VII. The financial sector

Highlights

Financial sectors across the industrialised world registered stronger performance during the period under review. Commercial banks, having proved resilient to the recent economic slowdown, posted higher earnings supported by reduced credit losses. The improvement in countries with a recent history of banking sector strains was due partly to action taken to tackle long-standing problems and partly to a more benign macroeconomic background. Similarly, insurance companies made some progress in repairing their damaged finances, helped by favourable developments in asset markets.

While a firming recovery had an important influence on the performance of financial institutions, a number of structural factors continued to play a key role. Banking firms' efforts to enhance efficiency through the rationalisation of operations, consolidation and the adoption of new technologies bore fruit in the form of an improved cost base. In addition, the development and deepening of securitisation and risk transfer markets helped financial systems to spread strains across a larger and more diverse set of players, strengthening their resilience to adverse shocks.

Looking forward, the main concern is whether the financial sector, having escaped the slowdown relatively unscathed, might be moving ahead of the business cycle. In the pursuit of profitable uses for their accumulated capital, some institutions may have undertaken investments premised on tenuous assumptions regarding the outlook for growth and the level of interest rates.

Performance of the financial sector

Stronger performance in an improving economic environment

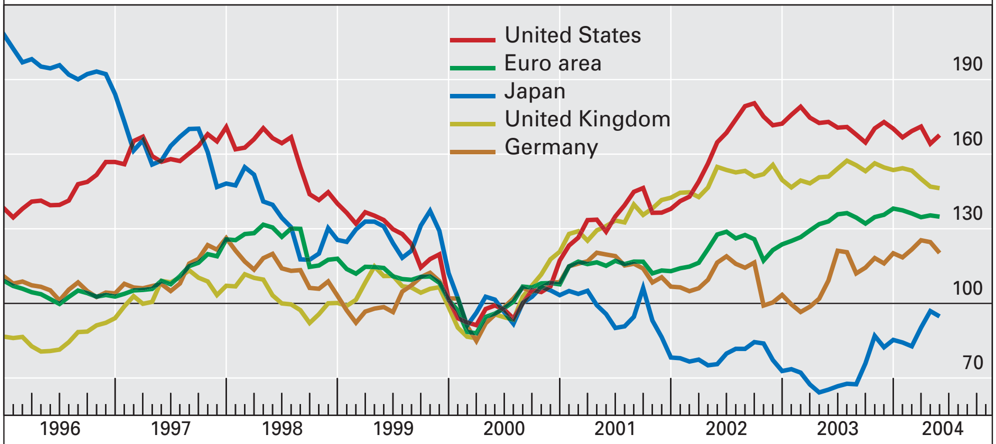
The improvement in the macroeconomic environment during the period under review translated into solid results for the financial sector in industrialised countries. As the signs of a general recovery multiplied, corporate profits stabilised, risks in the outlook subsided and financial asset prices staged a rebound (see Chapter VI). This environment supported better performance by commercial banks both in countries where the sector was building on a strong base and in those where institutions had been under strain (Graph VII.1). In addition, favourable asset market conditions boosted investment bank earnings and helped insurance companies make progress in repairing their weakened balance sheets.

Commercial banks

Higher profits for US and European banks ...

Lower default rates, higher investment returns and better cost control contributed to the profitability of commercial banks on both sides of the

Relative bank equity prices[1]



[1] Ratio to broad equity index; monthly averages, 2000 = 100.

Sources: Datastream; national data. Graph VII.1

… despite sluggish growth in corporate lending …

Atlantic. In general, solid earnings coexisted with reduced bad debt provisions as banks applied more conservative lending standards than in the early 1990s.

The resilience of commercial banks' profitability proved their ability to cope with downward pressures on revenues through prompt readjustment of the business mix. A first challenge to revenue growth was continuing subdued demand for credit by the corporate sector, notably in the United States. The challenge persisted despite the improved quality of outstanding loans, as corporations remained focused on balance sheet rebuilding and efficiency enhancements took precedence over expansion of capacity (see

Profitability of major banks[1]

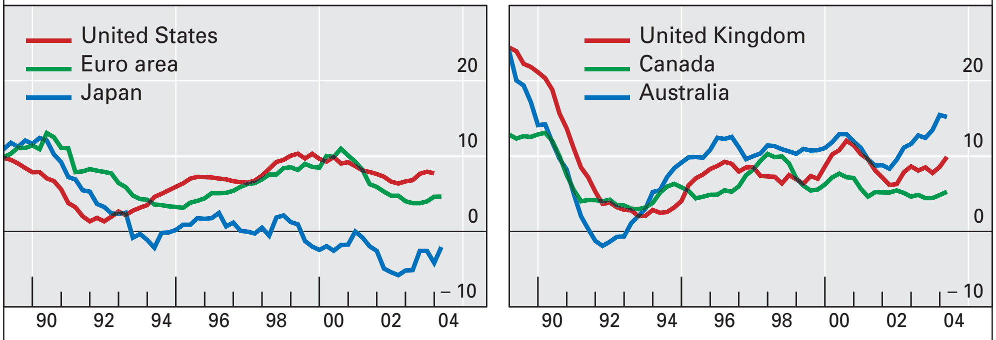
As a percentage of total average assets

	Pre-tax profits			Provisioning expenses			Net interest margin			Operating costs		
	2001	2002	2003	2001	2002	2003	2001	2002	2003	2001	2002	2003
United States (11)	1.52	1.71	2.04	0.69	0.69	0.44	3.11	3.11	2.99	4.03	3.54	3.41
Canada (5)	0.91	0.61	1.00	0.41	0.58	0.23	1.96	2.07	1.99	2.84	2.75	2.78
Japan (11)	–0.69	–0.45	0.07	1.15	0.64	0.20	1.01	1.00	0.55	1.01	1.01	0.80
Australia (4)	1.47	1.49	1.49	0.27	0.26	0.21	2.22	2.16	2.13	2.15	2.04	2.30
United Kingdom (5)	1.24	1.08	1.22	0.32	0.36	0.32	2.04	1.96	1.82	2.38	2.24	2.12
Switzerland (2)	0.41	0.06	0.63	0.10	0.14	0.03	0.68	0.84	0.88	2.83	2.40	2.03
Sweden (4)	0.83	0.69	0.77	0.10	0.09	0.10	1.50	1.48	1.44	1.53	1.44	1.37
Austria (2)	0.44	0.46	0.53	0.39	0.39	0.36	1.66	1.80	1.72	1.76	1.92	1.85
Germany (4)	0.14	0.05	–0.20	0.24	0.39	0.28	0.90	0.82	0.79	1.77	1.68	1.66
France (3)	0.67	0.46	0.58	0.16	0.17	0.18	0.65	0.75	0.91	1.50	1.48	1.55
Italy (5)	0.90	0.53	0.81	0.53	0.63	0.51	2.21	2.25	2.05	2.42	2.44	2.52
Netherlands (3)	0.62	0.46	0.65	0.20	0.26	0.20	1.57	1.62	1.63	2.08	1.95	1.86
Spain (3)	1.20	1.05	1.27	0.56	0.55	0.44	2.92	2.72	2.38	2.61	2.37	2.12

[1] The figures in parentheses indicate the number of banks included. For Australia, Canada and Japan, fiscal years.

Source: Fitch Ratings. Table VII.1

Credit growth[1]



[1] Private domestic credit; annual changes, in per cent.

Sources: IMF; national data. Graph VII.2

Chapters II and VI). US banks reacted to the weak demand for business loans by boosting fee income on the back of sustained household spending and mortgage refinancing. Likewise, European lending institutions sought growth in consumer credit, a line of business accounting for 70% of their 2003 revenues. A robust household mortgage market, in which financing costs were low relative to revenues, contributed to the build-up of a capital cushion by European banks, and was particularly profitable in Spain and the United Kingdom.

