VII. The financial sector in the advanced industrial countries

Highlights

Overall, the financial sector in the advanced industrial countries registered a good performance in the period under review. Building on the strengths of recent years, financial firms continued to improve profitability against a backdrop of generally favourable economic conditions and strong capital market activity. However, compared to the recent past, the picture was less uniform across institutions. In certain segments, clear signs emerged that excessively optimistic expectations might have been boosting the recent growth in activity.

The more sizeable risks to financial stability appear to lie in the medium term. Given the strong position of balance sheets and current profit levels, financial systems are well positioned to cope with likely near-term sources of strain. The potentially more important sources of vulnerability are indirect and remain linked to broader macroeconomic developments. The implications of past risk-taking, in the form of exposures related to property investments and to the leveraged financing boom, will depend critically on the future path of interest rates and the economy as a whole. A turn in the credit cycle, or a more general worsening of macroeconomic conditions, including a weakening in household spending, remain key sources of longer-term vulnerability.

Financial globalisation has been a major structural trend with important implications for the organisation of banking firms, the nature of their business strategies and their risk profiles. Banking firms seeking growth through cross-border mergers and exposures outside their home markets have created a network of international capital flows which offers profit and diversification opportunities. At the same time, these strategies carry a number of risks that relate to the performance of both individual institutions and national economies. As a result, the internationalisation of banking also has implications for prudential structures and for the calibration of policy instruments.

The performance of financial firms

The sound overall performance of financial firms continued to be supported by largely the same factors that have driven the positive results over the past several years. A favourable macroeconomic environment has provided the foundation upon which firms have built, taking advantage of the increased scope for diversification through new risk transfer instruments, the rapid pace of innovation in financial markets, and continuing efforts to control costs. The sector's general optimism about the rewards from risk-taking has so far been supported by a benign credit environment and generous revenues from expansion into new areas. The financial system as a whole has been able to

deal effectively with problems that materialised with individual firms or specific markets, indicating the existence of comfortable cushions and a sufficient degree of flexibility to respond to shocks. However, patchy performance in various segments, coupled with a general trend towards higher leverage and more aggressive risk-taking, also suggests that those attributes could be put to more severe tests in the medium term.

Commercial banks

Commercial banks had a solid overall performance last year. Profits remained generally buoyant, helped by continuing growth in credit demand, low costs from defaults and low yield curve volatility (Table VII.1).

European banks grew stronger ...

European banks continued to pursue growth on the basis of fee-generating services to households and retail business clients. Credit growth remained quite strong overall, although its pace began to moderate in countries like Spain, where it has been the strongest for some time (Graph VII.1). Moreover, surveys point to a relaxation of credit standards vis-à-vis households and businesses. Competitive pressures and access to alternative sources of funding have combined to encourage less stringent covenants on loans, in particular for corporate borrowers engaged in mergers and acquisitions. The increased ability of lenders to diversify away credit risk through derivatives or securitisation, or in the fast-growing secondary loan market, may also have contributed to this slippage in standards. Nevertheless, banks in most countries do not appear to be facing difficulties in managing pressures from defaults. On the contrary, provisions are generally low and declining. In those cases where signs of deteriorating quality of loan portfolios did appear, such as in the United Kingdom and Spain, lenders were able to maintain healthy profit levels.

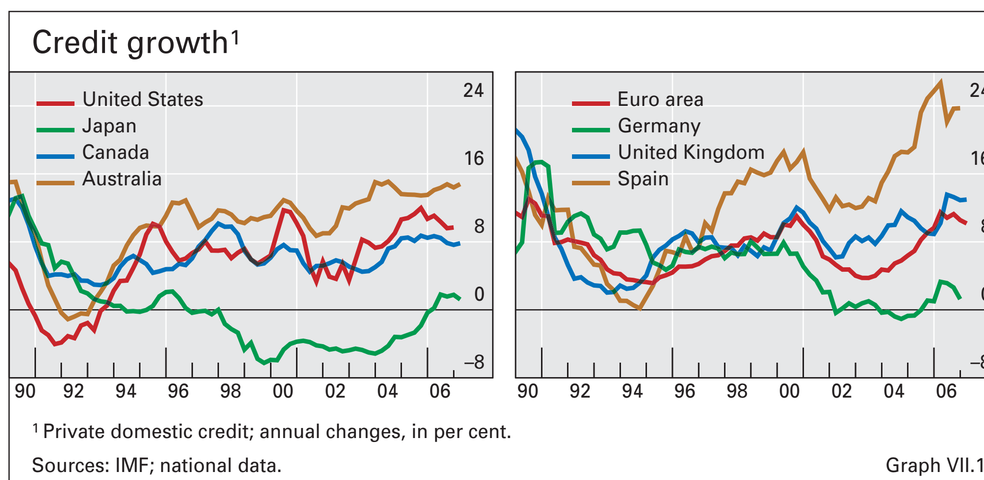
Profitability of major banks[1]

As a percentage of total average assets

	Pre-tax profits			Provisioning expenses			Net interest margin			Operating costs		
	2004	2005	2006	2004	2005	2006	2004	2005	2006	2004	2005	2006
United States (10)	1.84	1.89	1.83	0.19	0.17	0.18	2.78	2.65	2.51	3.46	3.25	3.10
Canada (5)	1.22	1.01	1.32	0.06	0.10	0.10	1.97	1.79	1.64	2.92	3.00	2.56
Japan (13)	0.34	0.73	0.94	0.55	0.14	0.09	0.95	0.85	0.97	1.70	1.29	1.37
Australia[2] (4)	1.48	1.39	1.61	0.18	0.13	0.13	2.09	1.68	1.96	2.18	1.62	1.64
United Kingdom[3] (9)	0.95	0.87	0.98	0.20	0.23	0.27	1.21	1.07	1.13	1.69	1.58	1.68
Switzerland (5)	0.73	0.68	0.84	–0.01	–0.02	–0.01	0.96	0.68	0.45	2.72	2.34	1.72
Sweden[2] (3)	0.91	0.90	1.03	0.02	0.01	0.01	0.99	0.88	0.76	1.21	1.07	1.12
Austria[2] (3)	0.78	0.85	1.64	0.34	0.31	0.38	1.83	1.64	1.90	2.41	2.09	2.40
Germany[4] (9)	0.13	0.37	0.47	0.22	0.08	0.09	0.72	0.63	0.66	1.41	1.15	1.19
France[3] (6)	0.65	0.67	0.86	0.08	0.05	0.06	0.86	0.83	0.81	1.49	1.94	1.43
Italy[2] (5)	0.87	1.05	1.15	0.41	0.24	0.32	1.99	1.70	2.14	2.83	2.11	2.54
Netherlands[2] (4)	0.50	0.59	0.55	0.08	0.05	0.10	1.26	1.10	1.14	1.51	1.30	1.45
Spain[2] (5)	0.89	1.18	1.51	0.24	0.23	0.34	1.47	1.55	1.78	1.78	1.80	2.12

[1] The values in parentheses indicate the number of banks included for 2006. [2] All values are IFRS. [3] For 2005 and 2006, IFRS; 2004 values are a mix of local GAAP and IFRS. [4] Values are a mix of IFRS and local GAAP.

Source: Fitch Ratings. Table VII.1



¹ Private domestic credit; annual changes, in per cent.
Sources: IMF; national data. Graph VII.1

... and continued to consolidate

European banks continued to consolidate. The removal of actual and perceived obstacles to mergers in countries like Germany and Italy has encouraged deals, which in the case of Italy have been the single most important driver of bank share performance. The prospective cross-border merger involving some of Europe's largest banks is also likely to trigger further deals among competitors. However, for most of the period under review, acquiring banks were primarily focused on exploiting rapid growth opportunities by establishing a presence in countries that have recently acceded to the European Union and in emerging markets in south-eastern Europe.

Record profits in the United States together with signs of levelling-off

US banks remained healthy and profitable, but a few signs began to suggest a possible tapering-off of profit growth. Although the period under review saw the sixth consecutive year of record earnings, the average return on assets and equity fell slightly while overall profits seemed to decelerate in the second half of the year. This was mostly the result of the continued compression of interest margins and the slowdown in housing market activity and associated revenues from mortgage lending. The effect was more pronounced for smaller lenders, whereas larger banks were more successful in supplementing their income from a broader range of non-interest sources. Banks remained well capitalised but, although provisioning costs stayed at very low levels, non-performing loans and charge-offs edged up, especially in loan categories where growth had been strongest in recent years. More recently, lenders are reported to have tightened credit standards in their retail book, apparently in response to increased signs that debt levels might be stretching the balance sheets of higher-risk households (see Chapter II). At the same time, survey evidence suggests that terms on credit to businesses eased.

