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 15 May 2023

This short note provides the Eurogroup with an overview of ECB Banking Supervision's activities in the light of recent financial market developments and the macroeconomic outlook ahead of the exchange of views on 15 May 2023.

1 Current state of the European banking sector

The euro area banking sector remains resilient from both a capital and a liquidity perspective, despite Russia's war of aggression in Ukraine and the market turmoil triggered by the failure of Silicon Valley Bank in the United States in March. The Common Equity Tier 1 (CET1) capital ratio of significant institutions stood at 15.3% at the end of 2022, while the liquidity coverage ratio (LCR) stood at 161%, well above both regulatory requirements and pre-pandemic levels. At the same time, asset quality remained stable, with a non-performing loan (NPL) ratio of 1.8% at the end of 2022, compared with 2.1% at the end of 2021.[1]

2022 year-end data also reveal that euro area banks[2] with direct exposures to Russia have made concrete progress in reducing risks. These exposures decreased by 25% between the third and fourth quarters of 2022 and by 37% between the end of 2021 and the end of 2022. Supervisory teams are continuing to monitor the wind-down and exit strategies of significant institutions with a presence in Russia.

The normalisation of monetary policy continued to support European banks' profitability, with a return on equity of 7.7% in the fourth quarter of 2022, mostly driven by growing net interest income, the contained cost of risk and a slight increase in cost efficiency. Banks and analysts alike expect the profitability outlook to remain equally positive this year, as confirmed by results published so far for the first quarter.

[1] Excluding cash balances at central banks from the denominator, the NPL ratio stood at 2.3% in the fourth quarter of 2022, compared with 2.6% in the fourth quarter of 2021.

[2] The sample includes both significant and less significant institutions.

The euro area did not experience significant spillovers from the turmoil affecting US banks as the business models of the banks we supervise do not share the same unique features as those of the regional banks that have come under stress in the United States. Euro area banks tend to rely on a more diversified depositor base and, in particular, do not exhibit the combination of extreme dependence on volatile funding sources, especially uninsured deposits, and material unrealised losses in securities portfolios held at amortised cost.

While the increase in interest rates has provided a positive boost to bank profitability, the pace of monetary policy normalisation is also increasing European banks' exposure to interest rate risk in the banking book and may adversely affect asset quality and lead to counterparty credit risk losses. Since inflationary pressures began to emerge at the end of 2021, European banking supervisors have been drawing banks' attention to the vulnerabilities associated with increasing interest rates, in particular the asset and liability management issues that we have recently seen at play in the United States. If not properly hedged, the economic value of bank equity typically declines when interest rates rise, owing to assets having a longer average duration than liabilities. This happens irrespective of the accounting practices followed by banks and can come under intense scrutiny from sophisticated depositors and investors in times of volatility and uncertainty. Some banks might even face decreases in their earning capacity if liabilities are repriced at a faster pace than assets. Borrowers in specific segments may struggle to service their debts, leading to credit losses, while counterparty credit positions held vis-à-vis other banks and non-banks become more volatile in an environment of rising rates.

Recent market developments, in particular the observed speed of transmission of information and financial decisions by depositors and other market players, confirm that increased attention needs to be paid to the liquidity and funding risk outlook of the sector as monetary policy shifts to a new regime.

2 Lessons from the recent market turmoil and legislative priorities

Recent market turmoil serves as a reminder of the importance and relevance of the global post-crisis frameworks for prudential regulation. Market events have confirmed that full, faithful and timely implementation of these standards – and their effective application by supervisors and resolution authorities – is essential. From an EU perspective, loosening our rulebook compared to the Basel standards would reduce the resilience of the European banking sector and could expose our banks to the same weaknesses we have seen in other jurisdictions. This demonstrates how important it is to minimise the deviations from the Basel standards in the upcoming Capital Requirements Regulation (CRR III)/Capital Requirements Directive (CRD VI) legislative framework.

While we are convinced that the rulebook designed in response to the global financial crisis is not in need of major changes, we welcome the intention of the Basel Committee on Banking Supervision and the Financial Stability Board (FSB) to assess whether any lessons can be learned from the events we have recently witnessed. We are also thoroughly assessing the lessons and reform proposals recently published by US authorities. The European Central Bank (ECB) is participating actively in the international work in this area. A thorough analysis is required, and we should avoid the temptation to prejudge the findings. However, areas of focus include some elements of the calibration of the LCR and the extent to which assets held at amortised cost, which may be difficult to sell without suffering losses when liquidity needs arise, can qualify as high-quality liquid assets. In addition, it may be beneficial to explore how factors such as high deposit base concentration and a predominant reliance on uninsured deposits could be dealt with in the Pillar 2 framework. More broadly, the question of the minimum scope of application of the Basel standards may also need to be discussed. The choice made in the EU to extend the Basel standards to all banks has proved to be a sound one when compared to the tiered system of application prevailing in the United States. Finally, further reflection on the role of digital banking and social media in accelerating deposit outflows may be needed, as this is clearly a new source of potential instability brought to the fore by recent events. Turning to the work of the FSB, it will also be important to look at how the recent crises were managed and see what lessons there are to be learned.

Beyond the remit of prudential regulation and supervision, another issue highlighted by recent market events is the transparency of credit default swap (CDS) trading. These markets are characterised by low liquidity and high opacity. As CDS spreads may also be used by institutional and corporate depositors as triggers for withdrawals, sharp price changes in this market have the potential to become highly destabilising for banks and wider securities markets. Enhancing transparency in this market is something that might need to be tackled at global and European level.

