IN-DEPTH ANALYSIS

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Evolving key risks in the banking sector and related priorities for the SSM

Supporting Banking Union scrutiny

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Evolving key risks in the banking sector and related priorities for the SSM

Abstract

While greater inflation may have led to some positive "first-round" effects for banks, several negative "second-round" impacts may occur, including: i) an increase in credit risk, affecting both families and companies, especially "heavy energy users"; ii) a drop in the value of fixed-rate assets held by lenders, including sovereign bonds; iii) liquidity pressures due to the ECB's recent decision to increase the cost of its outstanding 3-year facilities and to greater competition for retail deposits; iv) additional geopolitical risks, including local conflicts in Kosovo, Taiwan or Korea.

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LIST OF ABBREVIATIONS

ECB	European Central Bank
GDP	Gross domestic product
JST	Joint supervsory team
LCR	Liquidity Coverage Ratio
SSM	Single Supervisory Mechanism
TLTRO	Targeted Long Term Refinancing Operations

LIST OF FIGURES

EXECUTIVE SUMMARY

According to recent economic forecasts by the European Commission, the euro area is expected to suffer a significant economic slowdown in 2023, with individual Member States experiencing different degrees of economic strain, due to their vulnerability to shrinking energy imports and rising prices. As for banks, supervisory data at 2022Q2 shows signs that credit risk may experience an increase, while liquidity conditions look prone to some deterioration. Although impaired ("Stage 3") loans have kept decreasing, performing exposures suffering from a significant increase in default risk ("Stage 2") have been picking up, with a remarkable spike for "corporate/wholesale lenders". The share of lenders reporting Liquidity Coverage Ratios in excess of 150% has slightly declined, although the ratio generally remains above unity. Against this backdrop, supervisors have voiced concerns that banks may not be fully appreciating the challenges originating from a worsening macroeconomic framework.

Indeed, while greater inflation and the Ukraine war may have led to some positive "first-round" effects for banks (a sudden tightening of monetary policy, which widened net interest margin), a number of possible "second-round" impacts exist, which might pose a threat to bank stability in 2023.

First, credit risk is expected to increase in 2023, due to a combination of adverse factors: rising interest rates making corporate debt less sustainable, higher energy and food prices putting pressure on corporate margins, lower disposable income leading to a drop in demand from consumers. As with Covid-19, the impact of the above-mentioned factors might be felt more heavily by some specific industries. Although sectors identified as "vulnerable" by the ECB have mostly shown a decrease in their Stage 2 ratios over the 12 months ending in June 2022, business confidence has eroded quickly for "heavy energy users". Consumer lending may also suffer from a drop in the debt service capacity of individuals and families. Residential real estate prices seem to have peaked in June 2022, as the average cost of borrowing for house purchase increases.

Second, higher interest rates triggered by the ECB's anti-inflationary stance may affect lenders in negative ways, as the price of fixed-rate assets, including sovereign bonds, keeps deteriorating. Such adverse effects may be slow to materialise, since a large portion of the affected assets (including 75% of the sovereign exposures held in the banking book) is booked by banks at amortised cost. However, market participants are aware of such losses and might start dumping a lender's shares if they feel that its true equity value is falling. The value of sovereign bond holdings may also suffer from an increase in the issuer's credit spread, as several Member States witness a rise in the risk premiums requested by investors, due to higher rates making their debt-servicing costs less sustainable.

Third, liquidity may come under pressure, also due to the ECB's recent decision to increase the cost of its outstanding 3-year long term refinancing operations ("TLTRO") while allowing early repayment in November, January and February. As of November 23, early repayments were limited to about €300 billion, a small fraction of the total amount outstanding (about €2.2 trillion). This might signal that banks do not see many affordable alternatives to ECB funding. Although most lenders may not be facing liquidity constraints, some may have to significantly adjust their net interest margin forecasts for 2023 as competition for retail deposits picks up and expensive wholesale borrowing regains prominence in their funding strategies.

Fourth, as the Ukraine war led to deep changes in the global balance of power, it is unclear whether such a seismic shift might trigger aftershock, including e.g. local conflicts in Kosovo, Taiwan or Korea. This would certainly have deep repercussions for banks exposed to those areas, either directly or indirectly (e.g. to semi-conductor manufacturers depending on Taiwanese production facilities). Such bank-specific scenarios can be expected to be carefully reviewed by the ECB.