Stability in Japan

Japanese banks registered a second consecutive year of positive financial results, albeit not an improvement over the previous year's performance. Lower operating profits reflected the continuing pressure on margins and the persistently weak growth in credit demand. Having recovered a sense of stability on the domestic front, Japanese banks have been exploring opportunities to expand abroad, especially in Asia. The public sector continued to divest from its banking interests through privatisation and changes in the profile of state-owned lenders.

Investment banks

The period under review saw yet another year of record profits for investment banks. Strong drivers of revenue growth were the corporate advisory business, prime brokerage services and proprietary activities, including those associated with private equity deals. Higher profits were also supported in the near term by an increased appetite for risk among the major international houses.

Record investment bank profits driven by …

It was also a record year for merger and acquisition (M&A) transactions, partly due to booming activity of private equity funds (see Chapter VI). In addition to receiving advisory fees, investment banks benefited from this activity in a variety of ways. Larger houses supported these deals by offering loan financing to the private equity acquirer, but also by participating in many cases as equity investors committing their own funds. Securities underwriting contributed significantly to income growth (Graph VII.2), although the business environment favoured larger houses with global operations, to the disadvantage of lower-tier investment banks.

… an M&A boom …

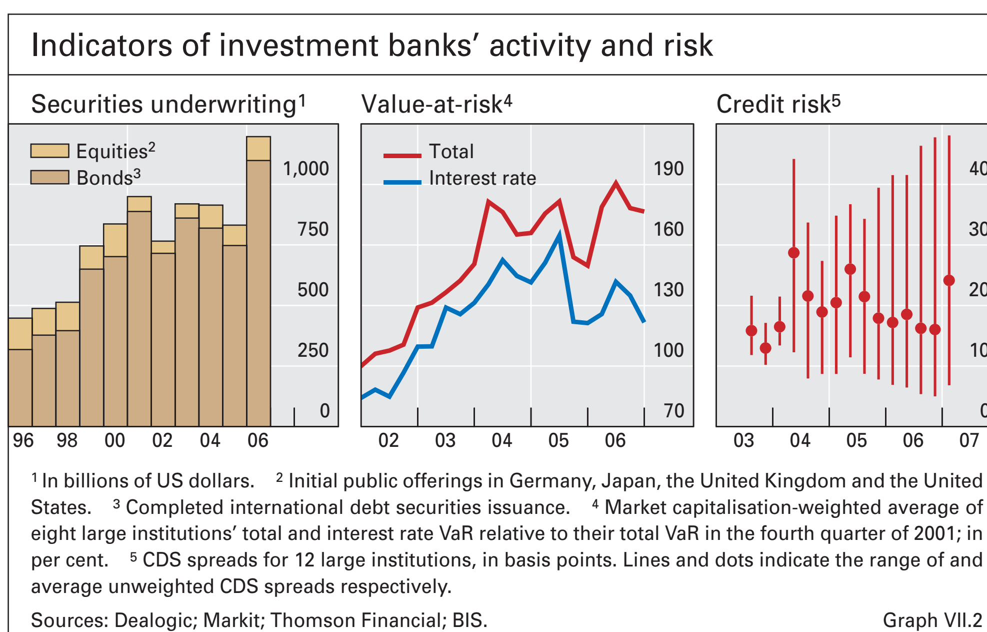
Proprietary trading and involvement in the structured finance business have been another important source of investment bank profits for some time. Major US houses registered record gains from such activities and were able to boost their return on equity beyond 20%. Universal banks relied more on the strength of their asset and wealth management franchise to achieve similar, albeit lower returns. Broader market liquidity and active trading by clients, including hedge funds, boosted the profits of those firms with strong capital markets functions.

… and proprietary business …

Higher profits have been associated with higher risk-taking. Disclosed figures of value-at-risk (VaR) for major investment banks have almost doubled since 2002 (Graph VII.2). Viewed against the backdrop of a low-volatility environment, this increase indicates an intensifying propensity to take on risk, although the relationship of VaR to equity has remained relatively

… go together with higher risk-taking

Indicators of investment banks' activity and risk



[1] In billions of US dollars. [2] Initial public offerings in Germany, Japan, the United Kingdom and the United States. [3] Completed international debt securities issuance. [4] Market capitalisation-weighted average of eight large institutions' total and interest rate VaR relative to their total VaR in the fourth quarter of 2001; in per cent. [5] CDS spreads for 12 large institutions, in basis points. Lines and dots indicate the range of and average unweighted CDS spreads respectively.

Sources: Dealogic; Markit; Thomson Financial; BIS. Graph VII.2

constant. Similarly, the credit risk associated with many of these firms' outstanding bonds, as measured by the premia on credit default swaps (CDSs), increased substantially in 2007, indicating counterparties' concern about the potential risks in their investment strategy in the event of a turn in market conditions.

Hedge funds

Continuing trends among hedge funds:

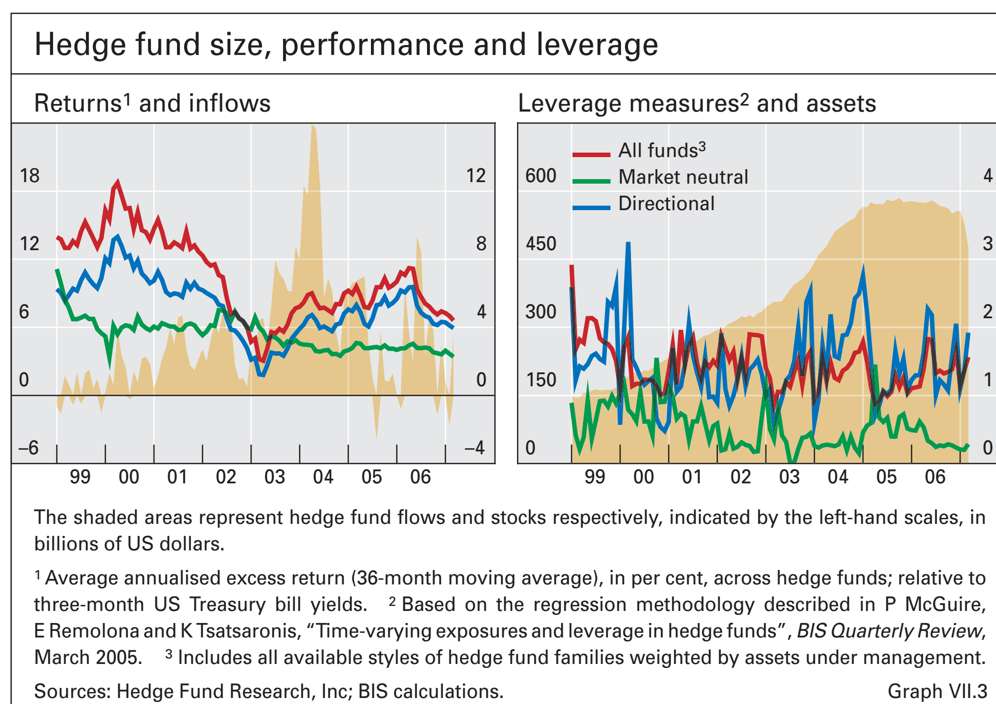
Developments in the hedge fund sector did not deviate significantly from the patterns established in the previous year. Continuing moderate investment performance, punctuated by the high-profile failure of a large fund, went hand in hand with a slowdown in the rate of growth of the sector. At the same time, the trend towards greater institutionalisation persisted, allied with continuing calls for greater transparency in funds' activities.

moderation in returns and inflows …

Overall, average investment performance remained subdued during the period under review (Graph VII.3, left-hand panel). Many funds experienced strains during the second quarter of 2006, and while performance rebounded slightly during the fourth quarter, returns suffered again in the subsequent one. Net inflows remained volatile during most of the period, before turning moderately negative towards the end of 2006. Investor interest in the sector appears to have levelled off over the past couple of years, and closures have outnumbered new funds launched.

… more risk-taking …

The search for yield opportunities has attracted hedge fund activity to many of the booming markets for risk transfer, most notably those related to credit risk. Hedge funds have become key suppliers of liquidity in these markets through active trading, while their willingness to take on risk has supported the hedging operations of those institutions that are more focused on originating and servicing the underlying assets. Coming under greater



The shaded areas represent hedge fund flows and stocks respectively, indicated by the left-hand scales, in billions of US dollars.

