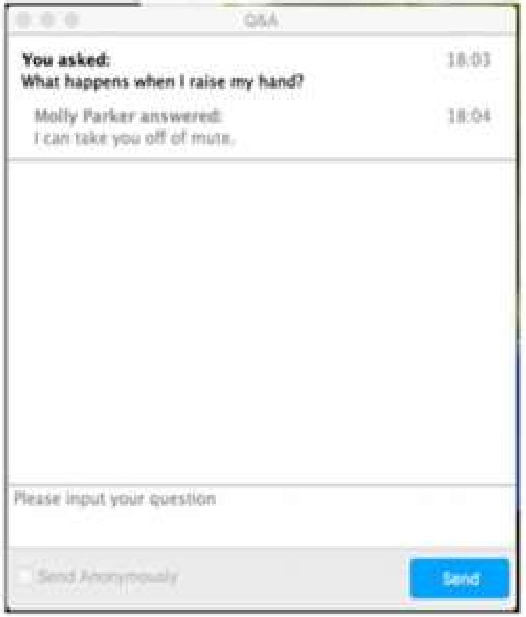
European Banking in 2025: Rethinking Risks and Opportunities, Perspectives from ECB and Finance Leaders

11 February 2025

Ask a question



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Today's speakers

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EUROPEAN CENTRAL BANK
BANKING SUPERVISION

Risk outlook and supervisory priorities for 2025

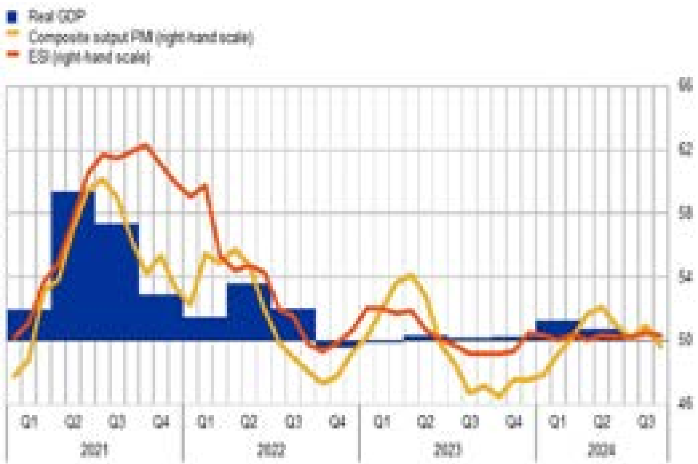
ICAEW 2025 Banking Outlook
11 February 2025

Directorate Supervisory Strategy & Risk
Klaus Duellmann, Head of Division

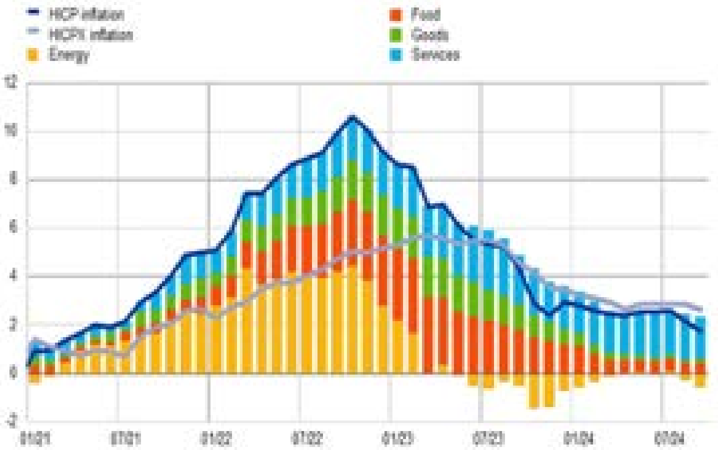
3. Macro-financial environment: Economic growth is expected to remain subdued in the near-term before strengthening over the medium term ….

- EA real GDP grew at a modest pace in the first half of 2024, after broadly stagnating throughout ‘23. Services supported this modest expansion while manufacturing activity remained weak.
  - Drivers: lower demand for goods and subdued business investments stemming *inter alia* from high-uncertainties and lingering effects of the past monetary policy tightening but also loss of competitiveness.
- Price pressures are gradually moderating, with headline inflation reaching lower point since ‘21, but core inflation remains sticky.
  - Drivers: lower energy prices partially offset by food and service inflation.
- Looking forward: EA economy is expected to strengthen over time, as rising real incomes and the gradual fading effects of restrictive monetary policy should support consumption and investment.

