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EU BANKING SECTOR STABILITY

NOVEMBER 2006

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EXECUTIVE SUMMARY

THE FINANCIAL CONDITION OF EU BANKS

The financial condition of EU banks continued to improve in 2005 and for the first half of 2006, adding to the trend in place since 2003. The introduction of the new international financial reporting standards (IFRS) by a large number of EU countries may have had a minor impact on some of the indicators used to assess the stability of the EU banking sector. In particular, the new accounting regime may have contributed to significant growth in banking assets which may affect the rates of growth of some indicators that are computed as a share of total banking assets. These issues notwithstanding, profitability figures improved across the board for all banking groups, especially for the set of large banks, irrespective of the accounting standards followed. On the interest income side, strong lending growth, both to households and to the non-financial corporate sector, compensated for the further erosion in lending margins, due to competitive pressures. Turning to non-interest income, fees and commissions and trading revenues benefited from the favourable economic environment and the mostly buoyant financial market developments.

The solid performance of EU banks in 2005 and the first half of 2006 was also driven by continued cost-containment and by a further decrease in impairment charges (in the IFRS context), or provisioning (in the local GAAP context), which reached new historic lows. Indicators of asset quality and the coverage ratio deteriorated for the set of IFRS reporting banks, showing that non-performing assets have increased. The solvency position of EU banks experienced a slight drop in 2005, largely due to the expansion of lending activities, which lead to an increase in the risk-weighted asset base. A slight drop in solvency levels of large EU banks was also observed in the first half of 2006, mostly on account of major acquisitions made in the previous year. However, solvency levels of EU banks remained strong and comfortably exceeded regulatory requirements.

BANKS' OUTLOOK AND RISKS

In view of the earnings performance of the banking sector over the past three to four years, and given that profitability is expected to improve further in the near-term, the vulnerability of the sector to adverse disturbances has diminished considerably. Nevertheless, there are still risks to this favourable outlook. In particular, the importance of risks that were identified in the Banking Stability Report of 2005 may have changed, and new risks may have emerged. This is mainly because there have been significant changes in the macro-financial environment over the past year including a broadening and deepening of the recovery in macroeconomic growth and an increase in interest rates at all points along the maturity spectrum.

With regard to the potential of risks external to the EU banking sector to crystallise, the signs that global macroeconomic growth could be gradually becoming more evenly distributed across the main economic areas may have reduced the probability in the near term of an abrupt correction of global current account imbalances. Nevertheless, the fact that such a scenario could, if it were to crystallise, pose a significant challenge for the global and the EU financial systems implies that the risks from global imbalances remain substantial. At the same time, the increase in interest rates and the gradual removal of excess liquidity in all major economic areas may have increased the probability of an abrupt unwinding of speculative trading positions that were funded at very low short-term interest rates. The likelihood could be greatest in those asset market segments where fashionable trades have become crowded and concentrated, possibly leading to an underestimation and mis-pricing of risks. EU banks could be exposed to adverse market dynamics arising from such an unwinding both directly through their proprietary trading activity and indirectly via their counterparty exposures to unregulated financial institutions, such as hedge funds and private equity funds.

EU banks' exposures to credit risks have grown further as banks' lending has continued to expand while loan-loss provisions (or loan impairment charges) have declined and credit standards have not been tightened. New lending to households has continued at a brisk pace, both for house purchases and for consumer credit, with banks indicating that competitive pressures were the main factor behind the easing of their credit standards on both new mortgages and consumer credit. That said, the quality of EU banks' household sector loan portfolios remains relatively high: default rates are exceptionally low, average loan-to-value ratios are generally comfortable enough to withstand significant declines in house prices and the share of mortgage loans being contracted at variable rate terms has been increasing, although the implications of the latter on banks' medium term credit risks are not unambiguous. At the same time, the average level of EU household sector indebtedness still remains rather low by international standards – some countries outside the EU have much higher degree of household sector indebtedness and have not yet encountered balance sheet strains despite rising interest rates.

Looking ahead, some pockets of vulnerability could yet be exposed in the household sector that could leave banks facing loan losses. Given rising variable rate mortgage servicing costs, risks of household sector financial distress could already be rising among the lowest-income households and within some geographical regions where indebtedness is much higher than average and where significant increases in house prices have taken place. In addition, in some non-euro area EU countries, a significant proportion of total bank loans to households (and to the private sector in general) is denominated in foreign currencies, rendering banks and borrowers exposed to exchange rate moves and the credibility of exchange rate pegs. All in all, while banks' credit risks from lending to households seem to have increased, the triggering factor for a more widespread deterioration in household sector credit quality would need to be a rather substantial

macroeconomic shock the likelihood of which is small at the current juncture. Nevertheless, the strength of competition in mortgage markets and the potential for the adoption of the rules of the new Basel II Capital Accord in the short-run to release additional regulatory capital, thereby possibly supporting further mortgage lending activity, suggests that banks need to carefully monitor the risks they are taking in mortgage markets.

As regards the risks associated with banks' lending to the non-financial corporate sector, the ongoing strengthening of firms' demand for loans has allowed banks to diversify their income bases. This should prove positive from a banking stability perspective to the extent that it produces better diversified loan portfolios. However, the credit risks associated with lending to non-financial firms may be growing for several reasons. Key among these is the fact that corporate sector leverage is high and that it has been rising at a time when interest rates across the maturity spectrum have also been rising. Although EU non-financial firms have generally seen considerable improvements in their profitability, which should provide them with ample buffers to withstand shocks to their loan repayment capacity, there are some signs of a slowing down in profit growth. While this could, in itself, be sufficient to lead to an adverse turn in the credit cycle, it could be exacerbated by a possible renewed surge in oil prices after the decline that took place in the third quarter of 2006. At the same time, new lending activity has been concentrated at shorter maturities. Insofar as this pick-up in short-term lending reflects increasing activity in the financing of the leveraged part of merger and acquisition (M&A) business, where competition among banks has been particularly intense, concerns can be expressed about the pricing of loans if the credit cycle should show more clear-cut signs of turning, including an upturn in corporate sector default rates from exceptionally low levels. In such a scenario, banks could find themselves substantially exposed to short-term loans granted for acquisition activity involving low-credit-quality

firms that would be most sensitive to adverse changes in the credit environment. It is therefore important that banks assess their risks adequately and subject their loan pricing to sufficiently rigorous stress-testing.

Regarding sources of risk internal to the banking sector, trading activities – a relatively volatile source of income – have been accounting for a growing share of EU banks' profits. It cannot be excluded that the appetite for risk-taking by banks was encouraged by persistently low volatility across various financial asset classes. This may have allowed banks to increase their trading exposures without necessarily breaching their risk limits. Moreover, the increasing blurring of the borderlines between banks' banking books and their trading books, facilitated by financial innovation and developments in risk management techniques, may have made it difficult for regulators and market participants to gauge the overall risks in banks' balance sheets. These problems may have been further aggravated by the aforementioned difficulties in comparing various banks' financial statements that are prepared on the basis of different accounting standards.

A near-term issue related to the regulatory environment is the adoption in the EU of the Basel II Capital Accord in January 2007. Once fully implemented, the new accord will substantially enhance the risk management environment where banks operate. A smooth transition to the new environment will be ensured by close cooperation between banks, central banks and regulators.

OVERALL ASSESSMENT

The accounting and prudential information available, complemented by information derived from financial market indicators suggests that the near-term outlook for EU banks is one of continuing solid performance. This overall positive assessment should, however, be seen as a baseline scenario that could be affected by positive and negative factors. In particular, the

outlook for risks that confront EU banks could be changing on account of the changes in the global and the EU macro-financial environment, namely the more evenly spread growth patterns and the upward movement of interest rates across all maturities of the yield curve. On the positive side the strong profits recorded by EU banks in 2005 and in the first half of 2006, as well as the improvement of their risk management techniques in recent years, are likely to have enhanced EU banks' resilience to shocks. On the negative side, the gradually maturing profit and interest rate cycles could contribute to a turn in the credit cycle, with the possibility of deteriorating credit conditions denting banks' performance in the foreseeable future. In particular for the set of large EU banks, increasing activity in leveraged buy-out transactions and in prime brokerage services provided for hedge funds could pose future risks if stiff competition on market shares force them to compromise in due diligence processes.

I INTRODUCTION

This report is based on the main findings of the annual macro-prudential analysis of EU banking sector stability conducted by the Banking Supervision Committee (BSC) of the European System of Central Banks (ESCB). The BSC is composed of representatives of the banking supervisory authorities and central banks of EU countries and the ECB. This is the fifth such report to be published since February 2003.

The report reviews the recent performance of EU banks, identifies the main potential sources of risk for EU banks' stability and assesses banks' ability to withstand adverse disturbances, including the unravelling of imbalances. The risks identified are not necessarily the most probable outcomes; rather they are seen as potential and plausible sources of downside risks for banks – with regard to the likeliest outcome.

The analysis in the report draws upon a number of sources. The primary source of quantitative information is a large set of indicators constructed by national supervisors, national central banks and the ECB. These are based on the consolidated banking data (CBD), which are regularly collected by the BSC. These data cover nearly the entire EU banking sector and are among the timeliest of comparable data collected by national authorities (see the Box 2 in the Statistical Annex). Publicly available data issued by large EU banking organisations according to the CBD definition (see Box 1) have been used to complement this analysis with partial information for the first half of 2006.

Although the report covers all 25 EU Member States, the different pace at which the International Financial Reporting Standards (IFRS) are being adopted by European banks for supervisory purposes in each country, as well as the fact that the new and old accounting standards are not directly comparable, required a split of the EU-25 banking data into IFRS-compliant and non-IFRS-compliant country

samples. IFRS reporting for regulatory and supervisory purposes has not yet been implemented in some EU countries where local GAAP or other accounting standards still apply. The vast majority of EU countries however, are in a transitory phase in which IFRS reporting has been implemented for supervisory purposes, although unquoted or small banks may still be allowed to report in accordance with the old standards. For this set of countries in which two (or more) accounting standards coexist for regulatory purposes, typically a large majority (if not all) of the banks are already IFRS-compliant, while unlisted and/or small banks have not yet adopted IFRS. For the production of the banking data supporting this report, only one reporting standard is assigned to each country, even if both IFRS and non-IFRS accounting were permitted for supervisory purposes in 2005.¹ Given that two large EU countries have not yet required IFRS implementation in their banking sectors, domestic banking assets of the non-IFRS sample still represent more than half of the EU banking assets in 2005.

The report is structured as follows. Section 2 discusses the major developments affecting the financial condition of EU banks in 2005 and the first half of 2006. Section 3 introduces and discusses the major sources of risk faced by EU banks, covering credit and market risks as well as counterparty risks and risks originating from EU banks' exposures to emerging market economies. Section 4 presents a forward-looking analysis based on various types of quantitative market indicators. Section 5 is devoted to a more detailed analysis of the risks confronting the banking sectors in some EU, and the two accession countries, as a result of the growth in foreign currency lending. It is based on an ad-hoc data collection exercise. The report concludes with an overall assessment of the stability of the EU banking sector.

¹ There was a slight drop in the banking sector coverage of the CBD data for 2005 in comparison with previous years because countries in which IFRS has been widely adopted but in which other accounting standards still coexist, did not report the proportion of non-IFRS-compliant banks.

2 EU BANKS' PERFORMANCE IN 2005 AND IN THE FIRST HALF OF 2006

Viewed in terms of the accounting regime, both 2005 and 2006 should be seen as transitional years in the EU banking sector since the full implementation of the new IFRS accounting standards is not expected to have taken place before the end of 2007, possibly in conjunction with the implementation of the Basel II Capital Accord. As described in the introduction, while the majority of EU countries have already adopted the new accounting regime for supervisory purposes, (even if in some countries small banks were still allowed to report their accounts under old standards in 2005), domestic banks' assets of IFRS-compliant countries represent only 46% of total EU banking assets.² This is largely due to the fact that two large EU countries – Germany and the United Kingdom – have delayed their adoption of IFRS for supervisory purposes, possibly until 2007, although UK large domestic banks already publish IFRS accounts.

The consolidated banking data for 2005 and the changes with respect to the previous year should be interpreted with a high degree of caution. Given that comparisons of indicators derived from IFRS-compliant accounts with non-IFRS compliant accounts have little value – due to significant differences in accounting definitions and practices – the discussion and analysis of performance indicators of EU banks in this part of the report divides the sample of banks into two groups. Notably, even within the set of IFRS reporting countries, the degree of comparability may not be as high as desired, given the different levels of implementation of some accounting standards. In particular, different interpretations of the standards at the national level require a further note of caution regarding cross-country comparability.

Countries compliant with the new accounting standards have reported data for both 2004 and 2005, so that comparisons and the computation of growth rates over this period are consistent. Nevertheless, it cannot be excluded that some

repeated accounts for 2004 may not be fully compliant with IFRS. In addition, the 2005 transitional numbers may not be sufficient to allow a robust assessment of earnings quality – the capacity to generate future earnings – in the banking sector.

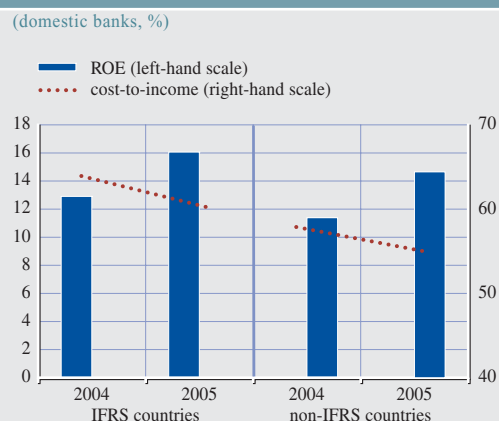
PROFITABILITY IMPROVED FURTHER

Strong and durable banking profitability is considered important for financial stability as profits are important first-line financial buffers that can insulate banks and banking systems from adverse financial disturbances. Irrespective of the accounting standards adopted, the profitability of EU banks improved further in 2005 (see Chart 1) and there were no signs of this abating in the first half of 2006 (see Box 1). The average return on equity (ROE) rose from 13% to 16% for the set of IFRS countries, and from 11% to almost 15% for the set of non-IFRS countries.

The aggregate improvement was, to a great extent, driven by the performance of large banks, although the ROE increased across all size groups. Wholesale banking, investment

2 IFRS reporting countries are: Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Greece, Ireland, Italy, Lithuania, Latvia, Malta, the Netherlands, Poland, Portugal, Slovakia and Spain.

Chart 1 Profitability and cost-to-income ratios of EU banks



Source: BSC.

banking and, in some countries, overseas banking, were the main drivers of profitability growth for large banks, contributing more than income derived from domestic markets and from retail activity. Declining impairment charges coupled with positive other non-recurring income items were also important contributors to the ROE increase in 2005. As Tier 1 capital increased at a much slower pace than risk-weighted assets, this may also have had a positive impact on ROE figures (computed as a percentage of Tier 1).

Box 1

THE FINANCIAL CONDITIONS OF LARGE EU BANKS IN THE FIRST HALF OF 2006

This box provides an overview of developments in the financial conditions of large EU banks during the first half of 2006.¹ Overall, during the first half of the year, the majority of large EU banks – reporting under IFRS – continued to benefit from broadly-based profitability growth despite persistent pressure on retail margins. The main drivers underpinning the further strengthening of profitability included increased lending growth in domestic and non-domestic retail markets, growth in fees and commissions, higher trading income, and continued operating cost control. At the same time, costs associated with credit risk increased slightly, largely reflecting a significant rise in impairment costs on unsecured lending in the United Kingdom. Overall, however, for large banks in the EU, these costs remained historically low due to better credit risk management by institutions and to a relatively benign macroeconomic environment. Capital ratios weakened slightly, mainly due to acquisitions, but they remained sufficiently high to cope with unexpected adverse events.

The financial positions of large EU banks continued improving in the first half of 2006, building on the positive performance of the previous three years. This was mainly facilitated by a favourable operating environment with economic growth picking-up in most EU Member States and business benefiting from conditions in fast growing markets in Latin America, Eastern Europe and Asia. The weighted average return on equity (ROE) among the sample of banks analysed increased from 18% in 2005 to just under 21% in the first half of 2006. Furthermore, the improvement in performance was broad-based with the weakest institutions (those in the left tail of the distribution of ROE) showing significant improvement compared with 2004 (see Chart A and Table 20).

It was notable that the strengthening of profitability occurred in an environment in which net interest income remained compressed. Despite the strength of lending growth, net interest income as a percentage of total assets fell slightly to 1.06%, on average, in the first half of 2006 compared with 1.07% for 2005 as a whole, and the importance of net interest income in overall operating income declined slightly. This was largely due to intense competition in certain retail segments which continued to put downward pressure on margins. Some institutions compensated for this by expanding activities in higher-margin lending in non-domestic markets. This was one of the reasons why the frequency distribution of net interest income across these large EU banks had a bi-modal shape (see Chart B). Many institutions reported increased non-interest income in the first half of 2006. This was mainly due to an increase in fee and commission income from about 25% of total income, on average, in 2005 to 26% in the first six months of

¹ The sample of banks used to conduct this assessment is comprised of banks with assets above €127 billion in 2005, which reported under IFRS, have their headquarters in an EU Member State, and have suitable published data for 2006 available before the cut-off date for this report. In total 34 banks were included in the sample and all have been included in the 2006 figures. The sample also includes one large euro area institution reporting under US GAAP.

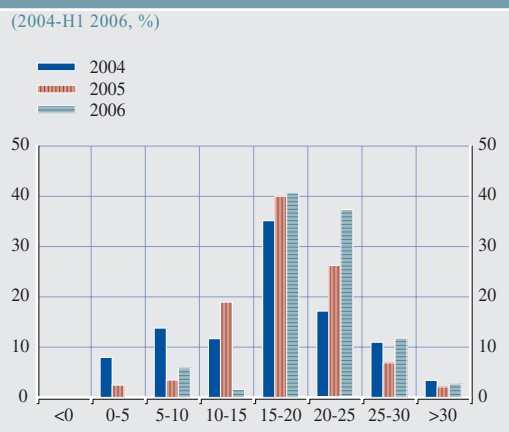
2006 (see Table 20). Trading income increased to about 14% of total income, on average, in 2006, compared with about 13% of total income for the full year of 2005.

For most institutions, loan impairment charges remained low in the first half of 2006. This was primarily due to a favourable macroeconomic environment and to more active management of credit portfolios. The median level of impaired loans as a percentage of total assets was 0.09% in 2006, a level slightly lower than that of 0.10% in 2005. However, some institutions endured material increases in impairments in the first six months of 2006 so that the weighted average increased from 0.14% in 2005 to 0.15%. This was due to an overall increase in the stock of lending, increased impairments on unsecured lending and lending in non-domestic markets. Some individual institutions indicated that provisions may increase over the next year as the benign credit conditions which have prevailed in all markets over the past few years are regarded as having been exceptional and are not expected – by the institutions themselves – to continue indefinitely.

Tight cost control continued to be an important factor underlying profitability improvement in the first half of 2006 (see Chart C). The cost-to-income ratio declined further – because operating income continued to grow faster than operating costs – from about 60%, on average, in 2005 to just under 56% in the first six months of 2006. The main contributions to the reduction of per unit operating expenses came from the centralisation of services and from improvements in IT infrastructures.

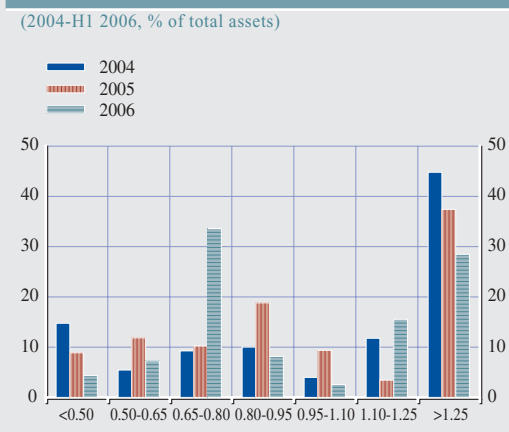
As regards solvency, the average Tier 1 ratio decreased slightly from 8.1% in 2005 to just under 8% in the first six months of 2006. This slight reduction was mainly explained by declines in the Tier 1 ratios of institutions that had made major acquisitions in 2005. This had been signalled by the institutions themselves when the mergers and acquisitions were announced. More encouragingly, institutions with the weakest performance – on this measure of solvency – managed to increase their Tier 1 ratios (see Chart D) which should contribute positively to the stability of the European financial system because overall, Tier 1 ratios remain adequate to cope with unexpected losses.

Chart A Frequency distribution of return on equity for large EU banks



Sources: Bureau van Dijk (Bankscope), published financial accounts of individual institutions and ECB calculations. Data for the first half of 2006 are annualised.

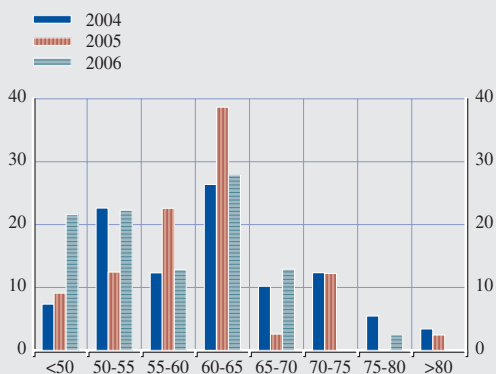
Chart B Frequency distribution of net interest income for large EU banks



Sources: Bureau van Dijk (Bankscope), published financial accounts of individual institutions and ECB calculations. Data for the first half of 2006 are annualised.

Chart C Frequency distribution of cost-to-income ratios for large EU banks

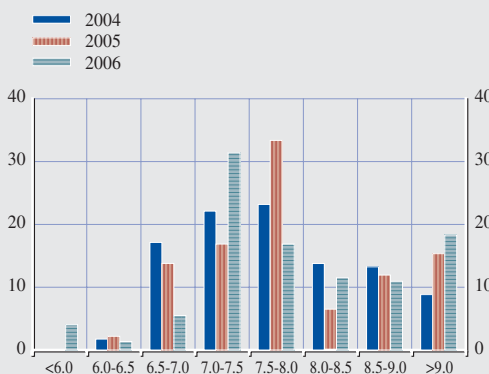
(2004-H1 2006, %)



Sources: Bureau van Dijk (Bankscope), published financial accounts of individual institutions and ECB calculations. Data for the first half of 2006 are annualised.

Chart D Frequency distribution of Tier 1 capital ratios for large EU banks

(2004-H1 2006, %)



Sources: Bureau van Dijk (Bankscope), published financial accounts of individual institutions and ECB calculations. Data for the first half of 2006 are annualised.

The ROE (based on Tier 1 capital), increased across all EU-25 bank size groups and foreign banks in 2005. For some countries, this improvement was due not only to increased profitability but also to declines in own funds. Regardless of the accounting regime adopted, the ROE was positively associated with bank size in 2005. The group of large and foreign banks – which also tend to be large – generally performed better than small and medium-sized domestic institutions (see Chart 2 for the IFRS sample). The fact that ROE averages across the various size groups were persistently higher for the IFRS sample, may point to the possibility of one-off effects deriving from the implementation of the new accounting rules.

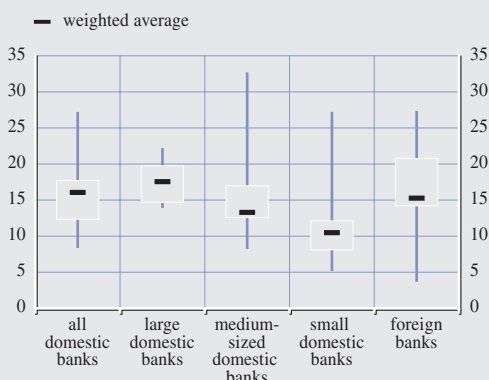
The distribution of ROEs across EU banking sectors shifted further to the right in 2005, continuing a pattern that has been evident over the last few years (see Chart 3). Notably, around 65% of the EU banking sector (in terms of assets) enjoyed ROE levels in excess of 15% in 2005, up from 43% (IFRS countries) and 60% (non-IFRS countries) of the banking sector in 2004. For non-IFRS banks, the degree of profitability dispersion declined in 2005 compared with 2004: ROE levels became more concentrated within the 15% to 20% interval

(comprising more than 40% of banks' assets) and declined or remained about the same in all other ROE intervals.

