

# Invasion of Ukraine: euro area banks so far resilient to a second exogenous shock

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# The view from end-2021: rebound in banking sector performance and a positive outlook

### End-2021: robust macroeconomic outlook<sup>(1)</sup>

 Strong GDP growth in 2021, real GDP to exceed pre-crisis levels in Q1 2022

### End-2021: strong prudential position, improved during pandemic<sup>(2)</sup>

- Strong capital (CET1 15.5%, LR 5.9%), liquidity (LCR 173.8%) and asset quality (NPL 2.2%) positions
- Rebound in profitability (RoE 7.2%)

### End-2021: overall positive lending dynamics<sup>(3)</sup>

- Q4 2021 largest net increase in loan demand since March 2020 extraordinary increase and expected further increase
- Only mild tightening in credit standards in Q4 2021 and broadly stable outlook

(1) December 2021 Eurosystem staff macroeconomic projections (2) Q3 2021 data (3) Q4 2021 data

#### Return on equity



#### Sample: 113 SIs

Notes: Green bars show positive impact on profitability (e.g. higher income, lower expenses). Red bars show negative impact on profitability (e.g. lower income or higher costs)

# COVID-related asset quality deterioration contained amidst positive revenue diversification and structural developments

# Cost of risk below pre-pandemic levels:

- Lower inflows into underperforming loans (Stage 2)
- Improved credit risk parameters

#### **P&L** impact of impairments



## Progress in revenue diversification on the back of cyclical and structural forces:

- 2021 approximate 15% increase in **net fee and commissions income**: 50% due to asset management, followed by managed products and payment services.
- Euro area banks increased their global market share of **investment banking** in: i) capital debt markets; ii) syndicated lending.

## Slight improvement in cost efficiency, current cost reduction efforts expected to bring delayed benefits:

• Q3 2021 cost-to-income ratio decreased to 63.6%, lowest since Q4 2017.

#### Some structural transformations taking place:

- Peak in M&A transactions reached in 2020 (over €300 billion in asset value), but muted in 2021.
- Numerous sales/acquisitions of business lines during the years 2019-22, also cross-border: asset management, consumer/retail, payments, fintech, etc.

Source: Supervisory reporting and ECB staff calculations. Note: The sample varies over time.

# The invasion of Ukraine reversed a steady improvement in investors' stance on EU banks

## Prior to the geo-political shock, investors were positive on banks:

- upside linked to reversal of provisions and gradual normalisation of interest rate environment
- aggregate banks' profit projections above pre-COVID levels until 2023
- some lenders projecting medium-term double-digit return on equity, to levels at or above cost of equity.

### Since escalation of the conflict, markets have been pricing in uncertainty over sanctions, extent of exposure, and macro implications:

- Direct exposures to Russian counterparts, including:
  - Towards sanctioned entities
  - Cross-border loans
  - · Euro area-owned subsidiaries in Russia
- Direct Russian links in euro area: Russian subsidiaries
- Indirect exposures and financial markets volatility (commodities)
- Russian-sovereign default scenario?
- Operational risk: cyberattacks, IT connections to Russia/Ukraine
- Macro impact: revised GDP growth and price inflation



## Direct exposures to Russia are manageable overall

## Exposures of euro area banks to credit, securities and derivatives appear contained

- Russian economic downturn likely to cause asset quality deterioration and credit valuation adjustments.
- Institutions are reducing exposures and unwinding positions. Operational hiccups due to sanctions (e.g. asset freezes, exclusion from SWIFT) contained so far.

### Even extreme "walk-away" scenarios from subsidiaries in Russia owned by significant institutions seem manageable given the currently solid group capital position

- In light of sanctions and Russian retaliation, market intelligence is not ruling out the possibility of "walk-away" scenarios.
- Limited intra-group funding at risk, as most establishments are locally funded;
- Equity in subsidiaries would be at stake.

### Impact from Russian links so far contained

 Sanctions and potential Russian retaliation can put pressure on EU establishments of Russian groups (e.g. Sberbank AG) or raise counterparty/correspondent banking concerns.

#### SIs' and LSIs' credit exposure to Russia



## Several channels of indirect impact, none disruptive so far

Need to check concentrated exposures to **non-Russian counterparts hit by sanctions** 

**Bank-Non-bank financial intermediation (NBFI) nexus:** regulated NBFIs' exposures to Russia-Ukraine appear limited (charts). Market intelligence does not see material risks within unregulated NBFIs.

