



# Written overview ahead of the exchange of views of the Chair of the Supervisory Board of the ECB with the Eurogroup on 4 October 2021

This short note provides the Eurogroup of 4 October 2021 with an overview of the activities of ECB Banking Supervision in the areas of (i) credit risk related to the coronavirus (COVID-19) pandemic, (ii) emerging risks, (iii) the structural transformation of the banking sector, and (iv) digitalisation and climate risk as drivers of structural business model adjustments.

## 1 Impact of the COVID-19 pandemic on credit risk

The support measures adopted in response to the COVID-19 pandemic played a crucial role in ensuring access to financing for the real economy. The economic outlook is improving, and this is good news. The September ECB staff macroeconomic projections indicate that real GDP will surpass pre-crisis levels by the end of 2021.<sup>1</sup>

Non-performing loan (NPL) ratios continued their declining trend in the first quarter of this year to stand at 2.54% in the first quarter of 2021, down from 3.22% in the fourth quarter of 2019. The typical time lag between episodes of corporate distress and the materialisation of NPLs is likely to be longer during this crisis given that several public support measures are still in place.

However, faster-moving indicators, such as the share of forborne loans (1.15% in the first quarter of 2021, up from 0.82% in the fourth quarter of 2019) and the share of Stage 2 loans<sup>2</sup> (8.77% in the first quarter of 2021, up from 7.87% in the second quarter of 2020), are already showing signs of asset quality deterioration.

In addition, in the first quarter of 2021, bankruptcies started to pick up from their subdued 2020 levels but remain below their pre-pandemic levels in most sectors (Chart 1). A further increase can be expected, particularly once support measures are phased out.

Therefore, banks need to properly monitor and classify individual debtors in order to identify distress at an early stage and provide appropriate solutions to these debtors in a timely manner.

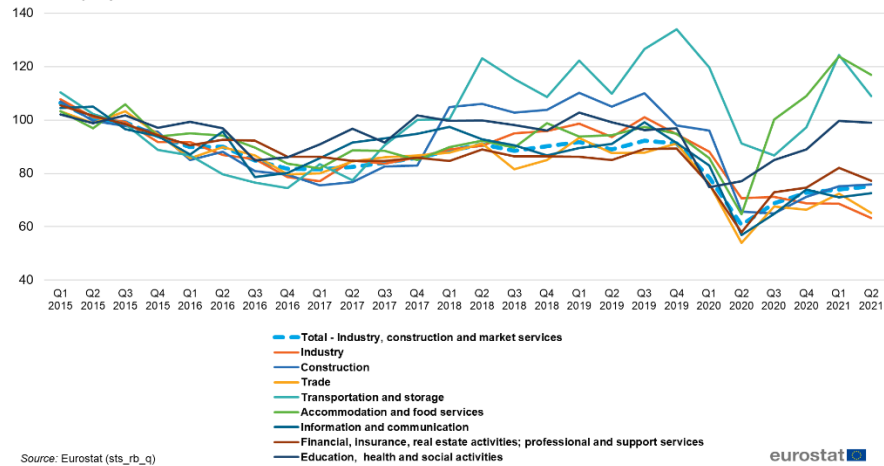
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<sup>1</sup> See European Central Bank (2021), "[ECB staff macroeconomic projections for the euro area, September 2021](#)".

<sup>2</sup> These are loans which have experienced a significant increase in credit risk.

## Chart 1

EU (available countries), declarations of bankruptcies by activity, Q1 2015 to Q2 2021



Source: Eurostat.