For the set of IFRS-compliant EU banks, the shift to the right of the distribution was more even across the two highest ROE intervals, with the proportion of banking assets reporting an ROE in excess of 20% more than doubling from the 2004 level (see Chart 3). In addition, 30% of IFRS-compliant banks earned an ROE of

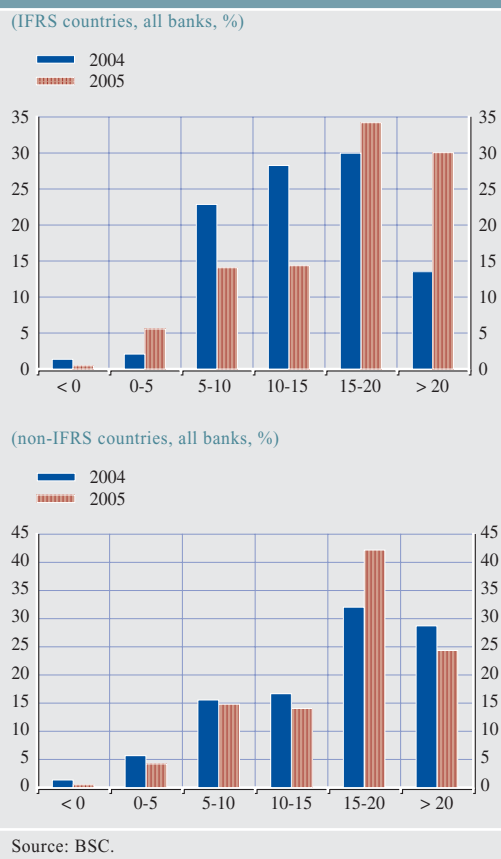
Chart 2 IFRS banks' ROE: average, maximum, minimum and interquartile range at the country level

(2005, after tax and extraordinary items, %)



Source: BSC.

Chart 3 Frequency distribution of ROE for EU banks



more than 20% in 2005. This may, however, to some extent derive from windfall effects resulting from the adoption of the new accounting rules.

A notable development in 2005 was that EU banks' total assets grew very rapidly. On account of this, total income as a ratio of total assets dropped in the domestic banking sectors of most countries. In fact, despite the positive developments in profitability, expressed as a ratio of capital, both interest income and net non-interest income expressed as a percentage of banks' assets decreased slightly, on average, compared with 2004 (see Tables 3 and 4 in the Statistical Annex).

The value of assets computed under IFRS increased significantly in 2005. This was mostly

due to the fair valuation of financial assets – including debt instruments, equity instruments, investments in affiliated undertakings (or other) and to a lesser extent off-balance sheet items (e.g. derivatives) that are now part of the balance-sheet – under IAS 39, possibly coupled with the consolidation of more subsidiaries and special purpose entities.³ Total assets of the non-IFRS set of countries also increased substantially in 2005. For some large banks, the total assets of subsidiaries (consolidated) increased materially, possibly on account of asset revaluations, while others recorded an increase in the value of debt securities, shares and participating interests that were not derived from banks' ordinary business results.

The source of EU banks' income growth (in absolute terms) in 2005 tended to be broad-based with both net interest income and net non-interest income expanding. The strength of net interest income was due to continued credit expansion, mostly to the household sector but also to the corporate sector, even though interest expenditure tended to increase more than interest receivable. The growth of non-interest income was fostered by favourable conditions in capital markets although, given the pace of asset growth, it dropped slightly as a percentage of total assets (in IFRS countries), or remained unchanged (in non-IFRS countries), in relation to 2004 (see Tables 3 and 4 in the Statistical Annex). Further contributing to the strengthening of profitability in 2005 was a decline in total expenses, both staff and administrative costs, and a further reduction of impairment charges (provisions). Overall, the increase of more than 3% in average ROE (computed as a share of Tier 1 capital) between 2004 and 2005, regardless of the accounting regime adopted by banks, was mainly a result of a material rise in profits. Tier 1 capital fell in a few countries (due to acquisitions, large dividend payouts or share buyback programmes) but increased slightly in most countries.

³ At the country level, it should be borne in mind that a cross-border merger that took place between two large euro area banks in 2005 may explain part of the asset value increase in the banking system of one large country in the IFRS set.

Turning now to developments in the composition of total income, the split between net interest and net-non interest income was almost even in 2005 for the IFRS sample. Net non-interest income represented the largest proportion of total income for the set of large banks. This was due, to a large extent, to a redefinition of net non-interest income under IFRS to also include gains (or losses) on financial transactions according to IAS 39. For the non-IFRS reporting countries, the relevance of net interest income in terms of assets decreased further across all size groups in 2005, but still represented just above 60% of banks' total income. As more countries move to the IFRS accounting regime, an increase in the weight of non-interest income in total income could be expected. While not necessarily of a non-recurring nature, non-interest income can be more volatile than interest income. More importantly, as many assets and liabilities are measured at fair value under IFRS, with gains or losses on re-measurement being recorded in the income statement (or in equity), non-interest income volatility is expected to increase.

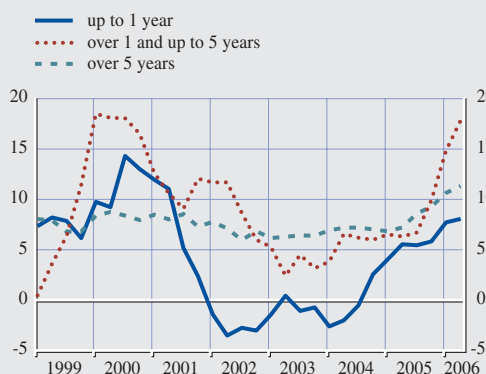
OPERATING INCOME FELL MARGINALLY

Against a background of slightly rising interest rates, the operating income⁴ of EU banks, expressed as a ratio of total assets, fell in 2005. Low credit risk and, more importantly, intense competition in the retail segment, appear to have been important factors in compressing interest margins in 2005 and in the first half of 2006. Total income expressed as a ratio of total assets decreased across all size groups regardless of the accounting standards adopted by banks (see Tables 3 and 4 in the Statistical Annex). The drop must however, be qualified since it was largely driven by faster growth in assets than in income, especially for the set of IFRS countries.

Although interest rate margins remained under pressure and declined further in 2005, there was compensation from very high rates of lending growth. Net interest income, expressed as a share of assets, nevertheless declined, on

Chart 4 Annual growth of loans to non-financial corporations in the euro area for selected maturities

(Q1 1999-Q2 2006, % per annum)



Source: ECB.

Note: Data are based on MFI loan transactions.

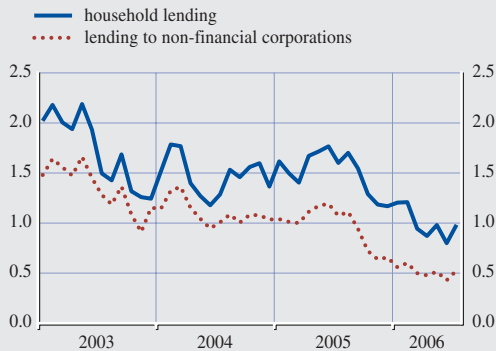
average, for EU banks across all size groups (see Tables 3 and 4 in the Statistical Annex), even though country-level data showed positive developments for a small set of countries (see Tables 13 and 14). While lending to households remained the main engine for lending growth, lending to the corporate sector continued to recover strongly in 2005 (see Chart 4). The overall pick-up in lending to corporates in 2005 was driven by accelerating economic growth in most countries with takeover activity explaining part of the growth at shorter maturities.

Despite the high lending growth rates reported across EU countries, loans to customers as a percentage of total assets from banks' balance-sheets decreased on average (see Tables 5 and 6 in the Statistical Annex), again due to the faster pace at which assets increased between 2004 and 2005 for both the IFRS and non-IFRS samples. However, developments varied significantly across EU countries, with the ratio

4 Operating income is generally defined as the sum total of net interest and net non-interest income that results from core banking business activities. It should be different from total income in that the latter includes extraordinary income. For the purpose of the consolidated banking data exercise, however, there is no distinction between the two concepts. Furthermore, under the new accounting standards (IAS 1) items of income and expenditure should no longer be presented as "extraordinary items" so that the concepts of total income and operating income should also coincide.

Chart 5 Lending margins of euro area MFIs

(Jan. 2003-July 2006, percentage points)



Source: ECB.

Note: The weighted lending margins are the difference between the interest rate on new lending and the interest rate swap rate, where both have corresponding initial rate fixations/maturities.

Chart 6 Deposit margins of euro area MFIs

(Jan. 2003-July 2006, percentage points)



Source: ECB.

Note: The weighted deposit margins are the difference between the interest rate swap rate and the deposit rate, where both have corresponding initial rate fixations/maturities.

tending to increase in the Baltic and Central and Eastern European countries, in particular. Average results were mostly driven by the drop in loans as a share of total assets of large and foreign banks. This reflects the different business models adopted by large banks, as opposed to medium and small-sized banks (for which lending activities tend to be more important), where the ratios increased overall for the non-IFRS sample and in various IFRS countries. Irrespective of accounting standards used, loans accounted for less than half of large and foreign banks' assets.

Intense competition among banks, especially in EU domestic mortgage markets, contributed to a further narrowing of lending margins in 2005 (see Chart 5).⁵ To some extent, even though the direct contribution to income may be low, mortgage loans have become an important product for attracting new customers in some countries. The thinning of margins in the second half of 2005 could reflect expectations of an imminent rise in ECB key interest rates (which occurred only in early December 2005) that were not passed through to lending rates.

Notwithstanding the thinning of lending margins, according to non-consolidated data

for euro area MFIs, deposit margins improved significantly from mid-2005 onwards (see Chart 6). This time, banks have benefited from the rise in market interest rates since mid-2005, on account of an expected increase in ECB key interest rates, that was not passed through to deposit rates. This increased the benefits for banks raising funds through deposits rather than at inter-bank market rates. EU-wide averages, however, showed a further fall in the ratio of customer deposits to assets, for both IFRS and non-IFRS domestic banks.⁶

Notwithstanding the improvement in the deposit margin, the funding gap⁷ increased, on average, by almost 5% of loans for EU banks, regardless of the accounting standards adopted, thereby putting further pressure on banks' net interest income (see also Chart 2.14 in the section on

5 This statement does not, however, apply to cross-border competition in retail banking markets since these markets tend to remain fragmented along national lines (see European Commission (2006), "Sector inquiry on retail banking", Interim Report, July).

6 For some EU countries, however, bank balance-sheets showed a slight increase in customer deposits as a ratio of assets in 2005. This was mainly seen within the group of small and medium-sized banks.

7 The funding gap is defined as the proportion of loans that is not covered by deposits and has to be funded in the market (see below the section on liquidity for more details).

liquidity below). This is because the larger is the gap between loans and deposits, the more banks will be forced to rely on more expensive market funding. Since September 2005, and throughout the first half of 2006, money market interest rates at all maturities increased in the context of strengthening market expectations of a further rise in key ECB interest rates increasing the overall cost of funding.

The growth of net non-interest income in 2005 was driven by favourable asset management performance, increased securities transactions and, for some banks, the sale of insurance products via the banking network (increasing fees and commissions). Favourable conditions in the financial markets also contributed to improvements in the trading and foreign exchange income of EU banks in both accounting standards groups. The ratio of net non-interest income to total assets nevertheless decreased in 2005, on account of the aforementioned strength of asset growth.

It seems that the environment of persistently low interest rates together with historically low volatility – especially for institutions which managed their risks with value-at-risk (VaR) – encouraged banks to increasingly turn to trading activity in an attempt to boost their income. Trading and foreign exchange income strengthened considerably – exceeding the growth of total assets – for EU banks across all size groups in 2005, irrespective of accounting standards followed (see Tables 3 and 4 in the Statistical Annex). While net fee and commission income represent the bulk of total net non-interest income, this income source suffered a marginal decline as a share of assets with respect to 2004, due to the strong pace of asset growth.

SLIGHT IMPROVEMENT IN COST-TO-INCOME RATIOS

After the publication of the EU Banking Sector Stability Report in October 2005, cost-to-income ratios among EU banks improved slightly for the sample of domestic banks

adopting non-IFRS and IFRS regimes, standing at around 55% and 60% respectively (see Chart 1). The corresponding ratios for 2004 were 58% and 64%. The improvement in cost efficiency was due mainly to a moderate decline in expenditure and impairment charges (provisions), regardless of the accounting standards adopted, although the changes were more pronounced in the IFRS-compliant sample.

Because it strongly depends on a banks' business model, it is important to note that the cost-to-income ratios can vary substantially across banks in different size groups. Small banks tend to have significantly higher cost-to-income ratios than larger banks. This is because small banks tend to focus their activities on relatively high-cost retail business, while larger banks may combine retail with wholesale activities, and have capital market activities. This certainly applies to some countries in the non-IFRS-reporting group where cost-to-income ratio of small banks exceeded 70% (see Table 4 in the Statistical Annex).

The transition to IFRS is likely to have had a certain one-off impact on some banks' costs. Under the new standards, goodwill can no longer be amortised, but is subject to impairment testing, which could explain a decline in costs. At the same time, personnel expenses may have increased due to equity-related compensation of employees which should, under the IFRS, be booked as staff costs.

For most EU banks, cost-cutting strategies were no longer the driving force behind the decline in cost-income ratios in 2005. In some countries, personnel expenses increased on account of organic growth and salary increases. Merger and acquisition activity in 2005, especially if it involved foreign markets, may also have contributed to the rise in the costs of some banks, although these costs are expected to be of a non-recurring nature. In general, however, total expenditure increased at a slower pace than total assets, producing a decline in the expenditure-to-assets ratio.

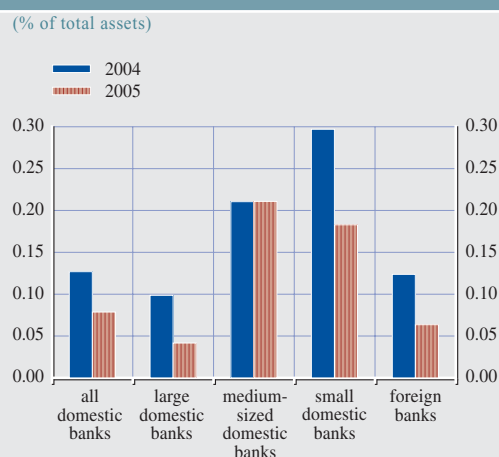
IMPAIRMENT CHARGES DECLINED FURTHER

Impairment charges (for IFRS banks), or provisions (for non-IFRS banks), as a share of total assets, declined further in 2005. The stock of provisions as a share of loans and advances has also decreased on average in 2005, as compared with the previous year, suggesting that a new historical low has been reached. There is the perception, however, that the very low provisioning environment could soon come to an end. Information from country reports indicates that in almost a third of EU countries, including some large countries, there were signs of increase in the level of impairment charges in the first half of 2006. Mid-2006 results for the set of large EU banks appear to confirm this view, indicating that the average level of impaired loans as a share of total assets has increased slightly (see Box 1). The increase was nevertheless from a very low base and mostly due to an overall increase in the stock of lending. In some countries, increased impairments on unsecured lending and lending in foreign markets have also contributed to this development.

In 2005, there were heterogeneous patterns in impairment charge declines, both across countries and, more distinctly, across bank size groups. While the new accounting rules may have had an impact on the levels of impairment charges, they did not appear to affect the magnitude and direction of change between 2004 and 2005.

The transition to IFRS introduced changes to loan-loss provisioning practices and accounting by imposing more stringent parameters or conditions under which a loan can be considered to be impaired. In the absence of specific impairment indicators (e.g. failure to pay interest or principal in a timely fashion, restructuring of a loan, financial difficulties of the borrower, etc.), IFRS does not permit banks to record a reserve for credit losses. For this reason, impairment losses under IFRS should, in general, be lower than under the earlier accounting standards. Because the IFRS

Chart 7 Impairment charges on financial assets of EU banks in IFRS countries

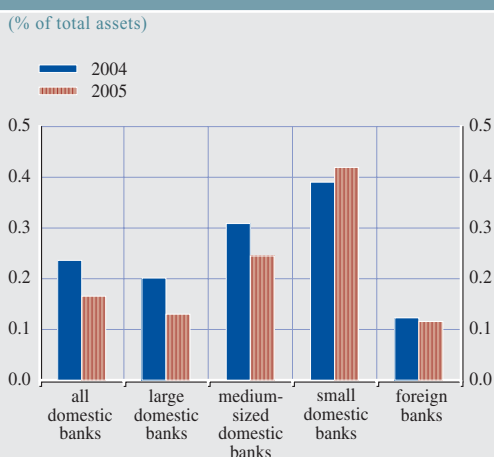


Source: BSC.

consolidated banking data for both 2004 and 2005 should already exclude the impact of this one-off effect, the further drop in impairment charges as a ratio of total assets in IFRS countries between 2004 and 2005 is thought to reflect the improvement in institutions' risk management systems. The drop in impairment charges (for all but the set of medium-sized banks), however, suggests that restated 2004 data may not be fully compliant with the new standards for most IFRS reporting banks (see Chart 7).

The sample of non-IFRS banks also exhibited a further decrease in the flow of provisions for loan losses with respect to 2004. Improvements in risk management systems and the risk profiles of loan portfolios were the main explanations put forward by banks for the decline in provisioning in 2005. There were considerable differences in the provisioning patterns of non-IFRS reporting banks across size groupings. Small banks raised their flow of provisions somewhat as the credit quality of some of their retail loans deteriorated (see Chart 8). In general, information from country reports suggests that the incipient rise in provision flows or impairment charges (also registered in the first half of 2006) was mainly driven by financial distress among households

Chart 8 Provisions of EU banks in non-IFRS countries



Source: BSC.

and that impairments on corporate lending remained low.

Asset quality indicators (such as non-performing and doubtful assets as a share of loans or own funds) and other indicators such as the coverage ratio (total provisions as a ratio of non-performing and doubtful assets) are available for banks under both accounting regimes. This is because these data are still required by regulators for supervisory purposes.

There was a deterioration in the asset quality of IFRS reporting banks in 2005: non-performing assets and impairments increased as a share of loans and of own funds (see Table 7 in the Statistical Annex). As impairment charges were not raised to the same extent as the loan quality deteriorated, there was also a significant fall in the coverage ratio. This was most likely due to the more restrictive concept of impairment charges under IFRS.

Regarding banks reporting under non-IFRS schemes, despite the slight drop in the flow of provisions (as a share of assets), the coverage ratio improved substantially (see Table 8 in the Statistical Annex), especially for large banks in non-euro area countries. The rise in the stock of provisioning, however, was not as fast as the

pace of loan growth. Turning to the asset-quality indicators, figures are also comfortable for non-IFRS banks. Non-performing and doubtful assets, expressed as a share of loans and of own funds, decreased for all banks except for medium-sized domestic banks, standing at comfortable levels.

SOLVENCY POSITIONS DROPPED SLIGHTLY

In 2005, the solvency levels of EU banks remained high, on average, comfortably exceeding the minimum requirement of 8%. Nevertheless, EU domestic banks experienced a slight drop in their solvency positions. This was largely due to the aforementioned expansion of lending activities, which was reinforced by the pick-up in lending to non-financial corporations that expanded the risk-weighted asset base. By the end of 2005, the overall solvency ratio for banks in non-IFRS countries dropped marginally to 12.2% from 12.4% in 2004, while that of banks in IFRS countries remained stable at 11.4% (see Chart 9).

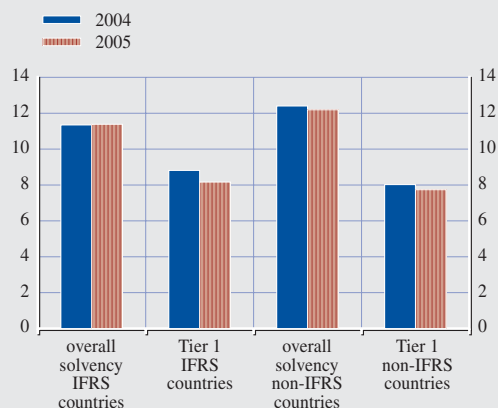
The average solvency ratio of banks in IFRS countries benefited slightly from the adoption of the new accounting standards, partly offsetting the deterioration that resulted from an expanded risk-weighted asset base. Although it is difficult to be precise about the extent to which, and on how, IFRS impacted on total own funds, it is thought that changes in the capital base mainly resulted from lower impairment losses (general provisions), the revaluation of financial assets held for trading, goodwill revaluation, and changes in profits.⁸

The Tier 1 solvency ratio decreased, on average, for banking systems in both groups of countries, standing at close to 8% by the end of 2005. The

⁸ The Committee of European Banking Supervisors (CEBS) has issued guidelines on “prudential filters” for regulatory capital in the context of the new IFRS. The objective of these adjustments is to minimise variations in the regulatory capital which are likely to be introduced with the adoption of IFRS and to preserve the fundamental features of regulatory capital. Prudential filters are to be implemented by the competent national authorities on a best-efforts basis, with due consideration of particular national circumstances.

Chart 9 Overall solvency and Tier 1 ratios for EU banks

(domestic banks, % of risk-adjusted assets)



Source: BSC.

drop in this solvency ratio was due to major acquisitions undertaken by some banks in 2005, which restrained the growth of Tier 1 capital vis-à-vis risk weighted assets. A contraction in minority interests may have also restrained the growth in Tier 1 capital of banks in IFRS countries.

Frequency distributions of overall solvency ratios shifted to the left for banks reporting in both IFRS and non-IFRS countries in 2005 (see Chart 10). For banks in IFRS countries, the shift was rather sharp: the proportion of risk-adjusted assets having a solvency ratio of less than 11% rose from 36% in 2004 to 52% in 2005. At the same time, the degree of dispersion of this solvency ratio widened. For non-IFRS countries, the shift was less severe, and the degree of dispersion changed little: the mode of the overall solvency ratio distribution remained in the 11-13% interval.

Concerning the left-hand tails of the solvency distributions, these grew somewhat larger, particularly for non-IFRS countries. The share of total banking sector assets with an overall solvency ratio of less than 9% increased significantly in non-IFRS countries, reaching 8.2% of total banking assets, implying that the

shock-absorption capacity of the most weakly capitalised banks deteriorated in 2005. With respect to IFRS countries, this proportion remained relatively stable, standing at 4.1% of total bank assets (see also Tables 9 and 10 in the Statistical Annex).

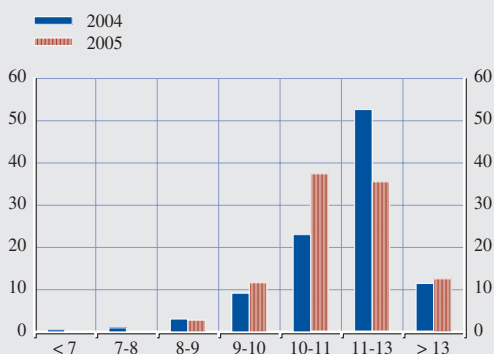
Taking into consideration the dispersion of the overall solvency ratio according to size and ownership of banks, IFRS countries tend to have a larger degree of disparity. Nevertheless, a common feature, for both IFRS and non-IFRS reporting banks, is to be found among small banks. Under both accounting standards, these banks have both higher solvency ratios and a very high degree of dispersion (see Chart 11). The reason why small banks tend to have solvency ratios that are higher than the average is that they are generally more predisposed to niche markets, hence resulting in different capital structures and requirements. Moreover, small banks tend to be more conservative and their risk management systems are generally not as sophisticated as those of large banks, hence resulting in a larger capital base.

The slight changes reported in 2005 in the structure of risk-adjusted assets are somewhat different for the two groups of countries. IFRS reporting banks recorded an increase in the share of the banking book risk-weighted assets, which reflected the strength of credit demand resulting from ongoing financial deepening in Central and Eastern European countries. On the other hand, non-IFRS countries reported an increased share of risk-adjusted trading and off-balance sheet assets, while there was a drop in the proportion of banking book risk-weighted assets. The emergence of new financial products, coupled with possibly riskier activities undertaken by some banks, partly reflects the minor changes in the structure of risk-adjusted assets.

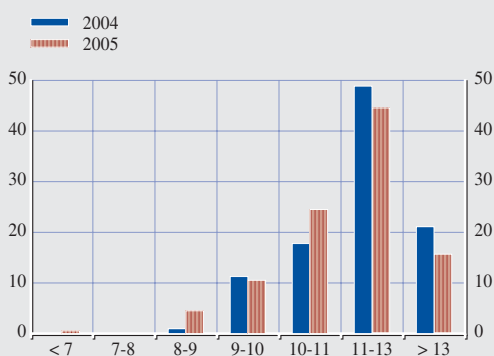
Finally, the adoption of the new accounting standards also contributed to these variations, particularly when considering that IFRS countries reported the largest variations in the structure of risk-adjusted assets. Nevertheless,

Chart 10 Frequency distribution of overall solvency ratios for EU banks

(IFRS countries, all banks, % of risk-adjusted assets)



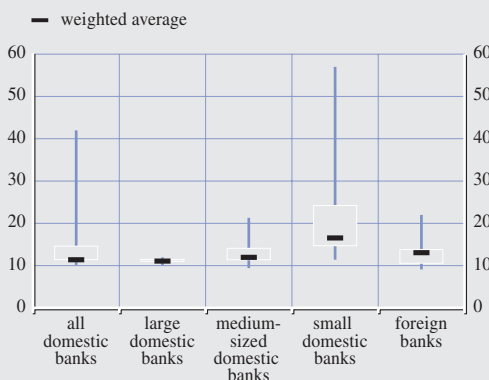
(non-IFRS countries, all banks, % of risk-adjusted assets)



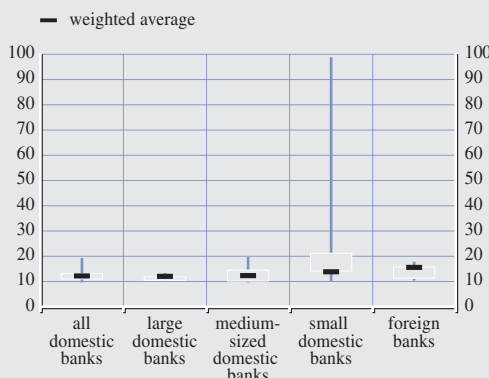
Source: BSC.

