EUROPEAN CENTRAL BANK

BANKING SUPERVISION

The euro area banking sector, one quarter after the start of the war in Ukraine

Associazione Bancaria Italiana

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Chair of the Supervisory Board of the ECB

Agenda

1 **Impact of the war on euro area banking sector**

2 Impact of the war on SSM supervisory priorities

3 Reform agenda

Macro developments of conflict in Ukraine infringe on positive momentum in sector up to Q1 2022

Banks proved resilient throughout the pandemic and in the wake of the geopolitical shock

- Improved **capital** and **liquidity** positions
- Uninterrupted improvement in ratio of **non-performing loans**
- **COVID-19 credit risk** much more manageable than expected
- Contained and concentrated **direct exposure to conflict** area
- Rebound in **profitability**: Q1 2022 adjustments mainly confined to banks directly exposed to Russia (*)
- Catch up on **distributions**

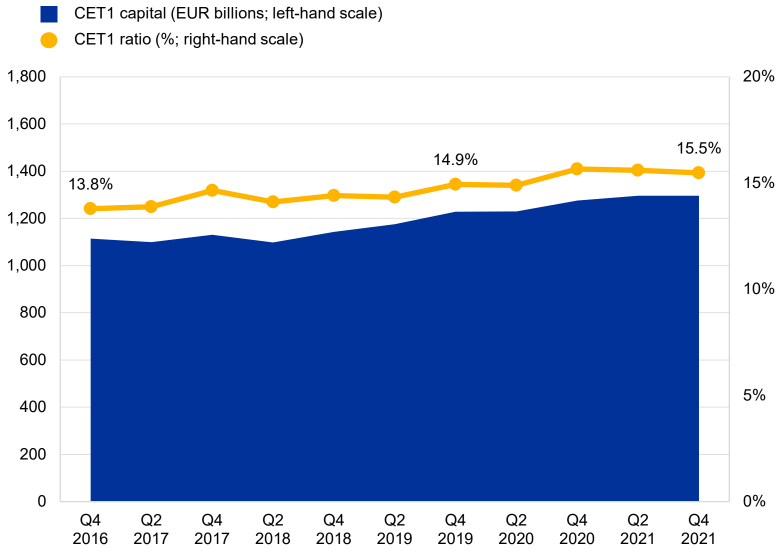
But as the war persists, the worsening macroeconomic outlook is leading investors to downgrade their valuations of EU banks

- **Energy and commodity prices** drive inflation and dampen activity across sectors
- Exit from low rates scenario; beneficial for banks overall but overshadowed by **forecast of economic slowdown**

(*) according to available disclosures of Q1 2022 results of listed institutions

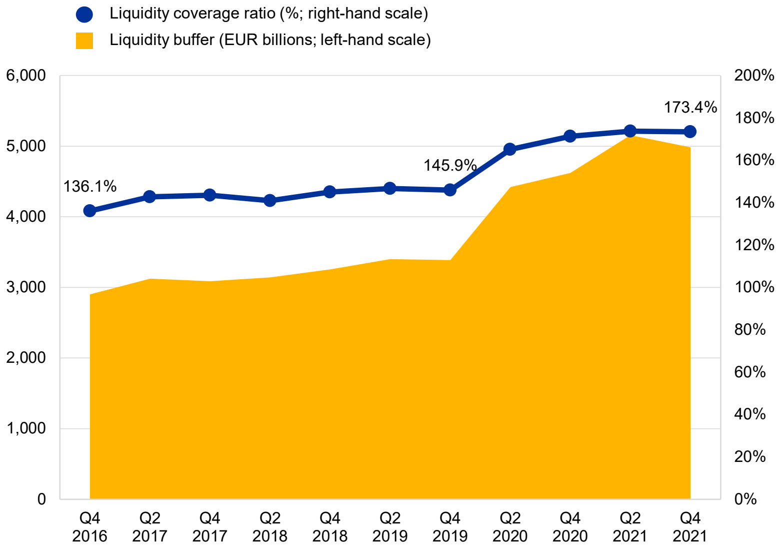
Q4 2021 data confirm that euro area banking sector remains resilient to pandemic shock

