Written overview ahead of the exchange of views of the Chair of the Supervisory Board of the ECB with the Eurogroup on 4 April 2022

This short note provides the Eurogroup of 4 April 2022 with an update on (i) the banking sector outlook and the supervisory activity in the current geopolitical context, (ii) the Single Supervisory Mechanism (SSM) priorities, and (iii) the ECB's stance on the reforms agenda.

1 Invasion of Ukraine: banking sector outlook and supervisory activity in the euro area

Only six months have passed since we last met and exchanged views. Still, we meet today in what is in many respects a completely different world. The Russian invasion of Ukraine is causing human suffering and the displacement of millions right at the European Union's borders. It is changing the global geopolitical order, and threatening global food and energy security in Europe and beyond.

In the euro area, banks face this second exogenous shock in a robust prudential position, which has so far enabled the sector to navigate heightened uncertainty and volatility without any significant disruptions.

At the end of the third quarter of 2021, banks' capital position had improved with respect to the pre-pandemic period (CET1 ratio 15.5% and leverage ratio 5.9%). Liquidity buffers had reached levels far above the regulatory minima (LCR 173.8%) and asset quality had been on a steady path of improvement (NPL ratio 2.2%).

On the back of limited concerns about the effect of the pandemic on asset quality, a strong rebound in banks' profitability and the prospects of a gradual exit from the low interest rate environment, the period prior to the conflict saw a long-awaited improvement in investors' stance on European banks. This was reflected in rising stock market valuations, improving price-to-book ratios and an overall bullish market analysis.

The escalation of the conflict, the array of EU and international sanctions deployed against Russian counterparties and the Russian Federation's retaliatory measures have abruptly halted that trend, increasing uncertainty and prompting concerns over potentially numerous channels of impact. In recent weeks ECB Banking Supervision has been fully mobilised to monitor the impact of geopolitical developments on euro area banks, and has taken supervisory actions when needed.

In our view, direct exposures of euro area banks to Russian counterparties remain contained and thus generally manageable. Credit exposures to Russian counterparties are mostly concentrated in a handful of significant institutions. At the end of 2021 these exposures amounted to approximately €70 billion (or slightly above €100 billion when including the original exposure value of off-balance sheet commitments).[1] Preliminary indications are that entities hit directly by EU sanctions represent only a very minor share of total credit exposure. Our indications also show that significant institutions have limited amounts of securities (around €5 billion[2]) and derivatives exposures to Russian counterparties.

Sanctions and retaliatory measures are prompting banks to reduce their direct exposure to Russia in terms of cross-border credit and derivative positions, and, under extreme conditions, may lead them to consider

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[1] Data refer to the fourth quarter of 2021 and reflect the highest level of consolidation.

[2] Data refer to the third quarter of 2021.

selling or abandoning their Russian operations. Some of them have already publicly announced that they intend to do so. ECB Banking Supervision is in close contact with the institutions most affected to ensure all the potential risks and operational aspects involved in such decisions are duly taken into account. According to preliminary ECB estimates, in an exit scenario from the Russian market[3] that assumes the full write-off of direct cross-border exposures to Russian counterparts (approximately €25 billion[4]) and of the equity held in Russian subsidiaries, the average CET1 capital depletion suffered by the nine euro area banking groups with a presence in Russia would range between approximately 70 and 95 basis points[5]. The precise figures would depend on how such groups manage to close intra-group exposures to their Russian subsidiaries, including intra-group funding and open derivative positions. Individual capital depletion figures would in any scenario remain below 200 basis points, and significant institutions with Russian subsidiaries would maintain headroom above capital requirements and guidance.

In the current environment, institutions located in the euro area which are Russian-owned or have direct links to Russia may also be put under pressure. After the first round of sanctions, Sberbank Europe AG and its subsidiaries in Croatia and Slovenia experienced a sharp deterioration in their liquidity situation, and were declared failing or likely to fail. Resolution, and in particular the sale of business tool, was promptly and successfully applied to the euro area subsidiaries, allowing operations to resume without major disruptions for depositors and clients. More recently, RCB Bank decided to phase out its operations by selling performing assets to a competitor on the Cypriot market and proceeding with the orderly repayment of all depositors. EBC Banking Supervision approved the deal, imposed restrictions on the bank's business and appointed a temporary administrator to ensure the orderly wind-down of banking activities, with full repayment of depositors and the cancellation of its licence. Other EU-based subsidiaries of Russian parent institutions are under the direct supervision of national competent authorities. In this case, ECB Banking Supervision fulfils its oversight role by monitoring the situation and working closely with the national competent authorities.