Chart 11 EU banks' overall solvency ratios

(2005, IFRS countries, % of risk-adjusted assets, minimum, maximum and inter-quartile distribution of country values)



(2005, non-IFRS countries, % of risk-adjusted assets, minimum, maximum and interquartile distribution of country values)



Source: BSC.

the impact of the new reporting standards on risk-adjusted assets is hard to quantify.

By the end of 2005, banking book risk-weighted assets still accounted for the bulk of total risk-adjusted assets, equivalent to over 80%. Risk-weighted off-balance sheet items accounted for around 10% of total risk-adjusted assets, whereas the remainder related to risk-adjusted trading assets (see Tables 9 and 10 in the Statistical Annex).

LIQUIDITY POSITIONS REMAINED FAVOURABLE

Liquidity for a bank means the ability to meet its financial obligations as they come due. Bank

lending typically results in the financing of investments in relatively illiquid assets, but banks usually fund their loans with primarily short-term liabilities. Thus one of the main challenges for a bank is to ensure its own liquidity under all reasonable conditions. A healthy liquidity position in the banking system, can also facilitate the smooth running of the payments system, and may also prevent financial crises from occurring. For these reasons, the management of liquidity risk is an integral part of banks' core operations, particularly in case of maturity transformation activities.

The proportion of liquid assets that a bank holds relative to its short-term liabilities can provide an

indication of its dependency on volatile market sources of funding.⁹ The higher the reliance of a bank on short-term funding, the greater is the liquidity risk. In circumstances where demand for liquidity is high, on account of an overwhelming demand for cash by depositors, for instance, funds will become more expensive and difficult to access. Hence, banks need to hold an adequate level of liquid assets to provide cover for their short-term liabilities in case of a possible funding shortage. It is important to bear in mind that banks of different size differ widely in the way they manage liquidity. Small banks typically derive their funds primarily from customer deposits, normally at fairly stable source of funding. Their assets tend mostly to be loans to small firms and households. They also usually have more deposits than creditworthy borrowers, with excess funds typically invested in assets that will provide liquidity. By contrast, large banks generally lack sufficient deposits to fund their main business – dealing with large companies, governments, other financial institutions and wealthy individuals. Most of them borrow the necessary funds from other major lenders in the form of short-term liabilities which must be continually rolled over – a riskier form of liquidity management than that practiced by small banks.

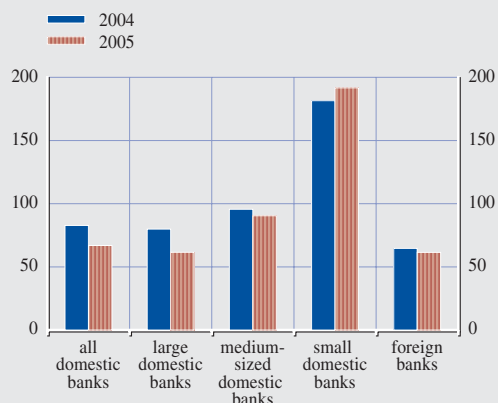
The liquidity positions remained favourable in 2005, despite the drop reported by some groups of banks, particularly in IFRS countries. The liquidity ratios, which stood at 67% and 89% for IFRS and non-IFRS countries respectively, indicate an adequate cover of liquid assets to short-term liabilities (see Charts 12 and 13, and Tables 11 and 12 in the Statistical Annex).¹⁰ An environment of higher interest rates together with the flattening of the yield curve in 2005 has induced banks to reduce their holdings in liquid assets, with the consequence of downward pressure on the liquidity positions of some group of banks (see Table 17 and 18 in the Statistical Annex).¹¹

The banking sector customer funding gap represents the proportion of customer loans that

- 9 Given that inter-bank (wholesale) funding is generally of a short-term nature and highly volatile, it is a synonym to short-term liabilities and is hence taken as the denominator for the liquidity ratio.
- 10 Due to the adoption of a new *IFRS-compliant CBD template*, only one liquidity ratio could be computed for countries reporting under IFRS. The liquidity ratio for IFRS countries is defined as the sum total of *cash and loans to credit institutions* expressed as a proportion of *amounts owed to credit institutions*.
- 11 Liquidity ratios in non-IFRS countries are higher than in IFRS countries because liquid assets in non-IFRS countries also include short-term government debt.

Chart 12 Liquid asset ratio for EU banks in IFRS countries

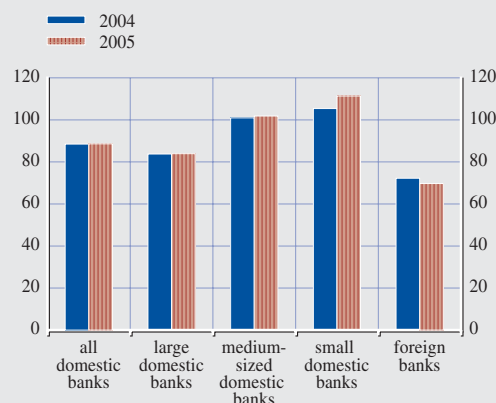
(cash and loans to credit institutions, % of amounts owed to credit institutions)



Source: BSC.

Chart 13 Liquid asset ratio for EU banks in non-IFRS countries

(cash, short-term government debt and loans to credit institutions, % of amounts owed to credit institutions)



Source: BSC.

is not covered by customer deposits and that must be funded in the market.¹² On average, customer funding gaps in the EU were positive in 2005 (see Chart 14), having widened in comparison with 2004 because the growth of loans exceeded that of deposits.

The widening of the funding gap does not necessarily imply heightened liquidity risk. However, because market funds are generally more expensive than deposits, this was a factor in driving the thinning of bank margins in 2005.

The dispersion of customer funding gaps in IFRS countries in 2005 was rather wider than that of the non-IFRS group (see Chart 14). The main explanation for this appears to be differences in the banking sector structures in the two groups of countries.

The widening of the funding gap implies a higher reliance of banks on inter-bank funding. This is so, despite the fact the inter-bank funding as a proportion of total assets dropped in 2005. Inter-bank financing tends to be of a short-term nature, and therefore has to be renewed frequently, possibly implying higher

funding volatility. Additionally, banks have also been increasingly engaged in the trading of market instruments, such as debt certificates and subordinated debt, which provide an alternative source of liquidity.

3 EU BANKS' OUTLOOK AND RISKS

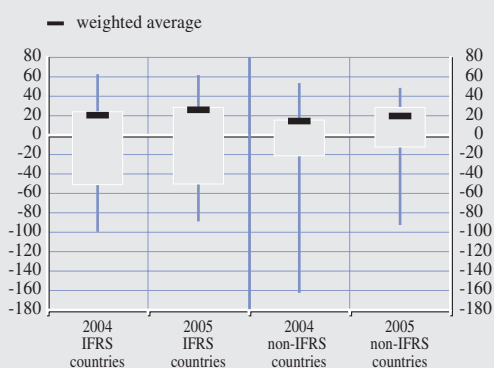
After the publication of the last EU Banking Sector Stability Report in October 2005, there were some changes in the macro-financial environment facing the EU banking sector. Most notably, economic growth gained momentum in most of the Member States where growth had been more subdued over the last three to four years, and remained buoyant in other countries. At the same time, there was a general increase in interest rates across all maturities of the yield curve.

Against this background, analysts' forecasts for the weighted average profitability of EU banks, over the short-term, improved in the course of 2006 (see Chart 15). A macroeconomic

¹² Customer loans/deposits are defined as total loans/deposits net of interbank transactions.

Chart 14 Customer funding gap for EU banks

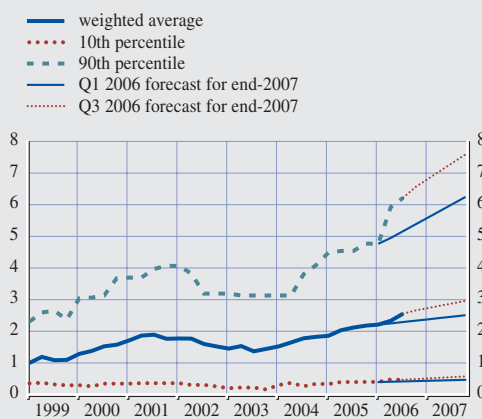
(% of loans to customers, average, inter-quartile range, maximum and minimum of country values)



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

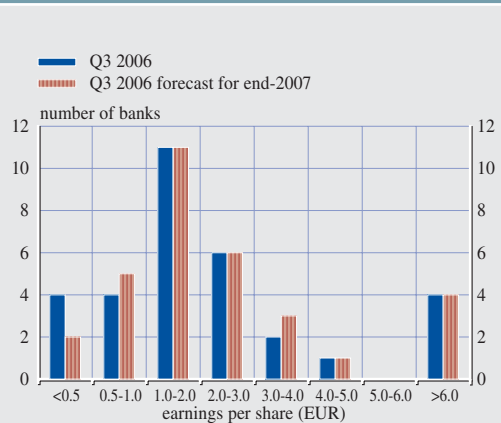
Chart 15 Earnings per share (EPS) and end-2007 forecasts for large EU banks

(Q1 1999-Q4 2007, EUR)



Sources: Thomson Financial Datastream, I/B/E/S and ECB calculations.

Chart 16 Distribution of earnings per share (EPS) and end-2007 forecasts for large EU banks



Sources: Thomson Financial Datastream, I/B/E/S and ECB calculations.

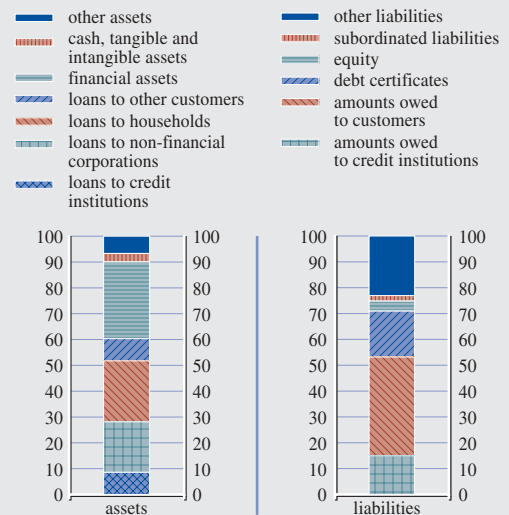
environment marked by recovery, favourable credit conditions and buoyant financial market performance, in conjunction with expectations of continuing cost containment and more effective use of capital, may have contributed to the positive assessment by financial analysts of banks' future earnings performance. Further corroborating the positive picture, Chart 16 illustrates that the main contribution to the upward revision of the average earnings forecasts came from the reduction of the number of banks in the percentile with the lowest earnings forecast, while the number of banks in the percentiles of the best expected performers either remained stable or increased.

Notwithstanding the positive earnings outlook, there remain risks facing the EU banking sector and it cannot be excluded that the changing macroeconomic environment will affect the likelihood and potential impact of the various risks faced by the EU banking sector in the period ahead.

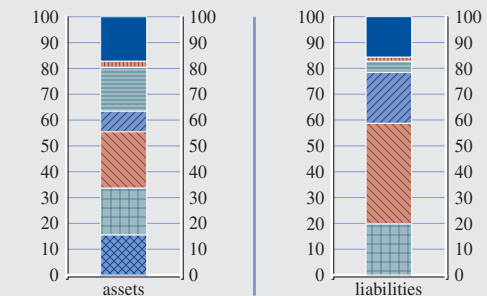
Crucial for assessing the relative importance of various sources of risk facing the banking sector is an overview of the balance sheet structure. In that context, Chart 17 suggests that EU banks have credit and interest rate risk exposures

Chart 17 EU banks' balance sheet structure

(2005, IFRS countries, %)



(2005, non-IFRS countries, %)



Sources: BSC and ECB calculations.

through their lending to the domestic and foreign corporate and household sectors. They also face counterparty risks via exposures in interbank markets and various market risks from their financial asset holdings. In 2005, the relative sizes of the potential exposures varied somewhat between the IFRS and non-IFRS reporting countries – with exposures to market risks being higher and exposures to interbank risks lower for IFRS banks – although it is not obvious whether the disparity necessarily reflected differences in accounting standards.

EU BANKS' CREDIT RISKS REMAIN LOW BUT THE OUTLOOK IS FOR HIGHER RISKS

HOUSEHOLD SECTOR CREDIT RISKS MAY HAVE INCREASED

The pace of the growth of EU banks' lending to households continued to be rapid after the publication of the EU Banking Sector Stability Report in October 2005 (see Chart 18). In terms of stocks, the share of loans to households in the total amount of outstanding loans to domestic residents – measured on an unconsolidated basis as MFI loans granted by euro area institutions – stood at 46% in August 2006, broadly unchanged from the year before. Apart from the large balance sheet exposure of banks, conducting business with households also provides them with a substantial share of their income, in relation to both interest and non-interest categories. These large exposures, however, need to be seen against the background of the fact that around 70% of the outstanding stock of loans to households is secured by property, which mitigates the overall credit risk associated with the banks' lending to households.

The continued strength of – or, in some EU countries, pick-up in the pace – of lending by

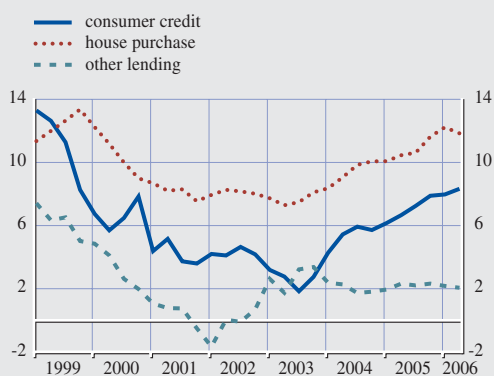
banks to households mainly reflected favourable financing conditions, facilitated by the still low level of interest rates in most Member States, by continued strong housing market dynamics in many countries, and by the general improvement in consumer confidence that took place after mid-2005.

Looking at EU banks' activity in the mortgage lending market, banks increased their exposures further amid strong demand that may, in some countries, have been stimulated further by changes in the mortgage markets which have expanded access to credit. Moreover, country level information suggests that preparations by EU banks for the implementation of the new capital requirements under Pillar I of the Basel II Capital Accord may have provided banks with additional impetus for extending their activities in the mortgage market. In particular, banks may be shifting the composition of their lending portfolios away from lower-rated corporate loans to higher-quality mortgage loans, which carry lower capital requirements. Exposures also grew because of aggressive pursuit of market share by some banks in several Member States.

With regard to consumer credit, EU banks' overall lending remained dynamic despite the fact that loan spreads were compressed further. However, some Member States in which business cycle conditions were further advanced reported a slowdown in loan growth that could act as a harbinger of more general future developments in the EU banking sector. There were indications in some countries that demand for consumer credit may have been supported by borrowers topping up mortgage loans with consumer loans to either bridge borrowing constraints imposed by loan-to-value ratios or to finance housing improvements. This may have increased banks' overall exposure to housing market developments although the magnitude of the effect is difficult to estimate. Although consumer credit is mostly unsecured, and is therefore inherently more risky for banks than mortgage lending, EU banks' overall exposure to consumer credit remains around

Chart 18 Annual growth in loans to households in the euro area

(Q1 1999-Q2 2006, % per annum)



Source: ECB.
Note: Data are based on financial transactions involving MFIs' loans.

13% when approximated by the share of the total stock of MFI loans to euro area households.

Regarding the quality of banks' incremental household credit exposures acquired in 2005, indications of an easing of credit standards – corroborated by the ECB bank lending surveys for the first two quarters of 2006 – against a background of intense competition and buoyant demand have been evident since the publication of the 2005 Banking Stability Report. Nevertheless, despite the somewhat worrisome developments in terms of flows of new mortgages, average loan-to-value (LTV) ratios for the existing mortgage lending stock are estimated to remain between 70 and 90% in most Member States which still represent rather conservative levels. It should also be borne in mind that the growth of mortgage lending has largely been matched by rising house prices in most EU Member States in recent years. As a consequence, the higher value of lenders' collateral mitigates the risk of future loan write-offs by supporting recovery rates in the event of defaults.

According to the ECB bank lending surveys for the first two quarters of 2006, banks did not foresee any change in credit standards in coming

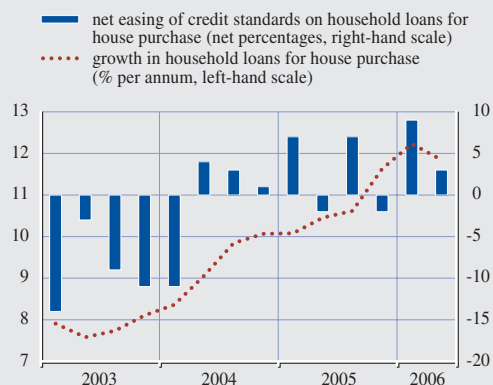
quarters and they expected demand for loans, both loans for house purchases and consumer credit, to continue to strengthen. However, it is worth pointing out that the relationship between banks' credit standards and the growth in loans to households for house purchases has not been very stable throughout the time period of available data (see Chart 19).

Looking forward, the extent of credit risks to banks from their lending to households will ultimately depend on the vulnerability of EU households to future re-payment difficulties. The average degree of indebtedness among households did not increase further after the publication of the EU Banking Sector Stability Report for 2005, with the average household debt-to-financial assets ratio estimated to have remained at 30% in 2005. At the same time, the ratio of debt-to-liquid financial assets increased slightly to 92%, indicating that the financial buffers of euro area households have diminished (see Chart 20).

The average level of indebtedness remained relatively low by international standards – some countries outside the EU have much higher household sector indebtedness ratios and have not yet encountered balance sheet strains despite rising interest rates. In addition, as a

Chart 19 Annual growth of euro area MFI loans to households and changes in credit standards

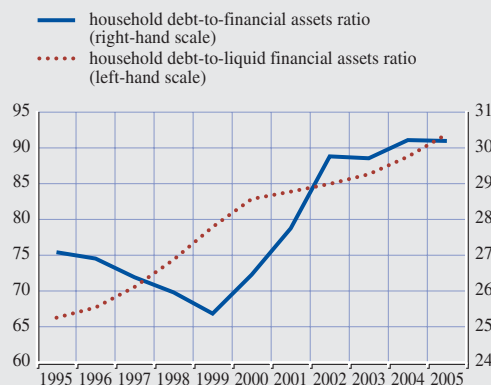
(Q1 2003-Q2 2006)



Source: ECB.

Chart 20 Ratio of household debt to financial assets and liquid financial assets in the euro area

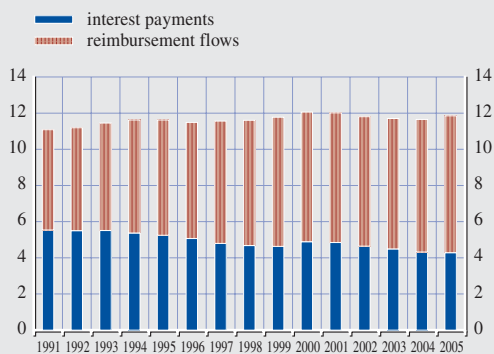
(1995-2005, %)



Source: ECB.

Chart 21 Total debt servicing burden of the euro area household sector

(1991-2005, % of disposable income)



Source: ECB calculations.

proxy for EU-wide developments, the total debt servicing burden of euro area households has remained very stable from the early 1990s onwards, with the share of interest rate payments falling steadily as interest rates declined (see Chart 21).

While these indicators might suggest that the vulnerability of EU households to possible income and/or interest rate shocks could be moderate, on average, considerable diversity remained in the levels of indebtedness across different regions and income groups. Several Member States where household debt has grown rapidly, and/or where the bulk of mortgage loans are contracted at variable interest rates, have reported that vulnerabilities, among the lowest income segments in particular, could be mounting amid high levels of indebtedness and rising debt servicing costs. In many cases, the households with large mortgages relative to their income are also the same ones with highest concentration of consumer credit. An additional factor that has raised the vulnerability of households to repayment difficulties in several non-euro area EU countries in particular, but not exclusively, has been a rapid increase in the share of foreign currency-denominated mortgage loans over recent years.¹³ Concerns about the vulnerability of households in the face of strong credit growth has already

prompted regulatory authorities in several of the countries concerned to resort to various prudential measures to tackle the risks from the perspective of both financial stability and consumer protection.

The continued expansion of lending to households, the rapid increase in household sector indebtedness in some parts of the EU and the more lax credit standards applied by banks – insofar as this reflects competitive pressures and not less concern about future credit risks – all suggest that the household sector-related credit risks of banks may have risen. Nevertheless, the write-off rates by banks on mortgage loans extended to euro area households – measured on an unconsolidated basis as a percentage of amounts of MFI loans outstanding – remained relatively stable over the past year, while write-off rates on consumer credit and on loans for other purposes declined overall (see Chart 22).¹⁴ However, given that some non-euro area EU Member States witnessed sharp increases in write-offs on consumer credit, as debt servicing burdens gradually increased, it cannot be excluded that similar patterns could be seen on a more broad-based basis in the event of a deterioration of the macroeconomic environment.

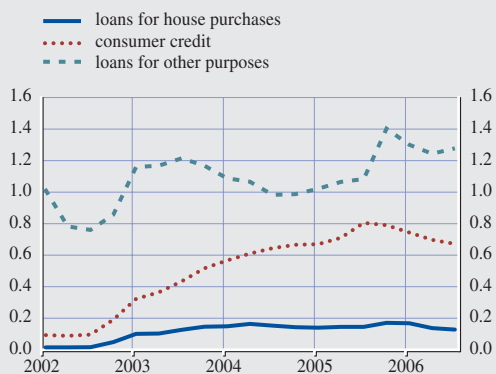
Given the growing exposure of EU banks to lending to households and the simultaneous increase in the vulnerability of the household sectors in some member states to adverse disturbances, the likelihood of the banking

¹³ Section 5 provides a more detailed overview of these developments.

¹⁴ One should be cautious when drawing direct parallels between the loan impairment charges (loan-loss provisions) as reported in Charts 7 and 8 and loan write-offs as reported in Charts 22 and 23, both backward looking indicators of credit risk, for several reasons. First, impairment charges (provisions) are measured on a consolidated basis, while write-offs are measured on an unconsolidated basis for MFI institutions. Second, impairment charges as reported in Charts 7 and 8 include loans to all sectors while write-offs are measured separately for households and non-financial corporations. Third, the data sources for the two indicators are different. Data on impairment charges (provisions) comes from the BSC's EU-wide consolidated banking data while the write-off data originates from the ECB euro area MFI statistics where the coverage is different.

Chart 22 Euro area MFI's write-offs/write-downs of loans to households

(Q1 2002-Q3 2006, % of amount outstanding)



Source: ECB.

sector being materially affected depends on the probability of the occurrence of a triggering event. Although the macroeconomic outlook remained favourable in late 2006, the fact that impairment charges among EU banks remained very low may imply some increase in charges if downside risks to the main scenario were to materialise. That said, even a moderate slowdown in the currently rapid pace of household sector lending growth could have a substantial negative impact in EU banks' income. All in all, however, given that the solvency of EU banks has remained very comfortable, households would need to face significant financial strain before EU banks' potential losses from their household sector exposures would pose a concern for financial stability.

DOWNSIDE POTENTIAL FOR CORPORATE SECTOR CREDIT RISK HAS INCREASED

The annual growth rate of lending by EU banks to non-financial corporations continued to rise after the publication of the 2005 EU Banking Sector Stability Report. Within the EU, data on non-consolidated MFI loans for the euro area showed that buoyant lending growth was concentrated in short and medium-term maturities, while lending at longer maturities stabilised at rather high levels (see Chart 4). By

July 2006, banks' overall exposure to the non-financial corporate sector, as measured by the stock of all outstanding MFI loans to domestic residents, was about 38%. The combination of better-diversified income bases and low corporate sector default rates has been welcome for those EU banks which had become increasingly reliant on lending to the household sector.

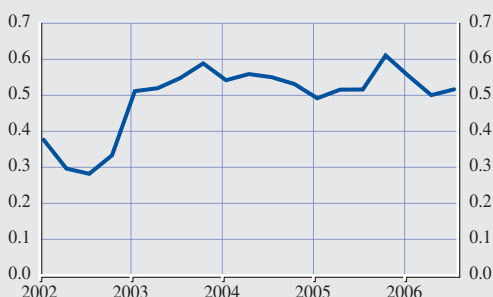
The recovery of EU banks' lending to non-financial corporations took place against a background of a generally improving economic environment and a strengthening of investment activity. In addition, EU banks' activity in the financing of mergers and acquisitions (M&As) expanded which has contributed to banks' income developments on both the interest and the non-interest side. In part, this seems to explain growth in bank exposures to short-term corporate loans which are often initially used as bridge loans and subsequently converted into debt securities issues. The fact that M&A activity was particularly strong in the leveraged buy-out (LBO) segment suggests that EU banks' credit risks from their involvement in M&As is likely to be higher than was the case in previous M&A booms which were largely equity-financed. At present, however, the high fees and commissions earned by banks in the LBO loan origination and syndication process are likely to provide them with initial buffers against a possible slowdown in market dynamics.