[1] Average annualised excess return (36-month moving average), in per cent, across hedge funds; relative to three-month US Treasury bill yields. [2] Based on the regression methodology described in P McGuire, E Remolona and K Tsatsaronis, "Time-varying exposures and leverage in hedge funds", *BIS Quarterly Review*, March 2005. [3] Includes all available styles of hedge fund families weighted by assets under management.

Sources: Hedge Fund Research, Inc; BIS calculations. Graph VII.3

competitive pressure, and making use of favourable funding conditions, the sector has opted for somewhat higher leverage levels compared to the recent past, in an effort to boost returns (Graph VII.3, right-hand panel).

The combination of an opportunistic investment style and reliance on leverage has prompted concerns among some market observers about hedge funds' ability to withstand a more challenging market environment. In fact, the failure of a large fund due to outsize bets in the natural gas market served as a reminder of the potential fragility of hedge funds' financial strategy. In that particular event, however, other market participants were ready to contribute to the smooth unwinding of these positions, and the fund's difficulties did not have repercussions in the broader market.

... and pressure to improve disclosures

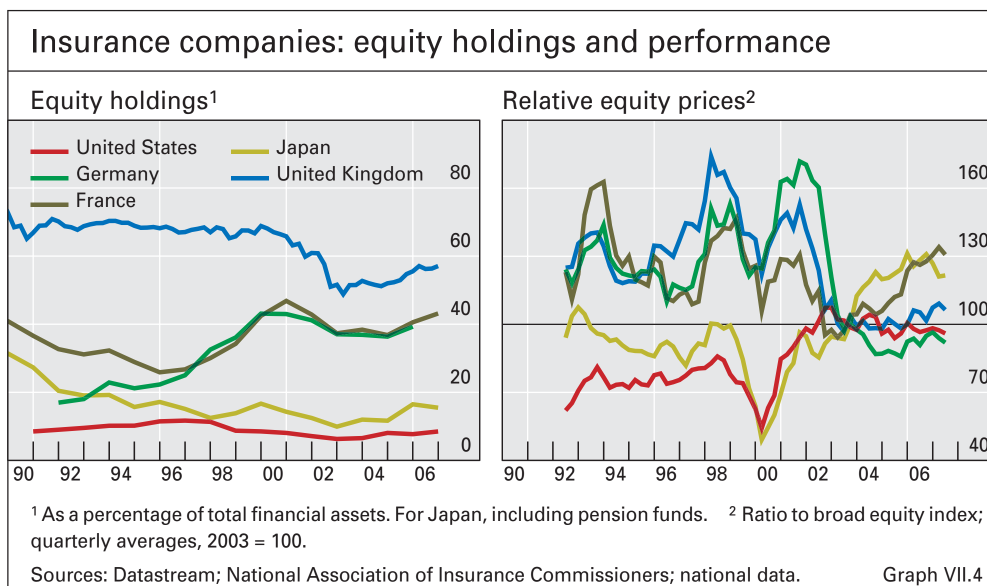
An important change in the sector has been the trend towards greater transparency. Some of the larger fund companies have sought stock exchange listing or have disclosed information about their operations in the process of issuing public bonds. Rating agencies are also prepared to issue counterparty ratings for hedge funds. On the official side, pressure continues towards more formal arrangements for the oversight of the sector.

Insurance companies

The fortunes of insurance companies improved during the period under review. More favourable market conditions shored up balance sheets in all sectors, while the non-life sector made a dramatic recovery from the challenging environment of the previous year.

Life insurers remained strong ...

Healthy equity market performance and somewhat higher interest rates improved life insurers' balance sheets and boosted demand for their policies (Graph VII.4). In the United States, individual variable annuity sales continued to grow strongly, thanks to a rising stock market and the increase in the number of retirees. In France, life insurance premium growth was driven by a surge in demand for unit-linked policies, while growth in the UK annuity market was supported by strong demand by pension funds.



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, 2003 = 100.

Sources: Datastream; National Association of Insurance Commissioners; national data. Graph VII.4

By contrast, the recovery in premium growth in Japan halted, as the increased demand for individual annuities failed to offset the decline in individual life insurance premiums.

... despite low yields

Relatively low long-term yields represent a challenge to life insurers, especially in the presence of minimum guaranteed returns on their policies. Flat yield curves do not encourage demand for savings-type products, while low long-term interest rates raise the cost of their funding. This increases companies' dependence on sales of investment-type products. Given the large financial market exposure of life insurers, a potential turn in the credit cycle and adverse global macroeconomic developments could pose risks to profitability.

Non-life insurers recovered ...

Non-life companies recovered well from a very costly 2005, when claims had surged as a result of a series of natural catastrophes. Most US and Bermudian property and casualty insurers and reinsurers registered a remarkable turnaround, as firmer premium rates, a low level of claims and strong investment performance combined to boost income and restore profitability. In contrast, premium growth for European non-life insurers was more modest, while Japanese non-life insurers exhibited lower net profits owing to higher typhoon-related claims and investment losses.

... but risks are expected to remain high

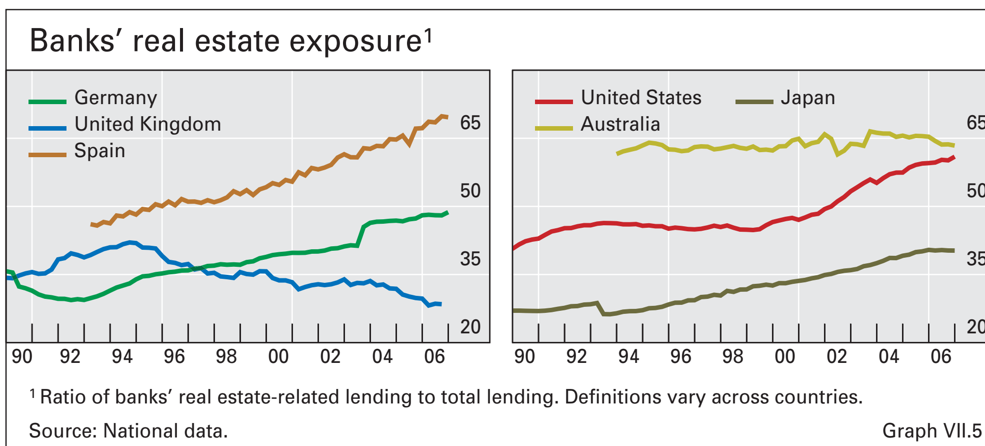
Despite the relatively benign 2006 tropical storm season, the coming years are expected to witness a higher level of hurricane-related losses in the United States than the pre-2005 average. The increased risk raised premium rates and limited global reinsurance capacity in 2006. In order to overcome capacity limits and withstand large-scale natural disasters more easily, non-life insurers are likely to continue building up their capital buffers.

Vulnerabilities

The main sources of financial system risk may be rooted in possible excesses over the past years of growth, but their effects may only materialise over the medium term. Elevated exposures to real estate, an increase in leveraged finance, including in the booming private equity market, and a worsening in the credit cycle are important areas of vulnerability. In the near term, the continuing good performance of the financial sector augurs well for the system's ability to withstand likely shocks. Over the longer run, the severity of strains will remain critically connected to future macroeconomic developments.

Property exposures

The possibility of a slump in real estate markets remains a significant risk to financial stability. Over the past several years, real estate financing has been a major activity and an important source of profits for banks in many countries (Graph VII.5). The boom in the markets for securitised assets related to property financing has spread the direct and indirect exposures to property risk widely across the financial system. Residential property investments account for most of the growth in exposures. Commercial property markets are arguably less exuberant, although markets for related investments are susceptible to contagion from their residential counterparts (see Chapter VI).



Banks' real estate exposure[1]

[1] Ratio of banks' real estate-related lending to total lending. Definitions vary across countries.