While direct impacts are more easily identifiable, there are also several indirect economic and financial channels of impact which by definition are more complex to track. While none of these channels have so far led to market disruptions and material losses for euro area banks, they all merit close monitoring.

First, in addition to direct credit exposures to Russian entities, euro area banks may hold concentrated indirect exposures to Russia. These are credit or counterparty credit positions vis-à-vis corporate and financial entities whose creditworthiness, in turn, heavily depends on that of sanctioned counterparties, other affected Russian counterparties or, more broadly, the Russian sovereign issuer. While regulated non-bank financial entities (NBFIs), such as investment funds and insurance and pension funds, have very few direct exposures to Russia, a similar picture is not available for non-regulated market players.

Second, some euro area banks may finance large market players heavily affected by the heightened volatility of commodity and energy prices. Commodity traders are one such example, typically appearing among the top 50 clients of globally active banks. According to public disclosures, at global level commodity traders have outstanding bank loans of around €80 to €100 billion. Around one third of this amount may stem from institutions supervised by the ECB. Also in this case, to the extent that regulated and unregulated funds are exposed to commodity and energy sectors, liquidity stress suffered by such funds may feed back to banks through their connections with NBFIs. More broadly, the exceptional volatility of currencies and commodity prices caused by the geopolitical crisis may occasionally cause spikes in margin calls and other counterparty

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[3] The impact figures presented here also include the exit from the markets of Ukraine and Belarus. Cross-border exposures and exposures held by euro area-owned subsidiaries in these two markets represent, however, an extremely minor share of the total exposures considered.

[4] Net of provisions and offshore collateral, i.e. collateral located outside the areas involved in the conflict.

[5] Before taxes.

credit risk management difficulties, particularly at banks that operate as clearing members and offer correspondent banking services.

In view of the liquidity risk that may arise from counterparty credit services and credit lines offered to commodity-focused clients, we have made this a focus of our ongoing dialogue with affected banks. As part of this dialogue, we also request further information needed to assess the magnitude of this risk.

The wider deterioration of the global economic outlook represents perhaps the most visible channel of the indirect impact of the current crisis on the banking sector, and something euro area banks will have to take into account in their capital planning. According to revised macroeconomic projections published by the ECB last month, as a result of the invasion of Ukraine real GDP growth will be 50 basis points lower this year and will only revert to the previously forecasted trajectory by mid-2023. The inflation rate, mainly driven by commodity prices and supply bottlenecks, will also be significantly higher than previously forecasted in 2022, and revert to the pre-conflict trajectory by mid-2023. In a more severe scenario, our economy would experience a more pronounced slowdown in GDP growth in 2022 (140 basis points below the baseline projection), while inflation would spike to 7.1%.

In addition to economic and financial risks, cyber risk remains a concrete threat stemming from the ongoing conflict, even though no major events have occurred in the European Union so far.

While the institutions most affected by the invasion of Ukraine are revising their capital trajectories and associated distribution plans, the resilience shown throughout the pandemic and up to the current phase of geopolitical crisis, coupled with the strong rebound in profitability recorded in the last part of 2021, will allow the banking sector to slightly catch up with the distributions planned for 2022 to achieve an aggregate payout ratio of around 50%, which includes the extraordinary distribution of accumulated excess capital in the form of share buybacks. As recently stated to the public, the ECB is taking a purely bank-specific approach to distribution plans, guided by the credibility of the individual banks' capital plans.

2 European banking supervision priorities

With the conflict in Ukraine taking centre stage, at least in the short run, the supervisory priorities for the 2022-2024 period that the ECB set last year are not only still valid, but potentially assume increased relevance.

The first of our supervisory priorities – ensuring banks emerge healthy from the pandemic – will principally focus on banks' credit risk controls, ranging from risk identification and classification practices to provisioning policies. With the implications of the conflict in Ukraine becoming clearer, the planned analysis of the sectors and portfolios typically hit by the pandemic, such as commercial real estate, will have to be accompanied by close monitoring of those sectors and portfolios linked to commodities and energy, that are most likely to suffer as a result of the geopolitical shock.

