



EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Supervisory points of attention in the euro area banking sector



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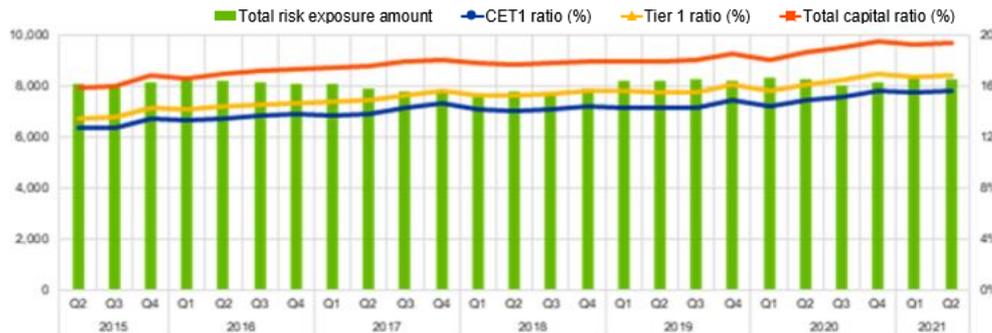
- The banking system has shown its resilience, which will be further increased in the new regulatory framework
- But it has to improve its risk management to face the challenges of the post-pandemic era
- Strong strategic steering is also needed to face emerging risks and structural challenges

Capital levels remain well above minimum requirements and 2021 stress test confirms banks' resilience

- The aggregate capital ratios of significant institutions (SIs) have significantly improved since the beginning of the Single Supervisory Mechanism (SSM) and remained resilient throughout the pandemic, with the Q2 2021 CET1 ratio at 15.6%, up from 12.72% in Q2 2015
- The 2021 stress risk test results show a system-level CET1 ratio (fully-loaded) depletion of around 5.2 percentage points (from 15.1% to 9.9%) under the adverse scenario, driven by higher credit and market risk losses and lower net interest income and net fee and commission income
- This forward-looking exercise confirms the euro area banking system is resilient despite a significantly more severe adverse scenario (prolonged COVID-19 pandemic in a lower-for-longer interest rate environment) than in 2018

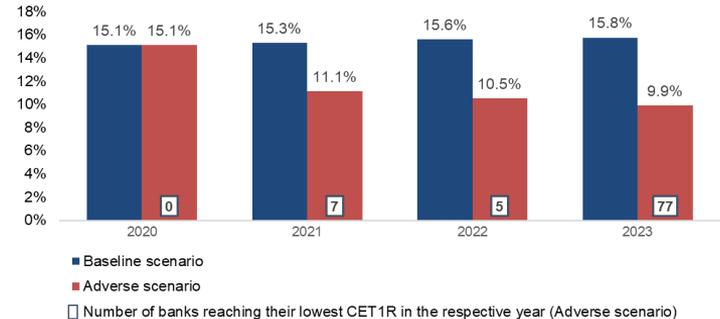
Capital ratio and components

(left-hand scale: EUR billions; right-hand scale: percentages)



Source: ECB Supervisory Banking Statistics.

SIs: Projected evolution of CET1 ratio (fully-loaded) (percentages)



Source: ECB Banking Supervision (2021), "[SSM-wide stress test 2021 – Final results](#)", 30 July.

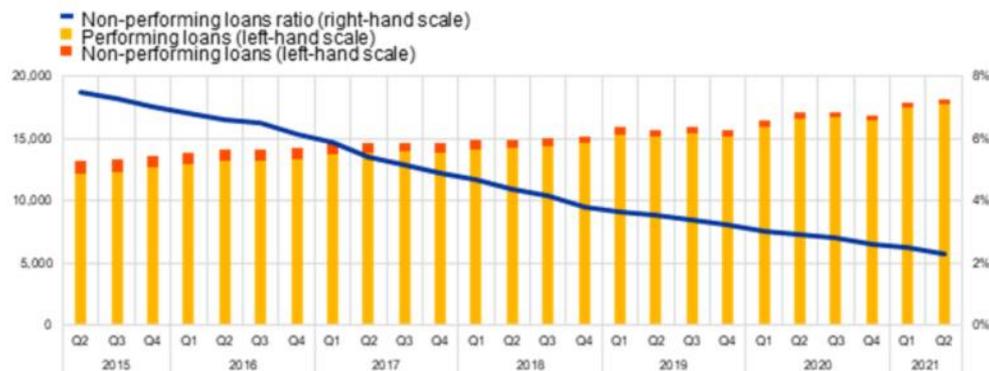
Note: Conclusions in the text are drawn from the source presentation mentioned above.