- 0.31% Euro area investment funds' shares holdings (market value)
- 0.52% Euro area investment funds' debt holdings (nominal value)

Rating agencies warn about possible **Russian-sovereign default scenario**, following Russian decree on payments to foreign creditors

**Broader financial markets volatility** can trigger counterparty credit risk (margin calls) losses, which remain contained so far.

• Oil, gas and other commodities fluctuations (charts), currency fluctuations;

Cyber risk: no major events in the EU so far, but remains a concrete threat

#### Euro area regulated NBFIs holdings of securities issued by Russia and Ukraine (EUR billions)



 $({}^{*})$  Figures for pension and insurance funds have been corrected. A previous version of these slides mistakenly showed the values of 0.2 and 0.1

#### European commodities futures (index)



# Escalation of international sanctions and Russian response to trigger a temporary slowdown in euro area growth

## Headwinds to the euro area growth intensified and real GDP growth revised downwards for 2022-23:

- outlook for euro area activity has become more uncertain;
- rising energy and commodities prices and negative confidence effects introduce downside risks to domestic GDP growth.

### Soaring energy prices have resulted in a substantial upward revision of HICP inflation for 2022 adding further upside risks to the near-term inflation outlook:

 near-term price pressures have risen significantly, mainly driven by the recent rise in commodity prices and ongoing supply bottlenecks.

Source: March 2022 ECB staff macroeconomic projections for the euro area. Note: Compared with the baseline, the adverse scenario assumes stricter sanctions on Russia and more sustained geopolitical tensions, while the severe scenario additionally includes a stronger reaction of energy prices due to cuts in supply, stronger repricing in financial markets and larger second-round effects.

## Real GDP growth projections for the euro area (annual percentage changes)



## HICP inflation projections for the euro area (annual percentage changes)



# What implications for shareholders? Banks catching up with distributions, resorting more to share buy-backs

- 2021 aggregate payout ratio (right chart) slightly above pre-pandemic (left chart).
- Catch-up broadly acceptable in light of previous period of restriction (ECB recommendation middle chart).
- As banks are reviewing their capital trajectories, those most affected by Ukraine war are revising their distribution plans

Significant institutions' planned and realised distributions (EUR billions)



#### Source: JSTs' internal surveys on banks' profit distribution plans.

Notes: The number of SIs can change from one reference period to another owing to amendments to the list of SIs following assessments by ECB Banking Supervision. "Gross profits" are profits attributable to the owners of the parent company, in line with supervisory reporting, and do not include losses. As a reminder, on <u>27 March 2020</u> the ECB asked banks not to distribute dividends or buy back shares during the COVID-19 pandemic. A similar recommendation was made in <u>July 2020</u>, and in <u>December 2020</u> the ECB asked banks to limit their distributions. Finally, in <u>July 2021</u> it was decided that the ECB's dividend recommendation would not be extended beyond September 2021.

# Supervisory approach to distributions: plans anchored to sound bank-specific capital planning

The ECB assesses banks' distributions on an individual basis and expects:

- Distributions anchored to **sound capital planning** under credible **baseline** and **severe institution-specific adverse scenarios**.
- In particular: banks to define sound internal capital targets, including minimum thresholds
  (management buffers) above supervisory requirements and buffers, and evidence that their distribution
  plans remain compatible with those targets in the context of their capital planning exercise.
- Banks to refrain from expressing distribution policies in terms of absolute amounts,<sup>(1)</sup> and anyway clarify that distributions are subject to the fulfilment of strategic plans, both in terms of profit generation and capital trajectories
- Banks to liaise in supervisory dialogue before publicly announcing their distributions.

# Cash dividends vs. share buy-backs: different process but same assessment framework

The ECB is neutral on cash dividends vs. share buy-backs. By law, different tools are subject to different processes:

- Banks can distribute cash dividends after the **supervisory dialogue**. Possible **formal restrictions** apply if a bank breaches its maximum distributable amount trigger or where the supervisor has serious concerns about the bank's capital trajectory and its ability to meet supervisory requirements;
- Share buy-backs require an **ex ante authorisation** by the supervisor **within three months**: decision taken by the SSM Supervisory Board but can be delegated to Senior Managers below an impact of 100 basis points. Process is eased in the case of yearly renewal of authorisations in the same amounts;
- **Distributions of excess capital,** i.e. exceeding profits generated in any specific year, are admitted, as long as they are consistent with sound capital planning and capital targets, both in baseline and adverse scenarios. Banks should clearly distinguish in their disclosures the ordinary component of distributions from the extraordinary distribution of excess capital.