

1 Credit risk: key points

Near-term risks to the UK financial sector from direct and indirect exposures to household, corporate, and overseas borrowers have, on the whole, changed little since the previous *Review*. Although the immediate prospects for UK financial stability are broadly favourable, some areas of longer-term vulnerability remain as a result of which credit risks could rise significantly if the macroeconomic environment were to weaken:

- The continuing rapid growth in debt means that the UK household sector has become increasingly sensitive to any adverse shocks to employment income. Given the MPC's central forecast for output growth over the next two years, benign labour market conditions are likely to limit pressures on debt servicing. But if the macroeconomic outlook were to become significantly weaker, credit risks might increase, particularly on unsecured debt;
- The non-financial corporate sector remains, in aggregate, profitable and able to weather the consequences of sudden shocks (such as the sharp rise in the price of oil). Nevertheless, capital gearing remains high, suggesting that firms are more vulnerable to unfavourable events than on average over the past. Pension fund deficits have continued to contribute to financial pressures for some firms, and there are signs that financial strength may not extend across the whole of the corporate sector – a significant number of (mainly smaller) firms made operating losses during 2003. Banks' recent domestic corporate lending has been highly concentrated in the commercial real estate sector, where property yields have continued to decline, and it is possible that some investors may have underestimated the risks associated with this lending;
- Debt-servicing difficulties arising overseas may place pressures on the UK financial system through the significant international exposures of UK-owned banks. The economic outlook in the major overseas economies is largely favourable, although higher oil prices and downward revisions in forecasts for GDP growth in 2005 in the United States and Europe could contribute to weaknesses in some balance sheets – for instance, there is some evidence of fragility in the aviation and motor industries. Household debt-to-income ratios have also risen in the United States and parts of continental Europe, increasing households' vulnerability to adverse shocks in these countries. In the event of further rises in the price of oil, higher world interest rates or a sharper-than-expected slowdown in economic activity in China, there is a risk that the economic outlook for emerging market economies (EMEs) could also weaken, though market confidence in EME credit prospects appears to have strengthened and central forecasts for global growth are still favourable.

The UK banking system remains well placed in the face of these credit risks. Mortgage arrears continue to decline and loan-to-value ratios on new mortgages have been reduced further since the June 2004 *Review*. Unsecured lending to UK households and lending to the UK corporate sector, both of which appear somewhat riskier than mortgage lending, still only constitute a relatively small part of UK banks' lending activities. Risks from international credit exposures also appear moderate. But there remains the possibility that lenders and borrowers may be underestimating the longer-term vulnerabilities highlighted above, at a time when the immediate operating environment appears benign.

1 Credit risk

On-balance-sheet credit risk is a key part of any assessment of the risks to UK financial stability, given the size of the financial sector's exposures to household, corporate and sovereign borrowers (see Box 1). New provisions set aside by the large UK-owned banks against bad and doubtful debts have remained low (Chart 1.1). Most other major banking systems have also been benefiting from relatively low losses on their lending portfolios, as the later sections of this chapter illustrate.

The recent low level of banks' provisions reflects the favourable macroeconomic environment, which has lowered credit risk by boosting households' income and raising corporate profits.¹ Output growth is expected to be robust in the large UK-owned banks' major markets in 2004,² and to be slightly stronger than had generally been anticipated at the time of the June 2004 Review (Chart 1.2).

Credit risk has also been affected by the unexpected rise in the oil price (Chart 1.3). As discussed in the August and November *Inflation Reports*, the aggregate impact of oil price increases on firms' costs and profitability, and world output growth, is unlikely to be as great as that of the 1970s oil price shocks; in real terms, prices are lower and the oil intensity of production in OECD countries has fallen. However, higher oil and commodity prices may affect the distribution of credit risk across both companies and countries. For example, higher oil prices may benefit a small number of oil-producing countries, while reducing the incomes of a larger number of net oil importers (see Chapter 1.6).

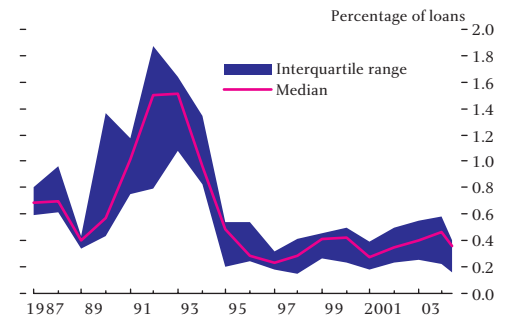
UK and US short-term interest rates rose in 2004; this might have increased the pressures on some borrowers, despite the pickup in growth. But past experience suggests that a given change in the level of interest rates tends to have a smaller impact on UK banks' provisions than a similar change in output growth,³ and the debt-servicing burden for many borrowers has been lightened by the low level of short-term interest rates in large UK-owned banks' major markets. Short-term interest rate expectations for 2005 in the United Kingdom, United States and euro area have all fallen since the June 2004 Review. And, in the case of the United Kingdom, market participants now expect short-term rates to remain broadly unchanged. Ten-year US-dollar, euro and sterling government bond yields have all fallen since the June 2004 Review.

(1) Banks' provisions are typically backward-looking and thus follow the cycle of credit losses. See Jackson, P and Lodge, D (2000), 'Fair Value Accounting, Capital Standards, Expected Loss Provisioning and Financial Stability', Bank of England *Financial Stability Review*, June.

(2) In June 2004, claims on UK residents accounted for 61% of large UK-owned banks' assets, euro-area residents 9%, US residents 14% and other countries 16%.

(3) See Hoggarth, G and Pain, D (2002), 'Bank provisioning: the UK experience', Bank of England *Financial Stability Review*, June.

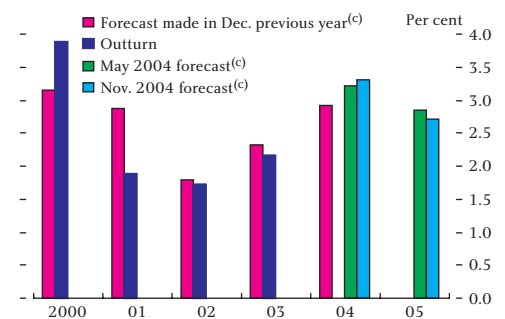
Chart 1.1
Large UK-owned banks' new provisions for bad and doubtful debts^(a)



Sources: Thomson Financial Datastream, published accounts and Bank calculations.

(a) New provisions charge for bad and doubtful debts in the P&L account as a percentage of loans to customers (including finance leases) and banks.

Chart 1.2
Real GDP growth^(a): United Kingdom, United States and selected euro area^(b)



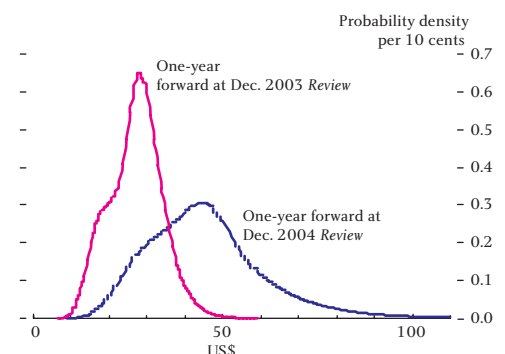
Sources: Consensus Economics Inc, OECD and Bank calculations.

(a) Weighted by large UK-owned banks' claims on those countries in June 2004.

(b) Ireland, Netherlands, Spain, France, Italy and Germany.

(c) Consensus forecasts.

Chart 1.3
Implied probability density functions for crude oil futures prices^{(a)(b)}

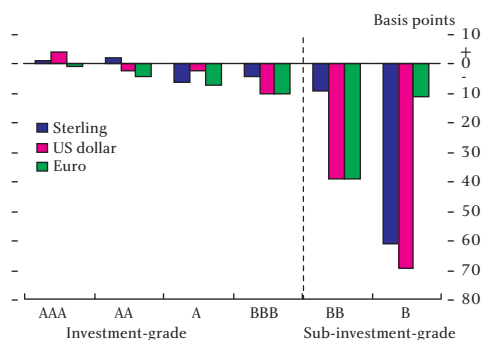


Sources: New York Mercantile Exchange, Bloomberg and Bank calculations.

(a) Risk-neutral distributions derived from options prices for West Texas Intermediate.

(b) Oil price at the Dec. 2003 Review was US\$30. Oil price at Dec. 2004 Review was US\$49.

Chart 1.4
Changes in credit spreads by rating^{(a)(b)}



Sources: Merrill Lynch and Bank calculations.

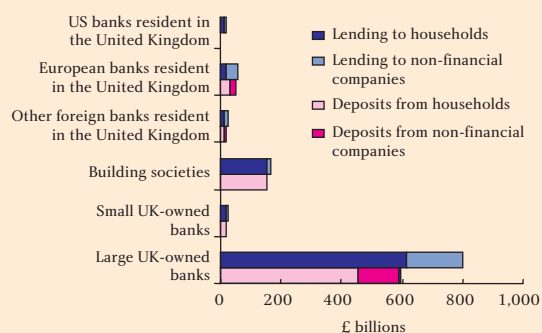
(a) Spread over swaps.

(b) Changes since June 2004 *Review*.

Market indicators point to lower corporate credit risk. With the exception of Japan, equity indices in the major industrial economies have increased over the past six months. Credit default swap premia have mainly fallen since the June 2004 *Review* and corporate bond spreads have declined (Chart 1.4), with the improvements greatest for sub-investment-grade companies and borrowers in emerging markets. Although that may partly reflect investors' higher risk appetite (see Chapter 2), corporate bond default rates have declined, suggesting that there has been some improvement in fundamentals. Rating agency assessments have pointed in the same direction, with upgrades outnumbering downgrades over the period. The remainder of this chapter considers the major factors affecting near-term credit risk.

Box 1: The large UK-owned banking sector

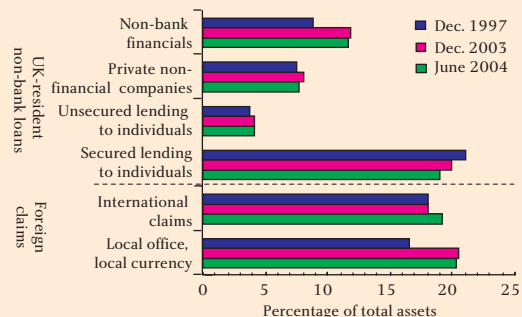
Chart A
UK-resident financial institutions' UK-based lending and deposit-taking activities, as at September 2004



Source: Bank of England.

While more than 400 banks and building societies operate in the United Kingdom, ten large banking groups undertake the majority of UK households' and companies' banking activities (Chart A). The ten largest banking groups by total assets are: Abbey, Alliance & Leicester, Barclays, Bradford & Bingley, HBOS, HSBC Holdings, Lloyds TSB, Northern Rock, RBS Group and Standard Chartered. Throughout this *Review*, these banks are described as the large UK-owned banking sector. Unless otherwise stated, charts include data for these banking groups' subsidiaries prior to merger or acquisition, while figures for demutualised building societies are included from the date that data became available.

Chart B
Composition of large UK-owned banking sector's total assets^(a)



Sources: Bank of England and FSA regulatory returns.

(a) Domestic exposures are net of securitisations.

By type of borrower, households and non-financial companies in the United Kingdom and abroad together constitute the major part of the large UK-owned banking sector's collective on-balance-sheet exposures (Chart B). Overseas exposures account for around 40% of the total assets of the sector, although there is considerable variation across institutions. Foreign claims have increased in recent years through acquisitions by UK-owned banks of foreign financial institutions, especially in the United States. Since the June 2004 *Review*, cross-border links have been further strengthened by the Spanish-owned bank, Banco Santander, acquiring the sixth largest UK-owned bank by total assets, Abbey, in November.¹

(1) Abbey has been retained in the peer group of large UK-owned banks used in this *Review*, given that the acquisition occurred after the period of the latest financial results (2004 H1). The June 2005 *Review* will revisit the criteria used to select a peer group of banks for UK banking sector surveillance.

1.1 UK household sector credit risks

For most large UK-owned banks, lending to households is the largest single component of their domestic loan portfolio. On average, it makes up around 76% of their loans to UK-resident households and private non-financial companies, and 23% of their total assets. Any assessment of the risks to banks from the household sector needs to consider both the nature of banks' exposures to the sector and the extent of financial pressures on households.

The exposures of large UK-owned banks

Secured lending

The annual growth of large UK-owned banks' mortgage lending remained rapid in 2004 H1 (Chart 1.5). At around 10%, it considerably exceeded the growth rate of nominal GDP. Since mid-year, there has been a slowdown in mortgage lending for house purchase. Buy-to-let lending has continued to grow particularly quickly, but nevertheless still makes up only 7% of aggregate mortgage exposures.¹

Unsecured lending

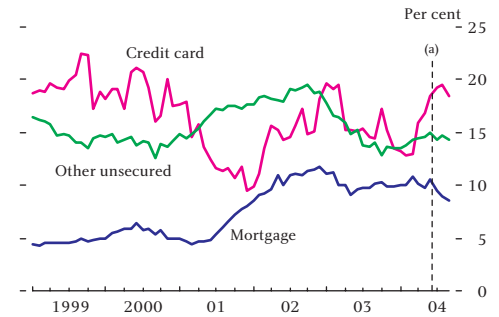
The large UK-owned banking sector's unsecured lending has continued to grow even faster than their secured lending during the second half of 2004 (Chart 1.5). Despite its faster rate of growth, unsecured lending still makes up only 18% of large UK-owned banks' lending to UK-resident individuals (Chart 1.6). Nevertheless, with growth rates exceeding those for secured lending for the past five years, unsecured lending to UK households is becoming a more substantial proportion of the large UK-owned banking sector's exposures. Given that many characteristics (such as loss given default, 'draw-down' behaviour and pricing) of unsecured lending are different to those of secured lending, the risk management challenges facing banks are also gradually changing.

Financial pressures on households

Growth of debt

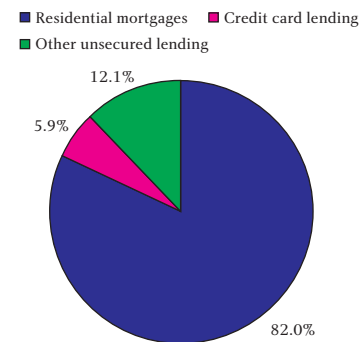
Households' total borrowing from all banks and other lenders has increased even more rapidly than their borrowing from the large UK-owned banks. Total borrowing growth has remained close to an annual rate of 15% this year (Chart 1.7), raising households' debt to 140% of aggregate income (Chart 1.8). This is above the levels in the United States and most large European countries. But whether this leaves UK households more vulnerable than elsewhere to future adverse shocks depends on how debt is distributed in different countries across households

Chart 1.5
Annual growth of large UK-owned banks' lending to individuals



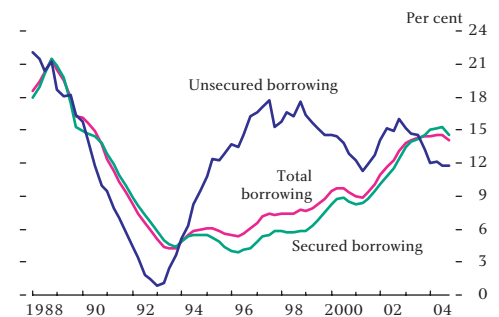
Source: Bank of England.
(a) June 2004 Review.

Chart 1.6
Large UK-owned banks' stock of lending to UK individuals^(a)



Sources: Bank of England and published accounts.
(a) Sep. 2004.

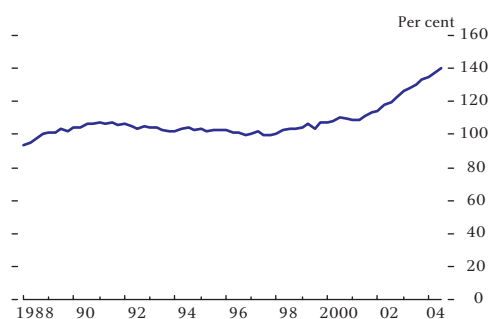
Chart 1.7
Households' secured and unsecured borrowing^{(a)(b)}



Source: Bank of England.
(a) Data are seasonally adjusted and quarterly.
(b) Twelve-month growth rate.

(1) See 'Box 1: The buy-to-let mortgage market' in the June 2004 Review, page 20.

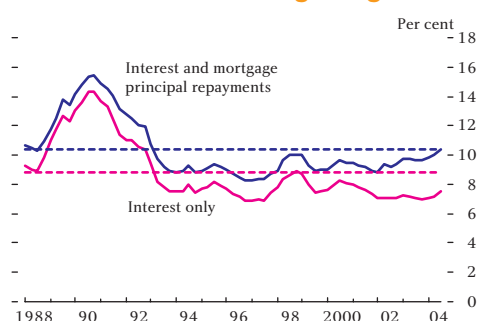
Chart 1.8
Ratio of household sector debt to
income^{(a)(b)(c)}



Sources: ONS and Bank calculations.

- (a) Percentage of annualised post-tax income.
- (b) Debt equals total liabilities.
- (c) Debt data are not seasonally adjusted.

Chart 1.9
Household sector income gearing^(a)



Sources: ONS and Bank of England.

- (a) Dashed lines indicate averages from 1988 Q1 to 2004 Q2.

subject to different financial pressures, and on the responses of the relevant financial systems to such shocks.¹

UK households' borrowing growth is likely to remain strong over the next few years, partly because the aggregate level of debt is likely to continue to adjust to the recent rise in house prices relative to income.² The boost to borrowing would, however, be less strong – or could even be reversed – if housing market turnover or prices were to fall substantially. Aggregate debt would also be increased if the upward trend in the number of mortgage borrowers continues. In the past few years, this increase has mainly reflected the rising number, and smaller average size, of households.³

In aggregate, the growth of debt has been accompanied by an increase in financial assets, reflecting both gross saving and equity price gains. However, these assets are unlikely to be available to the most vulnerable households, as they tend only to have a small amount of financial wealth.⁴

Debt affordability

Income gearing, which provides an indication of the burden faced by the household sector as a whole in servicing its debt, picked up modestly during the first half of 2004 (Chart 1.9). Households' average effective borrowing rate increased further in Q3, reflecting the latest interest rate changes. This is likely to have caused a further rise in gearing.

The increase in mortgage interest repayments is likely to have been more abrupt for those households for whom short-term fixed-rate mortgage contracts have recently expired.⁵ The current average standard variable rate is about two percentage points higher than the average two-year fixed-rate product that was available two years ago. Given market expectations for interest rates, a household whose fixed-rate mortgage contract expires over the next year is also likely to experience a mortgage rate increase. Similarly, the interest rate on some households' 'annual review mortgages' may increase on the next review date.

(1) Higher aggregate debt can also signal an improvement in welfare. Households may have been able to maintain consumption during temporary periods of lower income, or to match expectations of higher future income. Or they may have been able to use debt to purchase expensive durable goods and housing. See Hancock, M and Wood, R (2004), 'Household secured debt', *Bank of England Quarterly Bulletin*, Autumn.

