and the Statistical Annex, Table 10) indicate that the general trends in banks' profitability that were apparent in consolidated data for the entire banking sector in 2003 continued during the first half of 2004. The outlook for banks' profitability remains positive, conditional on the pace of GDP growth quickening from 2003 (see Chart 2 and footnote 1).

Box 1

FINANCIAL CONDITIONS OF A SAMPLE OF 50 LARGE EU-15 BANKS IN THE FIRST HALF OF 2004[1]

In order to complement the analysis on the annual financial results of EU-15 banking sectors in 2003 with more up-to-date information, this Box assesses the financial results of 50 large EU-15 banks in 2003 and the first half of 2004.

1 These banks were selected on the basis of their total assets and also because they are generally active in more than one European country. The sample of banks remains the same over the reference period. Where the group owns substantial insurance operations, only figures for the banking side are reported. Comparability of banks' annual results could be affected by different accounting standards.

Overall developments

The financial positions of the 50 large banks in the sample in the EU-15 continued to improve in the first half of 2004. This was mainly driven by reduced provisioning and continued cost-cutting measures. Income from traditional intermediation began to pick up, but at the same time income from trading activities weakened, clouding an otherwise positive performance for large EU-15 financial institutions.

Profitability

The financial performance of this group of banks varied across EU-15 countries in 2003. Banks located in Member States in which macroeconomic conditions were favourable tended to show greater improvement, as opposed to banks located in countries where economic conditions were weaker. The positive developments in profitability observed in 2003 are likely to be repeated in 2004, based on the unaudited annualised data (see Statistical Annex, Table 10). On aggregate, ROE increased from 8.7% in 2003 to 13.1% by mid-2004.[2] The proportion of the distribution of banks reporting an ROE of more than 10% in the first half of 2004 was essentially unchanged from end-2003 (see Chart B1.1). However, banks in the weakest performing quartile managed to improve their average ROE.

Income developments

Net interest income continued to decline in 2003 for most of the 50 large banks in the sample. Margins narrowed because of relatively low nominal interest rates in most EU countries, coupled with increased competition in some market segments. Net interest income showed signs of improvement in the first half of 2004. The effect of rising short-term interest rates in the United Kingdom meant that the aggregate interest income for the 50 banks in the sample increased from around 1.3% of total assets in 2003 to around 1.5% in mid-2004.

The need to rely more on market funding has contributed negatively to banks' net interest income in the past few years.[3] The funding gap between loans granted to the non-bank sectors and deposits taken from these sectors has been positive in the last few years (see Chart B1.2).[4]

Interim financial statements also indicate that net non-interest income increased in the first half of 2004. This was largely due to increasing fee and commission income. Trading profits are likely to be a less significant factor for 2004 than for 2003 as a whole.

2 All figures in the text refer to weighted averages unless otherwise stated. The averages are weighted by each institution's total assets. The figures for the first half of 2004 (2004 H1) are not audited, as they are based on interim reports provided by approximately 40 EU-15 banks. Several institutions only report ROE on a before-tax basis for 2004 H1, and are thus not included in this indicator, as ROE is calculated after tax and extraordinary items.

3 Customer funding is defined as non-bank deposits. These include deposits from non-financial corporations, government and households. Customer loans are defined in a similar manner. Market funding includes issuance of debt securities such as medium-term notes, repos and unsecured interbank borrowing.

4 The funding gap is defined as customer loans less customer deposits expressed as a percentage of customer loans. A positive value indicates a funding gap, i.e. more loans are being advanced than can be funded by bank core deposits, thus requiring additional funding sources.

Chart B1.1 Frequency distribution of ROE for large EU-15 banks[1)]

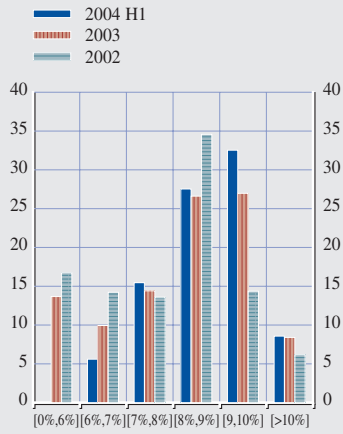


Chart B1.2 Customer funding gap for large EU-15 banks[2)]

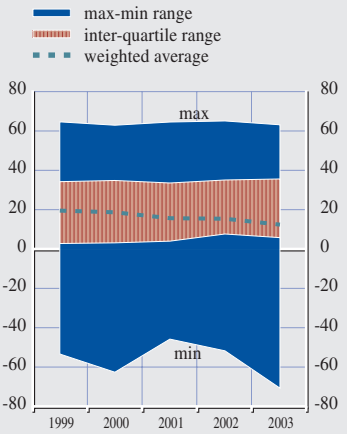
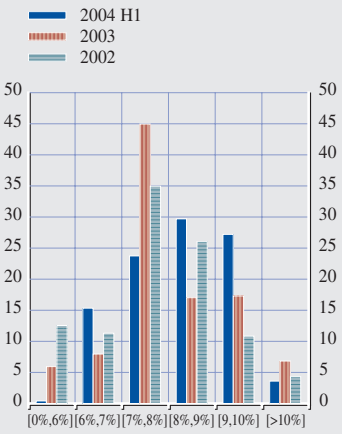


Chart B1.3 Frequency distribution of equity Tier 1 capital for large EU-15 banks[1)]



1) Source: ECB calculations based on published accounts. Data for the first half of 2004 are unaudited and are not based on the full sample.
2) Source: ECB calculations based on the annual accounts of individual banks. The gap is calculated as the difference between customer loans and deposits expressed as a percentage of customer loans.

Provisions and costs

In order to maintain profitability, cost control has been a priority for the large institutions. The average cost-to-income ratio decreased 3 percentage points to a level of 64.5% in 2003. This ratio improved further in the first half of 2004 to 59.9%. Moreover, the degree of dispersion of this ratio between the quartiles continued to decrease up to the first half of 2004 (see Statistical Annex, Table 10). The main areas of cost-cutting were a rationalisation of branch networks and a reduction in staff numbers. Given the extent of cost-cutting over the previous few years, it remains to be seen whether further scope for cost reduction exists as a means of restoring sustainable profitability.

Interim financial results for first half of 2004 indicate that provisioning for loan losses continued to fall, thus contributing to increased profitability. According to mid-year results, on average they fell from 0.3% of total assets in 2003 to 0.2% in mid-2004. Indications from some banks' third-quarter results are that this trend is set to continue for the full year.

Solvency

The key regulatory solvency ratios remained relatively healthy in 2003. The average Tier 1 ratio for the large banks in the sample stood at 6.7% in 2003. Encouragingly, those banks with the weakest solvency ratios managed to move these ratios onto a more solid footing by mid-2004, reaching an average of 7.1% (see Chart B1.3). This implies improved shock absorption capacity of these banks, which should contribute positively to financial stability in the EU-15.

OPERATING INCOME IMPROVED DESPITE THE DROP IN NET INTEREST INCOME

Net interest income of EU-15 banks fell slightly in 2003. The slow growth in the aggregate loan stock and the low level of interest margins contributed negatively to this income category (see Statistical Annex, Table 2).

In 2003 the low interest rate environment supported increasing household demand for housing loans. Looking at euro area developments, notwithstanding the rapid growth in loans for house purchase, with an annual growth rate of 7.9% in December 2003,[3] the growth rate of the total loan stock was lower than the one of total assets. In fact lending growth to non-financial firms remained lacklustre, with year-on-year growth of 2.2% in December 2003.

Even though the share of total loans, including loans to credit institutions, in total assets slightly fell in 2003, it continued to be the most significant asset class, with a share of 66.3% of total assets according to the consolidated data (see Statistical Annex, Table 4).

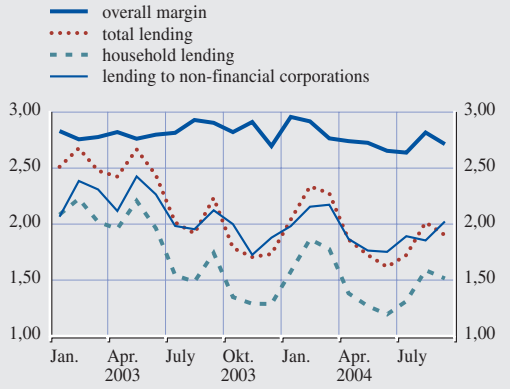
Holdings of other interest-bearing assets, such as public and private bonds as well as treasury bills, grew by less than 1 percentage point to 19.3% of total assets (see Statistical Annex, Table 4).

According to non-consolidated data on euro area MFIs, bank lending margins generally fell in the course of 2003 as a result of the low-yield environment (see Chart 5). However, the overall margin remained quite flat owing to improvement in the deposit margin after May 2003 (see Chart 6). The increasing funding gap after 2001 may have pressured banks' net interest income further, as banks have been forced to rely increasingly on more expensive market funding (see Chart 7). Moreover, EU-15 banks' margins may remain under pressure in the future as the customer funding gap may remain positive, forcing banks to continue to rely partly on more expensive market funding (see Chart 7).

3 Based on data available for euro area monetary financial institutions (MFIs), excluding central banks. It should be noted that the definition of MFIs differs from that of banks. MFIs comprise central banks, credit institutions as defined under Community law, money market funds and other institutions whose business it is to receive deposits and/or close substitutes for deposits from entities other than MFIs and, for their own account (at least in economic terms), to grant credits and/or make investments in securities. A complete list of MFIs is published on the ECB's website.

Chart 5 Margins on new lending and overall margin of euro area MFIs

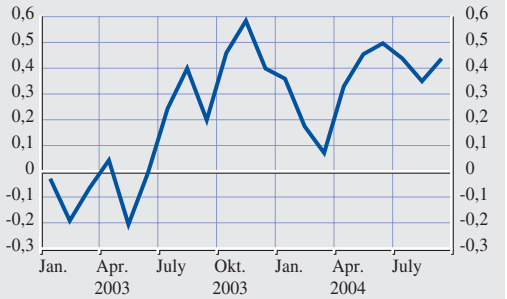
(Jan. 2003-Sep. 2004; percentage points)



Source: ECB.
Note: The overall margin is computed by summing the average margin on new lending and the average deposit margin.

Chart 6 Deposit margin of euro area banks

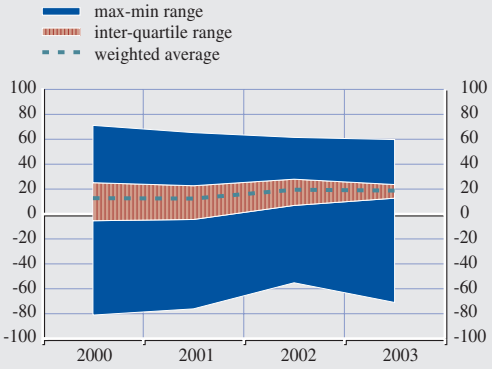
(Jan. 2003-Sep. 2004; percentage points)



Source: ECB.

Chart 7 Customer funding gap for EU-15 banks

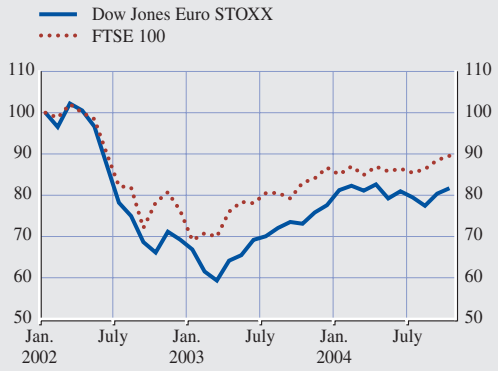
(2000-2003; % of loans to customers)



Source: BSC.
Note: The customer funding gap is calculated as the difference between customer loans and deposits expressed as a percentage of customer loans.

Chart 8 Stock prices in the euro area and the UK

(Jan. 2002-Oct. 2004; Jan. 2002 = 100)



Source: Bloomberg.

In the first half of 2004, some signs appeared of improved credit conditions and a pick-up in corporate loan demand. For instance, lending growth to non-financial firms accelerated in the euro area after February 2004, rising from 3.0% to 4.3% by July 2004.

In 2003 the share of non-interest income in total operating income increased slightly to 42%, 1 percentage point higher than in 2002 (see Statistical Annex, Table 2). In the EU-15, trading income and other non-interest income as measured against total assets increased in 2003, while commissions and fees were lower than in 2002.

Global financial markets provided a benign environment for banks' trading income in 2003. Equity markets recovered from the low levels reached at the beginning of 2003 (see Chart 8). In addition, over the same period, government bond yields remained low and spreads on corporate bonds stayed narrow, contributing positively to the return on banks' bond portfolios (see Charts 9 and 13). Looking at the consolidated banking data, the share of trading income in total operating income was highest for the group of large banks, increasing by 1.9 percentage points in 2003 to 9.6% of total income (see Statistical Annex, Table 2).

Turning to fees and commissions, their share of total income fell in EU-15 banks on average in 2003, driven by developments in large banks. The share of fees and commissions rose in medium and small banks. This may be partly explained by the fact that smaller banks tend to have a larger share of consumer credit in their loan portfolios. Consumer credit demand rebounded in the first quarter of 2004, as reported in the October 2004 ECB Bank Lending Survey. If this continues, related fees may further increase the scope of fee income for small banks.

Chart 9 EU-15 ten-year government bond yield

(Jan. 1990-Oct. 2004; %)

Source: ECB.

BANKS CUT COSTS FURTHER

A key factor underlying the improvement in the EU-15 banking sector's profitability in 2003 was a continuation of the decline in costs as a percentage of total operating income that began in 2002 (see Chart 1). This points to ongoing efforts to contain costs in 2003, and indications are that further measures were taken in the first half of 2004.

Banks achieved cost-cutting mainly by reducing staff and administrative costs, which fell as a percentage of total assets for large and medium-sized banks as well as for foreign banks. The positive developments in cost containment were shared by those large banking sectors that experienced weak profitability over the same period. Owing to reductions or lower growth in costs compared to income, cost-to-income ratios fell in all domestic groups and foreign banks, reaching 60.4% in 2003, on average (see Statistical Annex, Table 2).

PROVISIONS WERE REDUCED

In 2003 signs of a clear pick-up in economic growth were not apparent until the second half of the year, but indications of improved conditions in large firms who benefited from the strengthening of external demands became visible. Provisioning by banks was in line with the improved condition of large firms: it fell as a share of total assets (see Statistical Annex, Table 2). This had a positive impact on banks' profitability.

In some large banking sectors, low profitability in 2003 was driven by write-downs on investment portfolios as banks cleaned their balance sheets. However, in most EU-15 countries, write-downs had little impact on banks' profit results in 2003. This can partly be explained by the relatively small share, on average, of other assets apart from loans in banks' investment books.