Despite rising corporate sector leverage and intensifying competition among banks, the quality of EU banks' corporate loan books remained solid over the past year. Write-off rates for MFI loans to the corporate sector, measured on an unconsolidated basis, declined in the last quarter of 2005 and in the first half of 2006 (see Chart 23).

Low corporate loan write-off rates mirrored exceptionally low corporate sector default rates. To a large extent this appears to be explained by the strengthening of corporate sector profitability together with favourable financing conditions that provided firms with easy access

Chart 23 Euro area MFI's write-offs/write-downs of loans to non-financial corporations

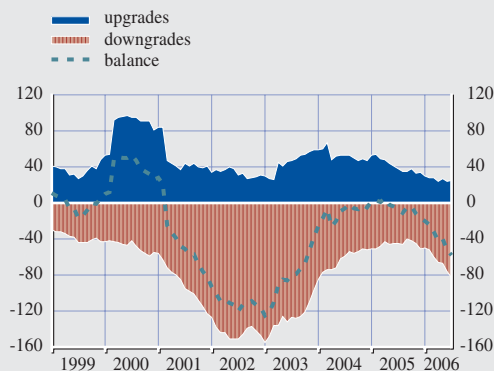
(Q1 2002-Q3 2006, % of amount outstanding)



Source: ECB.

Chart 24 Western European non-financial corporations rating changes

(Jan. 1999-July 2006, number, 12-month trailing sum)



Source: Moody's.

to credit and re-financing facilities. However, it cannot be excluded that the favourable conditions in credit markets may have fostered an environment where even less-viable firms were able to secure financing and that the gradual removal of liquidity from the financial system as interest rates rise further could ultimately contribute to rising default rates, increasing loan impairment charges and growing write-off rates. Reflecting this possibility, the ratio of upgrades of corporate sector credit ratings to downgrades in the EU declined significantly after the publication of the EU Banking Sector Stability Report in October 2005 (see Chart 24).

As mentioned above, there have been some indications that EU banks are making efforts to mitigate their credit risks by restructuring their loan books in anticipation of the implementation of new Basel II capital requirements. The new Capital Accord has encouraged banks to securitise the loans that they extend to lower-rated corporates because they will receive less favourable risk-weightings under the new requirements (see the next sub-section for more details).

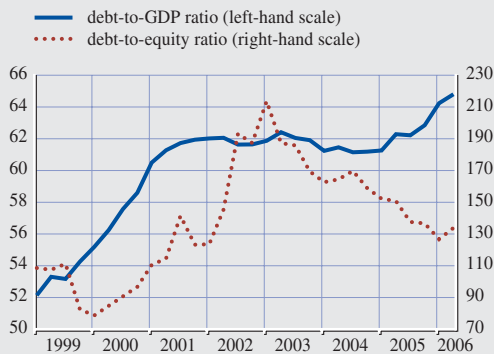
To the extent that EU banks have not reduced their corporate sector credit exposures, the risk

to banks of an upturn in corporate sector loan write-off rates remains conditional on the vulnerability of the EU corporate sector to adverse cash-flow and interest rate shocks. The sector's debt-to-GDP ratio increased further in 2005 and in the first half of 2006, exceeding the levels recorded in the previous peak in mid-2003 (see Chart 25). Rising corporate sector indebtedness, however, needs to be considered in conjunction with the outlook for corporate sector profitability. The debt-to-equity ratio of the euro area corporate sector remained broadly unchanged in the second quarter of 2006, suggesting that there has not been any material change in the degree of corporate sector gearing and its vulnerability to adverse shocks. Regarding the vulnerability of the corporate sector to interest rate shocks, although the increasing tendency of firms to contract new loans at variable interest rates has helped shift interest rate risks away from banks, credit risk exposures will have increased in the medium term if firms acquiring these loans have not hedged their interest rate risks.

The July 2006 ECB bank lending survey suggested that banks had not materially changed the credit standards they applied to average loans. The results also indicated that, while the credit risk concerns among banks about average

Chart 25 Total debt of non-financial corporations in the euro area

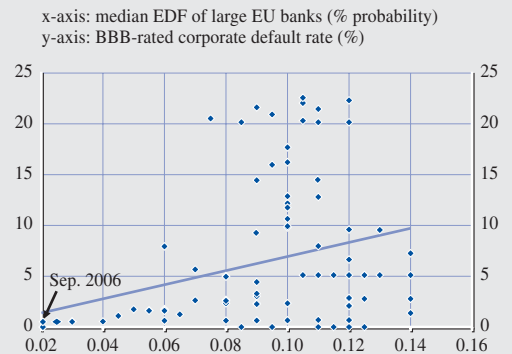
(Q1 1998-Q2 2006, %)



Source: ECB.
Note: Data for Q1 2006 and Q2 2006 are partly based on estimates.

Chart 26 Western European BBB-rated corporate default rates and expected default frequencies (EDFs) of large EU banks

(Jan. 1999-Sep. 2006)



Source: Moody's.
Note: Due to measurement considerations, the EDF values are restricted by Moody's KMV to the interval between 0.02% and 20%.

loans were not much greater than in the previous quarters, competitive pressures contributed towards an easing of credit standards. This notwithstanding, banks continued to tighten their margins, on net basis, on riskier loans, possibly in anticipation of a gradual turn in the credit cycle.

An indication of the role of the currently good corporate sector credit quality in underpinning the solid balance sheet condition of the EU banking sector can be obtained by correlating large EU banks' median expected default frequencies against BBB rated corporate default rates (see Chart 26).¹⁵ Should corporate sector default rates start edging up, a gradual deterioration in the financial condition of banks could be envisaged.

All in all, by late 2006, EU banks' risks stemming from corporate credit seemed to be growing amid higher exposures and signs of maturing cyclical conditions. However, and notwithstanding the low rates of expected obligor defaults implied by very low impairment charges, even if credit quality were to deteriorate significantly and unexpectedly, banks' solvency ratios remained at very comfortable levels. That said, the increasing exposure of banks to short-term leveraged financing since the assessment

in the 2005 Banking Stability Report implies that banks' income and credit quality in this segment could have become vulnerable to a reversion of default rates in the high-yield sector back to long-term average levels.

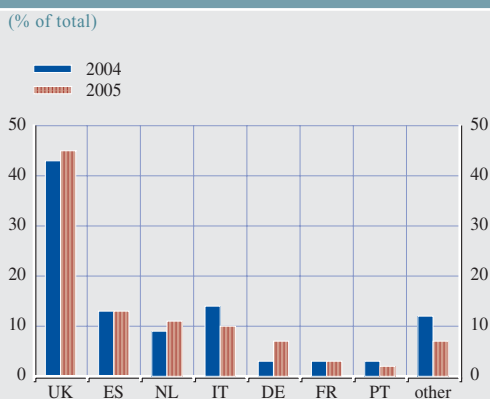
CREDIT RISK-MITIGATING ACTIVITY HAS IMPROVED EU BANKS' RESILIENCE BUT COULD IMPLY NEW RISKS

The management of credit risk by banks has been undergoing profound changes in recent years. The main driving force behind this process has been the introduction of new tools and financial instruments for transferring credit risk, while ample liquidity in global financial markets and changes in the regulatory environment have provided further impetus.

The new rules for calculating risk-weighted assets (RWA) under Pillar I of Basel II imply that banks will have either to set aside greater amounts of capital for the riskier parts of their loan books or to transfer risks out of their balance sheets by securitising them. In the latter case, exposures can be deducted from RWA calculations if a risk transfer has genuinely

¹⁵ September 2006 represents the latest observation on the cut-off date for this report.

Chart 27 European loan securitisation issuance by country of collateral



Source: ESF Securitisation Data Report, winter 2006.

taken place. Indeed, one of the features of the move towards a risk-based capital environment (effectively facilitated by the new Pillar I rules) is to recognise risk mitigation in banks' loan portfolios. On the other hand, banks which are willing to take on credit risk benefit from higher income. Under economic capital such additional income, in addition to loan-loss impairment charges, is increasingly recognised as providing them with a buffer against expected losses.

The intensity of banks' activities across the EU in the securitisation business has continued to vary rather substantially. In 2005, UK banks accounted for almost half of total loan securitisation in all EU countries. The relative shares of other Member States remained broadly stable between 2004 and 2005, except for Germany where the share of total loans securitised more than doubled (see Chart 27).

From the perspective of banking sector stability, greater risk sharing should be seen as a positive development to the extent that those who ultimately bear the risks are able to do so. This is because it allows banks to diversify their loan portfolios and optimise the use of their capital. Moreover, innovations in structured credit products, improvements in banks' loan portfolio management functions and a broadening

investor base have been gradually facilitating a move by larger banks towards an originator-distributor business model. New synthetic products, such as leveraged loan credit default swaps, have been allowing banks to securitise loans of entities even if they have no corporate bonds outstanding (as in the case of small and medium-size enterprises), while institutional investors have been developing appetites for such loans, mainly attracted by the higher yields they offer.

While the net impact of credit risk-mitigating activities on banking sector stability is likely to be overwhelmingly positive, pockets of vulnerability could nevertheless be building up within the complex structures of many credit derivative products and the frameworks that have been implemented to manage the risks.

First, with the move to IFRS, large numbers of instruments purchased to provide credit risk protection are being placed into banks' trading books as they are often unlikely to be held until maturity. The increasing concentration in trading books of positions in instruments that carry credit risk is likely to raise the correlation between the banking and the trading books, thereby lowering diversification. In addition, concerns have been expressed about the adequacy of existing VaR methods for monitoring the risks of these instruments, as VaRs typically assume that positions can be liquidated at short notice. Although liquidity in the credit derivatives markets has improved substantially over recent years, it remains to be seen how the market will function under strained conditions – including high volatility and low liquidity.

Second, a broadening of the investor base in securitised assets has meant that credit risks are increasingly being transferred out of the banking system. While information is scant on the nature and extent of the transfer, there is anecdotal evidence that the share of the insurance industry as a destination for credit risk has been declining because of an increasing tendency towards mark-to-market accounting

by insurers that discourages long-term investment in riskier assets. At the same time, a growing presence of specialised originators of collateralised loan obligations (CLOs) and unregulated financial institutions, such as hedge funds, in the secondary markets for loans, has been driven by high yields which are offered on riskier loan tranches. A key financial stability question that arises from the activity of such investors in taking credit exposures through the securitised market is whether they have the ability to absorb temporary losses during periods of high market volatility. Concerns may be aggravated if investor lock-up periods are not sufficiently long. Given that banks, especially the largest ones, can have sizeable financing or investment exposures to such end-holders of credit risk it cannot be excluded that credit risks could migrate back into the banking system via counterparty exposures.

Third, it is possible that the gradual drainage of liquidity from global financial markets could constitute a more general challenge for the securitisation business. Some banks may have grown rather dependent on securitisation both as a way to offload credit risk and as a source of additional funding. In the latter case, disruptions in the securitisation processes could imply higher funding costs for the banks involved.

INTEREST RATE RISKS MAY HAVE MOVED TO THE UPSIDE

Among the different sources of market risk that face banks, interest rate risk is probably the most important. Banks can be exposed to interest rate risk in several different ways, either directly via the holdings of interest rate-sensitive securities in their trading and banking books, or indirectly via impacts on income and credit quality in their trading and loan origination businesses.

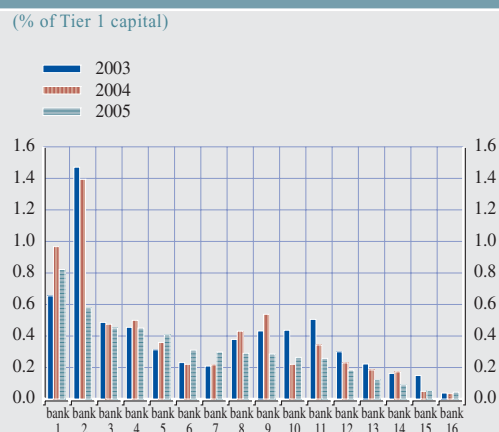
Regarding the outlook for interest rate risks in EU banks' banking books, the increasing tendency to contract lending at variable rate terms both in the household and in the non-

financial corporate sectors helps to insulate banks from short-term interest rate moves. In addition, banks increasingly hedge their existing loan book exposures either via interest rate derivatives or by means of securitisation.

The orderly increase in interest rates across the maturity spectrum over the past year may have provided banks with an opportunity to adjust their positions in traded debt instruments to changes in expected returns. Against this background, as a share of trading book regulatory own funds requirements, EU banks' interest rate exposures declined in 2005 (see Tables 9 and 10 in the Statistical Annex). At the same time, with interest rates at all maturities remaining at low levels with volatility in fixed income markets also remaining low, some banks may have been encouraged to extend their risk-taking. Information from interest rate VaRs available for a sub-set of large EU banks nevertheless suggests that almost all banks reduced their direct exposures to interest rate risk in 2005, with the exception of a few banks that had relatively low levels of exposure (see Chart 28).

After the publication of the EU Banking Sector Stability Report in October 2005, long-term government bond yields first increased in all

Chart 28 Interest rate Value at Risk (VaR) for selected EU banks



Source: Financial disclosures of banks.

major economic areas, including the EU, but subsequently declined moderately after the temporary market turbulence in May and June 2006. The increase in short-term interest rates which took place concomitantly in most of the EU Member States implies that yield curve slopes remained relatively flat, and country-level information indicates that a flatter yield curve environment had a negative impact on income derived from maturity transmission in 2005 and in the first half of 2006. Regarding the outlook for long-term interest rates, information derived from options prices on euro area ten-year government bond yields in early October 2006 suggested that market participants assigned a higher probability to the likelihood of bond yields rising rather than falling in the near-term. Nevertheless, a more prolonged period of flat yield curve environment, and the possibility that the yield curve could even invert, cannot be ruled out at the current juncture.

EU banks increasingly use stress-testing for assessing the vulnerability of their banking and trading books to various interest rate shock scenarios, including parallel shifts and changes in the slopes of domestic and foreign yield curves, possibly in conjunction with other shocks. Banks with significant trading activities typically examine interest rate risk events in more detail. For example, the effects of disorderly interest rate movements are often assessed through scenarios that are based on past episodes of rapid adjustment of bond yields. Stress scenarios also embody increases in volatility, reductions in liquidity and adjustments of swap and credit spreads. Member States in which banks are extensively using stress testing to assess their market risk exposures report that banks have generally found their interest rate exposures to be manageable even under fairly stringent stress scenarios. This could reflect the mitigating effects of a rather extensive use of interest rate derivatives that allow banks to hedge their exposures to interest rate risk, thereby reducing their vulnerability to adverse shocks.

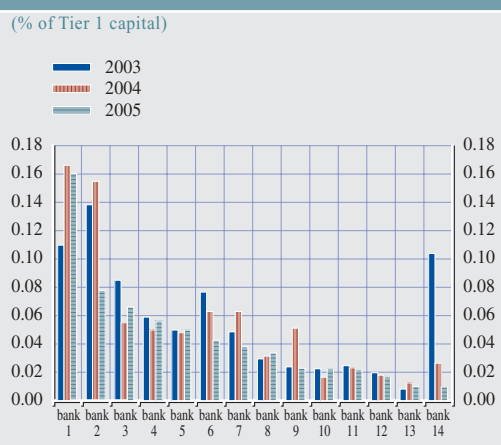
EXCHANGE RATE RISKS MAY HAVE INCREASED FOR SOME EU COUNTRIES

The exposure of EU banks to exchange rate risk varies across the region. For some non-euro area countries, direct exposures – including those built up through foreign currency lending – could be more relevant. Nonetheless, as discussed in detail in Section 5, even for those countries in which banks' lending in foreign currency is relatively high, the natural hedge of exports helps in mitigating banks' foreign exchange risk, at least to the extent that borrowers are mainly medium-sized or large firms.

More generally, net open foreign exchange positions tend to be very small across EU banks, thanks to hedging. Banks also regularly employ in-house stress tests to assess exchange rate risk – a practice that is likely to become increasingly common as banks adopt Basel II – and the findings typically indicate resilience to foreign exchange rate risk. Furthermore, a number of EU countries has also recently undergone IMF FSAPs at the country level, in which a frequent stress scenario has been a substantial depreciation of the US dollar. In general, the results have shown that conditions in banking sectors in these countries are robust. Finally, it should be borne in mind that the strength of EU banking sector profitability has allowed the setting-aside of comfortable buffers for unexpected events.

Aggregated supervisory data for 2005 confirms that the overall direct exposure of EU banks to foreign exchange risk is small, as the observed prudential requirements for this type of risk are considerably lower than for equity and other traded instruments. Moreover, as a percentage of total trading book own funds, requirements have remained basically unchanged since the lows of 2004 (see Tables 9 and 10 in the Statistical Annex). Finally, considering information on EU banks' foreign exchange VaRs, this yardstick has fallen in all but one case between 2003 and 2005, and has remained small for most banks, confirming that EU banks have kept their exposure to this type of risk

Chart 29 Exchange rate Value at Risk (VaR) for selected EU banks



Source: Financial disclosures of banks.

contained (see Chart 29). Although the low volatility in financial markets between 2003 and 2005 may explain the low readings of foreign exchange VaRs, the fact that volatility remained broadly unchanged over the same period of time indicates that the fall represents an actual reduction in banks' exposure to this type of risk.

Nonetheless, some indirect risks remain for the banking sector: large swings in foreign exchange rates could be prompted by an unruly unwinding of global imbalances combined with a turn in the credit cycle, although the likelihood of such a scenario is low. As balance sheets of households and corporates have become more stretched, these sectors have in fact become more vulnerable to changes in the overall economic environment. Although in general EU companies and households are not severely exposed to foreign exchange risk, small and medium-sized enterprises do not manage to hedge their exposure as well as large companies, so that some residual exchange rate exposure remains. But for such indirect foreign exchange rate risk to materialise, currency markets' turbulence would have to coincide with a material deterioration in the credit cycle, to the

point that this market risk would become intertwined with the general credit risk for banks, and would, in this way, become capable of affecting banks substantially. However, given the general macroeconomic developments, such an unfavourable scenario is highly unlikely.

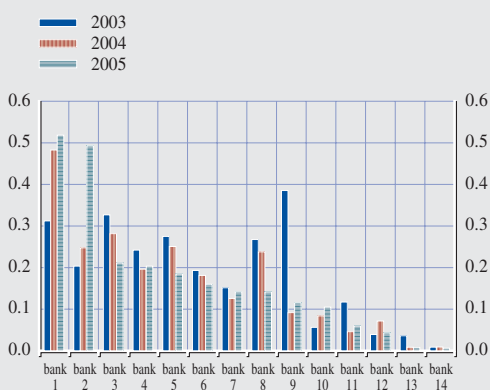
DIRECT EXPOSURE TO EQUITY MARKET RISKS REMAINS MODERATE

EU banks' direct equity market exposures, as measured by the share of regulatory own funds requirements, remained broadly unchanged in 2005 compared to 2004 (see Tables 9 and 10 in Statistical Annex). At the same time, favourable developments in equity markets throughout 2005 allowed banks to benefit from their indirect equity market exposures by raising their fee and commission income from trading-related activities.

In May and June 2006, global equity markets went through a period of heightened volatility which led to significant falls in share prices in EU markets. Although equity prices subsequently recovered, suggesting that the fundamental outlook remained broadly intact, the episode nevertheless provided a reminder of the risks of abrupt changes in investor sentiment and their potential to spread wider in the financial system.

Despite the fact that aggregated supervisory data for 2005 show low exposures, the vulnerability of EU banks' trading books to higher equity market volatility may have grown as the protracted low levels of volatility have allowed banks working with VaR models to expand their exposures without necessarily breaching risk limits. Under such circumstances, spikes in equity market volatility could suddenly push large numbers of positions simultaneously beyond VaR limits and generate strong volatility feedback effects. Indeed, Chart 30 shows that some banks with already high exposures increased their positions substantially in 2005, although the split between the banks that increased and those that decreased their

Chart 30 Equity market Value at Risk (VaR) for selected EU banks



Source: Financial disclosures of banks.

exposures was even in this sample. Nevertheless, there are indications, based on stress testing exercises, that banks have equity market risks well under control.

EU BANKS REMAIN EXPOSED TO COUNTERPARTY AND OPERATIONAL RISKS

Banks may be exposed to the risk of credit losses in their dealings with other financial institutions if these counterparties fail to honour their financial commitments. In this connection, the risks that banks face in dealing with hedge funds have been found to be concentrated mainly on banks’ prime brokerage businesses where banks provide hedge funds with leverage, as well as various operational and financial services against lucrative fees and commissions and where intense competition among banks may have contributed to a certain erosion of standards.¹⁶

Recent developments in the prime brokerage business include the introduction of multi-asset platforms that enable hedge fund clients to deal with a wide spectrum of financial assets worldwide and that are rapidly becoming a compulsory service in the highly competitive

prime brokerage business. In addition, portfolio-based cross-product margining is becoming a common practice among prime brokers. Such margining practices can provide substantial margin savings if all trades are implemented with one prime broker and, therefore, provide incentives for hedge fund managers to work with fewer prime brokers but it could also encourage greater hedge fund leverage. Finally, so-called “principal” prime brokerage, when prime brokers offer a full over-the-counter (OTC) intermediation service, is becoming more widely used. Under this model, and assuming the prime brokers work under adequate risk management, prime brokers serve as a principal counterparty to both parties of the original transaction, thus concentrating and usually also lowering counterparty risk for both transacting parties. From a banking sector stability point of view, it is important going forward that banks retain sound risk management practices vis-à-vis their hedge fund exposures.

Although many of these initiatives aim at simplifying the daily transactions between prime brokers and their hedge fund clients, it cannot be excluded that competitive pressures may have forced some prime brokers to compromise on due diligence when dealing with hedge funds. Continuing vigilance therefore remains essential for banks to ensure that they retain a good grasp of their overall exposures to unregulated financial institutions.

The increasing popularity of complex financial derivative instruments has generally improved banks’ risk management practices. At the same time, however, such products may also have introduced new risks for banks, of which the long backlogs in settlement process have featured prominently since the publication of the 2005 Banking Stability Report. Since banks are the largest buyers of credit protection,

¹⁶ See ECB (2005), “Large EU Banks’ Exposures to Hedge Funds”.

unsettled trades could become a problem if, in the event of a default of a large corporate bond issuer, banks were to discover that they were not covered against the default when they had assumed that they were. In the event of such a disruption, substantial re-stating of banks' past earnings and hedging books could become necessary, with potential negative impacts on investor sentiment and banks' share prices.

Reacting proactively to these concerns, US and European regulators asked the industry in September 2005 to address these problems without delay and numerical targets were agreed to bring the number of unconfirmed trades to more reasonable levels. At the end of September 2006 it was confirmed that the number of all confirmations outstanding had been reduced by 70%, with confirmations outstanding for more than 30 days down by 85% and the share of trades that are confirmed on an electronic platform doubling to 80% of the total trade volume. Despite the apparent success thus far, it is likely that further effort will be needed to sustain the progress already achieved.

As mentioned above, EU banks' exposures to the leveraged buy-out (LBO) business have grown substantially over the last two years. Direct exposures by banks to LBO funds arise through credit, investment and income channels. Credit exposures arise from banks' activities in lending and from loan underwriting activities, where market conditions have been favourable and where intense competition among banks may have contributed to a dilution of credit standards and some mis-pricing of risks. Furthermore, banks also face several indirect exposures via the potential impact of LBO activity on their bond, loan and equity portfolios insofar as these contain debt or equity issued by target companies. Shocks to deal valuations that could affect the general market sentiment and impair loan syndication processes could act as potential triggers for a slowdown in activity with a potentially substantial impact on many EU banks' income and credit risk outlook.

EMERGING MARKET EXPOSURES INCREASED FURTHER

General economic conditions in emerging market economies were relatively stable after the publication of the EU Banking Sector Stability Report in October 2005, underpinned by high commodity prices and historically low interest rates. Moreover, after the temporary turbulence in global financial markets receded in May-June 2006, the credit spreads of most emerging market economies recovered to levels seen at the beginning of the year.

With regard to exposures to individual geographic areas, as measured by the size of cross-border financing flows to selected emerging market economies, the exposure of EU banks to the main emerging market economies in Latin America continued to rise throughout 2005 (see Chart 31). Exposures to Argentina remained more contained, following the default in 2002 and the larger ownership links between EU banks and the local banking sector.