Chart 1: CET1 ratio



Source: ECB

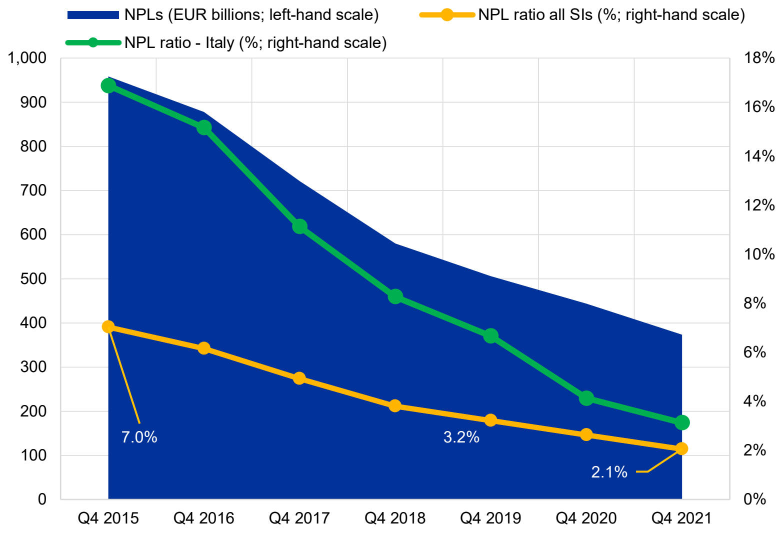
Chart 2: Liquidity coverage ratios (LCR)



Source: ECB

Balance sheet cleaning continued in 2021; COVID-19 defaults remain contained, but increase among non-financial corporations

Chart 3: Stock and ratio of non-performing loans (NPLs)



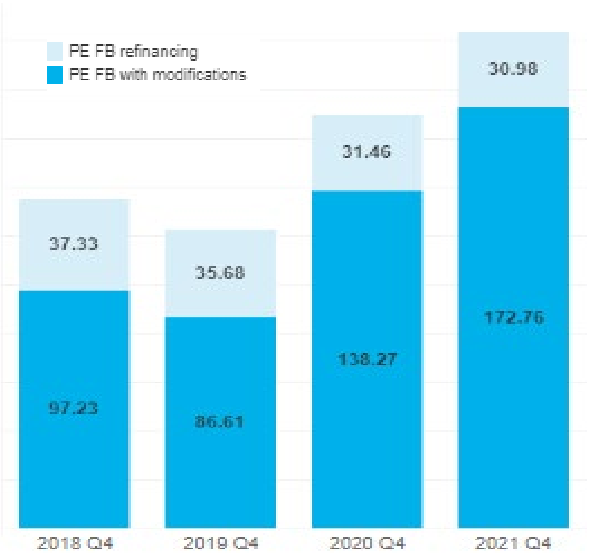
Source: ECB

Non-financial corporations' realised defaults remain contained, but:

- increase in Q4 2021 in a number of euro area countries
- and in Q1 2022 among speculative-grade corporations

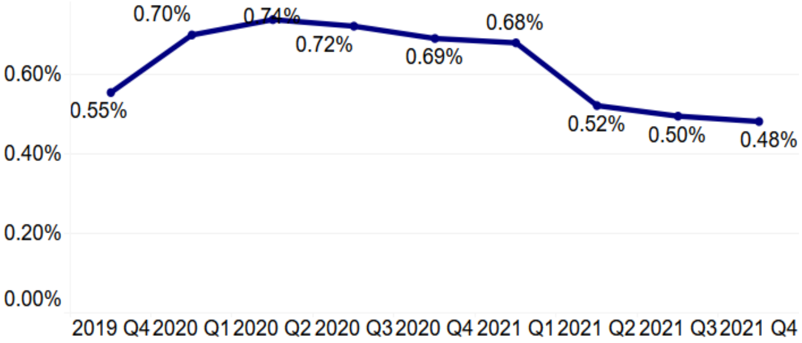
Banks increased their restructuring of loans with expired COVID-19 measures, but their cost of risk improved

Chart 4: Stock of performing forborne loans



Source: ECB

Chart 5: Cost of risk



Source: ECB

- Cost of risk below pre-pandemic levels for 60% of significant institutions
- Flow of impairments also below pre-pandemic levels (Stage 1 and Stage 2)
- Some release of COVID-19 provisions (Stage 1)

Bank profitability: rebound in 2021, with adjustments in Q1 2022 mainly confined to banks directly exposed to Russia