The share of non-performing and doubtful loans in total loans decreased slightly between 2002 and 2003.[4] Gross non-performing loans on average absorbed a smaller share of own funds in the EU-15 banks in 2003 (see Statistical Annex, Table 3); non-performing loans net of provisions, as a share of own funds, also fell across all size and ownership categories. The reduction was particularly large in the case of medium-sized and foreign-owned banks.

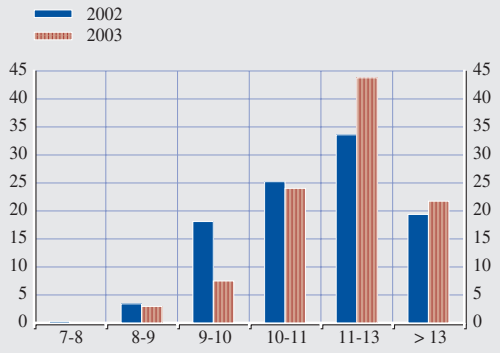
With regard to the stock of provisions, coverage rose, as the ratio of provisioning stocks over non-performing and doubtful loans increased across the board in the EU-15, for all domestic and foreign bank groups. Provisioning as a percentage of total loans also increased slightly in the EU-15, driven by developments in small and medium-sized domestic banks. This ratio slightly fell for foreign and large domestic banks (see Statistical Annex, Table 3).

The issue of the adequacy of provisioning over the past business cycle has often been raised. Lower than expected profitability could materialise if provisioning by banks over the past few years turned out to be too low. Assessment of the adequacy of provisioning requires detailed information on banks' loan books. However, such information is unavailable for EU-15 banking sectors. According to preliminary information for 2004, in some countries banks are reportedly considering increasing their provisioning by end-2004 to enhance their provisioning buffers.

4 Assets are defined as non-performing when either the obligor has filed for bankruptcy or similar protection from creditors, or the obligor is past due more than 90 days on any material credit obligation to the banking group. Doubtful assets are defined as all other irrevocable commitments that could give rise to risk. It should be noted that definitions of non-performing and doubtful loans can differ significantly between countries.

Chart 10 Frequency distribution of overall solvency ratios for EU-15 banks

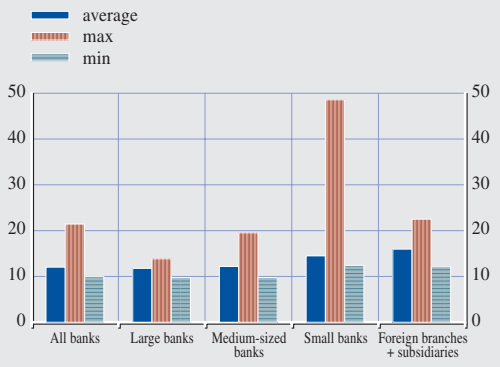
(2002-2003; % of risk-weighted assets)



Source: BSC.

Chart 11 EU-15 banks' overall solvency ratio: average, maximum and minimum

(2003; %)



Source: BSC.

BANKS ENHANCED THEIR SOLVENCY BUFFERS

EU-15 banks' capital adequacy levels improved on average in 2003, as indicated by the increase in both the overall solvency and Tier 1 ratios (see Chart 10 and the Statistical Annex, Table 5). At end-2003, the EU-15 average overall solvency ratio stood at 12.4%, and the Tier 1 ratio at 8.8%. Moreover, those large banking sectors with weak ROE readings for 2003 also increased their regulatory solvency ratios markedly after 2002.

All indications suggest that these tendencies continued in the first half of 2004 (see Box 1 and the Statistical Annex, Table 10). In addition, the distribution of the overall solvency ratio shifted towards the higher brackets, further indicating a strengthening in the solvency of EU-15 banks (see Statistical Annex, Table 5). Developments across size groups and including foreign banks are broadly comparable, with small banks registering the highest level of overall solvency ratios (see Chart 11).

EU-15 banks recorded a fall in on-balance sheet risk-weighted assets between 2002 and 2003, as a percentage of total risk-weighted assets. On the other hand, there was a slight increase in the share of both risk-weighted off-balance sheet and risk-adjusted trading book items (see Statistical Annex, Table 5).

LIQUIDITY DEVELOPMENTS WERE BROADLY FAVOURABLE, WHILE FUNDING SHIFTED FROM DEPOSITS TO MARKETS

Liquidity developments were broadly favourable in EU-15 banks in 2003, although with differences across liquidity ratios and size groups (see Statistical Annex, Table 4).

The majority of banks' funding comes from deposits. The share of customer deposits in total liabilities was about 42% in 2003 (see Statistical Annex, Table 4). Banks' funding shifted more towards interbank funding in 2003, as deposit growth in a number of countries was sluggish. In those countries which registered positive deposit growth, this was seen as a catching-up process after low rates of deposit growth that were recorded in 2002.

2 EU-15 BANKS' RISK OUTLOOK

This section assesses the risks facing the EU-15 banking sectors. It should be noted that these risks are not highlighted with the aim of identifying the most probable outcome. The section rather aims at identifying potential and plausible sources of downside risk – even if relatively remote – with regard to the likeliest outcome.

Taking into account the positive financial results of banks in 2003 and the enhancement of solvency levels in the EU-15, the baseline assessment of the outlook for the sector is cautiously positive. However, certain vulnerabilities can be identified, some of which are internal to the banking sector, while others relate to external factors.

With regard to the internal vulnerabilities, the low level of profitability of the banking sectors in some major economies may have a negative impact on the overall ability to sustain risks should they crystallise. However, these sectors were also able to improve their solvency buffers in 2003, and preliminary indications show that the condition of banks in these sectors improved in the first half of 2004.

As for external sources of vulnerability, persistently large global imbalances and the surge in oil prices through 2004 need to be taken into account. A disorderly unwinding of global imbalances could have an impact on banks if it were to affect foreign exchange markets, as well as other financial market segments. However, movements in global imbalances as well as oil price developments could have even stronger indirect impacts via second-round effects on income generation and the asset quality of banks. The crystallisation of these risks could weigh on the quality of bank loans extended to sectors where balance sheet repair has been less pronounced. This may be particularly the case for the small and medium-sized enterprise (SME) sector in Europe. While large European companies have benefited from the strength of import demand in the US, Japan and China, this does not appear to hold for the SME sector. For these firms, a deterioration in global economic conditions would compound generally weak domestic demand and would test their financial strength. Household disposable income is also heavily dependent on positive macroeconomic developments. In the unlikely scenario of lower than expected economic growth combined with higher unemployment and higher interest rates, household credit quality would decrease. Household credit quality is also dependent on residential property prices. Although these prices are not widely expected to decline in the EU-15, downside risks to house price inflation may have increased in some countries.

Large global imbalances have also most likely contributed to maintaining low government bond yields and emerging market and corporate bond spreads. As there are some indications that banks took on more interest rate risk, the low-yield environment may have induced additional fragility. Shocks to banks from an abrupt upturn in long-term interest rates could be transmitted via their direct market exposures as well as indirectly through existing interlinkages to other financial institutions via rising income and credit risks.

To assess the possible impacts of these risks, this section provides an overall assessment of EU-15 banks' household and corporate sector credit risk, interest rate, exchange rate and other market-related risks, as well as banks' exposures to emerging markets and hedge funds.

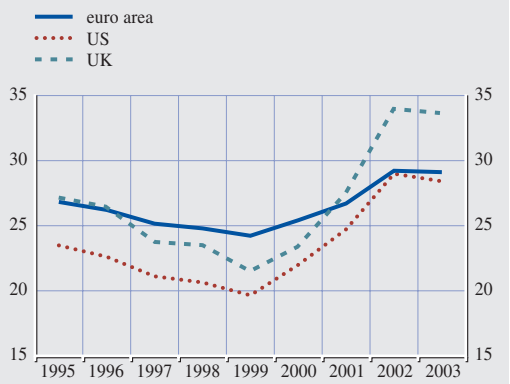
CREDIT RISK CONTINUES TO BE DRIVEN BY GENERAL ECONOMIC DEVELOPMENTS

HOUSEHOLD CREDIT RISK CONTAINED

According to available data on the euro area, households have become increasingly indebted. Although the share of their debt to financial assets levelled off in 2003 (see Chart 12), debt to disposable income ratios steadily rose. However, so far households' debt servicing ability has been supported by low interest rates.

Chart 12 Household debt to financial assets ratio

(1995-2003)



Sources: ECB and OECD Economic Outlook No. 75.

The non-consolidated data for the euro area indicate that lending by banks to households represents one of the major lines of banks' activities, accounting for roughly 30% of total new lending. Owing to the large share of household loans in the total loan stock, the continued growth in household lending counts as a potentially important source of credit risk for banks. In those countries where lending growth has been particularly rapid, the exposures of banks to household credit risks may have increased.

The importance of credit risk associated with the household sector depends upon several factors, such as actual exposures and the interest rate sensitivity of household loan portfolios, as well as collateral values and other credit standards on loans. In countries where banks grant most housing loans at fixed rates, household credit risks might be contained, with the banking industry being however vulnerable, in the short run, to a decline of household credit demand.

Regarding the exposure of banks to risks in their mortgage loan portfolios, an important factor affecting the quality of loans to households is the repayment burden of households. The degree to which this is affected on aggregate by changes in interest rates depends on the share of fixed and variable-rate mortgages. While there are no EU-15-wide estimates available, the estimate for the euro area may be used as a proxy. For the latter, there are some indications that in the second quarter of 2004 the share of outstanding mortgage debt that could be exposed in the short run to a change in interest rates stood at one-third of the total stock, although there are wide differences across countries. At first glance, it would appear that, at least in euro area countries, the major impact from changes in interest rates would be carried by banks themselves. However, banks are likely to have put in place various hedges against interest rate risk.

Developments in residential property prices are important as they affect the value of collateral. High residential property prices guarantee the value of mortgages, even in the event of reduced household income or an increase in the repayment burden, assuming that banks can realise collateral. However, the ability of banks to realise collateral could easily be impaired by market conditions or because it is not one of their core activities. In terms of buffers held by banks against risks to collateral values, there is some evidence that in certain EU-15 countries in 2003 some borrowers' loan-to-value ratios (LTVs) hovered in a range between 90% and 100%, even though LTVs in several other countries remained at very conformable levels. The proportion of the overall stock of lending for house purchase linked to high LTV values is estimated to be small. Low LTV ratios should leave banks relatively well-cushioned, which would mean that households would bear the brunt of any property market reversal. For banks, this could have negative impacts through reduced income from the household sector.

Turning to consumer lending, while there were substantial increases in unsecured consumer credit outstanding in some countries, the stock of consumer loans and other credit as a proportion of total household loans remained rather low. For example, in the euro area it stood at 13.6% of the total household sector lending stock in July 2004. However, consumer

lending is often uncollateralised. The quality of consumer credit may be more sensitive to changes in interest rates than mortgages, as consumer credits are often linked to variable interest rates. However, according to available information for euro area countries, floating rates and short-term initial rate fixation for consumer loans are important but not predominant (measured as a share of total consumer credit loans).

Households with financial difficulties tend to default on consumer credit before defaulting on mortgages. Some country experiences suggest that there is usually a higher level of arrears on consumer credits than mortgage debt. Banks have been making efforts to price risk more efficiently. For example, the use of credit scoring models by banks or their consumer finance company subsidiaries has become widespread, thereby helping to contain these risks.

Taking lending to households as a whole, the overall household loan portfolio is only deemed to pose a risk of significant losses for banks in the event of several negative factors occurring simultaneously (for example, under growing unemployment, falling house prices and rising interest rates).

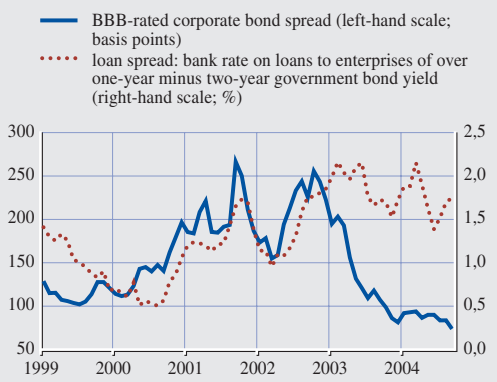
CREDIT RISK IN NON-FINANCIAL CORPORATE PORTFOLIOS IS HIGHER FOR SMEs

Developments in the credit quality of banks' corporate loan portfolios have been mixed. In comparison to the euro area, the corporate credit risk condition is however likely to be more benign in the EU-15 on aggregate owing to the relatively better condition of firms in non-euro area EU-15 countries.

Large EU-15 companies' balance sheets have moved onto more solid footing – mainly owing to the strength of external demand. However, SMEs continued to face sluggish domestic demand and insolvencies are expected to rise for the year 2004 as a whole (see Chart 2). The pricing of risk by banks diverged significantly from the risk premia demanded in corporate bond markets (see Chart 13). This is because banks also lend to SMEs. However, in some countries divergence in the pricing of risk was not apparent as banks tended to lower their margins substantially even towards SMEs due to the strong competition among credit institutions.

Chart 13 Euro area corporate bond and bank loan spreads

(Jan. 1999-Sep. 2004)



Source: Thomson Financial Datastream.

In some countries, lending to SMEs may account for a substantial share of banks' overall corporate loan portfolios. However, aggregate information on these exposures is not currently available. The SME sector also plays an indirect role, accounting for a large share of employment in the economy. Hence, financial strains in this corporate sub-sector can also pose risks for banks through their impact on household balance sheets.

The available data on expected default frequencies and exposure data of eight EU-15 countries on seven aggregate industries indicate that exposures at risk have declined across most industries (see Statistical Annex, Table 12).

This notwithstanding, from a sub-industry point of view, banks' exposures to the real estate and/or construction industries are likely to be sizeable in many countries, and there are also signs that banks in several countries increased

lending to these sectors in 2004. The financial conditions of these industries move in close conjunction with the business cycle, and this development is likely to be strongest in those countries with excess capacity or where commercial real estate prices have declined.

Finally, given the strength of oil prices, costs of industries that use oil as a major input can be expected to rise. These industries include the chemical industry, as well as airlines, shipping and other transport industries. If the recent rise in oil prices proved to be sustained, risks would rise commensurately.

INTEREST RATE EXPOSURES HAVE INCREASED

A substantial change in the level of long-term interest rates, possibly as a result of a sizeable increase in global long-term interest rates, could pose a challenge to financial stability. In the EU-15 context, there are indications that some banks have been taking on additional interest rate risk, both in their trading and banking books in the search for higher yields.