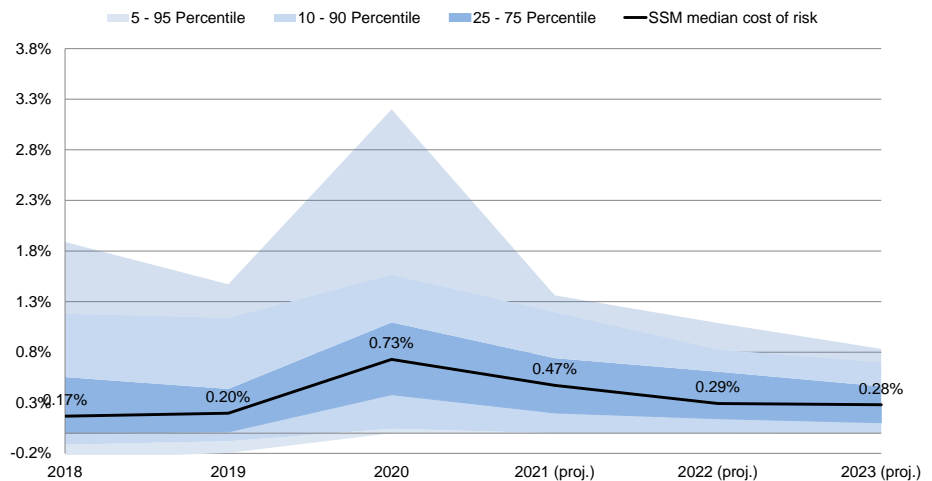
Note: index: 2015=100, declarations are seasonally adjusted.

For this reason, and since risk levels are hard to estimate at the current juncture, our supervisory focus was initially on risk controls. We communicated our expectations to banks on their operational preparedness and credit risk management, classification and measurement and are following up with individual banks to ensure that any gaps identified are properly addressed. In addition, we are currently performing deep dives into vulnerable sectors such as food and accommodation services and commercial real estate.

At the beginning of the year, banks projected a slight increase in their profitability in 2021 and an accelerated recovery to pre-crisis levels by 2023, fuelled by a strong reduction in impairments (Chart 2). Now, it appears that profitability is recovering even faster, having already returned to pre-pandemic levels in the first half of the year.

## Chart 2

Significant institutions' projections of impairments for 2021-23  
(impairments to financial assets over average loans to households and NFC,  
percentage)



Sources: ECB (FINREP) and EBA funding plans.

Notes: The sample comprises 91 significant institutions. Impairment is calculated as aggregate impairments to financial assets over average loans to households and non-financial corporations.

Specifically, banks projected that from 2021 onwards, the highest impairment charges recorded will be significantly lower than the highest impairment charges seen in 2018 and 2019.

Banks' NPLs projections may not adequately capture a continued potential for a deterioration of asset quality in the aftermath of the pandemic, therefore supporting rosy profitability prospects. Sound profitability should be grounded in medium to long-term value creation opportunities and structural transformation plans.

## 2 Emerging risks

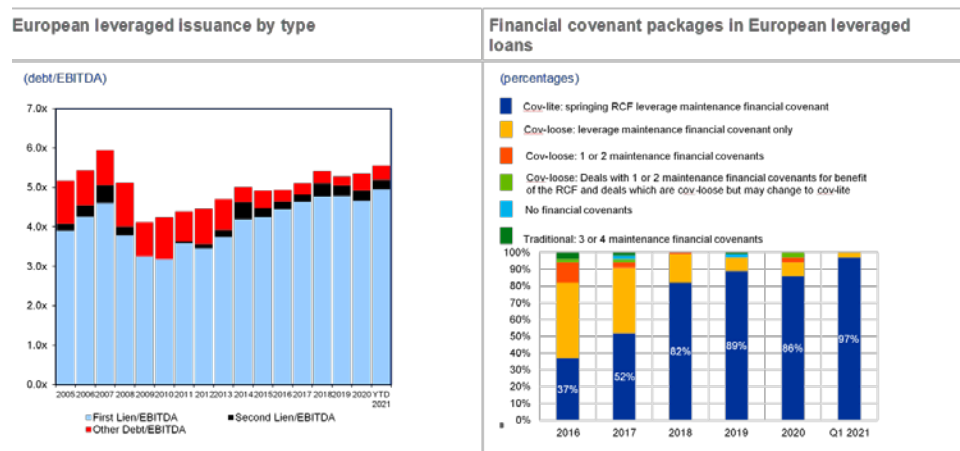
Beyond credit risk, there are other emerging risks which may warrant supervisory action. Unprecedented levels of liquidity and the wide array of government support measures have dampened financial market volatility and muted market participants' perceptions of uncertainty and risk. However, those same measures may be fomenting and exacerbating an environment of muted risk sentiment and market exuberance. There was already evidence of risk mispricing in some market segments before the pandemic, and the appetite for financial leverage and financial complexity has also been growing.