Chart 31 International exposures of EU banks to Latin American countries

(Q1 2000-Q4 2005, USD billions)



Source: Bank for International Settlements (BIS).
Note: Data only for BIS reporting banks.

Exposures via cross-border financing flows to Asian emerging market economies remained considerably smaller than those towards Latin America, with the only exception of South Korea (see Charts 31 and 32). There was an increase during 2005, compared with 2004, but that increase in exposure was almost exclusively towards the largest countries in the region, and especially vis-à-vis South Korea.¹⁷ This may be explained by the fact that the Chinese and Indian economies continued to grow at a rapid pace, and there is likely to be an expectation that they would continue doing so in the near future. As for South Korea, a financially more advanced emerging market economy, it is likely to have benefited from the strengthening of its domestic credit market, possibly also on account of the resolution of the credit card payments backlog.

Overall, as conditions in emerging market economies have improved and their markets have generally weathered the May-June turbulence well, exposures of EU banks to these markets are likely to be beneficial for banks' profitability, with a limited impact on EU banks' solvency even in the unlikely event of deterioration in general macroeconomic conditions affecting emerging market economies.

4 EU BANKS' ABILITY TO WITHSTAND SHOCKS

MARKET INDICATORS CONTINUE TO SUGGEST A POSITIVE OUTLOOK

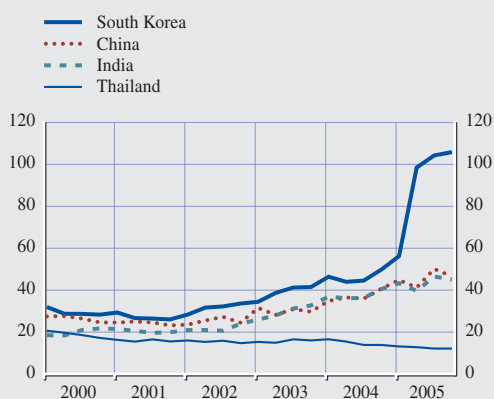
Because they are forward-looking, indicators based on prices of bank securities can provide information on how market participants assess the outlook and risks for the banking sector. After the publication of the EU Banking Sector Stability Report in October 2005, market indicators continued to suggest a bright outlook for the EU banking sector, notwithstanding increasing vulnerabilities outside the sector.

The short-lived turbulence in the stock markets in May-June 2006 had a far more pronounced impact on the share prices of EU banks than on those of US banks, possibly on account of the fact that EU banks' stock prices had been growing at a considerably faster pace since mid-2004. Notwithstanding this, EU banks' stock prices continued to rise thereafter, outperforming the limited rise in US banks' stock prices after the publication of the last EU Banking Sector Stability Report (see Chart 33).

17 A large acquisition of a South-Korean bank by a EU bank may partly explain the substantial increase in exposures in 2005.

Chart 32 International exposures of EU banks to Asian countries

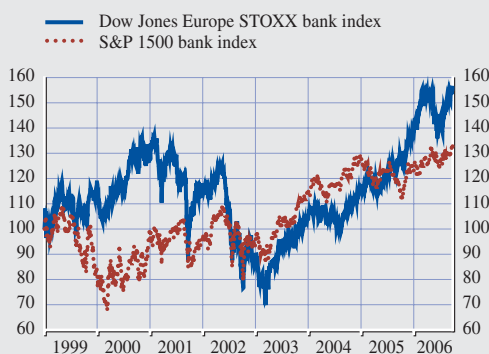
(Q1 2000-Q4 2005, USD billions)



Source: Bank for International Settlements (BIS).
Note: Data only for BIS reporting banks.

Chart 33 Bank stock prices in Europe and the US

(Jan. 1999-Sep. 2006, index: Jan. 1999 = 100)



Source: Thomson Financial Datastream.

The rapid recovery of EU banks' stock prices may suggest that markets consider the May-June 2006 turbulence as a test that financial institutions have passed well, and that this justifies increased confidence in their financial conditions, as supported by the pattern in price-earnings (P/E) ratios (see Chart 34). In fact, patterns in the banking sector P/E ratios can shed some light on how market participants expect future profitability to develop in view of recent earnings performance. In this respect, the lack of a discernible trend in the P/E ratios over the past year at a time when profitability has strengthened further would tend to suggest that market participants have an optimistic view with regard to the likelihood of banking sector profitability being sustained. At the same time, the strong performance of banks is not expected to extend to the whole banking sector, as seen by looking at the 10th percentile: banks that have experienced lower earnings growth are also expected to continue to produce low earnings. Moreover, by comparing the simple and the weighted averages, there are indications that it is the earnings prospects for larger banks that are somewhat weaker, a pattern that has been captured by P/E ratios since mid-2005.

At the same time, although the financial markets turbulence in May-June was contained and

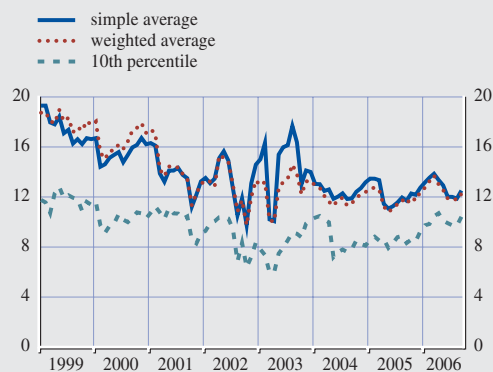
although it mainly consisted of an upward adjustment of market volatility towards historical averages, the minor increase in implied volatilities may indicate a riskier operating environment for banks going forward (see Chart 35).

Nonetheless, banks' stocks continued to outperform the general stock market index, although remaining range-bound, at a premium of between 20 and 30% over the general stock index between 2003 and 2006 (see Chart 36). As indicated by the P/E ratios and as already mentioned, the main explanation for this appears to have been expectations that the strengthening of EU banking sector profitability over the past three years will be sustained, as reflected in analysts' forecasts. To some extent, the outperformance could reflect a greater exposure of the banking sector than the corporate sector to fast-growing markets outside the EU.

Turning to market-based assessments of the credit quality of EU banks, after increasing more or less continuously for two consecutive years, the distance to default continued to improve after October 2005 (see Chart 37). This was the case both for the median and for the lowest decile, indicating that the positive reassessment of banking sector credit risk –

Chart 34 Price-earnings (P/E) ratios for large EU banks

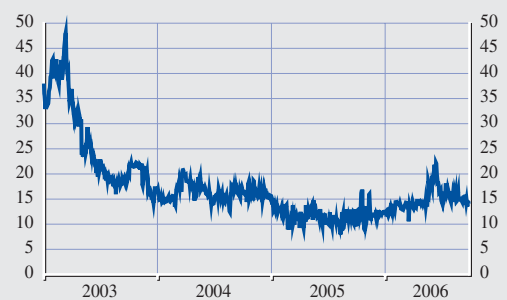
(Jan. 1999-Sep. 2006, %)



Sources: Thomson Financial Datastream and ECB calculations. Note: Earnings forecasts for the same period the price indicator refers to.

Chart 35 Implied volatility for the Dow Jones Europe STOXX bank index

(Jan. 2003-Sep. 2006, %)



Source: Bloomberg.

Chart 36 Ratio of the Dow Jones Europe STOXX bank index to the overall market index for Europe

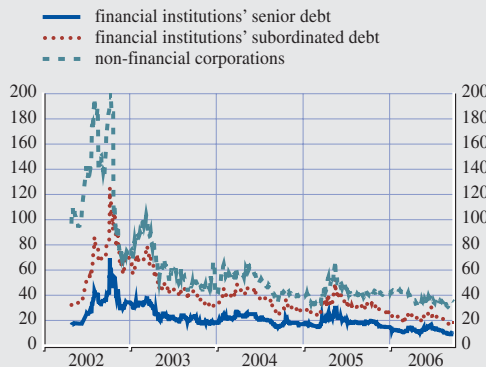
(Jan. 1999-Sep. 2006, index: Jan. 1999 = 100)



Source: Bloomberg.

Chart 38 European financial and non-financial institutions' credit default swaps

(May 2002-Sep. 2006, basis points, five-year maturity)



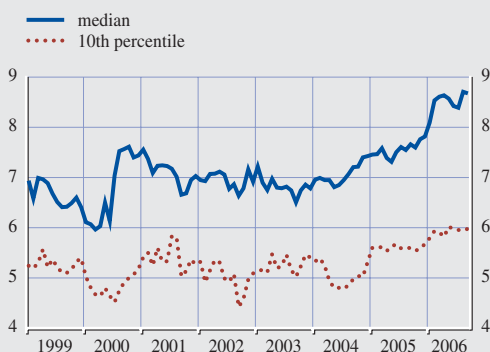
Source: JP Morgan Chase & Co.
Note: European financial institutions and non-financial institutions correspond to the definitions of JP Morgan Chase & Co.

which brought this indicator considerably above the levels of the late 1990s – was broad-based.

Patterns in credit default swap spreads for EU financial institutions¹⁸ after October 2005 also indicated a positive reassessment of credit risk. This was the case for both senior and subordinated debt spreads, which continued to decline, notwithstanding a moderate and short-lived rise in June 2006 (see Chart 38).

Chart 37 Distance to default for large EU banks

(Jan. 1999-Sep. 2006)



Sources: Moody's KMV and ECB calculations.
Note: An increase in the distance to default reflects an improving assessment.

All in all, patterns in market indicators imply a favourable outlook for the banking sector, notwithstanding growing vulnerabilities in non-financial sectors. Stock market patterns suggest that profitability will be sustained while indicators of credit quality have also shown significant improvement. Although this could reflect perceptions of the risks and vulnerabilities identified in this report as having a low probability of occurring, it may also reflect a favourable assessment of the capacity of the banking sector to absorb shocks against the background of comfortable solvency and improved risk management.

RATING AGENCIES CONTINUE TO ASSESS BANKS POSITIVELY

According to the three major rating agencies, the average credit quality of EU banks has improved since the publication of the 2005 EU Banking Sector Stability Report. Most banks were rated in the mid-upper "A" category, with stable outlooks. Moreover, as of August 2006,

¹⁸ As in Chart 38 credit default swaps premia cover all financial institutions, including non-banks, the information presents an assessment of the condition of the financial sector as a whole.

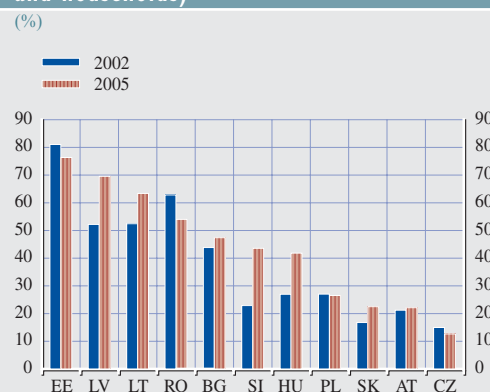
positive outlooks outnumbered negative ones – the only negative outlook, as assessed by a single credit rating agency, Standard & Poor's, was related to the risks of a bank integrating with its newly acquired bank (see Table 19 in the Statistical Annex). Although the already high ratings of the EU banks suggest that the scope for further rating upgrades is rather limited, the prevalence of positive outlooks indicated that rating agencies assessed EU banking sector conditions very favourably. In the coming quarters, the positive momentum for rating improvements could slow down somewhat as earnings growth is expected to moderate, after a strong first half of the year.

Looking further ahead, rating agencies view possible further increases in long-term interest rates and a possible deterioration in the credit cycle as the main challenges for future revenue generation and margin improvement. In the long run, rating agencies consider the pace of loan growth experienced over the past few years to be unsustainable and expect a deterioration in asset quality, albeit from a high base. Further challenges will derive from banks' ability to grow, either organically or through external growth. In fact, organic growth is likely to be restricted by the expected decline in loan growth and a potential deterioration in the operating environment. External growth may entail acquisition risk,¹⁹ in case potential acquisitions turn out sour or fail, imposing financial losses to banks. Moreover, although rating agencies do not rule out further major intra-European deals, major European banks may consider targets in other parts of the world, especially in emerging markets.

5 RISKS OF FOREIGN CURRENCY LENDING BY EUROPEAN BANKS

In some EU Member States and acceding countries, a significant proportion of total bank loans to the private sector is denominated in foreign currencies. This chapter analyses the reasons for the use of foreign currency loans, elaborates on their various risk aspects and

Chart 39 Share of foreign currency loans in total loans to private customers (corporates and households)



Source: BSC.

presents measures to limit these risks. The analysis is based on a survey that was carried out among central banks and/or supervisory authorities in 11 countries²⁰ in the first half of 2006.

STRUCTURE AND DEVELOPMENT OF FOREIGN CURRENCY LOANS

By the end of 2005, the share of foreign currency loans in total loans to private customers (corporates and households) ranged from 13% to 76% in the countries surveyed (see Chart 39). In most countries, the share of foreign currency loans in total corporate loans was considerably higher than the respective share in household loans (see Chart 40), although differences have been declining as foreign currency loans to households have expanded very rapidly in many countries. In nearly all

¹⁹ Acquisition risk refers to the risk of external acquisitions failing or diluting shareholder value. Rating agencies have argued that in the current state of the European banking system many banks dispose of surplus capital and liquidity and are looking for potential acquisitions to boost shareholder value. Some academic studies have argued that over half of completed M&A deals actually dilute shareholder value within the first year.

²⁰ The countries include Austria, Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.

Chart 40 Share of foreign currency loans in corporate loans and household loans

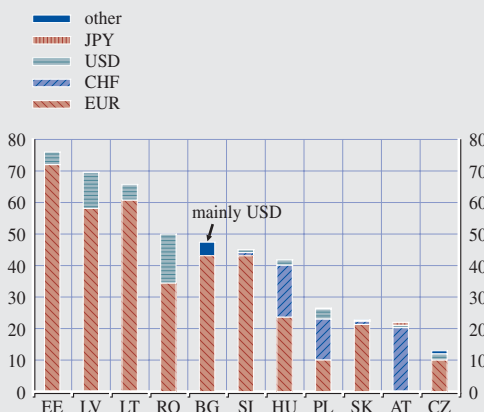
(2005, %)



Source: BSC.

Chart 41 Currency distribution of foreign currency loans to private customers

(2005, % of total assets)



Source: BSC.

countries that report significant foreign currency borrowing by households, the share of foreign currency loans in housing loans is higher than the respective share in consumer loans.

By end-2005, foreign currency lending in euro was prevalent in nine out of the 11 countries surveyed. The most frequently used foreign currency in the remaining countries was the Swiss franc. A common pattern found was that countries with a fixed, or quasi-fixed, exchange rate vis-à-vis the euro (Bulgaria, Estonia, Latvia, Lithuania and Slovenia) showed the highest shares of euro-denominated loans in total loans to private customers (see Chart 41).

FEATURES OF FOREIGN CURRENCY LOANS

The riskiness of a foreign currency loan is determined by several factors, including the initial maturity, the fixation period of the interest rate and the mode of redemption. In the majority of the countries surveyed, the initial maturity of foreign currency loans did not differ much from that of loans extended in domestic currency. The same largely applied to the rate fixation period. There were only a few exceptions where foreign currency loans were

contracted more frequently at variable interest rates than loans extended in domestic currency. Loans – in both foreign and domestic currency – were typically instalment loans, especially for household lending. Bullet loans in foreign currency were the dominant mode of redemption only in one of the countries surveyed.²¹

REASONS FOR THE WIDESPREAD USE OF FOREIGN CURRENCY LOANS

According to the survey, a positive interest rate gap between domestic and foreign currency loans seemed to be a necessary but not a sufficient condition for customers borrowing in foreign currency. In some cases, however, a noteworthy interest rate spread may not even be necessary for borrowing in foreign currency. In a few EU Member States with a (quasi-) peg to the euro, for instance, the interest rates on loans in domestic currency were no longer (significantly) higher than those on foreign currency loans, at least in some loan categories when the survey was conducted.

21 In this case, FCLs were usually coupled with repayment vehicles (e.g. life insurance contracts or mutual funds) to which monthly contributions are made during the maturity period of the loan and whose capital is used to cover the principal of the FCL at maturity.

Clearly, the interest rate advantage of foreign currency loans represents compensation for the inherent foreign exchange risk. If the foreign exchange risk perceived by an individual borrower is lower than the risk compensation offered by the market, it is rational to borrow in foreign currency. Consequently, borrowers will take out foreign currency loans either if they incur no foreign exchange risk at all, if they consider it to be lower than the premium offered, or if they ignore it.

Foreign exchange risk for a borrower is absent in cases where there is a natural hedge. If borrowers earn income or generate revenue denominated in the same foreign currency as that of their loan, they incur no foreign exchange risk. In the countries surveyed, usually exporters (often subsidiaries of multinationals) have a natural hedge against foreign exchange risk. Smaller companies typically have no such hedge, because their markets are largely domestic. With a few exceptions (e.g. cross border commuters and certain employees of larger export companies), private households have no natural hedge either.

Exchange rate risk is usually considered to be nil, or at least quite low, in the case of a close currency peg. According to the survey, fixed or quasi-fixed exchange rate regimes clearly contributed to the popularity of foreign currency loans in all countries with a currency board, a close peg or a very narrow band. Also the awareness that currency risk for euro-denominated loans will disappear with the expected introduction of the euro was explicitly cited as a factor that encouraged foreign currency borrowing.

Moreover, (historically) low exchange rate volatility, or a clear long-term exchange rate trend, had evidently created a belief in de facto low foreign exchange risk, thus encouraging foreign currency borrowing in some cases.

A lack of risk awareness – especially among private households and, to a lesser extent, small and medium-sized enterprises – appeared to

exist in many countries, especially in those with a relatively flexible exchange rate regime. When assessing the pros and cons of a foreign currency loan, many households and small businesses gave more weight to the lower interest service in the near term than to the potentially higher repayment burden in the distant future.

One special form of insufficient risk awareness, which encouraged foreign currency borrowing in some countries, is herd behaviour, whereby borrowers adopted the borrowing behaviour of others rather than relying on their own (incomplete) information.

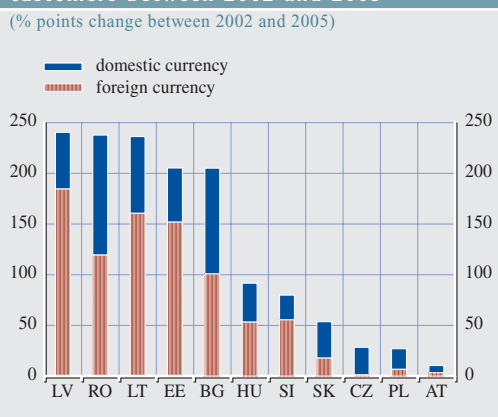
The ability and willingness of banks to supply loans in foreign currency depends primarily on their access to foreign funds and on the competitive situation in the loan market. With respect to the availability of finance in foreign currency, subsidiaries and branches of foreign banks may have an advantage over domestically owned banks as their parent institutions or head offices are likely to provide them with foreign resources if they dispose of (cheap) surplus deposits. In reality, domestic establishments of foreign banks were only particularly active in the promotion of foreign currency loans in a few countries. In addition to – and partly as a consequence of – their easy access to (low-cost) foreign funds, branches and subsidiaries of foreign banks may contribute to stronger competition. The entry of foreign-owned banks has intensified competition in the lending market of the new EU Member States and acceding countries. In most countries, it fostered growth in foreign currency loans more than in loans in domestic currency. In some countries the comparatively low costs of foreign currency loans even attracted borrowers that might otherwise not have taken out a loan.

Banks are not the only promoters of foreign currency loans. In some countries, financial advisors, credit agents, leasing firms and real estate agencies were found to be playing a significant role in the propagation of foreign currency loans.

As regards structural market imbalances, domestic demand for funds was observed as clearly outpacing the domestic supply of funds in some of the new EU Member States surveyed. Banks in these countries tend to lend (parts of) the funds borrowed abroad without converting them into domestic currency, perhaps with the intention of mitigating (direct) foreign exchange risk or hedging costs. In this context, it should be recalled that commercial banks – at least in countries with a currency board – can usually sell foreign exchange to the central bank at low or no cost in order to adjust their liquidity in domestic currency. As a consequence, there is no actual need for banks to put pressure on customers to take out foreign currency loans.

In this respect, an important question is whether the expansion of foreign currency loans boosts total lending or merely gives rise to a shift from loans in domestic currency to loans denominated in foreign currency. In some countries, the ability to borrow in foreign currency mainly resulted in such a shift, while it was also seen as having contributed to the strong expansion of total lending in others. Between 2002 and 2005, foreign currency loans accounted for half, or more, of the growth of total lending in seven countries and these countries also registered the highest overall loan growth (see Chart 42). This suggests that the expansion of foreign currency lending stimulated overall credit growth in these countries.

Chart 42 Contributions of foreign currency loans to the growth of total loans to private customers between 2002 and 2005



Source: BSC.

Fiscal incentives in the form of tax deductibility, interest subsidies or government guarantees for housing loans did not play any major role in the actual expansion of foreign currency loans.

Table 1 shows the most important reasons for the popularity of foreign currency loans according to an informal assessment of national authorities. It should be noted, however, that some of the items mentioned might have been relevant triggers for growth in foreign currency lending at an early stage but no longer play an important role at the current juncture.

Table 1 Main reasons for the popularity of foreign currency loans

	AT	BG	CZ	EE	HU	LT	LV	PL	RO	SI	SK
interest rate advantage	x	x		x	x	x		x	x	x	
fixed exchange rate regime		x		x		x	x				
expectation to join euro area soon				x		x	x			x	
lack of risk awareness	x				x			x	x		
herd behaviour	x										
appreciation trend of local currency								x	x		
strong export orientation						x	x				x
scarcity of domestic financing					x		x				

Source: BSC.

Note: The reply from the Czech Republic is not included due to the minor relevance of foreign currency loans in private lending in this country.

RISKS OF FOREIGN CURRENCY LOANS FOR BORROWERS

Foreign exchange risk is usually the most important risk involved in foreign currency borrowing. A revaluation of the foreign currency increases the interest servicing and the capital repayment in domestic currency. The likelihood of a significant appreciation of the foreign currency depends on the relative economic fundamentals, on the exchange rate regime (floating versus fixed) and on the credibility of the peg (for fixed-rate regimes) or the degree of exchange rate volatility (for floating rate regimes).

Euro-denominated loans carry considerable foreign exchange risk primarily in countries whose exchange rate is not pegged to the euro. Loans denominated in Swiss franc (CHF) are undoubtedly exposed to significant foreign exchange risk and play an important role in three countries. The foreign exchange risk of loans denominated in US dollars (USD) may diverge from that of CHF-denominated loans for two reasons: on the one hand, it can be deemed higher because the volatility of the USD vis-à-vis the respective domestic currency is usually higher than that of the CHF. On the other hand, USD loans may be regarded as less risky than CHF loans, as USD borrowers tend more frequently to have a natural hedge than CHF borrowers.

The persistence of a fixed exchange rate regime hinges on the credibility of the peg. Whether market participants expect a monetary authority to (be forced to) devalue its currency, and how they assess the probability of such a move largely depends on the compatibility of economic policies with the currency peg. The central banks of countries with a fixed exchange rate regime assess the credibility of their peg as being very high. They point to the fact that – thanks both to appropriate economic policies and to the clear commitment of the monetary authorities – a currency board or close exchange rate peg has been employed successfully for many years so far. A number of market indicators

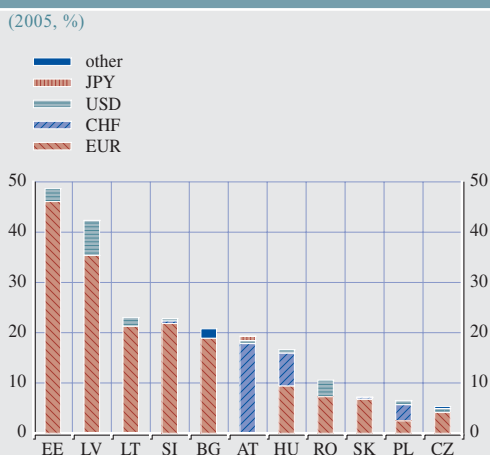
– e.g. interest rate spreads, forward quotations and the scope of hedging activities – also point to the high (and rising) credibility of the fixed exchange rate regimes.

Foreign currency loans may also be exposed to higher interest rate risk than loans in domestic currency. This is the case (i) if borrowing in foreign currency is more frequently based on variable interest rates than borrowing in domestic currency, or (ii) if the interest rate volatility of the foreign currency exceeds that of the domestic currency. As the period of interest rates fixation is quite similar for loans in both foreign and domestic currency in most countries and as the interest rate volatility of foreign currency loans is usually not higher than that of loans taken out in domestic currency (in some countries it is even significantly lower) foreign currency loans are usually not exposed to a higher interest rate risk than loans denominated in domestic currency.

