EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Written overview ahead of the exchange of views of the Chair of the Supervisory Board of the ECB with the Eurogroup on 7 November 2022

This short note provides the Eurogroup of 7 November 2022 with an overview of ECB Banking Supervision's activities in the currently complex environment affected by a macroeconomic shock and geopolitical tensions.

1 General state of the European banking system in the current macroeconomic and geopolitical environment

The latest available prudential statistics portray a euro area banking sector which is strong from both a capital and a liquidity perspective and which continues to reduce legacy non-performing loans (NPLs) and to benefit from the ongoing normalisation of interest rates, with profitability levels not seen since European banking supervision began. Russia's invasion of Ukraine, which has developed into a widespread macroeconomic shock, has not yet produced visible balance sheet damage, and both banks and analysts seem to be looking at the near term with optimism. At an aggregated level, the Common Equity Tier 1 (CET1) capital ratio of significant institutions stood at 15% in the second quarter of 2022, while the liquidity coverage ratio stood at 164.4%, well above pre-pandemic levels. Thanks in particular to sales, securitisations and write-offs, the headline NPL ratio continued to decrease in the second quarter of this year to reach 1.8%. The post-pandemic economic rebound coupled with the beneficial impact of rising rates on margins have supported banks' profitability over the last few quarters. In fact, in the second quarter of 2022 the return on equity of significant institutions reached 7.6%. As of this summer, listed banks and analysts alike are projecting that the 2023 return on equity will remain broadly stable at 2022 levels or that it will improve.

However, owing to the war in Ukraine, the macroeconomic outlook has been continuously deteriorating and financial markets have proven particularly sensitive to abrupt adjustments in asset prices and interest rates and prone to dislocation episodes not necessarily linked to fundamentals.

In my view, these two types of dynamics require both banks and supervisors to remain very vigilant and prudent when looking at banks' near-term performance. Although the war, the sanctions against Russia and the latter's retaliation measures have so far had a limited direct impact on banks, the macroeconomic repercussions of this geopolitical crisis are starting to be felt across the euro area. The September 2022 ECB staff projections pointed towards yet another deterioration in growth under the baseline and downside scenarios accompanied by high inflation. Under the downside scenario, the projections suggest negative growth (-0.9%) for real GDP in 2023. On 26 September the ECB flagged that a recession in the euro area is becoming more likely as some of the assumptions behind the downside scenario are starting to materialise. In addition, the ongoing energy crisis is further exacerbating the pre-existing inflationary pressures driven by pandemic-related supply chain bottlenecks. As a response to rising prices, monetary policy efforts are focused on bringing inflation back to levels consistent with price stability. In this type of environment, substantially different from the one at the start of the COVID-19 pandemic, it is becoming increasingly clear that potential fiscal support interventions ought to remain well targeted and carefully calibrated to be compatible with the fight against inflation.

On financial markets, heightened uncertainty and volatility have put specific market segments under strain. Volatile energy and commodity prices have resulted in utility companies, commodity traders and other non-financial corporates using energy and commodity-related derivatives as hedges to deal with extraordinary spikes in margin calls. In the United Kingdom, sharp upward adjustments in gilt yields in response to the Government's economic policy announcements have led to pension funds and their liability-driven investment strategies being faced with severe spikes in margin calls, threatening fire-sale spirals on gilts and prompting the Bank of England to intervene with very material public debt purchases. In the event of abrupt stock price or other asset price adjustments, events such as the 2020 default of the private equity firm Archegos cannot be ruled out. The opaqueness of leverage and risk-taking at non-bank financial institutions raises concerns about the potential impact on banks through unexpected channels of contagion.

Against this background, banks may come under pressure on several fronts. First, the combined impact on asset quality of the economic slowdown, high inflation and rising interest rates is testing several pockets of vulnerability to credit risk, including banks' exposure to energy-intensive corporate sectors, residential and commercial real estate markets, consumer finance and leveraged

finance. In the future, this may lead to a more pronounced deterioration in asset quality, translating among other things into an increase in NPLs. While the overall credit risk of bank balance sheets has thus far remained contained, some signs of heightened credit risk can be observed. As I mentioned earlier, over the last few quarters the headline NPL ratio has continued to decrease. However, NPLs in the consumer loans and early arrears segments are increasing, and the aggregate share of underperforming loans (stage 2 ratio in accounting terms) stood at 9.7% in the second quarter of 2022, above its pandemic peak. Despite the recent increase in stage 2 loans, the cost of risk decreased to pre-pandemic levels (0.52%) as new provisions related to the uncertain outlook were more than offset by the release of COVID-19-related overlays and the decrease in stage 3 provisions.