Chart 6: Return on equity − all significant institutions

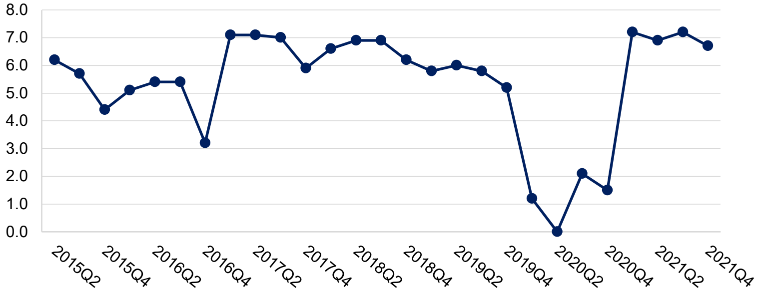


Chart 7: Return on equity - listed significant institutions (*)

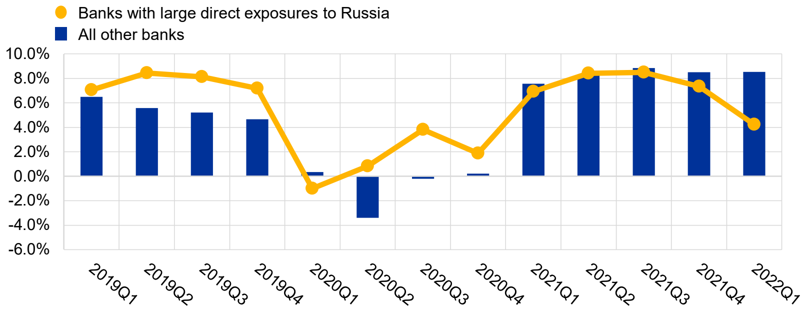
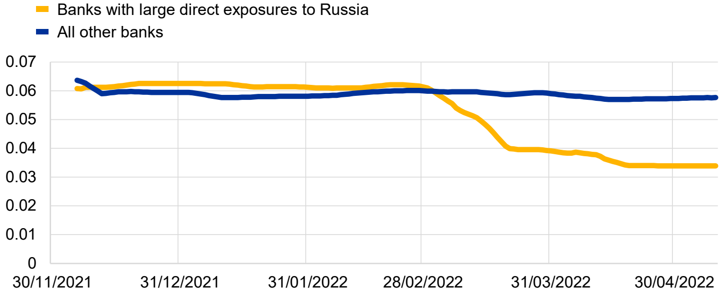


Chart 8: Analysts' most conservative RoE expectations for full year of 2022 - listed significant institutions



Catch-up in planned distributions:

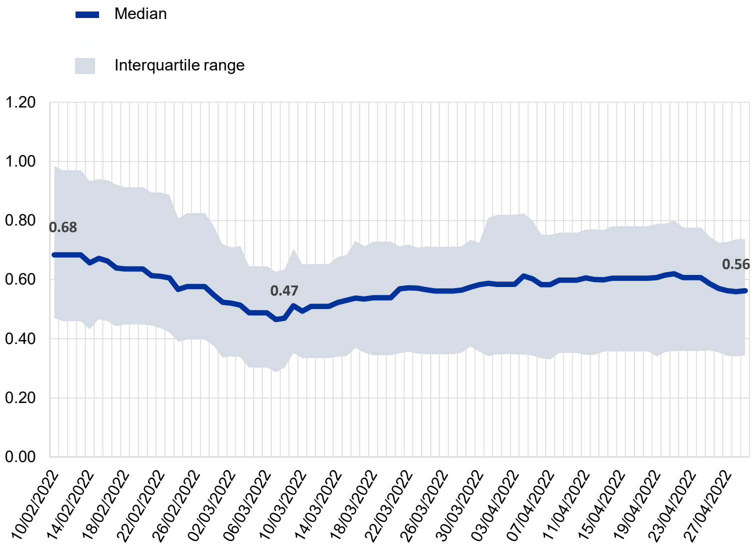
- 50% payout ratio planned for 2022 vs. 45% planned for 2020 (pre-COVID)

Source: ECB.
Notes: Supervisory statistics for 2022 are yet to be published. The projections and data refer to a small sample of significant institutions, including those most exposed to Russian counterparts.

Despite overall resilience, investors are far less optimistic about the sector than before the conflict

Chart 9: Banks valuations (STOXX Europe 600)

Chart 10: Price-to-book ratio



As conflict persists, worsening macroeconomic forecasts overshadow resilience and net benefits of an orderly exit from low rate environment

Chart 11: GDP growth projections for the euro area.