Source: National data. Graph VII.5

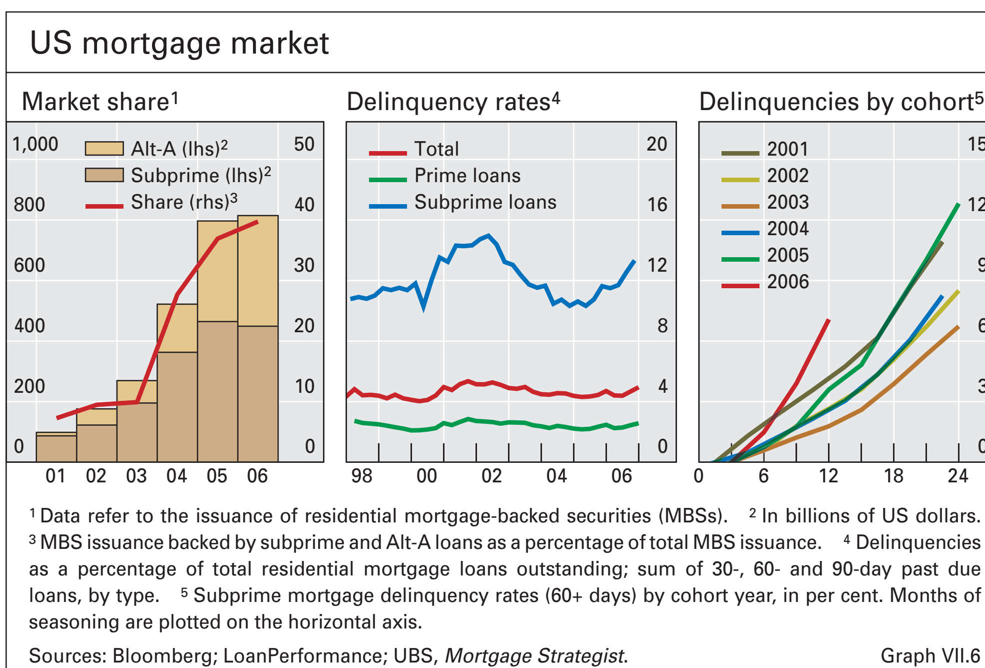
Residential real estate

Buoyant housing markets …

The buoyancy of residential property prices in many jurisdictions has been supported to a large extent by low interest rates and accompanied by a rapid expansion of mortgage credit to households. Intensified mortgage activity has also been an important source of fee income for the originating institutions. Moreover, a favourable economic environment has meant that credit costs associated with overall mortgage defaults have stayed at historically low levels, further flattering the bottom line of banks and other mortgage holders. The low incidence of losses has also supported the deepening of structured finance markets for residential mortgages by stimulating the interest of portfolio investors in securities linked to the cash flows from such loans.

… and laxer standards …

Greater securitisation has brought about a broader dispersion of exposures among market participants but has also distorted the incentives of mortgage originators, principally in the United States. By placing greater emphasis on income that is directly linked to the volume of originated loans,



US mortgage market

[1] Data refer to the issuance of residential mortgage-backed securities (MBSs). [2] In billions of US dollars. [3] MBS issuance backed by subprime and Alt-A loans as a percentage of total MBS issuance. [4] Delinquencies as a percentage of total residential mortgage loans outstanding; sum of 30-, 60- and 90-day past due loans, by type. [5] Subprime mortgage delinquency rates (60+ days) by cohort year, in per cent. Months of seasoning are plotted on the horizontal axis.

Sources: Bloomberg; LoanPerformance; UBS, *Mortgage Strategist*. Graph VII.6

securitisation has often led to an erosion of credit standards. In addition, mounting competitive pressures and extrapolative expectations about house price growth have arguably led to an underpricing of mortgage risk, a shift towards floating rate contracts designed to keep servicing costs low early in the life of the loan, and a boom in the issuance of the riskier types of mortgage (Graph VII.6, left-hand panel). As a result, moderate increases in the level of interest rates have affected a larger fraction of outstanding mortgages than in the past. Delinquencies have risen, especially among the most recent loan vintages to high-risk categories of borrowers whose access to financing had been severely restricted in the past (Graph VII.6, right-hand panel).

… created risks

Future developments in interest rates, house prices and overall business conditions will play a key role in mitigating or exacerbating these risks. Interest rates will influence the cost of servicing existing mortgage debt and affect the demand for new loans, while the state of the business cycle will impact household incomes (see Chapter II). Forced sales are likely to compound the unsold housing stock, putting further downward pressure on house prices.

Commercial real estate

In most countries, commercial real estate markets appear to be in an upward cyclical phase. Absorption of new properties has been strong, vacancy rates

Commercial property prices[1]

	Nominal change[2]			Level[3]	*Memo: Office vacancy rates*[4]		
	1997–2005	2005	2006	2006	*2004*	*2005*	*2006*
United States	2.9	12.0	12.3	42.3	*16.0*	*13.9*	*12.6*
Japan	–7.9	10.5	19.6	19.2	*6.0*	*3.9*	*3.0*
Germany	–1.5	–4.9	–5.2	36.2	*11.4*	*11.6*	*9.9*
United Kingdom	3.8	13.4	17.2	69.4	*9.8*	*7.3*	*5.7*
France	4.2	6.2	15.0	71.5	*6.6*	*6.5*	*5.1*
Canada	2.8	9.1	13.2	59.5	*14.4*	*12.1*	*10.5*
Spain	1.4[5]	5.0	7.6	98.6	*8.4*	*6.1*	*3.4*
Netherlands	2.5	0.1	4.3	80.9	*12.0*	*13.6*	*11.7*
Australia	4.2	10.9	2.6	54.5	*11.5*	*7.2*	*8.3*
Switzerland	1.2	2.1	0.0	61.0	*9.0*	*11.5*	*10.9*
Sweden	2.8	5.6	9.5	48.5	*17.6*	*16.8*	*15.4*
Norway	1.6	6.3	10.8	63.8	*11.0*	*9.0*	*8.2*
Denmark	7.8	19.8	9.0	100.0	*10.3*	*7.9*	*5.0*
Finland	4.2	11.9	12.0	80.3	*9.5*	*9.0*	*8.1*
Ireland	12.0	16.7	21.7	100.0	*16.7*	*15.2*	*12.0*

[1] For Australia and Denmark, prime property in major cities; for Japan, commercial land prices for six large city areas. [2] Annual changes, in per cent. [3] Peak period of inflation-adjusted commercial property prices = 100. [4] 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, the Netherlands and Spain, average of major cities; for other countries, capital city. [5] Between 2001 and 2005.

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. Table VII.2

have been falling from a high level, and prices have been rebounding from generally low levels (Table VII.2).

Commercial property exposures have risen ...

Commercial bank lending to the sector has been growing sharply in a number of countries, in some cases triggering concern among regulators. US banks have nearly doubled their commercial property loans over the last five years, with such loans making up 14% of total assets in September 2006. Loan growth has been mostly concentrated in small and medium-sized banks, where commercial real estate lending amounts to more than three times their risk-weighted capital. In Japan, bank regulators have cautioned lenders against indiscriminately increasing their exposures to commercial property.

... but markets remain resilient so far

The publicly traded segments of the market have been performing exceedingly strongly. Annual market rates of return on equity stakes in commercial real estate investment vehicles have been in the range of 15–20% in the past three years, making the asset class a favourite among investors searching for higher yields. However, returns seem to be driven mainly by capital gains as rental yields have remained steady or even declined in some markets, such as the United Kingdom and the United States. This raises the possibility that a worsening of the strains in the markets for securitised residential mortgages could create ripple effects in traded markets for commercial real estate investments.

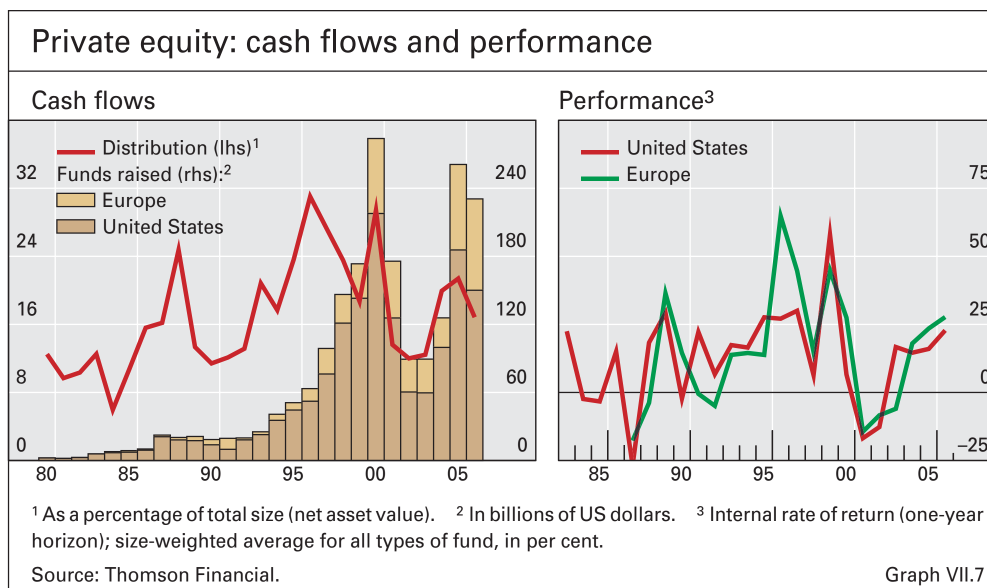
Leveraged financing

A feature of financial sector activity over the past several years has been a greater reliance on leverage to enhance investment returns. Two manifestations of this feature have been the boom in the activity of private equity funds and the gradual trend towards more highly leveraged strategies among hedge funds. In both cases, the incidence of higher leverage has been somewhat concentrated on a relatively small number of players so far, but in an environment of laxer credit standards there is a risk of it becoming more generalised.

