



ACCOUNTING FOR THE RESILIENCE OF THE EU BANKING SECTOR SINCE 2000

From 2000 to 2003 the EU banking sector endured a sequence of adverse shocks that came in rapid succession in an environment marked by slow economic growth. In spite of this challenging business environment, banks remained relatively robust and, by mid-2004, no major banking problems had surfaced in the European Union. This article investigates more closely the performance of the EU banking sector from 2000 onwards and identifies the most important factors that appear to account for the overall resilience of the sector. A distinction is made between cyclical and structural factors, with particular emphasis on the latter. In addition, comparisons are made between the current situation and some past stressful episodes for the banking sectors of some European countries.

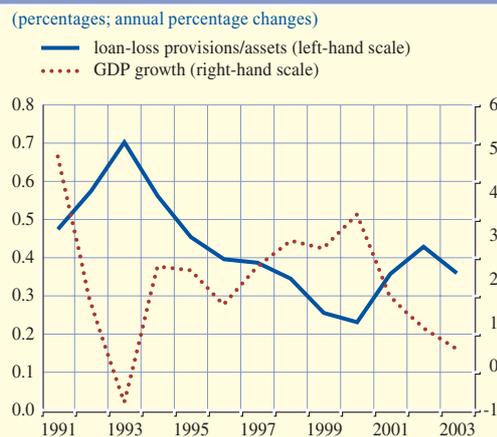
I A TURBULENT PERIOD FOR EU BANKS

In the period from 2000 to 2003 EU¹ banks were confronted with a slowdown of the global economy and a set of adverse shocks that crystallised over a relatively short time span. A significant stock market correction began in early 2000, correcting a bubble that had been building up since 1995. The stock market decline was amplified by revelations of alleged financial malfeasance by some major firms. Not only did this serve to heighten volatility in financial markets as confidence in the reliability of financial results disclosed by corporations was shaken, but it also raised questions about the role that banks had played in sustaining such practices. In addition, the Argentinian and Turkish economies were shaken by severe currency and banking crises, once again bringing the issue of country risk to the fore. Finally, the terrorist attacks in September 2001 in the United States not only proved to be a severe test for financial infrastructure and the markets, but also shook investor and consumer confidence.

AN ECONOMY IN SLOWDOWN

The constellation of adverse events occurred against the backdrop of a slowdown in the pace of economic growth in the euro area. From the late 1990s, a large build-up of corporate debt had occurred which made firms vulnerable to weakening economic conditions. The debt of non-financial firms in the euro area reached almost 65% of GDP in 2003, compared with somewhat more than 50% only five years earlier. Economic growth reached a peak in mid-2000 (see Chart 1).

Chart 1 Euro area GDP growth and loan-loss provisions of banks



Source: ESCB Banking Supervision Committee (see also Box 2 in the March 2004 issue of the Monthly Bulletin) and ECB.

In the following years, weak economic conditions prevailed given vulnerability in the international environment, geopolitical uncertainties and adverse developments in financial markets. The sluggish pace of economic activity led to slower bank lending growth, particularly for lending to the corporate sector. To some extent, this was compensated for by a robust increase in mortgage lending activity, spurred by the environment of historically low interest rates. The worsening economic conditions had a negative effect on the financial positions of firms and this in turn led to a deterioration in the asset quality of banks through an increase in loan-loss provisions (see Chart 1).

¹ In the absence of appropriate data, reference will sometimes be made to the euro area rather than to the European Union. The EU figures do not include the new Member States that joined on 1 May 2004.

A SEVERE STOCK MARKET CORRECTION

After 1995 equity prices showed an almost uninterrupted rise, but from March 2000 onwards they fell for three consecutive years (see Chart 2). By the end of 2002, stock prices had dropped to levels that were last seen in the aftermath of the financial crisis of autumn 1998. It was not until March 2003 that a gradual recovery set in. A major factor behind the fall in stock prices was a gradual realisation among market participants that profits might not live up to the optimistic expectations that had been discounted into equity prices. As optimism gave way to pessimism, an unwinding of the excesses that had built up in the late 1990s was set in motion, lowering stock prices and widening corporate bond spreads.

