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European Banking in 2024: Rethinking Risks and Opportunities, Perspectives from ECB and Finance Leaders

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Agenda

1. **Welcome**

2. **Opening Keynote by the ECB**

3. **Panel discussion**
    - **Section 1: Economic Factors and Risk**
    - **Section 2: Sustainability in Banking**
    - **Section 3: Technology's Role**

4. **Questions**

Speakers

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Keynote speech

EUROPEAN CENTRAL BANK
BANKING SUPERVISION

SSM Risk outlook and supervisory priorities

European Banking in 2024: Rethinking Risks and Opportunities

ICAEW Banking in Europe series
23 November 2023

Directorate Supervisory Strategy & Risk (D-SSR)
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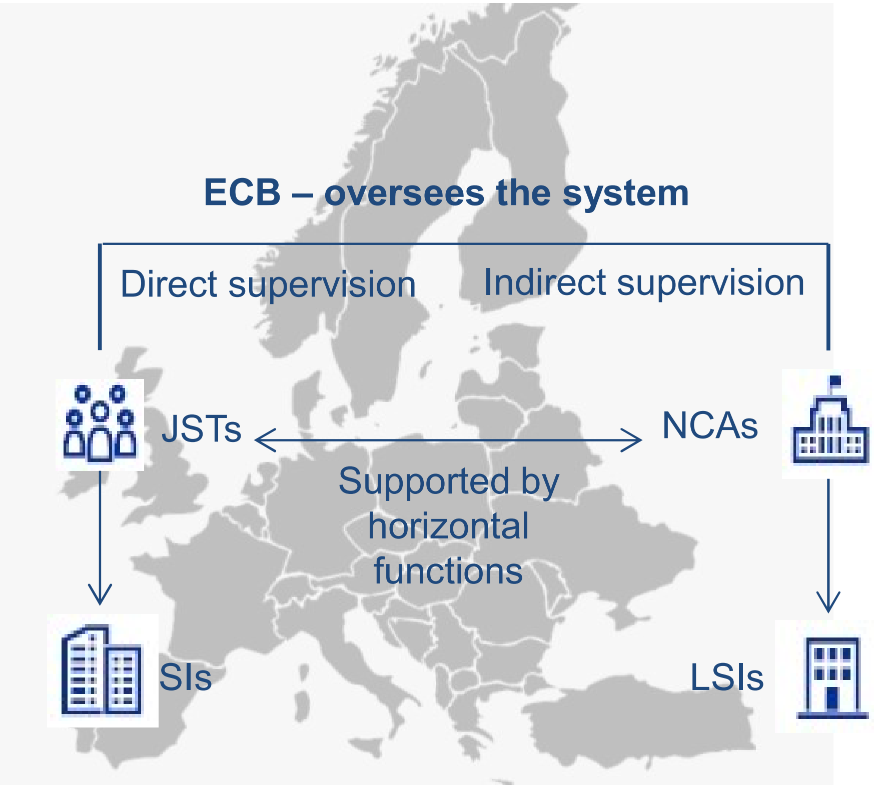
Setting supervisory priorities requires beforehand a sound assessment of the risk situation in the SSM banking sector

- ECB directly supervises 110* Significant Institutions in the SSM (about €2.6 trillion total assets) from 21 EU member states (while NCAs in charge of direct supervision of Less Significant Institutions).
- Size & heterogeneity (business models, regional specificities) of SSM banking sector require a prudent and well-thought through approach to set strategic priorities and translate them into a work programme of supervisory activities.
- The setting of new priorities needs to strike a balance between continuity needed for planning over a 3-year horizon and flexibility to respond in a timely manner to a (at times rapidly) evolving risk situation.
- Efficiency in the strategic planning is supported by the introduction of a Risk Tolerance Framework and the SREP Multi-Year Approach.



