Box 12

SURVEY ON MAJOR EU BANKS' PERCEPTION OF RISKS IN THE YEAR AHEAD

This Box summarises the answers from a survey of banks' perceptions of main risks for the year ahead. The survey was undertaken by the Banking Supervision Committee, with the assistance of the Working Group on Developments in Banking (WGBD), in February and March 2005, covering all EU Member States. It was similar to the one held in 2004 (see ECB (2004), *Report on EU Banking Structures,* November). It was completed by 99 banks, 43 of which were from euro area Member States, and 56 from non-euro area Member States. A maximum of five banks per country participated in the survey. The respondent banks were asked to state what they perceived as major risks and to distinguish between macroeconomic, financial market, sectoral, strategic and regulatory risks. They were then asked to assign different scores to these five broad categories on a scale from 1 (very low) to 5 (most important), and to elaborate in more detail what they felt constituted those risks.

Chart B12.1 Sources of risk for euro area banks

(2005, % bank answers per score)

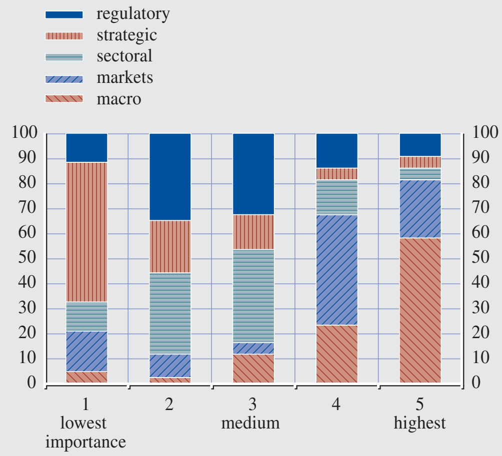
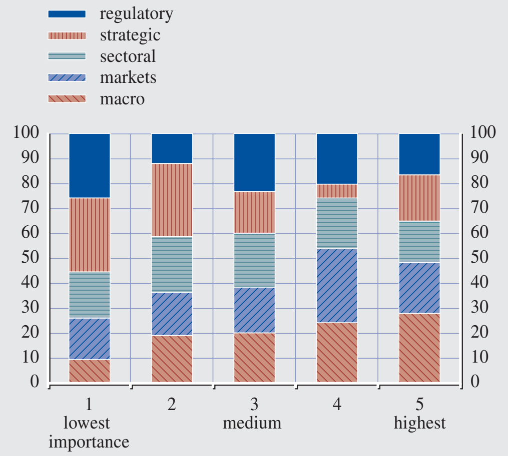


Chart B12.2 Sources of risk for non-euro area banks

(2005, % bank answers per score)



Sources: Banking Supervision Committee and ECB calculations.
Note: Data not available for Irish banks.

Charts B12.1 and B12.2 present the distribution of the banks' scores on the different broad risks, each as a percentage of the replies rated 1 to 5, with a further disaggregation between the euro area and non-euro area. A higher percentage of replies with score 5 for a specific risk, for example, indicates that relatively more banks see this risk as a very important one. It should be noted that the risks reported here are directly attributable to the respondent banks, and do not necessarily reflect the ranking of risks by supervisory authorities or central banks (as reflected elsewhere in this Review).

The results clearly indicate that, similar to last year, euro area banks regard macroeconomic risks as the major challenge in the period under review (i.e. until Q1 2006), followed by possible risks stemming from the financial markets. For non-euro area banks, the balance of risks is more evenly spread across different sources of risk. This possibly reflects relatively more favourable macroeconomic and financial market conditions in the latter countries, which allows banks to pay more attention to other sources of risk.