(2) Slow adjustment occurs because only a relatively small proportion (averaging 10% over the past thirty years) of the housing stock changes hands each year. See Hamilton, R (2003), 'Trends in households' secured debt', *Bank of England Quarterly Bulletin*, Autumn.

(3) The increase in the number of households is likely to have raised the aggregate level of debt because there has been no offsetting reduction in the average dwelling (and thus, potentially, mortgage) size.

(4) See Cox, P, Whitley, J and Brierley, P (2002), 'Financial pressures in the UK household sector: evidence from the British Household Panel Survey', *Bank of England Quarterly Bulletin*, Winter.

(5) In 2002, 23% of new mortgages were taken out at a fixed interest rate, with this proportion rising to 36% in 2003.

Changes in aggregate default risk also depend on changes in the repayment difficulties associated with a given level of income gearing. As discussed in Box 2, the proportion of households reporting mortgage payment problems has fallen by about two thirds since the early 1990s, largely because households are less likely to report a problem for a given level of mortgage payments relative to income.

Income and unemployment

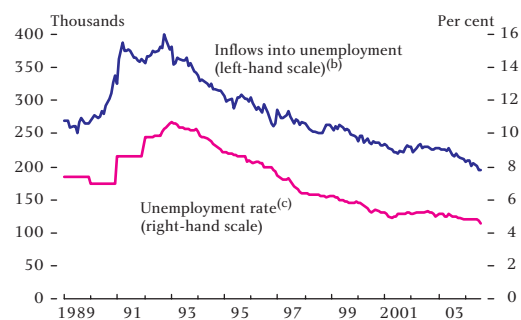
Previous research has found that income shocks were the largest single determinant of household debt difficulties in the early 1990s.¹ So it is reassuring that labour market conditions remain benign. Whole-economy earnings grew by 3.7% in the year to 2004 Q3. Unemployment is low, at only about half its early 1990s level (Chart 1.10). And inflows into unemployment have also fallen, reducing the number of households experiencing a sudden loss of employment income. As discussed in the November *Inflation Report* (page 41), the MPC expects the employment rate to increase marginally over the next two years, with wage growth probably rising.

House prices

The increase in house prices in recent years has strengthened the financial position of many homeowners by increasing their capacity to refinance debts.² Reflecting this, a recent survey³ found that 40% of mortgage holders agreed with the statement, “My house value has risen so much that I do not worry about other debts I may have”. Over half those sampled had remortgaged, with a number of these having taken the opportunity to consolidate other debts. Overall, 56% of households reported looking to save money on monthly payments when remortgaging.

As discussed in the November *Inflation Report* (pages 6–7), the outlook for house prices remains uncertain. Any sustained fall in prices would reduce homeowners’ cushion of housing equity. This might reduce their opportunity to remortgage to consolidate other debts or to lower their monthly payments. Financing difficulties would be exacerbated if any fall in house prices were accompanied by a wider economic slowdown, although the MPC’s November central projection is for output growth to be close to trend. Any fall in house prices might also increase the financial pressures associated with buy-to-let borrowing if it were accompanied by a reduction in rental values.

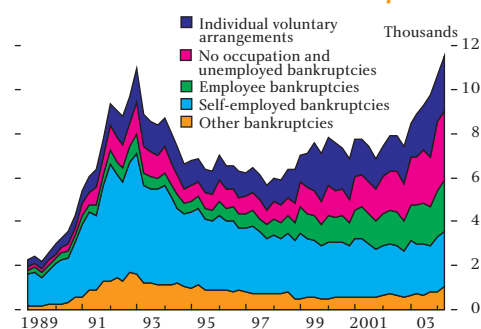
Chart 1.10
Unemployment: level and inflows^(a)



Source: ONS.

- (a) Unemployment rate data are annual between 1989-92. Data are monthly from Apr. 1992.
- (b) Claimant count inflows.
- (c) LFS measure.

Chart 1.11
Personal insolvencies and bankruptcies^{(a)(b)(c)}



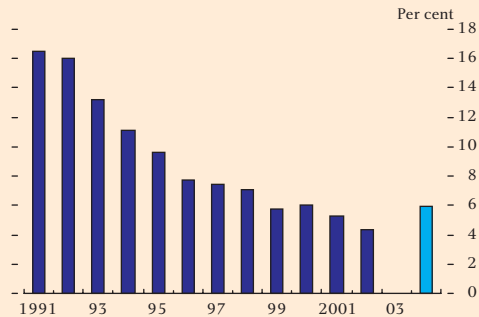
Source: DTI.

- (a) Data are for England and Wales. Data are quarterly and not seasonally adjusted.
- (b) Individual voluntary arrangements include Deeds of Arrangement.
- (c) Other bankruptcies includes directors and promoters of companies and those whose occupation is unknown.

(1) See Coles, A (1992), ‘Causes and characteristics of arrears and possessions’, *Council of Mortgage Lenders Housing Finance*, No. 13, pages 10-12.
 (2) But increasing house prices raise the cost of housing services, and any gain for those trading down will be offset by the corresponding extra outlay for households that are trading up or buying for the first time. See November 2004 *Inflation Report*, pages 12–13.
 (3) Market research conducted by Bradford and Bingley in March 2004.

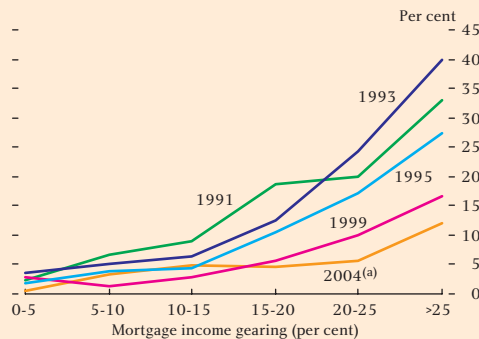
Box 2: Households' perception of their mortgage burden

Chart A
Proportion of households reporting problems paying for mortgage



Sources: BHPS (1991-2002), Bank/NMG (2004) and Bank calculations.

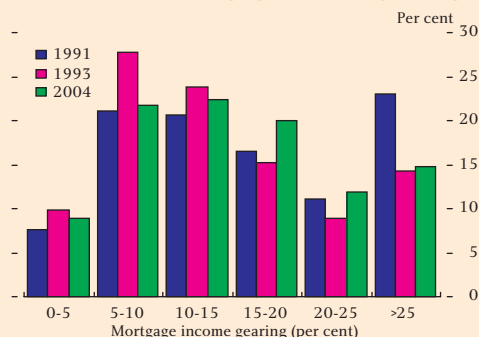
Chart B
Proportion of households reporting problems paying for mortgage by level of mortgage income gearing



Sources: BHPS (1991-2002), Bank/NMG (2004) and Bank calculations.

(a) Because of a smaller sample size for the 2004 survey, the results have been averaged with those for 2002 to reduce sampling volatility.

Chart C
Distribution of mortgage income gearing



Sources: BHPS (1991-2002), Bank/NMG (2004) and Bank calculations.

Median monthly mortgage payments have eased from 15% of households' income in 1991 to 13% in 2004.¹ Yet the proportion of households reporting problems meeting these payments has fallen by about two thirds over this time (Chart A).²

Examination of the distribution of mortgage payment problems by mortgage income gearing³ reveals two key stylised facts (Chart B). First, households with higher gearing are more likely to report payment problems; in 2004, households with gearing over 25% of income were about twice as likely to report problems as those with lower gearing. Second, over the past decade, households have become less likely to report payment problems for any given level of gearing. This reduction has been particularly pronounced at high gearing levels.

Shift-share analysis⁴ reveals that the reduction in the proportion of households reporting problems between 1991 and 1993 was largely due to the decline in the fraction of households with high gearing (Chart C), reflecting the reduction in interest rates.

In contrast, the (larger) reduction in mortgage payment problems since 1993 is more than accounted for by households being much less likely to report problems for any given level of income gearing. Over this time, the distribution of gearing across households has changed relatively little, while there is now less difference in the proportion of reported payment problems among households with different gearing levels.

Households' greater tolerance of a given level of mortgage income gearing may be associated with a number of factors, including: steady economic and wage growth; the fall in unemployment (and inflows into unemployment); lower and less volatile nominal interest rates and inflation; and the increase in house prices which (for most homeowners) has raised housing equity. Of course, should some of these factors change, the burden of debt might increase.

- (1) Data from the British Household Panel Survey (BHPS) for 1991 to 2002, and a special survey commissioned by the Bank and conducted by NMG Research in September 2004.
- (2) In contrast, the fraction of households reporting that their unsecured debt is a heavy burden has changed little since 1995.
- (3) Defined as a household's total mortgage cost as a percentage of their income.
- (4) Aggregate changes in reported payment problems over time are decomposed into changes in the probability of each group (i) reporting problems (P_i) and changes in each group's weight in the total (W_i). Groups are defined on the basis of mortgage income gearing.

$$\Delta \sum_i P_{i,t} W_{i,t} = \sum_i \Delta P_{i,t} \frac{(W_{i,t} + W_{i,t-1})}{2} + \sum_i \Delta W_{i,t} \frac{(P_{i,t} + P_{i,t-1})}{2}$$

Personal insolvencies

Personal insolvencies have continued to rise this year, and are now above their early 1990s level (Chart 1.11), despite a fall in bankruptcies amongst the self-employed (which probably reflects the benign business environment discussed in Chapter 1.2). Although unemployment has fallen substantially since the early 1990s (and there has been no increase in inactivity), the unemployed and inactive now account for twice as many bankruptcies as they did in the early 1990s. Any future pickup in unemployment might therefore be accompanied by a larger increase in the overall personal insolvency rate than it would have done in the past.

The rise in insolvencies has largely reflected an increase in debtor, rather than creditor, petitions for bankruptcy (Chart 1.12). This may have been partly due to the implementation of the Enterprise Act (2002) on 1 April 2004,¹ which changed the penalties associated with most bankruptcies in England and Wales. But that seems unlikely to be the whole story; these penalties remain high and there has been a similar increase in insolvencies in Scotland over the past few years, where the legal regime has remained unchanged (Chart 1.13).

Risks to large UK-owned banks

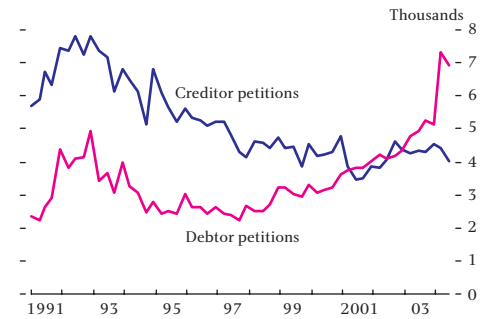
Secured lending

Backward-looking indicators continue to show little sign of stress on the UK-owned banking sector's secured lending. New provisions for bad and doubtful debts, for example, at around 0.35% of total loans, remain low, which is broadly consistent with what might have been expected given the macroeconomic environment.² Mortgage arrears and write-offs remain at or near historical lows (Chart 1.14). And while mortgage possessions have increased in recent months, this has been from a low base.³

Forward-looking indicators of risk, such as spreads on mortgage-backed securities (MBS) and demand for MBS issues, show little sign of investor concern. However, these indicators should be interpreted with caution, given that spreads on MBS can be influenced by factors other than the underlying quality of the assets, such as the way in which the issue has been structured. Lack of secondary market liquidity means that it is difficult to monitor developments in MBS spreads.

- (1) The Enterprise Act reduced the period for automatic discharge of most bankrupts, while increasing it for those whose conduct is deemed to have been irresponsible or reckless.
- (2) Based on the simple model in Hoggarth, G and Pain, D (2002), 'Bank provisioning: the UK experience', Bank of England *Financial Stability Review*, June.
- (3) The increase in possession orders may be associated with recent changes to bankruptcy legislation that have limited the period in which a bankrupt's home may be possessed to three years. Previously there was no time limit.

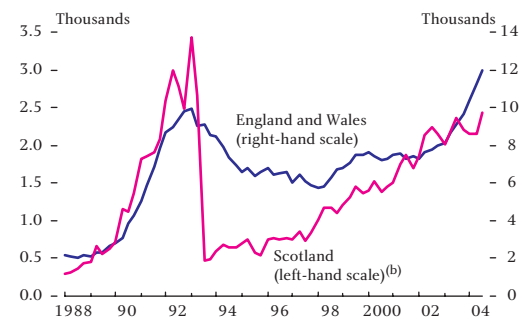
Chart 1.12
Bankruptcy petitions in England and Wales^{(a)(b)}



Source: Department for Constitutional Affairs Judicial Statistics.

- (a) Number of bankruptcy petitions registered does not necessarily sum to number of bankruptcy orders made.
- (b) Data are quarterly and not seasonally adjusted.

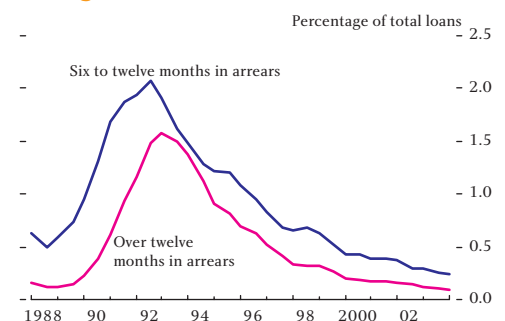
Chart 1.13
Personal insolvencies^(a)



Sources: DTI, Accountant in Bankruptcy and Bank calculations.

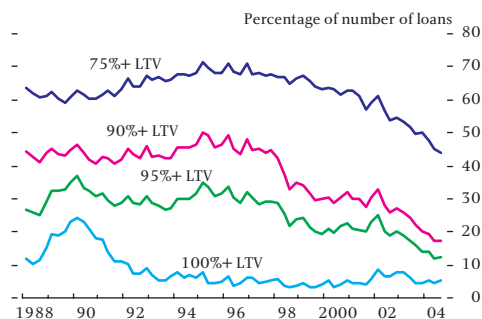
- (a) Includes bankruptcies and individual voluntary arrangements for England and Wales, and sequestrations and protected trust deeds for Scotland. Data are quarterly.
- (b) The timing of insolvencies in the early 1990s may have been distorted by the introduction of the Bankruptcy (Scotland) Act in Apr. 1993.

Chart 1.14
UK lenders' arrears on domestic mortgage lending



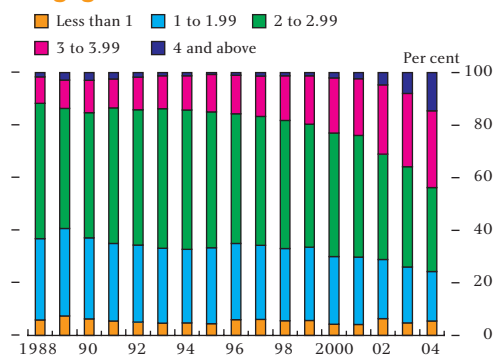
Source: Council of Mortgage Lenders.

Chart 1.15
Loan-to-value ratios on new UK mortgages



Source: Council of Mortgage Lenders.

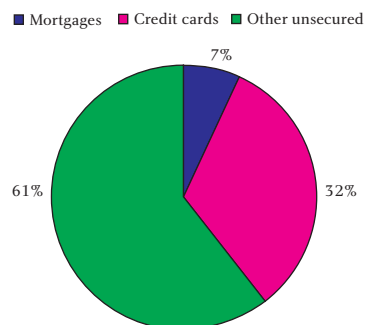
Chart 1.16
Loan-to-income multiples on new UK mortgage advances^(a)



Source: Council of Mortgage Lenders.

(a) Excludes lending for which loan-to-income ratios are not known.

Chart 1.17
Breakdown of UK-owned banks' write-offs on lending to UK individuals^{(a)(b)}



Source: Bank of England.

(a) From Oct. 1997 to Sep. 2004.

(b) Adjusted to reflect one bank's change in accounting method.

Even were defaults to rise, large UK-owned banks would not necessarily face material losses, because mortgage lending is backed by collateral. Average loan-to-value (LTV) ratios on new lending continued to fall during 2004 H1, and are now considerably lower than in the late 1980s (Chart 1.15). The mean and distribution of LTV ratios on the total outstanding mortgage stock are less easy to measure, though they are a more appropriate indicator of the risk to banks. Many large UK-owned banks report mean LTV ratios in their published accounts, and these tend to be in the region of 40 to 50%. This accords with a special survey of households commissioned by the Bank and conducted by NMG Research in September 2004, in which 45% of mortgage debt was held by households where the current LTV was 50% or above, and 16% of mortgage debt where the LTV was 70% or above. LTV ratios on mortgage portfolios should, however, be interpreted with some caution. In a scenario where there was a market-wide fall in the value of housing collateral, any widespread attempt by banks to realise its value could put further downward pressure on house prices.

The risk of loss to banks will be greater if mortgage lending with high LTV ratios has been concentrated amongst borrowers under financial pressure. In processing information from a sample of lenders, the FSA tracks and categorises new mortgage lending with both high LTV ratios and high loan-to-income (LTI) ratios – the latter being one indicator of financial pressure on households (Chart 1.16). In 2004 Q2, the proportion of new lending falling into the combined medium and higher risk categories had moved a little ahead of the fairly narrow range within which it had fluctuated over the past couple of years. However, over a longer horizon, evidence from the Survey of Mortgage Lenders and The British Household Panel Survey suggests that in recent years fewer households than in the late 1980s have high debt repayment commitments but little collateral to offer.¹

Unsecured lending

Unsecured lending is always likely to incur proportionally higher loss given default than is secured lending, given the absence of collateral or guarantees. Indeed, although unsecured lending makes up only 18% of large UK-owned banks' lending to UK-resident individuals, it has been responsible for 93% of write-offs on such lending in the past seven years (Chart 1.17). However, the overall profitability of banks' unsecured lending depends on whether the risks they face have been reflected in the interest rates and fees charged to borrowers.

(1) Hancock, M and Wood, R (2004), 'Household secured debt', *Bank of England Quarterly Bulletin*, Autumn.

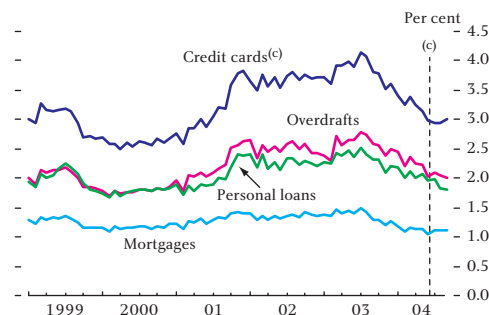
The spread between effective interest rates on unsecured lending and banks' cost of funds has continued to fall since the June 2004 *Review* (Chart 1.18). Market contacts attribute this to strong competition between unsecured lenders, illustrated by the increase in zero-interest credit card offers (Chart 1.19).¹ The downward trend in unsecured lending spreads should, however, be interpreted with caution. The average level of effective interest rates on credit cards, for example, still remains high relative to that on secured lending. Furthermore, some unsecured lending, such as personal loans, is undertaken in conjunction with fee income.