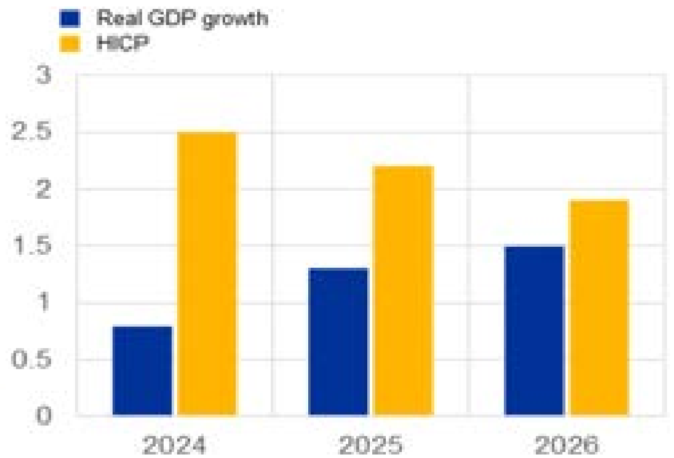
EA real GDP, composite output PMI and ESI



EA headline inflation and its components (%)



EA real GDP growth and inflation projections (%)



3. Macro-financial environment: … but risks to the baseline remain tilted to the downside as high geopolitical uncertainties keep weighing on the euro area

- With inflation is expected to return to target by '25, market analysts assume a continuing easing of monetary policy throughout the year
    - Slower pace than assumed by end-2023 as inflationary pressures proved more persistent.

- The benign risk pricing in financial markets over the last year, makes they susceptible to sudden re-assessments of asset prices when market sentiment shifts.
    - Market sentiment proved highly sensitive to macro-related news (e.g. short-lived global sell-off in August) while geopolitical risks seems not fully priced in.

Outlook: Risks to the growth outlook remain tilted to the downside over the medium term on the back of high uncertainties stemming i.a from higher geopolitical risks (e.g. RU-UA war, new US administration policies)

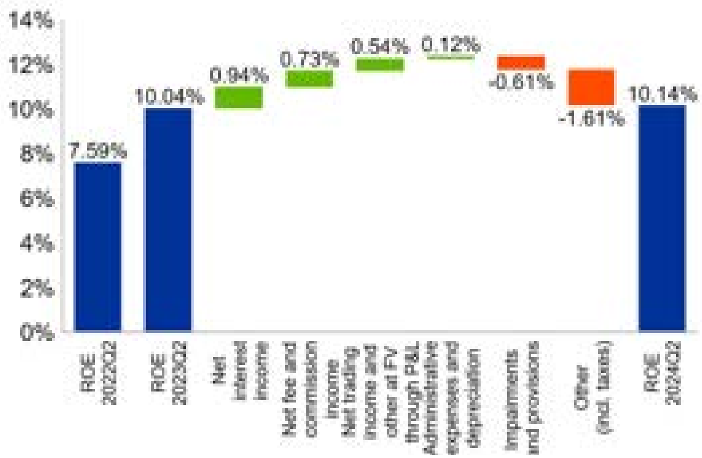
DFR evolution and market analysts' expectations

Equity market developments (indices, 17.03.2020 = 100)

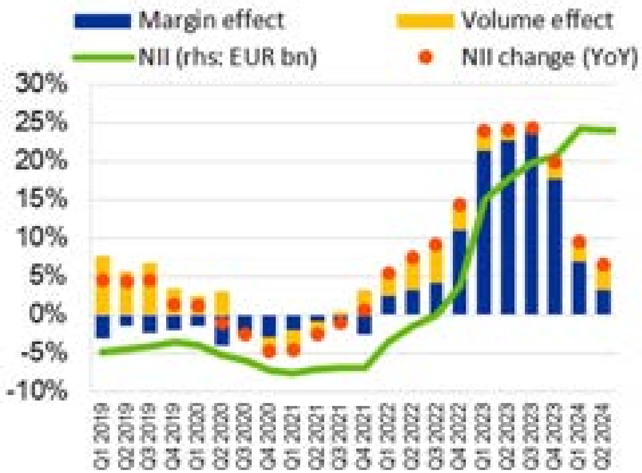
3. Business model: Positive profitability outlook driven by regime shift towards positive interest rates but structural challenges persist (e.g. digitalisation)

- Supervised banks' profitability reached multi-year highs in 2024, largely supported by the higher interest rate environment.
  - Boost in NII primarily driven by margin effects while higher rates did not lead to an (anticipated) increase in cost of risk.
  - Banks improved their operational efficiency (boost in profit + cost containment).
- Going forward, profits are projected to remain above historically low levels, but banks' projections largely rest on the assumption that margins will remain elevated. Adverse macroeconomic/geopolitical developments may challenge the baseline. Recent quarterly profitability dynamics could indicate a turning point.
- Market valuation gap with US peers remains while structural challenges persist: digitalisation, obstacles to cross-border consolidation and competition.

