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 13 May 2024

- Over the past decade, European banks have strengthened their financial positions and resilience. Changes in the external macroeconomic environment and new risks require a forward-looking risk assessment and a continued focus on resilience.
- ECB Banking Supervision is focusing on heightened macroeconomic and geopolitical risks, climate change and the impact of digitalisation. We are taking measures to make supervision more effective and efficient.
- The structural changes and challenges that lie ahead make completing the banking union and capital markets union a key priority. This will allow European banks to provide their services to households and firms while maintaining financial stability.

1 State of the European banking sector

During the first decade of the banking union, the resilience of European banks has strengthened. Legacy risks have been reduced, banks are better capitalised, and the new institutional framework of the banking union provides better tools for preventing and managing stress situations. These are significant achievements.

At the end of 2023 their average risk-weighted Common Equity Tier 1 (CET1) ratio for banks under the direct supervision of the ECB was 15.7%, up from 13.5% in 2015. This is the highest quality of regulatory capital as it absorbs losses immediately when they occur. Banks' fully phased-in leverage ratio has increased slightly to 5.7%, compared with 4.9% in 2016.[1] Banks' liquidity has remained well above regulatory requirements. Their average liquidity coverage ratio, which measures whether they have sufficient liquid assets to cover periods of short-term liquidity stress, stood at 164.4% at the end of 2023, while their net stable funding ratio, measuring the degree of stability of banks funding, was 126.5%. Bank profitability has also increased, largely driven by higher interest rates, with their return on equity reaching 9.3% in the last quarter of 2023. Moreover, asset quality has improved significantly over the last ten

[1] This measures the ratio between Tier 1 capital and on and off-balance sheet total exposures.

years. The non-performing loans (NPL) ratio, which was above 7% in 2015, fell to just 2.3% in the last quarter of 2023.

Table 1
Key indicators

	Q5 2015	Earliest figure2	Q4 2023
Number of supervised banks	117		107
CET1 ratio	13.5%		15.7%
Leverage ratio	N/A	4.9%	5.7%
Liquidity coverage ratio (LCR)	N/A	137.6%	164.4%
Net stable funding ratio (NSFR)	N/A	129.1%	126.5%
Return on equity	4.4%		9.3%
NPL ratio3	>7%4		2.3%

Source; ECB Banking Supervision statistics

Resilient, well-capitalised banks provide benefits to society. They are better equipped to absorb potential shocks and to compete with their international peers, and they contribute to economic growth by lending to the real economy. Bank funding continues to account for around 30% of the financing of European firms,[5] despite increasing competition from non-bank financial intermediaries. Well-capitalised banks are thus the backbone of a strong economy.

In recent years, European banks have had to demonstrate this resilience in the face of a series of external shocks. These include the COVID-19 pandemic, the energy crisis, Russia’s invasion of Ukraine and the turmoil on international banking markets in the spring of 2023, all of which have placed significant stress on European economies and societies. European banks have weathered these stress episodes well, thanks to their resilience. But they have also benefited from significant fiscal and monetary support that mitigated the impact of the shocks on their balance sheets. Unlike a typical recession, the recession caused by the pandemic did not lead to an increase in corporate insolvencies or in loan losses.

All this being said, while European banks may have coped well with yesterday’s problems, they must be able to withstand tomorrow’s challenges equally well. European banks are operating in an environment marked by new risks. Climate change, digitalisation, demographic trends and geopolitical risks require structural adjustments, both in the real economy and in the financial sector. And heightened competitive pressures are challenging banks’ profits margins, which may ultimately compromise their resilience and prompt them to take excessive risks.

[2] The leverage ratio and LCR figures are for the third quarter of 2016, while the NSFR figure is for the second quarter of 2021.

[3] This excludes cash balances at central banks and other demand deposits.

[4] Before the second quarter of 2020 cash balances and loans and advances were grouped together in the NPL reporting template, therefore it is not possible to calculate the NPL ratio (excluding cash balances) precisely before that period.

[5] Sources: Securities Holdings Statistics (SHSS), Centralised Securities Database (CSDB), ECB Statistical Data Warehouse and ECB calculations. See also slide 4 in Buch, C. (2024), “Banking union and financial integration in Europe: Where do we stand?”, 30 April.

There are several key dimensions to resilience. Well-capitalised and liquid banks are better able to withstand adverse shocks and continue lending in times of stress. Banks that strengthen their operational resilience and IT infrastructure will be able to confront the increase in cyber risks. And on a more general level, banks that have good governance and risk management systems in place will be resilient in the face of a broad range of challenges.

