Written overview ahead of the exchange of views of the Chair of the Supervisory Board of the ECB with the Eurogroup on 21 May 2021

This short note provides the Eurogroup of 21 May 2021 with an overview of the activities of ECB Banking Supervision in the areas of (1) credit risk, (2) climate risk, and (3) Brexit.

1 Credit risk – update on non-performing loans

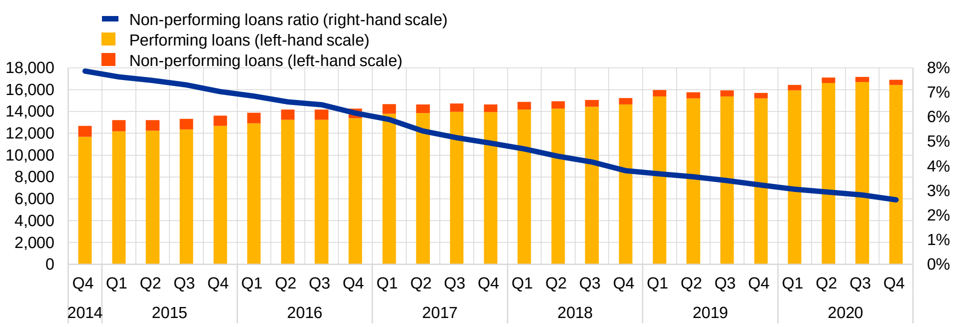
Overall trends

The stock of non-performing loans (NPLs) has declined considerably since the establishment of the banking union. Significant institutions (SIs) in the euro area reduced the volume of NPLs from €998.0 billion at the end of 2014 (corresponding to a gross NPL ratio of 7.9%) to €506.0 billion at the end of 2019 (equivalent to a gross NPL ratio of 3.2%) (Chart 1). The downward trend in NPLs continued in 2020, with NPLs falling by a further €62.5 billion to €443.5 billion between the fourth quarter of 2019 and the fourth quarter of 2020 (reaching a gross NPL ratio of 2.6%).

Chart 1

Change in NPLs and gross NPL ratio of SIs

(left-hand scale: EUR billions; right-hand scale: percentages)



Source: ECB.

It should be noted that the impact of the coronavirus (COVID-19) pandemic is only partially reflected in the figures for the fourth quarter of 2020, mainly owing to the public support measures adopted by Member States.

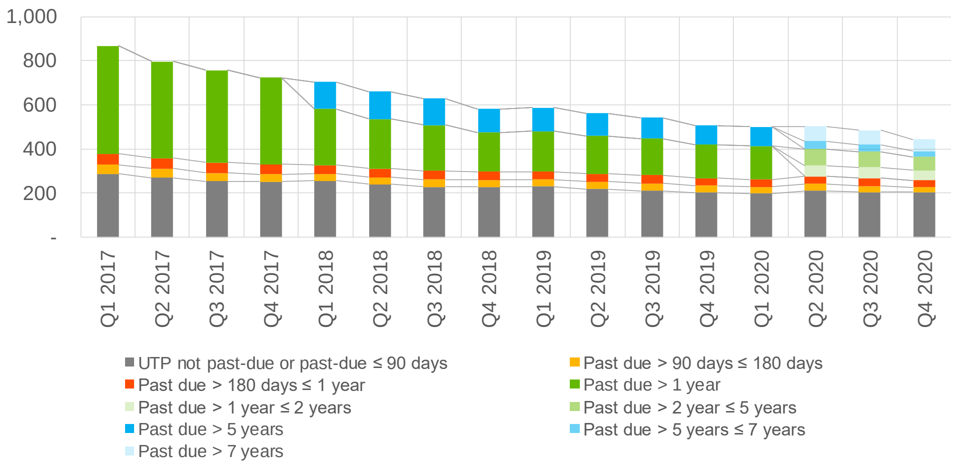
Vintage composition

The NPL vintage structure can be used to determine how long an exposure has been classified as non-performing. As Chart 2 shows, SIs have in particular reduced NPLs which are older than one year.

Chart 2

NPL vintage distribution over time

(EUR billions)



Source: ECB.