Credit losses from unsecured lending have increased marginally since the previous *Review*. Annual write-off rates on credit cards rose to 3% in 2004 Q3, while rates on other unsecured lending rose to 2.1% (Chart 1.20). Some of the rise in write-offs on credit cards could be associated with the recent increase in personal insolvencies discussed above. However, bank contacts suggest that only around 5 to 20% of write-offs are related to bankruptcy, so that may only provide a part of the explanation. Despite their recent rise, write-off rates on large UK-owned banks' unsecured lending still remain below rates in some other countries, such as the United States and Hong Kong.

Looking forward, banks face a number of risk management challenges. One is managing the transition to the new personal insolvency law regime, which could have a long-lasting effect if it changes debtor behaviour and thus the sensitivity of write-offs to adverse macroeconomic shocks. Another is managing the implications of the strong growth in unsecured lending over the past five years (Chart 1.5), especially where this has occurred through lending to new customers for whom the bank has no past current account information with which to supplement a credit assessment. Lending to customers with multiple borrowing relationships may also pose a challenge when the bank does not have complete information about the evolution of a customer's total indebtedness over time.

Banks have been undertaking measures to strengthen their risk management in the face of such problems, for example, by studying the impact of changes in insolvency regimes in other jurisdictions, such as Australia and Hong Kong. Most UK banks already share some indicators of adverse credit history with other lenders, which helps address the challenge posed by multiple borrower relationships. Contacts suggest that indicators that confirm borrowers have a history of timely repayment could be shared more freely in future. In part encouraged by the introduction of Basel II, banks have also been developing their quantitative risk modelling techniques over recent years,

Chart 1.18
The large UK-owned banking sector's effective interest rate spread over Libor^{(a)(b)}



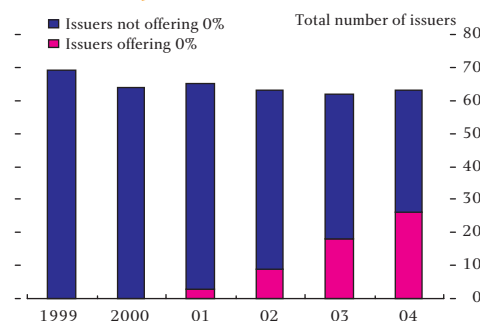
Source: Bank of England.

(a) Medians of average effective interest rates. Includes only interest-bearing balances.

(b) Using three-month Libor.

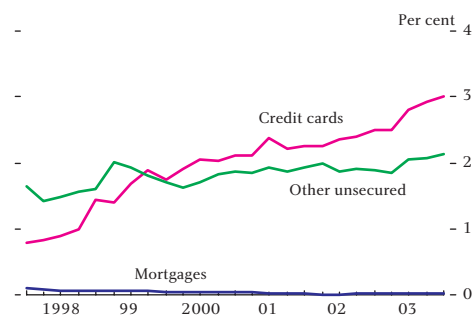
(c) June 2004 *Review*.

Chart 1.19
Prevalence of credit card issuers offering 0% interest periods



Source: Bank of England.

Chart 1.20
UK-owned banks' annualised write-off rates on lending to UK individuals^(a)

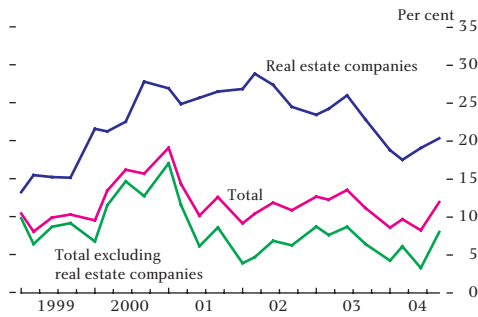


Source: Bank of England.

(a) Adjusted to reflect one bank's change in accounting method.

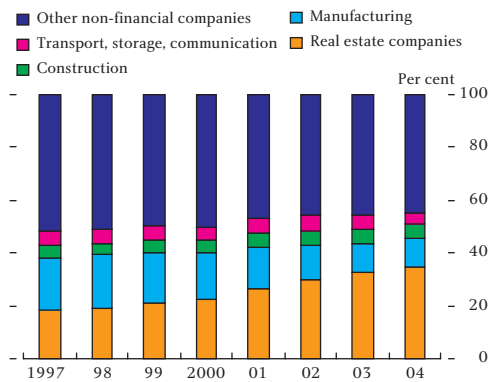
(1) The 2004 Bank/NMG survey found that about 7% of all unsecured debt is interest free. See May, O, Tudela, M and Young, G (2004), 'British household indebtedness and financial stress: a micro picture', *Bank of England Quarterly Bulletin*, forthcoming.

Chart 1.21
Annual growth of large UK-owned banks' lending to non-financial companies



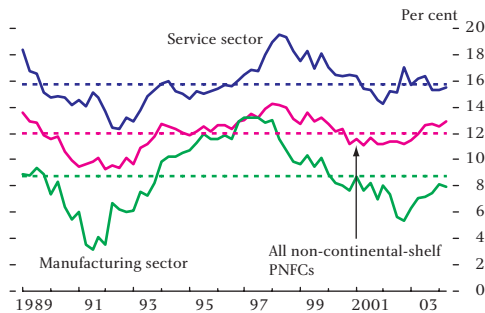
Source: Bank of England.

Chart 1.22
Large UK-owned banks' stock of lending to non-financial companies



Source: Bank of England.

Chart 1.23
Net rate of return on capital^{(a)(b)}



Source: ONS.

- (a) Net operating surplus/net capital employed.
(b) Dashed lines indicate averages taken from 1989 Q1 to 2004 Q2.

including credit scoring models, which use micro-level information on individual borrowers, and stress tests, which model the implications of macroeconomic shocks. Many of these models, however, are yet to be tested by a period of actual economic stress.

If credit quality were to deteriorate, one response by banks could be to reduce their exposure to unsecured lending, by either cutting back on new lending or by raising interest margins. Although reducing lending could be an effective strategy for some individual banks, simultaneous action could exacerbate pressures on both borrowers and lenders.

1.2 UK corporate credit risks

Large UK-owned banks' lending to private non-financial companies (PNFC) represents around 8% of their total assets. Although lending to this sector accounts for only 24% of lending to UK-resident households and PNFCs, it has accounted for 35% of total domestic write-offs since 1997. Furthermore, over the past five years the volatility of write-off rates on lending to this sector has been higher than that for lending to individuals. Any evaluation of risks to banks from non-financial companies, as with risks from the household sector, will depend on both the nature of banks' exposures and the extent of financial pressures on the sector.

Exposures of large UK-owned banks

The growth of large UK-owned banks' new lending to UK non-financial companies increased to around 12% in the year to 2003 Q3. There has been considerable dispersion in growth across sectors: for example, the annual growth rate of lending to real estate companies is still rapid, at 20%, while that of lending to other non-financial companies is 8% (Chart 1.21).

Lending to real estate companies accounted for 55% of large UK-owned banks' new lending to non-financial companies in the year to September 2004, following a 65% contribution in 2003. As a result, this sub-sector now makes up around 35% of the stock of large UK-owned banks' lending to non-financial companies. This compares with around 10% for the manufacturing sector, for example (Chart 1.22).

Financial pressures on companies

Aggregate profitability

Corporate profitability continued to pick up over the first half of 2004. This partly reflected strong profits from UK Continental Shelf companies (oil producers), due to high oil prices. But average profitability amongst other companies also rose, with the net rate of return on capital remaining above its long-run average (Chart 1.23). Although positive, the mean expectation of profit

growth for 2005, as reported by Consensus Economics, is below its 2004 value, and has been revised down over the past year.

The strength of profits helped the corporate sector remain in financial surplus for the eighth successive quarter in 2004 Q2. Reflecting this, PNFCs' demand for external finance has been relatively weak for most of this time (Chart 1.24). Bank borrowing picked up in 2004 Q3, although bond issuance remained weak and there was a net repurchase of equity.

Disaggregated measures of profitability

Credit risk also depends on the distribution of profitability across firms, and whether there are any pockets of unusually high vulnerability. Data from UK companies' accounts reveal that the dispersion of quoted companies' profit margins has increased over much of the past twenty years (Chart 1.25). In 2003, 38% of quoted companies made a loss – similar to the rates in 2002 and 2001, but substantially above those prior to 1999 (Chart 1.26). But these are primarily small companies, accounting for about 14% of quoted non-financial companies' debt. And if non-quoted companies are also considered, the proportion of companies making a loss is close to its average since 1991. Also reassuring is that the proportion of firms that have reported so far in 2004 that made losses is fractionally lower than in 2003,¹ while profit warnings this year have been running a little below their levels over the previous three years.

Since the start of the year, movements in the FTSE All-Share index have only been weakly correlated with oil price changes. However, rising oil and commodities prices are likely to have had a more marked effect on some companies than others. For example, increased fuel costs have affected airlines, the share prices of which have fallen over the year to date.

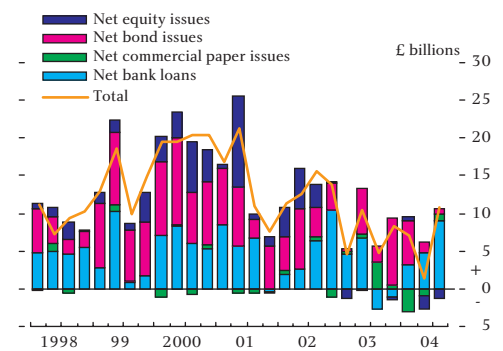
Capital gearing and balance sheet adjustment

The ratio of companies' debt to the market value of their assets – a measure of capital gearing – provides an aggregate indicator of the sustainability of their balance sheet position. Gearing has continued to ease in 2004 (Chart 1.27), reflecting the small fall in net debt and the increase in market values. However, by historical standards, gearing remains high and is also above the estimated 'equilibrium level' calculated in a recent Bank working paper.²

(1) Based on the results from 401 quoted companies that have so far published accounts for 2004, about a third of the final sample.

(2) The equilibrium level is calculated by offsetting the tax advantages of debt finance against the costs to the firm of financial stress, which becomes more likely at higher levels of debt. For more information, see Bunn, P and Young, G (2004), 'Corporate capital structure in the United Kingdom: determinants and adjustment', Bank of England Working Paper No 226.

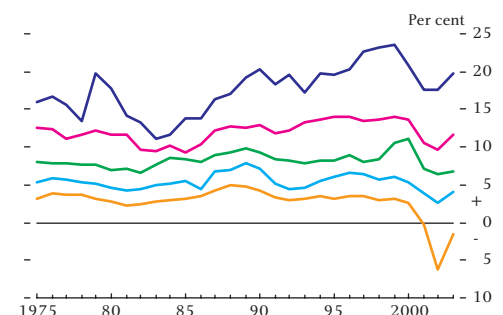
Chart 1.24
PNFCs' external finance^(a)



Source: Bank of England.

(a) Excluding securitisations and borrowing by PNFCs from non-resident monetary financial institutions. The components do not sum to the total in each quarter because the total has been seasonally adjusted independently.

Chart 1.25
Distribution of weighted profit margins of quoted PNFCs^{(a)(b)}

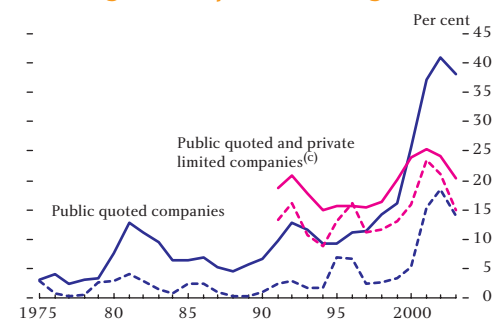


Sources: Thomson Financial Datastream and Bank calculations.

(a) Earnings before interest and taxes divided by turnover, sales weighted.

(b) 90th, 75th, 50th, 25th and 10th percentiles shown.

Chart 1.26
Percentage of companies making a loss^{(a)(b)}



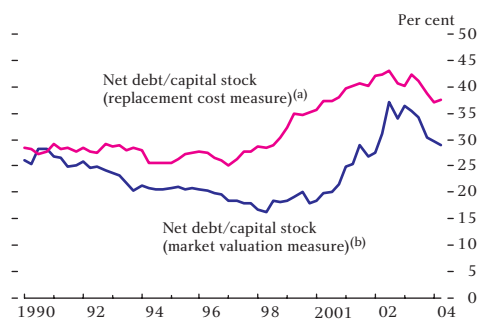
Sources: Bureau van Dijk, Thomson Financial Datastream and Bank calculations.

(a) Profit (loss) = earnings before interest and taxes.

(b) Solid lines are % of companies making a loss, dashed lines are % of debt owed by these firms.

(c) Sample includes all public quoted companies and private limited companies with over 100 employees.

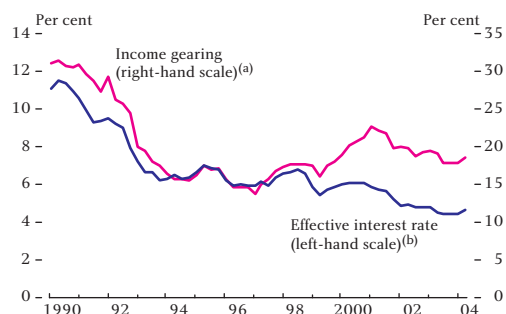
Chart 1.27
PNFCs' capital gearing



Sources: ONS and Bank calculations.

- (a) PNFCs' net debt divided by the total value of capital at replacement cost.
- (b) PNFCs' net debt divided by the market value of assets of UK-resident firms.

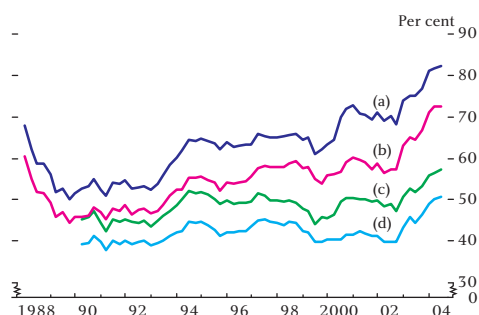
Chart 1.28
PNFCs' income gearing and effective interest rate



Sources: ONS and Bank calculations.

- (a) As measured by interest payments as a percentage of gross operating surplus.
- (b) As measured by annualised interest payments as a percentage of gross debt.

Chart 1.29
Indicators of corporate liquidity



Sources: ONS and Bank of England.

- (a) PNFCs' liquidity = (all currency deposits + money market instruments (MMIs) + bond assets)/(all borrowing - bonds issued - direct investment).
- (b) As (a) excluding holdings of MMIs and bonds.
- (c) As (a) but also dividing by bonds issued.
- (d) As (b) but also dividing by bonds issued.

There is little evidence that many firms are actively seeking to reduce gearing further by making cutbacks in dividends, lowering capital expenditure or refinancing debt. Although average dividend payments relative to GDP in the first half of 2004 were fairly low by historical standards (particularly given the strength of corporate profitability), the fraction of highly geared quoted companies cutting their dividend fell in both 2002 and 2003. Capital expenditure has recently been robust, growing by an average of 1.9% over the past three quarters. And, rather than repaying debt, there was a net buy-back of equities in 2004 Q3.

Consistent with this overall picture, the 2004 Q3 Institute of Directors survey revealed that a net balance of only 6% of companies believed that their gearing was too high. There also appears to be little pressure to reduce gearing from investors; on the contrary, corporate contacts suggest that there has been a rising appetite for debt relative to equity.

Pension fund deficits have continued to add to financial pressures for some companies. Adding these deficits to traditional balance sheet exposures increases the aggregate debt of FTSE 100 companies with defined-benefit pension schemes by 6%.¹ The size of these deficits has remained little changed over both the past year and since the June 2004 *Review*, as favourable equity price movements have been offset by upward revaluations to liabilities (reflecting a slight fall in the long-term interest rate used to discount future payments and an upward reassessment of life expectancy).

Debt servicing

High profitability, together with low average borrowing rates, has ensured that aggregate corporate income gearing remains relatively low (Chart 1.28). Liquidity ratios are at a record high (Chart 1.29), indicating that in aggregate companies have a significant buffer against any future adverse shocks. However, discussions with companies over the past year have suggested that liquidity may in some cases be higher than desired in the long run, reflecting the expense of repaying long-term borrowing, the lack of suitable investment opportunities or precautionary motives.

Market contacts have highlighted the increasing number of highly leveraged buyouts involving private equity firms. Given the current benign conditions, it is possible that some firms have underestimated the risks of high leverage. If so, that could cause some such deals to come under strain and thus possibly lead to a rise in debt restructuring.

(1) Bank of England calculations as at 1 November 2004.

Corporate insolvencies

The number of corporate insolvencies has continued to fall (Chart 1.30). Market contacts report that, in addition to reflecting the robust profitability of the corporate sector, this may also reflect an increased willingness of financial institutions to maintain credit to distressed firms.

The number of receiverships has declined in 2004, which could suggest that insolvencies will fall further.¹ However, this has been accompanied by an increase in administrations (Chart 1.31). The divergence between the two may partly reflect measures introduced by the 2002 Enterprise Act, which made it easier for firms in financial difficulties to enter administration. Although one aim of the Act was to provide incentives to maintain companies as going concerns, and to avoid unnecessary insolvencies, the increase in administrations over the past year is too small to explain much of the overall fall in insolvencies. For companies that remain solvent, administrations may nevertheless ultimately lead to write-downs of debt by banks.

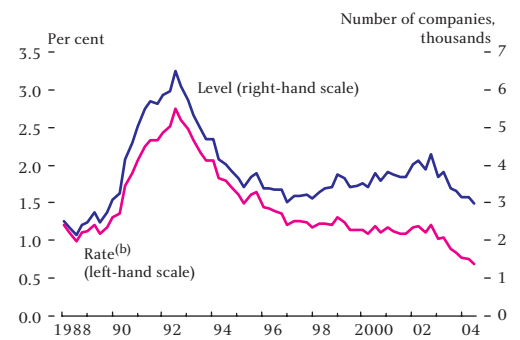
Market indicators of corporate prospects remain benign. Corporate bond spreads are low by historical standards. Equity prices have, in general, risen, both since the June 2004 *Review* and over the past year, and the dispersion in the distribution of equity returns for FTSE 350 companies is lower than on average, with significantly fewer companies suffering heavy equity price falls. Reflecting these positive developments, the likelihood of corporate default over a twelve-month horizon (as measured by models based upon leverage, equity prices and volatilities²) has declined further during 2004.

The commercial property sector

Commercial property companies' demand for finance remains strong. Their total borrowing from all UK banks grew by 17% in the year to 2004 Q3, unchanged from the previous quarter.³ This finance has partly been used to fund the purchase of property assets from companies, who subsequently lease them back ('sale and lease back'). The risks associated with this debt may be low if it is secured against the rental stream from good quality tenants. Nevertheless, quoted commercial property companies' capital gearing has increased over the past ten years, although it remains below the early 1990s high.