Second, looking at financial markets, clearing margin pressure on utility companies and commodity traders may translate into higher counterparty credit risk exposure for banks acting as clearing members and, more generally, higher credit risk exposures towards those players. The strain placed by liquidity and counterparty credit risk on pension funds, asset managers, private equity firms and other non-bank financial institutions may result in higher credit and counterparty credit risk exposure for banks, but may also give rise to damaging asset price correction spirals which will have an impact on banks' balance sheets beyond direct exposures.

Whereas heightened financial market volatility continues to support the trading component of revenues at investment banks, which had already reached record-high levels in the wake of the pandemic, investment banking revenues stemming from debt, equity underwriting and mergers and acquisitions are now being put under pressure by the worsening macroeconomic outlook and deteriorating capital market conditions.

Worsening funding costs along the interest rate normalisation path may also threaten the sustainability of ill-advised asset and liability carry trade strategies in some banks which are excessively geared towards targeted longer-term refinancing operations (TLTRO) funding and long-dated government debt investments.

In this exceptional context, we have called on banks to proactively monitor the downside risks underlying the macroeconomic and financial outlook.

We have also collected updated capital projections from them and carried out deep dives in a number of areas. The capital projections were collected under a baseline scenario and under an adverse recessionary scenario. We are assessing potential vulnerabilities stemming from the current environment based on these projections.

Earlier this year, we conducted a deep dive of supervised banks' credit and derivative exposures to the largest energy commodity traders, representing a total exposure of around €70 billion. We also looked at exposures to the energy utilities sector, which comprises more than 40,000 firms of varying sizes, including large utilities conglomerates, smaller municipal firms and renewable energy projects. Banks play a more prominent role in financing smaller municipal firms and renewable energy projects. As of June 2022 supervised banks' loans to utility companies amounted to over €350 billion (approximately 5.5% of their corporate loan book).

At an aggregate level, leveraged finance exposures, mainly in the form of leveraged loans, account for more than 60% of euro area banks' CET1 capital. A large share of these are exposures to highly leveraged corporates, which is the riskiest segment of an already high-risk asset class. Banks have consistently originated riskier loans of this kind over the last few years, and have continued underwriting transactions during 2022 even as the opportunities to syndicate them have become increasingly uncertain, with markets slowing down in the course of the year. As a result, there has been an increase in the level of risk related to inventories held on balance sheets.

We looked into banks' risk management capabilities for dealing with interest rate and credit spread shocks. The preliminary results show that the assumptions banks use in internal stress tests are not always sufficiently conservative and that they need to establish appropriate risk appetite frameworks and limits. Severe interest rate shocks can also affect customers' behaviour and asset quality in ways that might not be fully captured by banks' existing models.

As regards banks' derivatives exposures to non-bank financial institutions, the ECB has published supervisory expectations and stressed that banks should have sound risk management, strong governance and a proper risk culture when engaging in prime brokerage services. Additionally, the ECB is performing a targeted review of governance and the high-level management of counterparty credit risk.

2 Climate-related, environmental and IT/cyber risks

In 2022 we continued to monitor banks' progress in meeting our expectations on climate-related and environmental risks (C&E risks). We carried out a climate stress test, a targeted review of banks' commercial real estate exposure to transition risk and several on-site missions, and just last week published the thematic review of C&E risks.

The stress test[1] results published in July this year revealed that, despite the relevance of climate-related risks, most banks do not have robust climate risk stress-testing frameworks in place. They also struggle to provide sound climate risk projections and need to step up their efforts to collect better climate-relevant counterparty data.

