

Written overview ahead of the exchange of views of the Chair of the Supervisory Board of the ECB with the Eurogroup on 8 November 2023

This note provides the Eurogroup with an overview of ECB Banking Supervision's activities in the light of the recent financial market developments and the macroeconomic outlook ahead of the exchange of views on 8 November 2023.

1 Current state of the European banking sector

In the last few years, significant institutions in the banking union have strengthened their financial position and proved to be resilient to a succession of exogenous shocks, including the COVID-19 pandemic, Russia's invasion of Ukraine and the turmoil that followed the failure of some US regional banks and the takeover of Credit Suisse in the spring of 2023. While the pandemic delayed the exit from the low interest rate environment, the fallout from Russia's invasion of Ukraine hastened it. Banks have therefore had to adjust to these shocks emanating from the rapidly changing economic environment, characterised in particular by a rapid tightening of interest rates. The exit from the "low-for-long" interest rate environment bolstered bank profitability, but the financial market turmoil unleashed by the failure of Silicon Valley Bank (SVB) showed that the path can be bumpy if banks do not rapidly adjust their asset and liability management and their risk management focus.

The banking sector has strengthened its balance sheet and proven to be resilient. The Common Equity Tier 1 capital ratio of the banks under our direct supervision stood at 15.7%, while the leverage ratio stood at 5.4% in the second quarter of 2023. Notwithstanding the gradual reimbursement of extraordinary ECB financing, banks' liquidity remained strong, with an average liquidity coverage ratio of 158% and net stable funding ratio of 126% in the same period, both well above regulatory requirements and pre-pandemic levels. In addition, profitability continued to improve, with the annualised return on equity reaching 10% in the first half of 2023. Asset quality has improved over time across the banking union, with the aggregate volume of non-performing loans (NPLs) down from nearly €1 trillion in 2015 to around €340 billion today, with an NPL ratio of 1.8%.

The 2023 stress test results confirmed that the banking sector could overall withstand a very severe economic downturn. The adverse scenario was much more severe than in previous rounds and included sharp interest rate hikes, high inflation and a significant decline in asset prices. The marked improvement in banks' starting position in terms of capital, asset quality and profitability means that the sector would be able to weather the severity of this scenario. The exercise also helped to highlight pockets of vulnerability which call for improvements in risk management and additional capital buffers. Furthermore, an ad hoc data collection focused on unrealised losses, reflecting the depreciation of securities holdings held at book value. As one of the root causes behind the recent demise of some US banks, this issue has attracted a considerable amount of market attention. The overall amount of unrealised losses net of hedges in the banking union is contained (€73 billion). This is especially true when compared with the figures disclosed by US banks (over USD 600 billion). Under the adverse market risk scenario, these losses could increase to around €150 billion, which looks manageable given the significant cash holdings and excess central bank reserves that can be tapped in a liquidity stress situation. In contrast to SVB-like business models, which are characterised by extreme interest rate risk and a strong reliance on a concentrated, uninsured deposit base, European banks also tend to have well-diversified funding sources and customer bases.

Despite this largely positive assessment, banking union valuations remain depressed, with the latest price-to-book ratio standing at 0.7. Investors want to understand whether the current higher level of profits is sustainable given the gradually deteriorating macroeconomic outlook, an expected increase in funding costs and greater uncertainty surrounding governments' taxation of banks' interest income. In this context, the cost of equity remains very high and is still above the average return on equity.

Given the current economic backdrop, credit risk remains a potential threat to the profitability outlook and a source of supervisory concern. The tightening of credit conditions driven by rising interest rates, coupled with a slowdown in economic activity affecting large parts of the EU, is starting to affect the asset quality of supervised banks. Figures for the first half of 2023 show a slight increase in the NPL ratio of significant institutions, driven by rising NPLs in

the consumer credit and commercial real estate portfolios. Furthermore, the share of loans in early arrears (i.e. between 30 and 90 days past-due), which is a good leading indicator of a potential increase in NPLs, has maintained an upward trend since mid-2022, although it is still below pre-pandemic levels. As regards commercial real estate, concerns are emerging about bullet and balloon, non-recourse loans granted under variable interest rates. These types of commercial real estate loans may lead to high refinancing risks for borrowers, particularly under current market conditions. Banks' estimates of the cost of risk, which do not yet seem to reflect these downside risks, may have to be adjusted, which will have an impact on their profits.