ROE annualised YoY decomposition



Decomposition of annualised NII growth



Evolution of EA vs US banks PtB value ratio

3. Credit Risk: Asset quality remained resilient to inflationary pressures and tightening of financing conditions, but the outlook suggests further deterioration in some segments

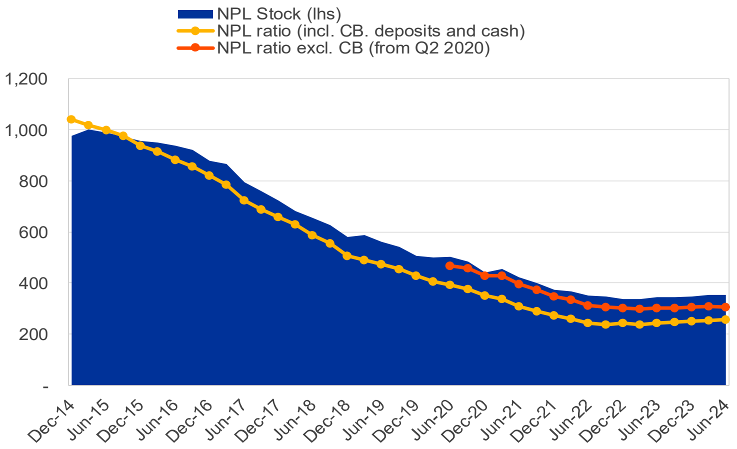
- Supervised banks' asset quality remained overall resilient so far, supported by strong fundamentals of households & corporates. SSM NPL ratio stabilised at low levels, masking significant country and portfolio heterogeneity: larger NPL increases recorded in countries with historically stronger asset quality, especially in CRE, SME but also consumer loans portfolios.

- Mild increase in headline NPL ratios conceals nevertheless a stronger deterioration in corporate and retail default rates, partially offset by the continued disposal of legacy NPLs, still material in countries most affected by the European sovereign debt crisis.

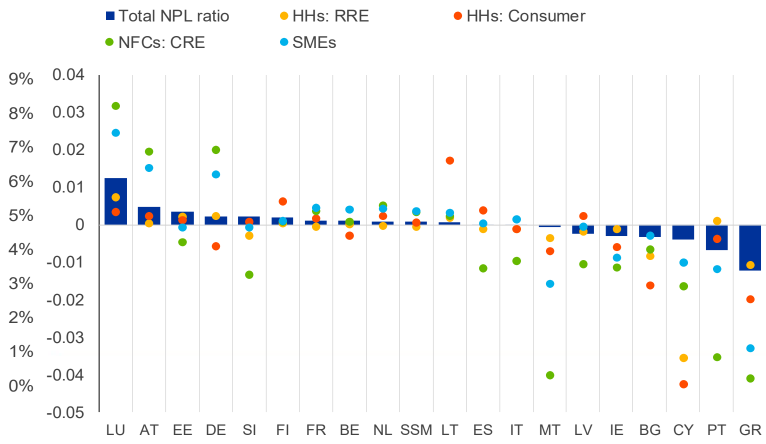
- Going forward asset quality deterioration is expected to remain contained and concentrated in riskier segments but could nevertheless be amplified in case of further weakening of the EA economy or materialization of downside risks (e.g. geopolitics).