Asset quality remains a key area of concern, also in the light of persisting credit risk management deficiencies

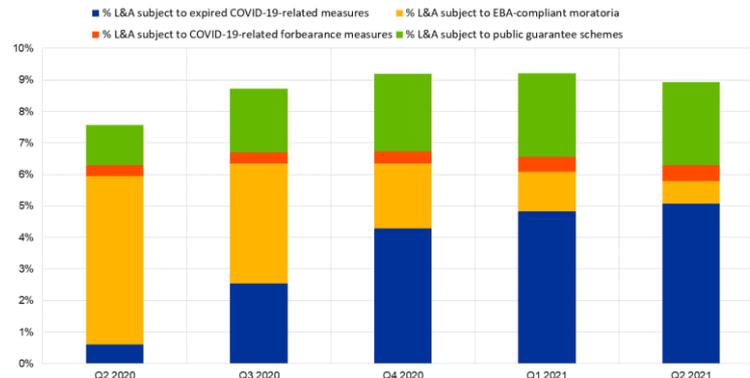
- SSM banks' non-performing loan (NPL) ratios continued to decrease despite the COVID-19 crisis, also thanks to the extraordinary policy measures (NPL ratio at 2.3% in Q2 2021, a record low since the beginning with the SSM)
- However, increased private indebtedness and the withdrawal of relief measures might lead to a rise in defaults, particularly in sectors more affected by the pandemic, making it essential for banks to address persistent shortcomings in their credit risk management frameworks (e.g. unlikelihood to pay (UTP) classification, forbearance flagging, etc.)

NPLs by reference period

(left-hand scale: EUR billions; right-hand scale: percentages)



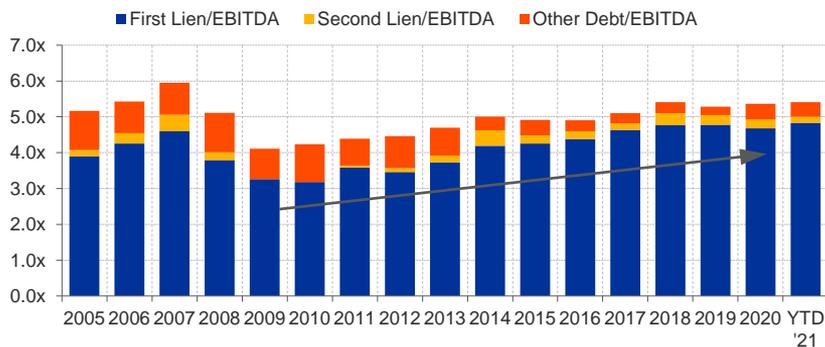
Share of loans and advances benefiting from COVID-19 support measures at SSM level



Pockets of risk building up in leveraged lending and real estate sectors

- Environment of abundant liquidity and search for yield led to the most active supervised banks having an increased risk appetite and looser underwriting standards for riskier leveraged transactions
- Commercial real estate (CRE) transactions and prices decreased significantly, with retail being worst hit followed by offices; potential structural changes might further affect the CRE sector
- In contrast, continued rise in residential real estate (RRE) prices and robust mortgage lending added to the increase in households' indebtedness and estimated overvaluation of RRE

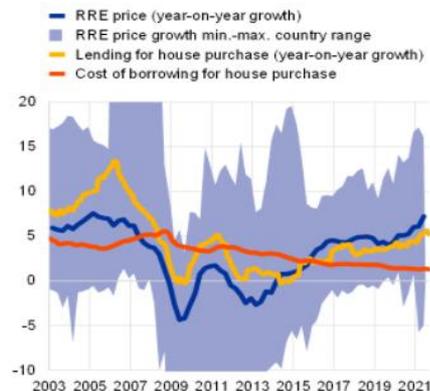
European leveraged loan market debt/EBITDA ratios (total debt/EBITDA)