... and narrow margins

A second challenge was posed by low policy interest rates and declines in credit spreads, which compressed the margin between lending and deposit rates. Depressed interest margins were a prominent issue in Europe, where margins account for more than half of banks' revenue base (Table VII.1). Spanish commercial banks, which faced strong competition from non-bank financial firms, and the fragmented Italian sector experienced quite pronounced revenue pressure but were successful in boosting asset management income. In France, where there has traditionally been less dependence on margins, a reduction of regulated deposit rates helped support profits. Margins in the United States continued to be the highest among industrialised economies, even though they remained at historically low levels and were offset by higher commission and fee revenues.

German banks confronted their challenges

Germany proved the main exception to the generally buoyant condition of European banks. The combination of an intensely competitive environment and a weak role for market discipline in fostering sound risk management continued to act as a drag on performance. The economic slowdown depressed German bank profits to the lowest level in industrialised Europe. In addition, market commentators estimate that the banking sector harbours distressed debt amounting to 9.5% of total loans, a legacy of the earlier quest for revenue growth in high-risk lending. Against this backdrop, and in anticipation of the removal of explicit state guarantees in 2005, some rating agencies drew the market's attention to probable downgrades of public sector banks evaluated on a standalone basis.

Notwithstanding these difficulties, the German banking sector witnessed some encouraging developments that primarily reflected initiatives by the larger private sector institutions. In early 2003, the securitisation of loans to higher-rated credits improved the liquidity of bank balance sheets. Moreover, the restructuring of problem loans, destined eventually to be sold to international investors, provided a boost to capital adequacy later in the year.

The Japanese banking system

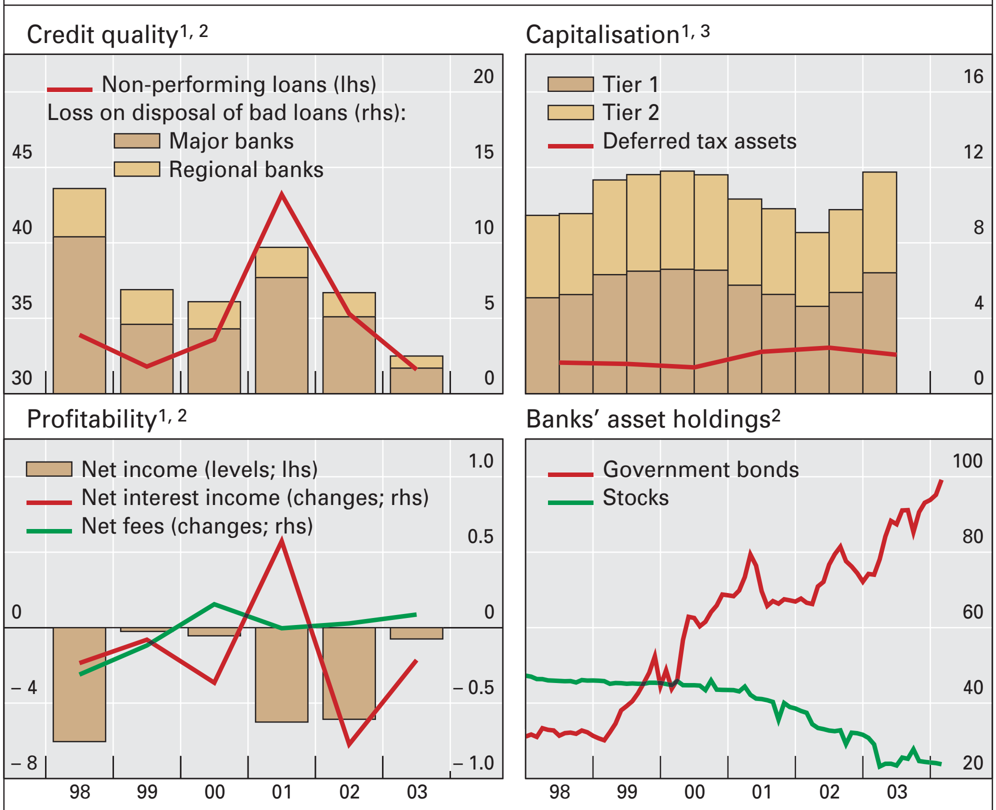
Japanese banks returned to profit …

In the past year, Japanese banks showed encouraging signs of better health, despite the persistent influence of certain chronic sources of weakness. For the first time in 11 years, the operating profits of major banks exceeded their credit costs owing to a combination of the recovery in macroeconomic conditions, the easing of the non-performing loan (NPL) problem and the strong performance of the equity market.

… reduced the burden of bad loans …

The NPL problem, which has burdened the Japanese banking system for a decade, finally appeared to ease during the period under review. Major banks stepped up efforts to meet the regulator's goal of halving their NPL ratio in the three years to the end of March 2005. They look to be well on course to meet this goal, having already removed an estimated ¥13.2 trillion in the two years to end-March 2004. By contrast, progress was much slower for regional banks, as their NPLs declined only slightly from ¥14.8 trillion in March 2002 to ¥13.9 trillion in September 2003 (Graph VII.3).

The banking industry in Japan



[1] Data refer to fiscal years (ending in March of the following year). The latest observation is for September 2003. [2] In trillions of yen. [3] As a percentage of risk-weighted assets.

Source: National data. Graph VII.3

The equity market rebound provided unexpected support for bank profits, facilitating the write-off of NPLs. To comply with the regulator's mandated guidelines, major banks had drastically reduced their equity holdings in previous years. In recent months, this sell-off was reversed to take advantage of the rising stock market. As their equity-related gains more than offset losses incurred in the bond market, banks posted a net gain from the revaluation of securities for the first time since mark to market accounting was introduced in April 2001. At the same time, with equity holdings standing only slightly above their Tier 1 capital, major banks were in a stronger position to deal with future equity price fluctuations.

... and benefited from an equity market recovery

Even so, risks remain. An improving economic environment may have lessened the vulnerability of banks, but it has had only a limited effect on interest margins that remained much lower than in other industrialised countries. Admittedly, the narrow margin problem is partly a result of deposit rates being constrained by the zero lower bound in the current deflationary environment. Moreover, structural obstacles, such as competition from the public sector and the lack of risk-based pricing schemes, also contribute. There is anecdotal evidence that individual banks may have taken some steps to tackle this issue. It is less clear, however, how the sector as a whole could do the same without some adverse impact on the supply of credit to the corporate sector.

However, margins remain thin ...

The quality of the banks' capital base also deserves special attention, with public funds and deferred tax assets still accounting for a major share of Tier 1 capital. Capital adequacy ratios fell slightly in the fiscal year ending in March 2003, before rebounding strongly in the first half of the following fiscal year. The improved ratios, however, conceal a marked decline in risk-weighted assets over this period.

... the quality of capital is uncertain ...

A related but more delicate issue is the role of the government in bank restructuring. The substantial injection of public funds to recapitalise weak banks and bail out distressed banks raised the concern that the extent of government subsidies could lessen the banks' commitment to reform. From this perspective, some recent initiatives aimed at phasing out other distortions caused by government intervention could be helpful in levelling the playing field and creating a more competitive environment in the long run. These measures include the incorporation of Japan Post in 2003 and, from April 2005, the imposition of a cap on deposit insurance and the discontinuation of the purchase of bad loans by the Industrial Revitalization Corporation.