There has been steady growth in leveraged loan and high-yield bond markets since the great financial crisis and risks are building up. These markets feature highly indebted corporate counterparties of speculative-grade credit quality.

The market for leveraged credit is global and highly interconnected and the investor base is now broad, featuring both bank and non-bank financial entities. Therefore, banks face both direct and indirect risks when taking on excessive exposures in these markets.

Market expansion in a search-for-yield environment has been characterised by a loosening of underwriting standards and covenants, even during the pandemic.

**Chart 3**

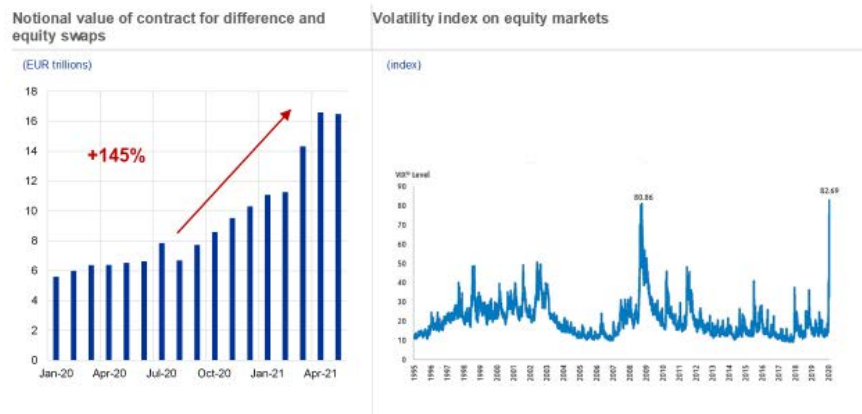


Source: Left-hand panel: LCD, an offering of S&P Global Market Intelligence; right-hand panel: Reorg

The COVID-19 shock brought the leveraged loan market to a complete standstill in March 2020. Unprecedented public support measures have so far kept default rates low, incentivising further increased risk-taking and making these markets highly vulnerable to further shocks. ECB Banking Supervision is assessing market practices against its supervisory guidance and will take action, if necessary.

Turning to the equity market, overvaluation concerns have been intensifying following strong price increases in recent months. Market participants across the globe have been increasing their exposure to financial products with intrinsic leverage such as equity derivatives. European Market Infrastructure Regulation data show that, for the euro area, the volume of equity swaps and total return swap contracts for difference reached nearly €15 trillion in the first quarter of 2021.

**Chart 4**



Source: Left-hand panel: ECB; right-hand panel: VIX.

These developments are accompanied by growing signs of complacency on the part of market participants, including banks, which has led to higher levels of leverage, financial complexity and opaqueness.

The defaults of some hedge funds and, more recently, of the Archegos family office, are a reminder for the banking and supervisory community of the importance of sound counterparty credit risk management practices, including client acceptance, margining, early identification of problematic counterparties and default management. Such events also highlight the risks arising from the interconnectedness between the banking sector and non-banking financial institutions.

This build-up of risk exposes the banking sector to potentially abrupt and pronounced asset price corrections. As experience shows, these could be triggered by changes in global investors' expectations regarding the path of inflation and interest rates. ECB Banking Supervision is engaging more intensively with bank boards and risk officers to ensure that these threats are properly considered.

### 3 The structural transformation of the European banking sector

The ability to sustainably generate profits is crucial for a resilient banking system. Low profitability has been a long-standing challenge for the European banking sector. It is deeply rooted in cyclical factors, such as the deterioration of asset quality and the low interest rate environment that followed the financial and sovereign debt crises, and in structural factors, including overcapacity and the increasing competition from the fintech sector.

