Edgar Meister: EU banking sector stability

Speech by Mr Edgar Meister, Member of the Executive Board of the Deutsche Bundesbank and Chairman of the Banking Supervision Committee, on the occasion of the presentation of the EU Banking Stability Report, Frankfurt am Main, 7 November 2006.

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In my capacity as Chairperson of the Banking Supervision Committee, I am very pleased to present to you the report entitled “EU banking sector stability” published by the ECB today. As always, the BSC’s EU banking sector stability report examines the implications of recent macro-economic and financial market developments for the performance of the banking sectors of the 25 EU Member States.

Let me draw your attention to a special feature of this year’s report: Since the implementation dates of the new International Financial Reporting Standards (IFRS) are different across the EU, the banking data for the year 2005 were not – as in previous years – aggregated at the EU level. Instead, they are grouped according to whether they have already adopted the new standards or still follow the old national accounting regimes, based on local-GAAP. For 2005 data, EU total banking assets are roughly equally split between the two groups. Although the accounting differences may complicate the analysis, their impact on the overall assessment proved to be rather minor.

Now I would like to turn to the main findings of this report.

In brief: The resilience of the EU banking sector has further improved in 2005 and the first half of 2006, adding to the trend in place since 2003. The most obvious cause of this enhanced stability is higher earnings.

Profitability increased for EU banks across all size groups. The return on equity (ROE) reached roughly 15%, an increase of around three percentage points from 2004 figures for both groups (those who adopted IFRS and those who didn’t). All in all, the banks benefited from the favourable economic environment and from the generally buoyant financial market conditions. In addition, the impairment charges (in the IFRS terminology) or provisions (according to local GAAP) decreased further.

The strengthening of profitability showed no signs of abating in the first half of 2006 as the ROE for the set of large banks also increased three percentage points to stand just under 21 %. The main drivers of the further improvement in profitability were strong lending growth both to households and to the non-financial corporate sector, fees and commissions income and trading revenues, as well as continued cost containment.

Although the solvency position of EU banks slightly declined, this was largely due to the expansion of lending activities. Banks’ solvency levels nevertheless remained adequate to cope with unexpected losses, comfortably exceeding regulatory requirements. However, banks’ net interest income continued to fall in 2005 and the first half of 2006. The narrow lending and deposit margins were mostly due to competitive pressures or flat global yield curves.

Along the positive earning growth and the consequent increase in buffers against potential drawbacks of income growth, we note improvements in the banks’ risk modelling and risk management systems which have significantly enhanced their loan portfolio.

While these developments generally improve banking sector stability, potential risks also need to be considered. In this regard, two recent developments should be subjected to intensified scrutiny.

First, the credit cycle might be showing more clear-cut signs of turning. Then, the currently appetite for risk-taking might be punished by rising volatility in various financial asset classes. Also, the bulk of mortgage loans that have been recently contracted at variable rates might result in increasing credit risk, as more and more households might become unable to service their debts. Moreover, the exceptionally low levels of default rates in corporate sector might turn up again.

Ample stress-testing has been conducted to evaluate the effects of various scenarios of rising interest rates, and the banks seem to be well prepared for this event. However, we should remain vigilant with respect to this risk.

Second, banking activities involving high direct leverages such as leveraged buy-outs and indirect leverages such as investment in hedge funds are gaining importance. High leverages increase the vulnerability to unexpected events, and the volumes in these types of businesses underscore the

significance of this matter. At present, however, the high fees and commissions earned by banks in these activities represent initial buffers against potential risks.

Now, I would now like to stress two interesting themes mentioned in the report that – in my view – merit special attention.

Let me begin mentioning how impressive it is that such a broad spectrum of EU institutes have managed to improve profitability. One has to realise that 2006 is already the fourth consecutive year of rising profits. Not only the "usual suspects" of the banking industry took part in this favourable development, weaker institutes also trended upwards. Moreover, it was not only one source of banking income that outperformed in 2005 and the first half of 2006: lending to households and to the corporate sector grew, as well as income generated by fees and commissions. This broad spectrum of improved profitability is one reason for my generally optimistic outlook of banking sector stability in the near future.

The second topic I would like to draw your attention to is an interesting paragraph in the report that reflects on the links between large banks and hedge funds. Here, new practices are arising and are quickly establishing themselves as common standards. The report mentions e.g. the introduction of multi-asset platforms, portfolio-based cross-product margining and the prime broker services as the principal counterpart in hedge funds' transactions.

As analysts of banking sector stability, we have to take into account that the links between large EU banks and hedge funds are intensifying. It cannot be excluded that competitive pressures may have forced some prime brokers to compromise on due diligence when dealing with hedge funds. Continuing vigilance therefore remains essential for banks to ensure that they retain a good grasp of their overall exposures to unregulated financial institutions. However, in terms of financial market resilience, I tend to answer that the markets – and here I refer to a point I made before – have been making enormous progress in understanding the specific risks and in aligning their risk management systems accordingly.

While banks' risk management systems have improved over recent years, there are some uncertainties about the ways in which risks have been redistributed by credit risk transfer products, both within the banking system and between banks and other financial institutions, as well as about how the market for these products would perform in a more challenging macro-financial environment.

I would like to close my remarks with a cautious but positive outlook. The mostly positive assessment of financial conditions of banks outlined in the report is confirmed by forward-looking market-based indicators that continue to suggest a robust outlook for the EU banking sector in terms of profitability and credit quality.

Thank you for your attention. I am looking forward to receiving your questions on our assessment of the stability of the EU banking sector.