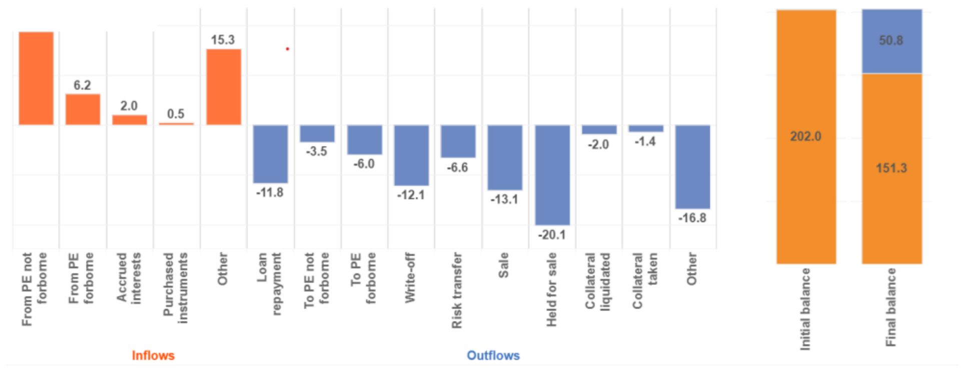
High-NPL banks

As part of its work on NPLs, the ECB has asked SIs with higher NPL levels (referred to as "high-NPL banks") to submit NPL and foreclosed asset reduction strategies and to define their portfolio-level reduction targets over the medium term. High-NPL banks continued to reduce their levels of NPLs in 2020, despite the COVID-19 crisis, with the largest reductions stemming from sales, write-offs and loan repayments (Chart 3). In this context, securitisation schemes and asset management companies proved to be important policy tools which enabled high-NPL banks to reduce their NPL levels, even during the pandemic. The Joint Supervisory Teams (JSTs) are continuing to closely monitor the change in NPL ratios, as well as other related activities such as sales of NPLs.

Chart 3

NPL flows for high-NPL banks in 2020

(EUR billions)



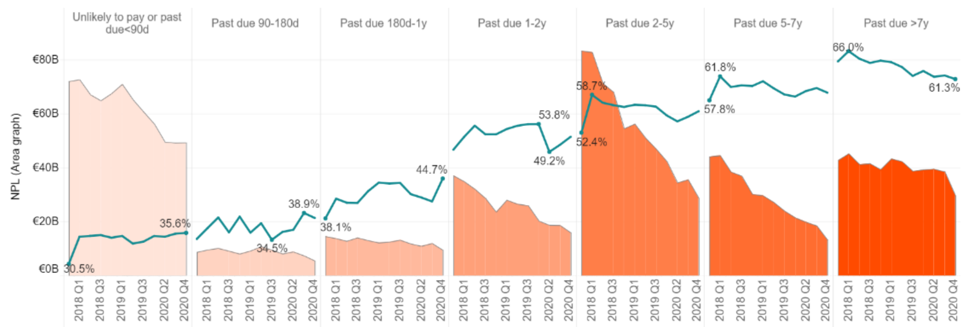
Source: ECB.

High-NPL banks have also reduced older vintages of NPLs over the last few years. As shown in Chart 4, NPLs have been reduced across all categories older than one year. Despite these reductions, high-NPL banks still hold a substantial amount of legacy NPLs on their balance sheets.

Chart 4

Change in NPLs and coverage for high-NPL banks by past-due category

(left-hand scale: EUR billions; right-hand scale: percentages)



Source: ECB.

Credit risk strategy

The unusual features of the pandemic-induced recession, including the unprecedented public support provided to banks' customers, have challenged banks' standard credit risk management toolkits and may have a bearing on their risk management incentives.

The NPL count has to some extent been contained by the use of broad-based debt moratoria, but may also have been moderated by banks' struggling \, up to now, to assess individual borrowers' repayment prospects and implement and duly report bespoke forbearance and restructuring solutions.

While there has been some increase in the share of loans reported as subject to heightened credit risk – referred to in accounting terms as Stage 2 loans – throughout 2020, this has been accompanied by very wide-ranging provisioning responses. In a number of cases, banks reduced their share of Stage 2 loans between the first wave of the pandemic and the end of the year, potentially taking an optimistic view of how the pandemic is developing. In the same context, a somewhat unexpected downward trend in retail credit risk parameters, such as probabilities of default, has been observed during 2020. This warrants further analysis.

The pandemic outlook and the in-depth scrutiny of banks' risk management practices remain at the core of the ECB's credit risk strategy for 2021.