Turning to crisis management, in recent weeks we have seen a powerful demonstration of the need for effective and agile crisis management frameworks. While it is not a direct response to the recent turmoil, we strongly welcome the European Commission's recent crisis management and deposit insurance proposal. Three aspects of the proposal are of particular relevance. First, expanding the scope of resolution to ensure that the failure of small and medium-sized banks can be addressed in a harmonised and effective manner. Second, ensuring adequate resolution funding to address the failure of such banks (e.g. by supporting their exit from the market) by introducing a single-tier depositor preference and making it possible for deposit guarantee schemes (DGSs) to contribute towards reaching the prescribed 8% loss-absorption amount for accessing the Single Resolution Fund. This will allow DGS funds to support resolution strategies to protect depositors, subject to a least-cost test and other safeguards. Third, harmonising the least-cost test to ensure DGSs intervene in a consistent and uniform manner in those Member States where preventive and alternative measure are allowed. These three elements are complementary and will need to go hand in hand in order to ensure a well-functioning crisis management framework.

Loss absorption by shareholders should remain the first line of defence when a bank runs into solvency problems. In this regard, the ECB, the Single Resolution Board and the European Banking Authority have clarified that the EU resolution framework requires the full write-down of CET1 instruments before Additional Tier 1 (AT1) instruments can be written down. In the banking union, authorities have not requested the inclusion of triggers enabling a permanent write-down of AT1 instruments at the discretion of the supervisor before the full use of CET1 capital. We are fully committed to respecting the hierarchy of claims in any crisis situation.

3 Supervisory activities

ECB Banking Supervision started to assess the risks and vulnerabilities associated with a rising interest rate environment in the second half of 2021 when the first signs of inflationary pressure emerged and well before the recent market turmoil. Interest rate risk and credit spread risk in the banking book, counterparty credit risk and the credit risk arising in segments of the lending business such as leveraged finance and commercial real estate were all supervisory priorities in 2022. In all these areas, targeted reviews of risk management practices at banks have been complemented by dedicated on-site inspection campaigns, some of which are still ongoing.

Regarding interest rate risk in the banking book, which is at the core of the turmoil observed at some US regional banks, we regularly assess how the economic value of banks is affected by changes in interest rates and credit spreads. Furthermore, we performed deep-dive analyses of banks' modelling practices as regards behavioural items, such as sight deposits and loan repayments, their credit spread stress-testing practices and their use of derivatives for hedging interest rate risk. Our targeted reviews and on-site inspections also extended to residential real estate exposures and exposures to energy and commodity traders. In addition, we are focusing increasingly on how banks are applying IFRS 9 with a view to better understanding and assessing the way banks provision for risks.

A second issue associated with the fast-paced normalisation of monetary policy relates to banks' asset and liability management strategies, as these need to remain compatible with the new monetary policy environment. In view of the normalisation of monetary policy and the forthcoming phasing-out of extraordinary central bank funding facilities, we have identified a need to focus on the sustainability of banks' funding plans. As a result, more prominence has been given to liquidity and funding risks in the supervisory priorities.

Supervisors have reviewed the targeted longer-term refinancing operation (TLTRO) exit strategies of selected banks that showed a material reliance on this funding source and were more vulnerable to increases in market funding costs. This targeted review will be complemented later this year by a broader analysis of banks' liquidity and funding plans and, where appropriate, targeted on-site inspections in order to identify weak practices and the more vulnerable institutions and to take the necessary supervisory actions where needed.

We also maintain our strong focus on the long-term challenges that banks are facing, such as the impact of climate change as well as digitalisation. As regards climate change, we intend to follow up on the results of the various reviews of climate-related and environmental risks that were conducted in 2022. We are also urging banks to further develop their risk management frameworks and reduce data gaps. Banks have now received individual letters setting out the steps to be taken in order to be fully compliant with our supervisory expectations by the end of 2024. As regards digitalisation, last year, we conducted an extensive survey to better understand the state of play of the digital transformation and the use of innovative technologies of the banks we supervise, and to prioritise our supervisory activities around this. This year we follow-up on these results by performing targeted reviews and on-site inspections on digital transformation to shape supervisory expectations in the years to come.

Finally, recent developments have again confirmed the importance of effective, risk-based supervision. Therefore, we will continue to work towards improving our processes and strengthening our effectiveness. Over the past decade we have built harmonised supervisory practices and processes. We are now working to make them even more risk-sensitive and efficient. Starting this year, supervisors will apply a new risk tolerance framework to strengthen our focus on strategic priorities and key vulnerabilities, with more flexibility in planning activities based on a multi-year approach as part of the SREP.

The European Commission and the European Court of Auditors have recently published the results of their respective reviews of the overall application of the SSM Regulation[3] and of the audit of the ECB's operational efficiency in supervising banks' management of non-performing loans[4]. These reports recognise the success of the ECB in establishing effective supervision and include some recommendations on how to further enhance its processes. Work on the implementation of these recommendations has already started.

We recently published the results of an external assessment of the SREP, drafted by a group of external high-level experts.[5] This report acknowledges the success of ECB Banking Supervision in establishing itself as an effective and respected supervisor. It also provides recommendations on how to further enhance the efficiency and effectiveness of our work, leveraging on what we are already doing. We will start implementing some of the report's recommendations as early as in the 2023 SREP cycle and will take the report into account in a review of supervisory processes planned for 2024.

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[3] See "REPORT FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT AND THE COUNCIL on the Single Supervisory Mechanism established pursuant to Regulation (EU) No 1024/2013", European Commission, 18 April 2023.

[4] See "Special report 12/2023: EU supervision of banks' credit risk – The ECB stepped up its efforts but more is needed to increase assurance that credit risk is properly managed and covered", European Court of Auditors, 12 May 2023.

[5] See "Assessment of the European Central Bank's Supervisory Review and Evaluation Process – Report by the Expert Group to the Chair of the Supervisory Board of the ECB", ECB, 17 April 2023.