Rising long-term interest rates could have several impacts on banks. With regard to banking books, rising rates would cause changes in banks' net interest margins through repricing effects on assets and liabilities.[5] However, while increasing long-term interest rates would result in a steepening of the yield curve and would probably contribute positively to interest income, there would also be adverse effects on the demand for credit and the ability of customers to service their debts. In addition, rising interest rates would negatively affect the value of banks' bond holdings in their banking books. Combining the reduction in loan demand as well as customer credit quality with the negative impact of banking and trading book valuations under increasing interest rates could imply that the adverse effects of an upturn in long-term interest rates outweigh the benefits from improved margins. Rising rates would also contribute to changes in basis risk[6] and in the use of optionality within banking books (such as the option of prepayment) and in off-balance sheet items.

To assess the valuation risk from rising interest rates on banks' fixed income trading portfolios, value-at-risk (VaR) measures can provide a useful yardstick.[7]

Interest rate VaR usually accounts for the largest part of the total VaR. Notwithstanding the significant differences across financial institutions in the level of their VaRs, these market risk measures had increased in most countries by mid-2004 compared with a year before. Given the low level of volatility prevailing in the summer of 2004,[8] the increase in the level of VaR readings suggests that the underlying risk positions had increased by even more. This is also indicated by the increased size of banks' trading books. On the other hand, these VaR figures only constitute a small proportion of bank equity capital. In addition, a possible, mitigating factor could be the increased capital ratios of banks (see Statistical Annex Table 5).

5 Repricing risk is the risk that banks' interest expenses – i.e. those incurred in financing assets – could increase by more than interest receivables upon a sudden rise in interest rates. The underlying reason for this risk is the existence of maturity mismatches between assets and liabilities.

6 Basis risk arises from imperfect correlation in the adjustment of the rates earned and paid on different instruments with otherwise similar repricing characteristics.

7 VaR is a statistical measure of potential losses over a given holding period. The measure consists of a benchmark loss amount and an accompanying probability estimate. On the basis of a historical distribution of returns, a confidence interval is constructed in which losses in excess of the benchmark loss are estimated to occur with a specified likelihood. For instance, for a 99th percentile VaR, losses in excess of the benchmark loss would be expected to occur 1% of the time. VaR indicators are available for a smaller set of banks, as they are often not collected by national authorities. Consequently, these figures should be considered only as representative of a small part of the EU-15 banking sector (see Statistical Annex, Table 11).

8 Low volatility, all things being equal, implies low VaR readings.

FOREIGN EXCHANGE RISK EXPOSURES HAVE DECLINED

The persistence of global imbalances may imply an eventual need for a rebalancing of a number of countries' international positions through changes in exchange rate levels.

In analysing the possible impact of foreign exchange risks on the EU-15 banking sector, a distinction should be made between direct and indirect effects. Direct effects can be defined as those that have a direct impact on banking groups' balance sheets and profitability, while indirect effects are those that have an impact on the balance sheets and cash flows of the banks' clients. At the banking group level, direct foreign exchange risks can originate through two different channels: currency mismatches – either in asset and liability positions or in respective income and cost streams – and translation effects (i.e. the conversion of profits denominated in a specific currency to the banking group's accounting currency). Indirect effects can arise from mismatches in clients' asset/liability positions and income/cost streams, or from adverse effects arising from subdued economic activity, particularly in the traded sector of the economy.

With regard to trading books at the end of 2003, the share of banks' trading book own funds requirements for foreign exchange risk decreased from 7.7% in 2002 to 6.3% in 2003. The share of total trading book requirements was significantly lower than the share of requirements of traded debt instruments and equities (see Statistical Annex, Table 5).

In 2004 there were indications that banks' USD-denominated assets remained broadly constant or decreased. In particular, in the case of euro area countries, holdings of USD-denominated fixed income assets appear to have decreased in the first half of 2004. Overall, this evidence suggests that foreign exchange risk is likely to have decreased.

EQUITY RISK EXPOSURES HAVE INCREASED MODERATLY

In 2003 the strength of stock markets increased EU-15 banks' income from market activities compared with 2002 (see Statistical Annex, Table 2). For most of 2004, however, stock markets were generally characterized by lack of direction, coupled with low volatility (see Chart 8). These developments may have reduced trading income for EU-15 banks. However, the increase in equity VaRs of these banks between mid-2003 and mid-2004 indicate increasing exposures during this period.[9]

BANKS MAY BE INCREASINGLY EXPOSED TO HEDGE FUNDS

Banks' direct exposures to hedge funds arise mostly from their prime brokerage services to these institutions. Direct credit exposures include loans, credit lines and trading exposures in over-the-counter (OTC) and other markets. The CSFB Tremont Hedge Fund Index increased by only 5.1% year-to-date in October 2004, and returns were negative in three months in 2004 in comparison to a annual return of 15.4% in 2003. Lower returns appear to reflect increasing competition in the sector which may have adverse implications for individual hedge funds and prime brokers.

While the market for prime brokerage services is mainly dominated by US banks, some EU-15 institutions also provide these services. The share of income stream from prime brokerage services can be quite significant in total trading and commission income for these banks.

The prime brokerage business is rather concentrated. However, it is becoming more competitive as new banks enter the market. As hedge funds may use several different prime

9 Information on VaRs was collected from public reports of six major banks. Although these VaRs are broadly in line with those collected by the BSC (see Statistical Annex, Table 11), the publicly available VaRs are broken down further into equity, interest rate, exchange rate and commodity VaRs.

brokers, it is possible that a single bank lacks information on the full risk profile of its customers. This opaqueness may pose a risk to banks that provide prime brokerage services.

In addition to income and credit exposures, a further risk for banks' arises through their investments into these funds. Finally, some banks may be directly exposed by having set up their own hedge funds.

Indirect risks may also materialise, for example through credit risk on counterparties that have large exposures to hedge funds. Moreover, as hedge funds proliferate, banks risk losing asset management income, while the value of their trading book positions is increasingly affected by hedge fund activities in the financial markets.

EMERGING MARKET EXPOSURES HAVE INCREASED

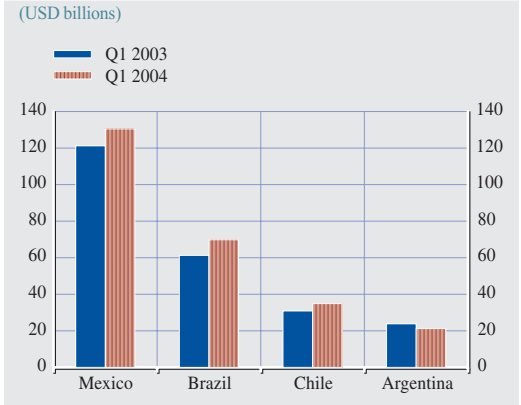
The economic performance of emerging market economies was strong in 2003 and in the first half of 2004, and EU-15 banks have increased their exposure to these countries, possibly in a search for yield.

Concerning individual regions of the world, most EU-15 banks remain relatively heavily exposed to Latin America, and exposure to all the main economies in the region increased in the course of 2003 with the exception of Argentina (see Chart 14). In the case of Argentina, this situation can most probably be explained by the uncertainty associated with the ongoing renegotiation of its foreign debt. On the other hand, strong economic performance in Brazil partly explains the increased exposure by EU-15 banks.

Exposures of EU-15 banks to emerging Asia remain slightly lower than those to Latin America (see Chart 15). EU-15 banks also appear to have differentiated across countries in the region to a larger extent. However, aggregate figures show an increase in exposures to emerging Asia since Q1 2003.

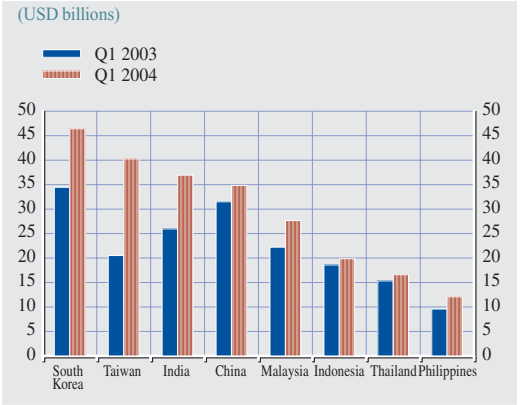
While there are signs of improved conditions in emerging market economies, the possible hunt for yield may have pushed bond spreads below intrinsic values, leaving EU-15 banks' exposed to these economies' external shocks. With emerging market economies still being characterized by relatively high debt ratios, a sudden increase in risk aversion or a change in market participants' expectations over the pace of interest rate changes in industrialised countries may endanger emerging markets' stability. Were an upward adjustment in spreads to take place, EU-15 banks would probably

Chart 14 International exposure of EU-15 banks to Latin American countries



Source: Bank for International Settlements (BIS).

Chart 15 International exposure of EU-15 banks to Asian countries



Source: Bank for International Settlements (BIS).

suffer some losses on their emerging market portfolios. However, as these exposures are relatively small with respect to banks' own funds, this risk appears manageable.

3 EU-15 BANKS' ABILITY TO WITHSTAND SHOCKS

MARKET INDICATORS SUGGEST A POSITIVE OUTLOOK

Market indicators have pointed to an improved assessment of banking sector profitability and banks' external conditions since the end of 2003. This positive trend can also be seen as a forward-looking assessment that the future risks are manageable for the majority of large banks.

In the course of 2003 and especially in 2004, bank share prices outperformed general stock market indices, possibly also on the grounds of the broadly positive income results for 2003-2004 (see Chart 16 for the euro area).

The average distance-to-default[10] of a set of large EU-15 banks began to show signs of improvement after July 2003. By September 2003, the average values of this indicator had risen to levels not seen since early 1998 (see Chart 17). Additionally, the minimum distance-to-default and the average one for the weakest 10% of banks had also improved from the low points reached in early 2003. However, they still remained below the levels that had prevailed between January 1998 and mid-2001.

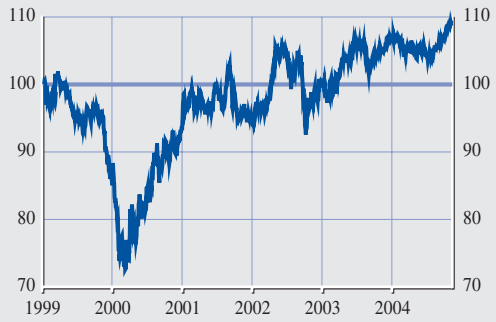
The asset-weighted distance-to-default can be useful for assessing banking system stability as this indicator measures the proportion of the EU-15 banking sector at risk. Trends in the average distance-to-default and asset-weighted distance-to-default have closely mirrored each other in the past, but the asset-weighted distance-to-default has consistently remained at a lower level, suggesting that the largest banks in the sample have been assessed by market participants to be weaker. However, the gap between the two averages narrowed over the second half of 2003 and in 2004, indicating that the larger, and weaker, banks had made a faster recovery. This suggests more homogeneous and improved conditions in the banking sector.

The share of large banks with a low distance-to-default continuously declined from mid-2003 onwards. By September 2004, only 9% of total assets of the banks in the sample were classified as speculative grade according to a

10 The distance-to-default represents the number of asset value standard deviations away from the default point. It is calculated using option pricing theory to solve for the unobservable market value of assets and its volatility from observable equity market capitalisation, volatility figures and leverage data. The default point is defined as the point at which the value of the bank is precisely equal to the value of its liabilities (i.e. equity is zero).

Chart 16 Ratio of bank stock market index to the overall market index for the euro area

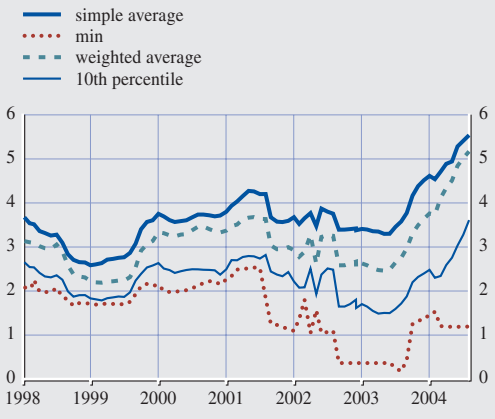
(Jan. 1999-Oct. 2004; index: Jan. 1999 = 100)



Source: Thomson Financial Datastream.

Chart 17 Distance-to-default indicators for large EU-15 banks

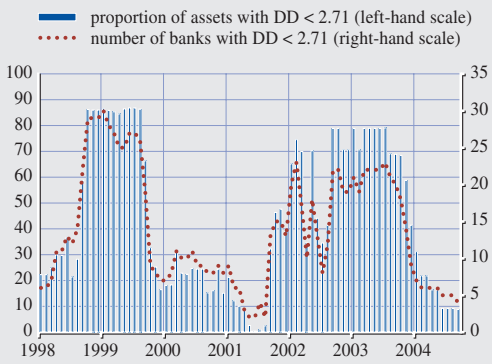
(Jan. 1998-Sep. 2004)



Sources: Thomson Financial Datastream, Bankscope and ECB calculations.
Note: The indicators are based on data for 48 large banks. An increase in the distance-to-default reflects an improving assessment.

Chart 18 Threshold indicators based on distance-to-default of 48 large EU-15 banks

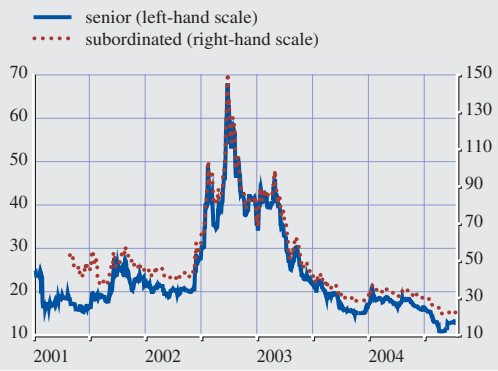
(Jan. 1998-Sep. 2004)



Sources: Thomson Financial Datastream, Bankscope and ECB calculations.

Chart 19 European banks' credit default swaps and subordinated debt spreads

(Jan. 2001-Oct. 2004; basis points)



Source: Credit Trade.
Note: "European" corresponds to Credit Trade's definition.

threshold indicator which is based on the distance-to-default measure.[11] This compares with over 70% of total assets in the sample in the third quarter of 2003 (see Chart 18). This indicator suggests that substantial improvement has taken place in the major EU-15 banks.

Subordinated debt spreads and credit default swap (CDS) spreads for the EU-15 banking sector declined markedly in the course of 2003 (see Chart 19). Notwithstanding a slight upturn in early 2004, they began to fall again in the third quarter of 2004, to levels last seen in early 2001. Although the patterns in CDS spreads generally confirm and reinforce the assessment contained in distances-to-default, it is also possible that movements in these spreads are affected by the hunt for yield that has taken place across a variety of fixed income markets.

RATING ACTIONS AND CREDIT QUALITY OUTLOOK REMAIN BROADLY POSITIVE

The three major international rating agencies concur in their assessment that the condition of most European banks had improved by mid-2004. These agencies also identified good earnings prospects for the year ahead.