The private equity boom intensified ...

The boom in private equity intensified in the past year. There was a further increase in the number of private equity deals completed and, importantly, in

Private equity: cash flows and performance



[1] As a percentage of total size (net asset value). [2] In billions of US dollars. [3] Internal rate of return (one-year horizon); size-weighted average for all types of fund, in per cent.

Source: Thomson Financial. Graph VII.7

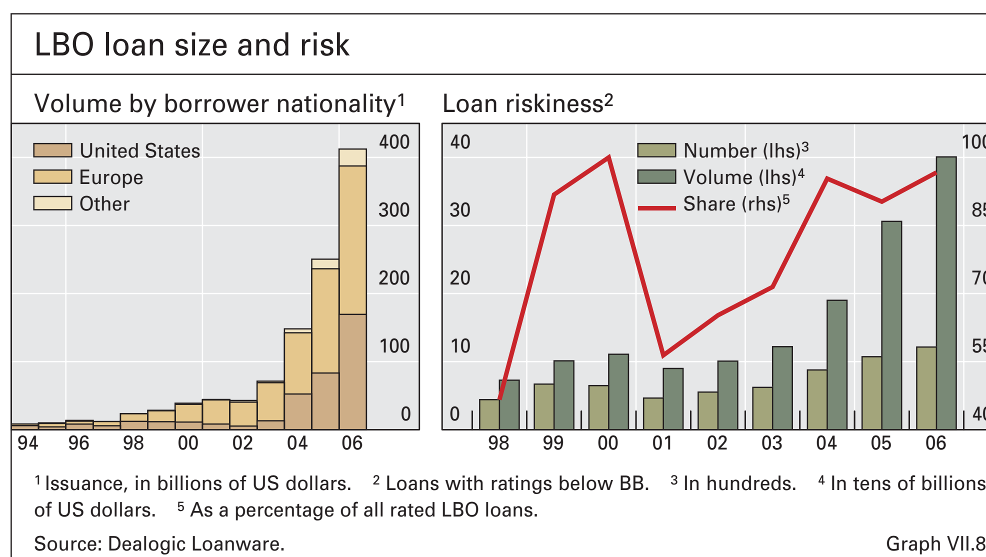
the average size of transactions (see Chapter VI). Private equity funds targeted larger companies, often pooling their resources in consortia. Increased activity was matched by enhanced performance (Graph VII.7), although arguably the latter largely reflected previous investment decisions. As a result, funds were able to raise near record sums of capital from investors seeking higher yields, including many pension funds and funds of hedge funds. Few of the larger funds have issued, or are interested in issuing, public equity in order to gain access to a permanent source of capital.

... fuelled by easy credit

Easy financing has played a key role in the private equity boom. Funds have issued record levels of debt to finance these deals. The volume of international syndicated loans related to leveraged buyouts (LBOs) increased by 70% last year. While the strongest growth was registered in the United States, the majority of loans were granted to European borrowers (Graph VII.8, left-hand panel). Reported leverage in such transactions has been trending upwards, as funds have been able to access financing on easier terms, including through contracts with covenants that are considerably less restrictive for the borrower. Together, these factors have led to a surge in speculative grade loans, which account for 90% of all LBO loans arranged over the last two years (Graph VII.8, right-hand panel).

Higher leverage and ...

The levels of leverage employed in private equity transactions have raised questions about their longer-term sustainability. Acquired companies' capital structures are altered through so-called "leveraged recapitalisations", which flatter the acquirer's income at the expense of the target's equity. This is a key component of funds' financial strategy and can partly account for their strong performance. However, the strategy depends on the availability of cheap funding, and the financial health of the acquired companies (and associated debt) would be the most vulnerable in the event of a worsening in the credit or business environment. While the releveraging appears to be largely confined to the targeted companies (see Chapter VI), there are concerns that expanding LBO activity will create pressures for companies to increase debt levels more generally, either as a defence against being



[1] Issuance, in billions of US dollars. [2] Loans with ratings below BB. [3] In hundreds. [4] In tens of billions of US dollars. [5] As a percentage of all rated LBO loans.

Source: Dealogic Loanware. Graph VII.8

taken over or in an effort to raise the return on equity to match that of private equity targets.

Another concern is the relative opacity of the companies that have been taken private. Reduced disclosure requirements for companies that are not listed in public markets restrict public scrutiny of their management, while the growing size of the acquisitions puts a premium on the adequacy of governance structures in private companies.

... opaqueness increase overall risk

Similar worries relate to the activities of hedge funds. Higher levels of leverage (Graph VII.3) combined with relative opaqueness have raised concerns that any future problems in the sector could spread widely across the financial system. Counterparties may have underestimated the riskiness of individual funds and the overall fragility of markets where the funds are active.

The credit cycle

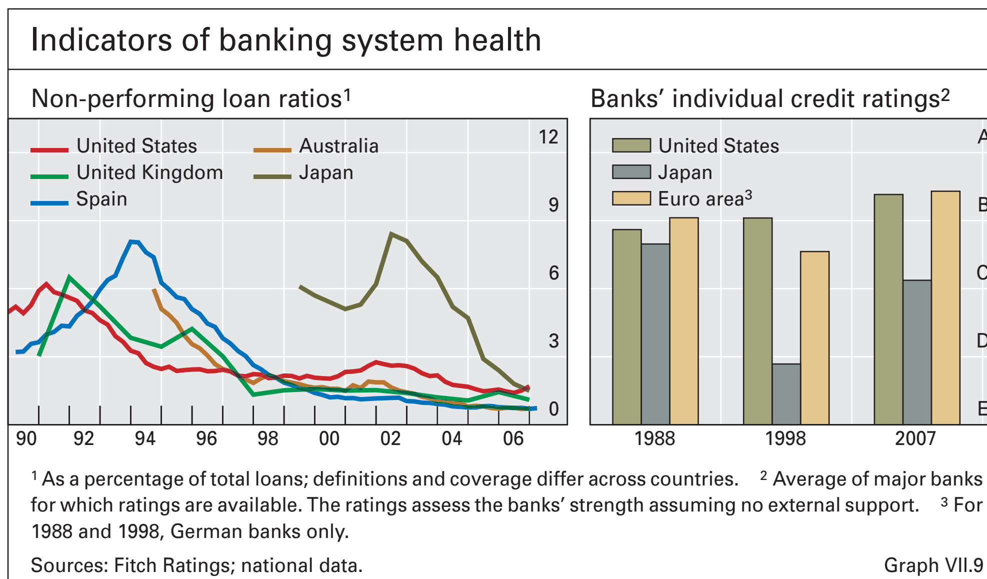
Given the key role that a benign credit environment has been playing in boosting the performance of the financial sector over the past years, a turn in the credit cycle represents a significant risk to its outlook. Investment strategies that are predicated on continuing low spreads and rising asset prices are critically exposed to an increased incidence of defaults. The way the credit cycle interacts with overall macroeconomic conditions will determine the challenges to financial stability over the medium term.

Benign credit conditions ...

Low and declining credit costs have been a major feature of financial firms' performance. The level of non-performing loans in bank portfolios has been at historical lows in many countries (Graph VII.9) and, coupled with low provisioning, has contributed to banks' high profitability. Together with low interest rates, the benign credit environment has supported the supply of funding that has been the driving force behind the buoyancy of structured credit product markets and leveraged financing activity.

... may have been exceptional

In many respects, these conditions could be characterised as exceptional from the perspective of recent business cycle experience. The long period of



[1] As a percentage of total loans; definitions and coverage differ across countries. [2] Average of major banks for which ratings are available. The ratings assess the banks' strength assuming no external support. [3] For 1988 and 1998, German banks only.

Sources: Fitch Ratings; national data. Graph VII.9

economic growth that started in the mid-1990s was interrupted only briefly by the relatively mild slowdown in the early part of this decade following the bursting of the technology bubble. During this episode, the financial system was able to deal effectively with a spate of corporate defaults thanks to growing demand for credit by households and the beneficial impact of strengthened credit risk transfer mechanisms.