The outlook for interest margins is another source of uncertainty in the sector's profitability outlook. On aggregate, banks' profitability currently looks healthy, which is welcome after years of poor return on equity. The rise in aggregate profitability can to a large extent be attributed to rising interest margins in the context of monetary policy normalisation. For euro area banks, the passthrough to depositors in this interest rate hiking cycle is proving slower than on past occasions. This also offsets the partial and delayed pass-through of negative interest rates in previous years. However, average results mask a significant heterogeneity across banks, driven by differences in the pass-through of higher interest rates to depositors and the varying reliance on floating or fixed interest rates on the asset side. Household deposits have benefited the least from higher interest rates, while corporate deposits saw their interest rate increase by approximately 40% of the overall policy rate hike, and wholesale deposit rates have closely mirrored policy rates. In this adjustment process, households and corporates have started shifting from sight deposits to term deposits, reversing the trend seen in the low interest rate environment. Higher margins will gradually recede and the pass-through of interest rates to depositors is expected to accelerate. The pace of this process will depend on the degree of competition on deposit rates, which in turn will affect the trajectory of bank profitability. The level of concentration in local markets is significantly affecting the ability of banks to preserve higher interest margins and boost profitability to the detriment of local depositors. A more integrated market within the banking union could enable a faster and more uniform adjustment to monetary conditions throughout the euro area.

A third source of uncertainty for banks concerns potential public interventions, such as windfall profit taxes or administrative interest rate

measures. Measures of this kind, which have been applied in certain Member States, may generate a drag on bank profitability even after the transmission of higher interest rates to depositors. They could also act as a disincentive to raising provisions and capital buffers in the light of heightened credit risk and could have a negative effect on investor appetite.

2 European banking supervision work and priorities

Banking union supervisors responded flexibly and promptly to recent exogenous shocks. However, there is no room for complacency, and supervisors will need to take a prudent approach and closely monitor the development of long-lasting and new, emerging risks in the banking sector. ECB Banking Supervision is thus focusing its attention on several key areas.

The real estate sector is one area of heightened supervisory focus. The cycle in this sector has turned, as euro area real estate prices have started to fall, while there are still significant accumulated vulnerabilities in several countries. Looking ahead, higher interest rates could result in further downward pressure on office and house prices, while the debt servicing capacity of households could deteriorate. It is therefore important for banks to ensure that their provisioning practices and capital planning are aligned with supervisory expectations and that they properly account for the deteriorating risk environment. Banks should conduct reviews to assess the resilience of their mortgage portfolios and identify customers susceptible to interest rate risk, inflation on the income side or a reduction in house prices on the collateral valuation side. Similarly, banks need to frequently monitor and adjust to emerging risks in their commercial real estate portfolios, ensuring that they proactively engage with distressed borrowers at an early stage. Increases in risk should result in changes in the prudential classification of loans as and when required.

Credit institutions' funding mix is another area of our supervisory focus. The upheavals we saw last spring illustrate the changing and more volatile nature of depositors' behaviour. Social media and digitalisation, combined with the attractiveness of alternative instruments for short-term investments offered by non-bank competitors, may affect the speed with which retail depositors react to price signals and market rumours. More importantly, the recent turmoil showed that sophisticated institutional and corporate treasurers can respond rapidly to deteriorating market metrics – such as widening bank credit default swap spreads

and falling stock prices – by withdrawing deposits, thus precipitating a negative spiral at banks perceived as weak.

In addition, the failure of SVB and other regional banks in the United States in March 2023 clearly highlighted the need to ensure that banks have proper asset liability management (ALM) governance and strategies in place. Against this background, ECB Banking Supervision is currently conducting a targeted review of selected significant institutions to assess their liquidity contingency planning and collateral optimisation capabilities, as well as the adequacy of their ALM governance and strategy arrangements. This is in addition to our supervisory work on interest rate and credit spread risks as well as liquidity and funding risk that started in the second half of 2021 in response to the first signs of rising inflation.

Cyber risk has been a topic of interest for ECB Banking Supervision for several years now and it is one of the key vulnerabilities to be addressed in the near future. Activities to improve supervised banks' operational resilience include the annual Supervisory Review and Evaluation Process (SREP), cyber incident reporting, on-site inspections, targeted reviews of cyber resilience and work on the implementation of the Digital Operational Resilience Act. To get a better insight into the response and recovery capabilities of European banks, ECB Banking Supervision is planning a cyber resilience stress test in 2024 for all its supervised institutions. The test will be the first of its kind and will focus on stressing banks' response and recovery mechanisms in the event of a severe but plausible cyberattack. Banks will be required to test the effectiveness of their response and recovery capabilities for the defined scenario and assess how the attack would affect them. Supervisors will review the results for any potential weaknesses so that banks can remedy them to protect themselves against real attacks. It will also be an opportunity to identify and disseminate good market practices.

