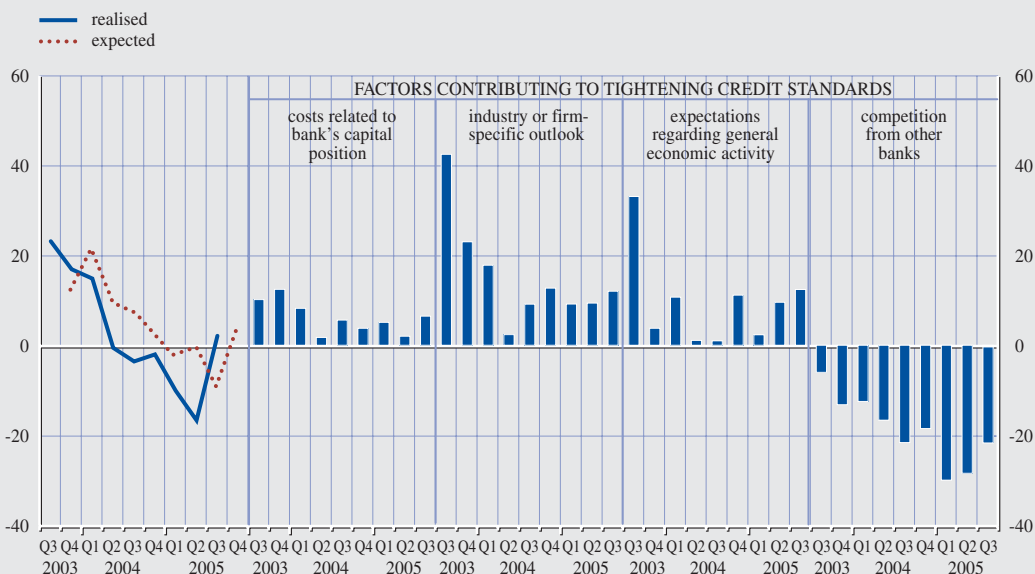


Box 11

ASSESSING FINANCIAL STABILITY IMPLICATIONS OF RECENT FINDINGS FROM THE ECB BANK LENDING SURVEY

The ECB's Bank Lending Survey (BLS) provides timely qualitative evidence of the lending policies of the euro area banking sector, and should be a useful tool for detecting turning points in the credit cycle and potential credit crunches facing euro area households and firms. This Box examines recent developments in banks' credit standards – and the underlying determinants – on the approval of loans to households and loans since early 2005, as reported in the October 2005 BLS.

Chart B11.1 Changes in credit standards applied to the approval of loans or credit lines to enterprises

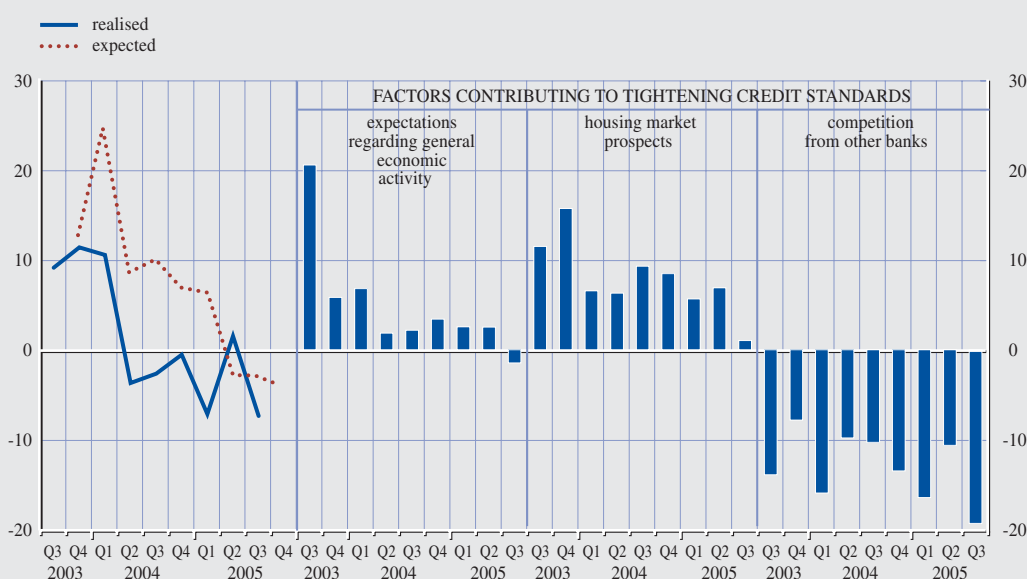


Source: ECB Bank Lending Survey.