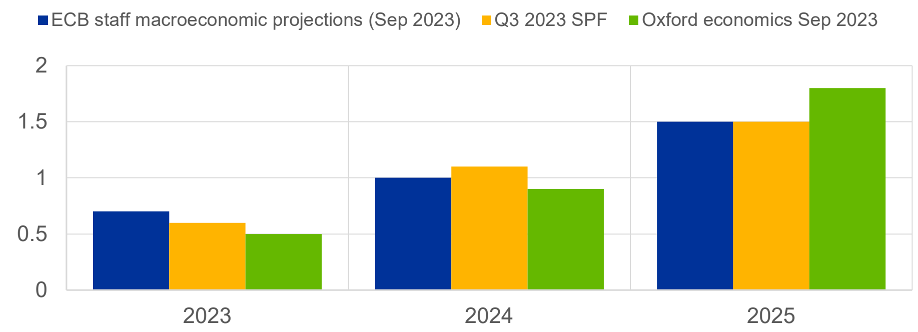
JST: **J**oint **S**upervisory **T**eam
NCA: **N**ational **C**ompetent **A**uthority
LSI: **L**ess **S**ignificant **I**nstitution

* In Q2 2023.

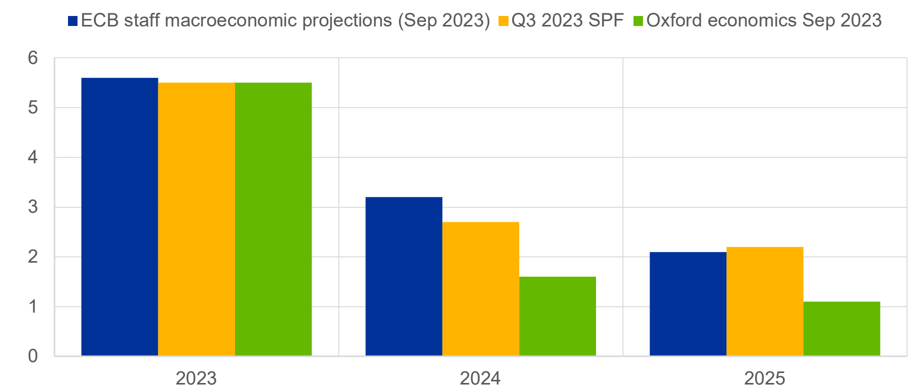
Euro area growth outlook uncertain as core inflation remains sticky and tighter financing conditions weigh on the economic activity

- High uncertainty keeps shaping the economic growth outlook for the euro area as monetary policy tightening feeds through the real economy.
  - The short-term real GDP growth outlook for the euro area has deteriorated resulting in a significant downgrade of expected growth rates for 2023 and 2024.
- Euro area headline inflation is expected to continue to decrease, while core inflation (excl. energy and food) is projected to only gradually decline and remain above the headline until early 2024:
  - Although on a downward path, core inflation is expected to remain elevated mainly due to strong, though slowing, wage growth.
- Future monetary policy path is expected to drive the economic outlook. Deepening geopolitical fragmentation and potential further repricing in financial markets pose further downside risks.

Real GDP growth projections for the euro area (%)



HICP projections for the euro area (%)