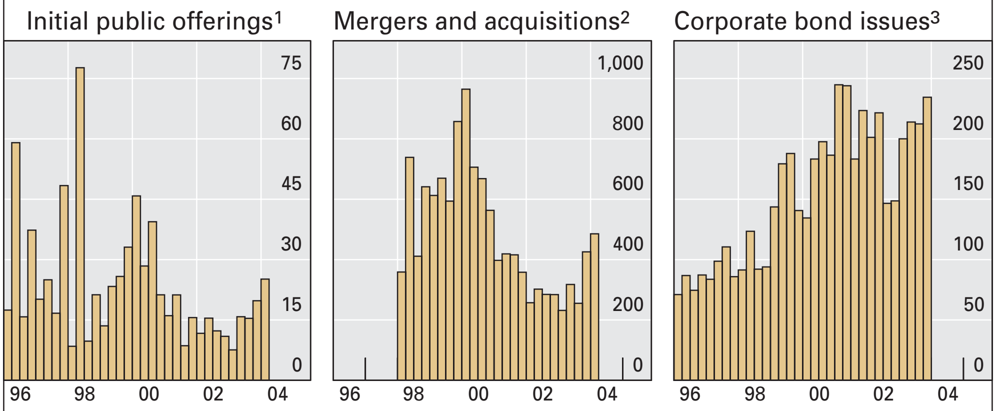
... and the role of the public sector is unclear

Investment banking

Buoyed by a favourable asset price environment, investment banks in a number of countries recorded very positive results last year. The recovery in equity markets boosted trading revenue, primarily sustained in previous years by activity in the fixed income markets. Trading in mortgage-related securities was an additional important source of revenue. A tentative revival in the merger and acquisition and equity IPO (initial public offering) markets during the second part of the year, after three years of subdued deal flow, made only a moderate contribution to advisory revenue. By contrast, the intensification of primary market activity in fixed income securities, as borrowers eagerly

Investment bank profitability recovered ...

Indicators of investment banking activity
In billions of US dollars



[1] Germany, Japan, the United Kingdom and the United States. [2] Global value, announced excluding terminated transactions. [3] Completed international debt securities issuance, based on the business sector of the parent company of the issuer.

Sources: Bloomberg; Dealogic; Euroclear; Thomson Financial Securities Data; BIS. Graph VII.4

took advantage of low interest rates and reduced credit spreads, provided a significant boost to income (Graph VII.4).

… and firms pursued growth

The rebound in profitability prompted investment banks to start reversing the downsizing which had followed the collapse of the investment and equity market boom of the late 1990s. Employment numbers, which had declined sharply, began to increase. Institutions actively pursued growth by rebuilding their deal-making capacity and by expanding into new business areas.

The insurance sector

Insurance sector divergence between …

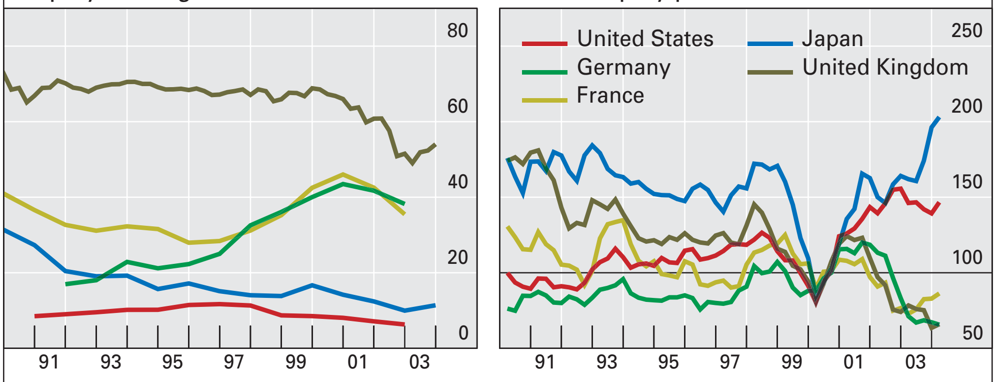
A number of favourable macroeconomic developments in 2003 boosted the performance of insurance companies, but were in part offset by the legacy of liabilities side difficulties from previous years. In general, the non-life and reinsurance sectors entered 2004 in better shape than life companies, which still need to address challenges with respect to capital adequacy.

… life companies bearing the legacy of past losses …

During the year under review, successful life insurers matched conservatively priced liabilities with low-volatility fixed income investments and took advantage of the equity market rebound. This approach underpinned the continued robust performance of French and Spanish companies. For its part, the US life insurance industry, with 74% of its assets in bonds, benefited particularly from a decrease in credit losses. At a more global level, the steepening of the yield curve supported life insurers' profits by widening the gap between investment returns and guaranteed policy rates. Further helped by a drop in mortality rates and by weakened pressure on margins from guaranteed yields, the Japanese sector outperformed the broad stock index by the largest margin among major industrialised countries (Graph VII.5).

However, the last year also revealed problems in the life insurance sector that seem likely to persist. In the United States, a shift away from traditional life products and competitive pressures increased revenue volatility and restrained capital accumulation. The German and UK sectors experienced

Insurance companies: equity holdings and performance



[1] As a percentage of total financial assets. For Japan, including pension funds. [2] Ratio to broad equity index; quarterly averages, 2000 = 100.

Sources: Datastream; National Association of Insurance Commissioners; national data. Graph VII.5

serious difficulties, including the failure of large national players, as a result of losses due to overly generous policies that had induced companies to look for higher returns in riskier investments.

... as well as facing new regulatory challenges ...

Life insurance companies in the European Union face additional challenges in the form of proposed changes to the financial reporting and regulatory solvency rules. Proposed new international accounting standards aim at a more transparent match between returns on investments and policies sold but are also likely to heighten the volatility of reported earnings. The introduction of a new solvency framework is also expected to increase capital requirements for a number of companies across the European Union. Insurers in Germany, Sweden and the United Kingdom account for a large portion of the estimated €65 billion capital shortfall that the EU life insurance sector would have experienced had those requirements been in place in 2003. The latent shortfall represents roughly a quarter of the total capital base of the sector, but is concentrated in about one third of the companies. This led industry commentators to forecast substantial redistribution of market share towards those life insurers that maintain strong and stable balance sheets.

... and non-life companies in a healthier position

Underwriting discipline, coupled with a below average incidence of natural catastrophes, resulted in a robust performance for the non-life sector. Better underwriting results at US non-life insurers cut their loss ratios, even as costs rose. However, increased reserve needs from obligations incurred in prior underwriting periods continued to be a drag on profitability. Unlike their life sector counterparts, European non-life companies were quite well insulated from equity market volatility and saw premium volumes grow faster than their historical trend. Similarly, an upward spike in premiums contributed to an improved performance by Japanese non-life insurers.

Reinsurers addressed weakness

The improved overall performance of equity prices of reinsurance firms in both Europe and the United States was primarily the result of greater market confidence in companies that took bold steps to strengthen their capital base. In the United States, newly formed or recently recapitalised reinsurers boasted an annual return on equity of 20%. In Europe, the industry increased its profits in 2003, owing to abating reserve charges and a steep yield curve which boosted net investment returns.

Factors underpinning the positive performance

Cyclical factors

The financial sector benefited from the recovery and low interest rates

The positive performance of the financial sector owed much to the confluence of a number of cyclical factors. Chief among them were the strengthening of the pace of economic recovery and the accommodative stance of economic, especially monetary, policies. Low interest rates helped institutions fund their positions and cushioned their operating results from the impact of corporate distress during the recent downturn. Asset prices also played an important role in shaping the condition of financial institutions. The recent rebound in asset prices supported the earnings of investment banks and helped to restore the health of insurance company balance sheets. Booming housing market activity provided a significant source of income to banks in many countries, while the absence of problems with commercial real estate investments, which had often been a cause of major stress for banks in the past, also helped the bottom line.