- Banks' cost of risk and coverage ratios do not seem reflecting these uncertainties questioning the adequacy of IFRS 9 frameworks

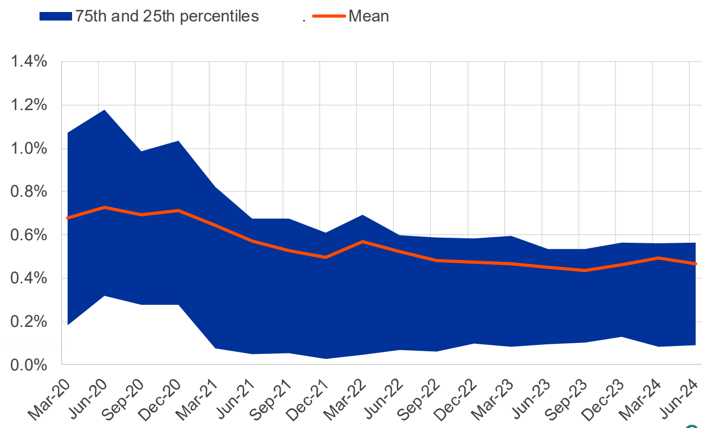
Evolution of NPL ratio and volumes



Yearly NPL% evolution by country / segment



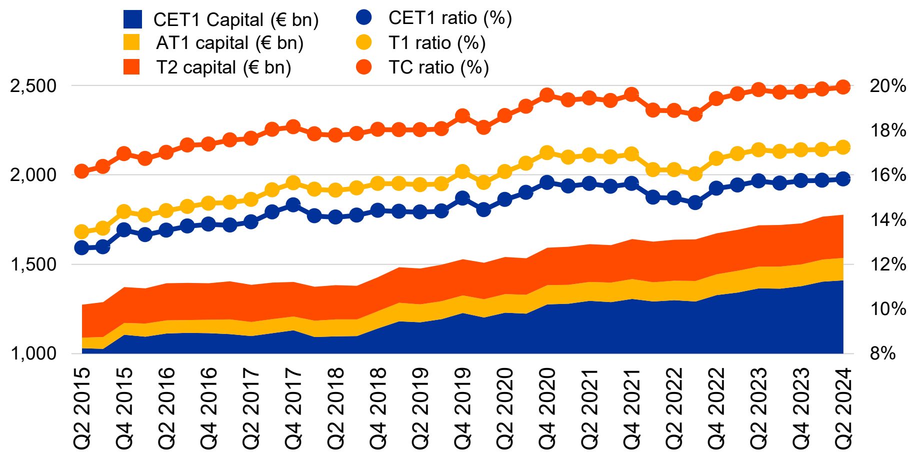
Evolution of cost of risk



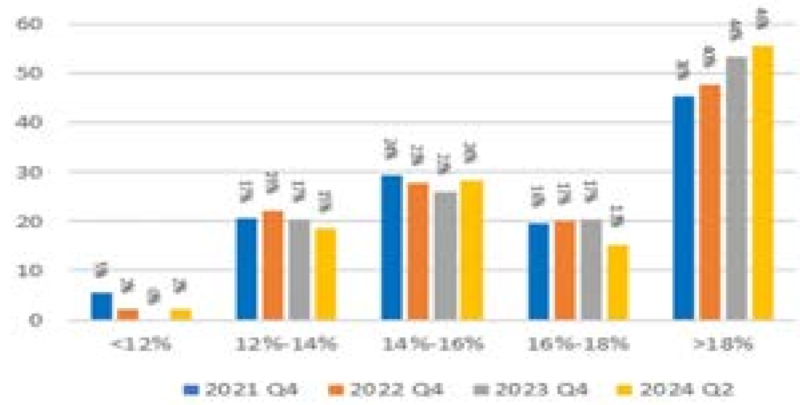
3. Capital adequacy: Record high capital levels and sizeable management buffers underpin EA banks soundness and resilience

- Euro area banks have maintained broadly stable capital ratios which reached new highs in 24Q2 (CET1 15.8%, at ratio +6 bps YoY).
  - 46% of supervised institutions report a CET1% above 18%
  - Leverage ratio continued to increase as well (5.8% in 24Q2), although at a more muted pace (+5 bps YoY)
- The strong recovery in banks' profitability supported the accumulation of retained earnings, which offset balance sheets and risk weights growth while allowing sizeable distributions to shareholders.
  - Positive capital headroom and in many cases sizeable management buffers should allow banks withstand adverse scenarios and additional provision needs.
- Major events and market fluctuations over the last years reiterate the need to strengthen banks' capital planning capabilities, while the implementation of the Banking Package will be a major challenge in 2025.