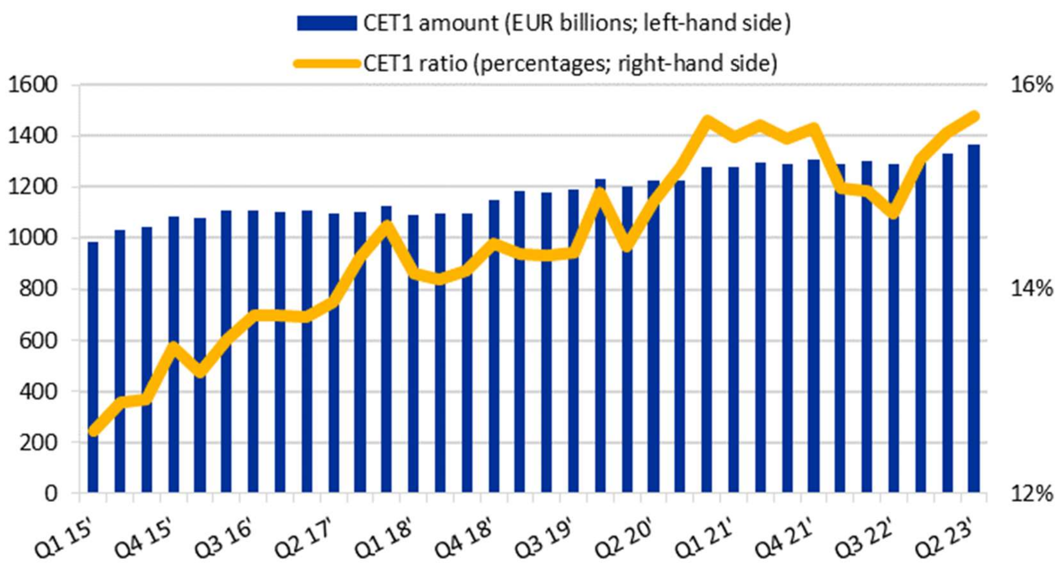


Sources: upper chart: ECB staff macroeconomic projections for the euro area, September 2023; ECB Survey of Professional Forecasters Q3 2023, July 2023; Oxford Economics, September 2023: “Eurozone: Forecast of stagnation faces downside risks”

Euro area banks keep reporting robust capital and liquidity positions, sign of overall strength and resilience of the sector

Average CET1 ratio at historical high levels, with high revenues supporting retained earnings increases

Significant institutions' average CET1 capital and CET1 ratio



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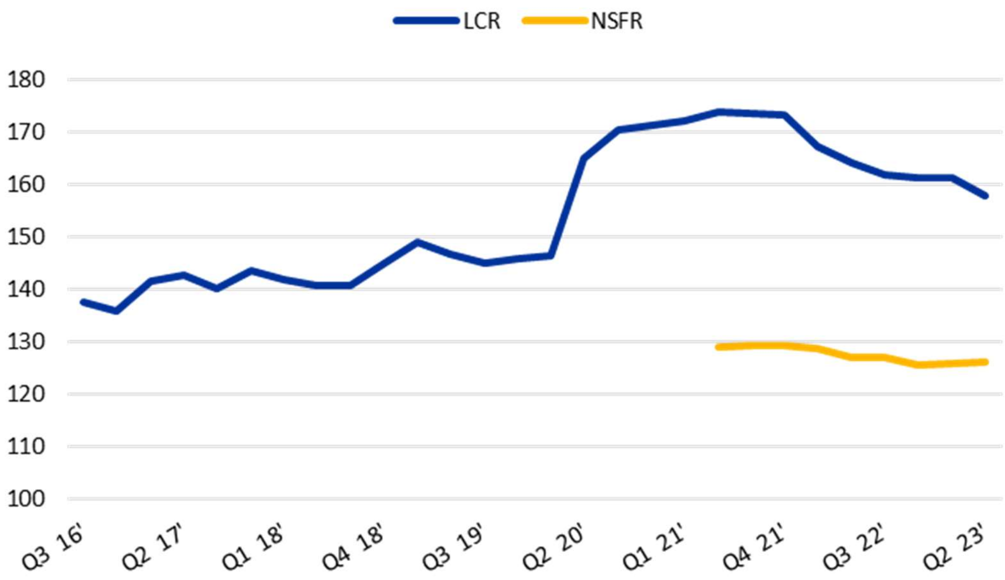
Average LCR and NSFR still robust despite monetary policy tightening and recent TLTRO repayments

Significant institutions' Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR)