The stock market correction had several implications for EU banks. In particular, the growing importance of investment banking and asset management business, which had significantly boosted the fee income obtained by EU banks until 2000, came to an abrupt halt as the stock market slide impacted adversely on activity in the capital markets (see Chart 3). Falling equity and corporate bond issuance depressed investment banking income, and the boom in the asset management business

came to an end, at least temporarily. Investors tended to retreat from risk, showing greater appetite for highly liquid instruments with relatively low risk, such as money market funds, bond funds and deposits. The stock market decline also had a severe impact on EU insurance companies and this in turn affected those banks with close links to the insurance sector.

EPISODES OF ALLEGED CORPORATE MALFEASANCE

Amplifying the stock market correction, a number of corporate scandals shook investor confidence further. Some major companies, which had been considered star performers only shortly before, collapsed under huge debt that was often hidden behind complex financial transactions. Accounting irregularities were a common thread and these failures in corporate governance undermined market confidence in the reliability of corporate disclosures at a time when profits were already under severe pressure. Although some of the main abuses took place in the United States, as in the case of Enron and WorldCom, Europe too had a growing list of cases of alleged corporate malfeasance, including Ahold, Parmalat and Vivendi Universal.

Chart 2 Equity prices in the euro area

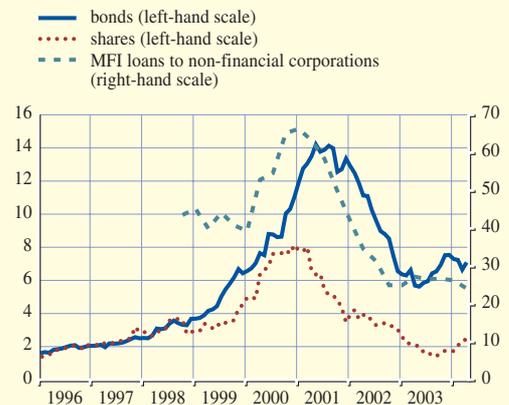
(index: 1995 = 100)



Source: Datastream (EMU indices).

Chart 3 Bond, equity and loan issuance in the euro area

(EUR billions)



Source: ECB.

The direct impact of these events on banks came mainly through their lending exposures. All in all, the exposures of European banks were not only fairly limited, but also well diversified, so that losses were absorbed without too many difficulties. However, general issues – including counterparty risk management, banks' ability to consolidate and control exposures when use is made of complex corporate structures, and the effectiveness of certain credit risk mitigation techniques – were raised. Apart from direct credit losses, some of these events also had an adverse impact on the way the market perceived the banks' legal and reputational risk. In particular, the conflicts of interest resulting from the different roles that a bank may assume in its relationship with a firm came under intense scrutiny. In some cases, banks were found to have underwritten and distributed securities, or to have provided favourable investment advice, knowing the parlous financial condition of their customers. Moreover, in certain cases, banks appeared to have aided some firms in concealing their underlying financial situation by engaging in intricate off-balance-sheet financing. Hence, banks may have suffered more from episodes of alleged corporate malfeasance than their direct credit exposures to the affected firms would suggest.

THE FALL-OUT FROM THE TERRORIST ATTACKS IN THE UNITED STATES

The immediate effects of the tragic terrorist attacks of 11 September 2001 in the United States were visible in the functioning of market infrastructures, such as payment and securities settlement systems, and of financial markets. The downward trend in stock prices was also temporarily reinforced (see Chart 2). However, no major disturbances occurred in the EU financial system. It may well be that the contingency plans that banks had in place for the millennium changeover contributed to their preparedness for a crisis situation. In the days immediately following the attacks, the authorities responded quickly and effectively to alleviate any liquidity strains that emerged in the system.

The more lasting impact of the terrorist attacks on the EU banking industry came mainly through the non-interest income and credit exposures of banks. In particular, the events reinforced the negative effects of the global decline in primary capital market activity that was already under way (see Chart 3). Banks that relied heavily on investment banking activity, or had credit exposures to economic sectors or regions that were significantly affected by the events, were vulnerable. More generally, the EU banking industry was faced with a deterioration of macroeconomic conditions that resulted from a fall in business and consumer confidence.

