

Box 10

FINANCIAL CONDITIONS OF LARGE EURO AREA BANKS

Problems in individual large euro area financial institutions could potentially spill over to other parts of the euro area financial system. For this reason, it is particularly important to monitor closely developments in these institutions. This Box complements the analysis in the main text by reviewing the recent financial results of a sample of large euro area banks. Because of the varying dates of implementation of IFRS by European banks, some of the set of euro area banks used in previous editions of this Review have begun to compile their financial statements under IFRS, whereas others have continued reporting under local or US GAAP (Generally Accepted Accounting Principles). During the implementation period, this complicates to some extent the analysis of financial statements from a financial stability perspective, given that IFRS and non-IFRS accounts are not directly comparable. Consequently, in order to ensure a consistent analysis, the large banks are analysed in two sub-groups depending on whether they reported their 2005 accounts under IFRS or non-IFRS.¹

IFRS-reporting banks

As only a limited amount of historical data exists for comparison, any inferences on performance must be treated with a high degree of caution because the restated accounts for end-2004 or mid-2005 are not audited, and because institutions vary considerably in the degree to which they have implemented the accounting standards IAS 32, IAS 39 and IFRS 4 in their pro forma 2004 figures. Furthermore, given that 2005 is viewed by banks and rating agencies as a transitional year for accounting purposes, there is uncertainty about the extent to which the development of banks' financial results reflects either underlying circumstances or accounting changes. For example, profitability, provisions, and the overall size of banks balance sheets may be affected. The full impact will probably only become evident in 2006. In the short term, there may be important country-specific effects related to IFRS implementation that may affect the interpretation of the results.

Profitability for the largest euro area banks reporting under International Accounting Standards (IAS), as measured by the weighted average ROE, increased from 13.6% in 2004 to 20.8% in the first six months of 2005 (see Chart B10.1). While it is difficult to assess the degree to which the change in accounting standards affected this performance, this does suggest that the underlying performance of most large euro area banks has remained solid. In fact, all of the institutions in the sample reporting results for the period up to the end of June 2005 posted an increase in ROE.

For banks reporting under IFRS, net interest income fell from 1.55% of total assets in 2004 to 0.93% at the end of Q2 2005. As with those banks that did not report financial results under IFRS, this reflected increased competition as well as the need to fund new loan growth from more expensive sources. By contrast, non-interest income such as fee and commission income rose for most institutions in the first half of 2005.

Provisions declined from 0.16% of total assets at the end of 2004 to just over half that figure at 0.08% of total assets at the end of H1 2005. Costs also declined, with the weighted average

¹ For a detailed overview of IFRS, see Special Feature E in this Review entitled "Main effects from the new accounting framework on banks".

Chart B10.1 Frequency distribution of return on equity for large euro area banks (IFRS)

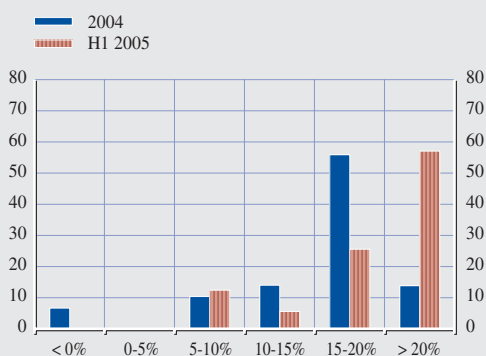
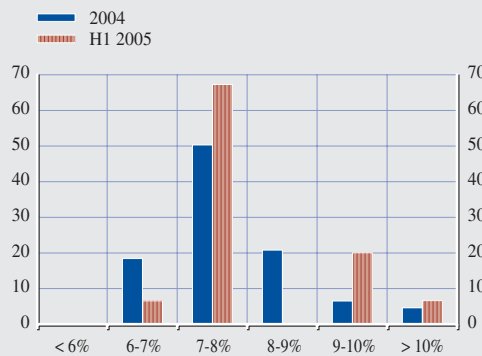


Chart B10.2 Frequency distribution of Tier 1 ratio for large euro area banks (IFRS)



Sources: Published accounts of individual banks and ECB calculations.
 Note: Data for the first half of (H1) 2005 are annualised and unaudited and are based on 14 banks from a sample of 15.

cost-to-income ratio falling from 63.52% in 2004 to 61.44% in June 2005. The cost-to-income ratio not only decreased in the best performing group of institutions (first quartile for the cost-to-income indicator), but also for those performing worse than the weighted average (the third quartile), perhaps signifying that cost control has been firmly established.