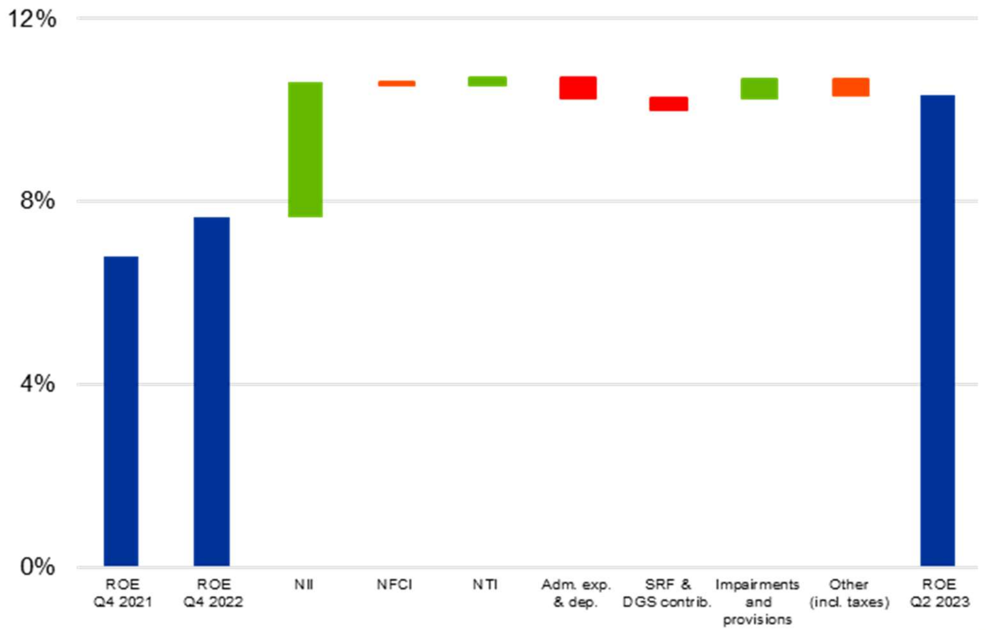


Source: Supervisory data.

Higher interest rate regime boosts euro area banks profitability, while NPL ratios remain stable at historical low levels despite tighter financing conditions

High profitability mainly driven by interest rates hikes while costs remain contained despite inflationary pressures

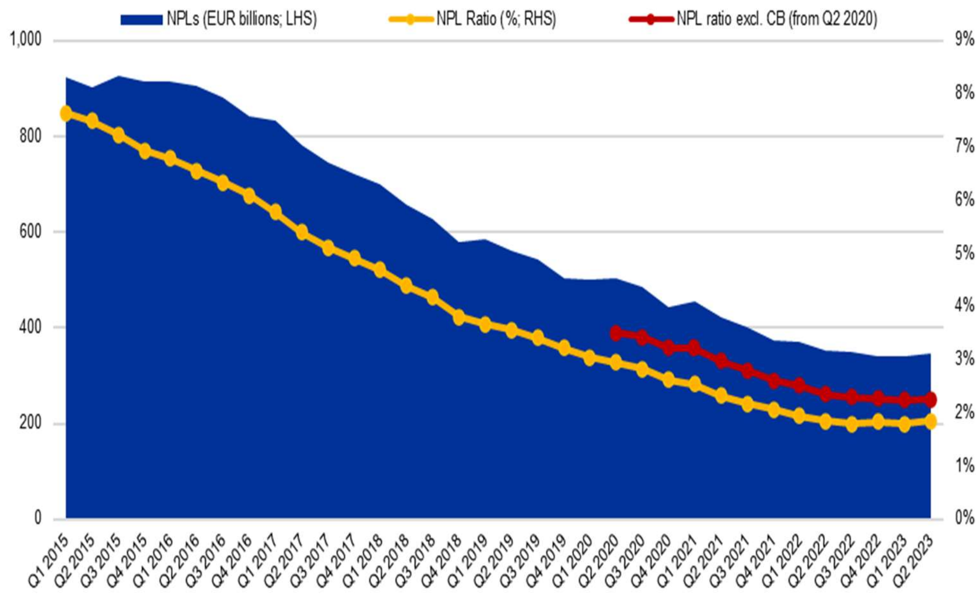
Significant Institutions' Return on Equity (ROE)
(2021Q4-2023Q2; %)



Source: Supervisory data.

While NPLs remains broadly stable, prudence prevails as full impact of monpol tightening expected to materialise with a lag

Non-performing loans trend since the inception of the SSM
(EUR bln / lhs; % of total loans / rhs)