THE RE-EMERGENCE OF COUNTRY RISK PROBLEMS

In the period from 2000 to 2001, Turkey and Argentina were caught up in currency and banking crises, which even developed into a full-blown sovereign default in the case of Argentina. Over time, EU banks had increased their claims on these two countries. At the end of 2000, the consolidated gross international claims of EU banks were estimated at around €50 billion for Argentina and €35 billion for Turkey. In the case of Argentina, some major EU banks also had a large presence through local establishments, thus providing an additional spillover channel for the crisis. The crises had a limited economic effect on the EU banking sector as a whole, and only a few internationally active banks with cross-border exposures or local establishments incurred limited losses.

2 OVERALL RESILIENCE DESPITE ISOLATED WEAKNESSES

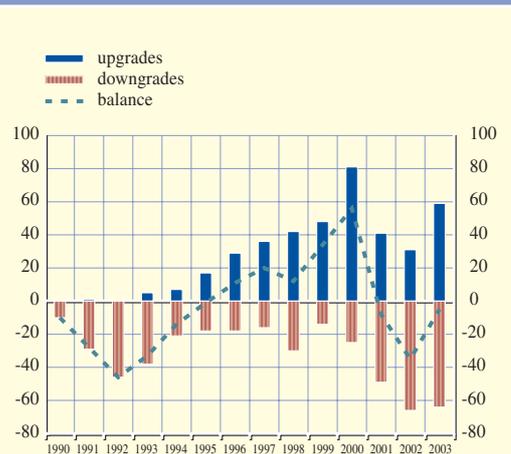
In spite of the challenging environment, the EU banking sector as a whole remained robust. The weak economic and financial market conditions translated into a reduction in the profitability of EU banks (see Chart 4). After reaching a peak of more than 12% in 2000, their return on equity declined for two consecutive

Chart 4 Profitability and operating efficiency of EU banks



Source: EU Banking Sector Stability Report (November 2003).

Chart 5 Rating changes of western European banks



Source: Moody's.

years. Increased loan-loss provisions for corporate loans, together with reduced commissions and trading income from capital market-related business, were the main factors behind this. Net interest income developments were also sluggish as growth in corporate loans declined.

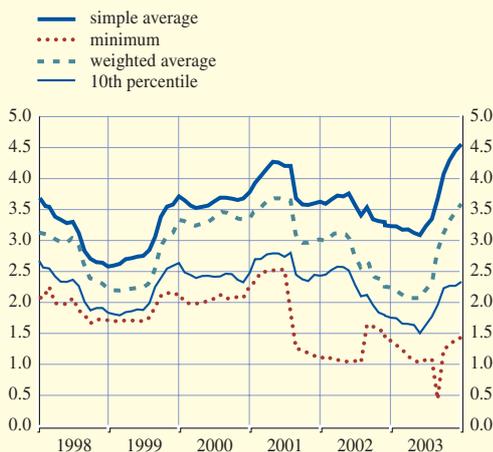
Although the decline in bank profitability was substantial, it still remained well above the levels reached in the mid-1990s. In response to the profitability pressures, banks started to implement cost-cutting measures by reducing the number of branches and employees. Some banks also reduced capacity in securities-related activities. At the same time, banks tightened their credit standards by increasing margins on new lending, particularly in lending activities with firms in higher-risk industries such as technology and construction. Some banks managed to boost their profitability significantly by selling non-core assets. Meanwhile, the ratio of loan-loss provisions to assets increased to 0.43% in 2002, compared with 0.23% in 2000, but declined again in 2003 (see Chart 1). As a result, the profits of banks began to recover from 2003 onwards.

The regulatory solvency ratios of EU banks remained relatively unaffected by the

deteriorating business environment, so that their capacity to absorb shocks remained intact. The aggregated total regulatory capital ratio hovered around 12%, well above the required minimum ratio of 8% for individual institutions. From 2002 onwards, there was even a slight improvement in the solvency position of banks, although this mainly reflected a reduction of risk positions rather than new equity issuance. The composition of the own funds of banks remained sound, with extensive reliance on stable and high-quality capital components.