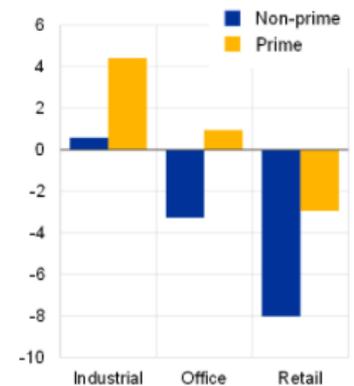
Source (right chart): LCD (S&P Global Market Intelligence), 31 July 2021 (see also Enria, A. (2021), "Enhanced outlook and emerging risk in the banking union", 2 July).

Source (middle and left charts): ECB (2021), "Financial Stability Review, November 2021".

RRE developments, Jan. 2003 to Sept. 2021 (percentages)



CRE 12-months ahead rent change expectation, Q2 2021 (percentages)



Stretched asset price valuations despite ongoing uncertainty and underlying vulnerabilities

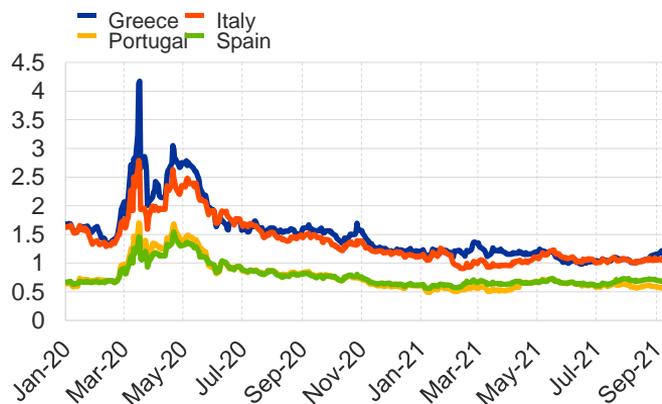
- Valuations in equity markets have risen throughout 2021 despite ongoing uncertainty and underlying vulnerabilities
- Monetary policy measures have led to a **tightening of sovereign yield spreads** since the onset of the pandemic. A potential sustained rise in sovereign bond yields could have an adverse impact on sovereign debt sustainability
- Spreads on corporate bonds, in particular for the high-yield segments, have fallen below pre-pandemic levels despite growing vulnerabilities, making them susceptible to price corrections and disorderly deleveraging
- Current search-for-yield strategies have incentivised **banks' exposure to highly leveraged and less-transparent counterparties**, often non-bank financial institutions. Archegos fallout has raised concerns about the potential implications of such practices

Equity market price developments
(indices, 17 March 2020 = 100)

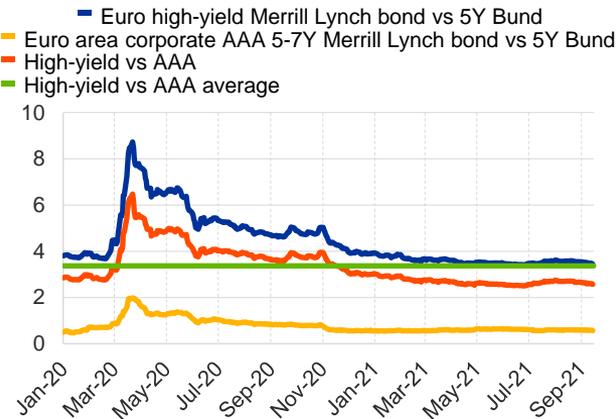


Sources: Bloomberg via SDW and ECB staff calculations.
Note: The latest observations are for 15 September 2021.