Distribution of SSM SIs CET1% over time



Distribution of SSM SIs CET1% over time



3. Liquidity and Funding Risks: Robust liquidity ratios and good funding access despite TLTRO repayment

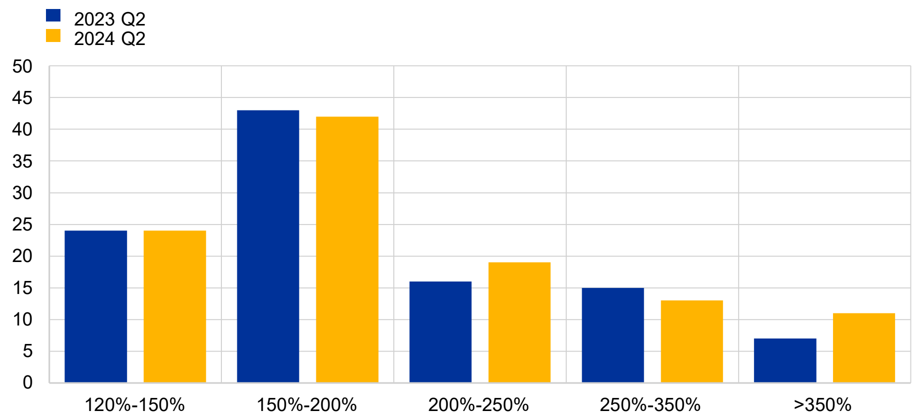
- Supervised banks' liquidity ratios remain robust and well above regulatory requirements (LCR: 159.4%, NSFR:127.5% in Q2) despite large volume of TLTRO repayments since 2022.

- Several factors explain the resilience of banks liquidity ratios:
  - System-wide excess liquidity remains sizeable (EUR 3.1 tn vs EUR 1.8 tn pre Covid levels) and TLTRO repayment were partially compensated by autonomous factors releasing liquidity in the banking system
  - Steady increase in banks non-cash HQLA holdings, especially govies and covered bonds.

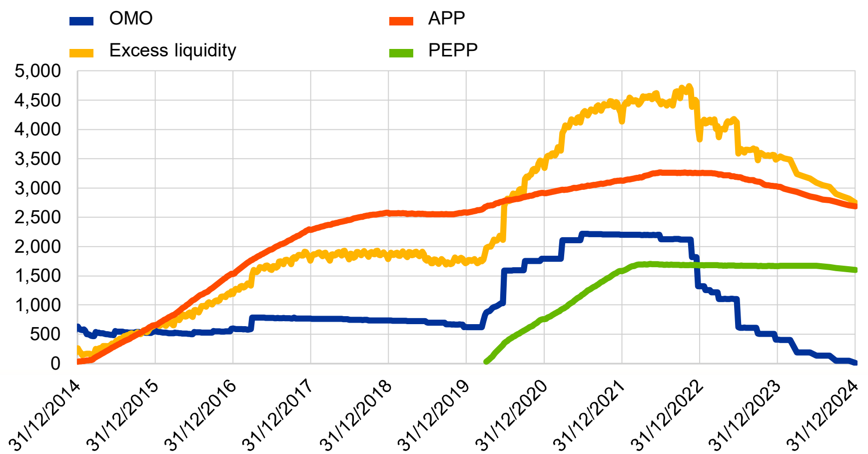
- Good access to retail funding (deposit volumes +3.8% YoY) with deposit rates on new business stabilizing or tilting downwards and smooth wholesale funding access with attractive pricing and conditions so far, benefiting from strong investors demand.

- The review of the ECB monetary policy operational framework announced in March 2024 suggests favourable future liquidity conditions for banks.

Distribution of SSM SIs LCR ratio



System-wide excess liquidity and outlook



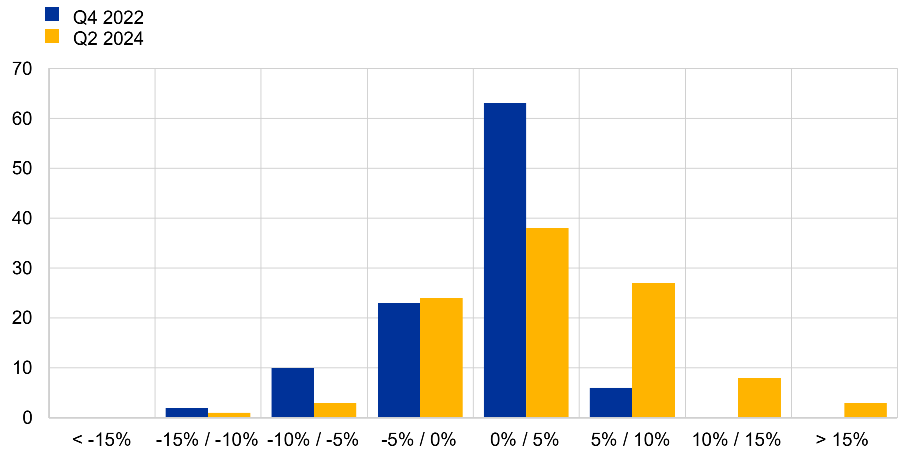
3. IRRBB and CSRBB: Supervised institutions management of these risks proved efficient as risk profiles remained resilient to the unprecedented interest rate hikes