Notwithstanding the ability of the banking sector as a whole to withstand shocks, some individual institutions did experience serious difficulties, mostly because of problem loans in certain sectors such as real estate. Other banks experienced less severe stress, but were nevertheless confronted with a reduction of their credit lines with other banks, thus reflecting increased credit risk concerns. More generally, the trend towards more secured transactions (such as repos) continued, which points to more careful counterparty risk management by banks.

The increased stress experienced by the banking system is also evident from the rating changes (see Chart 5). While the number of

Chart 6 The distance to default of 50 major EU banks

Sources: Datastream and Bankscope, ECB calculations.
Note: An increase in the distance to default reflects an improving assessment.

upgrades almost continuously outpaced the number of downgrades in the period from 1992 to 2000, a strong reversal took place afterwards, and there were no signs of improvement until 2003.

In addition, forward-looking market measures, such as the distance to default (see Chart 6),² and the conditions placed on banks' credit default swaps and subordinated debt pointed towards growing market concerns about banks' financial condition in the period from mid-2001 to mid-2003. Since mid-2003, however, these measures have indicated a significant improvement.

3 THREATS TO BANKING STABILITY IN THE PAST

On several occasions in the past, EU banks were exposed to challenging circumstances which affected their soundness and in some cases resulted in banking crises (see Box 1). A distinction can be made between isolated cases of bank failure and disruptions of the banking system as a whole. The former are often rooted in management and internal control failures. The latter tend to be closely linked to

macroeconomic factors, which can be either cyclical (e.g. recession) or structural (e.g. a weak regulatory environment) in character. Interestingly, as can be seen from Box 1, the frequency of crises has been very limited since 1997. In the following analysis, the focus will be on crises in banking systems resulting from macroeconomic factors, which serves to put the current performance of the banking sector into a historical perspective.

Available literature shows that macroeconomic instability has been an important underlying factor in most systemic banking crises. Stable macroeconomic conditions, in particular price stability, are an important precondition for banking and, more generally, financial stability. Overly expansionary monetary and fiscal policies can lead to lending booms, debt accumulation and spiralling asset prices. Since such policies are not sustainable in the long run, the subsequent corrections may lead to declining economic growth, lower asset values, debt-servicing problems and, ultimately, corporate defaults that affect the banking sector's financial health. External macroeconomic conditions, such as adverse terms of trade or real exchange rate swings, may contribute further to the development of a banking crisis.

Structural developments can be an important additional factor in explaining banking crises. Robust legal and supervisory frameworks are preconditions for a stable banking system. The liberalisation of entry conditions to local banking markets may lead to the emergence of new intermediaries, thus challenging the position of incumbent banks. Financial innovation can lead to the rapid growth of new financial products, such as financial derivatives, outpacing the experience of the banks in dealing with them.

² The distance to default represents the number of asset value standard deviations from a bank's default point. It can be calculated using option pricing theory. The default point is defined as the point at which the value of the bank is precisely equal to the value of its liabilities, i.e. equity is zero (see also the box on pages 60-61 of the August 2002 issue of the ECB's Monthly Bulletin).

A CHRONOLOGY OF BANKING CRISES IN EUROPE

Over recent decades, Europe has experienced several banking crises, at the level of both individual institutions and banking systems. The list below provides a fairly comprehensive selection of the most significant cases, starting in the early 1970s. The gravity of the problems, in terms of risk to the financial system or estimated costs, varied extensively. Some of the problems were solved exclusively through the use of private money, while others led to a recapitalisation of the entire banking sector by the government, with costs sometimes exceeding 10% of GDP. In a number of cases, external support was examined by the European Commission in order to ensure compliance with the Community rules on competition and state aid.