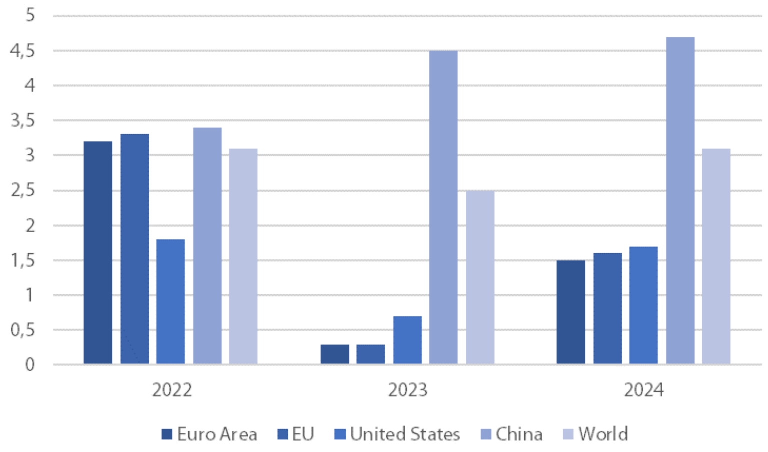
A further factor, which might exacerbate the threats discussed above, is that banks and supervisors seem to disagree on the severity of the dangers that lie ahead. Banks feel that higher loan loss provisions should be easily covered by wide net interest margins generated by the increase in policy rates, and that growth should pick up again in late 2023. Additionally, there is a sense that any extreme, low-probability scenarios are likely to be addressed by public sector interventions, shielding banks from life-threatening losses. Some risk managers have also informally expressed concerns that an over-conservative attitude by supervisors might end up compounding the recessionary effects of tighter monetary policies. However, if supervisors are right in believing that euro area lenders are vulnerable to second-round effects, then the lenders' unwillingness to fully share such concerns might impair their capacity to prepare for, and react to, an unfavourable context.

As requested by the European Parliament, this paper also includes two exemplary questions that could be asked during the forthcoming meeting between ECON and the SSM chair. The former relates to the SSM's willingness to cap, or otherwise constrain, the dividend policies (including share buybacks) of large euro area lenders. The latter relates to safe governance practices, a key tool to address the risks that lie ahead in 2023, and addresses the concerns expressed by some bankers about the intrusiveness of the SSM's practices in this area.

1. BACKGROUND

Based on the recent economic forecasts by the European Commission, the euro area and the EU are expected to suffer a significant economic slowdown in 2023 (see Figure 1), with several Member States that could be witnessing negative real growth rates in the first quarter(s) of the new year.

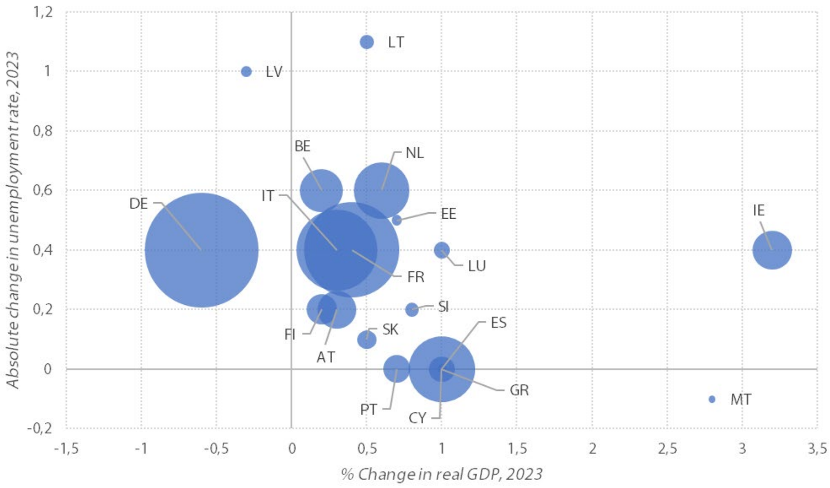
Figure 1: real GDP growth rates for selected economic areas



Source: (European Commission 2022).

What is worse, individual Member States can be expected to experience different degrees of economic strain, due to their vulnerability to shrinking energy imports and rising prices. When one looks at the Commission's expectations for GDP growth and unemployment rates, e.g., Germany and some Baltic countries look braced for a stronger slowdown than, say, Ireland or some Mediterranean nations (see Figure 2). On the other hand, "peripheral" euro area countries, like Italy of Spain, might have less room for expansionary budgets aimed at offsetting the decline in aggregate demand and disposable income.