- SSM SIs smoothly navigated the sharp increase in interest rates since July 2022 but need to remain cautious in accommodating their IRRBB strategy to an uncertain future interest rates environment.

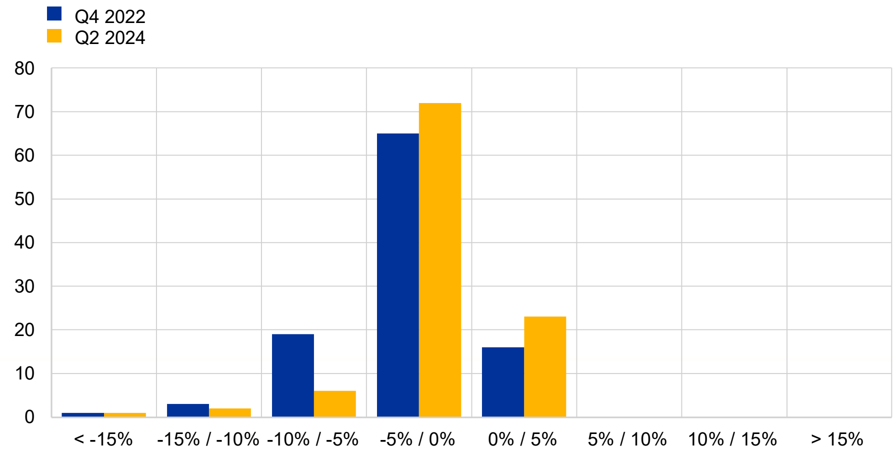
- SSM SIs do not display noticeable IRRBB pressure in a -200 bps scenario (only 10 SIs breach the SOT thresholds in Q2 2024), with banks' overall risk profile broadly improving between Q4 2022 and Q2 2024.
  - Under the +200bps scenario, no SI breaches the SOT thresholds

- Unrealized losses are contained and on a decreasing trend (EUR 45 bn as of Q2 2024 vs EUR 73 bn in February 2023). Some SIs however show outsized exposure to unrealized losses in terms of CET1 capital.

SSM SIs EVE SOT distribution, -200bps shift



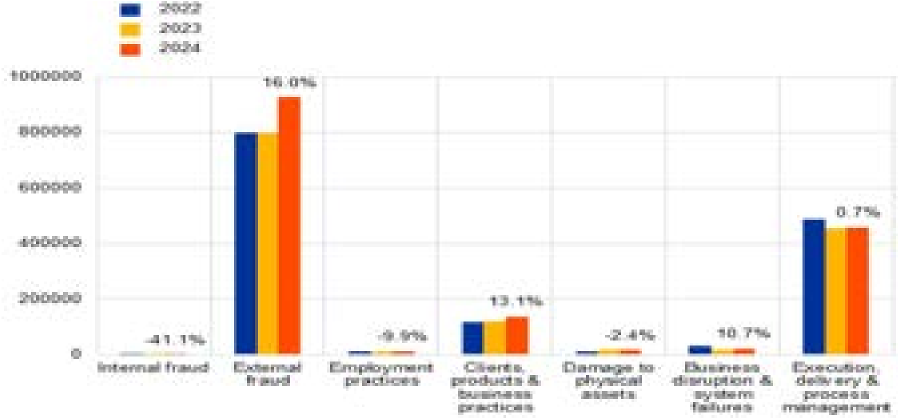
SSM SIs NII SOT distribution, -200bp shift