Strengthening banks' resilience requires forward-looking risk assessments. While capital and liquidity ratios are important indicators of a bank's soundness, they primarily take a backward-looking perspective. So these indicators must be complemented by a thorough analysis of new or emerging risks, which are not captured well by existing risk models. Banks' risks can increase as a result of direct exposures to countries or sectors affected by geopolitical shocks, but also due to the knock-on effects of weak growth, deteriorating investment sentiment or heightened inflationary pressures. And escalating geopolitical tensions could result in greater financial market volatility and trigger asset price corrections. Banks need to reflect these risks in their capital planning and internal stress tests.

A forward-looking perspective is also required when assessing the profitability of the banking sector. Bank profitability and valuations have recently improved due to higher interest rates. But the longer-term profitability outlook may deteriorate if funding costs increase, loan growth weakens or losses materialise. So far, higher interest rates have not been fully passed through to deposit rates. However, competitive pressure for deposits may lead to a stronger pass-through and thus higher funding costs for banks. The ability to pass higher costs on to customers in the form of higher interest rates on loans may be constrained by weak loan demand.6 In this uncertain environment, taxes on bank profits or administrative interest rate measures may weaken bank profitability and resilience. However, higher current profitability provides an opportunity for banks to strengthen their resilience, both in terms of capitalisation and investment in robust IT infrastructure.

2 ECB Banking Supervision's objectives and activities

Heightened macroeconomic and geopolitical risks, climate change and the impact of digitalisation are key priorities for the ECB's Supervisory Board in 2024-26. ECB Banking Supervision is thus focusing its attention on the following key areas.

First, the timely identification of credit risk and the proactive management of distressed debt remain at the top of our priorities. Banks must regularly monitor and adjust to emerging risks in their portfolios. Weaker growth and higher interest rates have already led to a larger inflow of NPLs in the small and medium-sized enterprises and commercial real estate portfolios. Yet defaults often only materialise with a

[6] In the April 2024 bank lending survey, euro area banks reported a slight additional tightening of credit standards for loans or credit lines to enterprises in the first quarter of 2024, with a net percentage of 3% of banks tightening. The cumulative tightening since 2022, coupled with a prolonged decrease in loan demand, has contributed to a significant decline in the growth of loans to firms. Expectations for the second quarter of 2024 suggest a moderate net tightening of 6%. For more information, see ECB (2024), *The euro area bank lending survey – First quarter of 2024*, April

significant delay after borrowers experience the first signs of stress, so banks need to ensure they take a forward-looking perspective on the financial situation of borrowers. If loans become non-performing, banks should react quickly and find solutions that minimise losses. However, there can be various obstacles to progress here, such as complex legal frameworks. For example, different insolvency laws across countries can complicate the NPL resolution process for banks with cross-border exposures.

Exposures to the real estate sector require particularly close monitoring. Higher interest rates are already impairing the debt servicing capacity of real estate firms. Moreover, the aggregated index for euro area commercial real estate prices had fallen by 8.7% year-on-year by the fourth quarter of 2023[7], which has lowered the valuations of banks' collateral. Both of these factors can lead to losses for banks, which need to ensure they have adequate risk monitoring in place and that they make sufficient provisions for loan losses. ECB Banking Supervision identified commercial real estate risks as a priority and started dedicated on-site reviews as early as 2018. Currently we are focusing on banks with material commercial real estate portfolios, particularly in countries that are experiencing sharp market corrections where there are already signs of asset quality deterioration. Intensified engagement and risk monitoring is now in place to ensure that affected banks deal with real estate risks proactively.

We have also been closely monitoring the presence of significant banks in Russia. Exposures appear to be quite contained, and direct exposures fell by 55% between the end of 2021 and the end of 2023. Some banks have even managed to fully exit the Russian market. ECB Banking Supervision has asked all other banks with significant exposures to Russia to speed up their de-risking efforts by setting a clear roadmap for downsizing and exiting the Russian market.

Second, in the current environment, the management of liquidity risk is becoming more important. Monetary policy has moved from quantitative easing to quantitative tightening, which has triggered changes to the liquidity and funding mix of significant banks. The two main liquidity ratios – the LCR, measuring whether banks have enough liquid assets for short-term needs during a crisis, and the NSFR, which shows whether funding for banks' long-term assets is sufficiently stable – are still at comfortable levels. Supervisory assessments of banks' funding plans show that the underlying scenarios are quite diverse and sometimes not sufficiently prudent. In addition, banks' assumptions about their ability to generate liquidity by selling assets or borrowing against assets are often quite optimistic.[8] Supervisors therefore emphasise the need for banks to have robust liquidity management and take measures when banks are insufficiently resilient to short-term liquidity shocks.