Figure 2: real GDP growth rates and absolute change in unemployment for individual euro area countries

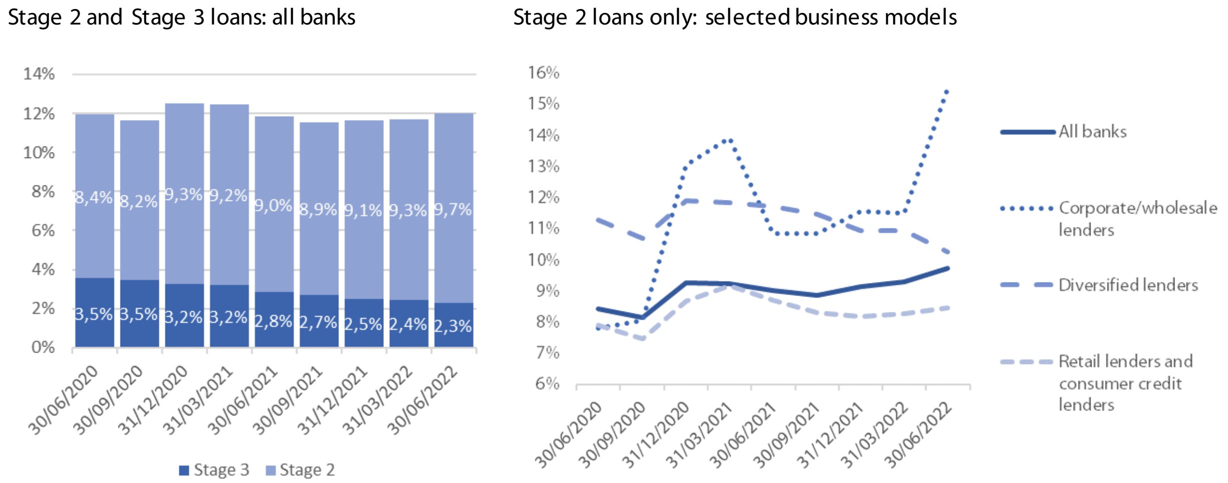


Source: (European Commission 2022). The bubbles' size is based on 2021 GDP (source: World Bank)

When it comes to banks, although supervisory data stop at 2022Q2, there are signs that credit risk may experience an increase, while liquidity conditions look prone to some deterioration.

Although impaired ("Stage 3") loans have kept decreasing in the first half of 2022, Stage 2 exposures (i.e., exposures where default risk has significantly increased since the loan was issued) have been picking up, with a remarkable spike for "corporate/wholesale lenders" (see Figure 3). As concerns 2022Q3, anecdotal evidence suggests that the weight of Stage 2 exposures may be expanding further for some institutions (e.g., up to 9.0% for Deutsche Bank, up from 8.2% at end 2021); many large euro area lenders, however, are not signalling increases in Stage 2 or Stage 3 loans.

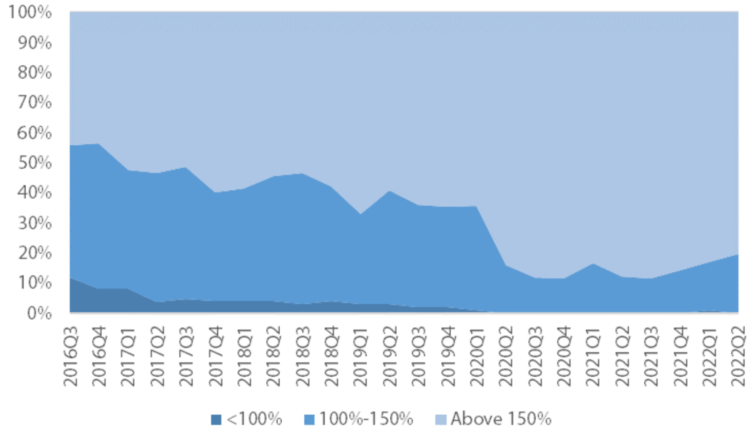
Figure 3: Stage 2/3 loans over total loans subject to impairment assessment



Source: ECB Statistical Data Warehouse, supervisory statistics

The Liquidity Coverage Ratio (LCR), a mandatory indicator showing whether banks hold enough high-quality liquid assets to withstand 30 days of moderately adverse market conditions, has recently seen a modest increase in the share of institutions reporting values below 150%. However, situations where the ratio has dropped below one remain immaterial (see Figure 4).