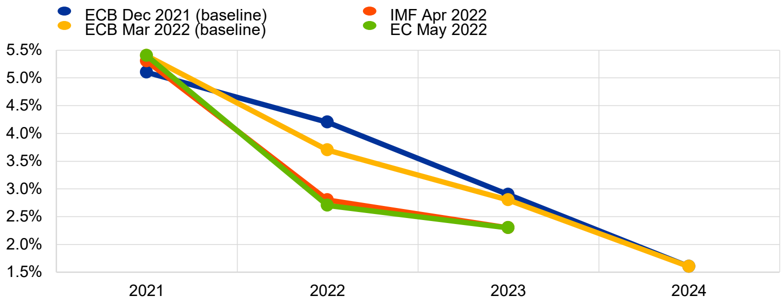


Chart 12: Inflation projections for the euro area.

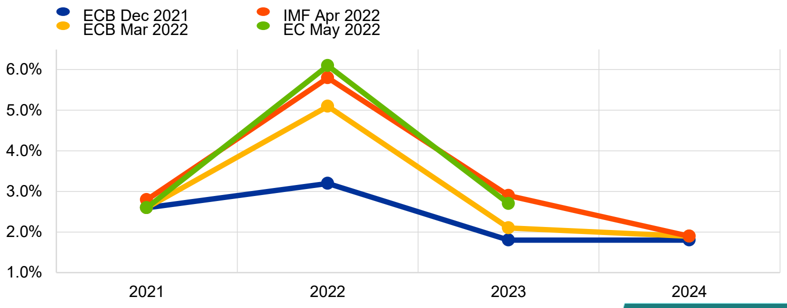
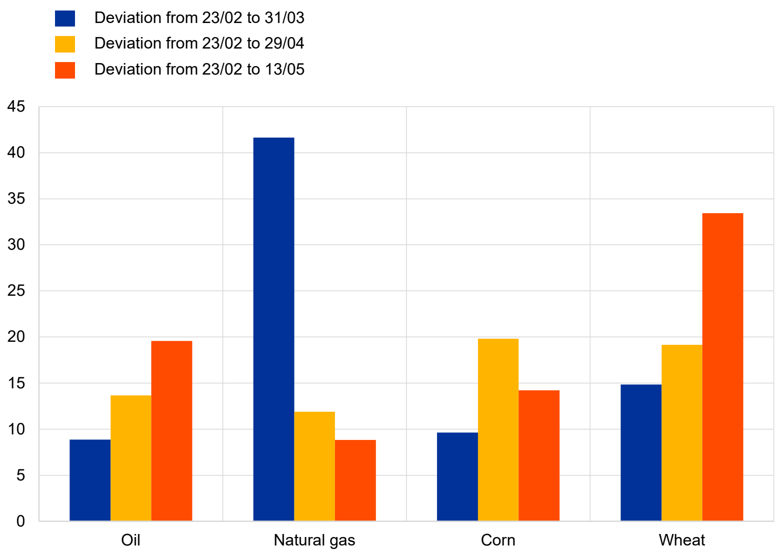


Chart 13: Observed percentage price changes in energy and commodities



Banks tighten lending standards for corporates and house purchases due to higher perceived risk and uncertainty and lower risk tolerance

Chart 14: Lending growth and lending standards (non-financial corporations)