Commercial property prices[1]

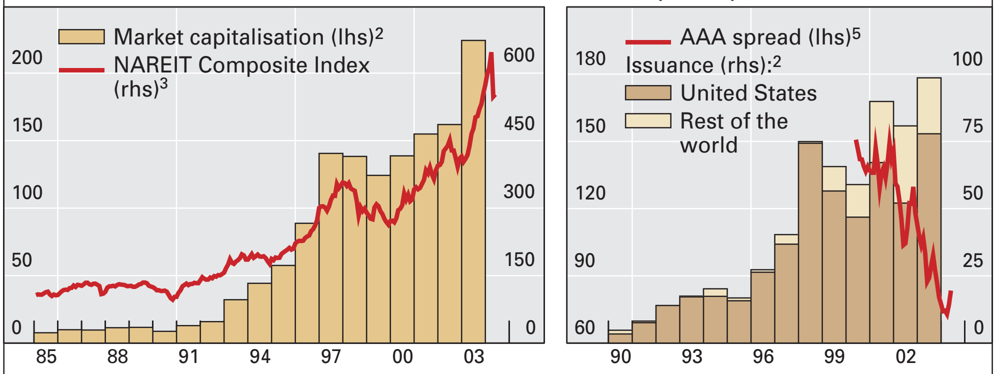
	1995–2002	2003	2003	*Memo: Office vacancy rates*[2]	
	Nominal change[3]		Level[4]	*2002*	*2003*
United States	3.2	–2.5	35.4	*15.6*	*16.7*
Japan	–8.7	–10.2	34.5	*8.0*	*8.5*
Germany	4.1	–18.4	50.8	*7.1*	*9.8*
United Kingdom	2.8	–4.1	32.7	*8.0*	*11.3*
France	5.9	–3.4	60.7	*5.9*	*6.0*
Italy	11.6	–5.1	77.6	*4.7*	*5.4*
Canada	4.2	–2.7	47.9	*13.7*	*15.6*
Spain	12.5	–10.9	42.3	*4.8*	*7.7*
Netherlands	7.5	–3.0	81.8	*7.4*	*9.7*
Australia	4.2	4.0	50.7	*8.3*	*10.3*
Switzerland	0.2	–2.2	59.0	*8.0*	*10.8*
Belgium	4.0	10.9	84.4	*8.8*	*9.5*
Sweden	4.9	–8.0	47.2	*12.5*	*18.3*
Norway	6.8	–1.9	56.3	*8.3*	*11.0*
Denmark	7.2	–1.2	82.5	*2.5*[5]	*9.0*
Finland	4.2	–4.7	59.4	*1.7*[5]	*7.0*
Ireland	15.5	0.2	83.5	*18.4*	*17.5*

[1] For Australia, Belgium, Italy and Spain, prime property in major cities; for Japan, land prices. [2] Immediately vacant office floor space (including sublettings) in all completed buildings within a market, as a percentage of the total stock. For Switzerland and the United States, nationwide; for Australia, France, Germany, Italy, the Netherlands and Spain, average of major cities; for other countries, capital city. [3] Annual changes, in per cent. [4] Peak period of real commercial property prices = 100. [5] 2001.

Sources: Catella Property Consultants; CB Richard Ellis; Investment Property Databank Ltd; Japan Real Estate Institute; Jones Lang LaSalle; National Council of Real Estate Investment Fiduciaries; Sadolin & Albæk; Wüest & Partner; national data. Table VII.2

Public commercial real estate markets

US REIT[1] market | CMBS[4] yield spread and issuance



[1] Real estate investment trust. [2] In billions of US dollars. [3] December 1984 = 100. [4] Commercial mortgage-backed securities. [5] In basis points.

Sources: Bloomberg; Commercial Mortgage Alert; Global Property Research; Morgan Stanley Dean Witter; National Association of Real Estate Investment Trusts (NAREIT). Graph VII.6

Falling commercial property prices …

Admittedly, commercial property prices did fall in 2003 in practically all industrialised countries, after a period of tempered growth since 1995 (Table VII.2). While price declines were moderate in most cases, they exceeded 10% in Germany, Japan and Spain. Moreover, the fundamentals remained mixed. Demand for office space (other than prime property) did not recover in the absence of a pickup in employment, while demand for retail outlet space grew, reflecting the continuing strength of consumption growth.

… did not affect bank profits because of securitisation

Even so, the pullback in commercial property prices remained limited by past standards, as did the impact on banking sector profitability. This was partly due to the cautious attitudes in lending for commercial development subsequent to the last market collapse in the early 1990s, which helped to avoid a price boom. It was also a reflection of the ongoing development of markets for instruments linked to commercial real estate financing (asset-backed securities, real estate investment trusts and other equity instruments), which provided a substitute for bank-intermediated credit and a channel for the dispersion of associated risks (Graph VII.6). Prices of these instruments were boosted by stronger demand from institutional investors seeking higher-yielding investment opportunities outside the more traditional asset classes.

Structural factors

In addition to these cyclical influences, a number of structural factors underpinned the positive performance of the financial sector. These relate to the longer-term restructuring of banks' business lines, greater focus on the retail sector and the further development of risk transfer mechanisms.

Banking sector restructuring

Restructuring has been a source of resilience

Over the 1990s, banks pursued the rationalisation of their internal cost structure and improvements in the efficiency of their business operations, while seeking greater earnings stability via revenue diversification. A visible by-product of these efforts was the wave of merger and acquisition activity in the financial sector that marked the second half of the decade. The resilience of the financial sector to the recent economic downturn represents in part the fruits of these efforts.

Internal efficiency pursued globally

Internal cost containment has primarily taken the form of reductions in staff levels. Increased recourse to IT and outsourcing has enabled banks to take advantage of scale economies and focus operations on core functions of intermediation and distribution of financial products (Table VII.3). Banks in North America started this process earlier in the 1990s and have arguably advanced faster. European institutions have followed in earnest more recently. The process was triggered in a number of countries by the withdrawal of the public sector from bank ownership, but it was often hampered by rigidities in national labour markets. Japanese banks, after a particularly slow start, have accelerated the implementation of rationalisation plans.

In contrast to the trends in staff costs, the picture is less clear when it comes to branch networks (Table VII.3). While the rollout of new technologies would imply a move towards more cost-efficient delivery channels than the traditional bank branch, the success of various forms of remote banking has been rather mixed. Moreover, an intensified focus on the retail banking market (see below) has transformed branch networks into important sales outlets for a growing variety of financial services.