The risks identified by rating agencies mirrored those discussed in this report. These agencies identified two major risk factors that could negatively affect the outlook for banks' ratings: firstly, the fragility of the global economic recovery, also in light of the persisting and growing global imbalances; and secondly, the possibility of further increases in oil prices.

In relation to banks' specific credit risks, rating agencies did not expect the slow pace of economic recovery in most of continental Europe to produce any material decline in the number of SME insolvencies. On the other hand, concerns remained that some banks have excessive single-name concentrations on their loan books. As for household credit risk, rating agencies made the assessment that risks from housing markets, in the face of significant increases in house prices in some countries, could manifest themselves either in falling property prices or weaker consumer confidence.

In relation to market risks, some rating agencies signalled that banks' revenues from fixed-income markets could deteriorate with rising interest rates.

11 The threshold used in Chart 18 of DD<2.71 corresponds to the threshold between investment-grade and speculative-grade credit quality used by rating agencies (i.e. an implied probability of default in a year larger than 0.65).

4 BANKS IN THE NEW MEMBER STATES

PROFITABILITY CONDITIONS

This section analyses the banking sectors in the NMSs in terms of profitability, solvency and risk. The analysis complements the findings of the previous sections since, as discussed below, a majority of the banks in the NMSs are owned by credit institutions in EU-15 countries.[12] The consolidated data on EU-15 banks effectively already include a large share of NMS banks as subsidiaries. However, they also conceal some important differences between EU-15 countries and the NMSs which are needed to complete the analysis of EU banking sector risks.

PROFITABILITY IMPROVED MODERATELY

The overall performance of banks in the NMSs improved only moderately in 2003, mostly owing to the mixed performance of the banking sectors in the Central and Eastern European Countries (CEEC-5). Aggregate ROE rose by 0.7 percentage points to 11.6% for the NMSs as a whole. Differences across countries remained significant: the range of variation of ROE in NMS banks stood between -4.3% and 22.5% (see Statistical Annex, Table 6).

Breaking the set of NMSs into country groups,[13] the Baltic states registered the highest average ROE (see Chart 20). At the same time, however, it is worth bearing in mind that higher risk-taking may have contributed to the improved profitability of banks in this group of countries, as signalled by an increase in leverage (total assets to equity) as well as in the ratio of risk-weighted assets to total assets.

In relation to differences in profitability on the basis of either domestic or foreign ownership in the NMSs as a whole,[14] domestic banks outperformed foreign-controlled banks in terms of aggregate ROE by 0.5 percentage points (see Chart 21). The difference was largest for domestic medium-sized banks, with an ROE of 13.1%. However, profitability developments diverged across NMS banks in 2003, as indicated by the increase in the average ROE and the rise in the share of weak banks, i.e.

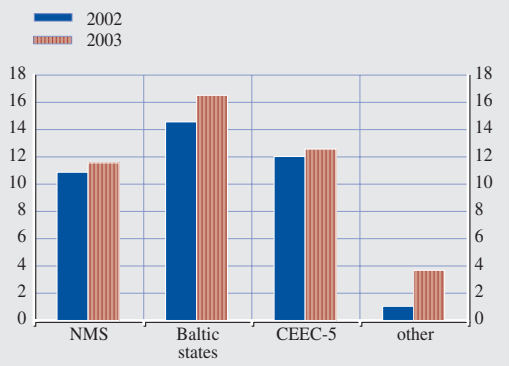
12 From the point of view of the EU-15 banking sectors, loan exposures to the NMSs still account for only a limited share of EU-15 banks' global exposures, comprising 2.6% of total foreign claims and 4.5% of claims on EU-25 countries.

13 The country groups are as follows: the Baltic states (Estonia, Latvia, Lithuania), the CEEC-5 (Poland, Hungary, Czech Republic, Slovenia, Slovakia) and others (Cyprus and Malta).

14 Foreign-owned banks in NMSs are to a large extent former domestic banks that have been privatised. After privatisation, it typically takes some time to reorganise banks according to the standards adopted by the new foreign owners, so that newly privatised domestic banks may initially resemble their domestic counterparts, and only over a longer period of time incorporate the changes brought about by foreign ownership.

Chart 20 NMS banks' ROE by country groups (after tax and extraordinary items)

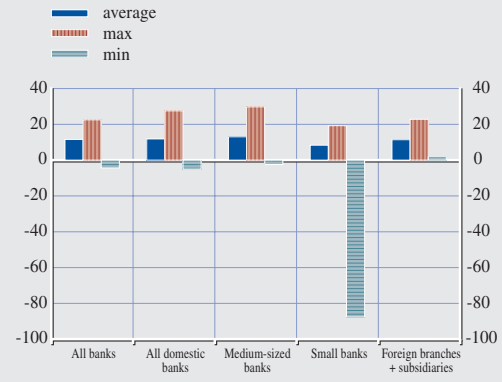
(2002-2003, %)



Source: BSC.

Chart 21 NMS banks' ROE (after tax and extraordinary items): average, maximum and minimum

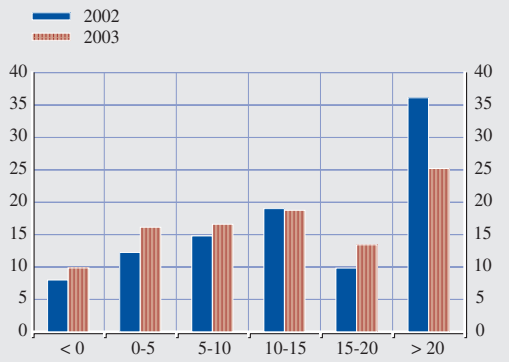
(2003)



Source: BSC.

Chart 22 Frequency distribution of ROE for NMS banks (after tax and extraordinary items)

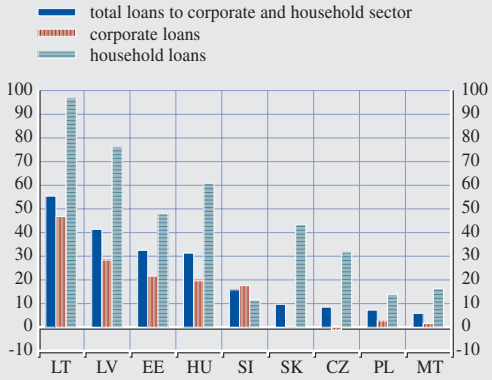
(2002-2003; %)



Source: BSC.

Chart 23 Annual growth in lending to the private sector

(2003; %)



Sources: BSC and national central banks.

those with an ROE of less than 5%. In particular, this share rose to 26% of total assets in 2003 (see Chart 22).

Preliminary information for the first half of 2004 indicates that the average level of bank performance generally improved in the NMSs. However, no information is currently available on the weakest performing banks. Profitability remained strong or increased in the Baltic states and some CEEC-5 countries. An important factor behind banks' ongoing positive performance in the NMSs was the continuing brisk pace of growth in credit, although in some countries the improvement in profitability was mainly driven by lower provisioning. Overall profitability ratios are expected to improve for the NMSs as a whole in 2004.

INCOME WAS SUPPORTED BY HIGH LENDING GROWTH

In 2003 and the first half of 2004, many banks in most NMSs thrived on robust credit growth owing to favourable macroeconomic conditions, low interest rates and the pressures faced by banks to maintain profitability by increasing lending volumes. However, significant differences exist across the NMSs. In the Baltic states, growth was highest, ranging from 33% to 55%, while in four other NMSs, annual credit growth remained in the range of 6% to 10% (see Chart 23).[15] The loan-to-asset ratio increased by 3 percentage points for the NMSs as a whole, to 49% in 2003. Regarding the relative size of the loan book, figures were once again highest for the Baltic states, where an average increase of 7 percentage points was recorded, raising the ratio to an average level of 60% of total assets.

Despite rapid lending growth in many countries, operating income grew at a slower rate than total assets, mostly owing to narrowing interest rate margins. In the NMSs as a whole, net interest margins declined by 0.2 percentage points to 2.7%. Thanks to strong competition in the household lending market, the narrowing of margins was most pronounced in the Baltic states, where it fell on average by 0.5 percentage points.

Net non-interest income as a percentage of total assets fell in 2003 by 0.3 percentage points. The main reason for this was the weak trading results in some countries. In terms of income structure, compared with EU-15 countries, banks in the NMSs depend more heavily on net interest income, which accounts for 62% of their total operating income. Owing to the

15 Note that currency depreciation had some impact on the size of the loan books in some countries.

increase in loan-related fees and commissions, the share of net commission income rose by 3.5 percentage points to 26% of total income. At the same time, the proportion of trading returns, a far more volatile source of income, decreased by 4 percentage points to 10.5% (see Statistical Annex, Table 6).

DETERIORATION IN COST EFFICIENCY

Unlike in banks in the EU-15, cost efficiency did not improve overall in banks in the NMSs. While the average cost-to-income ratio rose from 62% in 2002 to 65% in 2003, marked cross-country differences could also be observed. Banks in the Baltic states and a few other NMSs improved their cost efficiency, whereas the majority of banks in CEEC-5 showed less positive developments. Owing to the deterioration in 2003, the average cost-to-income ratio of the NMSs exceeded that of EU-15 countries. Moreover, as a share of total assets, operating costs have remained much higher than for EU-15 banks, reflecting the small average bank size in the NMSs and the considerable potential to increase scale efficiency (see Statistical Annex, Table 6).

Unlike in 2002, when foreign-controlled banks outperformed domestic ones in terms of cost efficiency, on average no significant differences could be detected between the two sets of banks in 2003. However, there are significant differences when it comes to the cost efficiency of medium and small-sized domestic banks: the cost-to-income ratio for medium-sized banks is 11 percentage points lower than for small ones.

ENHANCED ASSET QUALITY SUPPORTED PROFITABILITY

A broadly favourable macroeconomic environment supported the improvement in banks' asset quality in the majority of NMSs. The overall ratio of non-performing and doubtful loans to total loans declined in 2003 by 0.9 percentage points to 10.7%. On average, however, this ratio remained high compared with 3.1% for EU-15 banks (see Statistical Annex, Tables 3 and 7). While this can partly be explained by comparatively strict loan classification rules in some countries, it also reflected the overall higher credit risk in the NMSs. Regional differences were also significant in relation to these indicators: in the Baltic banking sectors, given particularly strong macroeconomic conditions, the average ratio of non-performing and doubtful loans was very low compared to the average level of NMSs.

In contrast to the developments in profitability, foreign ownership had a positive impact on the asset quality of banks, as the ratio of non-performing and doubtful loans to both total loans and advances and own funds was considerably lower for foreign-controlled banks. This difference was also confirmed by the diverging paths of domestic and foreign banks: in 2003 the ratio of non-performing and other doubtful loans climbed as a percentage of total loans and advances to 12.6% for domestic banks, whereas it fell to 9.8% for foreign-controlled banks (see Statistical Annex, Table 7). Developments on the profitability and asset quality side, taken together, suggest that foreign banks may have better risk management.

Given the improving asset quality, net provisioning costs, as a percentage of total assets, fell by 0.3 percentage points. The reduction in provisioning costs was particularly notable in some CEEC-5. At the same time, the coverage of non-performing and other doubtful assets by provisions diminished by 3 percentage points. On average, NMS banks have less coverage for their problem loans than banks in EU-15 countries. The ratio of provisions to non-performing and other doubtful assets was only 42% in the NMSs, compared with the EU-15 average of 67% (see Statistical Annex, Tables 3 and 7). Notwithstanding a possible downward bias in this indicator caused by strict loan classification rules, doubts may be raised about whether banks in some of the NMSs have adequate provisioning buffers in case of a potential credit quality shock.

BANKS MAINTAINED ADEQUATE SOLVENCY BUFFERS

High lending growth put pressure on banks' capital adequacy in some countries, but capital ratios generally remained high. On average, the overall solvency ratio declined by 0.5 percentage points to 13.6% (see Statistical Annex, Table 9). The fall in solvency ratios was more pronounced in countries that experienced the highest growth in risk-weighted assets or an overall loss in the banking system. Although a substantial part of the lending expansion can be attributed to the rapid increase in mortgage loans, where relatively lower risk weights (50%) are applied, the persistence of high lending growth may put some strains on banks' capital adequacy in the future, at least in the medium term.

The aggregated market share of banks with a solvency ratio of below 9% has been very small, comprising only 3% of total assets or 9% of risk-weighted assets in the NMSs (see Chart 24). With regard to the capital structure of banks, the high Tier 1 capital ratios indicate rather benign conditions. This is also evidenced by differences between old and new Member States, with a Tier 1 ratio of 13.4% in the NMSs, compared with 8.8% for EU-15 banks (see Statistical Annex, Tables 5 and 9).

When comparing banks in the NMSs on the basis of ownership, the average overall solvency ratio was higher for foreign than for domestic banks, suggesting that foreign ownership has had a positive impact on capital adequacy (see Chart 25). With regard to different size groups, small domestic banks have significantly higher capital ratios than medium-sized ones.

RISKS IN NMS BANKING SECTORS

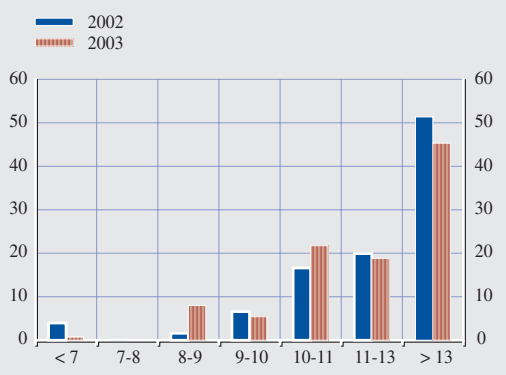
INCREASED RISKS FROM HIGH LENDING GROWTH TO HOUSEHOLDS; RISKS FROM LENDING TO CORPORATES ARE MIXED

The fast rate of credit growth in the NMSs may be a cause of concern from a financial stability perspective. In lending booms, banks may lower credit standards as risk management may be unable to keep up with the pace of lending growth. As shown in Chart 23, there have been rather significant cross-country differences, with the growth rate of lending to the private sector varying between 6% and 55% across the NMSs.

Variations in lending growth across countries can be explained by a number of factors, for

Chart 24 Frequency distribution of overall solvency ratio for NMS banks

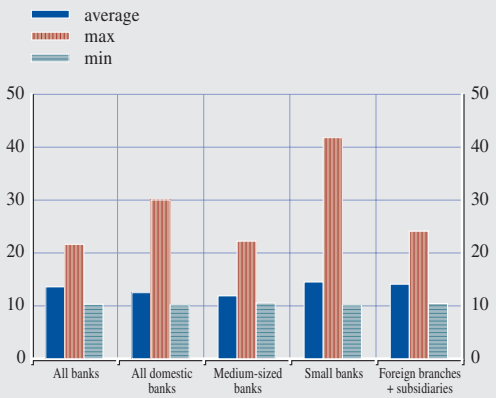
(2002-2003; % of risk-weighted assets)



Source: BSC.