Increased profitability has also led to the continued strengthening of capital ratios. The Tier 1 ratio increased over the period, rising from 7.53% in 2004 to 8.24% in 2005, marking an increase in the buffers available to banks to cushion against unexpected losses (see Chart B10.2). The overall regulatory solvency ratio also increased over the period from 11.36% in 2004 to 11.92% at the end of the second quarter of 2005.

Non-IFRS-reporting banks

On the whole, the financial positions of large euro area banks not reporting under IFRS continued to improve in the first half of 2005, consolidating the performance of the previous two years. This was mainly driven by reasonable performance from non-interest income sources, and benefited from the reduction in charges for credit losses. However, generating sustainable revenue in some domestic markets remains challenging for certain institutions. Profitability, as measured by the weighted average ROE, continued to improve from about 4.5% in 2004 to just over 15.3% in Q2 2005 (see Chart B10.3). Furthermore, the weaker institutions also managed to improve their performance, with banks in the bottom quarter of the distribution increasing profitability from -2.15% in 2004 to 14.50% in the first six months of 2005.

Banks' net interest income as a percentage of total assets continued to fall, dropping from a weighted average of 0.61% for 2004 as a whole to 0.55% in the first half of 2005. The continued effect of low nominal interest rates, increased competition in certain retail segments, and low loan demand in some of these banks' domestic markets has led to sustained pressure on margins. Most institutions also reported increased non-interest income, especially fee and commission income.

Improved credit risk conditions led to a moderate decline in provisions from a weighted average of 0.09% of total assets in 2004 to 0.08% of total assets at the end of Q2 2005. This

level of provisioning is particularly low compared to historical norms. While some individual institutions have indicated that provisions may increase slightly during the second half of the year, it cannot be ruled out that the adequacy of some banks' provisioning could be tested if credit conditions were to deteriorate unexpectedly.

Cost control measures continued to be implemented by most banks in the first half of 2005 in order to sustain profitability. The weighted average cost-to-income ratio decreased from 75.05% in 2004 to 71.93% in the first half of 2005. The weighted average Tier 1 ratio increased from 8.06% in 2004 to 8.28% during the first half of 2005, with the weakest performing institutions also managing to increase their Tier 1 ratios (see Chart B10.4). Overall solvency ratios improved as well (see Table S9).

A notable development was that most indicators of financial conditions for both sets of banks improved regardless of the accounting method followed. If this trend continues for the remainder of 2005, the resilience of euro area banks to adverse shocks should improve further. However, for some institutions without strong underlying performance in their most important markets, it remains to be seen how durable the current return to profitability will be, given the reliance of these institutions on certain types of non-interest income sources, in tandem with cost-cutting to boost overall profitability.

Chart B10.3 Frequency distribution of return on equity for large euro area banks (non-IFRS)

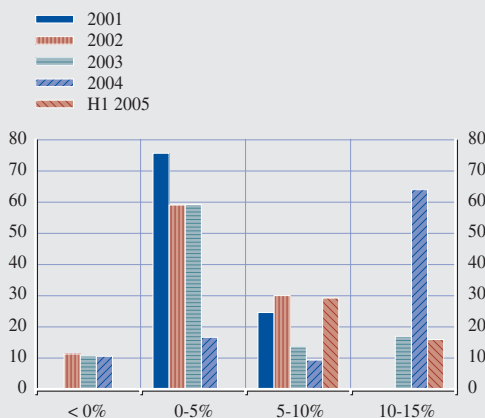
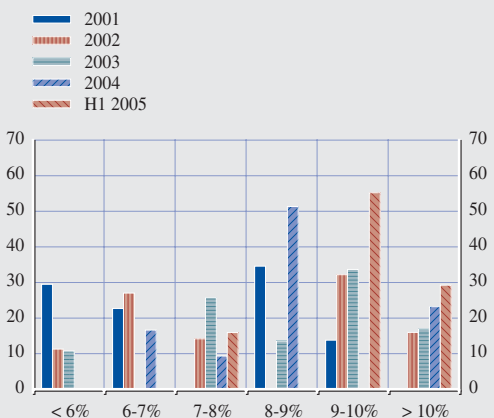


Chart B10.4 Frequency distribution of Tier 1 ratio for large euro area banks (non-IFRS)



Sources: Published accounts of individual banks and ECB calculations.

Note: Data for the first half of (H1) 2005 are annualised and unaudited and are based on three banks from a sample of six.