Slower pace of consolidation

Consolidation remains an important strategic option for bankers, despite a considerable slowdown in the pace of merger activity compared to the late 1990s. Two very large deals, which last year created the second and third

Restructuring of the banking sector[1]

	Concentration[2]			Number of branches[3]				Employment[3]			
	1990	1997	2003[4]	1990	1997	2003[4]	Change[5]	1990	1997	2003[4]	Change[5]
United States	13	21	24	72.8	77.3	84.8	0.0	1,911	1,847	2,129	0.0
Japan	42	39	42	24.7	25.4	22.7	–11.8	593	561	447	–27.8
Germany	17[6]	17	22	43.3	47.1	38.2	–22.3	696	751	732	–3.5
France	52	38	45	25.7	25.5	26.2	0.0	399	386	384	–3.8
United Kingdom	49	47	41	19.0	14.3	12.9	–32.4	423	360	360	–15.0
Italy	24	25	27	17.7	25.6	29.9	0.0	324	343	341	–4.3
Canada	83	87	87	8.7	9.4	10.4	0.0	211	264	279	0.0
Spain	38	47	55	35.2	37.6	39.4	0.0	252	242	239	–6.6
Australia	65	69	77	6.9	6.1	4.9	–31.2	357	308	344	–3.4
Netherlands	74	79	84	8.0	7.0	3.7	–54.1	123	120	140	–9.6
Belgium	48	57	83	8.3	7.4	5.6	–33.2	79	77	75	–5.6
Sweden	70	90	90	3.3	2.5	2.0	–37.2	45	43	42	–7.7
Austria	35	44	44	4.5	4.7	4.4	–6.2	75	75	75	–2.4
Switzerland	54	73	80	4.2	3.3	2.7	–35.9	120	107	100	–16.8
Norway	68	59	60	1.8	1.6	1.2	–32.9	31	24	22	–22.4
Finland	65	77	79	3.3	1.7	1.6	–55.8	50	30	27	–49.3

[1] Deposit-taking institutions, generally including commercial, savings and various types of mutual and cooperative banks. [2] Top five banks' assets as a percentage of all banks' assets. [3] In thousands. [4] For Belgium, France, Germany, Italy, Japan, Sweden and the United Kingdom, 2002. [5] Changes, in per cent, from peak (since 1990) to most recent observation; 0.0 indicates that 2003 was the peak year. [6] 1995.

Sources: National bankers' associations; national data. Table VII.3

largest banking organisations in the United States, help to underscore this fact. In addition, consolidation at the local and regional levels continued following the dismantling of institutional structures that had historically supported the fragmentation of the US banking system. In Europe domestic consolidation also continued, albeit at a slower pace, while cross-border deals remained an exception. In fact, disappointment with the persistent difficulties in the formation of a pan-European banking market persuaded some European banks to reduce the size of cross-border strategic stakes, previously seen as preludes to larger deals, in order to strengthen their domestic financial position.

Retail strategies

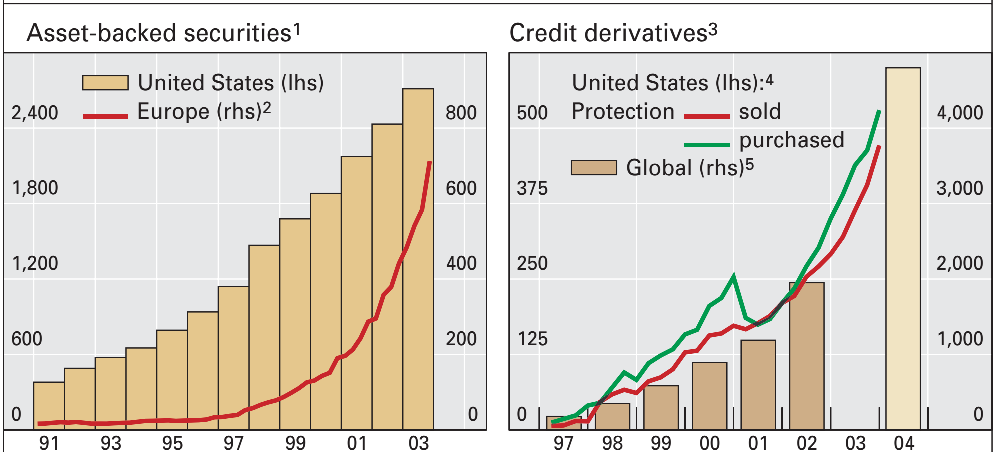
Growth in retail business

Buoyant demand for consumer credit has offered a welcome source of income for banks confronted with stagnant demand for corporate credit and compressed interest margins. Banks in many countries have pursued an aggressive expansionary strategy focused on the growth of their retail business. Mortgages, credit card loans, automobile loans and unsecured credit lines are some of the high-growth areas for banking products. In addition, other fee-based services to households, such as selling third-party financial products as well as brokerage services, have become a substantial source of revenue. This trend might be reinforced by the introduction over the next few years of the revised capital adequacy framework for banks, which recognises the mitigating effect of greater diversification in retail and consumer exposures compared to corporate credits.

Fee income is seen as a potential means of smoothing the cyclicality of earnings, especially when banks have been successful in building their franchise name and maintaining market share. Recent experience validated this assertion, as fee income provided an important buffer to declining interest

Credit risk transfer markets

In billions of US dollars



[1] Amounts outstanding. [2] International bonds. [3] Notional principal values. [4] All banks. [5] Market participants' estimates (BBA surveys). The 2004 observation is a projection from the latest survey.

Sources: Board of Governors of the Federal Reserve System; British Bankers' Association (BBA); Dealogic; ISMA; Loan Pricing Corporation; Thomson Financial Securities; BIS. Graph VII.7

margins. In fact, the substitution of fee income for margin income was more intense in countries where the environment was most competitive. This partly reflected the fact that consumer demand appeared less sensitive to fee charges than to interest rate charges, possibly because fee structures are more opaque and complicate comparisons across service providers.

Risk transfer markets

The rapid development of new risk transfer markets in recent years has enhanced the capacity of the financial system to absorb losses and supported its performance by helping to disperse risk across institutions and investors.

The growth of securitisation …

The growth of securitisation markets for bank-originated credits was boosted by demand from institutional investors and by advances in financial, computing and communications technologies (Graph VII.7). The securitised mortgage segment expanded particularly strongly in the United States, fuelled by a booming primary market and improved liquidity. In Europe, asset-backed securities markets received support from the introduction of the single currency as well as enhancements to the trading and legal infrastructure.

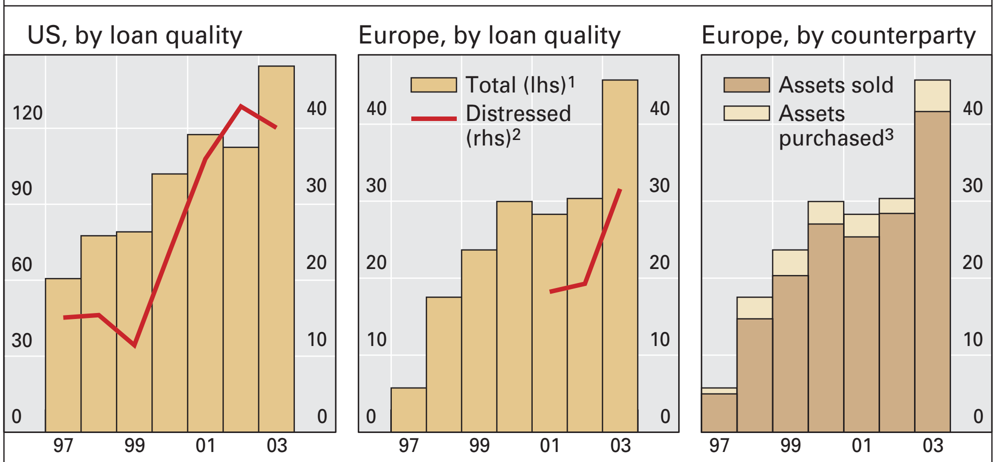
… and deepening of secondary loan markets …

The secondary market for syndicated credits has also grown over the past few years. During the period under review, trading of syndicated credits in the United States, the largest secondary loan market, grew by a quarter (Graph VII.8), while activity in Europe soared by more than 50%. Distressed loans continued to represent a sizeable fraction of total secondary trading on the US market, and gained in importance in Europe. Admittedly, this reflected to some extent higher levels of corporate distress in Europe. But it was also indicative of sustained investor appetite and the market's improved ability to absorb a larger share of below par loans.