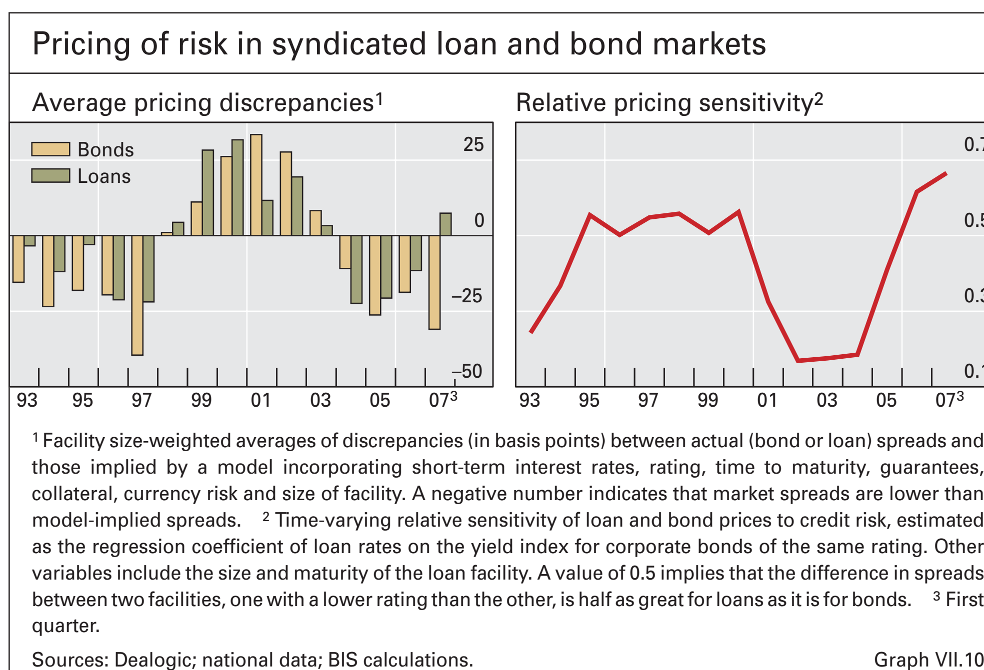
Dealing with higher credit risk ...

A turn in the credit cycle is arguably within the expectations of market observers, although its timing would be hard to predict. Signs of strain in housing finance markets have multiplied, primarily in the United States, and household indebtedness remains a concern in many jurisdictions as retail loan delinquencies have risen. While corporate defaults are still very low (see Chapter VI), the sustainability of higher debt levels would in some cases be at risk in the event of a worsening of business conditions or a less accommodating supply of credit.

... depends on ex ante discipline

A general question regarding the ability of banks to weather potential strains from a turn in the cycle, possibly associated with a broader slowdown in economic activity, relates to the discipline they have shown in their lending standards. A favourable environment has encouraged more aggressive lending practices in some segments, such as mortgages to high-risk borrowers. More generally, the risk sensitivity of loan pricing appears to have increased in recent years. Syndicated loan spreads appear to have widened compared to bond spreads over the past year and to have become more sensitive to credit risk (Graph VII.10). This is a positive sign, although the stock of richly priced debt accumulated over the earlier part of the decade may become a source of risk to lenders' portfolios as these loans mature. Dealing with higher default rates in a changing environment may create incentives for some form of forbearance with respect to existing borrowers, further weakening the asset quality of lenders and curtailing the supply of new credits.

Pricing of risk in syndicated loan and bond markets



[1] 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. A negative number indicates that market spreads are lower than model-implied spreads. [2] Time-varying relative sensitivity of loan and bond prices to credit risk, estimated as the regression coefficient 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. A value of 0.5 implies that the difference in spreads between two facilities, one with a lower rating than the other, is half as great for loans as it is for bonds. [3] First quarter.

Sources: Dealogic; national data; BIS calculations.

Graph VII.10

The internationalisation of banking

The growth in international banking activity has been a major structural trend in industrial economies for the last few decades. Initially, banks' international expansion mainly took the form of cross-border business. More recently, though, banks have increasingly established a direct presence in foreign jurisdictions. This trend has brought a number of benefits to both exporters and importers of financial services in the form of greater diversification, access to broader sources of funds and transfer of know-how. At the same time, however, it has presented a number of policy challenges for both home and host authorities in terms of how to assess and address financial sector risks and in terms of overall macroeconomic management.

Trends and patterns

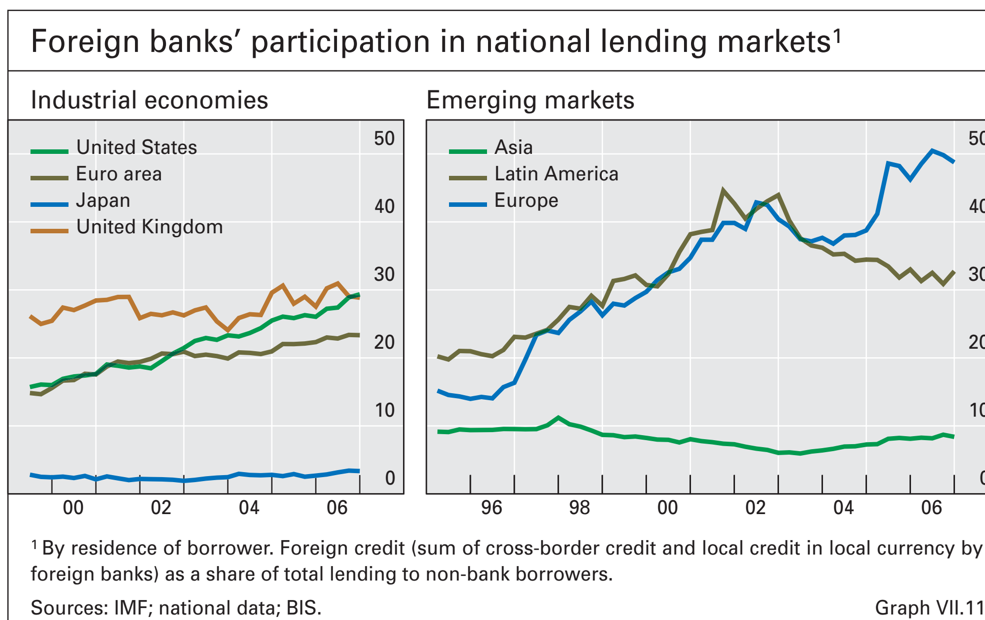
Growing internationalisation of banking …

The international component of banks' activities has been growing steadily over the past 30 years. International claims of banks located in industrial economies rose at an average annual rate of 11.5% between 1977 and 2006. Over the past 10 years the pace has accelerated, exceeding 18% in the most recent year. Measured against economic activity, these claims have quintupled since 1980, reaching the equivalent of 50% of world GDP by 2006. The rate of growth has not been uniform, with the data showing pronounced cycles in activity. However, the current pace of growth has only been exceeded twice since the mid-1970s.

… driven by general economic trends …

This progressive internationalisation has been driven to a large extent by the factors that have supported the general globalisation of business and trade. Financing the needs of booming cross-border economic activity and following banks' traditional customers in their international ventures have been important motivations for the development of international banking activity. Moreover, greater capital account liberalisation has allowed borrowers to receive funding

Foreign banks' participation in national lending markets[1]



[1] By residence of borrower. Foreign credit (sum of cross-border credit and local credit in local currency by foreign banks) as a share of total lending to non-bank borrowers.

Sources: IMF; national data; BIS. Graph VII.11

through foreign-based intermediaries. In many national markets, foreign-headquartered banks contribute a large and increasing share of total credit to non-bank borrowers, either directly from abroad or through their local offices (Graph VII.11). Among the major industrial economies, foreign banks account for a higher share of total credit in the United States, the United Kingdom and the euro area than in Japan. In emerging market economies, where privatisation and consolidation have altered the banking landscape, foreign bank participation has risen markedly in Latin America and Europe, albeit with substantial differences between individual countries.

