Edgar Meister: EU banking sector stability

Statement delivered by Mr Edgar Meister, Member of the Board of the Deutsche Bundesbank and Chairman of the BSC, Frankfurt, 24 February 2003.

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In my capacity as Chairman of the Banking Supervision Committee (BSC), I am very pleased to present to you the committee's *report on EU banking sector stability*, which has been prepared with the assistance of the Working Group on Macro-prudential Analysis, chaired by Jan Brockmeijer from the Dutch central bank. The report summarises the outcome of one of the main lines of the committee's activity, namely our regular monitoring of banking sector stability in Europe. This is an activity that we have developed over the past few years through the cooperation of the EU national central banks, the EU banking supervisors and the ECB. We have now reached a stage where we felt we could share our findings with a wider audience.

The stability analysis is based on a wide range of quantitative and qualitative information drawn from national supervisory data sources and the ECB, as well as on an exchange of information among the member organisations of the BSC, the EU central banks and supervisory authorities. The BSC has already achieved substantial progress in terms of harmonising consolidated bank profitability and balance sheet data - something which is of pivotal importance for macro-prudential analyses.

I am confident that today's presentation will be the starting point for what will develop into a good tradition. The main purpose of the document is to provide an overview - *from an EU-wide perspective* - of the resilience of the EU banking sector and of the potential threats to its stability. The report also places into the public domain new EU-level information on bank profitability and solvency developments.

I believe that the report - and, more generally, the monitoring activity of the committee reflected in the report - will bring two main benefits. First, the EU-wide scope of our analysis complements the similar analysis carried out by the competent authorities at the national level with reference to domestic banking systems. Second, the close cooperation among central banks and supervisory authorities produces substantive value added in terms of forming an assessment of the relevant issues.

Let me now turn to the main findings of the review. We find that banks' profitability weakened in 2001 and showed a further weakening in the first half of 2002. The downward trend in profitability has come about as a result of two adverse developments in the EU banks' operating environment. First, the deterioration in the economic cycle and in borrowers' credit quality has led to increasing provisions against loan losses. Second, the plunge in global and, in particular, European stock markets has given rise to greater risk aversion and uncertainty in other financial markets. This has reduced banks' non-interest income from investment banking and trading activities.

We also find that, for many large banks, diversification has not generated the desired benefits, as several businesses have deteriorated at the same time. In particular, internationally operating banks have been affected by the adverse capital market behaviour owing to the high proportion of their investment banking and asset management business. Banks that focus on retail banking and have a strong franchise in domestic markets have fared best under the prevailing circumstances.

In our analysis we have focused, in particular, on banks' heightened credit risks. Banks' loan loss provisioning has already accelerated and banks have generally anticipated the increase in loan losses by improving provisioning reserves. The strain on banks' profitability could therefore continue over the short term. Nevertheless, the profitability of EU banks at mid-2002 was not much below the average between1995 and 1999 and the level of provisioning is still in line with what tends to be normal provisioning levels in an economic downturn.

EU banks' solvency levels have remained unaffected in all size groups of EU banks, allowing them to withstand the shocks in their operating environment. The aggregated total regulatory capital ratio for the EU banking system as a whole in 2001 stood at 12%, i.e. well above the required minimum level of 8%. EU banks have made efforts not only to maintain but also build up capital levels. Their resilience in the face of adverse developments owes much to the satisfactory capital buffers that are in place as well as to improved risk management, active cost-cutting efforts and continuous access to wholesale market liquidity. However, attention should be paid to the preservation of adequate capital levels, since a deterioration in profitability reduces banks' ability to withstand further shocks.

Given the present circumstances, EU banks' lending policies are an issue of particular current relevance. The quantitative and qualitative information collected at the committee level does not provide strong evidence of supply-side constraints in any member state. EU banks seem to have appropriately tightened credit standards - pricing as well as collateral requirements - in line with increased risks, rather than becoming restrictive in lending because of capital shortages.

Finally, let me try to give an outlook for risks to EU banks stability. In this context, we find that the risk outlook is crucially dependent on the timing and speed of the recovery in the EU economy. However, the outlook for growth in the EU also hinges on global recovery. Developments in the US and possible military action against Iraq are key external factors in terms of potential risks. Adverse macroeconomic developments would impact quite strongly on EU banks' profits owing to a significant increase in provisioning needs and a reduction in income from traditional retail banking. Nevertheless, we remain confident that the EU banking sector will continue to display a notable capacity to withstand any further shocks in the economic and financial market environment.

Given this situation, efficient banking supervision is of paramount importance. Given the challenges posed to EU banks and potential cross-border implications, coordination among supervisors and central banks in the EU is essential. In particular, the BSC is taking due account of this necessity and providing a common forum. In this connection, it is worth mentioning that stability analyses and the monitoring of structural developments in the EU banking sectors form the core of the BSC's work. Thank you very much for your attention.