… have brought in new players

The growing participation of a diverse investor base in the secondary loan market has been a key factor in its success in dispersing risks through the financial system. The share of US banks' holdings of domestic syndicated

Volume of secondary loan market trading



[1] In billions of US dollars. [2] As a percentage of the total. For Europe, distressed and leveraged. [3] From non-LMA members.

Sources: Loan Market Association (LMA); Loan Pricing Corporation. Graph VII.8

credits has been in slow decline over the last few years. At the same time, non-banks and foreign market participants hold a proportionately larger share of distressed loans than do their US bank counterparts.

A similar development has been observed in the credit derivatives market. In this case, it is non-banks (primarily insurance companies and hedge funds) that have been net sellers of protection. Moreover, smaller banking institutions with a more regional focus in their loan business have used derivatives to increase their exposure to foreign names as a means of diversification.

Greater propensity for risk-taking

Greater risk-taking by banks ...

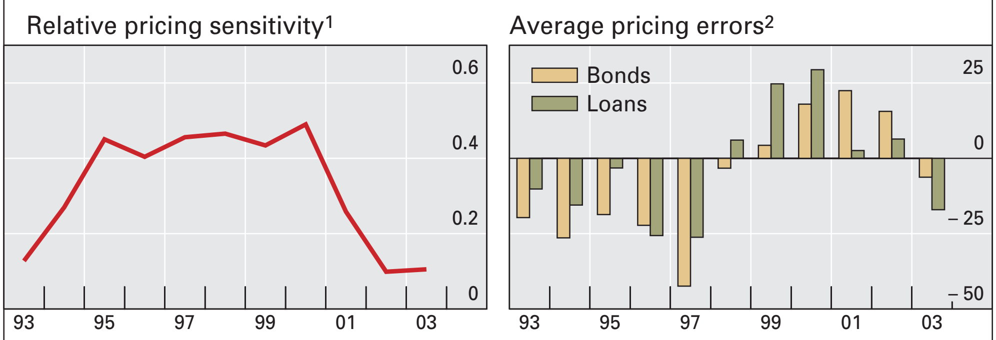
Positive results, alongside increasingly optimistic expectations, have encouraged greater risk-taking in a financial sector left relatively unscathed by the recent economic downturn. High levels of capitalisation, intensified competition, ample liquidity in financial markets and a low interest rate environment might also have contributed to this same outcome. Manifestations of this type of behaviour can be found both in pricing practices and in the growing reliance on certain business segments, such as proprietary trading. One concern is that the financial sector may have been left more vulnerable to unanticipated future developments in the pace and balance of growth in economic activity, as well as in the future path of interest rates.

Manifestations of risk-taking

... evidenced in the pricing of credits ...

There is evidence of more aggressive pricing of credit risk in bond and, especially, syndicated loan markets in recent years. Observed yields in the two markets are substantially lower than the levels predicted on the basis of their historical relationship with the prevailing level of interest rates and the risk associated with the specific characteristics of individual facilities. While progressively more aggressive pricing has been observed in both markets in the last two years (see, for example, the discussion in Chapter VI), spreads in

Pricing of risk on syndicated loan and bond markets



[1] Time-varying relative sensitivity of loan and bond prices to credit risk, estimated from a regression of loan rates on the yield index for corporate bonds of the same rating. Other variables include the size and maturity of the loan facility. [2] Facility size-weighted averages of discrepancies (in basis points) between actual (bond or loan) spreads and those implied by a model incorporating short-term interest rates, rating, time to maturity, guarantees, collateral, currency risk and size of facility.

Sources: Dealogic; national data; BIS calculations. Graph VII.9

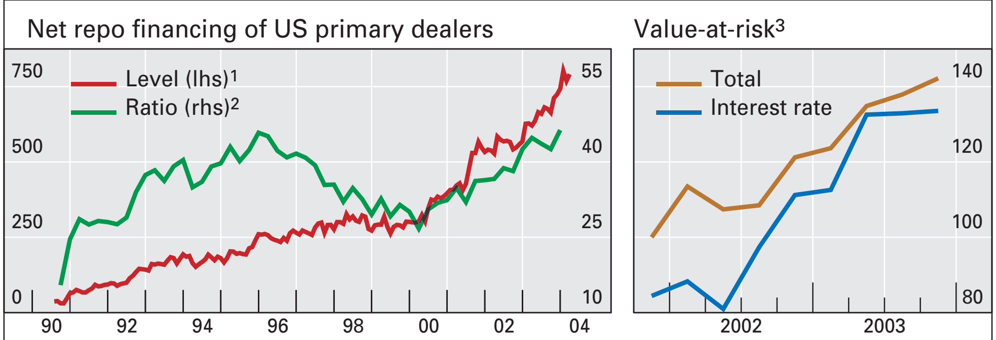
the syndicated loan market appear to have declined relatively faster (Graph VII.9, right-hand panel). The recent compression of spreads in the two markets is reminiscent of conditions prevailing around the end of a previous period of low interest rates in 1993–95. It is, however, less pronounced than in the two years leading up to the Asian crisis. Pricing grew increasingly firm at the end of the 1990s, arguably supported by intensified demand, before the more recent decline in spreads took hold. A comparison of the pricing of credits to similarly rated borrowers in the two markets shows that loan yields have been less responsive to credit risk than bond market yields (Graph VII.9, left-hand panel). Indeed, the convergence in pricing observed over the 1990s seems to have been rapidly reversed as loan markets have apparently grown much less discriminating since 2001.

… and an emphasis on proprietary trading

Another symptom of greater risk-taking is investment banks' greater exposure to proprietary trading. Signs of this trend are visible in the fact that most of the overall increase in capital exposure to market risk, as evidenced by value-at-risk (VaR) observed across the industry in 2003, is attributable to higher interest rate risk (Graph VII.10). Admittedly, high volatility in bond markets over the summer played a major role in the rise in banks' interest rate related VaR for the third quarter of 2003. Nevertheless, this type of VaR was still 20% higher at the end of 2003 than a year before, even after institutions had had time to adjust their risk-taking.

Over the period under review the financial system continued to build up its direct and indirect exposure to the hedge fund sector. As funds multiplied in number and grew in size, competition among larger banks for lucrative prime brokerage business became more intense, drawing in players that had all but withdrawn from this activity a few years earlier. Similarly, banks reportedly invested significant amounts of their own money in fixed income hedge funds in a strategy complementary to the expansion of their proprietary trading operations. These inflows combined with growing interest by institutional investors, such as pension funds, helped hedge funds to become important players in the corporate credit markets.

Major investment banks' liquidity and risk-taking



[1] In billions of US dollars. [2] As a percentage of total assets of securities dealers. [3] Market capitalisation-weighted averages of eight large institutions' total and interest rate VaR relative to their total VaR in the fourth quarter of 2001; quarterly data, in per cent.

Sources: Company reports; national data. Graph VII.10

Factors contributing to greater risk-taking

The explanation for greater risk-taking by banks can be found in the confluence of a number of factors in the current conjuncture. Chief among them seems to be the accumulation of healthy capital cushions as a result of the robust past performance and improving economic conditions (Graph VII.11). Low yields in some of the more traditional lines of business may have induced banks to pursue profitable opportunities for their capital in higher-risk activities. Similarly, a fall-off in customer-driven revenues in the corporate advisory area has motivated investment banks' search for yield.