Strong investor demand continues to put upward pressure on commercial property prices. Market contacts argue that this has partly reflected better returns than from equities over the past

Chart 1.30
Corporate insolvencies^(a)

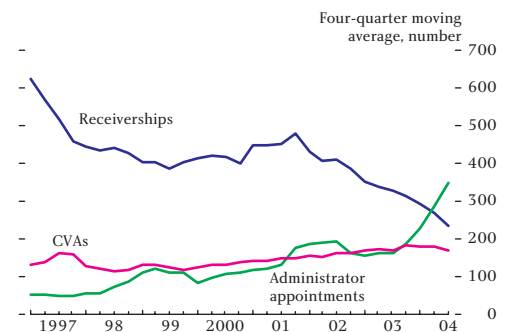


Source: DTI.

(a) Seasonally adjusted. Latest observation is for 2004 Q3 and is provisional.

(b) Ratio of insolvencies to average number of companies over the preceding year.

Chart 1.31
Administrator appointments, company voluntary arrangements (CVAs) and receiverships



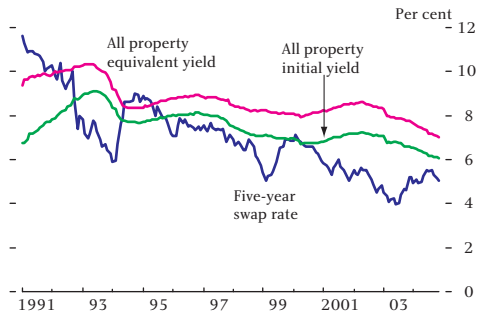
Source: DTI.

(1) Receiverships and Company Voluntary Arrangements turn into insolvencies if companies undergoing those proceedings fall into liquidation. The main aim of an administration is to rescue the firm as a going concern.

(2) See Tudela, M and Young, G (2003), 'Predicting default among UK companies: a Merton model approach', Bank of England *Financial Stability Review*, June.

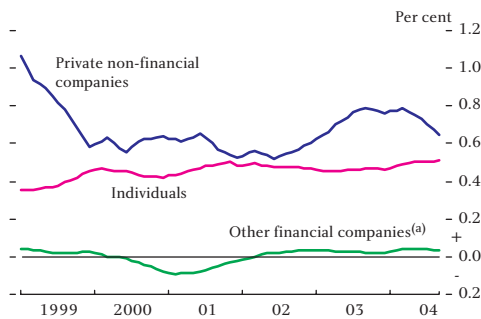
(3) Statistics are for real estate companies, including residential property developers.

Chart 1.32
Commercial property yields



Sources: Investment Property Databank and Bloomberg.

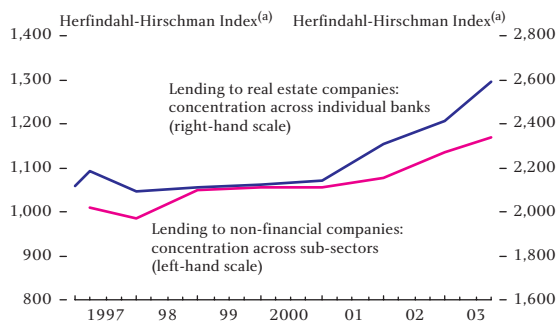
Chart 1.33
UK-resident banks' annualised write-off rates on domestic lending



Source: Bank of England.

(a) All financial companies which are not licensed as banks.

Chart 1.34
Concentration of large UK-owned banks' lending to non-financial companies



Source: Bank of England.

(a) The Herfindahl-Hirschman Index (HHI) is the sum of the squared market shares. A rise in the HHI indicates a rise in concentration.

decade and potential diversification benefits. Reassuringly, and in contrast to the early 90s, this demand has not translated into a high level of speculative, unlet, development.

Given recent weak rental growth and high vacancy rates, the increase in commercial property capital values has been accompanied by a reduction in yields (Chart 1.32), reducing the spread over money-market rates. Some lenders may have underestimated the risks associated with these loans: surveys point to a weakening in PNFCs' profits growth in 2005 and it is possible that investors' expectations of rental income and vacancy levels will not be met.

Risks to banks

Consistent with the fall in corporate insolvencies, the write-off rate on UK-resident banks' lending to PNFCs has fallen slightly since the June 2004 Review (Chart 1.33). According to the Finance Leasing Association, the fraction of balances in arrears has fallen during 2003 and 2004, suggesting that future write-offs may remain moderate.

Although backward-looking indicators show little sign of recent deterioration, increased concentration of lending to non-financial companies raises challenges for the future (Chart 1.34). In particular, lending to real estate companies accounts for a third of the large UK-owned banks' stock of lending to non-financial companies, compared with a fifth in 2000. This lending has also become increasingly concentrated amongst a small number of banks (Chart 1.34).

Commercial property lending provides little immediate cause for concern. Write-offs and arrears on existing lending in 2003 remained very low. And loan-to-value ratios on bank lending for new developments remained little changed between 2000 and 2003, at around 80%. The strength of 'sale and lease back' activity means that some of the growth in lending to real estate companies could merely have replaced lending to other types of non-financial companies. However, in some cases, banks may have credit exposures to both real estate companies and the corporate borrowers that are tenants. Also, the risks associated with unsecured lending to companies that have used property assets as collateral for other borrowing may have increased. Although the demand for commercial property investments is strong at present, any future fall in capital values could lead to breaches of loan-to-value covenants. That would reduce the degree of protection for banks' loans, although, in the absence of corporate defaults, losses may not crystallise.

1.3 The United States

Over the past few years, the United States has become an increasingly important source of business for UK-owned banks. By end-June 2004, claims¹ on the United States accounted for over an eighth of the assets of the large UK-owned banks, mostly via US branches and subsidiaries. US business is particularly important for Barclays, HBSC and the Royal Bank of Scotland (RBS), accounting for around a fifth of their total assets. Developments in the US household sector, in particular, are potentially important for the UK financial system. HSBC has a major presence in the US residential mortgage and credit card markets; while the completion in August of the acquisition of Charter One, a large US regional bank, further increased the importance to RBS of the US residential mortgage and unsecured consumer loan markets. By contrast, Barclays undertakes little lending to US households or companies, focusing its US operations on investment banking. More generally, developments in the US economy and financial sector are also important for UK financial stability because large US banks are major counterparties for the large UK-owned banks in both interbank and derivative markets.

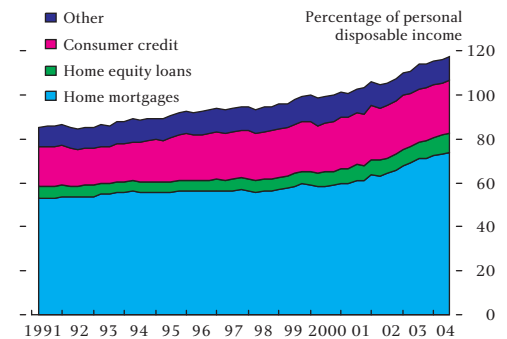
US growth was slightly weaker than expected in 2004 Q2 and Q3, and Consensus forecasts for real GDP growth in both 2004 and 2005 have been revised down since the previous *Review*. Nevertheless, the recovery is expected to remain robust, which is likely to help US borrowers to continue to service their loans. Since the June 2004 *Review*, the Federal Open Market Committee (FOMC) has raised the Fed Funds rate by 100 basis points, but long-term interest rates have fallen by 60 basis points and there have been downward revisions to the expected path of official interest rates.

The private non-financial sector

The household sector

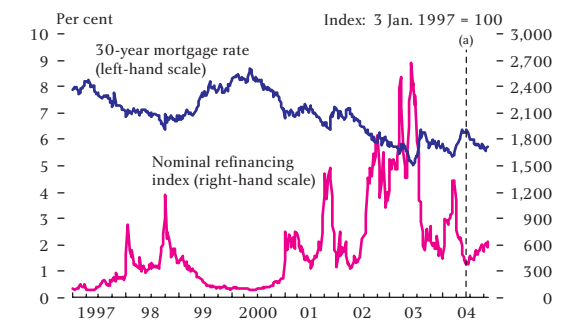
Household debt has continued to grow faster than disposable income, resulting in a further rise in the aggregate debt-to-income ratio (Chart 1.35). The growth in mortgage debt has remained rapid despite slowing somewhat in 2004 Q2. Home equity lending, particularly home equity lines of credit, continued to grow extremely rapidly, perhaps partly in response to the substantial rise in house prices over the past few years (Box 3). The growth of consumer credit has been fairly subdued since 2002, at least partly because of the high level of mortgage refinancing activity in the first half of 2003 (Chart 1.36). Although the household debt-to-income ratio is relatively high, the ratio of net worth to income is still higher than its average level in the 1990s.

Chart 1.35
US household debt-to-income ratio



Sources: Board of Governors of the Federal Reserve System: 'Flow of Funds Accounts of the United States', 2004 Q2, and Thomson Financial Datastream.

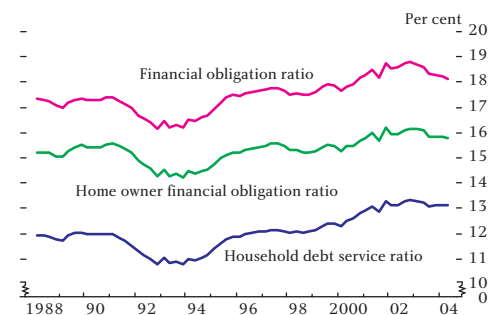
Chart 1.36
US mortgage refinancing



Sources: Mortgage Bankers Association of America and Bloomberg.

(a) June 2004 *Review*.

Chart 1.37
Household debt service and financial obligation ratios^(a)



Sources: Board of Governors of the Federal Reserve System and Thomson Financial Datastream.

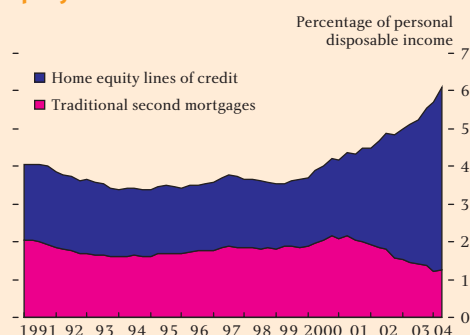
(a) Minimum debt payments, and payments for autoleases, rent, property tax and homeowner insurance as a proportion of personal disposable income.

(1) Consolidated foreign claims adjusted for risk transfers.

Box 3: Home equity lending in the United States

Chart A

US banks and savings institutions: home equity credit



Sources: Board of Governors of the Federal Reserve System: 'Flow of Funds Accounts of the United States', 2004 Q2, Federal Deposit Insurance Corporation, Bank calculations and Thomson Financial Datastream.

Table 1

US bank holding companies: outstanding holdings of HELOCs^(a)

	2004 (US\$ billions)	Growth since 2001 (Per cent)	2004 Percentage of total loans
Wells Fargo	50.5	288	19
Bank of America	42.2	50	8
JP Morgan Chase	37.4	119	10
Wachovia	15.3	311	9
National City Corp	13.8	150	16
Countrywide	13.7	425	40
Citigroup	11.1	162	2
US Bancorp	10.5	68	9
Keycorp	9.5	1,608	15
Citizens Financial	8.6	156	11
HSBC North America ^(b)	5.0	225	3
All commercial banks	341.2	121	7

Sources: Financial accounts and Federal Deposit Insurance Corporation.

(a) Data are for the top ten BHCs by HELOC lending, plus HSBC America Holdings, as at end 2004 Q2. Data for JP Morgan Chase and Citizens Financial include data for Bank One and Charter One respectively.

(b) The growth of HSBC North America's holdings of HELOCs may be overstated because Household International is only included in the 2004 figures.

US home equity lending has grown rapidly over the past few years and now accounts for 7.6% of household debt, compared with 5.1% in 1995 (Chart A). The growth may partly reflect the fact that house prices have risen by over one third over the past four years. The particularly rapid growth since 2003 Q3 may also be associated with a sharp decline in mortgage refinancing in the second half of 2003.

Home equity loans can be divided into two types. The first is the traditional second mortgage (TSM), with a fixed sum repayable over a fixed period. The second is a home equity line of credit (HELOC), which is a revolving credit line secured by housing. A HELOC plan specifies a credit limit, a repayment schedule and interest charges. The interest charges are typically at variable rates.

HELOCs have grown significantly since 1999. The amount of HELOCs drawn on commercial banks and savings institutions¹ has grown from 1.8% of personal disposable income to 4.9%. In that period, the TSMs of these institutions fell relative to personal disposable income. Given that HELOCs typically have variable rates, this may have increased somewhat the vulnerability of households to interest rate rises.

However, the 1997 Federal Reserve 'Survey of Consumers' found that homeowners with HELOCs have a relatively high median household income and median home equity – higher than homeowners with TSMs or homeowners with first mortgages. Moreover, despite the sharp growth in HELOC lending since the survey, charge-off rates on HELOCs have remained relatively stable.² These remain significantly below charge-off rates on credit cards, on other consumer debt and on TSMs. Finally, despite the rapid growth, outstanding home equity lending is still only 12% of that of first mortgages.

(Table 1) gives the outstanding HELOCs of the largest ten HELOC lenders (these account for over half of the total HELOC lending by commercial banks), as well as the outstanding HELOCs of HSBC North America. There is considerable variability in holdings relative to total loans. HSBC North America has low holdings of HELOCs relative to total loans, while the holdings of Citizens Financial, owned by RBS, are above the industry average.

(1) Commercial banks and savings institutions hold 68% of total home equity loans.

(2) However, the rapid growth in HELOCs may have reduced the average age of the stock of HELOCs, reducing average charge-off rates for a while.

Both the household debt service ratio and the Federal Reserve's broader 'financial obligations ratio' have remained broadly flat over the past three years, despite the rise in the debt-to-income ratio (Chart 1.37). In large part, this reflects the reductions in average effective interest rates achieved through mortgage refinancing.¹ Another factor has been the use of mortgage refinancing and home equity loans and lines of credit to pay down higher-cost unsecured debt.

The preponderance of long-term fixed-rate mortgages means that households' debt service costs are much less sensitive to rises in short or long-term interest rates than in the United Kingdom. Although there has been a marked shift recently to adjustable-rate mortgages (ARMs)² (Chart 1.38), around 85 to 90% of outstanding mortgages are still long-term fixed-rate loans. Unsecured consumer debt accounts for about 20% of household debt. Its largest component is instalment loans (for example, student loans and car loans), which typically have fixed rates; credit card debt, with variable rates, is significantly smaller.

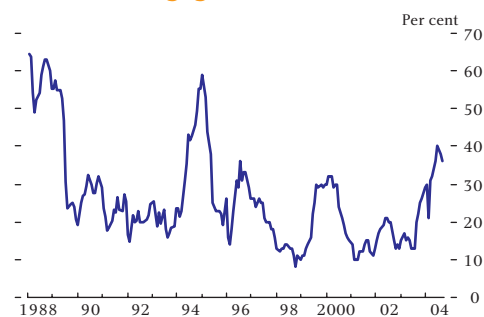
Charge-off rates on mortgages and home equity lending remain low (Chart 1.39). This is not surprising given that mortgage debt is largely insulated from the direct effect of rising interest rates; that the financial obligations ratio of home owners has been broadly stable; and that the unemployment rate has fallen. Although the financial position of renters has improved over the past two years, the financial obligations ratio of this group remains much higher than for home owners. Charge-off rates on credit cards and other consumer lending are substantially higher than for mortgages but have levelled off recently, mirroring the trend in personal bankruptcies.

Only a quarter of first-lien mortgages are originated with loan-to-value ratios (LTV) of more than 80%, and the average LTV for outstanding mortgages is about 45%. This significant equity cushion would provide protection for lenders against all but the most extreme declines in house prices. House price increases have been above average for the past four years, with the annual rate of house price inflation reaching 9.4% in 2004 Q2, the highest for almost 25 years.

The non-financial corporate sector

Corporate capital gearing at replacement cost³ continued to fall in 2004 Q2, as did income gearing (Chart 1.40) – both to their lowest levels for five years. This partly reflects strong profit growth in 2003 and continued robustness of profits in 2004.

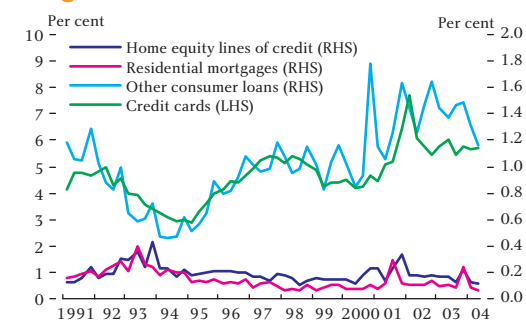
Chart 1.38
Adjustable-rate mortgages' share of new US home mortgages^(a)



Source: Federal Housing Finance Board.

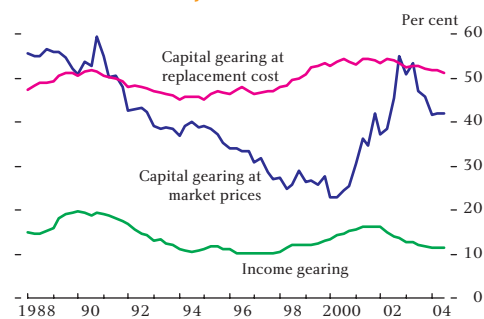
(a) As a percentage of total mortgage originations.

Chart 1.39
US banks and savings institutions: charge-off rates



Source: Federal Deposit Insurance Corporation.

Chart 1.40
Capital and income gearing of the US non-financial corporate sector



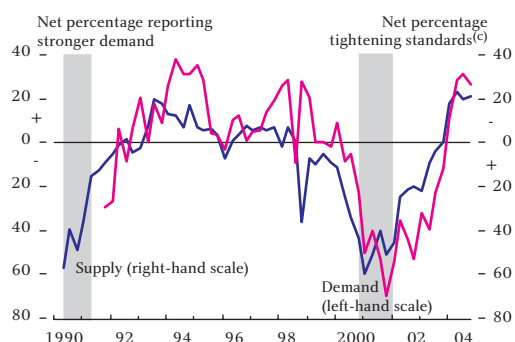
Sources: Board of Governors of the Federal Reserve System: 'Flow of Funds Accounts of the United States', 2004 Q2, Bureau of Economic Analysis; Department of Commerce, Bank calculations and Thomson Financial Datastream.

(1) Home owners who refinanced in 2001 and the first half of 2002 achieved an average reduction in mortgage rate of 1.83 percentage points.

(2) ARMs are similar to UK fixed-rate mortgages, with the interest rate fixed for an initial period – usually five or seven years – before switching to a variable rate.

(3) For consistency with the UK definition, inventories have been excluded, raising the ratio by, on average, 8 percentage points.