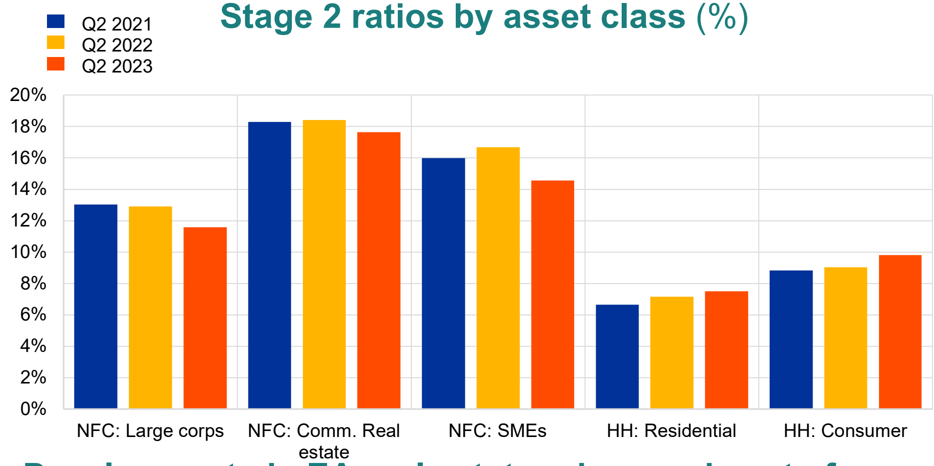


Source: Supervisory data.

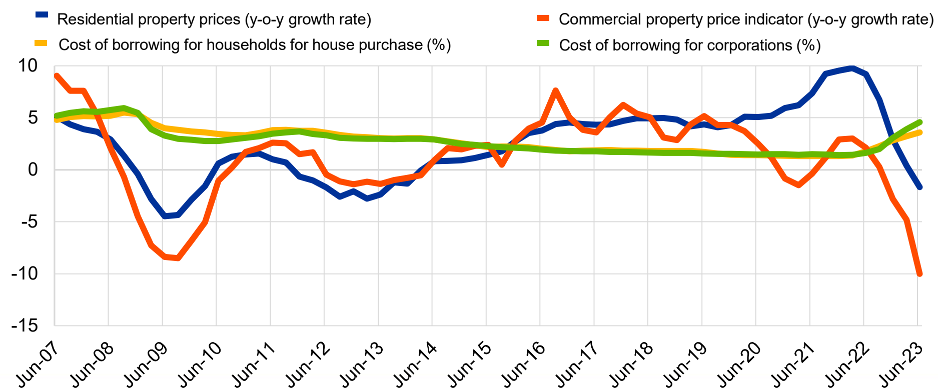
Credit risk: Outlook for NFCs has improved, but higher funding costs continue to pose challenges, especially in the leveraged segment

- Firms' balance sheets remain overall resilient notwithstanding weakening demand, tighter credit standards and rising borrowing costs that may negatively affect credit quality going forward.
- Vulnerabilities vary greatly across industry sectors and firm sizes. Riskier sectors are more affected by higher energy costs (e.g. transport, auto, chemicals) and declining demand (e.g. construction, retail). Smaller firms may be more vulnerable.
- Concerns higher in leveraged loan segment. Default rates expected to rise but possibly less than in previous downturns, since many companies have managed to push out maturities.
- House prices have started a moderate correction. Stabilizing factors are constraint supply, strong HHs' finances, resilient labour market, countries' macro-prudential measures, and a shift towards more fixed-rate mortgages in recent years.
- CRE valuations and transaction volumes continue to decline sharply driven by tighter financing conditions, macro uncertainty and structural changes in the sector, particularly for lower quality retail and offices.

Stage 2 ratios by asset class (%)



Developments in EA real estate prices and cost of borrowing for HHs and NFCs (%)



Sources: Supervisory data (top chart); Residential and Commercial Property Indexes and Interest Rate Statistics (bottom chart); June 2023.