1974	Bankhaus Herstatt (Germany)
1975-76	secondary bank crisis (United Kingdom)
Late 1970s	Giro institutions faced problems in Germany
1978-83	banking crisis in Spain
1982	Banco Ambrosiano (Italy)
1984	Johnson Matthey Bankers (United Kingdom)
1986-89	significant banking problems in Portugal
1987-92	significant banking problems in Denmark
1988-93	banking crisis in Norway
Early 1990s	small banks' crisis in the United Kingdom, banking crisis in Sweden
1990-95	banking crisis in southern Italy
1991	Bank of Credit and Commerce International (United Kingdom and Luxembourg)
1991-94	banking crisis in Finland, affecting especially savings banks
1991-95	banking crisis in Greece
1993	Banco Español de Credit – Banesto (Spain), Comptoir des Entrepreneurs (France) and Société Marseillaise de Crédit (France)
1994-95	Crédit Lyonnais (France)
1995	Barings (United Kingdom)
1996	Banco di Napoli (Italy), GAN-CIC (France) and Crédit Foncier de France (France)
1997	Banco di Sicilia – Sicilcassa (Italy)
2001	Bankgesellschaft Berlin (Germany)

Sources: Basel Committee on Banking Supervision (2004), Caprio and Klingebiel (World Bank, 2003), Glick and Hutchison (Federal Reserve Bank of San Francisco, 1999), Pesaresi and La Rochefordière (European Commission, 2000).

Finally, it has been observed that banking crises often coincide with sudden structural or cyclical regime changes. Such changes require economic agents, and banks in particular, to adapt to the new environment. This involves a learning process that can lead to estimation

errors that ultimately result in the mispricing of risks. How the combination of cyclical and structural elements, together with a sudden regime change, can lead to the emergence of a banking crisis is well illustrated in the case of the Nordic banking crisis (see Box 2).

Box 2

THE NORDIC BANKING CRISIS

In the late 1980s and early 1990s, the banking systems of Finland, Norway and Sweden experienced serious problems. Although experiences differed, they culminated in the first systemic crisis seen in Europe since the 1930s.

In response to growing international competition, the Nordic banking systems were rapidly liberalised in the late 1980s. Liberalisation measures included the easing of lending guidelines, as well as the withdrawal of restrictions on foreign exchange transactions and interest rates. This deregulation coincided with a period of strong economic growth. In order to match the rapidly increasing demand for bank lending, also spurred by tax incentives and low interest rates, banks accessed foreign funding. In this way, substantial foreign exchange risk positions were built up. Furthermore, banks shifted their loan portfolios towards both more cyclically sensitive sectors and loans denominated in foreign currency. The lending boom contributed to the development of an asset price bubble, in particular in the real estate sector, which in turn fuelled lending through higher collateral values. The situation was aggravated by poor banking practices, such as the underpricing of loans and poor risk management. Finally, the regulatory and supervisory framework also showed a number of deficiencies.

When the economies of the Nordic countries moved into recession and asset prices fell, the banking problems became manifest. External shocks, such as the collapse of the Soviet Union and the evolution of oil prices, further contributed to the crisis. The combination of high leverage ratios, a high floating interest rate and foreign currency debt, together with a shift towards a tighter monetary policy which led to rapidly increasing interest rates, augmented debt service problems for borrowers and gave rise to an unprecedented number of bankruptcies. At the same time, falling asset prices eroded the value of the collateral held by banks. Substantial government intervention and funds were used to recapitalise the local banking systems. In some cases, the government was subsequently able to recover part of its support.

Source: Drees and Pazarbaşıoğlu (IMF, 1998).

4 POSSIBLE REASONS FOR THE BANKING SECTOR'S RESILIENCE

Compared with earlier episodes of stress, the EU banking sector fared better over the period from 2000 to 2003 due to a combination of cyclical and structural factors. The economic downturn was relatively mild and, given a low inflation environment, interest rates declined, thereby easing strains on the banking sector. An improved regulatory and supervisory framework, better risk management, and deeper and more liquid financial markets all contributed positively to the resilience of the banking sector. Although the period from 2000

to 2003 was immediately preceded by the introduction of the single currency in 1999, which can be qualified as a major regime change, the euro area banking sector adapted relatively smoothly thanks to elaborate preparations undertaken in the years before the introduction. The single currency also set the framework for macroeconomic stability.