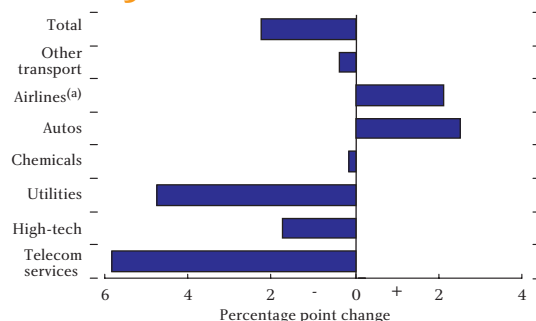
Chart 1.41
US bank lending conditions for commercial and industrial loans^{(a)(b)}



Sources: Board of Governors of the Federal Reserve System; Senior Loan Officer Survey, National Bureau of Economic Research and Thomson Financial Datastream.

- (a) To large and medium-sized firms.
- (b) Shaded area equals the period of recession.
- (c) Inverted scale.

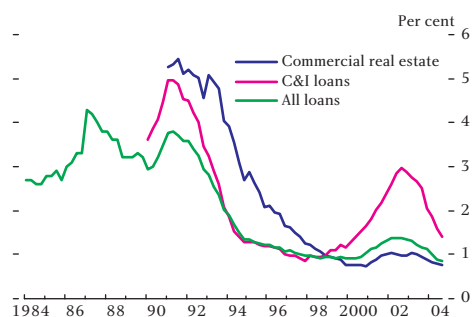
Chart 1.42
Change in capital gearing of US non-financial corporate sectors, end-2002 to end-2003



Sources: Standard and Poor's Compustat and Bank calculations.

- (a) Excludes UAL and US Airways.

Chart 1.43
US banks and savings institutions: non-current loan rates^(a)



Source: Federal Deposit Insurance Corporation.

- (a) Non-current loan rates are defined as loans 90 days past due plus loans in non-accrual status.

Debt growth was sluggish in 2004 Q2, with net issuance of bonds falling sharply. However the stock of commercial and industrial (C&I) loans grew for the first quarter since 2000 and continued to do so in the third quarter. Recent Senior Loan Officer surveys suggest that this reflected both supply and demand factors. Banks have been easing C&I lending standards and corporate loan demand has been increasing since the beginning of this year (Chart 1.41).

Data from firms' accounts suggest that capital gearing, as measured by the ratio of non-financial corporate debt to the book value of tangible assets, fell in 2003 in those sectors prominent in the late 1990s boom – the high-tech and telecommunication services sectors and the utilities (Chart 1.42). However, capital gearing increased in some of the sectors most sensitive to oil prices in 2003: gearing rose in the auto and airlines sectors and was broadly flat in the chemicals and 'other transportation' sectors.

Credit default swap (CDS) premia have risen for some of the major US auto and auto-parts companies since the previous *Review*, although they remain much lower than in late 2002. In mid-October, Standard and Poor's (S&P) downgraded General Motors (GM) and its GMAC financing subsidiary from BBB to BBB- (one notch above sub-investment-grade) but changed the outlook to stable. And in November, Moody's also downgraded GM's and GMAC's long-term debt ratings by one notch. As well as a tough operating environment the auto industry also faces large unfunded pension and healthcare obligations.

Rising oil prices have affected US passenger airlines. Most major airlines remain unprofitable, with US Airways Group filing for bankruptcy on 12 September 2004. CDS premia for most other major airlines have fallen since the June 2004 *Review*, but remain high. The direct exposures of US banks are small and mostly secured on aircraft assets, providing some protection in the case of default.

In the first three quarters of 2004, the annualised rate of total bankruptcies was about half of that in 2003. The annualised rates for the transport and chemicals sectors were also lower than in recent years. High-yield spreads in the chemical sector have fallen since the previous *Review*, consistent with reports that, despite higher energy costs, sales have grown.

Credit quality improved further in 2004 Q2 and Q3, with the proportion of non-current C&I loans falling to its lowest level since the beginning of 2000 (Chart 1.43). The Shared National Credit (SNC) Review¹ indicated that the stock of large syndicated loan commitments fell by 6% in the year to 2004 Q2. The value

(1) The SNC generally covers syndicated loans or commitments of at least US\$20 million that are shared by three or more financial institutions.

of 'classified' (substandard, doubtful and loss) commitments halved, reducing the proportion of 'classified' loans to just 4.8% of the outstanding stock. Loan quality improved across all industrial sectors, particularly in the telecoms and cable sector and the manufacturing sector. Nevertheless, over 10% of outstanding commitments to the telecoms and cable sector and the oil, gas, pipeline and utilities sector remain 'classified'.

Commercial property

Lending to commercial real estate (CRE) has continued to grow rapidly. It now accounts for almost one eighth of commercial banks' outstanding loans and over a quarter of total loans at small US banks; some of the latter might be vulnerable in the event of a downturn in the commercial property market. But delinquency and charge-off rates on commercial real estate have remained surprisingly low given the high level of vacancy rates (Chart 1.43). Demand for office space declined sharply in 2001 and, although it has picked up this year, office vacancy rates remain at a relatively high level (Chart 1.44). Vacancy rates for industrial property also rose sharply in 2001 and remain at a historically high level.

Banking

Overall, the US banking sector remains strong. Published capital ratios and profitability are high, and credit quality has improved. Since the June 2004 Review, bank share prices have outperformed the S&P 500 and CDS premia for large domestic banks have narrowed.

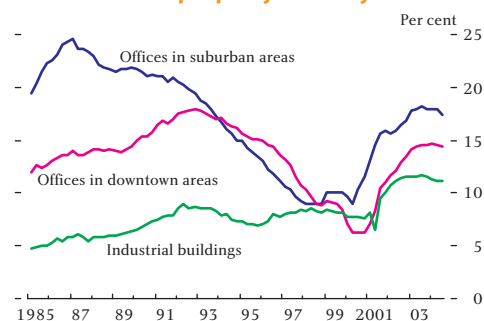
Having fallen in 2004 Q2, the profits of US commercial banks and savings institutions recovered in the third quarter and the return on equity remained relatively high (Chart 1.45). The Second-quarter profits were depressed by litigation charges at JP Morgan Chase and Citigroup and by lower gains on sales of securities following the rise in long-term interest rates.

Trading revenues fell sharply in the third quarter to their lowest level since the autumn of 1998. In aggregate, US banks and savings institutions recorded a loss of \$1.4 billion on interest rate exposures, largely accounted for by the largest US commercial banks. Market contacts report that some large US banks were wrongly positioned on long-term interest rates. Losses on interest rates exposures were partly offset by record trading revenues from 'commodity and other exposures'¹ (Chart 1.46).

Net interest income continued to increase rapidly as strong loan growth offset a further narrowing of net interest margins. The fall in net interest margins was accounted for by large banks which rely more on wholesale funding which tends to be repriced more quickly than retail deposits.

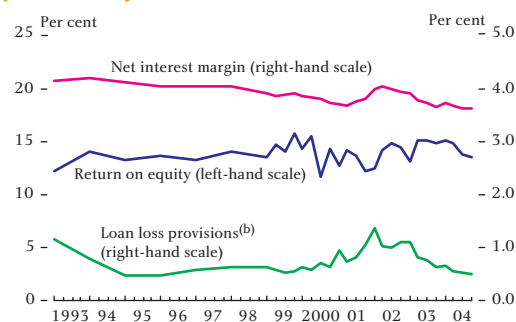
(1) Other exposures include exposures arising from credit default swaps.

Chart 1.44
US commercial property vacancy rates



Sources: CB Richard Ellis and Bloomberg.

Chart 1.45
US banks and savings institutions:
profitability indicators^(a)

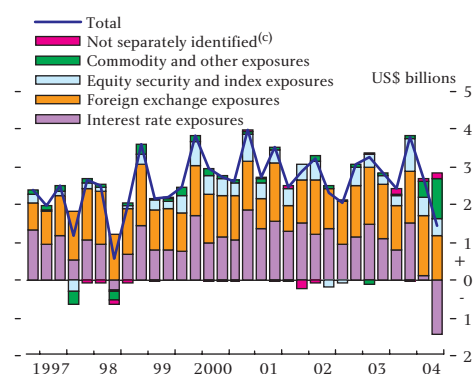


Source: Federal Deposit Insurance Corporation.

(a) Data are annual from 1992 to 1998, and quarterly from 1999 Q1 onwards.

(b) Loan loss provisions as a percentage of total loans.

Chart 1.46
US banks and savings institutions: trading
revenue^{(a)(b)}



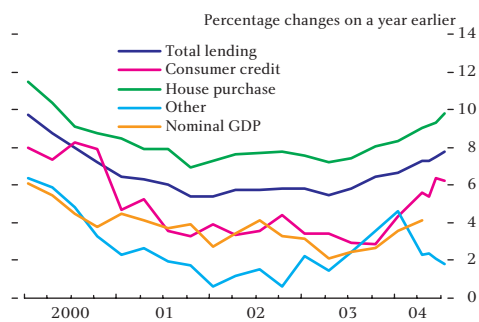
Source: Federal Deposit Insurance Corporation.

(a) Trading revenues comprises gains/losses on positions and fees.

(b) For banks and savings institutions with assets greater than US\$100 million. From March 2000, those with trading assets less than US\$2 million are exempt from the reporting requirement.

(c) Trading revenues of banks and savings institutions that are not required to provide a breakdown of their trading revenues.

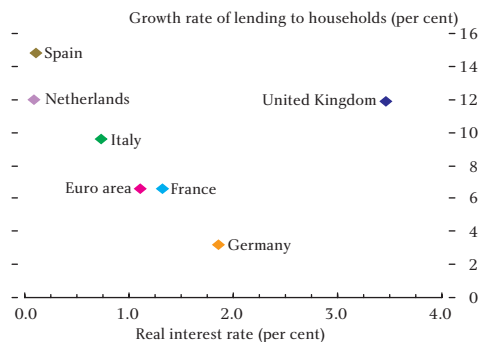
Chart 1.47
Household lending in the euro area^(a)



Sources: European Central Bank and Eurostat.

(a) Quarterly data to June 2004, monthly data from July 2004.

Chart 1.48
Average annual growth rate of lending to households vs average real interest rate since 2000^{(a)(b)}

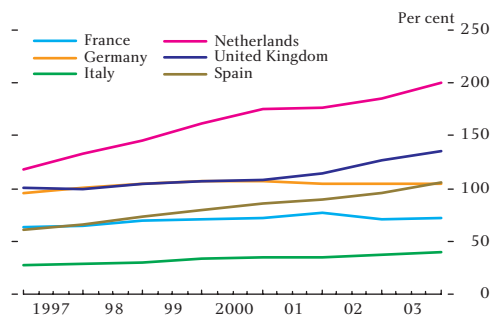


Sources: Eurostat, European Central Bank, Deutsche Bundesbank, De Nederlandsche Bank, Banca d'Italia, Banque de France, Banco de España and Bank calculations.

(a) Averages of quarterly lending data and monthly real interest rate data up to 2004 Q2. Real interest rates are proxied by the official interest rate minus the annual HICP inflation rate.

(b) Lending to individuals used for UK, Italian and German data.

Chart 1.49
Household debt-to-income ratios



Sources: Eurostat, Deutsche Bundesbank, Banque de France, Banca d'Italia, Banco de España, Netherlands Central Bureau of Statistics, ONS, OECD and Bank calculations.

1.4 Europe

UK-owned banks' exposures to borrowers in the rest of Europe¹ increased by some 15% in the first half of 2004, to account for some 35% of UK-owned banks' international exposures and 14% of UK-owned banks' total assets.² The increase was broadly similar to that for exposures to the United States. The biggest absolute increase was in exposures to Germany, which have risen above those to Hong Kong, largely reflecting a rise in holdings of public-sector debt. The rise in exposures was due more to growth of existing businesses than to mergers and acquisitions. But the purchase of First Active mortgage bank by RBS contributed to a sharp increase in exposures to Ireland; these rose by a third, though remain smaller than those to Germany or France.

Despite the recent increase, the share of UK-owned banks' international exposures accounted for by Europe has risen only slightly in the past five years, and by less than the share accounted for by the United States (the share of other international exposures has fallen). This pattern broadly mirrors the relative growth performance of the euro area and the United States. Euro-area growth eased further in 2004 Q3, and Consensus forecasts for euro-area growth in 2005 have edged down since the June 2004 *Review*, suggesting lower expectations of incomes growth. However, longer-term market interest rates have fallen since the previous *Review*, so the net effect on prospective debt servicing burdens is unclear. The depreciation of the dollar and uncertainty surrounding oil prices pose some risks to activity and income, although – as in other industrial economies – oil price effects may be limited by a reduction in the oil intensity of production over the years.

The private non-financial sector

The household sector

Euro-area banks' loans to euro-area households account for some 18% of their total assets, a smaller share than the analogue for UK-owned banks. But these exposures have risen rapidly in the past year (Chart 1.47), largely because of rising lending for house purchase, associated with rapid increases in house prices in a number of countries. Low real interest rates have also encouraged the increase in lending to households in some countries (Chart 1.48), and consumer credit growth overall has risen in the past year. As a result, household debt-to-income ratios have picked up in several European countries, increasing households' vulnerability to adverse shocks to interest rates or incomes³

(1) Defined here as the euro-area countries plus Denmark, Iceland, Liechtenstein, Norway, Sweden and Switzerland.

(2) Abbey National is included in UK-owned banks as these data cover a period before the takeover by Banco Santander on 12 November 2004.

(3) In Ireland, the ratio of personal sector debt to income has doubled over the past decade, to almost 95% in early 2004. Household debt-to-income ratios in the Nordic countries have also been rising.

(Chart 1.49). In some of those countries – particularly Spain and Ireland – some UK-owned banks have sizeable direct exposures to households via their operations overseas. But the picture across Europe is varied, and in Germany, in particular, house prices have been weak and the household debt-to-income ratio stable. Box 4 provides a further assessment of debt-to-income ratios across the major industrial countries.

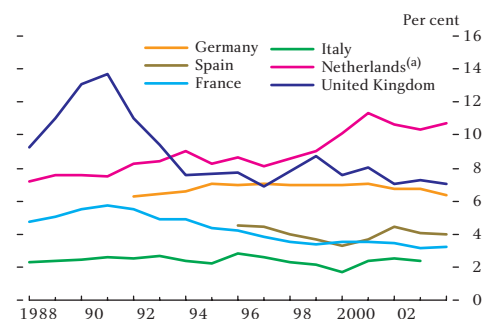
Nevertheless, income gearing seems likely to have remained moderate in most countries (Chart 1.50), reflecting continued low interest rates, stable, if high, unemployment and rising nominal earnings. Lending growth has been most rapid where most loans are advanced at variable interest rates, perhaps because of lower initial debt servicing costs (given the slope of the yield curve in recent years). That is likely to have increased the sensitivity of debt servicing in those countries to changes in interest rates.

The likelihood of households defaulting is also affected by personal insolvency law. Many continental European countries do not have formal personal insolvency regimes, so data are scarce. But in Germany personal insolvencies have risen markedly (Chart 1.51), albeit from a low base, following legislation making it easier for individual debtors to petition for bankruptcy.¹ That increase parallels the further rise in UK insolvencies following legislative change (see Chapter 1.1). But household lending forms a substantially smaller share of bank lending in Germany than in the United Kingdom, and comparisons are hard to draw given that personal insolvency laws differ in the two countries.

The private non-financial corporate sector

Lending by euro-area banks to euro-area PNFCs accounts for some 15% of total euro-area banks' assets, a higher share than lending to domestic companies accounts for in the United Kingdom, reflecting the generally greater reliance of continental companies on bank finance. Lending growth has edged up since the June 2004 Review, though the ECB's euro-area bank lending survey suggests continued subdued corporate loan demand, largely reflecting weak investment demand, greater use by companies of market-based finance and increasing availability of internal funds. The same survey also points to a slight net easing of credit standards in 2004 Q2 and Q3, in response to increased competition among both lenders and other investors. Gross issuance in the corporate loan markets has been robust, in large part reflecting the refinancing of debt on cheaper or easier terms. But capital gearing has edged down in the past 18 months, as equity prices have risen (Chart 1.52).

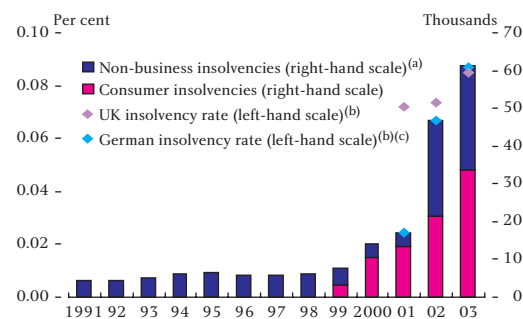
Chart 1.50
Household income gearing



Sources: Eurostat and ONS.

(a) Data for the Netherlands for 2003 are provisional.

Chart 1.51
German non-business insolvencies



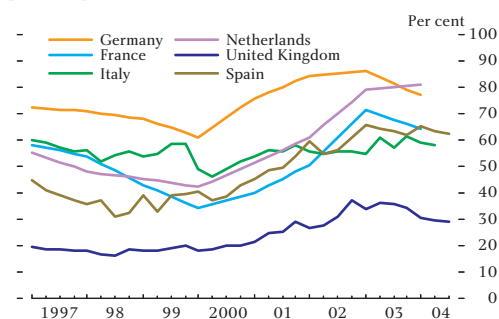
Sources: Federal Statistical Office Germany, DTI and Bank calculations.

(a) Separate consumer insolvency data only available from 1999 onwards. Prior to 1999, consumer insolvencies included within non-business insolvency data.

(b) Insolvency rate defined as the number of insolvencies as a share of resident population aged 16 years or older.

(c) UK personal insolvencies are for England and Wales only.

Chart 1.52
Private non-financial corporations' capital gearing at market value^(a)



Sources: Deutsche Bundesbank, Banque de France, Banca d'Italia, Banco de España, Netherlands Central Bureau of Statistics, ONS and Bank calculations.

(a) The UK measure excludes cross-border intra-company debt.

(1) Reform of consumer insolvency proceedings came into force in December 2001.

Box 4: International debt-to-income ratios

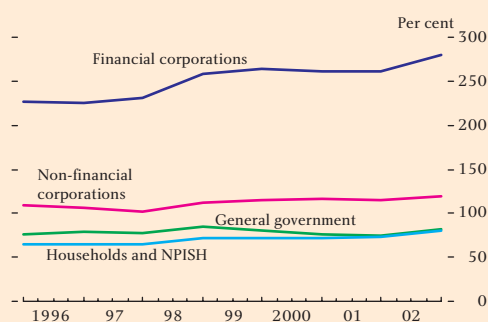
Table 1
Change in 'debt-like' liabilities as a share of annual GDP across countries, from end-1995 to end-2002^{(a)(b)(c)}

Percentage points	Simple average	Weighted average ^(d)	Minimum	Maximum
Non-financial corporations	17.3	9.5	-16.7	40.6
Financial Corporations	61.4	53.3	16.9	151.1
General Government	-2.6	5.4	-29.2	82.9
Households and NPISH	17.6	15.1	2.9	50.8

Sources: OECD, Board of Governors of the Federal Reserve System and Bank calculations.