The pandemic will further delay the normalisation of the interest rate environment and has intensified the pressure on banks' interest margins and interest income. There are also signs that the pandemic has accelerated the digital transformation process, potentially offering new avenues for cost optimisation and revenue growth but also fostering competitive pressure among banks and from non-banks. For these

reasons, instead of waiting for the business environment to normalise, banks should already be taking structural measures and engaging in business model transformation.

Some banks have already taken action. Our evidence suggests that notwithstanding high upfront restructuring costs, banks can make tangible improvements if they see beyond hasty cost-cutting measures and engage in strategic development plans, investing in cost optimisation, digitalising processes, and identifying business that creates value. Furthermore, diversifying sources of income and placing greater importance on fee-generating business has enabled banks to increase this type of revenue compared with before the pandemic.

Anecdotal evidence also points to several recent cases of targeted acquisitions or disposals of whole business lines, for instance in areas that generate fee and commission income, such as asset management, custodian services and payment technology, including across borders. Alongside this positive trend, banks should expand where justified by scale or diversification drivers, but also exit from business that is no longer profitable.

Last year also saw fully fledged bank consolidations gaining some momentum, with merger and acquisition transactions reaching a value not seen since 2008. While it takes time for the benefits of consolidation to fully materialise, it could lead to synergies and greater efficiency, reducing the excess capacity prevalent in the banking sector since the great financial crisis.

It is up to banks' management to choose to take specific strategic action. Our role, which we are determined to play actively, is to ensure that this diversity of business models develops in a safe and sound way.

While acquisitions of targeted business lines have had a certain cross-border dimension, bank consolidations are still predominantly national, and banking markets remain fragmented along national lines. It is clear that the process of deepening cross-border integration of the European banking sector would speed up significantly if we could make strides towards a fully-fledged banking union, with all three pillars in place.

That said, there are avenues to support deeper cross-border integration of financial and banking markets, within the current legal framework. One possible avenue is to design safeguards, such as intragroup guarantees introduced in recovery plans, to give greater room for managing liquidity at group level when cross-border business within the banking union is developed mainly through subsidiaries.<sup>3</sup>

Another avenue is for banks themselves to review their cross-border organisational structure more actively, keeping in mind the aim of banking sector integration. In particular, they could rely more extensively on branches, rather than subsidiaries, and the free provision of services to develop cross-border business within the

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<sup>3</sup> See Enria, A. and Fernandez-Bollo, E., "[Fostering the cross-border integration of banking groups in the banking union](#)", The Supervision Blog, ECB Banking Supervision, October 2020.

banking union and the Single Market.<sup>4</sup> When relocating their business to the euro area, several banking groups made use of the Statute for a European Company and the Cross-border Merger Directive<sup>5</sup> in order to streamline their legal structure, largely relying on branches to serve customers across the euro area. This should provide food for thought for the boards of other banks.

Such large reorganisations do involve significant complexities. And there are some disincentives in current EU banking legislation (in particular the Deposit Guarantee Scheme Directive), which we would support removing. These include the current rules for transferring deposit insurance contributions once the deposits of a credit institution leave a specific deposit guarantee scheme to join another one.

Nevertheless, we see considerable promise in supporting banks to engage in such reorganisations. In our discussions with the small number of groups that have embarked on such projects, they have reported significant efficiency gains in the form of simplified legal structures and corporate governance, savings related to annual accounts and internal audit and lower overall regulatory requirements, among many other things.

## 4 Adjustments to business models driven by digitalisation and climate risk

Moving on from structural issues to more concrete challenges, two important drivers of banks' business model adjustments are, and will continue to be, digitalisation and climate risk.

### 4.1 Digitalisation

Digitalisation and the use of innovative technologies have a major impact on (i) banks' business models in terms of revenue generation and cost control, and (ii) banks' risk profiles, as technologies affect a bank's activity across several dimensions.