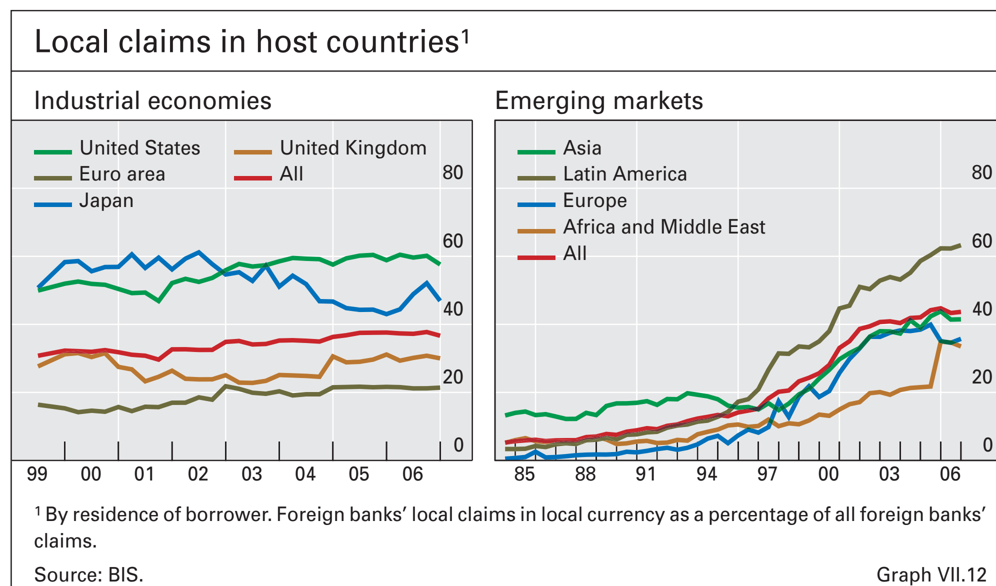
... and specific structural factors

In addition, a number of structural factors, more specific to the financial industry, have elevated international expansion to an independent objective of banking firms. Advances in communications and computing technology and innovations in financial markets, as well as advances in the measurement and management of financial risk, have helped many banks extend the scope and scale of their business. These developments have facilitated the increase in international activities by lowering their cost. At the same time, as the limits to domestic growth were being reached because of declining returns on investment and anti-monopoly regulations, international expansion presented the most promising avenue for those institutions seeking balance sheet growth.

Patterns include ...

It is not easy to describe global patterns in banking internationalisation. Experiences differ across countries and banks, owing partly to the influence of historical and institutional factors, and partly to differences in the underlying structure and development of the respective economies. Nevertheless, it is useful to review some broad characteristics of the internationalisation process. These relate to the choice between establishing a local presence abroad and providing banking services across borders, the associated patterns of funding and lending in local currency, and the growing size of the interbank markets, together with the role of banking centres in channelling international flows.

Local claims in host countries[1]



[1] By residence of borrower. Foreign banks' local claims in local currency as a percentage of all foreign banks' claims.

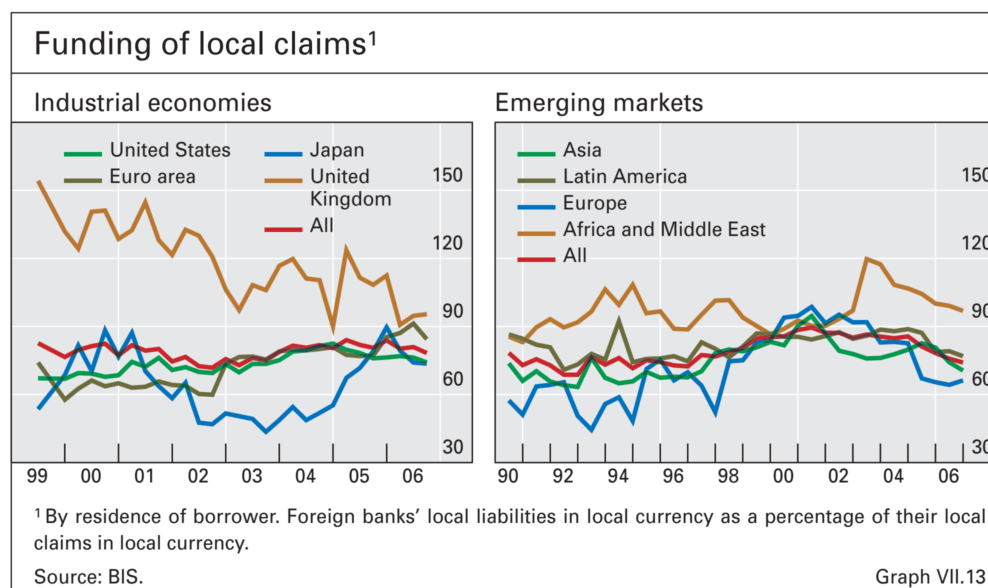
Source: BIS.

Graph VII.12

An important aspect of the international activities of banks is whether they are conducted through local offices in the foreign jurisdiction or cross-border from the home office. The relative importance of international credit channelled through local offices varies significantly across countries and over time. In the late 1990s, international banks' lending through local offices accounted for about one quarter of claims vis-à-vis borrowers abroad (Graph VII.12). There was, however, considerable diversity depending on the country of the borrower. Foreign banks tended to favour a local presence in the United States and Japan, while they seemed to opt for cross-border lending within the euro area. The diversity across emerging market economies was much less pronounced.

... a shift towards local presence ...

In most regions, there has been a consistent upward trend in favour of local presence. Among advanced industrial economies this has been particularly evident in the United States, where lending through local offices has risen to about 60% of total international claims. By contrast, despite the introduction of the single currency, there has been little discernible increase in cross-border establishment of banks within the euro area. The growing importance of local presence has been most pronounced among emerging market economies. Over the course of the current decade, the share of claims channelled through local offices has grown to more than 40% of the total. Financial sector liberalisation and privatisations, in many cases in the aftermath of financial crises, have facilitated the opening of branches or the acquisition of local banks. Even so, the aggregates conceal considerable variation across individual countries, owing to idiosyncratic factors. During the past decade, foreign bank ownership has risen most notably in the Americas and among emerging and transition economies in Europe, and less so in Asia, Africa and the Middle East. This reflects a broader trend whereby an increasing fraction of mergers and acquisitions in the financial industry are cross-border, both in industrial and in emerging market economies. As a result, a number of banking systems are now effectively foreign-owned, as in New Zealand, Mexico and some central and eastern European countries.



[1] By residence of borrower. Foreign banks' local liabilities in local currency as a percentage of their local claims in local currency.

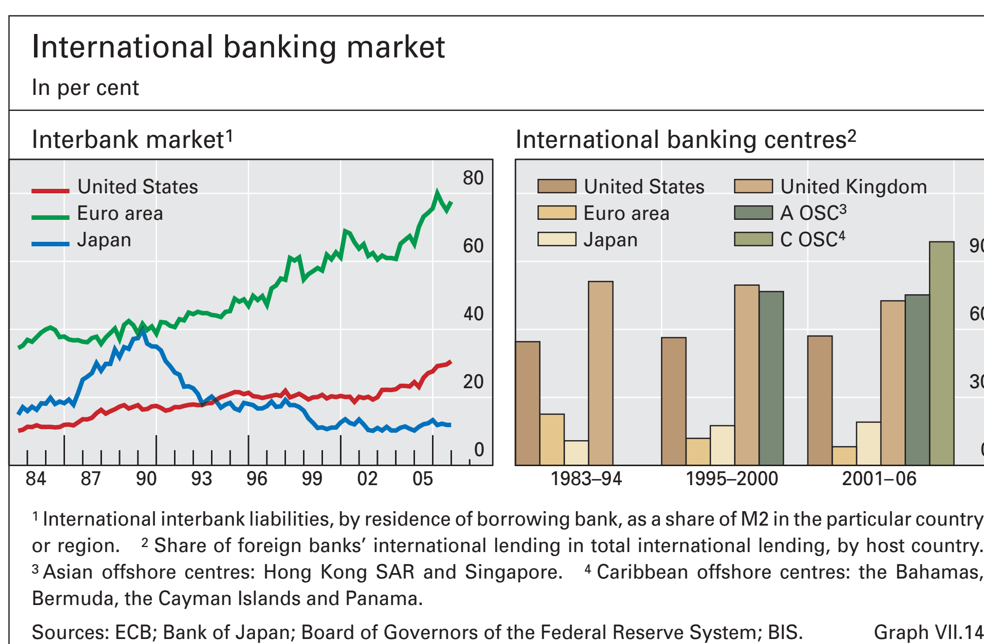
Source: BIS. Graph VII.13

… increased reliance on local funding …

The shift from cross-border banking towards the creation of international banking organisations can be seen in the extent to which their local claims are locally funded. Foreign banks increasingly serve foreign markets by having their offices raise deposits locally, substituting for cross-border liabilities or local liabilities in foreign currency. Local funding in industrial economies amounts on average to about 80% of local claims in local currency. While local offices in the United Kingdom have tended to overfund local sterling lending with local sterling deposits, the opposite has been the case for banking offices in Japan. In emerging market economies, an upward trend in local funding could be discerned during the late 1990s (Graph VII.13). This trend was especially evident in Europe and Asia, perhaps in response to vulnerabilities exposed during the Asian crisis. It has since reversed along with the incidence of currency crises. A strategy of balanced increases in local assets and liabilities may reflect a number of motivations, such as more emphasis on retail banking (offering mortgages and credit cards to local depositors) or reduced vulnerability to currency mismatches and transfer risk. Local assets and liabilities will tend to increase in parallel, whether foreign banks grow their local operations organically or engage in cross-border acquisitions of banks with an existing depositor base.