[7] This figure is based on an aggregate transactions-based index available in the ECB's Statistical Data Warehouse.

[8] More specifically, some significant institutions tend to be too optimistic in their assumptions regarding the "time-to-liquidity" of available unencumbered assets – in other words, how quickly a bank can access cash or liquid funds from its unrestricted assets (which, in this case, are either central bank-eligible assets or assets eligible for other secured funding transactions).

Third, increased cyber risks are a key vulnerability for European banks.[9] The impact of cyber risks on banks continued to grow in 2023, as more cyberattacks and incidents were recorded and the resulting losses increased.[10] Against this background, the ECB is conducting a cyber resilience stress test, which focuses on banks' response and recovery mechanisms in the event of a severe but plausible cyberattack. The aggregate results of this exercise will be published in the summer and supervisors will follow up on bank-specific findings. In addition to the cyber resilience stress tests, the ECB performs regular assessments of banks' IT risk management.

Fourth, climate change leads to transition and physical risks that, until recently, have barely been accounted for in banks' risk management. Physical risks affect the real economy and can lead to losses in banks' loan portfolios.[11] Banks are also exposed to transition risks that can affect the debt sustainability of their borrowers. These are risks that banks need to assess and manage. While they have taken steps to integrate climate-related and environmental (C&E) risks into their strategy, governance and risk management, a number of banks are yet to adequately assess the materiality of C&E risks. To ensure that banks address these risks, in November 2020 ECB Banking Supervision published supervisory expectations that include institution-specific remediation deadlines leading up to the end of 2024.[12] If banks do not comply with our supervisory expectations, we will take appropriate measures that may include periodic penalty payments.[13]

Fifth, periods of stress may expose weaknesses in banks' governance structures and in the sustainability of their business models. The failure of Silicon Valley Bank in March 2023 showed how poor risk management can lead to bank distress in the face of an external shock such as rapidly increasing interest rates. Therefore, banks need effective risk management and information systems, which are both areas where we have identified weaknesses in the past.[14] As regards governance, diverse management bodies are needed to avoid groupthink and strengthen risk management. Banks' ability to deal with digitalisation and geopolitical risks is key for the sustainability of their business models. The ECB continues its

9 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. In order to better address cyber risk at the systemic level, the ECB is actively participating in G7 cyber exercises. They rehearse international cyber crisis response protocols and coordination with other supervisory authorities, including those outside the remit of European banking supervision or the EU.

10 While the economic impact of cyber risks is difficult to quantify precisely, the growth of these risks can be seen in the ECB's data collection (IT Risk Questionnaire, losses due to cyberattacks and confidentiality incidents) as well as the IMF Global Financial Stability Report published in April 2024 (see Chapter 3 on cyber risks) and the ECB's Financial Stability Review (see the November 2023 and November 2022 editions).

11 For example, the large-scale floods in Germany and Belgium in 2021 resulted in physical damage amounting to €44 billion and the 2023 floods in Slovenia led to losses equivalent to 16% of national GDP. See European Environment Agency (2024), "European climate risk assessment", *EEA Report*, No 01.

12 By the end of 2024, banks are expected to meet all remaining supervisory expectations on C&E risks, including full integration in the internal capital adequacy assessment process (ICAAP) and stress testing. By the end of 2023, banks were requested to include C&E risks in their governance, strategy and risk management.

13 Elderson, F. (2024), "Making banks resilient to climate and environmental risks – good practices to overcome the remaining stumbling blocks", speech at the 331st European Banking Federation Executive Committee meeting, 14 March.

14 For more information on the work done in this regard, see McCaul, E. (2024), "Risk data aggregation and risk reporting: ramping up supervisory effectiveness", *The Supervision Blog*, ECB, 14 March.

targeted analysis of management body effectiveness and we will publish an updated guide on governance and risk culture in the coming months.

To be able to successfully focus on these risks, supervision itself must be effective and efficient. In a drive to improve effectiveness, ECB Banking Supervision is now implementing recommendations from the report of an external expert group.[15] A new multi-year approach and an updated risk tolerance framework ensure a better prioritisation of risks and a more efficient use of supervisory resources. To improve communication to banks, we now send an executive letter that summarises the main supervisory findings, including the qualitative measures issued for risks that are not easily quantifiable. The expert group also recommended to simplify methodologies and better integrate different types of supervisory activities. Further details will be published on the ECB Banking Supervision website soon, and full deployment of these enhanced practices will start with the 2025 supervisory cycle.