10-year sovereign bond spreads vs German Bund (percentages)



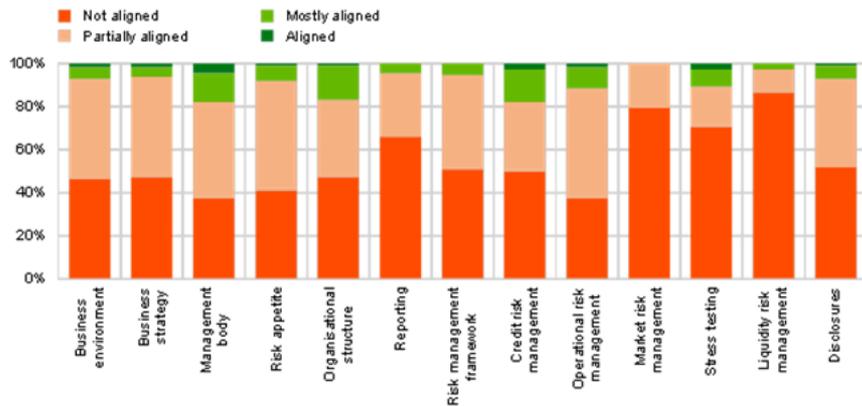
Corporate bond spreads
(percentages)



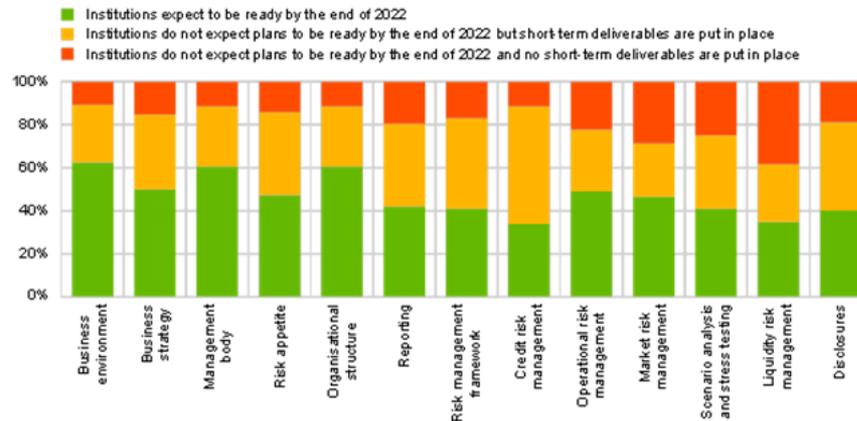
Major progress still expected from banks to address climate risk challenges*

- ECB assessment shows that most banks are either not aligned or are only partially aligned with our supervisory expectations, and there is considerable variation across banks
- Expectations related to the management body, organisational structure and operational risk management have seen the most progress, while market risk management, stress testing and liquidity risk management have seen the least progress

Banks' alignment with the 13 supervisory expectations set out in the ECB Guide



Timeliness of banks' plans to implement the 13 supervisory expectations set out in the ECB Guide



Source: ECB Banking Supervision (2021), "[The state of climate and environmental risk management in the banking sector](#)", November.

* ECB Banking Supervision (2020), "[Guide on climate-related and environmental risks – Supervisory expectations relating to risk management and disclosure](#)", November.

Cyber and IT risks among top operational risks to financial institutions

- While banks have successfully adapted to the remote working environment, the pandemic has increased cyber risk threats and challenged banks' IT resilience, with an increase in reported cyber incidents since 2020
- Risks related to IT disruptions, remote working environment and cyber/IT resilience are perceived as the most important operational risks for the financial sector
- Owing to increased outsourcing, banks need to tackle potential concentration effects (e.g. geographical, legal/entity, functionality) stemming from their increasing reliance on third-party providers

Reported incidents per quarter



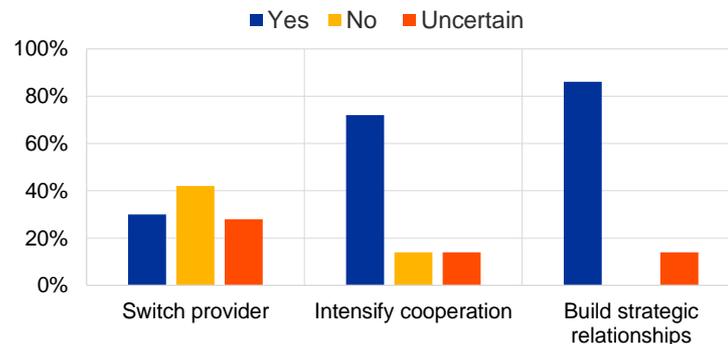
Source: ECB cyber incident reporting framework (see ECB Banking Supervision (2021), ["IT and cyber risk: a constant challenge"](#), *Supervision Newsletter*, 18 August).