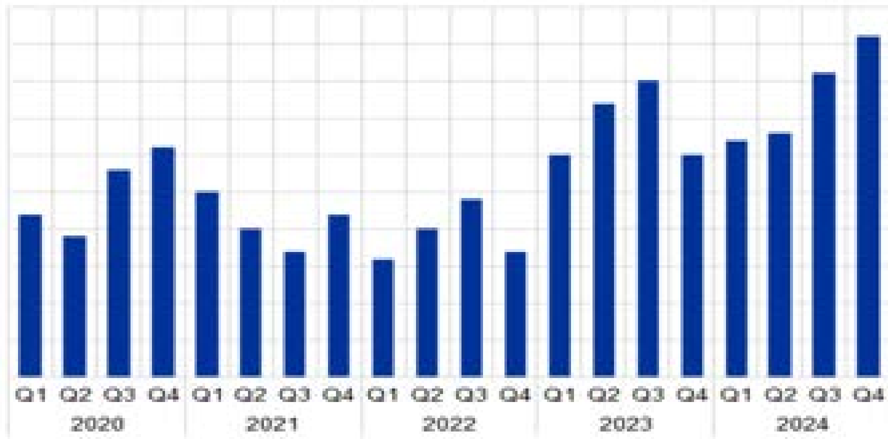
3. Operational Risk: Digitalisation and geopolitical context lead to increasing cyber threats and higher concentration risk towards 3rd party providers

- During the first half of 2024 the number of banks' operational risk events has increased y-o-y, while the aggregate loss amount decreased substantially.
- Cyber incidents are on the rise globally, among others driven by heightened geopolitical tensions.
  - Reported cyber incidents have remained at elevated levels in 2024, driven primarily by an increase in incidents affecting third parties and incidents related to unauthorized access.
- Increasing outsourcing of critical functions to globally concentrated group of third-party providers may expose banks to (in a worst case, simultaneous) operational disruptions.
  - SSM SIs report increasing dependency on third party providers for critical functions with large share offered from a non-EU country.
  - Recent incidents (Crowdstrike incident, DDoS attack at Microsoft services) uncovered large interdependencies among sectors and reliance on common providers.

Number of operational loss events (number as of Q2 of the year; labels above 2024 show y-o-y % change)



Number of reported significant cyber incidents by SIs

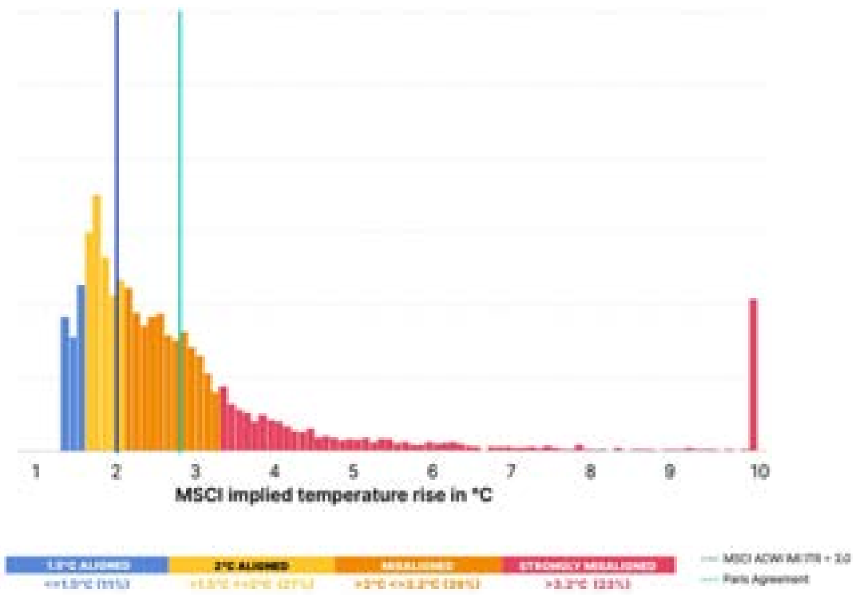


3. Climate-related and environmental risks: Physical and transition risks are rising and warrant strong supervisory scrutiny

- Physical risk on the rise with an intensification in extreme weather events:
  - 2024 is expected to be the warmest year on record - global temperatures continue to rise, averaging 1.64°C above pre-industrial levels from September 2023 – August 2024[2]
  - Economic losses from climate-related disasters in the EU are increasing - costing 650 billion euros from 1980-2022 (in 2022 prices)[1]
- Transition risks have increased by continued misalignment with targets:
  - 60% of listed companies are not aligned with Paris agreement - with only around 11% aligning to the 1.5°C target.[3]
  - EA banks show substantial misalignment with EU climate goals, with ~70% of banks facing elevated reputational / litigation risk.[4]