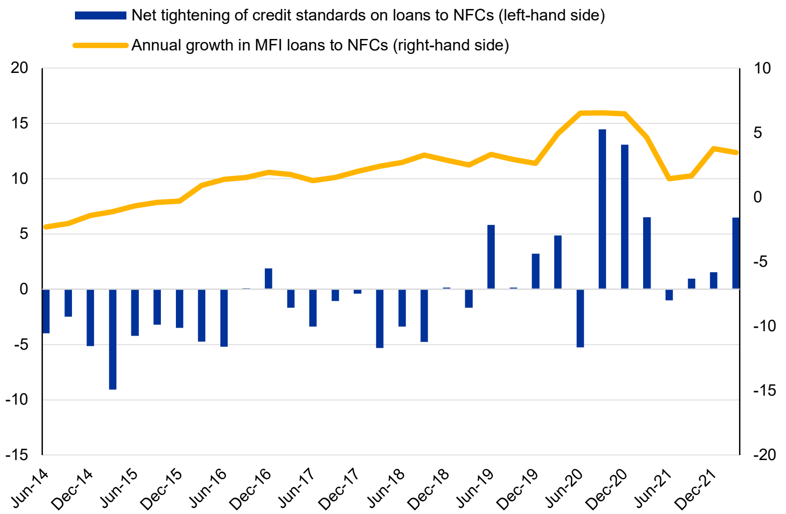
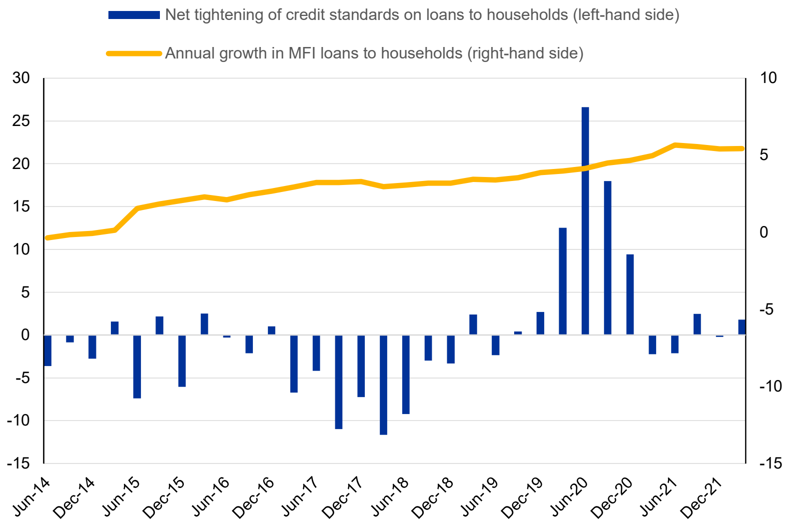


Chart 15: Lending growth and lending standards (households)



Agenda

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War in Ukraine has **confirmed and reinforced ECB's supervisory priorities** for 2022-24

Priority: **Banks emerge from the pandemic healthy**

- Main focus remains adequacy of banks' risk management practices
- Enhanced Joint Supervisory Team monitoring of exposures to vulnerable sectors: some new vulnerable sectors emerge as a result of Russian-Ukraine conflict **(→)**
- Follow up on leveraged finance (letters to banks): worsening macro outlook and risk of bumpy exit from low interest rates may hit leveraged borrowers

Priority: Addressing banks' **structural weaknesses**

- Banks' governance and management bodies' steering capabilities: sanctions linked to Russia-Ukraine conflict add legal and reputational risk dimensions
- Digital transformation remains key focus of business model sustainability

Priority: Tackling **emerging risks**

- Climate-related and environmental transition risks to become more prominent as net zero objective and energy independence objective interact
- IT and cyber risks heightened due to Russia-Ukraine war
- Counterparty credit risk (vs. non-banks) heightened due to market volatility and risk of bumpy exit from low rates

War in Ukraine expected to intensify pressure on asset quality over the coming quarters

Drivers of potential asset quality deterioration:

- Increased costs for corporates: energy (oil, gas, coal), commodities (metals, agriculture) and other imports
- Supply chain disruption
- Deterioration in market sentiment
- Decrease in households' disposable income (caused by unemployment and inflation)

COVID-19 vulnerable sectors remain under scrutiny: commercial real estate and residential real estate → supervisory deep dive

New **conflict-related vulnerable sectors**:

- Commodity trading and energy utility sector → supervisory deep dive
- Energy-intensive and raw material-intensive sectors → monitoring of concentration

Agenda

Reform agenda: CRR III and CRD VI proposals

ECB opinion on CRR III published March 2022

Faithful implementation of Basel III standards

Deviations, if any, should only be temporary as they expose banks to pockets of unaddressed risk

ECB opinion on CRD VI published April 2022

Proposals strengthen the single market and tackle emerging risks

Supervisory powers over banks' transition plans: banks to implement mitigating measures if misaligned with EU goals.

Harmonisation of supervisory powers (sanctions, fit and proper) for higher supervisory effectiveness and a more integrated banking sector

Reform agenda: crisis management and banking union

Absolute priority is to take the next steps towards completing the banking union

Upgraded crisis management framework for mid-sized banks

- Expand the pool of banks which qualify for resolution
- Harmonise framework for administrative liquidation
- Ensure all available resources can be deployed to finance market exit

Empowered European authorities instead of rigid legislative provisions on home-host balance

- European authorities could require adequate capital, liquidity and minimum requirement for own funds and eligible liabilities at subsidiary level
- Recovery and resolution plans could be used to ensure losses are appropriately distributed within group