



ECB Banking Supervision Market Contact Group (BSMCG)

Friday, 1 July 2022, virtual meeting

MEETING SUMMARY

Kerstin af Jochnick, Member of the Supervisory Board (ECB Representative), opened the third meeting of the BSMCG. Mrs af Jochnick recalled that the exchanges of views with market participants are an essential component of the market intelligence activities conducted by ECB Banking Supervision to support its assessment of the main risks and vulnerabilities of the banking sector.

1. European banking sector outlook

The first part of the meeting benefited from two presentations on recent developments shaping the risk outlook for European banks. BSMCG members broadly concurred that the overall outlook for banks' profitability remains positive amid the normalisation of interest rates. The positive sentiment was also underpinned by the strong perceived resilience of the banking sector reflected in both banks' solid capital and liquidity positions, low aggregate NPL ratios and the limited impact of the war in Ukraine on asset quality so far. Most members, however, also noted that rising interest rates, high inflation, and a potential deterioration in the macroeconomic outlook could negatively affect the debt repayment capability of households and corporates, resulting in challenges for banks. It was also noted that banks are facing increasing competition from non-bank competitors that would exert a continuous pressure to develop and execute effective digital transformation strategies to achieve sustainable business models going forward.

Overall, BSMCG members shared the view that the capacity of the banking sector to absorb shocks has significantly improved since the great financial crisis, also as a result of the joint efforts by policy makers, regulators and supervisory authorities. Rising interest rates were generally expected to have a positive impact on banks' return on equity, supported especially by higher interest rate margins. However, some BSMCG members expressed the view that while asset quality has surprised on the upside in the recent period, tail risks remain especially in the case of a further prolongation or even escalation of the war in Ukraine, which may adversely impact energy supply with negative consequences for the economic outlook (in particular, for example, in the manufacturing sector). While acknowledging these risks, other members noted that if such a tail event was to materialise, public support measures would be deployed and contribute

to mitigating the impact on banks' asset quality. Separately, some members expressed concerns about a rising risk from adverse sovereign-bank feedback loops after public debt has increased considerably during the pandemic and sovereigns might need to intervene with additional protection schemes should default and unemployment rates start rising.

2. Challenges for banks posed by climate risk

The second part of the meeting focused on the challenges posed by climate-related and environmental (C&E) risks to banks' business strategies and risk management frameworks. In this context, much of the discussion evolved around the recent policy changes regarding the EU energy supply amid the war in Ukraine and the implications for transition risk. The two presentations introducing the issue noted that banks are increasingly considering C&E risks from a risk management perspective. However, it was also highlighted that there is still room for improvement as only a few banks were deemed prepared to address these risks adequately. The climate stress test conducted by the SSM was mentioned as very useful in this context. Filling data gaps and building robust risk assessment methodologies to ensure coherence of credit ratings were regarded as essential milestones to support the transition. Several issues were seen as obstacles to the full integration of C&E risks in banks' risk management frameworks, namely the integration of C&E risks into the regulatory capital framework, the need to broaden the focus to other environmental risk drivers, and the recent challenges posed by geopolitical tensions, which might lead to the prolonged usage of non-renewable energy sources.

Overall, BSCMG members agreed that transition risk has gained in awareness and importance over the past few years and that banks are making progress in improving their ability to manage it. Nevertheless, some members noted that banks have moved C&E risks down their list of priorities on account of pressing conjunctural risks, including those related to potential fallout from the war in Ukraine. Recognizing that funding the transition from a "brown" to a "green" industry is a key challenge, most members favoured a gradual regulatory approach in addressing C&E risks, arguing that a harsher stance in this regard (for example, imposing additional capital requirements on "brown" exposures) would not be adequate. They argued that the green transition needs to be funded and some banks would still need to lend to carbon-intensive industries during the transition period. Separately, the completion of the capital markets union was seen as an essential element to effectively raise the large resources needed to fund the transition.

BSMCG members broadly agreed that international cooperation and level-playing field are crucial to support the green transition and avoid a shift in lending to carbon-intensive industries across geographical regions and/or towards less-regulated financial market sectors. Some members also mentioned that filling data gaps, finalising the EU taxonomy and developing reliable methodologies to assess the materiality, the exposure to, and the management of C&E risks are substantial elements on the way to develop adequate

transition plans. Lastly, most members agreed that the time horizon of materialisation of both physical and transition risks is shortening and that C&E risks are becoming increasingly relevant factors for banks' risk management already in the short-term.

3. Concluding remarks

Mrs af Jochnick concluded the meeting by thanking the members for their active participation in the discussions and noting that the next BSMCG meeting will take place in the beginning of 2023.