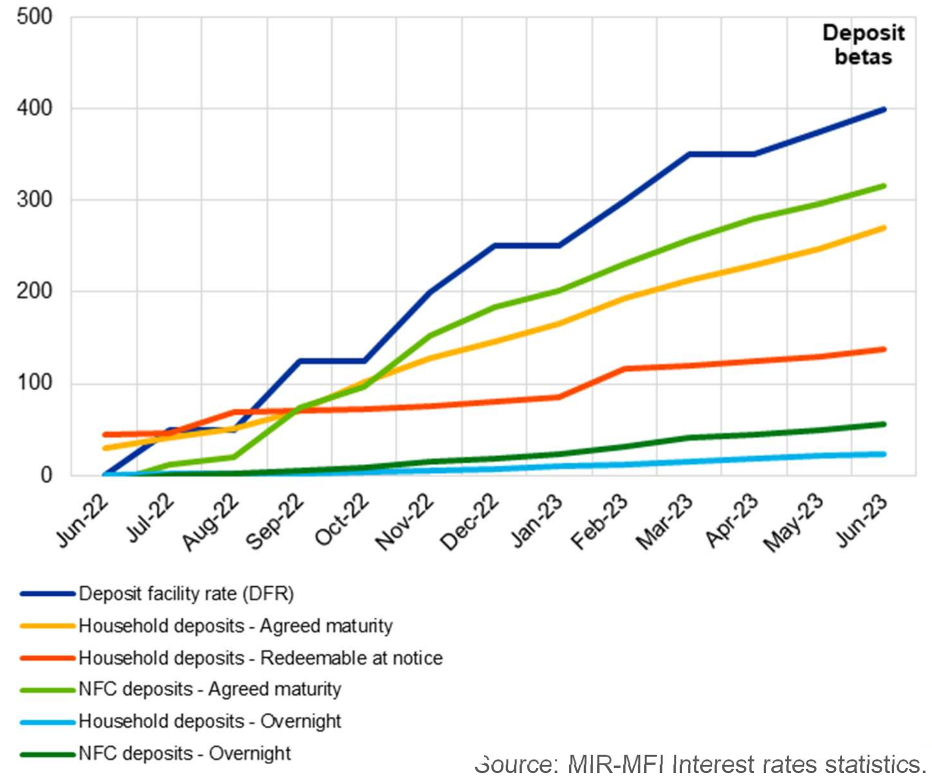
Liquidity / funding positions remain strong but vulnerabilities emerge as excess liquidity drains as a result of quantitative tightening (QT)

- Large TLTRO repayments in June went smoothly with banks' repayment mostly driven by excess cash and wholesale funding (e.g. Covered Bonds, CP and Senior unsecured issuances).
- Total deposit volumes increased during H1 2023 and did not follow the worrying trends observed in some US regional banks

SSM SIs' prudential ratios (LCR, NSFR) remained stable at robust levels in Q2'23.

- Banks benefitted from limited / sticky pass-through to deposit rates but shift towards term deposits and increasing competition might further pressure funding costs.
- Strong bonds issuances confirm good market access … so far.
- Challenges ahead: while excess liquidity remains high, further ECB QT and a highly uncertain / volatile market environment may add pressure on banks.

Evolution of deposit betas and DFR
(22Q2-23Q2; bps)



Source: MIR-MFI Interest rates statistics.

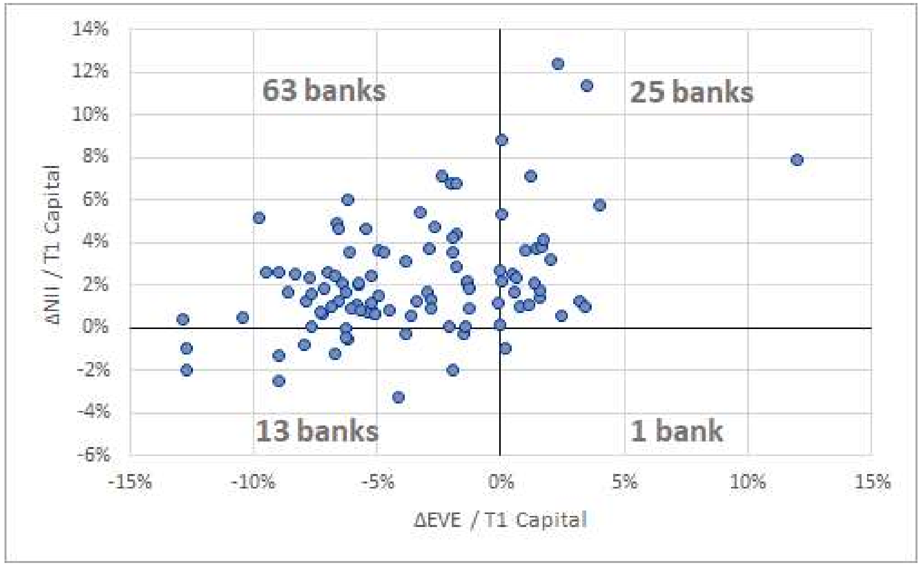
IRRBB: Rising concerns regarding ALM strategies and models

- SSM SIs balance-sheets positioned to benefit from interest rates increases while negative EVE impacts remain manageable.
  - EVE and NII SOT results largely stable since mid 2022;
  - Downside risk for NII stemming from IR downward shift.