Chart 25 NMS banks' overall solvency ratios: average, maximum and minimum

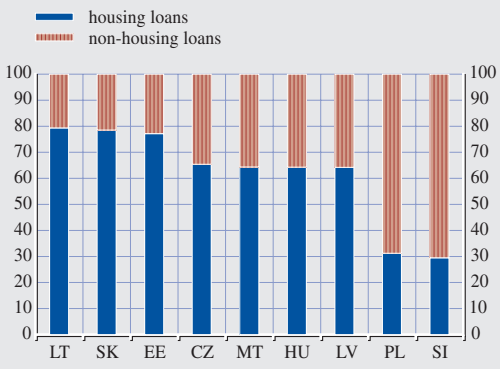
(2003; %)



Source: BSC.

Chart 26 Distribution of household loans in the NMSs

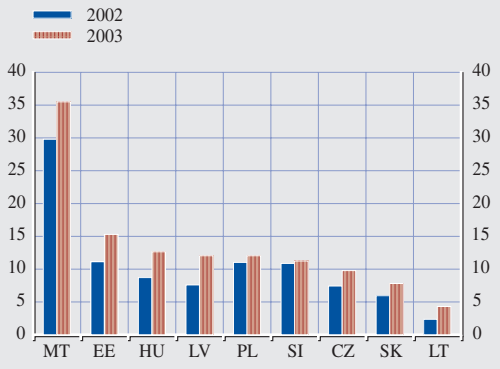
(2003; %)



Source: BSC.

Chart 27 Household debt in the NMSs

(2002-2003; % of GDP)



Sources: BSC and national central banks.
Note: MFI loans only.

instance by differences in financial depth. Among former transition NMSs, however, the highest growth rates have been recorded in countries with full or quasi-currency boards. An implicit exchange rate guarantee, which is provided by credible exchange rate regimes, may, coupled with low interest rates, have been very important in boosting credit demand in these countries.

Household lending rose dramatically during the past few years in many NMSs, albeit from a low initial level. This was mostly driven by mortgage lending. With regard to differences in the pace of lending growth, growth rates across countries varied from 12% to 97% in 2003. Looking at the distribution of household lending, housing loans represent at least 60% of total loans to households in most NMSs (see Chart 26).

Household indebtedness increased considerably in most NMSs over recent years (see Chart 27). Notwithstanding this, the level of household indebtedness remained well below the EU-15 average, except in non-transition NMSs. Rapid growth in borrowing by households continued in the first half of 2004, with annual growth rates of more than 30% in six countries, suggesting a further increase in debt-to-income indicators in 2004.

Owing to the lag between the granting of a loan and the accumulation of loan losses, the fast expansion of housing loans has had a positive short-term impact on the quality of household loan portfolios. In addition, the growing proportion of collateralised debt has also contributed positively to asset quality.

There are some risks that may materialize over the longer term. First, the ratio of non-performing housing loans is likely to rise after the high rate of lending growth decelerates. Second, in periods of high lending growth, risk management may lag behind the lending expansion, resulting in an underpricing of credit risk or the setting of lower than required non-price credit standards. This may be further exacerbated by increased competition. Problems with risk management and credit standards could be more acute in those NMSs in which banks do not have access to a credit history that is sufficiently long.[16]

Lending margins followed a decreasing trend in most countries from the beginning of 2003 to mid-2004. By mid-2004 lending margins had

16 In some countries this situation is exacerbated by the lack of proper debtor information systems on households, or the lack of an adequate property price database.

already reached a relatively low level of between 1-2% in some countries.[17] With regard to collateral values, available information reveals that robust mortgage lending growth has also been accompanied by a substantial rise in house prices in some countries. Risks, however, are mitigated by the fact that LTV ratios typically do not exceed 70% in most NMSs.

Since mortgage loan contracts in many NMSs typically have floating interest rates, rising interest rates would weigh mostly on households' debt servicing ability.[18] Based on the comparatively low proportion of interest payments to income, the negative impact that interest rate hikes would have on the debt servicing ability of households would be small.[19] However, caution is warranted, since lower-income households may be less resilient in the face of rising interest rates.

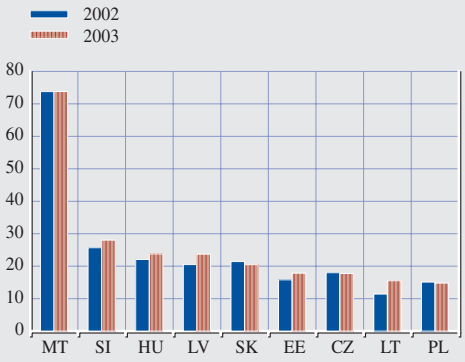
Rapid lending growth has already recently triggered responses from national authorities. The most commonly applied measures include central bank communications on the risks related to high lending growth, recommendations made by supervisors with the aim of increasing banks' risk awareness, and the use of monetary policy instruments.

Lending to non-financial firms by NMS banks varied greatly across countries. Broadly speaking, two groups can be identified according to the pace of lending growth. Corporate lending was buoyant in five countries, with growth rates varying from 18% to 47% in 2003. At the other end of the scale, corporate lending was very sluggish in four countries. Consequently, the aggregate loan-to-GDP ratio only increased marginally (by 0.4 percentage points) for the NMSs as a whole in 2003 (see Chart 28).

It is important to note that foreign bank lending and inter-company loans also play a large role in the financing of non-financial enterprises in most NMSs. In several countries the proportion of foreign debt is close to or even higher than

Chart 28 Domestic corporate loans in the NMSs

(2002-2003; % of GDP)



Sources: BSC and national central banks.

50% of total corporate debt. In the Baltic states, non-financial corporations shifted their borrowing from foreign debt to low interest rate domestic bank loans. Thus, robust growth in lending to non-financial corporations in 2003 can partly be attributed to this substitution effect.

Looking at the proportion of more risky sectors in the total corporate loan portfolio, banks in the NMSs are most exposed to the real estate and related sectors. The aggregate share of the "construction, real estate, renting and business activity" sector varies between 10% and 30% in most countries.[20] Some NMSs reported that lending to real estate-related sectors has picked up by the first half of 2004, which may heighten banks' vulnerability to adverse movements in property prices.

17 Lending margins are calculated as the difference between the interest rate on housing loans and a reference rate in local currency. Reference rates apply to the most typical repricing period.

18 Foreign exchange interest rate risk may be relevant in some countries where the recent expansion of foreign currency-denominated household loans took place at historically low interest rates.

19 The ratio of debt service costs (interest payments) to disposable income varies between 1.3% and 3.8% across the NMSs, compared with the euro area average of 4.6%.

20 Source: BSC.

Corporate sector debt servicing (interest payment) costs varied across the NMSs from 1.3% to 5.0% of GDP in 2003. While debt servicing burdens are expected to increase along with rising interest rates in some countries, corporate sector performance is mostly expected to improve in 2004 in an environment of high or accelerating economic growth.

FOREIGN EXCHANGE RATE RISK IS MORE LIKELY TO IMPACT BANKS INDIRECTLY VIA THE PRIVATE SECTOR

Exchange rate risk, which in principle applies to all countries, may be more important in the case of NMS banks, although the vulnerability of individual countries to foreign exchange risks varies quite significantly. Broadly speaking, NMSs can be classified into two groups based on their exchange rate arrangements.[21]

Sizeable differences emerge in the currency structure of banks' assets and liabilities across the NMSs. The proportion in total assets of foreign currency-denominated assets ranges between 14% and 74%, and that of the foreign currency-denominated liabilities from 17% to 67% (see Chart 29). The share of foreign currency balance sheet items tends to be highest in countries with full or quasi-currency boards. Euro-denominated assets and liabilities, in general, constitute the largest part of foreign currency items, except in two countries.[22]

Currency mismatches between assets and liabilities on banks' balance sheets are in general small. As a percentage of total assets, the on-balance sheet foreign currency position remains below 5% in most countries. The limited size of foreign exchange exposures is also confirmed by the low proportion of capital requirements for foreign exchange rate risk, since this ratio stood in a range of 0-1.3% in most countries in 2003.[23] As a further indication of banks' modest risk exposure, the results of stress tests carried out by the International Monetary Fund or national central

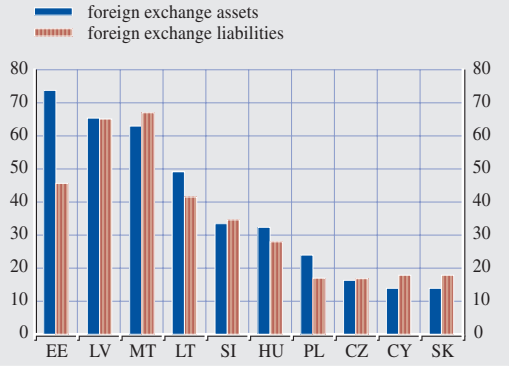
21 The first group contains the Baltic states, which either operate a currency board (Estonia, Lithuania), or a quasi-currency board (Latvia). Malta, with a basket peg, and Slovenia, with a de facto tightly managed exchange rate regime, can also be included in this group. The second group contains countries where swings in exchange rates are possible owing to their more flexible exchange rate systems. This group comprises countries with floating or managed floating regimes (Czech Republic, Poland, Slovakia), or a peg with wide bands (Cyprus, Hungary). This grouping does not suggest that one particular exchange rate regime is per se more prone to currency shocks than any other.

22 Exceptions are either due to the composition of the base currency of the peg, or to a substantial share of non-EU controlled banks, whose main currency exposure is their home currency or the US dollar.

23 As a percentage of total eligible own funds.

Chart 29 Share of foreign currency denominated assets and liabilities in the NMSs

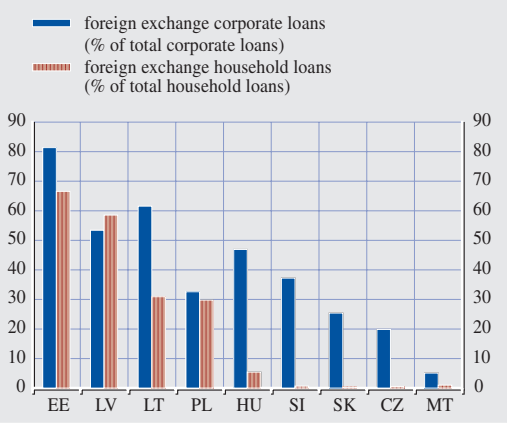
(2003; % of total assets)



Source: BSC.

Chart 30 Share of foreign currency denominated corporate and household loans in the NMSs

(2003)



Source: BSC.

banks confirm banks' resilience to foreign currency shocks. Thus, the available evidence suggests that overall direct exposures to foreign exchange rate risk are generally low in the NMSs.

Nonetheless, banks can face indirect foreign exchange rate risk exposure as a result of the indebtedness of domestic non-financial corporate and household sectors in foreign currencies. The proportion of foreign currency-denominated loans is significant in most NMSs, accounting for at least 20% of total loans in seven countries.[24] Borrowing in foreign currencies is more common among non-financial corporations: in six NMSs, foreign currency-denominated loans to non-financial firms make up at least a third of total bank loans to domestic enterprises (see Chart 30).[25] This raises potential concerns about borrowers operating in non-tradable sectors, which may also have substantial foreign currency-denominated debt and no natural hedge through the currency denomination of their income.[26] In the event of adverse exchange rate movements, these firms could suffer considerable losses, thereby increasing banks' credit risk.[27]

Concerning households' exposure to exchange rate risk, two distinct groups can clearly be identified. In the first group, which includes six NMSs, the proportion of foreign currency household loans is negligible (0-5%), whereas it is rather large in the second group, which includes the remaining four NMSs, varying between 30% and 67%. Thus, in the latter group, large swings in exchange rates may considerably increase households' debt burden. The probability of unexpectedly adverse swings in foreign exchange rates may be considered low in countries which currently operate full or quasi-currency boards, provided that sound economic policies are maintained during the period leading to the adoption of the euro.

INTEREST RATE RISK APPEARS LOW

In many countries, repricing risk is contained by the fact that a substantial share of loans are granted at variable interest rates. Relatively short repricing periods are typical on the liabilities side as well, owing to the dominance of deposits with a maturity of less than one year. Some countries reported that, based on changes in maturity or repricing gaps, interest rate risk increased in 2003.

The proportion of fixed income securities portfolios in total assets is quite significant in several NMSs.[28] In the absence of a well-developed interest rate derivatives market, banks may incur losses on their fixed income portfolios in case of interest rate shocks. In the second half of 2003, bond yields increased markedly in some CEEC-5 countries. Consequently, the losses from government bond portfolios can be significant: one country reported that the negative effect of rising bond yields had reduced pre-tax profits by around 5%.[29] The experience of turbulence in government bond markets in some countries has also revealed the fact that, in the event of unexpected shocks, banks have limited protection against losses owing to thin market liquidity. Banks who experienced losses began to shorten the duration of bond portfolios to limit their potential future losses.

The relative size of the trading book indicates a modest exposure to market risks in the NMSs. On average, the trading book accounted for only 8.3% of total risk-adjusted assets in 2003. Capital charges for traded debt instruments represented 48% of market risk capital requirements, while own fund requirements for

24 Cross-country differences are rather large in this respect as well, with the ratio of foreign currency loans ranging from 4% to 81%.

25 The external debt of the corporate sector is also substantial in many countries. Most companies with foreign debt are large multinationals that generate the bulk of their revenues in foreign currencies. Hence, their foreign exchange risk exposure is assumed to be non-significant.

26 Information on the proportion of companies with sizeable unhedged foreign exchange exposures is unavailable.

27 Certain non-tradable sectors, however, may still partly generate their income in foreign currencies (for instance, rents for commercial real estate companies).

28 The bulk of the fixed income portfolio is comprised of government securities in most NMSs.

29 Sources: National Central Banks' financial stability reports.

foreign exchange rate risk constituted 13% (see Statistical Annex, Table 9).

LIQUIDITY IS ON AVERAGE HIGH

Owing to high lending growth, banks' liquidity positions tightened in some countries, although most NMS banks still have a substantial funding surplus. The aggregate customer funding surplus in the NMSs decreased from 47% to 35%, which still compares favourably with the customer funding gap of 19% of EU-15 banks (see Statistical Annex, Tables 4 and 8). Banks' money market exposure also increased considerably in some countries owing to the higher dependence on foreign interbank liabilities (mainly parent bank funding) in financing lending growth. The ratio of liquid assets declined moderately, but nevertheless remained fairly high in most countries, indicating that banks had ample liquidity buffers. With regard to the liquid asset ratio, the gap between the EU-15 and the NMSs is significant. Based on a broad definition, the liquid asset ratio in the NMSs (36.8%) was 11 percentage points higher in 2003 than the average of EU-15 banks.[30]

Overall, on the basis of high liquid asset ratios, liquidity risk has generally been low in the NMSs. Owing to high lending growth coupled with declining household saving ratios, as well as the substantial increase in loans with long maturities, banks' liquidity management may be challenged in the medium term. Thus, diversification of funding sources may become more important in the future, for instance by enhancing access to capital markets.