Risk-taking encouraged by excess capital …

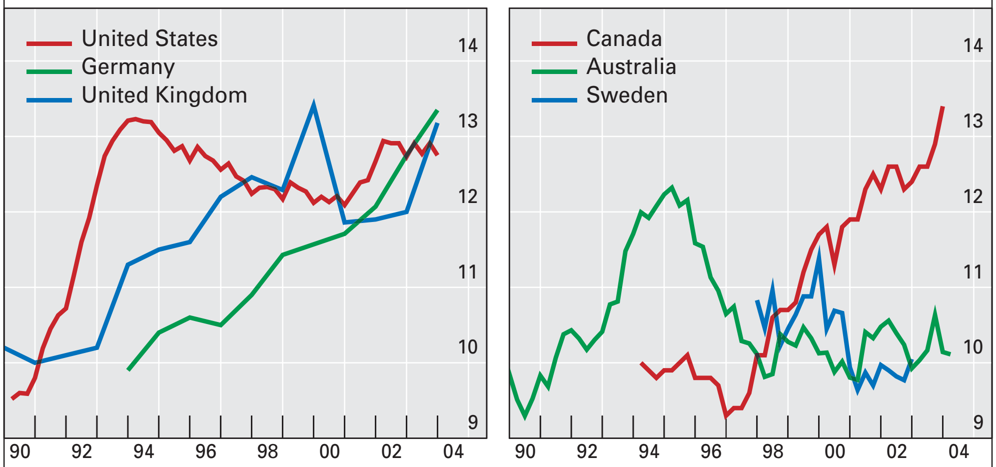
Another factor relates to greater competition in the area of traditional financial intermediation. Corporate credit demand has been sluggish because of lower corporate investment, more subdued merger and acquisition activity, and an increase in the number of syndicated loans self-arranged by borrowers. This has intensified competition among lenders for loan mandates on the basis of pricing, even in the absence of any real prospect of future ancillary fee-generating business from the borrower, such as merger advice or bond underwriting. The evidence on narrowing bond and loan market spreads (Graph VII.9) is suggestive of such a widespread search-for-business phenomenon.

… greater competition …

Finally, increased emphasis on proprietary trading activity was supported by ample liquidity in financial markets and increased appetite for risk. The growth of net repo financing of the operations of US primary dealers has accelerated in the last three years. As a percentage of their total assets, such financing almost doubled between the beginning of 2000 and the end of 2003 (Graph VII.10, left-hand panel). The comfort derived from more widespread use of advanced risk management technologies and a more relaxed shareholder attitude towards income volatility during a period of earnings growth has arguably reinforced banks' reliance on proprietary trading.

… and ample liquidity

Bank capital ratios[1]



[1] Total capital as a percentage of risk-weighted assets.

Source: National data. Graph VII.11

Potential dangers

The principal danger that arises from greater risk-taking is that the financial sector becomes more vulnerable to future disappointments regarding economic growth and interest rate movements.

Vulnerability to higher interest rates …

The main risk involved in the search for business described above is that banks may have underpriced loans based on optimistic forecasts of a long-lasting environment of low interest rates and sustained high rates of economic growth. Tight spreads reduce considerably the buffer to absorb losses. In the event of an unbalanced or slower economic recovery, this could result in a higher number of defaults among corporate borrowers than banks have priced into their risk spreads. This could lead to unexpectedly high loan losses for lenders. A financial sector hurt by an adverse macroeconomic environment could, in turn, further weaken the macroeconomy, for instance by becoming more restrictive in the granting of credits.

… and a flatter yield curve

The main risk associated with proprietary trading in fixed income products by investment banks stems from the reliance on both abundant market liquidity and the steepness of the yield curve. Large losses on these activities could affect a number of players if market liquidity were to dry up or the yield curve flattened beyond the expectations already priced into current forward rates. Further, a simultaneous unwinding of overextended positions could trigger or exacerbate adverse market movements, especially in highly concentrated markets (see Chapter VI).

A similar concern has been expressed by US authorities with respect to the level of indebtedness of the country's government-sponsored enterprises (GSEs). In September 2003, GSEs reported total debt outstanding of $2.4 trillion, with the proceeds used to accumulate portfolios of mortgages and mortgage-backed securities whose value is highly sensitive to swings in interest rates or refinancing activity. Even though the institutions continue to hedge these risks, the magnitude of the exposures has raised questions about the ability of the system as a whole to absorb the risk of higher interest rates smoothly. Since hedging requires the sale of long-maturity bonds as rates increase, the impact on the bond market could be significant.

Household debt and financial stability

As noted earlier, the resilience of the banking sector was due in part to strong household sector demand for financial services, including mortgage-related services and consumer credit. The growth of borrowing by households not only provided fee income for banks, but also reduced credit risk owing to the solid performance of property-related loans in a context of rising home values.

Household debt has increased substantially …

Household debt has risen to historically high levels in many countries in recent years, mainly because of low borrowing costs and the easing of liquidity constraints. The growth of household debt has been particularly strong in Australia, Spain and the Netherlands, which have experienced average annual rates of increase of 12–15% in the past five years, followed by Italy, the United Kingdom, the United States and a number of Nordic countries (Table VII.4). At the other end of the spectrum, household indebtedness in

Residential property prices and household debt

	Residential property			Household debt[1]	
	1995–2002	2003	2003	1995–2002	2003
	Nominal change[2]		Level[3]	Nominal change[2]	
United States	5.8	8.0	100	8.2	10.8
Japan[4]	–3.0	–5.8	65	0.3	–0.1
Germany	0.1	–1.0	84	4.2	1.0
United Kingdom	11.9	10.0	100	8.5	9.3
France	4.8	16.4	100	7.1	7.2
Italy	3.7	10.7	100	8.4	6.6
Canada	3.6	11.0	100	5.9	6.2
Spain	9.8	17.3	100	14.5	12.6
Netherlands	11.2	3.6	100	13.3	9.4
Australia	9.0	18.9	100	12.4	11.9
Switzerland	0.1	2.8	67	3.3	6.6
Belgium	5.4	7.6	100	3.5	2.2
Sweden	8.0	6.1	100	7.1	8.2
Norway	8.3	3.7	97	8.3	6.7
Denmark	7.1	3.2	100	8.2	8.2
Finland	8.2	7.4	84	7.0[5]	12.3
Ireland	14.5	13.9	100	…	…

[1] Broad financial accounts concept where available, otherwise credit from banks; partly estimated. [2] Annual changes, in per cent. [3] Peak period of real residential property prices = 100. [4] Land prices. [5] 1996–2002.

Sources: Nomisma; Office of Federal Housing Enterprise Oversight; Wüest & Partner; national data; BIS estimates. Table VII.4

Germany and Japan has been practically flat. Overall, the ratio of household debt to personal disposable income climbed steadily in most industrial countries from around 90% on average in 1990 to 115% in 2003.

… together with wealth …

This rise in household indebtedness has occurred against a backdrop of rapid gains in household wealth and very low levels of interest rates. With respect to wealth, the value of household assets has grown substantially over the past decade, driven initially by the buoyant stock market and more recently by higher house prices. Particularly in 2003, strong performance in both markets resulted in a noticeable rebound in household net worth in the OECD area. Hence, the increase in household debt is less remarkable when compared to the growth of aggregate household assets than when compared to the growth of personal disposable income. With respect to interest rates, the debt service ratio, a key measure of the financial soundness of the household sector, has remained below historical averages in many countries, largely because interest rates have stayed historically low (Graph VII.12).