RISKS OF FOREIGN CURRENCY LENDING FOR BANKS

With respect to foreign currency lending, banks are exposed to direct and indirect risks. Banks' indirect risks originate from their customers' direct risks of taking out foreign currency loans (see above). Besides the default risk of (individual) foreign currency debtors, banks must consider the concentration risk due to correlated exposures and correlated collateral. If an exchange rate shock occurs, all loans denominated in (a certain) foreign currency will be affected, since both the interest service and the value of the principal will rise in domestic currency terms. As a result, many debtors are likely to become insolvent at the same time. In addition, if housing loans in foreign currency are concentrated in certain regions, the value of mortgages is likely to decline in narrow regional markets owing to extensive repossessioning by banks. However, most respondents saw no or hardly any concentration risk with respect to their banks' foreign currency lending. Banks in countries where foreign currency loans are very high

Chart 43 Ratio of foreign currency loans to GDP



Source: BSC.

relative to GDP may be adversely affected as a result of the broader macroeconomic implications of changes in investment and consumer spending behaviour that result from a devaluation-induced increase in the debt service of a majority of their clients (see Chart 43).

Banks' direct foreign exchange risk has two aspects: First, if the foreign currency loans granted to customers are not refinanced in the same currency, to the same amount and with the same maturity, banks run a net open foreign exchange position. In the countries surveyed, there were generally no large open positions. Second, if banks' commission income is denominated in foreign currency, it will decline in domestic currency terms in the event of the foreign currency depreciation. Fortunately, direct and indirect effects of exchange rate changes have opposite effects on banks' net earnings. If the domestic currency appreciates, the probability of default of foreign currency loan debtors will decline, but banks will suffer from reductions in their commission income and vice versa.

The reputation and litigation risk connected with banks' foreign currency lending to, especially, households and small enterprises

can materialise when these groups of clients incur large losses and, in particular, when their collateral is to be liquidated. Borrowers might then argue that they had not been informed sufficiently well about the actual risks of foreign currency loans and may thus claim damages from banks. Authorities of countries with high levels of foreign currency loans and rather flexible exchange rate regimes see at least some danger for the reputation of banks, with potentially adverse effects on their global franchise values.

HOW CAN BORROWERS LIMIT THE RISK INHERENT IN FOREIGN CURRENCY LOANS?

In most countries, derivative hedging instruments are in principle available for borrowers to hedge against foreign exchange risk. In practice, however, these instruments are not applied very frequently. In general, only large corporate borrowers use them to some extent. The fact that this kind of derivative can be quite costly and that such derivatives are not always available for very long maturities, and for small amounts, is a factor explaining their rare use.

Conversion clauses, which allow the redenomination of loans from foreign into domestic currency or into a less volatile third currency, are another means that can help borrowers to reduce their foreign exchange risk. It should, however, be borne in mind that this option and its actual use generally provide no guarantee against an exchange rate-induced loss. An effective limitation of the foreign exchange risk can only be achieved if the borrower fixes a maximum increase in the value of the foreign currency in advance and eventually exercises the conversion option.²² The opportunity to convert a foreign currency loan into another currency without establishing a new contract does not exist in all countries. In some countries though, currency switching

²² In the event of a sudden large-scale devaluation of the domestic currency even this strategy does not guarantee that losses can be kept within certain limits.

options are quite usual and can be exercised at low cost. In some countries, no uniform practice has evolved thus far.

HOW CAN BANKS LIMIT THE RISK INHERENT IN FOREIGN CURRENCY LENDING?

Banks can lay down stricter credit standards and conditions for foreign currency loans than for loans denominated in domestic currency in order to account for their higher risks. They may demand higher debt servicing capacities from customers that take out loans in foreign currency and, in particular, they may require a more solid income basis from them. This is, in fact, done by at least a number of banks, while others do not seem to distinguish between loans extended in different currencies. In some cases credit standards and conditions for foreign currency loans might even be looser than those for loans in domestic currency. Another method for containing loan losses in foreign currency lending is the stipulation of higher collateral. However, the available information indicates that this is not usual practice. To the extent that the additional risk inherent in foreign currency loans cannot be eliminated by requiring higher debt servicing capacities or collateral from borrowers, banks must demand an additional risk premium. According to the presumptions of the responding authorities, banks typically do not demand higher risk premiums for foreign currency loans.

After having granted foreign currency loans, banks must monitor the actual development of the various risks carefully, and take corrective action where necessary. One instrument for taking corrective action is forced currency conversion, which permits banks to redenominate foreign currency loans from foreign to domestic currency without the borrower's consent. With some reservations,²³ this option enables banks to pull the emergency brake before the exchange rate-induced increase in the debt service is deemed to become unmanageable for the debtor. Only a few countries reported that their banks are usually in the position to convert a foreign currency

loan into a loan in domestic or another foreign currency.

To sum up, the additional risks posed by foreign currency loans should be manageable (i) if banks grant foreign currency loans only to customers with higher than normal credit standings, (ii) if they demand higher collateral or higher risk premiums from borrowers, (iii) if their risk monitoring and credit surveillance is adequate, and (iv) if they re-convert the loan into domestic currency if circumstances require this to be done. In a nutshell, foreign currency lending is unlikely to cause major problems for banks if their risk management is appropriate.

HOW CAN AUTHORITIES LIMIT THE RISK INHERENT IN FOREIGN CURRENCY LENDING?

Measures to contain the systemic risk of foreign currency loans can directly reduce their growth, address their causes or strengthen banks' means of limiting their risks. The policy tools employed by the authorities of the countries surveyed include administrative measures (e.g. quantitative growth limits and additional reserve requirements), the reduction of fiscal incentives, supervisory measures (e.g. tightening provisioning rules and increasing risk weights, setting minimum standards, enhancing reporting and disclosure requirements, demanding periodic stress tests and strengthening on-site inspections), moral suasion and financial education.

By late 2006, only the authorities of three countries (with significant lending in volatile foreign currencies) saw the necessity to deliberately dampen the expansion of foreign currency lending in order to safeguard financial stability. In a number of other countries, central banks aim at curbing overall credit growth (including foreign currency loans). Countries where foreign currency lending is (still) comparatively low did not see any need for disincentives directed primarily, or exclusively, at foreign currency loans.

²³ See previous footnote.

CONCLUSIONS

With respect to the risks inherent in foreign currency loans, the countries under review do not form a homogenous group. In some countries, foreign currency lending – especially to households – is still at a comparatively low level. In others, it is very high, but almost exclusively denominated in euro, the anchor currency of the (quasi-) peg. In these cases, the foreign exchange risk of foreign currency loans depends on the credibility of the peg, which is currently assessed by monetary authorities and financial markets as being very high. In countries with relatively flexible exchange rate regimes and a significant share of foreign currency-denominated bank lending, the risk foreign currency loans constitute for banks is not negligible and deserves close monitoring by central banks and supervisors.

6 OVERALL ASSESSMENT

After two years of strengthening, the profitability of EU banks continued to improve in 2005 and showed no sign of abating in the first half of 2006. The further improvement in profitability after 2004 was mainly driven by lending growth that was sufficiently strong to offset the effects of thin interest rate margins, continued growth in non-interest income – especially fees and commissions and trading activity – and very low provisioning or impairment charges. Lending growth benefited from a pick-up in corporate loan demand, possibly rendering banks' lending activity less dependent on the household sector. In spite of a further slight erosion of solvency levels, largely arising from expanding lending activities, EU banks' solvency positions remained very strong.

It is important to note, however, that in the current transitory phase between accounting regimes, developments in banking sector performance indicators between 2004 and 2005 should be analysed with caution since restated 2004 accounts may not be fully compliant with

the new International Financial Reporting Standards (IFRS).

The outlook for risks to EU banks in the short and medium term could be changing, primarily on account of two factors. The macroeconomic and financial environment of the EU banking sector could be changing as a result of more evenly spread growth patterns, both at the global level and within the EU. In addition, interest rates have risen for all maturities of the yield curve, although the yield curves remained remarkably flat in most member states. These developments may affect the likelihood and prominence of the various risks faced by banks going forward.

EU banks' credit risks remain low, but the downside potential may have increased, given the strong pace of lending growth coupled with some signs of erosion of credit standards on new loans and the all-time low levels of impairment charges (or provisions). The vulnerability of EU households to possible income and interest rate shocks may have increased for some countries, even if the average EU level of indebtedness remains low by international standards. In particular, mortgage loans denominated in foreign currency could pose risks to some EU countries. On the non-financial corporate side, the credit risk outlook has turned less favourable owing to the high and growing corporate debt ratios. In addition, the present exceptionally low levels of corporate sector default rates are expected to increase on account of the gradual deterioration of the currently benign credit and liquidity conditions. Banks' growing credit risk exposures should however, be seen against the background of their improved risk management capabilities and the strong profitability that constitutes a first-line buffer in the case of adverse developments.

Among the different sources of market risk, interest rate risks are the most prominent facing banks. Yield curves remain relatively flat, imposing negative pressure on income and posing a challenge to banks' maturity

transformation business. While equity market risks and risks stemming from emerging market exposures remain moderate, counterparty risk could be rising amid growth in short-term lending to LBO activity and an increasing participation of hedge funds in risk transfer markets. It is essential that EU banks subject their exposures to such market segments, where competition is particularly fierce, to rigorous stress-testing in order to avoid erosion of credit standards and mis-pricing of risks.

Looking forward, market indicators continue to suggest a robust outlook for the EU banking sector in terms of profitability and credit quality, possibly reflecting a favourable assessment of the capacity of the banking system to absorb shocks.

STATISTICAL ANNEX

Box 2

DATA ON EU BANKS

The macro-prudential analysis conducted by the Banking Supervision Committee (BSC) is based on the pooling of relevant aggregated information on the banking systems of all EU Members States. The key set of data for this analysis, on which this report is based, 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, and cover nearly 100% of the EU banking sector. Due to the introduction of the International Financial Reporting Standards (IFRS) in 2005, and their implementation for supervisory purposes, however, coverage was reduced slightly in order to preserve the quality of 2005 data (see below). In countries where IFRS accounting has been already adopted for supervisory purposes, local GAAP reporting is generally still permitted, in particular for small or non-quoted banks. Data on small banks, which are not yet IFRS-compliant, from countries in which the old and new accounting rules coexist for supervisory purposes were not included in the data collected in 2005. While significant in terms of the number of institutions, the loss in coverage was small in terms of the domestic banking assets of IFRS countries. The data contain information on EU banks, which have been divided into three size groups (small, medium and large). In addition, they provide information on foreign-controlled institutions active in EU countries.

This box summarises the key definitions used in Tables 2 to 18 in the Statistical Annex, and describes some of the most important changes in data collection in 2006, vis-à-vis that conducted in 2005.¹

Key definitions for domestic banks

Consolidation

In order to provide a fully consolidated view of risks, the EU authorities report cross-border and cross-sector consolidated data on domestically controlled banks. In cross-border consolidation, data on branches and subsidiaries located (from the reporting country's point of view) outside the domestic market are included in the data reported by 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. This perimeter of consolidation was maintained for all countries even if it differs from that recommended by the new accounting standards (IFRS) in which the insurance sector is included.

Size groups

Large domestic banks are defined as banks with total assets greater than 0.5% of the total consolidated assets of EU banks, while medium-sized banks have total assets of between 0.5% and 0.005% of those total consolidated assets and banks with total assets of less than 0.005% of those total consolidated assets are considered small. The threshold in terms of absolute amounts is defined on the basis of the total assets of the banking sector available from the data collection run in the preceding year. In the 2006 collection (concerning end-2005 data), the thresholds were computed using the total assets of €25,519,486 million from the 2005 data

¹ See the ECB (2005), "EU Banking Sector Stability Report", October.

collection. This figure comprises the total assets of domestic banks and non-EU foreign subsidiaries of all EU Member States (EU-25) at end-2004. The figure is slightly larger than that used in the 2005 EU Banking Sector Stability Report, mainly because last year only assets of domestic banks and non-EU foreign subsidiaries of the first 15 Member States were accounted for. Assets of EU-25 banks at end-2004 could now be used for the computation of the thresholds, as data collected from the ten countries that joined the EU in 2004, i.e. data fully compliant with the consolidation scope adopted, were available from last year's data collection.

Key definitions for foreign banks

Foreign banks are defined as 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. The data for these institutions are excluded from the definition of the domestic banking sector, and are aggregated under the heading "foreign banks" in the following tables. A separate analysis for foreign banks is justified by their large share of the domestic banking sector in some EU countries.

Key definitions for all banks

For some items in the tables presenting the consolidated banking data, a separation between domestic and foreign banks is not available. For these items, most of which refer to solvency indicators, the category "all banks", which includes all domestic and foreign banks, is reported.

Differences in the data in the 2005 and 2006 Banking Sector Stability Reports

Split of the sample into IFRS-compliant and non-IFRS-compliant accounting regimes

For the purpose of this exercise, IFRS-compliant and local-GAAP-compliant data were treated separately as the conceptual differences between the accounting regimes were thought to be too substantial to render the aggregation of IFRS and non-IFRS accounts meaningful. At present, eight EU countries (Austria, Belgium, Germany, Hungary, Luxembourg, Slovenia, Sweden and the United Kingdom) do not yet require IFRS-compliant reporting for supervisory purposes, even if listed banks have already adopted the new accounting standards and publish results accordingly. The remaining 17 EU countries² have implemented the IFRS since 2005, or even earlier, and/or allow for the coexistence of IFRS and local-GAAP reporting for supervisory purposes.

Differences in coverage

A drop in coverage was deemed necessary to preserve the quality of the consolidated banking data. Coverage in 17 EU countries comprises only the set of IFRS reporting banks, given that only one reporting scheme was assigned to each country.³ The loss in coverage was negligible for most countries, but represented slightly more than 20% of total domestic banking assets in the case of two large euro area countries (France and Italy). In addition, IFRS reporting countries were asked to report two years of data compliant with the new accounting regime (2005 data and 2004 restated IFRS-compliant data) based on the same sample of banks (only

2 The set of IFRS reporting countries comprises: Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Greece, Ireland, Italy, Lithuania, Latvia, Malta, the Netherlands, Poland, Portugal, Slovakia and Spain.

3 For technical reasons related to data submission, it was not possible to have a country transmitting two sets of data (IFRS and non-IFRS-compliant) so that full coverage could be attained.

IFRS reporting banks), so that two fully comparable years would be available.⁴ This request had reduced the total number of reporting banks further in a few cases (albeit only slightly) given difficulties in obtaining restated IFRS accounts for end-2004. The data coverage of the eight non-IFRS reporting countries was not affected.

Coverage is weaker on the set of small banks. For the IFRS set of countries, these are generally institutions still reporting in conformity with local-GAAP that are, for this reason, excluded from IFRS-compliant domestic banking system data collection. Turning to the non-IFRS set of countries, the number of small banks has also dropped in some countries with a very large number of small institutions that represent a small share of total domestic banking assets.⁵

Changes in size groups

The change in the level of the thresholds for the definition of large, medium-sized and small banks based on end-2004 data was insignificant (even if calculated on the basis of total consolidated banking assets of all EU-25 countries). However, the adoption of the new accounting standards in 2005 may have been responsible for growth in some banks' balance sheets with respect to non-IFRS 2004 data (e.g. due to the implementation of IAS 39, fair-value accounting, off-balance-sheet items that are on-balance-sheet under IFRS). Mostly for this reason, and especially within the group of medium-sized banks, a few institutions that were reported as belonging to one size group in the 2004 data collection have shifted to the next one due to the faster growth of their assets relative to total EU assets. A few downward moves among medium-sized non-IFRS reporting banks were observed due to these institutions' relatively slower growth (or even decrease) of assets. Such shifts, however, have had a limited impact on the aggregate EU data.

Differences in definitions of specific data items

The same reporting template (and technical infrastructure) was used for the production of 2006 consolidated banking data. However, while it remained totally unchanged for the non-IFRS reporting countries (no changes in definitions with respect to last year's report), most items were re-defined in accordance with the IFRS framework for the IFRS-compliant template. For example, where profit and loss data is concerned, the item "trading and foreign exchange results" in the non-IFRS template corresponds to "gains (losses) on financial transactions" (cf. IAS 39) in the IFRS template. The new accounting and practices on provisioning under the new standards also required the replacement of provisions items with those of impairment losses (net) of financial and of non-financial assets. A few items were suppressed where IFRS accounting offers fewer breakdowns than local GAAP (e.g. by debt securities issued by public and private bodies).

In addition, the liquidity ratios calculated as a percentage of total assets were replaced by a more informative indicator (liquid assets over short-term liabilities), which was also adjusted for the breakdowns available for all countries that have adopted the IFRS.

⁴ This request could not be fulfilled by Denmark and Finland.

⁵ Domestic banking data from Sweden (non-IFRS) does not comprise data on a significant number of micro banks that represent around 5% of total domestic assets (data from Belgium has always excluded micro-banks). Domestic banking data from Cyprus also excludes data on cooperative credit institutions (this is not related to the introduction of the IFRS since the new standards were adopted in Cyprus in 1981).

As has been mentioned in previous reports, data on asset quality (Tables 7 and 8) should be interpreted with caution owing to large differences between national definitions of both impaired assets (non-performing and doubtful assets) and provisions. Asset quality indicators could be computed for the set of IFRS banks since supervisors are still collecting information on non-performing assets and provisioning for supervisory purposes.

Country-level tables and aggregation

Although the EU Banking Sector Stability Reports aim to analyse banking sector developments at the aggregate EU level, or in relevant subsets of countries, additional information at the country level is provided in the Statistical Annex for reference. When analysing the data presented in these tables, and especially when attempting a comparison across countries, it should be borne in mind that country-level indicators reflect differences both in coverage and in definitions; in addition, differences in the banking sector structures across the EU should be taken into consideration. Finally, country-level information presented in Tables 10 to 17 may differ from that published in individual countries' reports on account of the differences in the reporting populations.

Using the consolidated banking data presented in Tables 2 to 10, split between the two reporting groups – IFRS and non-IFRS – two sets of country-level tables have been produced: the first (Tables 11 to 14) includes only domestic banks operating in each EU-25 country, while the second (Tables 15 to 18) includes both domestic and foreign banks operating in each country. Tables 11 to 14 present a disaggregated view of the data used in the computation of the averages for the IFRS countries and non-IFRS countries reported in Tables 2 to 10. Country-level information is weighted in the computation of aggregate indicators (or averages). A small number of aggregate indicators do not comprise data from all IFRS reporting countries due to the unavailability of certain reporting breakdowns at the country-level. Asset-quality indicators for IFRS countries reported in Table 7 exclude data from Denmark due to a break in the series as a result of a revised reporting requirement affecting 2005 figures.⁶

The country-level data in Tables 15 to 18 are presented for “all banks”, i.e. the group of both domestic and foreign banks in each country. For this reason, the data are affected by double-counting if cross-country aggregation is attempted, and are moreover not directly comparable with the data presented in Tables 2 to 10. Nonetheless, given the extensive foreign ownership of the banks operating in some EU Member States, Tables 15 to 18 offer a more realistic picture of country-level banking developments in these countries.

⁶ A new definition of non-performing and doubtful assets was adopted in Denmark in 2005 encompassing all loans and guarantees on which impairment losses have been performed, as well as loans expected to default based on objective evidence on impairment. This definition is broader than the one proposed by the IFRS.

Table 2 EU consolidated banking data reporting population

(2005)

	IFRS reporting countries	non-IFRS reporting countries
Number of credit institutions		
Stand-alone credit institutions	1,349	2,942
Banking groups	270	135
Credit institutions	1,619	3,077
Domestic credit institutions	1,177	2,609
Foreign-controlled subsidiaries and branches	442	468
Total assets of credit institutions in the sample (EUR billions)		
Domestic credit institutions	12,768	14,751
<i>of which (%):</i>		
<i>Large</i>	78.0	75.1
<i>Medium-sized</i>	21.2	20.9
<i>Small</i>	0.8	3.9
Foreign-controlled subsidiaries and branches	2,005	2,325

Source: BSC.

Table 3 EU banks in IFRS reporting countries: profitability and efficiency

(2005, changes from 2004 in percentage points)

	All domestic banks	Change from 2004	Large domestic banks	Change from 2004	Medium domestic banks	Change from 2004	Small domestic banks	Change from 2004	Foreign banks	Change from 2004
Income (% of total assets)										
Net interest income	1.22	-0.08	1.06	-0.04	1.77	-0.12	2.69	-0.05	1.13	-0.02
Interest receivable	3.09	0.07	3.17	0.14	2.79	-0.13	4.09	-0.48	4.21	0.12
Interest payable	2.12	0.10	2.30	0.14	1.46	-0.08	1.45	-0.43	3.18	0.19
Net non-interest income	1.14	-0.27	1.12	-0.33	1.19	-0.02	2.00	-0.77	0.80	-0.42
Fees and commissions (net)	0.64	-0.09	0.62	-0.11	0.70	-0.04	1.29	-0.19	0.49	-0.16
Trading and forex results/ gains (losses) on financial transactions	0.30	0.06	0.33	0.06	0.16	0.05	0.52	0.14	0.19	-0.04
Other operating income (net)	0.13	-0.23	0.11	-0.28	0.18	-0.04	0.15	-0.72	0.10	-0.22
Total income	2.36	-0.35	2.17	-0.37	2.96	-0.14	4.69	-0.81	1.92	-0.43
Expenditure structure (% of total assets)										
Staff costs	0.57	-0.43	0.45	-0.49	0.97	-0.16	1.59	-0.31	0.48	-0.23
Administrative costs	0.27	-0.21	0.23	-0.25	0.36	-0.06	0.97	-0.46	0.33	-0.21
Other	0.08	-0.02	0.07	-0.02	0.10	-0.02	0.22	-0.05	0.10	-0.08
Total expenses	1.43	-0.30	1.34	-0.30	1.69	-0.22	2.92	-0.72	1.07	-0.39
Profitability (% of total assets)										
Operating profits	0.93	-0.05	0.83	-0.07	1.27	0.08	1.77	-0.09	0.85	-0.05
Impairment losses (net) on financial assets	0.08	-0.05	0.04	-0.06	0.21	0.00	0.18	-0.11	0.06	-0.06
Extraordinary items (net)	0.02	0.01	0.03	0.01	0.02	0.00	0.01	0.00	0.01	0.00
Tax charges	0.20	0.00	0.19	0.00	0.25	0.00	0.36	0.06	0.15	0.00
Profits (before tax and extraordinary items)	0.81	0.02	0.76	0.01	1.00	0.11	1.54	-0.06	0.79	-0.01
Profits (after tax and extraordinary items) (ROA)	0.63	0.04	0.59	0.02	0.77	0.11	1.20	-0.13	0.65	0.00
Return on equity										
Profits (after tax and extraordinary items) (% Tier 1) (ROE)	16.06	3.15	17.55	3.31	13.29	2.67	10.48	1.81	15.26	2.77
Income structure (% of total income)										
Net interest income	51.72	3.71	48.58	5.50	59.82	-1.09	57.40	7.66	58.51	10.08
Net non-interest income	48.28	-3.71	51.42	-5.50	40.18	1.09	42.60	-7.66	41.49	-10.08
Fees and commissions (net)	27.13	-0.02	28.43	-0.03	23.60	-0.10	27.59	0.64	25.50	-1.99
Trading and forex results/ gains (losses) on financial transactions	12.60	3.78	15.29	4.40	5.44	1.96	11.19	4.21	10.08	0.04
Other operating income (net)	5.37	-7.74	5.14	-10.11	6.12	-1.07	3.28	-12.65	5.22	-8.52
Expenditure structure (% of total costs)										
Staff costs	62.30	-1.06	59.62	-2.58	67.88	0.07	57.20	4.41	52.56	3.25
Administrative costs	29.01	-1.33	30.78	-0.97	25.12	-0.13	34.99	-4.76	36.48	-1.68
Other	8.69	2.39	9.60	3.56	7.00	0.06	7.80	0.35	10.96	-1.57
Efficiency										
Cost-to-income ratio (% of total income)	60.45	-3.17	61.68	-2.68	57.00	-4.40	62.29	-3.95	55.70	-6.18
Asset share of banks with a cost-to-income ratio of over 80%	1.38	0.17	0.00	0.00	3.00	1.50	18.09	-4.49	8.37	-8.17

Source: BSC.

Note: For the items "Net interest income" and "Net non-interest income" the sum of sub-items is smaller than the total amount because some countries only provided information on the total amount.