- (a) G12 minus Switzerland.
- (b) 'Debt-like' liabilities include currency and deposits, loans, other accounts receivable/payable and securities other than shares.
- (c) Under current exchange rates.
- (d) Weighted by GDP.

Chart A
'Debt-like' liabilities as a share of annual GDP^{(a)(b)(c)}



Sources: OECD, Board of Governors of the Federal Reserve System and Bank calculations.

- (a) G12 minus Switzerland, weighted average.
- (b) 'Debt-like' liabilities include currency and deposits, loans, other accounts receivable/payable and securities other than shares.
- (c) Under current exchange rates.

If borrowers are highly indebted, this may lower their ability to service and repay their debts when faced with an adverse shock to their income. A high level of aggregate debt in a country or sector may, when combined with other information, help to provide an early warning of increasing aggregate default risk.¹

Estimates of the aggregate G12² sectoral debt-to-income measures were compiled using recently published OECD data³ based on the System of National Accounts 1993, which was designed to provide consistent but not exhaustive guidance on the compilation of national accounts. Table 1 highlights the range of movements across countries for 'debt-like' liabilities. Countries do not provide data on a completely uniform basis. For example, countries differ as to whether they provide consolidated (at the sector or sub-sector level) or unconsolidated data. Differences in method are more pronounced for total liabilities than for 'debt-like' liabilities,⁴ as the former include shares and other equity and the insurance technical reserves classes, for which there is greater scope for variations in measurement and institutional treatment.

The liabilities measured are predominantly on-balance-sheet, thus excluding some potentially large liabilities, such as unfunded pension schemes and financial derivatives. The data are only available annually from end-1995 to end-2002 so far. While of limited use for current surveillance, they do provide an insight into the broad trends.

'Debt-like' liabilities are more likely to be relevant for financial stability than are total liabilities. Chart A shows the ratio of 'debt-like' liabilities to GDP at market value for each of four sectors aggregated across the G12 countries. The financial corporations sector has the most liabilities, as, in carrying out financial intermediation, it acts as counterparty to each of the other sectors.

(1) Aggregate debt-to-income ratios do not, though, provide an insight into the distribution of debt across agents in the economy, and a given aggregate ratio can be consistent with quite different levels of aggregate default risk if that distribution differs. Some Bank work has adopted a micro-level approach, using agents' financial accounts to analyse the indebtedness of both households and companies. For example, the number and type of households accumulating debt have been investigated (see Tudela, M and Young, G (2003), 'The distribution of unsecured debt in the United Kingdom: survey evidence', *Bank of England Quarterly Bulletin*, Winter) while company accounts have been compared across countries (See 'Box 3: Comparing the leverage of US, UK, French and German firms', in the December 2003 Review).

(2) The G12 comprises thirteen countries: Australia, Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. Where not stated otherwise, G12 references exclude Switzerland because of data collection difficulties.

(3) Organisation for Economic Co-operation and Development (OECD) (2004) Financial Balance Sheets: Stocks Volume IIIb (1991-2002), National Accounts of OECD Countries.

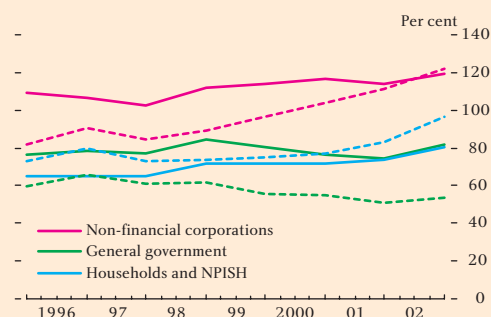
(4) Debt-like liabilities include currency and deposits, loans, other accounts receivable/payable and securities other than shares.

Chart B plots the G12 'debt-like' liabilities non-financial sectoral averages, together with those for the United Kingdom, and shows the recent rise in households' liabilities in the United Kingdom and the G12 as a whole. Chart B suggests that there has been a more rapid growth in the level of indebtedness of the UK household and non-financial sectors as a share of GDP than in the G12 as a whole. UK non-financial corporations' debt increased significantly faster than GDP after 1998, whereas the rapid growth in household debt started in 2001. The UK general government 'debt-like' liabilities appear to mirror movements in the corresponding G12 aggregate measure, though at a lower level.

Chart C shows *short-term* 'debt-like' liabilities; data are only available for a smaller sample of countries. While Chart A shows that aggregate 'debt-like' liabilities grew as a share of GDP in 2002, this is only apparent in the financial corporations sector in Chart C, possibly suggesting a switch from short-term towards long-term liabilities in other sectors.

The increase in 'debt-like' liabilities as a share of GDP over the sample period, together with the rise in financial corporations' total and 'debt-like' liabilities, also suggests that financial activity has been playing an increasingly important role in the economy.

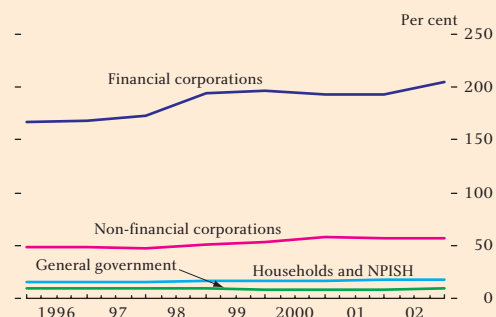
Chart B
UK and G12 'debt-like' liabilities as a share of annual GDP^{(a)(b)(c)}



Sources: OECD, Board of Governors of the Federal Reserve System and Bank calculations.

- (a) Continuous lines G12 minus Switzerland, weighted average. Dotted lines United Kingdom.
- (b) 'Debt-like' liabilities include currency and deposits, loans, other accounts receivable/payable and securities other than shares.
- (c) Under current exchange rates.

Chart C
Short-term 'debt-like' liabilities as a share of annual GDP^{(a)(b)(c)}

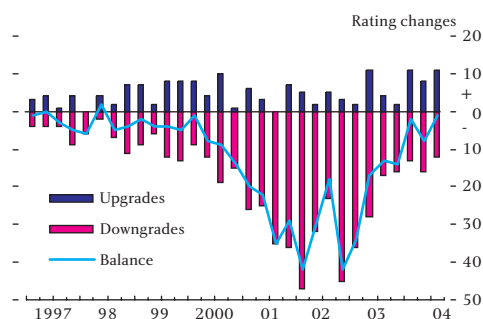


Sources: OECD, Board of Governors of the Federal Reserve System and Bank calculations.

- (a) Short-term defined as under one year.
- (b) Under current exchange rates.
- (c) G12 minus Australia, Canada, Italy, Japan and Switzerland, weighted average. Netherlands 2002 figures estimated using long-run proportions.

The number of corporate ratings downgrades has fallen back, broadly to match the number of upgrades (Chart 1.53), and corporate credit spreads have in general fallen further. Equity prices have risen since June and equity price volatility has fallen, implying, other things equal, a fall in default risk. And the equity prices of some sectors that had weakened since the start of the year – in particular airlines and technology – have recently recovered somewhat. Corporate income gearing is likely to have remained broadly stable in the euro area, as interest rates have remained low. Corporate earnings are estimated to have increased in 2004, probably reflecting the beneficial effects of

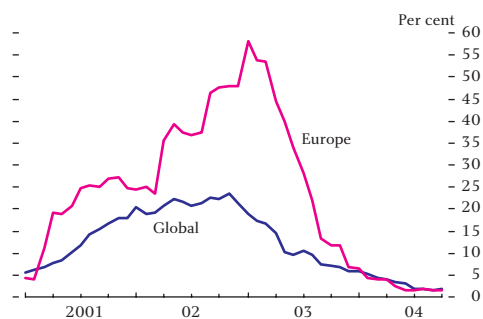
Chart 1.53
Number of European corporate ratings changes^(a)



Source: Moody's Investors Service.

(a) In the euro-area countries plus Denmark, Sweden and the United Kingdom.

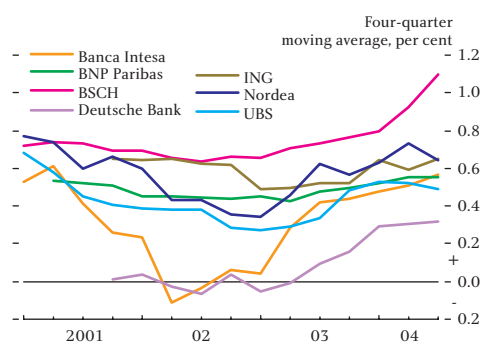
Chart 1.54
Sub-investment-grade corporate bond default rates^(a)



Source: Moody's Investors Service.

(a) Trailing twelve-month dollar-weighted default rates.

Chart 1.55
Return on assets for the largest banks in selected European banking sectors^{(a)(b)}



Sources: Bloomberg and Deutsche Bank company reports.

(a) Rate of return on assets, defined as annualised net income divided by total assets.

(b) Deutsche Bank and ING series start at 2001 Q4, because of reporting changes and exceptional non-operating items respectively. BNP Paribas reports assets on a half-yearly basis; assets are assumed to remain unchanged from previous half-yearly levels in the intervening quarters.

corporate restructuring. However, profits growth is generally expected to be slower in 2005 than for 2004.

Consistent with market indicators, the incidence of large-scale corporate failures has been low in the past year; sub-investment-grade corporate bond default rates have fallen further (Chart 1.54). And the number of corporate insolvencies generally seems to have stabilised or fallen during 2004. German corporate insolvency numbers have risen further, however, perhaps reflecting the effect of weak domestic demand on smaller companies, which are typically more dependent on domestic markets than are larger companies.

The financial sector

Non-bank financial institutions (NBFIs)

On-balance-sheet claims on NBFIs account for only 3% of euro-area banks' total assets, although this may understate the potential for contagion from NBFIs to banks, and particularly bancassurers, given that they often operate in the same markets. Ratings agencies report an improved performance among European insurers during 2004 and a continued stabilisation in the ratings outlook, suggesting that the risks facing these institutions have moderated.

Banking sectors¹

Over half of UK banks' consolidated international exposures to borrowers in the rest of Europe are to banks, a much higher share than for exposures to the United States. The profitability of large European banks has continued to recover (Chart 1.55), because of further reductions in costs relative to incomes and a fall in provisions (due primarily to a fall in large-scale corporate failures). However, the recovery for German banks has remained patchy, with two of the largest four banks reporting negligible profits or a loss in Q3. Interest income as a share of total assets has tended to edge down further. The ECB's euro-area bank lending survey suggests that interest margins on new household lending have been falling, partly because of strong competition and partly perceived improvements in the creditworthiness of households. In Germany, some large banks have sold non-performing loans to third parties, which may boost those banks' net interest income in future.

As discussed in previous *Reviews*, indicators of profitability suggest that German banks have significantly lower buffers than the European average (Chart 1.56). That may partially reflect structural factors, such as the extent of state involvement in the banking sector. Over five times as many banks operate in Germany as in the United Kingdom, and, measured by the return on equity, the average profitability of German banks over the past

(1) 'Banking sectors' are used here and in the charts as shorthand for the national banking sectors of Germany, France, Italy, Switzerland and Spain, and the increasingly integrated regional banking sectors of both the Benelux and Nordic regions.

five years has been around a third that of UK-owned banks. The removal of explicit state guarantees for German public banks scheduled for July 2005 is likely to add to pressures for consolidation within the German banking sector. In particular, 'shadow ratings' suggest that ratings for Landesbanks will be on average four notches below those under guarantee.¹ Some banks have already responded by consolidating and pursuing greater specialisation, and in aggregate Landesbanks have reduced their overseas operations, including those in the United Kingdom. Contacts suggest that Landesbanks have been building up liquidity while state guarantees are still available, providing a cushion for adjustment, but they are likely to need to diversify their sources of financing over the longer term.

Market indicators suggest some improvement in the performance of European banks and a reduction in the risk of default; CDS premia have narrowed further overall since the June 2004 Review (Chart 1.57). Solvency ratios have remained satisfactory overall, and picked up in the first half of 2004 for those large banks with the weakest solvency ratios. That, together with increased profitability, indicates an improvement in the financial health of European banks overall.

However, some have pointed to continued risks to banks in a number of European countries from high concentrations of balance-sheet exposures to individual companies.² The failure of Parmalat revealed that, in that case at least, risks had been widely dispersed, although subsequent proceedings have shown that European banks are not immune to litigation risk. Household lending has accounted for a smaller share of euro-area banks' write-offs and write-downs in recent years than has corporate lending, and in general euro-area banks charge a higher rate of interest on household lending. Nonetheless, the rapid pace of household lending growth may have been associated with increased credit risks in some countries; for example, the Banco de España has recently warned lenders in Spain against lending at high loan-to-value ratios.³

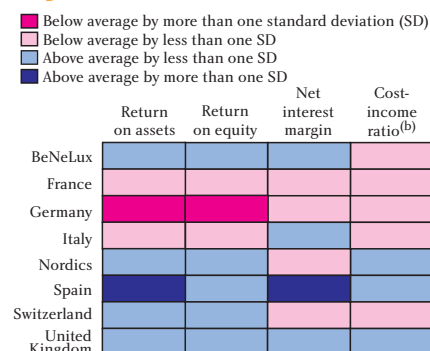
In aggregate, European banks continue to have a customer funding gap (Chart 1.58), as do their UK counterparts (Chapter 3). That gap has been filled by market-based sources of finance, which are generally more expensive than customer deposits and may be more prone to changes in market sentiment.

(1) Based on the assumption of ongoing financial support by the Landesbanks' owners, the savings banks and regional governments.

(2) 'Concentration risks remain high at European banks', Standard and Poor's, October 2004. Germany, Italy, Sweden and Portugal are highlighted as having a high concentration of single-name corporate credit risk.

(3) For example, see Deputy Governor Gil's speech at the Cultural Centre of Caixanova, Vigo, 11 November 2004.

Chart 1.56
European banking sector key ratios for 2003^(a)

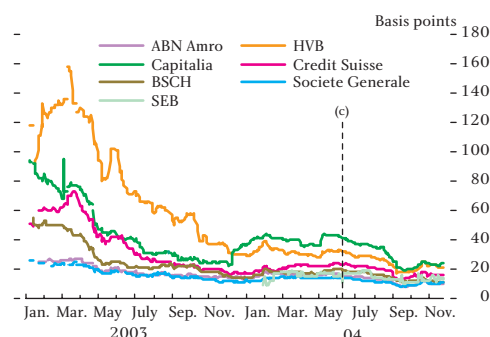


Sources: Bureau van Dijk Bankscope and Bank calculations.

(a) Sample consists of 92 of 100 largest continental European banks and ten largest UK banks.

(b) Inverted scale, so that pink colour implies above average rather than below.

Chart 1.57
CDS premia for selected European banks^{(a)(b)}



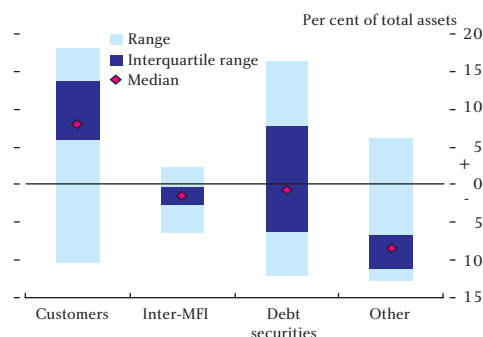
Source: Markit.

(a) Daily closing prices of five-year senior CDS contracts; gaps represent days for which there are no data.

(b) The banks with the highest current CDS price from each banking sector.

(c) June 2004 Review.

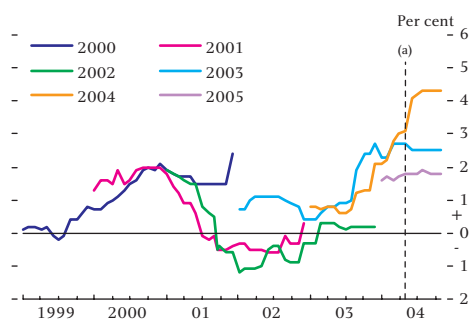
Chart 1.58
Euro-area MFIs' funding gaps at 2004 Q2, by type of funding^(a)



Source: European Central Bank.

(a) Measured as assets less liabilities in the balance sheet categories shown, as a percentage of total assets, for monetary financial institutions. Median and ranges are of national banking system funding gaps.

Chart 1.59
Consensus GDP forecasts



Source: Consensus Economics Inc.
 (a) June 2004 Review.

1.5 Japan

The pace of Japan's recovery appears to have slowed markedly since the previous Review, but Consensus forecasts show that growth is expected to continue through 2005 (Chart 1.59).¹ Although the direct impact of the Japanese economy on UK-owned banks is limited – Japan accounts for just 3% of their foreign claims – they and other internationally active banks may have both on- and off-balance sheet exposures to Japanese counterparties via capital markets. For example, the yen is involved in 20% of global foreign exchange (FX) transactions and 29% of over-the-counter FX derivatives turnover. These counterparties – especially Japan's major banks – are in turn exposed to risks from domestic borrowers, which are mainly corporations and the government.

Japan's non-financial sector

The household sector

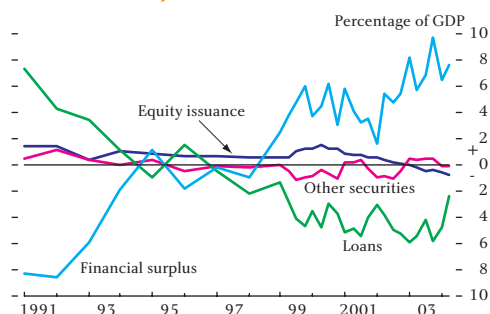
Despite the recovery of output and consumption, growth in employees' real compensation has been modest. However, consumer confidence is close to its highest levels in a decade, supported by improved employment prospects. Consistent with this, the number of personal bankruptcies has fallen further since the previous Review. The household sector's financial surplus has fallen, but in stock terms households remain large net creditors, and much household borrowing is at long-term fixed rates.

The private non-financial corporate sector

As higher demand has not been accompanied by rising labour costs, profits have continued to improve; in the six months to September, listed firms recorded a 21% year-on-year rise in net profits, and raised their profit forecasts for the year to March 2005 by 17%. Higher profits have allowed PNFCs in aggregate to fund investment while continuing to repay loans and increase financial surpluses (Chart 1.60). Thus, income gearing and the ratio of debt to operating cashflow (Chart 1.61) have fallen. Small firms remain more heavily indebted than large ones, but the gap has narrowed somewhat.