The thematic review showed us that most banks have started adapting their C&E risk management practices and adding C&E expertise to their governance structures, marking an improvement since 2021. In publishing the thematic review last week, we clearly highlighted a set of good practices in C&E risk management that we had identified across several different banks, and we intend to actively contribute to sharing information and disseminating knowledge in this area. Those good practices also show that the banking sector does possess the ability to innovatively address the challenges posed by C&E risks. However, the review also showed that many banks still have work to do. To take just one example, many banks still do not fully factor in how their own risk exposures are affected by their clients' misalignment with the Paris Agreement. We will send comprehensive letters to banks setting out all the identified shortcomings, together with concrete follow-up actions for them to take.

In the light of all these supervisory findings, we strongly welcome the proposed amendments to the Capital Requirements Directive (CRD VI), which will require banks to develop specific transition plans to monitor and address environmental, social and governance (ESG) risks. It is crucial that banks develop plans that are fully integrated into their strategies and that build on their counterparties' transition pathways.

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[1] ECB Banking Supervision (2022), "2022 climate risk stress test", July.

The ECB also welcomes the European Commission's proposal to introduce harmonised ESG risk definitions. We note that both the Council and the European Parliament have considered amending the Commission's proposal, including the definitions of assets or activities subject to impacts from environmental and/or social factors. We see some merit in potentially introducing such definitions, which would also support the European Banking Authority in delivering its mandate under Article 501c of the Capital Requirements Regulation, for which a discussion paper has already been published.

In parallel, digital transformation and the related use of innovative technologies are both affecting how banks implement their business models and changing their risk profiles. More traditional risks, such as operational risk, are evolving. And new risk areas are emerging, such as IT and cyber risk, and are currently being exacerbated by ongoing geopolitical tensions. While innovation and digitalisation provide opportunities by increasing efficiency and creating new business, they also pose significant challenges. Banks need to make significant investments if they are to adjust to processes and business models becoming increasingly digital. And they are exploring several avenues to expand their digital infrastructure, for example by developing solutions internally or partnering with fintech and big tech firms. Against this background, ECB Banking Supervision is conducting market intelligence-gathering initiatives with the industry, as well as dedicated surveys, targeted reviews and on-site inspections with banks on their digital transformation activities We are also following up with banks that show material deficiencies in these areas. In addition, raising IT security awareness among customers, employees and external stakeholders is a continuous process that supervisors have incorporated into their supervisory approach.

3 The need for a cautious approach: supervisory priorities and the reform agenda

Overall, the risks to the banking sector have increased and the current environment is characterised by substantial uncertainty. While euro area banks' capital and liquidity ratios confirm the sector is broadly resilient overall, banks still need to be prepared to face challenges in the near term. They must therefore remain prudent, proactively adjust their strategies and planning, and continuously monitor and manage risks stemming from the current environment.

In the light of current developments, European banking supervision priorities for 2022-24 remain broadly suited to addressing the current challenges. Nevertheless, the different nature of the shocks as compared with those from previous years, coupled with their effect on the economic environment, means some targeted adjustments to our medium-term strategy are called for. Towards the end of the year, we will announce our revised priorities for 2023-25. Our supervisors are ready to adjust their focus and planned activities at short notice in response to the dynamically shifting risk landscape.

The resilience of the banking sector in the wake of the recent exogenous shocks is also the result of the regulatory and institutional reforms implemented after the great financial crisis. Finalising those reforms in a timely and rigorous manner is of paramount importance. The Council is about to adopt its negotiation position on the latest banking package, the aims of which include implementing the final Basel III reforms in the EU and closing some gaps in the current prudential framework. Only a fully faithful implementation of Basel III will ensure banks are sufficiently capitalised to both cover risks and keep lending to the economy. Against this backdrop, the many deviations included in the Commission's proposal last year and foreseen in the Council's negotiation position are a cause for concern[2].

Finally, we welcome the Eurogroup's intention to move ahead with improving the crisis management and deposit insurance framework. As supervisors, we constantly work to ensure the safety and soundness of banks, but an efficient institutional framework should also ensure weak banks exit the market smoothly. So it is very important that we have a crisis management toolkit in place that can handle failures of banks of all types and sizes, and we see scope for targeted improvements to that end. We look forward to the Commission's legislative proposal, and we call on co-legislators to be ambitious in addressing the remaining areas for improvement.

[2] Campa, J.M., de Guindos, L. and Enria, A. (2022), "Strong rules, strong banks: let's stick to our commitments", The Supervision Blog, ECB, 4 November.