Top 10 operational risks 2021

Position	Op risk	2020 position
1	IT disruption	1
2	Data compromise	2
3	Resilience risk	5
4	Theft and fraud	3
5	Third-party risk	4
6	Conduct risk	7
7	Regulatory risk	8
8	Organisational change	6
9	Geopolitical risk	9
10	Employee wellbeing	-

Source: Risk.net/Baker McKenzie (2021), ["Top 10 Op Risks 2021"](#), March.

Changes in banks' outsourcing relationships in the next five years (percentage of respondents)



Source: Strategy & Outsourcing Survey 2021.
Note: "Yes" includes "Yes" and "Yes, for certain processes".

Profitability rebounded to pre-pandemic levels, but remains low

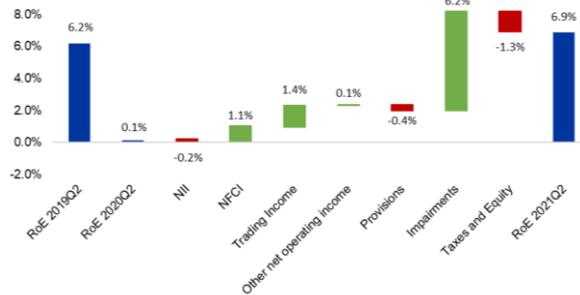
- After the rebound in Q1 2021, return on equity (ROE) remains around pre-pandemic levels, though still at structurally low levels. Recent increase is primarily driven by release of credit impairments, NFCI and NTI, while margins remain compressed
- Concerns around business model sustainability remain elevated and relate to long-lasting structural vulnerabilities associated with overcapacities. Cost inefficiencies persist, even in the light of cost-cutting efforts
- Enhanced business model sustainability given the shift in customers' preferences and the rapid growth of new entrants
- M&A drivers have been exacerbated by the pandemic, reinforcing the need to improve operational efficiency and investment capacity. There is recent momentum but potential for “wait and see” strategies

ROE (percentage points)



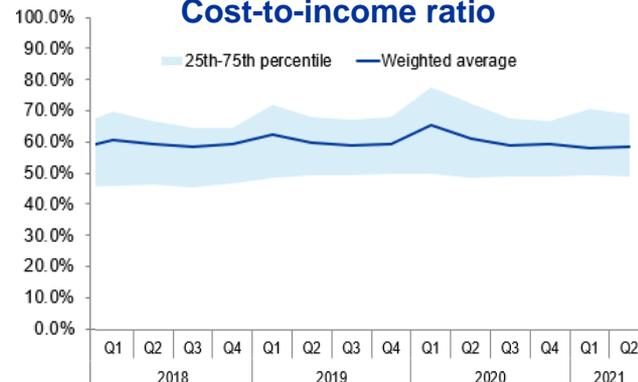
Source: ECB Supervisory Banking Statistics.

ROE annualised decomposition



Source: ECB Supervisory Banking Statistics.

Cost-to-income ratio



Source: ECB Supervisory Banking Statistics.

Takeaways for supervisory action

- On the capital requirements side, the priority is to finalise the implementation of the post-crisis, post-Brexit framework with the current banking package. While some enhancement of the buffers' usability can be envisaged, the ECB **is not asking** for new exceptional powers
- The most immediate challenge that will drive supervisory action next year, and possibly in the following years, is strengthening the internal actions of the banks, which involves:
 - ensuring that their risk management frameworks do not allow for complacency in identifying and managing the specific features of the “traditional risks” in the post-pandemic situation
 - ensuring that strategic thinking, action and follow-up is employed to tackle the emerging risks as well as the structural challenges that banks face