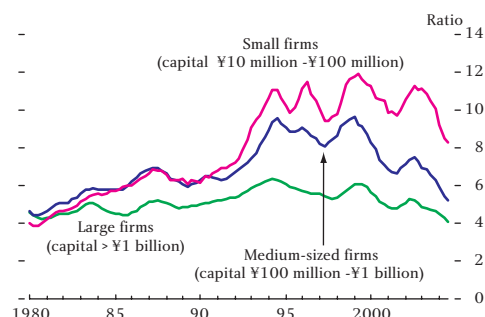
This improved financial position has been reflected in a steep fall in both the number and liabilities of failed businesses in the six months to September (Chart 1.62). A flurry of recent rating agency upgrades² suggests a continued upward trend in perceived credit quality, at least of larger companies.

Chart 1.60
Sources of corporate finance^(a)



Sources: Bank of Japan and Bank calculations.
 (a) Fiscal year data 1990-98, four-quarter moving averages from 1999 Q2.

Chart 1.61
Ratio of corporate debt to operating cashflow^(a)



Sources: Ministry of Finance corporate survey and Bank calculations.
 (a) Four-quarter moving average of gross debt divided by four-quarter sum of operating profits plus depreciation.

Japan's banking system

Non-performing loans (NPLs) have continued to fall at the major banks (Chart 1.63). With the Japanese Financial Services Agency (JFSA) target of halving NPL ratios from their peaks by

(1) However, these forecasts do not yet take account of weaker-than-expected growth in 2004 Q3 or the new chain-linked estimates of GDP.

(2) Moody's has upgraded 39 issuers so far in 2004, 15% of rated firms.

March 2005 looming, several banks reported higher-than-expected write-offs and provisioning for loans to troubled borrowers in the six months to September. Other borrowers were upgraded, benefiting from restructuring or the recovery in corporate profits.

The downward trend in banks' outstanding corporate loans has continued since the June 2004 *Review*. Banks have responded by increasing their holdings of Japanese government bonds (JGBs) – now 15% of total bank assets.¹ The duration of these holdings appears to be short, somewhat mitigating the increase in exposure to the JGB market. The major banks have further reduced equity holdings since the previous *Review*.

Operating profitability at the major banks remains weak, although they have made some progress in raising fee income over the past year. Interest margins remain low on corporate lending, and are lower still on the banks' short-duration bond holdings. Lending to individuals, which has higher margins, is growing but still accounts for only 15% of bank assets. Nevertheless, lower loan-loss charges and smaller valuation losses on securities than in recent years have allowed major banks to raise Tier 1 capital levels and increase capital quality by crystallising deferred tax assets² (Chart 1.64).

Deposit insurance on demand deposits will be capped from April 2005. Improved bank balance sheets, the official crisis management system for banks and exemptions for settlement accounts should contain the risk of large-scale withdrawals.

In July, UFJ and MTFG announced plans for a merger, which now looks likely to be completed by October 2005. Merging two very large³ and very different banks successfully will be challenging. UFJ's capital base, depleted by provisioning for NPLs that it had tried to conceal from JFSA inspectors, was strengthened by a capital injection from MTFG in September.

Reflecting the sustained improvement in the quality of the major Japanese banks' assets and capital over the past two years, CDS premia have continued to decline since the June 2004 *Review* and Moody's recently raised the bank financial strength ratings⁴ of SMFG and UFJ from E, the lowest possible level, to E+, and Mizuho's rating from E to D-. However, the banks remain poorly capitalised by comparison with their international peers, and low operating profits mean that any negative shocks would erode these capital buffers.

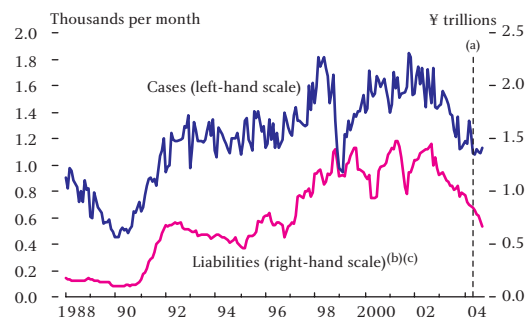
(1) For comparison, European government debt makes up 6.5% of euro-area banks' assets.

(2) These mainly reflect the fact that loan-loss provisions count as a tax-deductible expense only when the loss is finalised rather than when the provision is made. See Section 1.4 of the June 2003 *Review*, page 41, for a discussion of the associated risks.

(3) The combined entity will be the world's largest bank by total assets, accounting for around a quarter of domestic bank assets.

(4) Which represent Moody's opinion of a bank's soundness and safety excluding external support, eg from the government.

Chart 1.62
Corporate bankruptcies



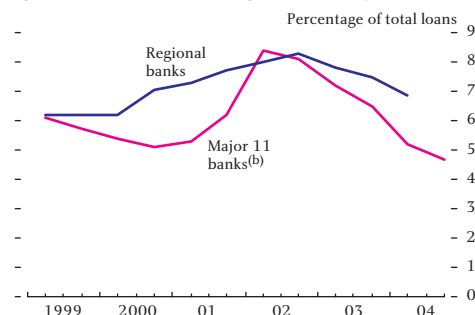
Sources: Bloomberg and Thomson Financial Datastream.

(a) June 2004 *Review*.

(b) Excluding debt of life insurers.

(c) Twelve-month moving average.

Chart 1.63
Japanese banks' non-performing loans^(a)

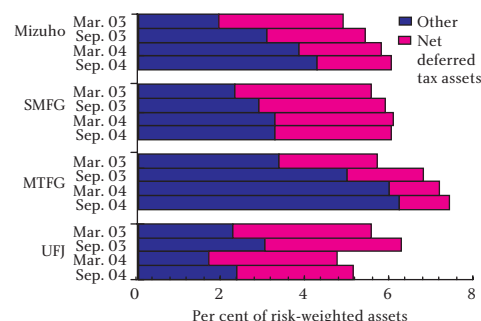


Sources: Japanese Financial Services Agency and Bank calculations.

(a) Financial Reconstruction Law basis.

(b) Constituent banks of the four major banking groups plus Resona Bank, Sumitomo Trust and Chuo Mitsui Trust.

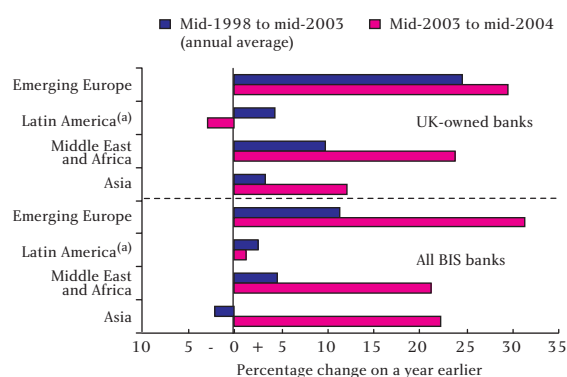
Chart 1.64
Composition of Tier 1 capital of major Japanese banks^(a)



Sources: Published accounts and Bank calculations.

(a) Consolidated.

Chart 1.65
BIS-reporting banks' consolidated foreign claims on selected EMEs



Source: Bank for International Settlements.

(a) Latin America includes the Caribbean.

Table 1.A
Net private sector financial flows to EMEs by region^(a)

(US\$ billions)		2001	02	03e	04f
Latin America	Equity investment	57.0	33.4	21.0	27.7
	Private creditors	-6.8	-17.1	9.5	9.4
	Banks	-11.4	-12.5	-3.3	-5.1
	Non-banks	4.6	-4.6	12.7	14.5
Asia	Equity investment	64.0	59.9	90.1	84.9
	Private creditors	-9.9	0.8	28.0	25.2
	Banks	-8.9	-1.1	13.8	15.6
	Non-banks	-0.9	1.8	14.2	9.6
Europe	Equity investment	17.4	22.3	8.7	17.0
	Private creditors	0.7	24.3	51.9	51.3
	Banks	-3.4	5.5	23.3	21.5
	Non-banks	4.1	18.8	28.7	29.8
Total^(b)	Equity investment	148.8	117.6	123.7	137.6
	Private creditors	-16.8	7.4	89.1	88.3
	Banks	-23.7	-8.3	31.6	32.8
	Non-banks	6.9	15.6	57.5	55.5
Total external financing		132.0	125.0	212.8	225.9

Source: Institute of International Finance, 'Capital Flows to Emerging Market Economies', 2 Oct. 2004.

(a) Equity investment is the sum of direct and portfolio investment.

(b) Total also includes Africa and the Middle East.

e = estimate. f = forecast.

1.6 Emerging market economies

Claims on emerging market economies (EMEs) by UK-owned banks, which account for around one-fifth of their lending overseas, grew briskly in the year to June 2004 (12%).¹ The growth in lending over the period was particularly strong in emerging Europe (29%), in Africa and the Middle East (24%), and, to a lesser extent, in Asia (12%). In contrast, lending to Latin America fell (Chart 1.65).²

Borrowing from abroad by EMEs is also intermediated through financial markets. There has been further large bond issuance by EMEs and bond spreads have fallen in recent months (Chapter 2.1). And, according to the Institute of International Finance (IIF), total net private sector (bank and bond) debt flows to EMEs this year are expected to be around US\$90 billion – the second successive year of strong borrowing (Table 1.A).

The external environment facing EMEs has remained benign, in large part, since the previous *Review*. World output growth is likely to reach a thirty-year high this year and world interest rates, and thus EME external funding costs, remain low despite the tightening of US monetary policy since the summer. And a number of EMEs have also benefited from the continued strength of (non-agricultural) commodity prices.

Consequently, private sector and IMF forecasts of output growth for this year in all the main EME regions have been revised upwards, to over 5% according to Consensus Economics (Chart 1.66). There have also been a number of sovereign credit rating upgrades in recent months, including of some large international borrowers such as Brazil and Turkey.

Only a modest slowdown is generally expected in world growth next year and so the external outlook facing EMEs remains favourable. There are, though, a number of downside risks. On the one hand, a combination of sustained higher oil prices, a sharp rise in world interest rates and significantly lower world growth (and non-oil commodity prices) would hurt many EMEs. If, on the other hand, the external environment remains benign, there is a risk that some EME governments or private sectors may borrow more than their future capacity to repay over the longer term.

This section explores these issues in more detail.

(1) EMEs are defined here as countries in central and eastern Europe, Latin America, the Middle East, Africa and Asia (other than Japan).

(2) Non-Japan Asia accounts for the lion's share of UK banks' exposures to EMEs. In June 2004, foreign claims on non-Japan Asia were US\$263 billion, compared with US\$38 billion in Latin America and the Caribbean, US\$37 billion in the Middle East and Africa and US\$16 billion in emerging Europe.

Sustained high oil prices

The price of Brent crude oil has risen to around \$40 per barrel from \$35 at the time of the June 2004 Review and less than \$30, on average, last year. If prices remain high, this could have a large impact on EMEs, by switching income from oil-importing countries towards a smaller number of oil-producing economies. This would be more likely to be harmful in aggregate if driven by a reduction in world oil supply rather than continued buoyant world demand.

The main gainers would be concentrated in OPEC countries and a few non-OPEC producers, in particular Russia. In the short run, the rise in oil prices has significantly improved the external and government financial balance sheets of these countries. However, in the longer term, it may, in some cases, delay structural reform and output diversification and build up underlying vulnerabilities that would become apparent if oil price increases were reversed.

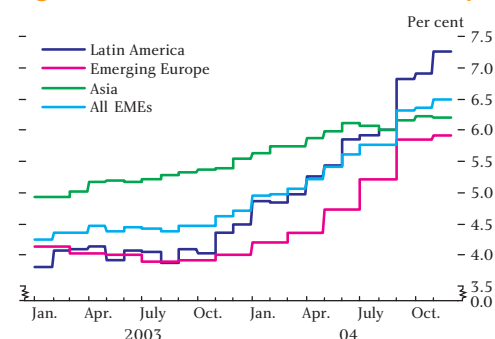
Net oil importers are more numerous; economies in Asia and, to a lesser extent, in emerging Europe (other than Russia) would be affected most. So far at least, the impact has been cushioned, to some extent, because the rise in oil prices partly reflects the fast growth of the Chinese and US economies. This has boosted non-oil exports, particularly from the rest of Asia, and, through raising prices, the export earnings of EME metal producers. The latter has benefited economies in Latin America and the former Soviet Union in particular (Chart 1.67).¹ In addition, most Asian economies have built up strong external positions in recent years by running current account surpluses and building up foreign currency reserves. Some emerging European economies would appear to be more vulnerable, since they are starting from a position of current account deficit (Chart 1.68).

The increase in oil prices is also likely to have a bigger domestic impact on EMEs than on developed countries, since the former tend to be much less efficient in using oil. To the extent that oil price rises are being passed on to consumers, inflationary pressures are building up. Across most EMEs, price inflation has been edging up during this year and some countries, such as Brazil, Poland and Thailand, have responded by increasing interest rates.

A number of EMEs, though, subsidise oil, shifting the cost of higher oil prices on to the government's budget instead. This has increased the burden on some already highly indebted governments such as India and Indonesia.

(1) According to IMF estimates, the increase in non-energy commodity prices this year has boosted the net exports of EME oil importers by almost 0.5% of GDP, on average (IMF World Economic Outlook, September 2004, Table 1.17, page 67).

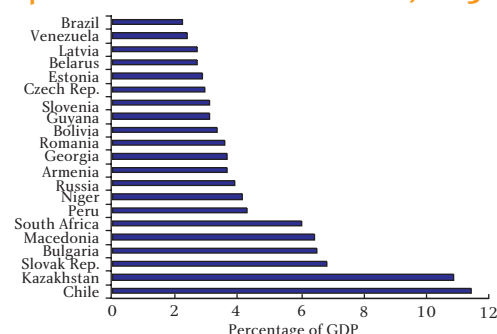
Chart 1.66
Regional Consensus GDP forecasts, 2004^(a)



Source: Consensus Economics Inc.

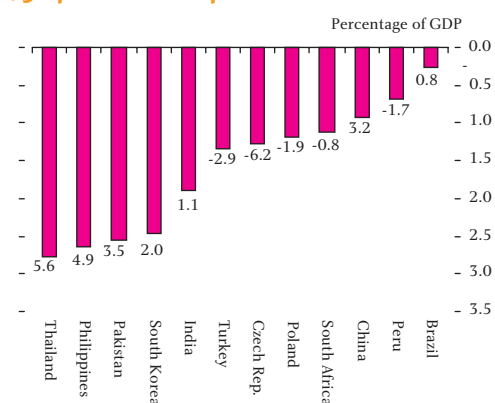
(a) An average of countries' monthly 2004 GDP forecasts. Bi-monthly forecasts for emerging Europe.

Chart 1.67
Exports of metals for selected EMEs, 2003



Sources: IMF and United Nations.

Chart 1.68
Impact on annual oil trade balance of a \$50 per barrel oil price for selected EMEs^{(a)(b)}

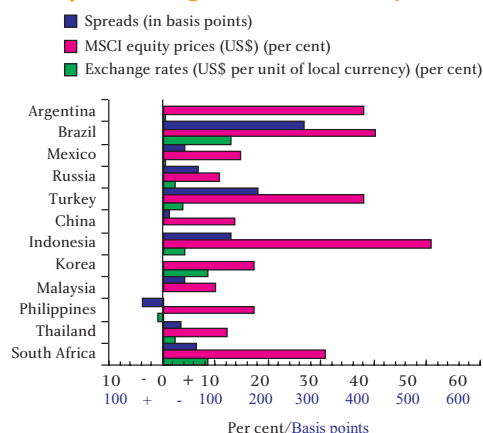


Sources: United Nations and IMF.

(a) Oil balance comprises the sum of crude and refined products, 2003 data.

(b) Calculated by multiplying the 2003 oil balance by the percentage increase in oil prices (2003: \$29 per barrel). The change in the oil balance is shown as a percentage of forecast 2004 GDP (2003 current account balance percentage of GDP shown below bars).

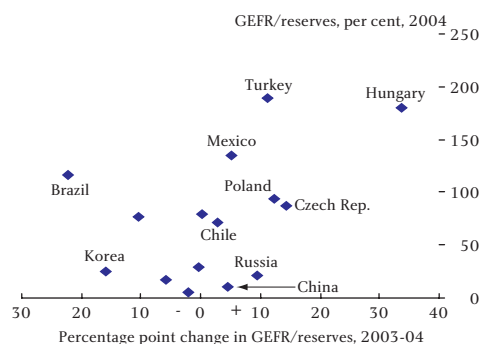
Chart 1.69
Asset price change since June 2004 Review^(a)



Sources: Bloomberg, JP Morgan Chase & Co. and Morgan Stanley Capital International Inc.

(a) Bars to the left of the axis denote rises in spreads, falls in equity prices and depreciation of the exchange rate.

Chart 1.70
Gross external financing requirement^(a) as a percentage of foreign currency reserves^(b)

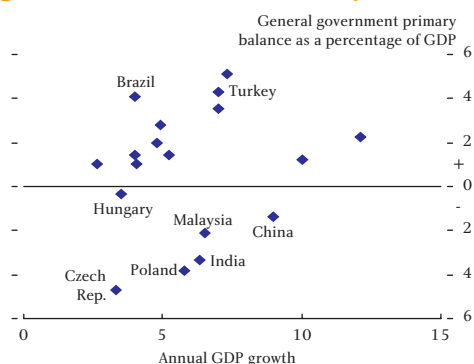


Sources: IMF and Institute of International Finance.

(a) Defined as short-term debt, plus amortisation, plus current account deficit. 2005 figures are estimates and 2004 are forecasts.

(b) Foreign currency reserves are defined as total reserves excluding gold at end-June.

Chart 1.71
Government primary balance and GDP growth for selected EMEs, 2004 forecast



Source: IMF, World Economic Outlook, September 2004.

The interest rate environment

Sustained higher oil prices and/or a marked slowdown in the world economy would weaken EMEs more if combined with an unexpectedly sharp rise in US interest rates associated with, for example, a rise in inflation expectations or marked downward pressure on the US dollar. That would increase EMEs' external funding costs and, *in extremis*, could prevent some borrowers obtaining external finance altogether.

Earlier Bank work suggests that, everything else equal, a 100 basis point rise in US policy rates would result in about an 80 basis point rise in the average EME spread from the current level.¹ However, in practice, the sensitivity of EME spreads to changes in US interest rates would also be affected by the cause of the increase and on general market sentiment at the time.² For example, the 100 basis point rise in official US interest rates since June has been associated with a fall rather than a rise in spreads in most EMEs (Chart 1.69).

But as discussed in previous *Reviews*, many EMEs have reduced their immediate vulnerability to a reversal in market sentiment. A number of EME sovereigns have taken the opportunity of low external funding costs not only to finance their needs for this year but to begin prefinancing for next year. Some have also continued to lengthen the maturity of their debt structures and reduce the proportion of debt linked to foreign currency.³ Nonetheless, some large EMEs, especially in emerging Europe (other than Russia), have large and growing external financing requirements (Chart 1.70).