LINKS WITH EU-15 BANKS ARE SIGNIFICANT FOR THE NMSs

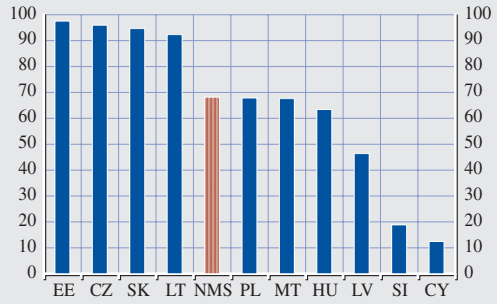
There are strong ownership links between EU-15 and NMS banks (see Chart 31). On average, nearly 70% of total assets of banks in the NMSs are controlled by foreign investors, a substantially higher figure than the 23% level of foreign ownership in EU-15 countries.[31] From the point of view of the NMSs, the level of foreign ownership in the local banking sector is significant. This ownership structure is a distinctive structural feature of the banking sectors in the NMSs.

These links may give rise to a risk transmission channel within the EU. However, a mitigating factor is that the assets of NMS banks only represent a small share of the total EU-15 banking sector assets. From this perspective, it

30 This includes cash, balances with the central bank, interbank loans, Treasury bills and debt securities by public bodies.
31 See "EU banking structures", ECB, November 2004.

Chart 31 Share of banking sector assets controlled by foreign banks in the NMSs

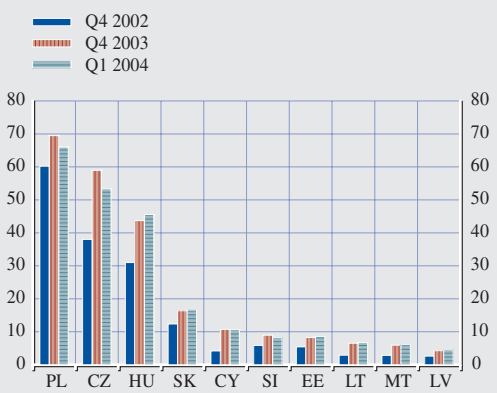
(2003; %)



Source: BSC.

Chart 32 Claims of EU-15 banks on the NMSs

(USD billions)



Source: Bank for International Settlements (BIS).

is more likely that the transmission channel is stronger from the EU-15 to the NMSs than the other way around.

Cross-border lending by EU-15 banks to the NMSs has gained in importance, increasing by 41% between 2002 and 2003 (see Chart 32). Expansion in cross-border loans was exceptionally strong in the Baltic states (74%), indicating the increased dependence on foreign liabilities in financing the high level of domestic lending growth.[32]

The cross-border exposures of EU-15 banks to the NMSs are characterised by a high level of concentration at both the creditor and borrower country levels. At the end of 2003, three countries accounted for nearly two-thirds of cross-border lending from EU-15 countries to the NMSs. On the borrowers' side, banks of the three largest CEEC-5 made up 74% of total claims on the NMSs.

With regard to potentially negative impacts, it is important to note that adverse effects resulting from ownership links could be quite asymmetric for home and host countries. The impact for EU-15 banks is likely to be limited on average. However, at the level of individual EU-15 banks with substantial equity investments in the NMSs, additional risks stemming from expansion into NMSs may be a source of increased earnings volatility. On the other hand, potential problems at EU-15 banks may negatively affect banking sector stability in the NMSs, for instance by preventing them from supporting their subsidiaries in case of need. Although the possibility that financial support will be offered at times of distress has largely been untested so far, strategic investors from EU-15 countries may provide liquidity support or capital injection if needed.

While it has to be recognised that these cross-linkages may increase the transmission of problems between the EU-15 and the NMSs, it is also important to stress the positive implications. NMS banks have contributed strongly to the profitability of EU-15 banks in recent years. In turn, NMS banks have benefited from close links with EU-15 banks through knowledge transfer, including improvements to their risk management systems. Looking ahead, over the medium to long term, this is expected to have a stabilising effect on the banking systems in the NMSs.

32 Parent bank funding played a dominant role in this process.

5 OVERALL ASSESSMENT

EU-15 banks' financial conditions began to improve on aggregate in 2003. In the majority of countries, improvements in banks' income were driven by an increase in non-interest income sources, as the subdued loan demand of the non-financial corporate sector and the low margin environment depressed net interest income. To improve their profitability, banks continued to keep a tight control on costs. They also reduced provisioning. Solvency buffers were further enhanced across the board in EU-15 banking sectors. Following initial signs of a pick-up in the pace of economic growth, preliminary data for the first half of 2004 indicate a further improvement in profitability in EU-15 banks. This was mainly achieved through improvements in income generation, cost-cutting and lower provisioning.

Despite these positive developments, a number of risks inside as well as outside the EU-15 banking sectors need to be monitored. Certain banking sectors still suffer from weakened profitability. However, increased solvency buffers as well as signs of improved profitability from the first half of 2004 indicate that even the weaker sectors have been able to enhance their shock absorption ability and performance.

Fragility may also have been generated by greater potential risk-taking by banks owing to the low-yield environment. Where information is available, there are some signs of increased general market risk-taking. On the basis of VaR readings of major European institutions, there are cases where VaRs have substantially increased, irrespective of low market volatility. In this environment, careful analysis and monitoring of market risk-taking by banks is required to ensure that they adequately stress test their open positions for unexpected events that are not ordinarily tracked by VaR techniques.The potential for an abrupt upturn in long-term interest rates, while not priced into market yield curves, cannot be excluded. While banks seem to have increased their trading and banking book exposures to interest rate risk, these are expected to be manageable assuming reasonable swings in long-term interest rates.

Most of the individual risks identified in this report could ultimately affect banks through an increase in credit risk. This could also be the case if long-term interest rates were to rise, as this would impact negatively on the debt servicing ability of banks' customer bases, including households and SMEs. With regard to specific industries, corporate sector credit risk could materialise through exposures to construction and real estate sectors, which warrant close monitoring owing to signs of weakness in the commercial real estate markets in some countries. While an across-the-board deterioration in credit quality would only become an issue in the unlikely event of substantially slower than expected economic growth and higher interest rates, authorities should continue to closely monitor developments in credit quality. With the adequacy of provisioning remaining uncertain for EU-15 banks, there may be a need to develop better tools in order to provide more accurate assessments.

Finally, the strong links between EU-15 and NMS banks can act as channels of contagion. In this context, it is important to recognise that risks faced by banks in the NMSs differ from those in EU-15 countries. Lending to the private sector, in particular foreign currency lending, needs to be monitored carefully in the NMSs, as this may pose increased credit risk for banks. This notwithstanding, while the possible importance of the transmission of shocks has to be acknowledged, it is also important to note that interlinkages between banking sectors provide clear benefits such as income diversification and knowledge transfer.

Looking forward, trends in market indicators confirm that the financial positions of the bulk of large banks in the EU have improved since late 2002, when concerns about fragility were highest. Moreover, given that the risks identified in this report should also be priced

into these indicators, this suggests that either the likelihood that these risks will crystallise is perceived to be low, or that banks are generally considered to be well-positioned to deal with them.

STATISTICAL ANNEX

Box

CONSOLIDATED DATA ON EU BANKS

The macro-prudential analysis conducted by the Banking Supervision Committee (BSC) is based on the pooling of relevant aggregated information. The key set of data is the consolidated banking data provided by the member organisations of the BSC. These data include detailed information on bank profitability, balance sheets and solvency. They cover nearly 100% of the EU banking sector. The data contain information on EU banks divided into three size groups. In addition, they provide information on foreign controlled institutions active in EU countries. The NMSs started providing data in 2004, for the years 2003 and 2002.

This box summarises some of the key data definitions, and it also describes some of the most important changes in the data collection in 2004 from the one conducted in 2003.[1]

Key definitions for domestic banks

These institutions are banks resident in domestic markets from the reporting country's point of view that are either stand-alone or domestically controlled.

Consolidation: In order to provide fully consolidated view to risks, the EU-15 authorities report cross-border and cross-sector consolidated data on domestically controlled banks. In cross-border consolidation, data on branches and subsidiaries located outside the domestic market (from the reporting country's point of view) are included in the data reported on the parent. In cross-sector consolidation, branches and subsidiaries of banks that can be classified as other financial institutions are included. The definition of other financial institutions excludes insurance companies.

Size groups: Large domestic banks are banks with total assets greater than 0.5% of the total consolidated assets of EU banks; medium-sized banks have total assets between 0.5% and 0.005%; and banks with total assets of less than 0.005% are considered small. The threshold in terms of absolute amounts is defined each year prior to the data collection, using the total assets of the banking sector available from the preceding data collection. In the 2004 collection, thresholds were computed using the total assets from the 2003 data collection of EUR 24,526,304 million (for the EU-15).

Key definitions for foreign banks

These institutions are subsidiaries and branches that are controlled by either an EU or a non-EU parent that is "foreign" from the reporting country's point of view. These data are not included in the EU-15 aggregates. A separate analysis on foreign controlled subsidiaries and branches is conducted owing to their potential relevance for the domestic banking sector. In some EU countries, foreign controlled entities represent a major share of the banking sector assets.

Consolidation: Data on foreign subsidiaries include their branches and subsidiaries.

1 See "EU banking sector stability", ECB, November 2003.

Differences in the data reported in 2003 and 2004 [2]

Differences in the samples: In the data collected in 2003, both domestic and foreign banks were included in the concept "all banks". In addition, size group breakdowns included foreign controlled subsidiaries so that the group "domestic banks" included foreign subsidiaries as well. In the data collected in 2004, "all banks" refers primarily to domestic banks except for one country that does not separate the foreign and domestic institutions owing to national statistical reporting standards. In the data collected in 2004, foreign banks are reported as a separate group without size group breakdowns.

Changes in ownership: In some countries, changes in the ownership and structure of the major banking groups resulted in the data being incomparable between those reported in 2003 and 2004. This has been taken into account by excluding data for these countries in comparisons thats are made over time.

Differences in the definitions of specific data items:

The income item labelled "dividends" in the 2003 data collection was replaced by the item "other income from securities" in the 2004 data collection and in the present report. This item comprises all dividends and other income from variable-yield securities, from participating interests and from shares in affiliated undertakings. In this report it has been reported as part of "other operating income". Some countries were not able to separate interest income from fixed-income instruments and dividends, which may have resulted in slight over-representation of "other operating income".

Comparability of cost-to-income ratios as well as cost compositions between data collected in 2003 and 2004 have also been affected by changes in definitions as some items have been excluded from the cost items but were included among deductions from profits (e.g. first positive or negative consolidation difference) to improve data consistency with national reporting.

As regards asset quality indicators, these should be interpreted with caution owing to large differences between national definitions of both non-performing and doubtful loans and provisions. In addition, between the data collections in 2003 and 2004, there have `een major changes in the definitions for a number of countries which may render figures published in 2003 incomparable with those published in 2004.

2 As the NMSs did not take part in the data collection in 2003, the discussion on the differences between the data collected in 2003 and 2004 applies to the EU-15 only.

Table 1 Structure of the banking sector in EU-15 countries and the NMS

(2003)

	EU-15	NMS
Number of credit institutions		
Stand-alone credit institutions	4,760	..
Banking groups	541	..
Credit institutions	5,301	1,016
Domestic credit institutions	4,258	846
Foreign controlled subsidiaries and branches	1,043	170
Total assets of EU-15 credit institutions in the sample (end of 2003 - EUR billions)		
Domestic credit institutions	22,553	109
of which (%):		
Large	*70*	*0*
Medium-sized	*26*	*76*
Small	*4*	*24*
Foreign controlled subsidiaries and branches	3,457	233
Are figures calculated on a consolidated basis?	YES	NO

Source: BSC.

Table 2 EU-15 banks' profitability and efficiency

(2003)