According to the BLS, in the third quarter of 2005 banks reported more or less unchanged (compared with the previous quarter) credit standards on the approval of loans to enterprises. The slight net tightening (+2%) in the third quarter of 2005 occurred following five consecutive quarters of net easing of credit standards towards the non-financial corporate sector. While it is still too early to tell whether this change constitutes a turnaround in the easing cycle of credit standards on corporate loans, it may partly reflect a strong increase in perceived loan demand (as reported in the October 2005 BLS), enabling banks to attract borrowers without having to ease credit standards. Broadly unchanged underlying factors (such as the industry or firm-specific outlook, and expectations regarding general economic activity) compared with the previous quarter contributed to ending the net easing of credit standards (see Chart B11.1). The increase in corporate loan demand may also have mitigated the effects of competition from other banks on credit standards applied to loans. With regard to the terms and conditions by which credit standards were applied, banks reported that margins on average loans were lowered (although less than in previous quarters), while non-interest rate charges and margins on riskier loans tended to support a net tightening of credit standards, suggesting that banks were becoming more discriminating in their pricing of risks.

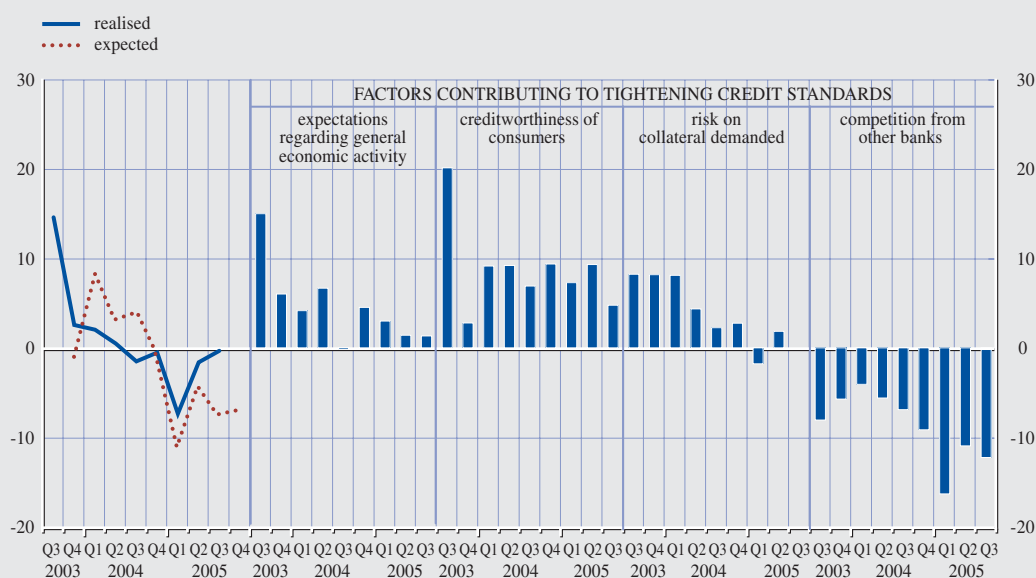
With regard to the approval of loans to households for house purchase, banks reported a net easing of credit standards in the third quarter of 2005. This was in line with developments in previous quarters, except for the second quarter of 2005 when a slight net tightening was reported. The net easing seemed to reflect, in particular, reduced concerns regarding housing market prospects as well as a slight improvement in expectations concerning general economic activity (see Chart B11.2). Moreover, competition from other banks continued to contribute to the net easing of credit standards. The tightening of credit standards on loans for house purchase was mainly carried out through the margin on riskier loans, while margins on average loans as well as less stringent loan-to-value ratios contributed to the net easing.

**Chart B11.2 Changes in credit standards applied to the approval of loans or credit lines to households for house purchase**



Source: ECB Bank Lending Survey.

Chart B11.3 Changes in credit standards applied to the approval of loans or credit lines for consumer credit and other loans to households



Source: ECB Bank Lending Survey.

In the third quarter of 2005, euro area banks reported broadly unchanged credit standards on the approval of loans for consumer credit and other loans to households, following four quarters of net easing (see Chart B11.3). The factors behind the applied credit standards were more or less unchanged from the previous quarter, with competition from other banks (and from non-banks) contributing to a net easing, while factors such as borrowers' creditworthiness, the risk of collateral demanded and expectations of the general economic activity continued to pull towards a net tightening. With regard to terms and conditions, the net easing of credit standards on consumer credit and other loans to households was carried out, in particular, through lower margins on average loans; margins on riskier loans were not eased, however.

Overall, as in previous quarters, in the second and third quarters of 2005 euro area banks largely continued to ease or to keep credit standards on loans to the non-financial private sector broadly unchanged. The net easing was mainly driven by strong competition from other banks, but took place against a background of deteriorating expectations regarding economic activity. This suggests that banks may have taken on more risk in order to gain market share and boost profitability. In the most recent quarter, however, there are some signs that banks have reacted to the still moderate economic growth prospects and increasing loan demand by ending the net easing of credit standards. Moreover, the perceived increase in risk-taking in recent quarters seems to have been reflected in more differentiated pricing of loans. All in all, the question whether these developments could entail future difficulties, such as a deterioration in the quality of banks' credit portfolios, depends on the extent to which the accumulated risks materialise in the period ahead.