CYCLICAL FACTORS

Although the euro area economy began to slow down as from 2000, this followed a period in which the financial markets had boomed and in which growth had been relatively strong. This

Chart 7 Household lending, real estate prices and long-term interest rates in the euro area

(annual percentage changes; percentages per annum)



Source: ECB.

expansive period laid the foundation for banks to build up financial buffers to withstand the downturn that followed (see Chart 4). Moreover, the deterioration in economic conditions was relatively mild: macroeconomic instability and the absence of price stability, which so often coincide with a banking crisis, were not seen in the European Union during the period under review. Stage Three of Economic and Monetary Union, a major structural factor, contributed significantly to this as the exchange rates between the legacy currencies disappeared and a common policy framework – based on price stability, fiscal discipline and commitments to implement structural reforms – was adopted.

Declining interest rates, as well as sustained real estate prices, were supportive of some lines of the banks' business (see Chart 7). Retail business fared well and mortgage lending, which represented about two-thirds of total bank lending to households in the euro area in 2003, boomed as households took on more debt in the face of declining financing costs and increasing collateral values. As a result, household indebtedness in the euro area rose significantly. Their ratio of debt to disposable income in 2003 was more than 80% compared with less than 60% ten years earlier.

IMPROVED REGULATORY AND SUPERVISORY FRAMEWORK

Over the past decades, the regulatory and supervisory framework for banks has been greatly reinforced, both at a national and at an international level. In part, this enhancement was a reaction to previous problems. In order to meet the challenges of financial business that is increasingly being performed on a cross-border and cross-sectoral basis, the authorities have substantially enhanced their cooperation and their exchange of information, both on a bilateral basis and in multilateral forums. At the European level, the committee structure has recently been reviewed with the aim of increasing the efficiency of the European regulatory and supervisory system and of reducing the burden caused by national divergences.

The crises in the financial markets in the late 1990s also led to an enhancement of the exchange of information and international cooperation in the field of financial stability, as is evident, for example, from the establishment of the Financial Stability Forum (FSF) in 1999 and the increasing involvement of the Economic and Financial Committee (EFC), the Eurosystem and the ESCB's Banking Supervision Committee (BSC) in this area.

The Basel Capital Accord of 1988, agreed by the Basel Committee on Banking Supervision (BCBS), undoubtedly played an important role in fostering the resilience of the banking sector to adverse shocks. The BCBS's work has strongly influenced the regulatory framework for banks that is in place in the European Union, both at the level of the Community and at that of the individual Member States. At the Community level, the important regulatory pillars are the Consolidated Banking Directive³ and the Capital Adequacy Directive (CAD)⁴. These Directives have greatly improved the regulatory framework by laying down requirements for access to banking activities as well as principles and instruments

³ Directive 2000/12/EC of 20 March 2000.

⁴ Directive 93/6/EEC of 15 March 1993.

for prudential supervision. Areas where minimum standards have been established include, for example, the conditions regarding the use of the term “bank”, administrative and accounting procedures, the “fit and proper” character of a bank’s management and shareholders, solvency requirements, limits on large exposures and shareholdings, and group-wide supervision.

Further progress in the regulatory and supervisory framework for banks is under way. At the Community level there is, foremost, the work conducted by the European Commission, in parallel with the BCBS’s review of capital requirements for banks – the so-called “New Capital Accord” or “Basel II”. The review aims to make capital requirements more risk-sensitive, thus better matching economic reality. Another important step was the adoption of the Financial Conglomerates Directive⁵ which the Member States are presently transposing into national law. This Directive introduces an additional supervisory layer for financial groups that combine, for example, banking and insurance, a quite common phenomenon in the European Union.

Furthermore, the authorities have taken several steps at a national level. Risk-based supervision has become more widespread. Under this approach, banks are treated differently according to their risk profile, so that scarce supervisory resources are allocated to the highest risk areas. This will gain even more prominence as, under the New Capital Accord, supervisors will have to ensure that banks have adequate capital in relation to their risk profile. Another trend has been towards an integrated financial supervisor in response to the growing role of financial conglomerates and the blurring of the borders between financial sectors. At the national level, the objective of financial stability has gained equally in importance, as demonstrated by the large number of central banks that have started to publish regular financial stability reviews. The need for increased surveillance of national financial sectors is also evident from the expansion of the

IMF’s macroeconomic surveillance to the financial sector under its Financial Sector Assessment Programs (FSAPs).