	All banks[1]	*Change from 2002[2]*	Large[1]	*Change from 2002[2]*	Medium[1]	*Change from 2002[2]*	Small[1]	*Change from 2002[2]*	Foreign[3]	*Change from 2002[2]*
Income (% of total assets)										
Net interest income	1.38	*-0.02*	1.22	*0.00*	1.64	*-0.04*	2.54	*-0.04*	0.99	*-0.21*
Interest receivable	3.96	*-0.63*	3.74	*-0.70*	4.42	*-0.47*	4.76	*-0.43*	4.01	*-1.13*
Interest payable	2.58	*-0.62*	2.52	*-0.70*	2.78	*-0.43*	2.22	*-0.40*	3.03	*-0.92*
Net non-interest income	1.00	*0.02*	1.06	*0.00*	0.80	*0.02*	1.24	*0.22*	0.84	*-0.14*
Fees and commissions (net)	0.64	*-0.02*	0.65	*-0.05*	0.57	*0.02*	0.84	*0.11*	0.58	*-0.18*
Trading and forex results	0.20	*0.04*	0.25	*0.05*	0.06	*0.00*	0.09	*0.06*	0.17	*0.01*
Other operating income (net)	0.17	*0.00*	0.16	*0.00*	0.17	*0.00*	0.31	*0.05*	0.09	*0.03*
Total income	2.38	*0.00*	2.28	*0.00*	2.44	*-0.02*	3.78	*0.18*	1.83	*-0.35*
Expenditure structure (% of total assets)										
Staff costs	0.88	*-0.03*	0.86	*-0.04*	0.84	*-0.02*	1.47	*0.04*	0.64	*-0.20*
Administrative costs	0.45	*-0.03*	0.42	*-0.04*	0.46	*-0.03*	0.87	*0.05*	0.37	*-0.10*
Other	0.11	*-0.01*	0.09	*-0.01*	0.13	*-0.01*	0.28	*-0.04*	0.08	*-0.03*
Total expenses	1.44	*-0.07*	1.37	*-0.09*	1.43	*-0.05*	2.62	*0.05*	1.09	*-0.33*
Profitability (% of total assets)										
Operating profits	0.94	*0.08*	0.91	*0.09*	1.00	*0.03*	1.16	*0.13*	0.74	*-0.02*
Specific provisions	0.36	*-0.02*	0.32	*-0.01*	0.44	*-0.02*	0.47	*-0.11*	0.18	*-0.12*
Funds for general banking risks	0.01	*0.00*	0.00	*0.00*	0.01	*-0.01*	0.02	*-0.01*	0.01	*0.00*
Net profits from subsidiaries less value adjustment from consolidation	0.01	*0.00*	0.00	*0.00*	0.02	*0.01*	0.00	*0.00*	-0.01	*-0.01*
Extraordinary items (net)	0.01	*-0.02*	-0.01	*-0.01*	0.05	*-0.04*	0.08	*-0.05*	0.03	*-0.03*
Tax charges	0.18	*0.03*	0.18	*0.03*	0.20	*0.02*	0.27	*0.08*	0.12	*-0.03*
Profits (before tax and extraord. items)	0.59	*0.10*	0.59	*0.10*	0.56	*0.07*	0.67	*0.25*	0.53	*0.07*
Profits (after tax and extraord. items) (ROA)	0.41	*0.05*	0.40	*0.06*	0.42	*0.01*	0.48	*0.13*	0.44	*0.08*
Return on equity										
Profits (after tax and extraord. items) (% Tier 1) (ROE)	9.87	*1.08*	10.89	*1.49*	8.73	*0.07*	6.20	*1.54*	9.93	*2.95*
Income structure (% of total income)										
Net interest income	58.05	*-0.71*	53.48	*-0.16*	67.29	*-1.13*	67.15	*-4.49*	53.97	*-0.80*
Net non-interest income	41.95	*0.71*	46.52	*0.16*	32.71	*1.13*	32.85	*4.49*	46.03	*0.80*
Fees and commissions (net)	26.77	*-1.02*	28.55	*-2.11*	23.42	*1.01*	22.22	*1.88*	31.86	*-3.33*
Trading and forex results	7.33	*1.42*	9.64	*1.91*	2.34	*0.05*	2.28	*1.45*	8.09	*1.83*
Other operating income (net)	6.94	*0.11*	6.88	*0.05*	6.79	*0.05*	8.22	*1.08*	4.95	*2.25*
Expenditure structure (% of total costs)										
Staff costs	61.43	*0.94*	63.02	*1.09*	58.84	*0.79*	56.16	*0.46*	58.63	*-0.44*
Administrative costs	31.10	*-0.68*	30.42	*-0.89*	32.19	*-0.74*	33.33	*1.30*	33.60	*0.48*
Other	7.47	*-0.26*	6.56	*-0.20*	8.97	*-0.05*	10.51	*-1.76*	7.42	*-0.46*
Efficiency										
Cost-to-income (% of total income) (incl. spec. taxes, value adj.)	60.39	*-3.18*	60.15	*-3.88*	58.89	*-1.63*	69.31	*-2.13*	59.53	*-5.12*

Source: BSC.

1) Information mostly on domestically-owned banking groups on a cross-border consolidated basis. However, for one country, "all banks" includes foreign EU and non-EU branches and subsidiaries owing to national statistical reporting standards. This causes some double counting in the consolidated data.

2) Percentage points. Based on data for 13 countries.

3) Information on foreign (EU and non-EU) controlled subsidiaries and branches for 14 countries.

Table 3 EU-15 banks' non-performing loans and provisioning

(2003)

	All banks[1]	*Change from 2002*[2]	Large[1]	*Change from 2002*[2]	Medium[1]	*Change from 2002*[2]	Small[1]	*Change from 2002*[2]	Foreign[3]	*Change from 2002*[2]
Asset quality (% of loans and advances)										
Non-performing and doubtful loans (gross)[4]	3.10	*-0.06*	2.66	*-0.05*	3.64	*-0.07*	6.48	*0.06*	1.85	*-0.90*
Asset quality (% of own funds)[5]										
Non-performing and doubtful loans (gross)[4]	51.08	*-1.98*	46.60	*-1.85*	55.66	*-2.38*	61.63	*-0.90*	29.60	*-4.62*
Non-performing and doubtful loans (net)[4]	16.67	*-1.85*	12.08	*-0.99*	22.74	*-3.69*	28.33	*-1.28*	10.72	*-2.53*
Provisioning (stock) (% of loans and advances)										
Total provisions	2.06	*0.03*	1.97	*-0.01*	2.07	*0.13*	3.49	*0.12*	1.11	*-0.46*
Provisioning (stock) (% of non-performing and doubtful assets)[4]										
Total provisions	67.38	*2.25*	74.09	*1.05*	59.14	*4.57*	54.04	*1.35*	63.79	*1.59*

Source: BSC.
1) Information mostly on domestically-owned banking groups on a cross-border consolidated basis. However, for one EU country, "all banks" includes foreign EU and non-EU branches and subsidiaries owing to national statistical reporting standards. This causes some double counting in the consolidated data.
2) Percentage points. Based on data for 13 countries.
3) Information on foreign (EU and non-EU) controlled subsidiaries and branches for 14 EU countries.
4) Definitions of non-performing and doubtful loans differ between countries. Consequently these data should be interpreted with caution. Since definitions as well as the sample of banks have changed from the ones used in the report entitled "EU Banking Sector Stability" (November 2003), the indicators differ and are not comparable between the two reports.
5) Tier 1 is used for own funds.

Table 4 EU-15 banks' balance sheet and selected off-balance sheet items

(2003)	All banks[1]	*Change from 2002[2]*	Large[1]	*Change from 2002[2]*	Medium[1]	*Change from 2002[2]*	Small[1]	*Change from 2002[2]*	Foreign[4]	*Change from 2002[2]*
Assets (% of total assets)										
Cash and balances	1.24	*0.05*	1.10	*-0.01*	1.48	*0.24*	1.96	*-0.04*	0.70	*-0.16*
Treasury bills	0.98	*-0.02*	0.84	*0.01*	1.10	*-0.10*	2.60	*0.06*	0.58	*-0.05*
Loans to credit institutions	15.77	*-0.18*	16.17	*-0.08*	15.16	*-0.38*	12.95	*-0.69*	26.48	*2.10*
Debt securities (public bodies)	7.82	*0.78*	9.41	*1.02*	4.46	*0.19*	1.99	*0.13*	7.61	*-1.56*
Debt securities (other borrowers)	10.54	*0.05*	10.60	*-0.07*	10.25	*0.40*	11.43	*-0.10*	7.17	*0.56*
Loans to customers	50.57	*-0.44*	47.42	*-0.56*	57.92	*-0.24*	57.38	*0.36*	43.70	*1.30*
Shares and participating interest	3.27	*-0.04*	2.99	*-0.11*	3.79	*0.09*	4.73	*0.31*	3.27	*-0.53*
Tangible assets and intangibles	1.64	*-0.02*	1.71	*-0.03*	1.39	*0.05*	1.99	*-0.15*	1.00	*-0.31*
Other assets	8.01	*-0.16*	9.75	*-0.15*	4.23	*-0.23*	2.44	*0.03*	7.14	*-0.97*
Liquidity										
Liquid asset ratio 1 (cash and T-bills)	2.22	*0.03*	1.95	*0.00*	2.58	*0.13*	4.56	*0.02*	1.28	*-0.21*
Liquid asset ratio 2 (ratio 1 + loans to cred. inst.)	17.99	*-0.15*	18.11	*-0.08*	17.75	*-0.25*	17.51	*-0.68*	27.77	*1.89*
Liquid asset ratio 3 (ratio 2 + debt sec. by public bodies)	25.81	*0.64*	27.53	*0.94*	22.21	*-0.05*	19.50	*-0.55*	35.38	*0.32*
Liabilities (% of total assets)										
Amounts owed to credit institutions	20.37	*0.14*	21.55	*0.15*	18.19	*0.13*	14.17	*-0.36*	39.04	*7.88*
Amounts owed to customers	41.92	*-0.22*	38.77	*-0.04*	46.80	*-0.54*	64.85	*-0.02*	29.05	*-1.19*
Debt certificates	20.73	*0.07*	21.24	*-0.07*	21.70	*0.31*	5.50	*-0.11*	12.42	*-3.12*
Accruals and other liabilities	8.83	*0.02*	10.53	*0.00*	5.02	*0.02*	4.12	*0.11*	9.59	*-1.73*
Fund for general banking risks	0.14	*0.00*	0.14	*0.00*	0.14	*0.00*	0.16	*0.02*	0.14	*-0.01*
Provisions for liabilities and charges	1.16	*-0.03*	1.14	*-0.06*	1.26	*0.06*	1.00	*0.07*	0.64	*-0.19*
Subordinated liabilities	1.83	*-0.03*	1.96	*-0.06*	1.64	*0.03*	0.73	*0.01*	1.44	*-0.35*
Equity capital	4.20	*-0.01*	3.88	*-0.02*	4.53	*0.02*	7.68	*0.10*	4.88	*-1.00*
Other liabilities	0.46	*0.02*	0.54	*0.03*	0.33	*-0.03*	0.07	*0.01*	0.14	*-0.04*
Profit or loss for the financial year	0.35	*0.05*	0.26	*0.07*	0.39	*-0.01*	1.70	*0.17*	0.39	*0.06*
Selected off-balance sheet items (% of total assets)										
Credit lines	14.20	*0.67*	16.85	*1.11*	8.51	*-0.58*	5.36	*0.55*	13.65	*-2.36*
Guarantees and other commitments	6.54	*0.69*	6.64	*0.78*	6.46	*0.58*	5.29	*-0.22*	5.16	*-0.48*

Source: BSC.
1) Information mostly on domestically-owned banking groups on a cross-border consolidated basis. However, for one EU country, "all banks" includes foreign EU and non-EU branches and subsidiaries owing to national statistical reporting standards. This causes some double counting in the consolidated data.
2) Percentage points. Based on data for 13 countries.
3) Information on foreign (EU and non-EU) controlled subsidiaries and branches for 14 EU countries.

Table 5 EU-15 banks' regulatory capital ratios and risk-adjusted items

(2003)

	All banks[1]	*Change from 2002* [2]
Overall solvency ratio	12.35	*0.41*
Tier 1 ratio	8.79	*0.28*
Distribution of overall solvency ratio (risk-weighted assets as % of total risk-weighted assets)		
Overall solvency ratio < 7%	0.02	*0.00*
Overall solvency ratio 7%-8%	0.01	*-0.26*
Overall solvency ratio 8%-9%	2.94	*-0.46*
Overall solvency ratio 9%-10%	7.49	*-10.61*
Overall solvency ratio 10%-11%	24.03	*-1.21*
Overall solvency ratio 11%-13%	43.77	*10.18*
Overall solvency ratio > 13%	21.74	*2.37*
Overall solvency ratio below 9%		
Number of banks	98	*-74*
Asset share (% of total banking sector assets)	0.70	*-1.26*
Risk-adjusted items (% of total risk-adjusted assets)		
Risk-weighted assets	82.28	*-0.16*
Risk-weighted off-balance-sheet items	11.12	*0.03*
Risk-adjusted trading book	6.60	*0.13*
Composition of trading book own funds recuirement (% of total trading book own funds requirement under CAD)		
Own funds requirement for traded debt instruments	40.63	*0.43*
Own funds requirement for equities	21.58	*1.47*
Own funds requirement for foreign exchange risk	6.29	*-1.38*
Own funds requirement for other trading book items	31.51	*-0.52*

Source: BSC.
1) Overall solvency ratio and Tier 1 ratios are weighted averages of domestic consolidated banking groups. However, for one country, this sample of banks includes foreign EU and non-EU branches and subsidiaries owing to national statistical reporting standards. This causes some double counting in the ratios. Other averages are weighted averages of data for all banks including foreign (EU and non-EU) subsidiaries and branches for all countries.
2) Percentage points. Based on data for 13 countries.

Table 6 NMS banks' profitability and efficiency

(2003)

	All banks[1]	*Change from 2002[2]*	All domestic banks[1]	*Change from 2002[2]*	Medium[1]	*Change from 2002[2]*	Small[1]	*Change from 2002[2]*	Foreign[3]	*Change from 2002[2]*
Income (% of total assets)										
Net interest income	2.71	*-0.22*	3.04	*-0.18*	2.92	*-0.05*	3.42	*-0.49*	2.55	*-0.23*
Interest receivable	5.50	*-1.17*	5.94	*-1.06*	5.85	*-0.88*	6.22	*-1.52*	5.30	*-1.22*
Interest payable	2.80	*-0.96*	2.90	*-0.88*	2.93	*-0.83*	2.79	*-1.04*	2.75	*-0.99*
Net non-interest income	1.66	*-0.27*	1.67	*-0.21*	1.58	*0.13*	1.96	*-1.12*	1.66	*-0.30*
Fees and commissions (net)	1.14	*0.04*	1.29	*0.09*	1.23	*0.13*	1.48	*0.01*	1.07	*0.02*
Trading and forex results	0.48	*-0.25*	0.30	*-0.12*	0.25	*-0.18*	0.45	*0.05*	0.57	*-0.31*
Other operating income (net)	0.04	*0.03*	0.08	*0.09*	0.10	*0.18*	0.03	*-0.15*	0.02	*0.00*
Total income	4.37	*-0.49*	4.71	*-0.39*	4.50	*0.07*	5.38	*-1.61*	4.21	*-0.53*
Expenditure structure (% of total assets)										
Staff costs	1.33	*-0.07*	1.64	*-0.09*	1.47	*-0.08*	2.17	*-0.06*	1.19	*-0.06*
Administrative costs	1.10	*-0.10*	1.02	*-0.06*	0.93	*-0.06*	1.29	*-0.04*	1.14	*-0.11*
Other	0.40	*-0.02*	0.38	*-0.02*	0.36	*-0.01*	0.42	*-0.04*	0.41	*-0.02*
Total expenses	2.84	*-0.19*	3.04	*-0.17*	2.77	*-0.14*	3.90	*-0.12*	2.74	*-0.19*
Profitability (% of total assets)										
Operating profits	1.54	*-0.22*	1.68	*0.04*	1.74	*0.22*	1.48	*-0.47*	1.47	*-0.34*
Specific provisions	0.36	*-0.31*	0.49	*-0.34*	0.47	*-0.26*	0.56	*-0.55*	0.29	*-0.29*
Funds for general banking risks	0.00	*-0.03*	0.05	*-0.02*	0.05	*0.00*	0.04	*-0.07*	-0.02	*-0.04*
Net profits from subsidiaries less value adjustment from consolidation	-0.01	*-0.01*	-0.01	*0.00*	-0.01	*0.00*	0.00	*0.00*	-0.01	*-0.01*
Extraordinary items (net)	0.00	*-0.02*	0.00	*0.00*	0.00	*0.01*	0.01	*-0.05*	0.01	*-0.02*
Tax charges	0.27	*0.00*	0.23	*-0.04*	0.22	*-0.02*	0.24	*-0.09*	0.29	*0.03*
Profits (before tax and extraord. items)	1.14	*0.10*	1.06	*0.32*	1.12	*0.35*	0.86	*0.20*	1.19	*-0.01*
Profits (after tax and extraord. items) (ROA)	0.85	*0.07*	0.81	*0.36*	0.87	*0.40*	0.61	*0.22*	0.87	*-0.07*
Return on equity										
Profits (after tax and extraord. items) (% Tier 1) (ROE)	11.56	*0.69*	11.87	*4.94*	13.08	*5.44*	8.34	*3.07*	11.43	*-1.10*
Income structure (% of total income)										
Net interest income	61.95	*1.77*	64.50	*1.42*	64.83	*-2.27*	63.62	*7.65*	60.61	*1.94*
Net non-interest income	38.05	*-1.77*	35.50	*-1.42*	35.17	*2.27*	36.38	*-7.65*	39.39	*-1.94*
Fees and commissions (net)	26.07	*3.47*	27.40	*3.83*	27.37	*2.37*	27.49	*6.44*	25.37	*3.28*
Trading and forex results	10.45	*-3.98*	6.06	*-1.77*	5.32	*-3.80*	8.10	*2.59*	12.69	*-5.21*
Other operating income (net)	0.89	*0.64*	1.78	*1.94*	2.22	*3.96*	0.58	*-2.04*	0.43	*-0.04*
Expenditure structure (% of total costs)										
Staff costs	47.02	*0.59*	53.89	*-0.06*	53.17	*-0.04*	55.52	*0.08*	43.48	*0.99*
Administrative costs	38.74	*-0.82*	33.52	*-0.24*	33.74	*-0.33*	33.05	*-0.11*	41.43	*-1.16*
Other	14.16	*0.16*	12.39	*0.10*	13.10	*0.38*	10.76	*-0.64*	15.07	*0.18*
Efficiency										
Cost-to-income (% of total income) (incl. spec. taxes, value adj.)	64.87	*2.73*	64.44	*1.73*	61.46	*-4.25*	72.45	*15.02*	65.09	*3.25*

Source: BSC.
1) Information for all banks in the jurisdiction on a solo basis.
2) Percentage points.
3) Information on foreign (EU and non-EU) controlled subsidiaries and branches.