Table 4 EU banks in non-IFRS reporting countries: profitability and efficiency

(2005, changes from 2004 in percentage points)

	All domestic banks	Change from 2004	Large domestic banks	Change from 2004	Medium domestic banks	Change from 2004	Small domestic banks	Change from 2004	Foreign banks	Change from 2004
Income (% of total assets)										
Net interest income	1.17	-0.09	1.05	-0.07	1.38	-0.06	2.36	-0.17	0.80	-0.23
Interest receivable	3.98	0.23	3.77	0.37	4.63	0.05	4.51	-0.25	3.73	-0.10
Interest payable	2.81	0.32	2.72	0.44	3.25	0.11	2.15	-0.08	2.93	0.13
Net non-interest income	0.76	0.00	0.75	-0.01	0.71	0.02	1.28	0.09	0.75	0.09
Fees and commissions (net)	0.58	-0.02	0.56	-0.03	0.55	0.01	0.96	0.06	0.72	0.05
Trading and forex results	0.19	0.04	0.23	0.04	0.06	0.01	0.04	0.00	0.17	-0.02
Other operating income (net)	0.00	-0.02	-0.05	-0.01	0.10	0.00	0.28	0.02	-0.14	0.06
Total income	1.93	-0.09	1.79	-0.08	2.10	-0.04	3.64	-0.08	1.55	-0.14
Expenditure structure (% of total assets)										
Staff costs	0.70	-0.04	0.66	-0.05	0.71	-0.02	1.57	0.05	0.56	-0.04
Administrative costs	0.30	-0.03	0.24	-0.04	0.42	0.01	0.84	-0.01	0.23	-0.03
Other	0.06	-0.02	0.04	-0.02	0.12	0.00	0.22	-0.08	0.07	-0.04
Total expenses	1.06	-0.10	0.93	-0.10	1.25	-0.01	2.63	-0.04	0.86	-0.11
Profitability (% of total assets)										
Operating profits	0.86	0.01	0.86	0.02	0.85	-0.03	1.02	-0.04	0.69	-0.03
Specific provisions	0.17	-0.07	0.13	-0.07	0.24	-0.06	0.42	0.03	0.12	-0.01
Funds for general banking risks	0.08	0.00	0.05	0.00	0.18	0.02	0.26	0.12	0.07	-0.04
Extraordinary items (net)	0.00	0.03	-0.01	0.02	0.01	0.01	0.22	0.22	0.03	0.02
Tax charges	0.19	0.01	0.19	0.01	0.17	0.00	0.25	0.00	0.13	0.01
Profits (before tax and extraordinary items)	0.69	0.07	0.73	0.08	0.58	0.02	0.54	-0.11	0.61	0.01
Profits (after tax and extraordinary items) (ROA)	0.50	0.09	0.52	0.10	0.42	0.04	0.51	0.12	0.50	0.02
Return on equity										
Profits (after tax and extraordinary items) (% Tier 1) (ROE)	14.65	3.27	16.88	3.80	10.45	1.45	8.00	1.64	12.79	1.07
Income structure (% of total income)										
Net interest income	60.59	-1.79	58.39	-1.31	65.97	-1.43	64.75	-3.10	51.59	-9.51
Net non-interest income	39.41	1.79	41.61	1.31	34.03	1.43	35.25	3.10	48.41	9.51
Fees and commissions (net)	29.91	0.41	31.50	-0.38	26.19	0.95	26.41	2.28	46.56	6.82
Trading and forex results	9.76	2.24	12.92	2.58	2.89	0.43	1.08	0.10	10.96	-0.17
Other operating income (net)	-0.26	-0.86	-2.81	-0.89	4.96	0.05	7.75	0.71	-9.11	2.85
Expenditure structure (% of total costs)										
Staff costs	66.06	1.94	70.37	2.45	57.06	-0.87	59.72	2.77	65.43	2.75
Administrative costs	28.17	-0.49	25.60	-0.93	33.56	1.14	31.92	-0.02	26.27	0.04
Other	5.77	-1.45	4.03	-1.52	9.39	-0.27	8.37	-2.74	8.30	-2.79
Efficiency										
Cost-to-income ratio (% of total income)	55.20	-2.42	51.95	-3.30	59.62	0.58	72.10	0.57	55.30	-1.72
Asset share of banks with a cost-to-income ratio of over 80%	11.33	-2.35	12.70	-0.97	7.03	-12.40	23.87	-11.92	6.26	-63.37

Source: BSC.

Table 5 EU banks in IFRS reporting countries: balance sheet and off-balance sheet items

(2005, changes from 2004 in percentage points)

	All domestic banks	Change from 2004	Large domestic banks	Change from 2004	Medium domestic banks	Change from 2004	Small domestic banks	Change from 2004	Foreign banks	Change from 2004
Assets (% of total assets)										
Cash and balances	1.41	-0.24	1.23	-0.41	2.01	0.32	3.00	0.88	1.74	0.32
Loans to credit institutions	8.57	-4.65	8.59	-5.91	8.20	-0.70	16.44	-0.90	16.99	-4.24
Financial assets at fair value through profit or loss	29.77	8.19	34.04	10.24	14.64	-0.04	14.93	-0.37	31.53	8.11
Debt securities including fixed-income securities	6.87	0.80	6.99	0.88	6.32	0.51	9.90	0.57	11.53	-1.00
Shares and other variable-yield securities	2.74	-1.15	2.99	-1.44	1.87	-0.37	1.46	-0.04	1.16	-0.43
Loans to customers	51.77	-1.42	47.25	-1.51	68.05	0.58	60.04	5.34	43.93	-0.22
Tangible and intangible assets	1.80	0.10	1.72	0.14	2.05	0.01	3.23	0.19	0.79	-0.30
Other assets	6.13	-1.06	6.48	-1.51	4.99	0.17	2.33	-0.42	4.39	-2.77
Liquidity (% of amounts owed to credit institutions)										
Liquid asset ratio (cash and loans to cred. inst.)	66.91	-15.87	61.55	-18.31	90.48	-5.05	191.65	10.15	61.46	-3.19
Liabilities (% of total assets)										
Amounts owed to credit institutions	14.91	-3.05	15.95	-4.25	11.29	0.21	10.15	-0.58	30.47	-4.57
Amounts owed to customers	38.29	-4.01	35.16	-4.63	48.60	-0.90	69.25	7.07	27.31	-2.15
Debt certificates	17.74	-5.02	16.58	-6.39	22.54	-0.43	3.54	-0.35	17.26	0.15
Other liabilities	21.33	12.90	25.09	15.98	8.17	1.79	3.88	-0.95	18.63	7.88
Provisions for liabilities and charges	0.78	-0.26	0.80	-0.27	0.73	-0.24	0.36	-0.49	0.26	-0.18
Subordinated liabilities	2.05	-0.13	2.12	-0.05	1.83	-0.44	0.79	0.00	1.03	-0.20
Equity (including valuation adjustments)	3.94	-0.20	3.37	-0.09	5.77	-0.04	11.19	-4.08	4.36	-0.82
Minority interests in own funds	0.40	-0.10	0.41	-0.10	0.37	-0.11	0.17	-0.43	0.12	-0.07
Profit or loss for the financial year	0.55	0.04	0.51	0.00	0.71	0.20	0.68	-0.11	0.57	0.02
Selected off-balance sheet items (% of total assets)										
Credit lines	9.59	-4.46	8.47	-6.07	13.72	1.17	9.03	-3.33	25.48	-3.85
Guarantees and other commitments	7.85	-1.49	5.55	-0.25	16.03	-4.06	14.90	-9.56	8.96	0.53

Source: BSC.

Table 6 EU banks in non-IFRS reporting countries: balance sheet and off-balance sheet items

(2005, changes from 2004 in percentage points)

	All domestic banks	Change from 2004	Large domestic banks	Change from 2004	Medium domestic banks	Change from 2004	Small domestic banks	Change from 2004	Foreign banks	Change from 2004
Assets (% of total assets)										
Cash and balances	0.75	-0.09	0.57	-0.09	1.15	0.02	1.97	-0.05	0.78	0.16
Short-term government debt	1.27	-0.06	1.15	-0.11	1.80	0.13	0.73	0.00	0.86	-0.27
Loans to credit institutions	15.50	-0.98	14.92	-1.41	17.89	0.39	13.99	0.55	23.88	-0.87
Debt securities	16.99	-0.33	17.54	-0.32	15.42	-0.70	14.82	-0.47	12.16	0.32
Debt securities (public bodies)	2.17	0.11	2.74	0.24	0.50	-0.63	0.20	-0.08	4.79	-0.10
Debt securities (other borrowers)	3.29	0.44	3.41	0.44	3.24	0.42	1.11	0.13	7.37	0.52
Loans to customers	47.90	-0.90	46.02	-0.44	52.71	-0.96	58.24	-0.76	44.65	-1.45
Shares and participating interest	3.93	-0.01	3.46	-0.05	5.06	0.26	6.81	0.88	4.38	0.24
Tangible and intangible assets	1.61	-0.04	1.74	-0.07	1.14	-0.01	1.75	-0.25	1.01	-0.24
Other assets	12.05	2.41	14.61	2.49	4.82	0.87	1.69	0.08	12.29	2.12
Liquidity (% of amounts owed to credit institutions)										
Liquid asset ratio 1 (cash and short-term government debt)	10.20	-0.10	8.67	-0.13	14.42	0.50	18.01	0.15	4.48	-0.29
Liquid asset ratio 2 (ratio 1 + loans to cred. inst.)	88.62	0.12	83.92	0.14	101.84	0.90	111.36	5.97	69.71	-2.53
Liquid asset ratio 3 (ratio 2 + debt sec. by public bodies)	99.62	1.33	97.77	2.50	104.27	-2.26	112.69	5.46	82.80	-2.77
Liabilities (% of total assets)										
Amounts owed to credit institutions	19.77	-1.31	19.82	-1.95	20.47	0.35	14.98	-0.36	36.61	-0.07
Amounts owed to customers	38.92	-2.04	35.34	-2.24	45.65	0.61	71.44	0.09	32.98	-1.06
Debt certificates	19.74	-0.41	19.86	-0.43	22.47	-0.50	3.07	-0.08	9.00	0.26
Accruals and other liabilities	14.18	3.80	17.68	4.53	3.92	0.00	1.89	0.08	14.62	1.55
Funds for general banking risks	0.08	0.00	0.05	0.00	0.18	0.02	0.26	0.12	0.07	-0.04
Provisions for liabilities and charges	0.85	-0.24	0.74	-0.19	1.19	-0.35	1.10	0.06	0.56	-0.09
Subordinated liabilities	1.61	-0.08	1.62	-0.14	1.76	0.10	0.59	-0.10	1.29	-0.07
Equity	4.24	0.16	4.17	0.29	4.09	-0.19	6.51	0.21	4.53	-0.46
Other liabilities	0.35	0.04	0.45	0.05	0.06	-0.04	0.00	0.00	0.03	-0.01
Profit or loss for the financial year	0.25	0.06	0.26	0.07	0.21	0.00	0.16	-0.02	0.31	-0.01
Selected off-balance sheet items (% of total assets)										
Credit lines	18.53	2.00	22.45	1.89	7.20	-0.10	3.90	0.65	18.77	0.81
Guarantees and other commitments	3.97	0.06	4.45	0.04	2.49	-0.23	2.61	0.00	6.76	-6.00
Derivatives	3.16	0.45	3.70	0.78	1.76	-0.80	0.30	0.05	11.19	1.27

Source: BSC.

Note: For the item "debt securities", some countries provided information only on the total amount and not on the split between the two sub-items, i.e. "issued by public bodies" and "issued by other borrowers" and the sum of these two sub-items is therefore smaller than the total amount.

Table 7 EU banks in IFRS reporting countries: non-performing assets and provisioning¹⁾

(2005, changes from 2004 in percentage points)

	All domestic banks	Change from 2004	Large domestic banks	Change from 2004	Medium domestic banks	Change from 2004	Small domestic banks	Change from 2004	Foreign banks	Change from 2004
Asset quality (% of loans and advances)										
Non-performing and doubtful assets (gross)	2.80	0.14	3.07	0.45	2.11	-0.59	2.72	-1.61	2.11	-0.27
Asset quality (% of own funds)										
Non-performing and doubtful assets (gross)	42.62	4.55	50.17	9.03	27.84	-5.57	21.51	0.59	29.82	1.01
Non-performing and doubtful assets (net)	7.22	4.41	9.55	8.23	2.35	-3.51	6.66	4.12	10.15	2.64
Provisioning (stock) (% of loans and advances)										
Total provisions	2.33	-0.14	2.49	-0.05	1.93	-0.29	1.87	-1.92	1.39	-0.37
Provisioning (stock) (% of non-performing and doubtful assets)										
Total provisions	83.07	-9.57	80.97	-15.81	91.58	9.11	69.03	-18.81	65.95	-7.98

Source: BSC.

1) In accordance with International Accounting Standard (IAS) 39.

Table 8 EU banks in non-IFRS reporting countries: non-performing assets and provisioning

(2005, changes from 2004 in percentage points)

	All domestic banks	Change from 2004	Large domestic banks	Change from 2004	Medium domestic banks	Change from 2004	Small domestic banks	Change from 2004	Foreign banks	Change from 2004
Asset quality (% of loans and advances)										
Non-performing and doubtful assets (gross)	1.93	-0.85	1.13	-0.98	3.50	-0.14	6.56	-0.68	0.99	-0.40
Asset quality (% of own funds)										
Non-performing and doubtful assets (gross)	35.60	-14.30	22.13	-18.52	61.47	0.55	74.27	-10.23	17.21	-6.37
Non-performing and doubtful assets (net)	13.23	-8.72	4.52	-11.62	31.32	1.57	33.65	-6.85	8.17	-3.31
Provisioning (stock) (% of loans and advances)										
Total provisions	1.21	-0.34	0.90	-0.37	1.72	-0.14	3.59	-0.18	0.52	-0.19
Provisioning (stock) (% of non-performing and doubtful assets)										
Total provisions	62.84	6.83	79.56	19.28	49.04	-2.13	54.69	2.63	52.51	1.20

Source: BSC.

Table 9 EU banks in IFRS reporting countries: regulatory capital ratios and risk-adjusted items

(2005, changes from 2004 in percentage points)

	All domestic banks	Change from 2004	Large domestic banks	Change from 2004	Medium domestic banks	Change from 2004	Small domestic banks	Change from 2004	Foreign banks	Change from 2004		
Overall solvency ratio	11.38	0.04	11.05	0.16	11.95	-0.09	16.53	-1.69	13.04	-1.38		
Tier 1 ratio	8.16	-0.65	7.81	-0.63	8.71	-0.30	15.36	-7.06	11.12	-1.80		
Risk-adjusted items (% of total risk-adjusted assets)												
Banking book	84.57	3.26	82.04	1.53	90.72	7.61	82.07	1.41	80.81	1.25		
Off-balance-sheet items	10.37	-3.69	12.52	-1.79	5.18	-8.19	12.02	-4.83	9.03	-1.38		
Trading book	5.06	0.43	5.44	0.27	4.10	0.58	5.92	3.41	10.16	0.13		
	All banks	Change from 2004							All banks	Change from 2004		
Overall solvency ratio	11.57	-0.11	Risk-adjusted items (% of total risk-adjusted assets)									
Tier 1 ratio	8.49	-0.77	Banking book								84.16	3.04
Distribution of overall solvency ratio			Off-balance-sheet items								10.22	-3.44
Overall solvency ratio < 7%	0.01	-0.04	Trading book								5.62	0.41
Overall solvency ratio 7%-8%	0.00	-0.58	Composition of trading book own funds requirement (% of total trading book own funds requirement under CAD)									
Overall solvency ratio 8%-9%	2.79	-0.26	Own funds requirement for traded debt instruments								52.56	-4.36
Overall solvency ratio 9%-10%	11.65	2.49	Own funds requirement for equities								12.47	-0.75
Overall solvency ratio 10%-11%	37.43	14.40	Own funds requirement for foreign exchange risk								7.85	0.17
Overall solvency ratio 11%-13%	35.54	-17.11	Own funds requirement for other trading book items								27.12	4.94
Overall solvency ratio > 13%	12.58	1.11										
Overall solvency ratio below 9%												
Number of banks	42	-15										
Asset share (% of total banking sector assets)	4.12	0.58										

Source: BSC.

Table 10 EU banks in non-IFRS reporting countries: regulatory capital ratios and risk-adjusted items

(2005, changes from 2004 in percentage points)

	All domestic banks	Change from 2004	Large domestic banks	Change from 2004	Medium domestic banks	Change from 2004	Small domestic banks	Change from 2004	Foreign banks	Change from 2004		
Overall solvency ratio	12.19	-0.21	12.02	-0.10	12.32	-0.58	13.85	0.41	15.59	-0.78		
Tier 1 ratio	7.74	-0.28	7.37	-0.17	8.28	-0.50	10.29	0.21	11.27	-0.37		
Risk-adjusted items (% of total risk-adjusted assets)												
Banking book	81.68	-1.19	77.67	-0.95	91.10	0.00	94.50	-0.04	70.80	-2.95		
Off-balance-sheet items	10.43	0.82	12.30	0.88	5.96	-0.15	4.73	0.10	10.01	0.29		
Trading book	7.89	0.37	10.03	0.06	2.94	0.15	0.77	-0.06	19.19	2.66		
	All banks	Change from 2004							All banks	Change from 2004		
Overall solvency ratio	12.57	-0.24	Risk-adjusted items (% of total risk-adjusted assets)									
Tier 1 ratio	8.13	-0.26	Banking book								80.47	-1.48
Distribution of overall solvency ratio												
Overall solvency ratio < 7%	0.24	0.24	Off-balance-sheet items								10.38	0.77
Overall solvency ratio 7%-8%	0.00	0.00	Trading book								9.15	0.71
Overall solvency ratio 8%-9%	4.50	3.53	Composition of trading book own funds requirement (% of total trading book own funds requirement under CAD)									
Overall solvency ratio 9%-10%	10.52	-0.75	Own funds requirement for traded debt instruments								28.96	-0.04
Overall solvency ratio 10%-11%	24.51	6.73	Own funds requirement for equities								31.90	1.88
Overall solvency ratio 11%-13%	44.56	-4.32	Own funds requirement for foreign exchange risk								5.45	-0.05
Overall solvency ratio > 13%	15.67	-5.44	Own funds requirement for other trading book items								33.52	-1.84
Overall solvency ratio below 9%												
Number of banks	90	52										
Asset share (% of total banking sector assets)	8.22	7.38										

Source: BSC.

Table II Key country-level indicators for banks in IFRS reporting countries: all domestic banks

(2005)									
	CY	CZ	DK	EE	ES	FI	FR	GR	
Profitability (% of total assets, if not otherwise indicated)									
Net interest income	2.22	1.19	1.13	4.65	1.55	1.50	0.88	2.78	
Net non-interest income	0.92	2.22	0.64	1.65	1.10	0.93	1.24	1.26	
Total expenses	1.81	1.82	0.98	3.33	1.46	1.41	1.33	2.22	
Profits (after tax and extraordinary items) (ROA)	0.49	1.30	0.66	2.64	0.88	0.78	0.55	1.04	
Profits (after tax and extraordinary items) (% Tier 1) (ROE)	8.36	17.71	14.01	8.64	17.17	11.61	18.69	15.63	
Net interest income (% of total income)	70.58	34.95	63.78	73.82	58.41	61.80	41.55	68.85	
Net non-interest income (% of total income)	29.42	65.05	36.22	26.18	41.59	38.20	58.45	31.15	
Cost-to-income ratio (% of total income)	57.70	53.09	54.95	52.83	54.93	58.12	62.42	54.90	
Solvency									
Overall solvency ratio	13.60	23.43	11.65	41.98	11.77	14.00	11.21	13.33	
Tier 1 ratio	10.49	22.11	9.23	39.96	7.92	11.82	7.95	10.99	
Liquidity (% of amounts owed to credit institutions)									
Liquid asset ratio (cash and loans to credit institutions)	868.45	123.01	68.53	435.02	65.83	246.29	64.85	98.19	
Balance sheet structure (% of total assets)									
Debt securities	19.20	15.87	14.89	0.04	20.32	4.72	51.43	19.93	
Loans to customers	54.00	48.64	68.15	63.26	64.10	70.73	33.61	59.84	
Amounts owed to credit institutions	2.78	27.39	16.29	6.95	14.51	4.68	11.94	13.29	
Amounts owed to customers	84.34	35.02	26.03	34.33	51.31	50.49	26.96	61.56	
Subordinated liabilities	3.01	0.55	1.82	1.54	2.75	2.08	1.56	1.68	
	IE	IT	LT	LV	MT	NL	PL	PT	SK
Profitability (% of total assets, if not otherwise indicated)									
Net interest income	0.96	1.44	2.02	2.71	2.19	1.07	3.55	1.76	3.31
Net non-interest income	0.59	1.48	1.57	2.50	1.13	0.90	1.98	1.45	1.29
Total expenses	0.80	1.74	2.15	2.94	1.59	1.35	3.67	1.96	2.57
Profits (after tax and extraordinary items) (ROA)	0.61	0.63	0.82	1.91	0.92	0.47	1.36	0.82	1.44
Profits (after tax and extraordinary items) (% Tier 1) (ROE)	19.34	13.30	12.34	27.23	13.53	14.68	18.68	15.55	9.52
Net interest income (% of total income)	61.87	49.20	56.24	52.01	65.87	54.17	64.15	54.86	72.01
Net non-interest income (% of total income)	38.13	50.80	43.76	47.99	34.13	45.83	35.85	45.14	27.99
Cost-to-income ratio (% of total income)	51.27	59.79	60.00	56.50	47.88	68.45	66.29	61.11	55.88
Solvency									
Overall solvency ratio	11.10	10.16	13.33	11.40	17.37	12.31	14.62	11.38	21.70
Tier 1 ratio	7.68	7.29	9.54	10.47	14.16	9.24	14.93	7.63	23.41
Liquidity (% of amounts owed to credit institutions)									
Liquid asset ratio (cash and loans to credit institutions)	56.34	69.67	320.11	277.16	98.71	59.10	231.78	110.83	175.06
Balance sheet structure (% of total assets)									
Debt securities	26.56	20.91	12.19	16.54	41.45	19.98	23.86	12.94	22.85
Loans to customers	56.78	58.18	43.96	45.09	38.59	55.56	49.04	68.62	57.70
Amounts owed to credit institutions	22.09	16.50	9.33	12.54	15.24	17.79	9.90	11.00	8.94
Amounts owed to customers	27.16	40.22	75.89	71.59	72.89	42.36	73.76	50.88	67.47
Subordinated liabilities	2.32	2.70	0.25	0.65	0.88	1.54	0.34	3.17	0.00

Source: BSC.

Table 12 Key country-level indicators for banks in non-IFRS reporting countries: all domestic banks

(2005)

	AT	BE	DE	HU	LU	SI	SE	UK
Profitability (% of total assets, if not otherwise indicated)								
Net interest income	1.56	0.93	0.85	5.24	0.79	2.39	1.02	1.58
Net non-interest income	0.85	0.66	0.76	1.65	1.34	1.87	0.84	0.74
Total expenses	1.54	1.03	1.11	3.29	1.25	2.47	1.03	0.94
Profits (after tax and extraordinary items) (ROA)	0.61	0.45	0.28	2.66	0.56	0.79	0.65	0.76
Profits (after tax and extraordinary items) (% Tier 1) (ROE)	14.90	15.34	9.44	35.42	9.83	16.19	19.51	18.56
Net interest income (% of total income)	64.65	58.20	52.98	76.03	37.05	56.09	55.04	68.04
Net non-interest income (% of total income)	35.35	41.80	47.02	23.97	62.95	43.91	44.96	31.96
Cost-to-income ratio (% of total income)	63.71	64.91	68.65	47.79	58.84	57.85	55.50	40.49
Solvency								
Overall solvency ratio	11.34	11.72	11.46	13.06	19.35	9.67	9.91	13.41
Tier 1 ratio	7.68	8.52	7.48	12.61	16.03	6.55	7.07	7.91
Liquidity (% of amounts owed to credit institutions)								
Liquid asset ratio 1 (cash and short-term government debt)	37.65	2.54	5.79	233.07	24.96	13.10	33.88	20.90
Liquid asset ratio 2 (ratio 1 + loans to credit institutions)	125.26	67.49	77.41	405.51	156.57	45.39	105.65	150.36
Liquid asset ratio 3 (ratio 2 + debt securities issued by public bodies)	125.40	113.86	77.41	406.10	163.33	109.49	105.65	201.19
Debt securities	3.18	25.99	23.85	1.24	25.43	26.68	9.35	9.12
Loans to customers	49.65	42.84	41.49	55.11	22.16	54.34	57.80	55.64
Shares and participating interest	10.64	2.41	4.87	1.24	0.83	3.21	1.43	2.64
Amounts owed to credit institutions	22.86	29.30	29.09	8.90	29.69	23.66	13.18	6.20
Amounts owed to customers	40.12	47.34	34.26	64.73	42.67	59.07	29.68	44.34
Subordinated liabilities	2.75	1.93	1.36	0.95	1.50	2.63	2.46	1.57

Source: BSC.