Concretely, the supervisory expectations on credit risk identification and loan loss provisioning, which we set out in a letter to banks in December 2020[1], are now resulting in follow-up actions, which can range from a simple supervisory dialogue to deep-dives, inspections and preparing actual SREP 2021 measures. Preliminary results show that only around half of the assessed banks follow practices that are broadly compliant with those expectations.

To increase our understanding of the impact of the pandemic on banks and ensure that our actions target credit risk arising from the most vulnerable sectors, we launched a targeted review of banks' risk management practices in early 2021. This review focused on a sample of directly supervised banks with relevant levels of loans to the food and accommodation sector.

According to available data referring to December 2020, accommodation and food services is the economic sector with the highest relative incidence of loan guarantees and loan moratoria. Work and discussions with the banks in the sample are still ongoing, but it is already apparent that some banks are not aligned with supervisory expectations set out in the ECB's letter to banks of December 2020. Some banks' early warning systems and procedures for assessing vulnerable sector borrowers' unlikeliness to pay are overly reliant on ineffective indicators, outdated ratings and backward-looking information. In many cases, these banks do not assess borrower's unlikeliness to pay and/or implement internal controls and risk indicators to challenge the effectiveness of their frameworks for the current crisis.

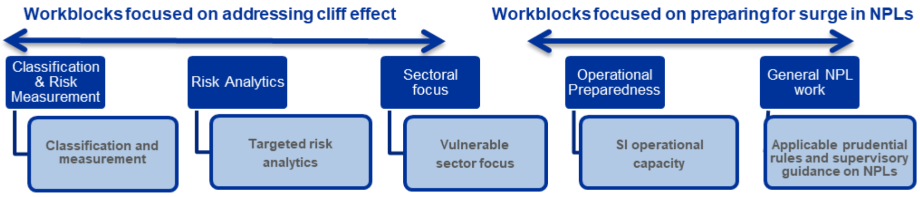
The overarching objectives of our work on credit risk identification and loan loss provisioning remain the same: i) prevent, to the extent possible, cliff edge effects in asset quality; and ii) ensure that credit risk is duly reflected in banks' financial accounts.

In addition, to ensure that banks adequately prepare for a potential surge in NPLs and to prevent these becoming a drag on the recovery, the ECB has assessed how

[1] See European Central Bank (2020), "Identification and measurement of credit risk in the context of the coronavirus (COVID-19) pandemic", December.

banks are meeting its expectations on the operational capacity to deal with distressed debtors, which were communicated in a letter dated July 2020[2]. With the same aim, we regularly monitor banks' compliance with the applicable prudential rules and supervisory guidance on NPLs.

With respect to operational preparedness, we have found that while banks have made progress in enhancing their capabilities, there is still room for improvement. Notably, banks need to ensure that they have robust data infrastructures to aggregate and generate useful management information, sound strategies based on a realistic assessment of the operating environment and forbearance procedures that are clear, detailed and fit for purpose in the current environment.



2 Climate risk

For the third year in a row, climate-related and environmental risks have been identified in the SSM Risk Map[3] as one of the key risk drivers for euro area banks. We are taking concrete steps to ensure that banks progressively embed the financial impact of climate change in their processes and practices.

In November 2020 we published the ECB Guide on climate-related and environmental risks[4], which sets out our supervisory expectations under the current prudential framework. The Guide describes how the ECB expects banks to consider climate-related and environmental risks when formulating and implementing their business strategy and governance and risk management frameworks. It also explains how the ECB expects institutions to become more transparent by enhancing their climate-related and environmental disclosures.

The ECB also assessed the climate-related and environmental risk disclosures of every institution under its direct supervision. The report[5] finds that only 3% of the institutions would meet a minimum level of expected disclosures. Furthermore, disclosure statements are substantiated only sparsely with relevant quantitative and qualitative information and most institutions do not yet comprehensively disclose

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2 See European Central Bank (2020), "Operational capacity to deal with distressed debtors in the context of the coronavirus (COVID-19) pandemic", July.

3 See SSM Risk Map for 2021.

4 See European Central Bank (2020), "Guide on climate-related and environmental risks – supervisory expectations relating to risk management and disclosure", November.