- The ECB data collection [1] conducted against the backdrop of the EU-wide ST showed limited and rather stable net unrealised losses for SIs on AC portfolios (EUR 73 bn, CET1% -86bps):
  - Impact becomes EUR 155 Bn and -183 bps in the adverse stress test scenario
  - Interest rate component is typically hedged while credit spread is not, sovereign spread driving the bulk of the net losses.

- Challenges ahead: the new / more complex environment (incl. higher rates, customers behaviors) challenges banks' ALM models and stresses, in some cases, banks' lagging strategy adaptation.

IRRBB Supervisory Outlier Tests: ΔEVE +200bps interest rate level shift impact (22Q2-23Q2)



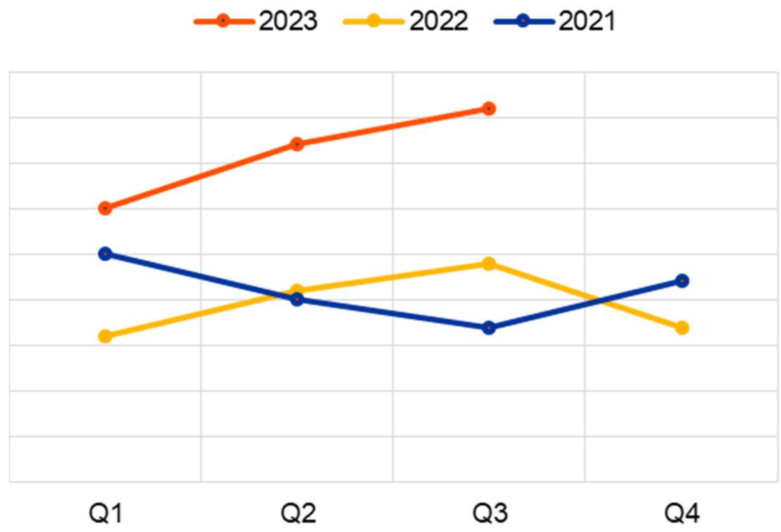
Source: Supervisory data.

[1] As of February 2023, see ECB report.

Operational risk, in particular IT/cyber risk, remains elevated with persisting threats stemming from the geopolitical environment

- The number of cyber incidents reported by SIs has surged in 2023 reflecting the large exposure of the banking sector to the evolving cyber threats, amongst others due to the Russian war in Ukraine.
    - Ransomware attacks are especially on the rise with banks being increasingly affected by evolving extortion techniques.
- Cyber risk and data security remain the main drivers of operational risk for banks, with geopolitical risk continuing to impact the cyber threat landscape.
- Weaknesses in banks' outsourcing arrangements such as high dependency on a few non-European external providers are confirmed by recent analyses.
- Other relevant drivers of operational risk refer to reputational and conduct risks, challenges stemming from new regulation (e.g. DORA).
- Banks are also increasingly facing a severe shortage of talent and difficulties attracting qualified staff, with the issue being most acute for critical technology roles.

Number of significant cyber incidents reported by SIs

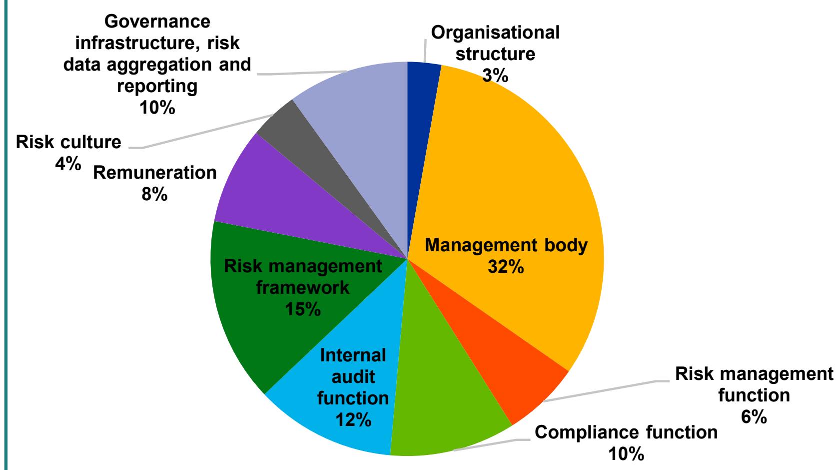


Source: Supervisory data. Cut-off date: 1 Oct 2023.