Table 7 NMS banks' non-performing loans and provisioning

(2003)

	All banks[1]	*Change from 2002*[2]	All domestic banks[1]	*Change from 2002*[2]	Medium[1]	*Change from 2002*[2]	Small[1]	*Change from 2002*[2]	Foreign[3]	*Change from 2002*[2]
Asset quality (% of loans and advances)										
Non-performing and doubtful loans (gross)[4]	10.68	*-0.85*	12.64	*0.16*	13.52	*0.95*	10.06	*-2.18*	9.84	*-1.27*
Asset quality (% of own funds)[5]										
Non-performing and doubtful loans (gross)[4]	94.37	*-8.97*	113.41	*-3.52*	121.52	*2.48*	89.83	*-22.19*	86.41	*-11.22*
Non-performing and doubtful loans (net)[4]	54.52	*-2.03*	61.49	*-2.21*	66.15	*2.36*	47.93	*-15.53*	51.60	*-1.95*
Provisioning (stock) (% of loans and advances)										
Total provisions	4.51	*-0.71*	5.79	*0.11*	6.16	*0.33*	4.69	*-0.61*	3.96	*-1.05*
Provisioning (stock) (% of non-performing and doubtful assets)[4]										
Total provisions	42.23	*-3.05*	45.78	*0.25*	45.56	*-0.85*	46.65	*3.30*	40.28	*-4.87*

Source: BSC.
1) Information for all banks in the jurisdiction on a solo basis.
2) Percentage points.
3) Information for foreign (EU and non-EU) controlled subsidiaries and branches.
4) Definitions of non-performing and doubtful loans differ between countries. Consequently these data should be interpreted with caution.
5) Tier 1 is used for own funds.

Table 8 NMS banks' balance sheet and selected off-balance sheet items

(2003)

	All banks[1]	Change from 2002[2]	All domestic banks[1]	Change from 2002[2]	Medium[1]	Change from 2002[2]	Small[1]	Change from 2002[2]	Foreign[3]	Change from 2002[2]
Assets (% of total assets)										
Cash and balances	3.63	*-0.71*	4.60	*-1.46*	4.75	*-1.75*	4.12	*-0.71*	3.18	*-0.33*
Treasury bills	11.28	*0.16*	12.10	*1.10*	12.71	*0.74*	10.14	*1.84*	10.90	*-0.29*
Loans to credit institutions	16.60	*-2.10*	14.17	*-2.44*	11.80	*-2.34*	21.80	*-1.70*	17.73	*-1.98*
Debt securities (public bodies)	5.29	*-0.62*	8.51	*-1.56*	8.73	*-1.88*	7.80	*-0.76*	3.79	*-0.12*
Debt securities (other borrowers)	5.73	*1.56*	5.72	*1.38*	6.52	*1.65*	3.17	*0.28*	5.74	*1.64*
Loans to customers	48.72	*2.79*	47.24	*2.34*	48.23	*3.26*	44.04	*-0.63*	49.41	*2.98*
Shares and participating interest	1.92	*-0.24*	2.79	*0.37*	3.16	*0.53*	1.59	*-0.24*	1.52	*-0.52*
Tangible assets and intangibles	2.37	*-0.21*	2.51	*-0.10*	2.33	*-0.04*	3.09	*-0.19*	2.30	*-0.27*
Other assets	3.60	*-0.76*	1.77	*-0.22*	1.79	*-0.18*	1.72	*-0.35*	4.45	*-1.05*
Liquidity										
Liquid asset ratio 1 (cash and T-bills)	14.91	*-0.55*	16.69	*-0.36*	17.45	*-1.01*	14.27	*1.13*	14.08	*-0.62*
Liquid asset ratio 2 (ratio 1 + loans to cred. inst.)	31.51	*-2.66*	30.87	*-2.79*	29.25	*-3.34*	36.06	*-0.57*	31.81	*-2.60*
Liquid asset ratio 3 (ratio 2 + debt sec. by public bodies)	36.80	*-3.28*	39.37	*-4.36*	37.98	*-5.23*	43.86	*-1.34*	35.60	*-2.72*
Liabilities (% of total assets)										
Amounts owed to credit institutions	13.74	*1.54*	9.81	*1.14*	9.79	*1.09*	9.88	*1.28*	15.57	*1.67*
Amounts owed to customers	65.67	*-1.93*	69.95	*-4.48*	69.54	*-6.07*	71.25	*0.12*	63.68	*-0.64*
Debt certificates	4.14	*0.82*	5.01	*2.48*	5.47	*4.12*	3.53	*-2.29*	3.73	*0.03*
Accruals and other liabilities	5.53	*-0.31*	3.88	*-0.19*	4.07	*-0.15*	3.26	*-0.41*	6.30	*-0.39*
Fund for general banking risks	0.44	*-0.16*	0.34	*-0.02*	0.35	*0.02*	0.29	*-0.14*	0.48	*-0.23*
Provisions for liabilities and charges	0.66	*-0.23*	0.84	*-0.23*	0.94	*-0.16*	0.53	*-0.45*	0.57	*-0.22*
Subordinated liabilities	1.05	*-0.01*	1.78	*0.53*	2.18	*0.59*	0.51	*0.18*	0.71	*-0.26*
Equity capital	7.83	*0.06*	7.23	*0.01*	6.87	*0.18*	8.38	*-0.31*	8.11	*0.07*
Other liabilities	0.02	*0.00*	0.05	*0.00*	0.06	*0.00*	0.01	*0.00*	0.00	*0.00*
Profit or loss for the financial year	0.75	*0.04*	0.66	*0.33*	0.72	*0.38*	0.48	*0.16*	0.79	*-0.09*
Selected off-balance sheet items (% of total assets)										
Credit lines	18.75	*0.61*	9.96	*-1.39*	9.85	*-2.49*	10.29	*1.74*	22.85	*1.44*
Guarantees and other commitments	13.84	*0.94*	10.51	*0.39*	12.44	*1.97*	4.28	*-4.85*	15.39	*1.15*

Source: BSC.
1) Information for all banks in the jurisdiction on a solo basis.
2) Percentage points.
3) Information on foreign (EU and non-EU) controlled subsidiaries and branches.

Table 9 NMS banks' regulatory capital ratios and risk-adjusted items

(2003)

	All banks[1]	*Change from 2002[2]*
Overall solvency ratio	13.58	*-0.52*
Tier 1 ratio	13.38	*0.16*
Distribution of overall solvency ratio (risk-weighted assets as % of total risk-weighted assets)		
Overall solvency ratio < 7%	0.73	*-3.22*
Overall solvency ratio 7%-8%	0.00	*-0.04*
Overall solvency ratio 8%-9%	7.99	*6.39*
Overall solvency ratio 9%-10%	5.41	*-1.16*
Overall solvency ratio 10%-11%	21.74	*5.14*
Overall solvency ratio 11%-13%	18.83	*-1.07*
Overall solvency ratio > 13%	45.30	*-6.03*
Overall solvency ratio below 9%		
Number of banks	38	*-17*
Asset share (% of total banking sector assets)	3.02	*0.16*
Risk-adjusted items (% of total risk-adjusted assets)		
Risk-weighted assets	83.74	*1.13*
Risk-weighted off-balance-sheet items	7.93	*-0.45*
Risk-adjusted trading book	8.33	*-0.68*
Composition of trading book own funds recuirement (% of total trading book own funds requirement under CAD)		
Own funds requirement for traded debt instruments	48.36	*11.39*
Own funds requirement for equities	4.17	*0.36*
Own funds requirement for foreign exchange risk	12.69	*0.67*
Own funds requirement for other trading book items	34.78	*-7.82*

Source: BSC.
1) Information for all domestically-owned banks on a solo basis.
2) Percentage points.

Table 10 Indicators of 50 major EU banks' asset quality, profitability and solvency

(%; weighted average *(range of variation between highest and lowest 10%)*)

	2001			2002			2003			mid-2004		
Annual growth in total assets	**10.11**	*-0.18*	*21.08*	**-2.01**	*-74.33*	*285.41*[1)]	**9.43**	*-6.83*	*21.08*	**8.18**	*-0.18*	*21.08*
Annual growth in lending	**8.29**	*-1.06*	*22.68*	**21.56**	*-75.46*	*92.22*	**12.68**	*-7.13*	*18.88*	**5.37**	*-24.85*	*11.95*
Asset quality												
Loan loss provision/total operating income	**9.60**	*3.60*	*18.60*	**13.18**	*3.80*	*29.69*	**11.13**	*4.08*	*18.77*	**6.87**	*2.52*	*13.30*
Loan loss provisions/total loans	**0.50**	*0.19*	*0.91*	**0.69**	*0.18*	*1.30*	**0.61**	*0.14*	*0.97*	**0.43**	*0.05*	*0.44*
Loan loss provisions/total assets	**0.24**	*0.08*	*0.48*	**0.31**	*0.08*	*0.64*	**0.28**	*0.09*	*0.60*	**0.22**	*0.08*	*0.50*
Non-performing loans/total loans	**2.45**	*0.97*	*6.96*	**2.84**	*1.07*	*7.66*	**2.30**	*0.73*	*7.97*	**n.a.**	*n.a.*	*n.a.*
Profitability												
Net interest income/total assets	**1.30**	*0.71*	*2.59*	**1.36**	*0.59*	*2.70*	**1.33**	*0.60*	*2.50*	**1.48**	*0.76*	*3.48*
Net non-interest income/ total assets	**1.27**	*0.47*	*1.79*	**1.24**	*0.41*	*1.80*	**1.22**	*0.34*	*1.70*	**1.27**	*0.41*	*2.25*
Non-interest income/total operating income	**50.74**	*29.45*	*65.19*	**48.85**	*26.67*	*65.25*	**47.52**	*26.14*	*62.03*	**43.11**	*22.78*	*63.80*
Cost-to-income ratio	**68.27**	*55.39*	*79.90*	**67.90**	*54.02*	*82.09*	**64.47**	*53.89*	*74.19*	**59.90**	*52.05*	*71.66*
Return on equity (after tax and extraordinary items)	**10.34**	*2.51*	*19.48*	**7.99**	*-4.29*	*18.09*	**8.70**	*-10.39*	*20.07*	**13.09**	*5.21*	*20.19*
Return on assets (after tax and extraordinary items)	**0.48**	*0.07*	*0.99*	**0.39**	*-0.15*	*0.92*	**0.44**	*-0.40*	*1.00*	**0.58**	*0.13*	*1.22*
Solvency												
Tier 1 ratio	**6.29**	*5.58*	*9.00*	**6.65**	*5.88*	*9.28*	**6.67**	*6.24*	*10.06*	**7.14**	*6.62*	*9.49*
Total capital ratio	**9.46**	*8.90*	*12.10*	**9.60**	*9.30*	*12.42*	**9.91**	*9.80*	*13.35*	**9.59**	*9.80*	*13.40*

Source: ECB calculations based on Bankscope consolidated data for 50 large EU banks.
Note: Not all indicators could be calculated for every bank. Data for the first half of 2004 are based on approximately 40 banks and are annualised.
1) The large values are due in part to mergers during the period.

Table 11 Total and interest rate (IRR) VaRs in the EU-15

(% of Tier 1, under the assumption of a 99% confidence interval and ten-day horizon)

	Total VaR			IRR VaR		
	end-2002	end-2003	mid-2004	end-2002	end-2003	mid-2004
Mean	0.47	0.50	0.73	0.33	0.37	0.61
Min	0.08	0.09	0.32	0.09	0.08	0.20
Max	0.70	0.86	1.39	0.61	0.67	1.33

Source: BSC.

Table 12 EU-15 banks' exposures at risk to seven aggregate sectors

(2003)

	BaC	EnU	Cap	CCy	TMT	CNC	Fin
Exposure of eight EU-15 countries (in EUR billions)	716,678.1	153,155.3	273,768.3	1,561,414.4	163,035.2	668,580.8	3,159,671.9
Sectoral EDF (as at May 2003)	1.04	0.26	1.85	1.465	4.95	0.89	0.19
Sectoral EDF (as at June 2004)	0.83	0.18	1.375	0.81	2.875	0.65	0.18
Exposure at risk (in EUR billions)	594,842.9	27,567.9	376,431.5	1,264,745.6	468,726.1	434,577.5	568,740.9
% change in exposure at risk, 2003-2002	-20.5	-34.6	-28.6	-50.1	-11.5	-27.6	39.6

Sources: BSC, Moody's KMV and ECB calculations.
Note: The data are provided by Belgium, Germany, Spain, France, Italy, Austria, Finland and the United Kingdom. The sectors are basic and construction (BaC), consumer cyclicals (CCy) and non-cyclicals (CNC), capital goods (Cap), energy and utilities (EnU), financial (Fin), technology and telecommunications (TMT). The expected default frequency is computed by multiplying the exposure to a sector by the EDF of this sector.