IMPROVED RISK MANAGEMENT PRACTICES BY BANKS AND MARKET DEVELOPMENTS

In recent years banks have significantly improved their risk management practices, frequently as a reaction to previous stressful periods. In this respect, events such as the sovereign debt crisis of the 1980s, the turbulence experienced in equity markets (1987) and bond markets (1994), and past banking crises (see Boxes 1 and 2) had a beneficial and lasting effect on banks’ risk management. In addition, market developments, including the availability of new types of financial instruments, banks’ growing involvement in off-balance-sheet transactions and breakthroughs in the quantification of risks were important driving forces. Regulatory developments played an equally positive role. These improvements are visible both at the level of banks’ organisation and in their use of specific risk management techniques.

To create shareholder value, banks have become increasingly aware of the need to integrate risk management into their overall decision-making processes. Risk management has frequently been centralised under a chief risk officer (CRO) at the board or management committee level and heading a separate risk department. This set-up separates the risk-taking business lines from the risk department, thus making it more difficult to sidestep sound risk management practices because of business considerations. A consistent and group-wide perspective has become more necessary as a result of the growing importance of financial conglomerates and the need to integrate acquired institutions. An asset/liability committee (ALCO) in charge of managing the bank’s interest rate, liquidity and foreign exchange risks often preceded the creation of a separate risk department.

5 Directive 2002/87/EC of 16 December 2002.

As far as risk management techniques are concerned, important progress has been made as a result of innovation in financial markets and advances in the quantification of risk. One such area is the development of risk models based on the “Value-at-Risk” (VaR) concept.⁶ The quantification of risk, already well developed in the area of market risk, is now becoming more important for other risk categories, such as credit risk and operational risk. In addition, the development of various types of financial derivatives has facilitated banks’ risk management. Following the introduction of the single currency, a number of highly liquid exchange-traded contracts emerged. The euro also led to an almost completely integrated money market that allows liquidity to be shifted quickly and efficiently from one part of the banking system to another.

As regards “over-the-counter” (OTC) derivatives, the most significant innovation has been the growth in credit risk transfer instruments such as credit derivatives. These instruments facilitate the trading and transfer of credit risk. Due to their role as loan originators, banks have been major users of this market in shedding risk, while insurance companies are seen to be important risk-takers. In this way, credit risk is spread more evenly over the financial system, thus making it easier for the system to absorb large corporate defaults. However, this new market has also raised a number of concerns related, for example, to transparency or to the risks incurred by “naïve” market players. Securitisation is another technique increasingly used by EU banks to transfer credit risk to other market participants.

More recently, banks have been observed to be focusing on non-traditional risks such as strategic, reputational and legal risk, and have stepped up efforts to control and possibly quantify them. In most cases, these risks have not been addressed individually, but rather as part of a more comprehensive strategy intended to improve management systems. For example, the compliance function, the purpose of which

is to assist the bank in managing its compliance risk,⁷ has become an important vehicle to achieve good corporate governance.

Finally, there are signs that banks have already started to improve their risk management in anticipation of the New Capital Accord. They have been doing this by developing data based on credit risk and operational risk, credit scoring techniques, credit risk models, integrated risk management and capital allocation models. As many of the smaller banks are unlikely to have the necessary resources and skills, banking sector federations have been working on joint projects to develop the systems and know-how. In this way, advanced risk management tools should also become available to smaller institutions.

EFFORTS BY BANKS TO INCREASE THE EFFICIENCY AND DIVERSIFICATION OF THEIR BUSINESS

Several EU Member States suffer from excess banking capacity, albeit to varying degrees. Under the influence of increased competition, the single currency, technological change and internationalisation, excess capacity has gradually been reduced. For instance, over the period from 1997 to 2003, the number of banks in the European Union fell from approximately 9,100 to slightly less than 7,500, a reduction of 18%. It is likely that the least efficient institutions were the first to disappear, with many being absorbed by stronger national rivals. But this decline did not affect the overall importance of the banking sector in the economy. On the contrary, the growth of banking assets continued to outpace that of GDP. Hence, banks’ average balance sheets continued to grow which, *ceteris paribus*, increased their loss-absorbing capacity as capital positions of banks remained robust.