Further detail was gained by a decomposition of the broad sources of risk into specific items, for which banks were also asked to assess the "expected negative impact" on profits, ranging from less than one month to one quarter or a full year's profit. The discussion below focuses on euro area banks, although Table B12.1 also displays evidence for non-euro area banks, which presents a fairly similar picture. The table shows that 86% of the respondent euro area banks see downside credit risks stemming from a deterioration in borrower quality as a major challenge to profits, of which 61% regard this as having a potentially major impact on profits. Another major macro challenge for euro area banks is weak capital spending, which would reduce the lending volume to the corporate sector. On the other hand, banks do not consider lower consumer spending and borrowing to be a major issue. A possible house price bubble, however, does worry banks from almost all euro area countries. At the time of the survey, oil prices had not risen to the levels currently experienced, and banks regarded oil prices therefore

Table B12.1 Respondent banks' main risks stemming from five broad classes of risk

(2005, %)

	euro area banks					non-euro area banks				
			trend					trend		
	all	major	constant	upward	major/ upward	all	major	constant	upward	major/ upward
Macroeconomic										
Credit risk-deterioration borrower quality	86	61	73	24	35	68	41	47	29	26
Weak capital spending corporates	60	40	54	46	80	45	9	72	16	40
House price bubble	42	61	44	56	46	57	23	31	69	69
Sustained high or rising oil prices	30	31	23	77	80	32	9	33	61	80
Credit risk-overheating-high indebtedness	26	18	73	18	0	59	29	36	61	69
Global imbalances	23	50	20	80	100	16	2	67	33	0
Financial markets										
Major downturn of equity market	67	36	79	3	0	38	7	71	24	50
Decrease in interest rates	49	40	38	14	0	59	29	33	58	50
Increase in interest rates	40	78	41	59	50	57	25	34	59	57
Exchange rate developments	37	27	63	31	43	54	13	53	33	14
Credit event	35	29	60	33	38	39	14	73	14	0
Flattening of the yield curve	33	69	71	0	0	36	20	35	55	55
Sectoral										
Competitive pressure/ overcapacity	88	41	42	55	39	96	55	15	83	90
Emergence of new players	63	20	37	44	36	63	25	43	46	57
M&A and consolidation, need for size	47	25	30	65	67	50	11	43	50	67
Strategic										
Need to increase performance/efficiency	77	45	39	55	32	82	45	24	70	72
Expansion in new markets	40	41	41	59	100	34	7	42	58	50
Need to increase size	37	19	69	31	10	43	18	46	50	50
Operational risks	37	25	63	31	43	32	13	50	39	29
Risks from financial innovations	35	13	20	80	50	34	7	37	58	75
Regulatory										
International accounting standards	93	40	20	70	88	70	30	26	67	76
Basel II	72	42	29	71	56	86	29	19	77	81
Corporate governance or reporting burden	49	24	5	95	100	36	7	25	75	75
New EU Directives	44	50	21	79	80	46	18	31	62	70
Increasing importance of rating agencies	33	36	36	64	100	20	4	36	64	100

Sources: Banking Supervision Committee and ECB calculations.
Note: "All" refers to the number of respondents mentioning a certain issue (as a % of the number of respondents). "Major" denotes the % of banks that identified the issue as having a major impact on profits (equal to quarterly profit or more). "Trend" compares the importance of the issue with one year ago, and gives the percentage of banks that identified a constant or upward movement in its importance. "Major/upward trend" refers to the % of banks that identified the issue as having a potentially major impact on profits and more important than one year ago (as a % of banks that expected a major impact).

as having a more remote and indirect impact on their profits, although the trend has been rising compared with 2004.

As for financial markets, around two-thirds of euro area banks factored in a possible downturn in equity markets later on in 2005. However, this seems to be a matter of normal caution, since in about 80% of the cases the issue has not become more pronounced compared with one year ago. Interest rate changes were a matter of concern for most euro area banks, although the direction in which banks expected these to influence their performance proved to be quite varied. Some banks expected to be mainly affected by rising rates, others by falling rates, and still others were concerned by a flattening of the yield curve or increases in interest rate volatility.

In the category of industry sector risks, almost 90% of euro area banks said they had been affected by tighter competitive conditions, which has been reflected in margin pressure in both deposit-taking and lending. In addition, around 60% of the surveyed banks were expecting competition from new market players (e.g. in consumer finance) to increase.

Although performance improved in 2004, many banks seemingly still see a need to take further measures to improve their situation. Otherwise, most banks seem to be relatively confident about their strategic choices.

Finally, in line with some other banking industry surveys, the results showed that for most banks the importance of regulatory and accounting issues has increased substantially compared with one year ago. Around 70% of euro area banks regarded the new regulatory framework (Basel II) as a challenge, while more than 90% mentioned that they expected to notice the effects of the new accounting standards.