Internal Governance and Risk Management is an area with persistent, severe deficiencies

- 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.
- Management bodies often miss a strong challenging culture and/or weak decision-making, combined with impaired independence of board members. IT expertise and diversity inadequate.
- Effectiveness of all three internal control functions remains an ongoing concern mainly affected by lack of adequate resources (both numbers and expertise) and insufficient oversight at management body level. Additionally, frequently observed impaired independence and stature have direct impact on quality of deliverables and interventions.
- Weaknesses in risk management framework mostly concern completeness of risk appetite framework, recognition & measurement of climate-related risks.
- Banks continue to demonstrate structural weaknesses in their risk data aggregation and reporting capabilities, especially with regards to IT infrastructure and risk data architecture.

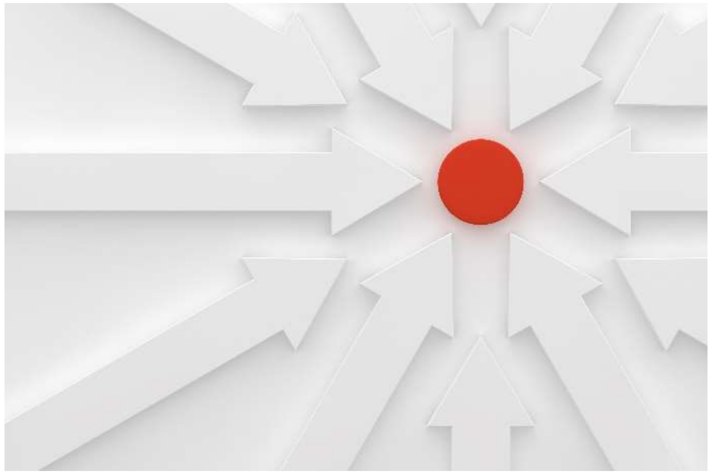
Breakdown of qualitative measures relating to internal governance



Source: 2022 SREP results

Internal Control Functions can play a significant role in the improvement of the bank's overall governance

- Banks' failures are failures to manage and control their risks. The internal control functions have a proactive role and should not rely on supervisors to identify risks.
- Internal control functions should strengthen the oversight and steering capabilities across group entities and reduce the dependence and/or reliance on the group's second and third lines of defense.
- Banks need to enhance their efforts to increase the resources of the internal control functions to ensure adequate quality of their deliverables and effective management of risks.
- The internal control functions should promote a strong risk culture and sound standards of conduct and have the appropriate stature within the organisation to do so.
- The existence of a robust internal audit function in combination with an enhanced interaction with supervisors could facilitate the effective implementation of supervisory measures and improvement of internal governance.



Supervisory priorities for 2023-25

Keeping the bar steady to deliver on the SSM medium-term strategy …

Priority 1: Strengthening resilience to immediate macro-financial and geopolitical shocks

Shortcomings in credit risk management, including exposures to vulnerable sectors	Credit risk
Lack of **diversification in funding sources** and **deficiencies in funding plans**	Funding risk

Priority 2: Addressing digitalisation challenges and strengthening management bodies' steering capabilities

Deficiencies in **digital transformation strategies**	Business model
Deficiencies **in operational resilience frameworks**, namely IT outsourcing and IT security/cyber risks	Operational risk
Deficiencies in **management bodies' functioning** and steering capabilities Deficiencies in **risk data aggregation and reporting**	Governance

Priority 3: Stepping up efforts in addressing climate change

Material exposures to **physical and transition risk drivers**	Climate-related and environmental risk

… while remaining ready to flexibly adjust our plans to changes of the SSM risk landscape!

Panel discussion

Questions

Next up from the Financial Services Faculty...

Unravelling the FTX Fallout: Lessons from the Collapse

View

Available | Virtual | DEC 13 WED | 14:00 - 15:00 GMT

In this webinar we digest what are the lessons learned over the last 12 months about the crypto market and How can crypto businesses and users of digital currencies avoid some of the same pitfalls?

Link: [Unravelling the FTX Fallout: Lessons from the Collapse (icaew.com)]

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