Figure 4: share of banks with LCR values below 100%, between 100% and 150% and above 150%



Source: ECB Statistical Data Warehouse, supervisory statistics

Against this backdrop, supervisors have voiced concerns that banks may not be fully appreciating the challenges originating from a worsening macroeconomic framework. The SSM's chair, Andrea Enria, has recently highlighted the "worrying dissonance" between the banks' positive expectations for 2023 and "the unique combination of risks" they could soon be facing (Enria 2022b). The EBA's executive director François-Louis Michaud has stated, in an interview, that while lenders try "to walk a thin line – and keep supporting the economy", they also "need to prepare for – possibly and probably very likely – more adverse times" (Collins 2022).

In the remainder of this paper, we briefly survey some key challenges faced by euro area lenders in the months to come, trying to highlight issues that might prove relevant for the work of the SSM in view of the downside risks awaiting banks in 2023. As per the European Parliament's request, we also include two exemplary questions that could be asked during the forthcoming meeting between ECON and the SSM chair.

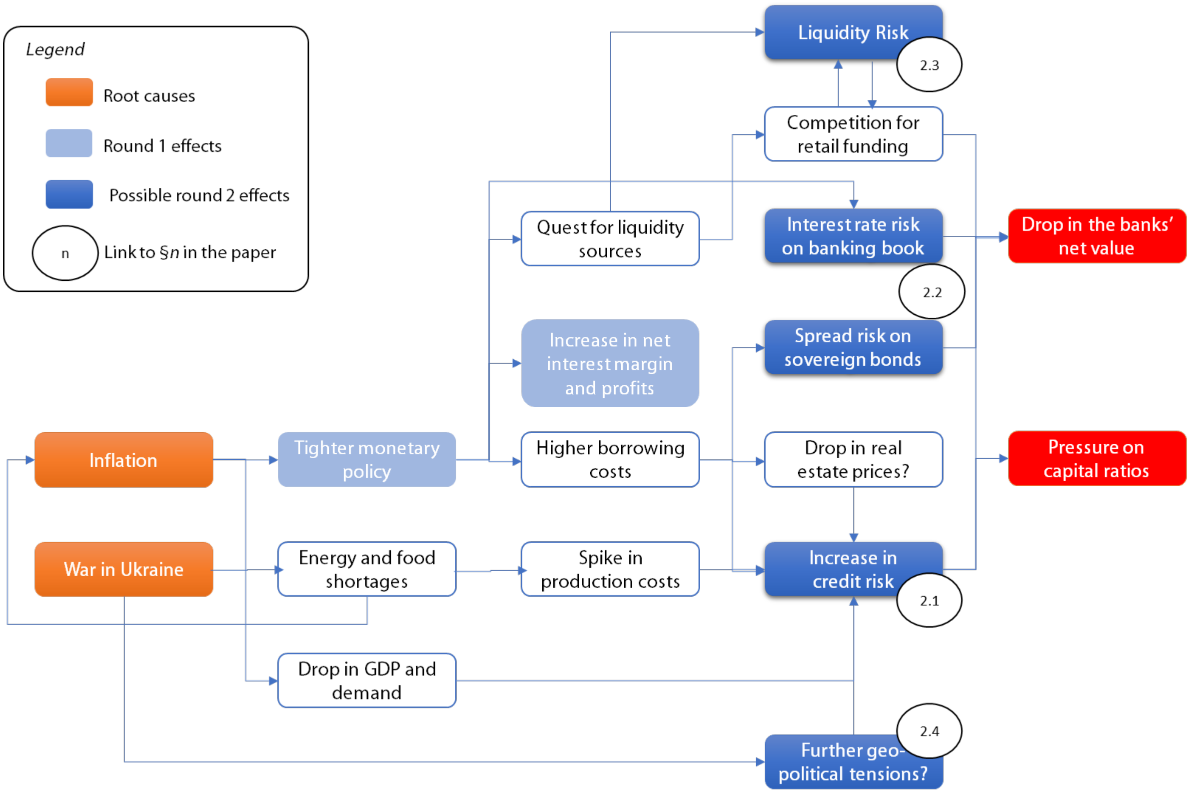
2. KEY ISSUES FOR BANK SUPERVISORS IN 2023

Figure 5 provides an overview of the main sources of risk surrounding euro area banks in 2023. From left to right, it shows:

- the main *root causes* that triggered the challenges currently faced by the real economy, financial markets, governments and lenders, i.e., inflation and the Ukraine war;
- some "first-round" effects that took place in 2022 and can be seen as beneficial, in the short term, for bank profits (a sudden and steep tightening of monetary policy, which led to a quick increase in euro-denominated yields and widened the spread between the rates earned on loans and those paid on deposits);

- a number of possible "second-round" effects, which might pose a threat to bank stability and may need to be addressed by supervisors.