Conversely, if world interest rates remain low, there is a risk that some EME governments or private sectors will borrow more than their future capacity to repay. Some EMEs with very large government debt-GDP ratios, such as Brazil and Turkey, are currently running large primary surpluses and thus have somewhat reduced their debt burdens since the end of last year. But, despite current robust GDP growth, some EME governments have maintained high debt burdens or increased them further, by running only small primary surpluses or deficits (Chart 1.71). These fiscal positions would look less favourable still if current strong GDP growth were not maintained.

(1) See Ferrucci, G (2003), 'Empirical determinants of emerging market economies' sovereign spreads', Bank of England *Working Paper* 205, October.

(2) For example, the Bank spread model can explain around only 40% of the variation in bond spreads of EMEs over the December 1991-March 2003 period.

(3) Brazil, for example, reduced its share of gross federal government domestic securities linked to the exchange rate from 33.5% at the end of 2002 to 11.2% in September this year.

Data on EMEs' private sector debt are less readily available. But EME foreign currency corporate bond issuance this year has been strong (Chart 1.72). This has been most pronounced in Asia and Russia. To the extent that this represents borrowing brought forward from next year to take advantage of cheap financing costs, this has reduced EMEs' funding costs. But it could also reflect lenders moving down the credit quality spectrum in search of higher returns. Moreover, unlike sovereigns, many corporate borrowers are unrated with limited public information on their creditworthiness. In Russia, whereas the government's outstanding external debt is falling, the private sector's is rising quickly, albeit from a low starting point. And to the extent that recent corporate issuance in Russia is rated, most of it is sub-investment-grade (Box 5).

However, from a UK perspective, although UK-owned banks' exposures to EMEs have increased strongly in the past two years, the average quality of these exposures, proxied by the sovereign rating of the borrower, has increased (Chart 1.73).

As discussed in the June 2004 *Review*, bank lending to households is growing strongly in emerging Europe (Chart 1.74). And in some countries sizeable loans are being made in foreign currency. This seems to have been partly financed over the past year by strong interbank borrowing from BIS-area banks in foreign currency (Chart 1.75). There is a risk that household borrowers in some EMEs do not fully realise the foreign exchange risk they are taking on. This could materialise as a credit loss to the lending banks.

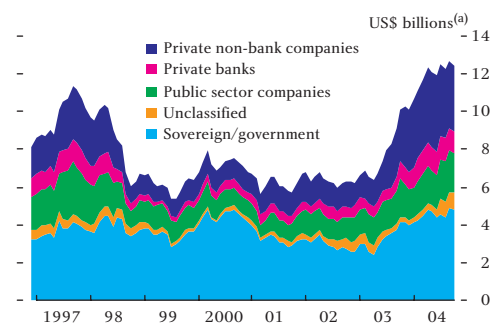
Slowdown in China

In China, the rapid growth in output over the past decade and continuing economic liberalisation mean that its economic conjuncture and policies are now having a significant impact upon the wider world economy and financial system.

There was a steady slowdown in the Chinese economy in the first half of the year, confined to the domestic corporate sector. But more recent data give conflicting evidence of whether the slowdown has continued since.

The annual growth in bank lending has been on a steady downward path during this year, from 20% in March to 13% in October – well below the authorities' 16%–17% target range. There are also reports of a severe shortage of credit in some sectors. But the annual rate of growth in investment and industrial production stopped falling in June (having declined rapidly earlier in the year). Companies are probably financing spending, to some extent, from outside the official banking system. The growth rates in retail sales and exports remain buoyant (Chart 1.76). Moreover, although annual consumer price inflation has fallen since the June 2004 *Review*, to 4.3% in

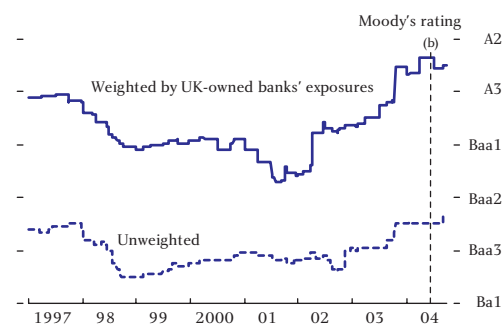
Chart 1.72
EME external bond issuance January 1997–October 2004



Source: Dealogic.

(a) Twelve-month moving average.

Chart 1.73
Average sovereign credit ratings for selected EMEs^(a)

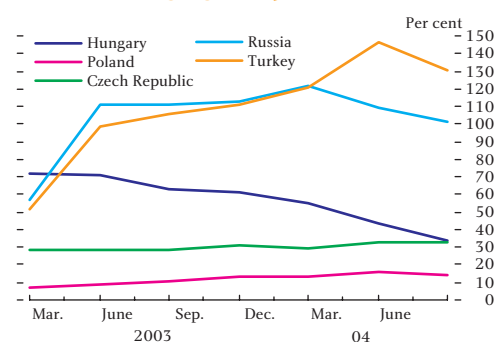


Sources: Moody's Investors Service, Bank for International Settlements and Bank calculations.

(a) Dotted line is a simple arithmetic average of the credit ratings of 20 EMEs' exposures. Solid line weights the credit ratings by UK-owned banks' international claims at the time.

(b) June 2004 *Review*.

Chart 1.74
Annual growth in credit to households for selected emerging European countries^(a)



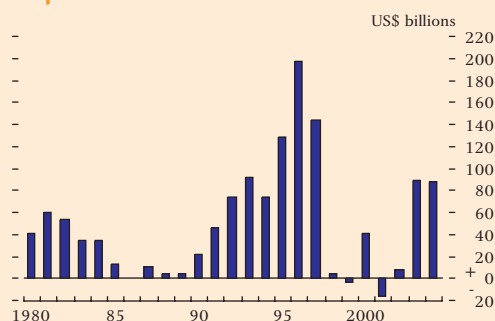
Sources: National central banks.

(a) Lending consists of both domestic and foreign currency.

Box 5: Are there risks of emerging market debtors over-borrowing?

Chart A

Net private debt flows to EMEs^(a)

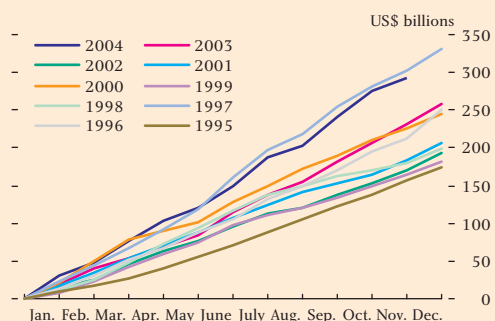


Source: Institute of International Finance.

(a) Estimate for 2003, forecast for 2004.

Chart B

Cumulative gross issuance of debt by EMEs^(a)



Source: Dealogic.

(a) Debt includes international bonds and syndicated loans. November data estimated by using data from 1-15 Nov. and linearly interpolating to form end-month data.

The rapid growth in foreign currency capital inflows, much of it short term, contributed to the financial crisis in a number of East Asian economies in the second half of the 1990s. In the aftermath of the crisis, net debt flows to emerging market economies (EMEs) dried up, but have again grown strongly over the past two years (Chart A). Moreover, gross issuance of foreign currency debt – bonds and syndicated loans – during this year has returned to levels last seen in 1997 (Chart B). External equity issuance has also been strong, although less so than debt.

This renewed borrowing by EMEs in the past two years partly reflects an improvement in fundamentals. Many EMEs have accumulated sizeable foreign exchange reserves, improved debt structures, adopted more flexible exchange rate regimes¹ and – in Asia and Latin America at least – are running current account surpluses. Therefore, the level of debt that EME borrowers can sustain has probably increased. The demand for EME debt has also been buoyed by low global interest rates. Moreover, longer-term structural inflows by pension funds from developed economies seeking to diversify their portfolios have increased the amount of funds available to EMEs.

Nonetheless, there is a risk that some emerging market governments or companies may borrow more than is sustainable in the medium term should the current benign conditions not continue. This would especially be the case if the strong output growth witnessed currently in many EMEs and high (non-agricultural) commodity prices are not maintained.

For governments, high indebtedness could lead to a future sovereign debt crisis. For companies, excessive leverage, especially if combined with a currency mismatch between assets and liabilities, could lead to widespread defaults on bonds and loans. The Asian crisis, in the second half of the 1990s, showed how a fast build-up of corporate debt can contribute to vulnerabilities in the financial system as a whole.

On the sovereign side, recent fiscal performance has improved in some highly indebted EMEs. For example, Brazil and Turkey are targeted to run primary fiscal surpluses of 4.5% of GDP and 6.5% of GNP respectively this year, while some other countries, such as Romania and Chile, have decided to cancel planned external debt issuance altogether. And a number of EMEs have accumulated sizeable foreign currency assets. However, the ratio of government debt to GDP, on average, in EMEs is estimated to

(1) According to the IMF (IMF World Economic Outlook (September 2004)), the proportion of emerging markets with fully floating exchange rates has risen from under 20% in 1998 to 40% today.

have risen by 6.5% of GDP since 2001.¹ Moreover, despite strong output growth, a number of EMEs (for example, the large new member states of the EU) continue to run primary fiscal deficits.

Although gross foreign currency debt issuance by both EME sovereigns and companies has been close to record levels this year, corporate sector issuance has increased particularly rapidly. Unlike sovereign debt, the majority of corporate issuance has been unrated, especially in Asia (Chart C), so lenders are increasing their exposures particularly to borrowers in EMEs about whom there is likely to be limited information on creditworthiness. One of the lessons of the Asian crisis is that lending to relatively untransparent borrowers carries the risk of not being able to identify potential vulnerabilities.²

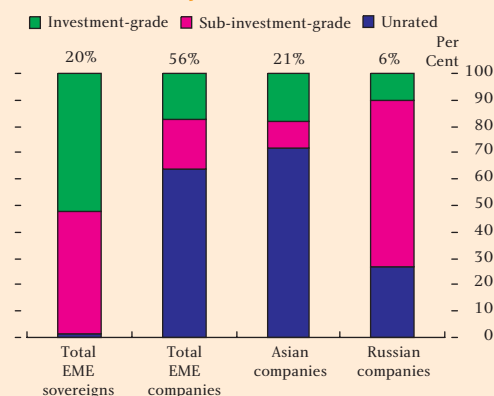
Corporate bond and syndicated loan issuance has risen particularly rapidly in Russia this year – by 52% in the year to mid-November over the same period last year. Most of this issuance has been sub-investment-grade (Chart C) but half has been made by oil and gas (related) companies which should be able to generate strong foreign currency earnings (if energy prices remain high). However, metal producers, banks and telecommunications companies have also been undertaking large amounts of issuance. Anecdotal evidence suggests that investors, particularly from Europe, are buying Russian debt to benefit from the generally improved macroeconomic outlook there. Given that the government has reduced its external debt (and built up a large cushion of foreign exchange reserves), investors instead have switched their exposures to companies. Although external private sector debt in Russia is low by EME standards, it has increased rapidly of late – from 1% to 9% of GDP in the two years to end 2003 (Chart D). Banks from the BIS area as a whole increased their international claims on Russia by 36% (US\$46 billion) in the year to 2004 Q2. UK-owned banks alone increased exposures by 80%, mainly to the non-bank private sector, but this level of exposure remains small, at around 1% of UK-owned bank exposures to all EMEs (Chart E).

Overall, as yet, there is no widespread evidence of EMEs increasing indebtedness sharply. But there is evidence in some countries of strong borrowing by unrated or low-rated firms. Given the lack of transparency of many companies, and the role that corporate defaults have played in previous financial crises, this trend deserves continuing monitoring.

(1) This estimate is based on the mean increase in gross general government debt to GDP of 15 EMEs: Brazil, Chile, Columbia, Mexico, Uruguay, India, Malaysia, Philippines, South Korea, Thailand, Czech Republic, Hungary, Poland, South Africa and Turkey.

(2) Baumann, H and Nier, E (2003), 'Market discipline and financial stability: some empirical evidence', Bank of England *Financial Stability Review*, June, find that banks which are more transparent tend to be financially stronger. Further discussion of the link between transparency and stability can be found in Nier, E, 'Bank stability and transparency' in this *Review*.

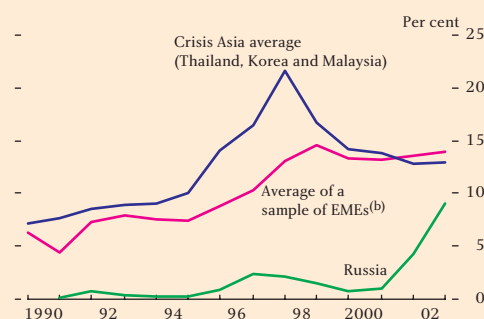
Chart C
Credit rating of foreign currency EME debt issuance in 2004^(a)



Source: Dealogic.

(a) Data from Jan. to 15 Nov. 2004. Percentage of total EME foreign currency debt issuance shown above bars.

Chart D
Private sector external debt relative to GDP^(a)

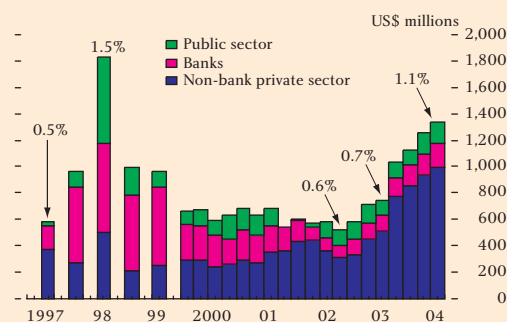


Sources: Institute of International Finance and Bank calculations.

(a) Private sector (non-bank) corporate debt of greater than one year original maturity.

(b) EME average is a GDP-weighted average of Brazil, Turkey, Colombia, Venezuela, South Korea, Malaysia, Mexico, Thailand, Russia, Czech Republic, Hungary and Poland.

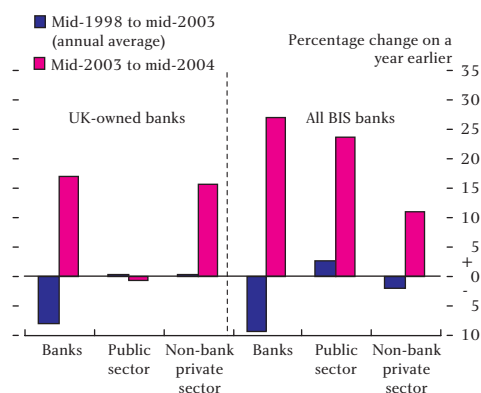
Chart E
UK-owned banks' cross-border claims on Russia^(a)



Source: Bank for International Settlements.

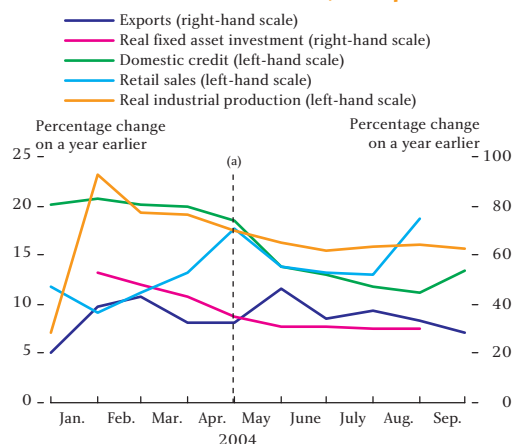
(a) UK cross-border claims on Russia as a percentage of total claims on emerging markets shown above bars.

Chart 1.75
BIS-reporting banks' consolidated international claims on selected EMEs



Source: Bank for International Settlements.

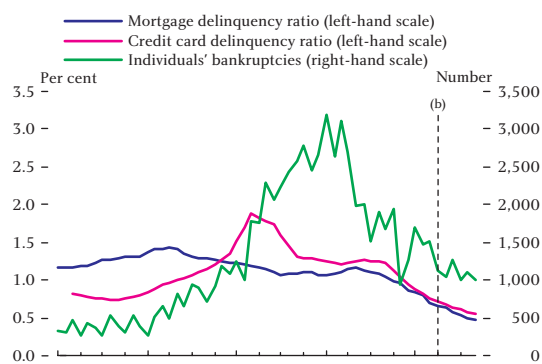
Chart 1.76
Chinese economic indicators, 2004



Sources: Thompson Financial Databstream, China National Administration of Customs, National Bureau of Statistics of China, OECD and People's Bank of China.

(a) June 2004 Review.

Chart 1.77
Hong Kong: indicators of banks' credit quality^(a)



Sources: Hong Kong Monetary Authority and Hong Kong Official Receivers Office.

(a) The delinquency ratio represents the total value of loans more than three months in arrears as a proportion of the total outstanding loans.

(b) June 2004 Review.

October, annual goods inflation is strong and still rising (9.6% in September) and real interest rates remain negative on some measures. In response to these renewed risks of overheating, the authorities increased interest rates by 0.27% points at the end of October – the first rise in interest rates in nine years.

A 'hard landing' would increase further the fragility of the Chinese banking system, where non-performing loans, estimated at US\$200 billion (14% of GDP), represent a large contingent claim on the government. But there is recent evidence of improvement, at least amongst some of the bigger banks. The non-performing loan ratio of the major banks¹ fell, on official figures, by 3.3% points during 2004 Q2, while the NPL ratio at the Bank of China – one of the largest state-owned banks – fell to 4.6% in October and its capital adequacy ratio is now above the Basel minimum. And the recent liberalisation of capital controls is likely to result in an inflow of foreign investment, thus strengthening some Chinese banks further.²

A marked slowdown of the Chinese economy would not only increase domestic vulnerabilities but also would reduce export and GDP growth in the rest of Asia, especially in the Newly Industrialised Economies and Japan.³ World commodity prices too might fall, hurting commodity-producing EMEs further afield; between 2001 and 2003, China's imports of raw materials and fuels increased by 55% and 67% respectively.

The most tangible impact of any slowdown in China on the UK financial system would probably be via Hong Kong, where UK-owned banks have large exposures. However, currently at least, the Hong Kong economy continues to witness a strong and broad-based recovery. Although output growth moderated in the third quarter, it remained robust – real GDP rose by 7.2% year-on-year (and by 1.9% during quarter). Despite the hard currency peg, substantial liquidity in the money market has meant that bank lending rates in Hong Kong have risen by less than the increase in US rates. Consumer prices have stopped falling. The banking sector has also strengthened further. Asset quality has improved, with credit card delinquency rates falling to 0.55% in the third quarter – the lowest since the survey started in 1996 – and the mortgage delinquency rate falling to 0.4% in October (Chart 1.77).⁴

(1) The four large state-owned banks plus eleven major commercial banks.

(2) In August, HSBC bought a 20% stake in the Bank of Communications – the fifth largest bank in China. This is the first major foreign acquisition in the Chinese banking system.

(3) See Eichengreen, B, Rhee, Y and Tong, H (2004), 'The Impact of China on the exports of other Asian countries', *NBER Working Paper*, 10768, September.

(4) The delinquency rate is defined as the share of lending in arrears for more than 90 days.