The need to address the challenges of climate change and grasp the opportunities of the transition to a low-carbon economy remain urgent topics for banks and as such are another area of supervisory focus. Climate change can no longer be regarded as a long-term or emerging risk. Its impacts are already visible today and are expected to grow materially in the years to come. To ensure that banks adequately incorporate climate-related and environmental (C&E) risks into their business strategy and governance and risk management frameworks, supervisors will conduct various on-site inspections and reviews, including targeted deep dives to follow up on shortcomings identified in the 2022 climate risk stress test and thematic review. With the entry into force of the

European Banking Authority's implementing technical standards on Pillar 3 disclosures on environmental, social and governance risks in 2023, banks are also subject to enhanced requirements to disclose how they incorporate these risks into their governance and business models. Our supervisors are already including bank-specific climate and environmental findings in the SREP and have imposed binding qualitative requirements on more than 30 banks in the current cycle. We expect banks to be fully aligned with our supervisory expectations on C&E risks by the end of 2024, having set intermediate deadlines and required banks to reach specific milestones. Not addressing them will trigger an escalation to enforcement measures.

The March 2023 market turmoil in Switzerland and the United States also threw into sharp relief banks' internal governance and the sustainability of their business models. ECB Banking Supervision and other supervisors worldwide are working on improving the effectiveness of supervision in these two areas, particularly since banks' progress has been very slow compared with other areas of risk management. As regards governance, diverse management bodies are needed to avoid groupthink, facilitate independent opinions, foster an effective challenging capacity and ultimately strengthen management bodies' risk oversight. Close attention is being paid to board composition in terms of expertise, gender, the collective suitability of board members, and the interactions between the board and the committees reporting to it. Strengthening the sustainability of business models and mitigating risks related to the use of innovative technologies is also a key area of focus. This is crucial given the ever-stiffer competition from digital champions, with financial technology (fintech) and big technology players potentially threatening traditional business models if banks fail to adapt to the evolving landscape in time. In 2023 ECB Banking Supervision published its expectations on digital transformation strategies and the outcome of a benchmarking exercise. Targeted reviews and on-site inspections on digital transformation are under way, combining both the IT and business model dimensions of the strategies.

Finally, European banking supervision has continued to closely monitor the presence of significant institutions in Russia. Exposures appear to be quite contained overall, both in terms of volumes and types of activities in the local market. The total direct exposure of supervised banks in the euro area towards Russia is shrinking further, declining by 47% between the end of 2021 and the end of the second quarter of 2023. There are significant risks in continuing operations, with groups not being able to properly scrutinise the governance and

internal controls in their Russian establishments, especially in the area of antimoney laundering and combating the financing of terrorism, as well as the proper application of sanctions. Some banks managed to fully exit the Russian market despite the legal obstacles arising from Russia's retaliatory measures. ECB Banking Supervision asked all other banks to speed up their de-risking efforts by setting a clear roadmap towards downsizing and exit and reporting regularly to their management bodies and to the supervisor.

3 Regulatory and institutional issues and future outlook

At the end of a long reform path embarked upon after the global financial crisis, it is now time to implement faithfully the finalised international standards. The CRR/CRD package should be fully finalised without delay. Swiftly implementing the internationally agreed standards will offer the banking sector the legal and regulatory certainty it requires. Any deviations from these standards should be regularly reviewed to assess their impact and consider a phasing-out.

Swift progress on the adoption of the crisis management and deposit Insurance (CMDI) package is also critical, given that the end of the current legislative term is fast approaching. The package is a key opportunity to further improve the ways in which supervisors and resolution authorities can handle crises. The current EU framework for crisis management has been shown to work in practice in a number of cases, such as the resolution of Banco Popular Español S.A. in 2017 and Sberbank d.d. and Sberbank banka d.d. in 2022. However, it also suffers from certain well-known shortcomings, namely the lack of appropriate tools to manage the failure of some medium-sized banks. The current package seeks to remedy these shortcomings by giving authorities more options to minimise value destruction in a crisis. Industry-funded safety nets in the banking union - the national deposit guarantee funds and the Single Resolution Fund are comparable in size to those available in other regions, such as the United States. However, we are much more constrained in the way we can deploy these funds, meaning that the current framework risks delivering sub-optimal solutions for mid-sized banks. The CMDI package offers an opportunity to achieve targeted and substantial improvements to the framework, without changing the current institutional set-up within the banking union or affecting the current level of resources devoted to crisis management.

Looking ahead, some fundamental aspects of the broader crisis management architecture are not tackled by the CMDI proposal and will need to be addressed in the next legislative term. Adopting the third pillar of the banking union, i.e. a European deposit insurance scheme, and creating a European framework for liquidity in resolution are needed urgently. Genuine progress on cross-border integration within the banking union will be another priority for the next term. Last, the introduction of the common backstop to the European Stability Mechanism should proceed without delay.