5 See European Central Bank (2020), "ECB report on institutions' climate-related and environmental risk disclosures", November.

their risk profile. Similarly, assessments of banks' risk management processes have shown that few banks incorporate climate risk comprehensively into their risk management frameworks.[6]

Table 1

Overview of institutions disclosing basic climate-related information

Category	Metric	Percentage
Disclosure policies and procedures	1. Percentages of institutions that substantiate consideration of climate-related risks as immaterial in their disclosures (where the institution reports it deems the risks to be immaterial)	8%
	2. Percentage of institutions disclosing methodologies, definitions and criteria associated with any figure, metric or target reported	45%
Business strategy	3. Percentage of institutions describing the potential strategic impact of transition risks in the short and long term	30%
	4. Percentage of institutions describing the potential strategic impact of physical risks in the short and long term	24%
Governance	5. Percentage of institutions describing the board's oversight of climate-related risks	55%
	6. Percentage of institutions describing the organisation's processes for identifying, assessing and managing climate-related risks	57%
Risk management	7. Percentage of institutions describing how climate-related risks feed into credit-granting policies	54%
	8. Percentage of institutions making any reference to the use of scenario-analysis or stress testing	29%
Metrics and targets	9. Percentage of institutions disclosing at least one metric and one target	37%
	10. Percentage of institutions disclosing a key performance indicator or key risk indicator	26%
	Percentage of institutions that disclose all of the above information	**3%**
	Percentage of institutions that disclose less than half of the above information	**58%**
	Percentage of institutions that disclose none of the above information	**16%**

In early 2021 the ECB asked banks to conduct a self-assessment of their compliance with the supervisory expectations outlined in the Guide and draw up action plans on that basis. The ECB will benchmark these self-assessments and plans before challenging them as part of the supervisory dialogue. In the initial stages of the supervisory dialogue, the findings from the abovementioned exercise are generally not expected to be taken into account in determining capital requirements, but we may take qualitative as well as quantitative supervisory measures on a case-by-case basis.

In 2022 the ECB will conduct a full supervisory review of all climate-related and environmental risk management practices and take concrete follow-up measures where necessary. We are also preparing a bottom-up climate risk stress test to conduct a deep-dive into banks' internal stress test practices and obtain a horizontal overview of the vulnerabilities of SIs to climate risks.

[6] See European Central Bank (2021), "ECB report on banks' ICAAP practices", August; and European Central Bank (2020), "Green Finance", *Annual Report on supervisory activities 2019*, March.

3 Brexit

In the last few years the ECB has engaged continuously with banks, urging them to prepare for Brexit, whether they were relocating to the euro area or subject to European banking supervision and had operations in the United Kingdom. As a result of these preparations, the transition to the new regime went smoothly. Banks have gradually built up their capabilities and so far, there have been no major disruptions to the provision of services to EU clients.

We have communicated continuously that empty shell institutions are not acceptable in the euro area. We expect activities and services involving EU clients to be carried out predominantly within the European Union. Banks must allocate sufficient capital and liquidity, as well as an appropriate amount of high-quality resources for risk management to establishments within the banking union. This is necessary to ensure adequate management of the risks undertaken by the institutions in relation to their European customers and counterparts. Based on these supervisory expectations, we worked with banks affected by Brexit to agree on their target operating models in the EU. Brexit has now taken place and the transition period has ended. We are now assessing in detail how SIs are establishing themselves in the banking union and keeping a close eye on whether they are meeting supervisory requirements, fulfilling expectations and adhering to policies. Our key focus in the coming months will be on banks’ booking practices and trading capabilities, including the use of back-to-back booking models and split desks. From what we have seen so far, we have strong doubts about whether all banks are truly meeting our expectations. We are also in close contact with UK supervisory authorities to ensure coordination on banks that are active in both the European Union and the United Kingdom.

The ECB will continue to monitor future developments in the EU financial sector arising from Brexit. We have expressed some concern about the possible fragmentation of international banks’ presence in the euro area. Several incoming banks plan to access EU markets through channels that are enshrined in national law, such as third-country branches in EU countries and direct cross-border access for the provision of investment services to retail clients. Such a fragmented structure limits the integrity of supervision and may even be used to avoid direct supervision by the ECB. We would therefore be in favour of addressing the respective regulatory loopholes in the European framework.

4 Conclusion

The COVID-19 pandemic and Brexit have shown that an aligned European regulatory and supervisory response is effective at both European and national level. This type of response ensures a level playing field within the European market and keeps uncertainty about potential individual supervisory reactions to a minimum. At the same time, there are relevant challenges ahead, including structural weaknesses in banks' profitability and the limited progress in cross-border banking integration over the last decade. More effort is required if we want to reap all the benefits of an integrated market.

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For specific terminology please refer to the ECB glossary (available in English only).