During periods of heightened volatility, such as the one we are currently experiencing, we need to increase our scrutiny of the leveraged lending business, which makes banks vulnerable to abrupt financial market adjustments. Therefore, at the end of March we sent a dear CEO letter to all the banks most active in this business, further specifying our expectations on the importance of setting well-defined risk appetite frameworks.

Increased financial market volatility is, more generally, a reason for intensified supervisory focus on the impact that sudden interest rate shocks may have on banks' balance sheets. It remains therefore essential that banks are adequately prepared to withstand such market shocks, and are able to adjust their risk management practices promptly.

In addition, structural challenges that predate the pandemic and the current uncertain geopolitical situation continue to weigh on banks, including the need to boost digitalisation as an avenue of business model sustainability and the need to resolve long-term governance deficiencies.

As part of our third supervisory priority, we will tackle emerging risks, which we have identified in the areas of i) IT and cyber security, ii) counterparty credit risk management, and iii) climate-related and environmental risks.

Even if no incidents to date can be imputed to the fallout from Ukraine, the geopolitical crisis culminating in the invasion of Ukraine has – at least in the short to medium term – substantially increased , the risk of cyber attacks and the need for banks to improve their operational resilience.

As I mentioned earlier, counterparty credit risk has come under intensified scrutiny since commodity prices have become subject to heightened volatility. Besides looking at the specific risks stemming from the current stressed environment, we are carrying out a broader review of counterparty credit risk management practices following the lessons learnt from the Archegos case and broader concerns regarding the bank-NBFI nexus. While we will substantiate our scrutiny later this year by means of targeted onsite inspections on counterparty credit risk, last month we already communicated to a set of banks most active in the prime brokerage and investment fund business our expectations in terms of client onboarding, risk management, margining practices and default management processes. In relation to global businesses such as prime brokerage, we intend to intensify our cooperation with other authorities, in particular the Bank of England's Prudential Regulation Authority and the US Federal Reserve System.

The fallout from the war in Ukraine, and in particular the threats to energy and food security that are emerging, may lead to increased use of fossil fuels and thus put at risk the global climate agenda. It is today more important than ever to deploy all possible efforts to stick to the commitments made. As physical and transition risks already pose substantial challenges to banks in the near term, it is vital that banks adequately incorporate climate-related and environmental, or C&E risks, into their business strategy, governance and risk management frameworks. In this regard, ECB Banking Supervision is currently conducting a thematic review to assess banks' progress towards achieving this objective, as well as a climate stress test to assess banks' resilience and risk management capacity in this area. In view of the upcoming regulatory requirements, banks also need to make sufficient progress towards aligning their disclosure practices with supervisory expectations.

3 The importance of the reform agenda

Even in these current times of turmoil, it is important not to lose sight of the reform agenda, as better regulatory and institutional frameworks make our banks more resilient and better able to support citizens and the wider economy under all possible scenarios. We have learnt this the hard way during the coronavirus pandemic and may see more of it in the current environment.

For these reasons, although we are all very much focused on the risks arising from the geopolitical crisis, let me reiterate the importance of swiftly finalising and implementing the banking package, which, as formulated by the Commission, introduces some very welcome new provisions, including in the areas of environmental, social and governance (ESG) risks, fit and proper assessment of banks' directors and key staff, and the supervision of third country branches. As the ECB stated in its first opinion on the reform, published at the end of March and focused on the proposed amendments to the Capital Requirements Regulation (CRR), several worrying deviations from the Basel III standards on the requirements applicable to real estate exposures, unrated corporate exposures and exposures to counterparty credit risk should be removed as they contribute to making the regulatory framework less solid. Furthermore, in order to take a concrete step towards a more integrated banking market, the legislator should consider applying the output floor requirement only at the highest level of consolidation.

Lastly, let me remind you of the importance of making progress with the completion of the banking union, in order to provide euro area banks with the institutional framework that best ensures their resilience and potential for growth and competitiveness. A clear roadmap to a fully-fledged European deposit insurance scheme, and a parallel removal of the constraints impeding a more integrated management of capital and liquidity within the banking union would provide banks with a much-needed European compass to guide the ongoing refocusing of their business models.

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