⁶ “Value-at-Risk” is a statistical measure that indicates the potential loss in the value of a portfolio of financial instruments that is due to a specific risk factor (e.g. market risk) and that is likely to occur with a certain degree of probability (e.g. 99%) within a certain period of time (e.g. 10 trading days).

⁷ Compliance risk is the risk of legal or regulatory sanctions, financial loss or damage to reputation as a result of a failure to comply with applicable laws, regulations, codes of conduct and standards of good practice.

As noted earlier, banks reacted to the pressure on profitability by taking corrective measures, including more risk-based pricing, the shedding of non-core assets and a reduction of the number of branches and employees. This was particularly evident in the national banking systems that were in need of further substantial restructuring.

In some EU countries, cooperative and public banks have been transformed into public limited companies through “demutualisation” and privatisation, and this was sometimes followed by a flotation on the stock exchange. This structural change had an impact on the incentives of those institutions as they became subject to the pressures of private shareholders. More generally, it seems that over time the markets have become a more important factor in bank behaviour. This is evident from the pressure from the (often institutional) shareholders of banks to create “shareholder value” and from the trend towards more transparency and market disclosure.

Over time, EU banks have diversified their activities across business lines and geographical areas, so that idiosyncratic shocks are more easily absorbed. Non-interest income has been the most dynamic component of bank income contributing significantly to the overall rise in profitability. In 2002 this income source represented around 40% of the total operating income of EU banks, compared with only 30% in 1995. Non-interest income is not strongly correlated with interest income, thus offering diversification benefits. Such income consists of heterogeneous elements, the most important being fees and commissions. Until recently, fees and commissions from the investment banking, asset management and insurance businesses were on the increase. Financial market activity, and the related fee business, was spurred by the introduction of the single currency which, more generally, also led to improved access for the economy at large to an alternative source of funding to the traditional bank channel. But the decline following the market downturn illustrates that this source of

income also has attendant risks. Moreover, some banks diversified into the new business areas during a period of general expansion and at too high a price, without having the required expertise or resources to withstand a prolonged market downturn.

In addition, EU banks have diversified on a geographical basis. When activities are more internationally spread, banks are better able to withstand local economic shocks. The Single Market and the single currency are strong drivers of pan-European diversification. Cross-border bank mergers continue to be relatively rare in the European Union, although there have been a number of important deals leading to the creation of regional groups like Dexia, Fortis and Nordea. Banks have also significantly increased their interbank loans and diversified their securities portfolios in the euro area. For example, in the period from 1998 to 2003, the share of cross-border securities issued by non-banks and held by euro area banks increased from 30% of the domestic holdings of those banks to around 80%. For cross-border interbank loans, the proportion increased from around 30% to somewhat less than 40%. Cross-border business in loans to non-banks is less impressive, with overall activity remaining low. The potential benefits of geographical diversification are illustrated by the fact that, despite poor conditions in their home markets, several EU banks were able to boost their profitability thanks to their activities in the new Member States.

5 CONCLUSION

Experience shows that widespread banking difficulties typically occur against the background of macroeconomic instability and structural weaknesses. In these circumstances a regime change, such as a change in regulation, may trigger the difficulties. The EU banking sector experienced a fundamental regime change with the introduction of the euro in 1999. In the period after 2000, in an environment of relatively slow economic growth, the EU

banking sector was exposed to a sequence of adverse shocks. Compared with earlier episodes of stress, which led to full-blown banking crises in some EU countries, the EU banking sector was able to withstand the strains without significant difficulty.

The reasons for the resilience of the banking sector to the challenges it faced as from 2000 are manifold and include both cyclical and structural factors. First, the adoption of the euro was very well prepared, both by the authorities and the banks. Second, although economic growth was weak in the period from 2000 to 2003, the overall macroeconomic environment in which banks were operating was stable, not least due to a stability-oriented macroeconomic policy framework. And, third, structural factors, such as an improved regulatory and supervisory framework, better risk management practices and developments in financial markets and the banking business, contributed as well.

Looking ahead, the stability of the banking sector is likely to be influenced by many factors. On the regulatory and supervisory side, the implementation of the New Capital Accord and the International Accounting Standards (IAS) are the main developments to monitor. On the market side, future consolidation can be expected, also in light of the recent enlargement of the European Union.