3 Regulatory and institutional issues

Given the challenges and structural changes that lie ahead, completing the banking union and strengthening banks' resilience remain critically important. This will preserve banks' competitiveness and ensure that the banking system can contribute to the sustainable growth of the European economy. A truly integrated single market for financial services, with a complete banking union at its heart, will guarantee that businesses and households have access to sufficient and affordable funding and that risks are shared.

This is why the ECB welcomes the adoption of the new banking package by the Council and the Parliament.[16] This marks the end of a long reform path that started after the global financial crisis and aimed at making banks more resilient to shocks while protecting taxpayers' money. The Basel III reforms contribute to a stable global financial system and as such are in the interest of European banks. Basel III enhances bank solvency and profitability, and these long-term economic benefits outweigh any potential short-term costs of implementing the package, as shown by an ECB study.[17] Impact studies of the Basel III reforms by the Basel Committee on Banking Supervision[18] and the European Banking Authority[19] similarly show the positive effects of the reforms on bank resilience. Well-capitalised banks can lend more and are more

[15] ECB (2023), "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,* April.

[16] The new banking package consists of the Capital Requirements Regulation III (CRR III) and Capital Requirements Directive IV (CRD IV).

[17] Budnik, K. et al. (2021), "Macroeconomic impact of Basel III finalisation on the euro area", *Macroprudential Bulletin*, No 14, ECB, 26 July. In this paper, the effects on potential growth of the Basel III package are assessed under normal and adverse economic conditions. Short-term economic costs correspond to the effect of the new rules under normal economic conditions, contributing to a slowdown in economic expansion during the initial phase of Basel III implementation.

[18] Basel Committee on Banking Supervision (2022), *Evaluation of the impact and efficacy of the Basel III reforms*, Bank for International Settlements, December.

[19] European Banking Authority (2019), *Basel III reforms: Impact study and key recommendations*, 4 December.

competitive. Despite initial concerns, the higher capital requirements imposed since the global financial crisis have not curtailed lending to the real economy.

Applying the new rules from 1 January 2025 will also provide legal and regulatory certainty. And any deviations from Basel should be monitored to assess their effects.

Swift progress on the crisis management and deposit insurance (CMDI) package is equally critical. Strong supervision and credible resolution are two sides of the same coin. Effective supervision reduces the risk of bank failure, but it does not eliminate it entirely. The more credible the resolution framework, the stronger the incentives for banks to manage risks well to avoid becoming distressed. The CMDI package improves the rules for handling the failure of medium-sized banks and ensures effective access to industry-funded safety nets, subject to sufficient safeguards. As a result, the package helps to better protect taxpayers from the costs of bank failure. We welcome the European Parliament adopting its final reports on the package and we stand ready to offer our technical expertise to support the Council Presidency in reaching an agreement.

In addition, creating a European framework for liquidity in resolution is still needed urgently. The delay in introducing the European Stability Mechanism's common backstop to the Single Resolution Fund is another important gap that needs to be closed.

At the same time, it is crucial to establish the third pillar of the banking union, a European deposit insurance scheme (EDIS). It would allow better risk-sharing, promote further banking market integration, and further enhance the credibility of resolution. The ECB therefore welcomes the fact that the ECON Committee of the European Parliament has adopted a position on the Commission's EDIS proposal. It is an important signal of its commitment to completing the banking union and encourages the EU co-legislators to make further progress.

Progress is also needed on the capital markets union (CMU). Banking union and capital markets union are complementary. Advancing the CMU is critical for the European economy, not least to support the private investment needed for the green transition and digital transformation. The recent statements on this topic by the Eurogroup[20] and the European Council[21], as well as the ECB Governing Council,[22] can be important building blocks for future progress on CMU in the coming legislative term.

Last, we very much welcome the upcoming single rulebook on anti-money laundering and countering the financing of terrorism and the imminent establishment of the EU Anti-Money Laundering Authority (AMLA). We stand

[20] Council of the European Union (2024), *Statement of the Eurogroup in inclusive format on the future of Capital Markets Union*, 11 March.

[21] European Council (2024), *Special meeting of the European Council (17 and 18 April 2024) – Conclusions*, 18 April.

[22] European Central Bank (2024), *Statement by the ECB Governing Council on advancing the Capital Markets Union*, 7 March.

ready to work closely with AMLA to strengthen the fight against money laundering and terrorist financing across Europe.