… growing interbank activity …

Exposures to other banks represent the lion's share of international bank assets and liabilities, accounting for over 60% of the total. The interbank segment of the international banking market has steadily expanded in most countries, both in absolute volume and relative to domestic monetary aggregates (Graph VII.14, left-hand panel). International interbank activity is particularly important for European banks, especially those domiciled within the euro area. With the advent of the euro the interbank deposit market within the single currency area received a major boost, becoming a key channel for the efficient allocation of liquidity. By contrast, the prolonged weakness of Japanese banks has led to a shrinking of their participation in the international interbank market since the mid-1990s.



[1] International interbank liabilities, by residence of borrowing bank, as a share of M2 in the particular country or region. [2] Share of foreign banks' international lending in total international lending, by host country. [3] Asian offshore centres: Hong Kong SAR and Singapore. [4] Caribbean offshore centres: the Bahamas, Bermuda, the Cayman Islands and Panama.

Sources: ECB; Bank of Japan; Board of Governors of the Federal Reserve System; BIS. Graph VII.14

While the international banking market is fairly diffused across jurisdictions, a small number of international banking hubs play a key role in the overall distribution of funds. These centres are characterised by a high percentage of international banking activity conducted by foreign-headquartered institutions. The dominant shares of the United Kingdom and the United States in interbank activity mirror the role of London and New York as international financial centres. The United Kingdom, in particular, attracts over 20% of global interbank deposits, with foreign banks accounting for more than 70% of the overall international banking activity in this jurisdiction (Graph VII.14, right-hand panel). In addition, a number of countries, including Asian and Caribbean offshore centres, have established themselves as regional hubs, playing an important role in intermediating banking flows between regions.

… and the emergence of hubs

Policy challenges

The internationalisation of financial intermediation brings benefits for home and host economy alike, but it also presents a number of challenges for individual institutions as well as for home and host country policymakers. Home and host financial systems benefit from banks that are better diversified, on both the assets and liabilities side of their balance sheets, and from a potentially more stable source of financing for economic activity. The challenges are both microeconomic and macroeconomic in nature. They relate to the management of the different types of risk that arise as a result of the greater complexity of banks with international operations. Assessing the performance and vulnerabilities of internationally active institutions and the stability of open financial systems requires cooperation between authorities in sharing information and coordinating policy interventions, often in the context of asymmetric incentives.

The trend poses challenges to banks and policymakers

Micro

At the level of the individual institution, the greater internationalisation of banks' operations brings about a greater degree of complexity. The conduct of cross-border business requires operations to be adapted to differing client, market and prudential cultures, and also coordinated across different units within the organisation. Meshing corporate cultures, harmonising practices and creating an effective reporting and control structure are key success factors. The fact that in some cases foreign units were previously independent entities may complicate the task.

Cross-border banks are more complex …

The challenges for the authorities in charge of the prudential oversight of internationally active banks are similar in scope, albeit different in nature. They revolve around the differences in perspective between the home and host authorities. Monitoring of performance and assessment of the risk profile of these institutions depend critically on the availability of sufficient information regarding overall activities and business practices. This task naturally includes forming a view on the risks associated with international exposures or mismatches in the maturity and currency composition of an institution's overall balance sheet. Cooperation between home and host authorities in sharing information, views and specific local knowledge is a key component of an

… and more difficult to monitor …

effective monitoring mechanism. Similarly, differences in the design and application of prudential tools in the various jurisdictions can conflict with the bank's attempt to manage its business on an integrated basis, taking advantage of synergies and diversification opportunities. Differences in the classification rules for non-performing assets and provisioning requirements are a case in point.

… and to manage under stress

Complexity also interferes with the effectiveness of intervention when the bank comes under stress. Assessing the solvency of a bank depends on forming precise views about the current and prospective value of its assets and liabilities. The timely and accurate evaluation of illiquid or opaque items often benefits from local supervisory expertise. This highlights the importance of open channels of communication between the authorities in different jurisdictions. Moreover, access to emergency support will be subject to potentially different practices and conflicting incentives of various authorities which would prefer that national resources not be put at risk in support of foreign operations and foreign creditors of the bank.

The resolution of crises is also complicated by the fact that decisions concerning the workout process, in the event of a failure, will also be influenced by national interests and differences in perspective of the parties involved. To what extent intermediation capacity should be preserved in the host jurisdiction could well be a point of contention. So too could be the sharing of the financial burden via the commitment of public funds. The issues become particularly complex when the distribution of the affected bank's international activities gives rise to asymmetric perspectives among the authorities involved. This would be the case when, for example, the operations in the host country are small in comparison to the size of the international bank, but systemically important when compared to the size of the local economy. The two authorities may then have sharply different views on the issue of closure.

Macro

Internationalisation …

The growing internationalisation of banking also presents challenges from the point of view of macroeconomic management, both in the traditional sense of control of liquidity and credit flows by the monetary authority and in the sense of ensuring the overall stability of the financial system.

… may complicate monetary policy …

The ability of internationally active banks to manage liquidity and balance sheets across the jurisdictions in which they operate may at times weaken the effectiveness of monetary policy instruments. Easier access to funding from abroad facilitates banks' ability to pursue high-yielding opportunities in periods of persistent international interest rate differentials. Aggressive lending strategies may also increase the supply of credit to households and businesses at lower interest rates, but at a much elevated exchange rate risk, which is more difficult to appreciate. These practices can weaken the power of monetary policy instruments and frustrate the authorities' pursuit of policy objectives. The experience in central and eastern European economies is a notable example. Until recently, credit expansion had defied the efforts of central banks to stem it, and this has boosted domestic demand, supported buoyant housing prices and contributed to rising current account deficits.

… and the management of systemic risk

Similarly, from a macroprudential perspective, internationally active banks present challenges to policy efforts aimed at financial stability. As regards the monitoring of vulnerabilities, these challenges are relatively balanced between home and host authorities. Both need to evaluate potential scenarios that involve developments in the economies where domestically active banks have important operations. By contrast, the application of prudential tools in leaning against imprudent practices comes up against control and incentive issues. Locally applied measures may be ineffective if largely international institutions represent a major share of domestic banking activity. And coordination between prudential authorities can be hampered because of differences in perspective if the host country operations are only a small component of the overall activities of these institutions. In addition, the management and resolution of systemic crises has to confront the obstacles highlighted above in the case of individual institutions, namely the availability of high-quality and timely information, legal and operational complexity, and conflicting interests of participating authorities. The situation is further complicated by misalignments between the claims on the institutions' resources from different authorities and the distribution of any fiscal costs of the workout.

Policymakers have been addressing the issues

In view of these policy challenges, efforts are being made to create structures that facilitate the risk assessment of internationally active banking firms and enhance crisis management. Concrete examples include setting up bilateral and multilateral mechanisms in the form of regular forums, and establishing templates and other communication channels to aid the joint assessment of the performance of these banks. Often these efforts are formalised as memoranda of understanding between the relevant authorities, but they can also have a more informal, although not necessarily less useful, character. The development of global regulatory standards is an important step towards achieving greater coherence in prudential frameworks across jurisdictions. While standards relate to the design of regulatory instruments, such as capital and provisioning rules, they also contribute to the formation of a common supervisory culture by establishing best practice in their application. Finally, structures that have been put in place to improve the flow of information for monitoring purposes have also been used to discuss and plan action in the event of systemic stress. These discussions may be necessarily more informal given the complexity of the issues and concerns about moral hazard.

Scope for further progress

Despite the progress made so far, many aspects require further work. This is not only due to the complex circumstances of particular banks or the institutional framework prevailing in specific jurisdictions. It also reflects the fact that the nature of the policy challenges is changing as the economics of cross-border banking evolve.