Table 13 Key country-level indicators for banks in IFRS reporting countries: all domestic banks

(2005, changes from 2004 in percentage points)

	CY	CZ	DK	EE	ES	FI	FR	GR	
Profitability (% of total assets, if not otherwise indicated)									
Net interest income	-0.18	-0.11	0.07	2.22	-0.06	-0.33	0.19	-0.10	
Net non-interest income	-0.05	0.69	0.12	-0.50	0.03	0.02	-0.63	-0.10	
Total expenses	-0.25	-0.16	0.10	-0.05	-0.09	-0.15	-0.36	-0.52	
Profits (after tax and extraordinary items) (ROA)	0.26	0.69	0.11	1.80	0.13	-0.08	0.00	0.46	
Profits (after tax and extraordinary items) (% Tier 1) (ROE)	4.48	9.00	1.65	3.18	2.74	0.41	6.07	6.50	
Net interest income (% of total income)	-0.67	-11.07	-3.30	20.77	-1.68	-4.90	14.42	0.90	
Net non-interest income (% of total income)	0.67	11.07	3.30	-20.77	1.68	4.90	-14.42	-0.90	
Cost-to-income ratio (% of total income)	-3.37	-16.50	-0.21	-20.83	-2.71	1.01	-3.37	-9.58	
Solvency									
Overall solvency ratio	-0.10	-2.63	-1.37	9.12	-0.40	-0.88	0.96	0.34	
Tier 1 ratio	0.34	-2.06	-1.28	10.27	-0.05	-0.78	-1.36	0.90	
Liquidity (% of amounts owed to credit institutions)									
Liquid asset ratio (cash and loans to credit institutions)	282.47	21.19	-7.68	-3245.78	-5.91	120.72	-27.35	-57.85	
Balance sheet structure (% of total assets)									
Debt securities	-0.79	2.43	-8.47	-3.93	0.18	0.53	24.38	1.86	
Loans to customers	-3.31	1.09	8.74	25.83	0.44	-7.26	-5.86	-1.39	
Amounts owed to credit institutions	-0.52	-7.63	3.73	5.59	1.24	0.45	-11.95	4.35	
Amounts owed to customers	0.74	6.60	3.89	-40.39	-3.87	-8.65	-5.92	-9.00	
Subordinated liabilities	-0.68	-0.05	0.39	-0.57	-0.33	0.42	-0.30	-0.08	
	IE	IT	LT	LV	MT	NL	PL	PT	SK
Profitability (% of total assets, if not otherwise indicated)									
Net interest income	-0.06	-0.49	-0.04	0.33	0.13	-0.31	-0.31	-0.10	-0.29
Net non-interest income	-0.14	-0.35	0.11	-0.07	0.15	-0.09	-0.13	0.17	0.47
Total expenses	-0.16	-0.64	-0.54	-0.15	0.03	-0.26	-0.41	-0.34	0.13
Profits (after tax and extraordinary items) (ROA)	-0.05	0.02	0.25	0.47	0.13	-0.03	0.04	0.25	0.41
Profits (after tax and extraordinary items) (% Tier 1) (ROE)	-1.64	2.00	5.20	4.40	0.67	1.44	-0.31	6.04	2.98
Net interest income (% of total income)	3.77	-1.98	-2.24	3.91	-1.71	-4.05	-0.49	-4.26	-9.45
Net non-interest income (% of total income)	-3.77	1.98	2.24	-3.91	1.71	4.05	0.49	4.26	9.45
Cost-to-income ratio (% of total income)	-3.19	-3.59	-16.58	-6.14	-3.50	0.61	-1.93	-12.18	0.61
Solvency									
Overall solvency ratio	0.00	-0.95	0.99	-0.58	1.94	0.49	-0.98	1.17	-4.00
Tier 1 ratio	-0.42	-0.59	-1.61	-0.32	1.36	-0.28	-0.72	-0.56	-3.36
Liquidity (% of amounts owed to credit institutions)									
Liquid asset ratio (cash and loans to credit institutions)	5.14	-19.35	-104.42	-138.96	27.70	-6.30	-83.10	-0.13	50.72
Balance sheet structure (% of total assets)									
Debt securities	0.12	10.25	2.30	0.88	-4.63	-2.51	-0.94	0.80	-4.74
Loans to customers	-1.32	-1.74	2.99	4.05	-0.92	-0.11	-0.44	-1.45	3.37
Amounts owed to credit institutions	0.39	2.76	0.87	3.01	0.56	-0.77	3.09	-0.12	-2.48
Amounts owed to customers	-1.47	-4.29	-4.56	-4.92	-0.91	-5.11	-0.98	-2.97	2.86
Subordinated liabilities	0.37	-0.23	-0.06	-0.14	-0.55	0.05	0.08	-0.25	0.00

Source: BSC.

Table 14 Key country-level indicators for banks in non-IFRS reporting countries: all domestic banks

(2005, changes from 2004 in percentage points)

	AT	BE	DE	HU	LU	SI	SE	UK
Profitability (% of total assets, if not otherwise indicated)								
Net interest income	-0.16	-0.18	-0.09	-0.46	0.07	-0.31	-0.27	-0.17
Net non-interest income	-0.01	-0.07	0.01	0.29	-0.04	-0.07	0.06	-0.01
Total expenses	-0.13	-0.15	-0.06	-0.28	-0.22	-0.40	-0.17	-0.11
Profits (after tax and extraordinary items) (ROA)	-0.03	-0.03	0.16	0.01	-0.08	0.07	0.00	-0.06
Profits (after tax and extraordinary items) (% Tier 1) (ROE)	0.00	1.20	5.57	0.69	-4.22	2.77	3.46	0.52
Net interest income (% of total income)	-1.95	-2.06	-2.88	-4.71	2.60	-2.08	-7.59	-1.96
Net non-interest income (% of total income)	1.95	2.06	2.88	4.71	-2.60	2.08	7.59	1.96
Cost-to-income ratio (% of total income)	-0.70	0.54	-0.24	-2.81	-11.11	-3.84	-2.55	-1.45
Solvency								
Overall solvency ratio	-0.49	-1.35	-0.37	-0.11	0.31	-1.62	-0.69	0.02
Tier 1 ratio	-0.34	-0.93	-0.03	-1.04	0.69	-1.15	-1.32	-0.38
Liquidity (% of amounts owed to credit institutions)								
Liquid asset ratio 1 (cash and short-term government debt)	0.68	-2.13	-0.56	-45.07	-14.69	-3.66	2.43	6.74
Liquid asset ratio 2 (ratio 1 + loans to credit institutions)	-1.94	-7.76	-3.37	-36.03	-2.40	-14.64	12.28	37.46
Liquid asset ratio 3 (ratio 2 + debt securities issued by public bodies)	-1.84	-26.74	-3.37	-36.25	-15.32	-55.97	12.28	56.09
Balance sheet structure (% of total assets)								
Debt securities	-0.48	-0.56	1.01	0.05	3.00	-1.46	1.47	-0.30
Loans to customers	-0.69	0.26	-1.42	0.76	4.86	0.84	-4.47	-2.37
Shares and participating interest	-0.34	-0.11	0.45	0.18	-0.26	-0.15	0.53	-0.50
Amounts owed to credit institutions	0.47	5.66	1.46	0.53	-4.13	7.05	-1.30	-3.86
Amounts owed to customers	-2.79	-2.22	-0.92	-2.08	-2.72	-5.61	0.75	-6.73
Subordinated liabilities	0.00	-0.29	-0.16	0.38	-0.67	0.08	0.54	-0.09

Source: BSC.

Table 15 Key country-level indicators for banks in IFRS reporting countries: all banks

(2005)									
	CY	CZ	DK	EE	ES	FI	FR	GR	
Profitability (% of total assets, if not otherwise indicated)									
Net interest income	1.93	2.26	1.13	2.30	1.50	1.28	0.85	2.68	
Net non-interest income	0.75	1.73	0.64	1.45	1.06	0.57	1.18	1.19	
Total expenses	1.57	2.27	0.97	1.75	1.42	1.00	1.26	2.21	
Profits (after tax and extraordinary items) (ROA)	0.40	1.29	0.65	1.77	0.83	0.80	0.55	0.94	
Profits (after tax and extraordinary items) (% Tier 1) (ROE)	7.04	24.13	14.18	24.55	17.04	10.24	19.06	15.82	
Net interest income (% of total income)	72.03	56.66	63.93	61.42	58.47	69.18	41.88	69.14	
Net non-interest income (% of total income)	27.97	43.34	36.07	38.58	41.53	30.82	58.12	30.86	
Cost-to-income ratio (% of total income)	58.79	56.87	55.00	46.60	55.52	53.99	61.99	57.11	
Solvency									
Overall solvency ratio	13.39	11.58	11.47	10.71	11.80	17.18	11.22	13.24	
Tier 1 ratio	10.15	11.10	9.07	10.01	7.98	14.86	8.02	10.90	
Liquidity (% of amounts owed to credit institutions)									
Liquid asset ratio (cash and loans to credit institutions)	238.28	226.48	76.18	67.94	53.87	172.75	60.74	100.47	
Balance sheet structure (% of total assets)									
Debt securities	20.23	22.63	15.65	5.26	21.58	14.22	50.81	18.53	
Loans to customers	51.44	40.36	66.80	75.29	62.04	53.70	33.90	58.89	
Amounts owed to credit institutions	10.89	14.59	16.36	23.99	19.74	14.48	12.54	15.96	
Amounts owed to customers	70.76	64.61	26.39	55.27	48.52	36.99	25.27	61.85	
Subordinated liabilities	2.87	0.38	1.76	0.51	2.54	1.72	1.54	1.50	
	IE	IT	LT	LV	MT	NL	PL	PT	SK
Profitability (% of total assets, if not otherwise indicated)									
Net interest income	0.81	1.45	1.99	2.46	1.38	1.06	3.18	1.76	2.12
Net non-interest income	0.52	1.47	0.98	1.93	0.66	0.90	2.32	1.39	0.91
Total expenses	0.63	1.76	1.75	2.33	0.71	1.32	3.38	1.88	1.99
Profits (after tax and extraordinary items) (ROA)	0.56	0.61	0.87	1.69	0.97	0.48	1.58	0.85	0.99
Profits (after tax and extraordinary items) (% Tier 1) (ROE)	14.70	13.07	17.19	27.29	14.86	14.97	20.14	15.61	17.46
Net interest income (% of total income)	61.06	49.60	66.85	56.08	67.72	53.98	57.80	55.85	70.06
Net non-interest income (% of total income)	38.94	50.40	33.15	43.92	32.28	46.02	42.20	44.15	29.94
Cost-to-income ratio (% of total income)	47.64	60.08	58.98	53.19	34.70	67.43	61.42	59.59	65.82
Solvency									
Overall solvency ratio	12.66	10.13	9.82	9.99	20.47	12.20	14.55	11.32	14.66
Tier 1 ratio	9.69	7.30	7.24	8.67	18.81	9.21	14.40	7.87	15.35
Liquidity (% of amounts owed to credit institutions)									
Liquid asset ratio (cash and loans to credit institutions)	59.63	69.07	57.41	81.00	34.83	56.65	191.04	82.55	150.03
Balance sheet structure (% of total assets)									
Debt securities	35.80	20.88	12.10	10.10	42.77	19.00	25.78	11.96	24.88
Loans to customers	44.78	58.20	67.37	62.73	40.68	56.38	47.85	70.06	37.95
Amounts owed to credit institutions	26.71	16.89	29.42	29.58	34.86	18.94	11.58	14.72	23.16
Amounts owed to customers	22.77	39.69	57.35	56.98	39.26	41.71	69.08	48.84	59.78
Subordinated liabilities	1.79	2.58	0.67	0.98	2.77	1.50	0.55	3.00	0.08

Source: BSC.

Table 16 Key country-level indicators for banks in non-IFRS reporting countries: all banks

(2005)

	AT	BE	DE	HU	LU	SI	SE	UK
Profitability (% of total assets, if not otherwise indicated)								
Net interest income	1.56	0.96	0.85	4.23	0.47	2.29	1.05	1.41
Net non-interest income	0.94	0.64	0.76	1.58	0.98	1.68	0.84	0.71
Total expenses	1.58	1.06	1.11	3.21	0.74	2.41	1.04	0.89
Profits (after tax and extraordinary items) (ROA)	0.63	0.50	0.28	1.80	0.51	0.68	0.66	0.69
Profits (after tax and extraordinary items) (% Tier 1) (ROE)	15.74	16.79	9.44	24.75	12.64	13.42	19.53	16.93
Net interest income (% of total income)	62.42	59.98	52.98	72.81	32.31	57.67	55.65	66.42
Net non-interest income (% of total income)	37.58	40.02	47.02	27.19	67.69	42.33	44.35	33.58
Cost-to-income ratio (% of total income)	63.29	65.61	68.65	55.18	51.22	60.84	55.32	41.75
Solvency								
Overall solvency ratio	11.52	11.49	11.46	11.98	15.51	9.94	9.99	14.01
Tier 1 ratio	7.77	8.48	7.48	10.62	13.10	7.12	7.17	8.44
Liquidity (% of amounts owed to credit institutions)								
Liquid asset ratio 1 (cash and short-term government debt)	34.41	2.37	5.79	78.76	5.96	9.05	33.88	9.51
Liquid asset ratio 2 (ratio 1 + loans to credit institutions)	116.72	67.50	77.41	149.82	104.80	39.00	105.67	90.68
Liquid asset ratio 3 (ratio 2 + debt securities issued by public bodies)	117.34	113.16	77.41	149.94	124.22	90.89	105.67	115.32
Balance sheet structure (% of total assets)								
Debt securities	3.23	25.39	23.85	1.11	27.87	24.97	9.31	8.10
Loans to customers	49.67	43.47	41.49	62.18	21.08	56.20	57.95	55.44
Shares and participating interest	11.73	2.13	4.87	0.75	1.30	2.60	1.42	3.12
Amounts owed to credit institutions	24.23	30.00	29.09	20.20	43.38	29.79	13.13	11.64
Amounts owed to customers	40.38	47.48	34.26	59.01	37.15	54.52	29.85	40.84
Subordinated liabilities	2.90	1.81	1.36	1.45	1.22	2.22	2.46	1.46

Source: BSC.

Table 17 Key country-level indicators for banks in IFRS reporting countries: all banks

(2005, changes from 2004 in percentage points)

	CY	CZ	DK	EE	ES	FI	FR	GR	
Profitability (% of total assets, if not otherwise indicated)									
Net interest income	-0.26	-0.01	0.07	-0.54	-0.07	-0.01	0.20	-0.12	
Net non-interest income	-0.31	-0.77	0.11	-0.30	0.03	-0.06	-0.69	-0.09	
Total expenses	-0.24	-0.73	0.08	-0.51	-0.09	-0.09	-0.41	-0.50	
Profits (after tax and extraordinary items) (ROA)	-0.07	0.00	0.11	-0.25	0.12	0.09	0.00	0.46	
Profits (after tax and extraordinary items) (% Tier 1) (ROE)	-0.21	-0.69	1.11	-0.19	2.80	1.97	6.44	7.48	
Net interest income (% of total income)	4.63	9.06	-3.05	-0.60	-1.82	2.06	15.87	0.72	
Net non-interest income (% of total income)	-4.63	-9.06	3.05	0.60	1.82	-2.06	-15.87	-0.72	
Cost-to-income ratio (% of total income)	2.85	-5.95	-0.92	-2.57	-2.99	-2.82	-4.02	-9.33	
Solvency									
Overall solvency ratio	-2.82	-0.33	-1.50	-0.76	-0.42	-2.19	0.80	0.41	
Tier 1 ratio	-1.91	-0.49	-1.26	-1.06	-0.06	-1.87	-1.55	0.89	
Liquidity (% of amounts owed to credit institutions)									
Liquid asset ratio (cash and loans to credit institutions)	32.04	-2.90	4.22	-38.08	-5.46	-1.84	-27.20	-34.56	
Balance sheet structure (% of total assets)									
Debt securities	-0.90	3.25	-7.20	-0.99	0.28	11.98	23.62	1.08	
Loans to customers	-2.72	0.27	9.01	2.04	0.65	0.54	-5.70	-1.30	
Amounts owed to credit institutions	0.42	0.13	-0.58	8.50	1.25	1.37	-11.72	4.06	
Amounts owed to customers	-0.77	-0.13	3.10	-1.94	-3.60	-3.15	-5.71	-7.87	
Subordinated liabilities	-0.50	0.08	0.38	0.21	-0.30	0.20	-0.30	-0.06	
	IE	IT	LT	LV	MT	NL	PL	PT	SK
Profitability (% of total assets, if not otherwise indicated)									
Net interest income	-0.16	-0.46	-0.25	-0.06	-0.07	-0.32	0.09	-0.12	-0.60
Net non-interest income	-0.17	-0.35	-0.27	-0.21	-0.13	-0.07	-0.05	0.14	-0.07
Total expenses	-0.20	-0.61	-0.58	-0.34	-0.14	-0.26	-0.18	-0.37	-0.28
Profits (after tax and extraordinary items) (ROA)	-0.12	0.01	-0.07	0.18	-0.11	-0.03	0.26	0.29	-0.06
Profits (after tax and extraordinary items) (% Tier 1) (ROE)	-0.49	1.78	0.91	4.46	-1.47	1.63	3.61	6.37	1.86
Net interest income (% of total income)	2.58	-1.54	2.72	2.00	2.71	-4.65	1.28	-4.12	-3.61
Net non-interest income (% of total income)	-2.58	1.54	-2.72	-2.00	-2.71	4.65	-1.28	4.12	3.61
Cost-to-income ratio (% of total income)	-2.50	-3.36	-7.91	-4.21	-2.95	0.17	-3.67	-12.11	4.38
Solvency									
Overall solvency ratio	-0.61	-1.00	-1.60	-1.50	-0.63	0.33	-0.88	1.13	-3.98
Tier 1 ratio	-0.82	-0.64	-1.40	-1.58	0.80	-0.36	-0.95	-0.52	-3.67
Liquidity (% of amounts owed to credit institutions)									
Liquid asset ratio (cash and loans to credit institutions)	6.52	-18.17	-24.66	-55.21	-13.33	-6.69	-11.32	-5.89	-21.13
Balance sheet structure (% of total assets)									
Debt securities	6.51	9.83	0.32	-1.73	-1.99	-2.29	0.23	0.64	-9.15
Loans to customers	-6.18	-1.49	1.99	7.14	0.99	0.73	-0.08	-1.47	2.38
Amounts owed to credit institutions	-3.07	2.85	7.15	8.32	12.03	-1.90	0.91	1.19	7.16
Amounts owed to customers	-3.38	-4.19	-6.57	-7.81	-3.11	-4.39	0.95	-3.57	-7.23
Subordinated liabilities	-0.01	-0.27	0.00	0.11	-1.08	0.05	-0.03	-0.24	0.04

Source: BSC.

Table 18 Key country-level indicators for banks in non-IFRS reporting countries: all banks

(2005, changes from 2004 in percentage points)

	AT	BE	DE	HU	LU	SI	SE	UK
Profitability (% of total assets, if not otherwise indicated)								
Net interest income	-0.14	-0.17	-0.09	-0.34	-0.11	-0.36	-0.37	-0.18
Net non-interest income	0.00	-0.06	0.01	0.03	0.16	-0.13	0.08	0.01
Total expenses	-0.12	-0.15	-0.06	-0.22	-0.01	-0.42	-0.26	-0.10
Profits (after tax and extraordinary items) (ROA)	0.03	0.03	0.16	-0.09	0.04	0.06	0.02	-0.07
Profits (after tax and extraordinary items) (% Tier 1) (ROE)	1.27	2.98	5.57	-0.16	1.27	1.95	3.27	0.18
Net interest income (% of total income)	-2.09	-1.75	-2.88	-1.88	-9.04	-1.68	-9.59	-2.84
Net non-interest income (% of total income)	2.09	1.75	2.88	1.88	9.04	1.68	9.59	2.84
Cost-to-income ratio (% of total income)	-1.34	0.28	-0.24	-0.81	-2.72	-2.62	-4.78	-1.18
Solvency								
Overall solvency ratio	-0.36	-1.44	-0.37	-0.24	-1.38	-1.17	-0.83	-0.07
Tier 1 ratio	-0.16	-0.90	-0.03	-0.55	-0.82	-0.63	-1.45	-0.37
Liquidity (% of amounts owed to credit institutions)								
Liquid asset ratio 1 (cash and short-term government debt)	0.20	-1.61	-0.56	-13.03	-2.26	-3.39	5.82	1.41
Liquid asset ratio 2 (ratio 1 + loans to credit institutions)	-1.60	-9.57	-3.37	-6.50	-12.32	-9.46	16.65	10.58
Liquid asset ratio 3 (ratio 2 + debt securities issued by public bodies)	-1.73	-27.25	-3.37	-6.55	-9.43	-38.56	16.65	14.68
Balance sheet structure (% of total assets)								
Debt securities	-0.38	-1.01	1.01	-0.10	3.35	-1.52	1.67	-0.31
Loans to customers	-0.88	0.92	-1.42	0.86	0.51	0.75	-3.31	-2.69
Shares and participating interest	-0.12	-0.05	0.45	0.05	0.18	-0.21	0.56	-0.41
Amounts owed to credit institutions	0.60	5.35	1.46	0.62	0.88	8.17	-3.09	-3.34
Amounts owed to customers	-1.95	-2.54	-0.92	-0.73	-0.30	-6.47	1.08	-5.73
Subordinated liabilities	-0.05	-0.30	-0.16	0.27	-0.04	-0.14	0.64	-0.09

Source: BSC.

Table 19 44 EU banks' ratings (August 2006)

	Moody's	S&P	Fitch	total
Ratings available out of sample	44	42	44	130
Outlooks/watch available	45	42	44	131
Rating average	3.75	4.74	4.25	4.24
Outlook/watch average	0.02	0.19	0.07	0.09
Standard deviation of outlook average	0.26	0.51	0.254	0.36
Number of negative outlooks	1	2	0	3
Number of positive outlooks	2	10	3	15
Rating of positive outlook (average)	3	5.25	5	4.42
Rating of negative outlook (average)		5		5

Rating codes	Moody's	S&P	Fitch	numerical equivalent
	Aaa	AAA	AAA	1
	Aa1	AA+	AA+	2
	Aa2	AA	AA	3
	Aa3	AA-	AA-	4
	A1	A+	A+	5
	A2	A	A	6
	A3	A-	A-	7
	Baa1	BBB+	BBB+	8
	Baa2	BBB	BBB	9
	Baa3	BBB-	BBB-	10
	Ba1	BB+	BB+	11
	Ba2	BB	BB	12
	Ba3	BB-	BB-	13

Sources: Moody's, Standard and Poor's, Fitch Ratings and ECB calculations.

Table 20 Selected indicators of large EU banks' asset quality, profitability and solvency

(%)	Minimum	1st quartile	Median	Average	Weighted average	3rd quartile	Maximum
Return on equity							
H1 2006	9.10	17.83	19.75	20.16	20.77	22.70	45.00
2005	5.00	14.97	17.92	17.94	18.26	20.98	37.00
2004	0.80	10.51	16.65	16.25	16.77	20.55	33.20
Net interest income (% total assets)							
H1 2006	0.20	0.72	1.11	1.15	1.06	1.72	2.11
2005	0.18	0.72	1.16	1.20	1.07	1.82	2.32
2004	0.22	0.86	1.26	1.26	1.17	1.75	2.48
Net interest income (% total income)							
H1 2006	25.04	39.52	50.32	49.78	47.31	55.67	73.84
2005	24.41	46.51	53.40	51.74	47.88	59.01	76.20
2004	24.04	47.62	53.22	1.26	50.83	61.36	105.18
Trading income (% total income)							
H1 2006	0.00	5.11	10.41	11.58	14.20	14.40	34.26
2005	-13.99	3.02	7.53	9.39	12.68	11.31	40.78
2004	0.78	0.06	8.06	11.38	14.14	11.69	57.09
Fees and commissions (% total income)							
H1 2006	3.56	17.84	27.17	26.37	25.99	35.65	41.58
2005	2.45	22.42	24.77	25.88	25.50	34.15	41.23
2004	3.98	22.91	26.43	26.99	27.01	33.91	44.10
Other income (% total income)							
H1 2006	-0.77	3.50	8.19	12.27	12.51	17.83	35.86
2005	-16.29	6.68	9.73	12.99	13.94	18.26	59.75
2004	-48.64	2.90	5.18	6.47	8.01	10.68	35.99
Impairments (% total assets)							
H1 2006	-0.01	0.03	0.09	0.14	0.15	0.27	0.49
2005	-0.04	0.03	0.09	0.13	0.14	0.22	0.52
2004	0.00	0.05	0.12	0.18	0.17	0.24	1.10
Cost-to-income ratio							
H1 2006	24.30	50.13	54.15	53.83	55.97	60.25	77.70
2005	26.38	54.33	59.32	58.40	59.79	63.76	80.42
2004	21.70	54.50	60.14	60.02	61.34	67.13	84.39
Tier 1 ratio							
H1 2006	5.94	7.20	7.60	7.92	7.96	8.63	11.40
2005	6.30	7.23	7.60	8.06	8.13	8.10	12.40
2004	6.30	7.33	7.83	8.02	7.96	8.30	11.90
Overall solvency ratio							
H1 2006	9.30	10.05	10.80	11.22	11.40	11.83	15.70
2005	9.20	10.35	11.00	11.52	11.67	12.48	16.90
2004	9.21	10.42	11.20	11.58	11.55	12.23	19.60

Sources: Bureau van Dijk (Bankscope), published financial accounts of individual institutions and ECB calculations.

Note: Data for the first half of 2006 (H1 2006) are annualised.

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