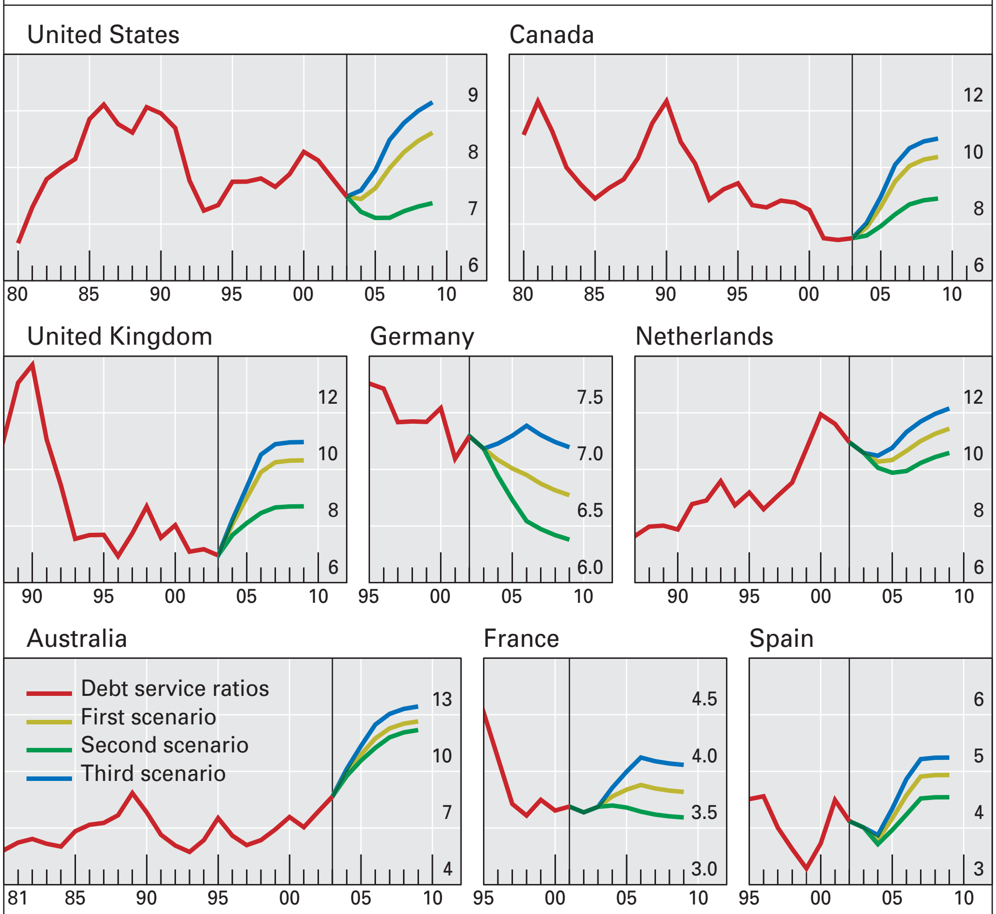
… making households vulnerable …

Nevertheless, high household indebtedness raises concerns about the vulnerability of consumer finances. This, too, could have potential implications for the financial system.

… to higher interest rates …

The first set of concerns relates to a rise in interest rates. The resulting increase in the debt service burden could lead to mortgage defaults and losses for financial intermediaries. Importantly, the impact of higher interest

Sensitivity analysis of debt service ratios[1]



[1] The projections reflect the estimated sensitivity of effective interest rates on household debt to policy rates and spreads on the basis of historical data for each country. The impact on the debt service ratio is then calculated by reference to the projected path of the effective rate and the household debt/income ratio under three scenarios. In the first scenario, the short-term interest rate returns to its historical average (since 1990) over three years, and the debt/income ratio remains at its current level. In the second scenario, the short-term interest rate increases gradually by 200 basis points over three years, and annual income growth exceeds household debt growth by 2%. The third scenario is similar to the first, except that household debt grows faster than income by 2% per annum in the next three years.

Sources: National data; BIS calculations. Graph VII.12

rates would vary significantly across countries, depending on the characteristics of the national mortgage financing systems. These factors, which can differ widely, include the duration of the mortgage rate, the cost of refinancing, the development of mortgage securitisation, transaction costs and special tax treatment for home purchases. In countries where variable mortgage rates are prevalent, such as Australia, Ireland, Spain, the United Kingdom and most Nordic countries, an increase in interest rates, particularly if unexpected, would feed back quickly to the household sector. Financial stress in the household sector might then translate into a deterioration in loan quality for financial institutions. By contrast, where mortgage rates are predominantly fixed, as in France, Germany, Italy and the United States, the interest rate risk is borne directly by lending institutions. The effectiveness of hedging strategies for interest rate risk can be substantially complicated in the presence of inexpensive refinancing options that introduce prepayment risk. Other factors tend to limit the vulnerability of banks to strains in the mortgage market. In countries where mortgage securitisation is fully developed, real estate loans could be sold outside the banking system, thereby partly transferring the interest rate risk to the capital market. In addition, the deductibility of mortgage interest payments tends to lower the effective interest rate on household debt and thus to reduce the responsiveness of debt servicing costs to interest rates.

Interest rate risk alone, however, is not very likely to pose a serious threat to the balance sheet position of households. Holding the household debt/income ratio constant, a rise in the short-term interest rate tends to push up the effective interest rate on household debt and by extension raises the debt service burden. Nevertheless, approximate calculations on the basis of aggregate data indicate that the debt service ratio would remain much lower than its historical peak in most countries (with the notable exception of Australia), even in the case of a marked run-up in rates (first scenario in Graph VII.12). For example, a return of the policy rate to its historical average in the United Kingdom (ie an increase of 335 basis points) over three years would raise the debt service ratio to slightly above 10%, a level well below the peak reached in the early 1990s.

… or subdued income growth

The impact of interest rate changes on the debt service capacity also depends critically on income growth. Should the economy experience a strong recovery and income grow faster than debt, the increases in the debt service burden would be much lower. By contrast, should the household debt/income ratio continue to climb, a rise in interest rates could cause significant financial difficulties for the household sector (third scenario in Graph VII.12).

Banks' exposure to house prices …

A second concern relates to the possibility that substantially slower rates of house price growth, or even price declines, might force households to cut their expenditure. Should this occur before the expansion of the corporate sector gained a firm footing, the financial sector would lose a major source of resilience. Moreover, if prices were eventually to fall, this would be likely to trigger mortgage defaults and financial stress. The strength of this feedback effect partly depends on the level of prudential ceilings on loan-to-value (LTV) ratios. These vary substantially: from 50% in Italy to the unusually high level of 110% recently observed in the Netherlands. The effect of high LTV ratios is reinforced when used in conjunction with mortgage accounting practices based on the current market value of property (as followed in most industrial countries except Denmark, Germany and Switzerland).

… and household debt …

While the above discussion applies to all market participants, the incidence of strains need not be evenly spread across different subgroups of households. Lower-income households, which are most likely to be affected by a decrease in income or an increase in unemployment, have relatively high debt service burdens. In the United States, for instance, about one quarter of lower-income households have a debt service requirement greater than 40% of their income. By contrast, only 2.5% of households in the highest income decile are leveraged to a comparable degree. Accounting for the impact of the distribution of debt across households might, therefore, have important implications for assessing the risk associated with rising household indebtedness.

... is only indirect

Overall, although household debt should not pose a major direct risk to financial intermediaries, it could have an indirect impact in the form of greater sensitivity of consumer spending to interest rates and asset prices (see Chapter II). Should consumer spending slow markedly, this would presumably affect corporations' profits and their capacity to service debt as well. Moreover, one cannot rule out entirely the possibility that these adverse shocks, including higher interest rates and lower asset prices, could occur simultaneously. Were this to happen, the macroeconomic effects of greater indebtedness would be more complicated, and this indirect risk to financial institutions would be more difficult to hedge.