Accordingly, our supervisory focus is on monitoring banks' digital transformation strategies and assessing the risks facing banks as a result of changes to their business models and the use of technologies.

We are currently conducting preparatory work to develop additional internal guidance for supervisors to assess banks' digital transformation efforts in line with existing European Banking Authority standards. Similar internal methodologies are being developed to assess risks stemming from new technologies, such as artificial intelligence, application programming interfaces, and distributed ledger technology/blockchain.

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<sup>4</sup> See Enria, A., "How can we make the most of an incomplete banking union?", September 2021.

<sup>5</sup> Directive (EU) 2017/1132, subsequently amended by Directive (EU) 2019/2121

We will engage with banks showing material deficiencies, assess remedial plans and contemplate escalation mechanisms. In the same vein, targeted on-site inspections are planned for areas where material deficiencies have been identified. These supervisory activities will inform horizontal assessments of banks' digital transformation approaches and their use of new technologies.

With the ongoing digital transformation, banks are becoming more exposed to cyber threats. Recent evidence suggests that cybercriminals are becoming more sophisticated, and attacks are becoming more frequent. A vigilant approach is therefore required, involving continuous improvements to defence mechanisms and control frameworks including prevention, early detection, and swift reaction.

In addition to the rise in cyber threats, the growing digital footprint, and increased interconnections within and outside the financial sector require an ongoing strong IT risk management. This has been a priority topic for ECB Banking Supervision since its inception and its importance has recently been acknowledged by the legislator in the context of the Digital Operational Resilience Act (DORA).

More generally, we need to ensure that the overall regulatory and supervisory framework remains adequate for the changing financial market landscape. The initiatives taken at European level in the context of the digital finance package are therefore important and welcome. They include the draft legislative proposal on crypto assets, the proposal on market infrastructures based on distributed-ledger technologies and DORA. The proposals currently under discussion could also lead to supervisory scrutiny of operational resilience being extended to relevant non-bank entities, as a failure to ensure continuity of services on their part could trigger major disruptions in the provision of financial services.

## 4.2 Climate risk

The transition to an environmentally resilient economy affects almost all sectors of the economy and has widespread effects across regions. This extensive impact warrants bespoke strategies and enhanced risk management capabilities to ensure the resilience of banks' business models and strategies in the short, medium and long term.

The need for banks to make further progress in understanding how their business model and risk profile are affected by climate-related and environmental risks is also reflected in the outcome of our assessment of banks' current practices. To date, more than half of significant institutions have no approach in place for assessing the impact of climate risks and 90% of practices are assessed by the banks themselves to be only partially or not at all aligned with the ECB's supervisory expectations.<sup>6</sup> In this context, if remedial action is not taken, the banking sector will remain exposed to the risks associated with the transition and adaptation to a more sustainable

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<sup>6</sup> See European Central Bank (2021), "[The clock is ticking for banks to manage climate and environmental risks](#)", Supervision Newsletter, August.



economy, increasing the likelihood of sudden build-ups of prudential risks for individual banks.

To ensure that banks comprehensively address climate-related risks in their strategy, governance, risk management and disclosures, ECB Banking Supervision is engaged in a supervisory dialogue with banks and expects banks to take decisive action to advance their practices. To assess banks' progress and determine further follow-up actions, in 2022 the ECB will fully include banks' climate-related risk management practices in the regular 2022 supervisory review process. In addition, our forthcoming supervisory stress test exercise will shed light on a wide set of datapoints, further informing the development of our supervisory approaches. Collecting the requested data will be challenging for banks so, to facilitate their work, the supervisory stress test methodology introduces proxies, where possible, and provides concrete examples. Robust data will help banks to identify any potential climate risk vulnerabilities. Meanwhile, to ensure the resilience of their business models in a forward-looking manner, it is crucial for banks to set ambitious and concrete goals and timelines, including intermediate milestones to mitigate their risk exposure to the transition and adaptation to a sustainable, climate-neutral and circular economy in the short, medium and long-term.

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