- Supervised banks to step up efforts to adhere with supervisory expectations and new regulations. (i.e. CRR3/CRD6)

World listed companies' alignment with <2°C goals



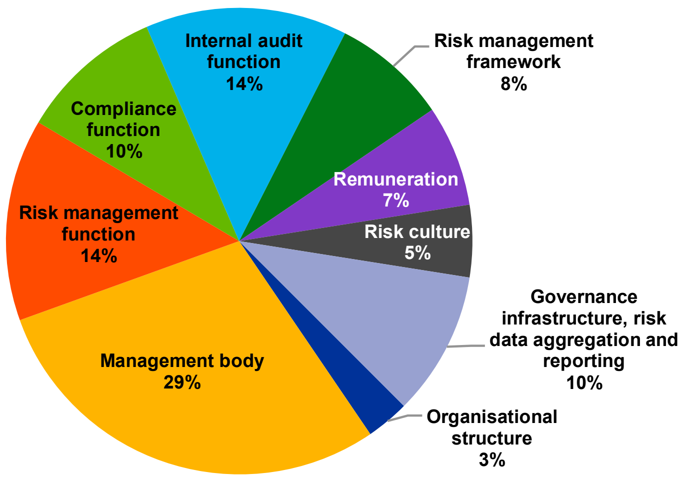
Source: MSCI Net Zero tracker, November 2024

[1] European Climate Risk Assessment, EEA Report 10/2023. [2] Pre-industrial levels (1850-1900), Copernicus – August 2024 data [3] MSCI Net Zero Tracker, 2024. [4] ECB misalignment report, 2024.

3. Governance: Supervisors assessments points towards stickiness of material shortcomings in the area of internal governance and control functions

- Progress in banks' governance arrangements has been slow, mainly affecting the areas of management body, internal control functions, risk management framework, and risk data aggregation and reporting.
    - Banks made some progress in tackling MB deficiencies, especially around diversity, while collective suitability (incl. low level of IT expertise, slow progress on boards' independence) and succession planning remain points of attention
    - The effectiveness of all three internal control functions remains a key supervisory concern due to, *inter alia,* lack of adequate resource (numbers and expertise) and insufficient oversight at management body level.
- Lack of adherence to BCBS239 principles and supervisory expectations in RDAR is a long-lasting issue, which can affect the ability of banks to produce timely reports and the effective strategic steering by boards.
- Mounting novel risks call for strong governance and risk management frameworks.

Breakdown of qualitative measures relating to internal governance and risk management



Source: 2023 SREP results.

4. Conclusions: 2024-26 supervisory priorities reiterate the call to keep the bar steady but remain vigilant to adjust the focus to changes in the risk landscape when needed

Priority 1: Banks should strengthen their ability to withstand immediate macro-financial threats and severe geopolitical shocks

Address deficiencies in **credit risk management frameworks**	Credit risk
Address deficiencies in **operational resilience frameworks as regards IT outsourcing and IT security/cyber risks**	Operational risk
Special focus: Incorporating the management of geopolitical risks in supervisory priorities	Multiple risk categories

Priority 2: Banks should remedy persistent material shortcomings in an effective and timely manner

Address deficiencies in business strategies and risk management as regards **climate-related and environmental risks**	Climate-related and environmental risks
Address deficiencies in **risk data aggregation and reporting**	Governance

Priority 3: Banks should strengthen their digitalisation strategies and tackle emerging challenges stemming from the use of new technologies

Address deficiencies in **digital transformation strategies**	Business model

Due to their cross-cutting nature, geopolitical risks are addressed through targeted initiatives related to different prioritized vulnerabilities

From governance …	… to credit risk …	… operational resilience …	… and stress testing
1 **Risk appetite & Risk culture project**	2 **Thematic review on IFRS 9**	3 Targeted reviews on Outsourcing and Cyber resilience	+ 2025 EU-wide stress-test and CCR exploratory scenario
Benchmarking exercise to assess governance mechanisms to monitor geopolitical risk and reflection in the risk identification process and in the RAF	Assess and monitor capture of geopolitical risks in banks' ECL, as part of the module focusing on emerging risks	Both activities aim *de facto* to assess and strengthen banks' resilience to external shocks, including geopolitical risks	Exacerbated geopolitical ten-sions will be a key narrative block of the adverse scenario + CCR exploratory scenario

Today's Panel

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