Figure 5: an overview of the main sources of risk surrounding euro area banks in 2023



Source: author's own elaborations

Such second-round effects are discussed in greater detail in the remainder of this paragraph.

2.1. Credit risk and vulnerable sectors

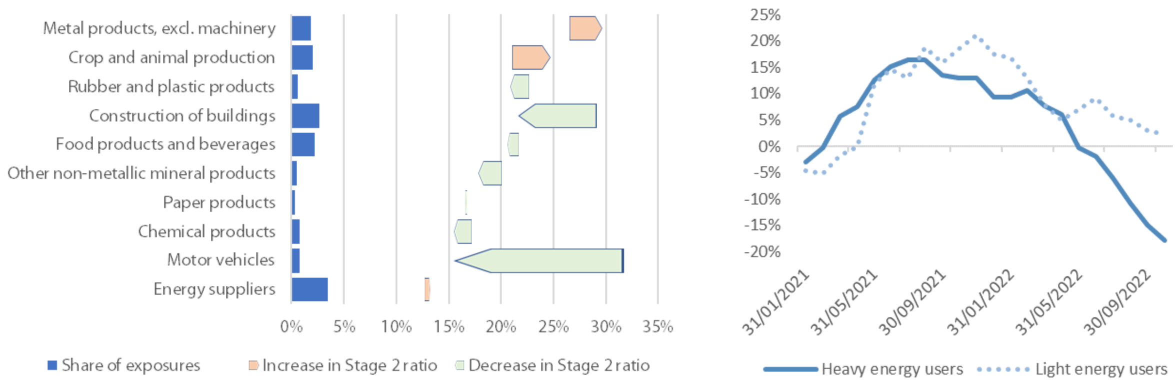
Credit risk is expected to increase in 2023, due to a combination of adverse factors: rising interest rates making corporate debt less sustainable, higher energy and food prices putting pressure on corporate margins, lower disposable income leading to a drop in demand from consumers. Such concerns have recently induced Moody's, a credit rating agency, to cut its outlook - from "stable" to "negative" - for banks operating in Germany, Italy, Czech Republic, Hungary, Poland and Slovakia (Sims 2022).

As with Covid-19, the impact of the above-mentioned factors might be felt more heavily by some specific industries. Although sectors identified as "vulnerable" by the ECB (none of which individually accounts for more than 4% of the euro area banks' credit portfolio) have mostly shown a decrease in their Stage 2 ratios over the 12 months ending in June 2022 (see Figure 6, left panel), business confidence has eroded quickly, and last Spring became negative for sectors classified as "heavy energy users" (see Figure 6, right panel).

Figure 6: credit risk for vulnerable sectors and heavy energy users

Vulnerable sectors: share of exposures and change in the Stage 2 ratio* between 2021Q2 and 2022Q2

Business confidence indicator for heavy energy users** and light energy users***



*Share of exposures in Stage 2

** Top 25% by energy use; *** Bottom 25% by energy use

Source: (Enria 2022a) for left panel, (European Central Bank 2022) for right panel

While it is true that non-performing loans have kept falling in the first part of 2022, as inflation may have eased many borrowers' debt-to-assets and interest coverage ratios, tensions are likely to build up in 2023 as fixed-rate loans are rolled over and higher reference yields translate into the cost of floating-rate facilities.

Consumer lending may also suffer from a drop in the debt service capacity of individuals and families, as a growing share of their monthly income is absorbed by energy bills and essential goods. Residential real estate prices in the euro area seem to have peaked in June 2022 and started showing a moderate reduction in the recent months, as the average cost of borrowing for house purchase rose to 2.44% in September, up from 1.30% one year before (European Central Bank 2022).

2.2. Interest rate risk (and spread risk) on the banking book

Higher interest rates triggered by the ECB's anti-inflationary stance have undoubtedly been beneficial to banks in 2022. Higher yields have translated into stronger interest income on floating-rate assets, while funding costs (especially in the retail market) have been slow to adapt to the new environment. As a result, net interest margin experienced sustained growth.

In the medium term, however, rate increases may affect the lenders' balance sheet in less favourable ways (see again Figure 5). As yields have gone up for medium-to-long maturities, the price of fixed-rate investments, including sovereign bonds, has taken the hit, and might deteriorate further in 2023.

In a recent speech (Enria 2022b), the SSM Chair has noted that this adverse effect may be slow to materialise, since a large portion of the affected assets (including 75% of the sovereign exposures held in the banking book) is booked by banks at amortised cost. This means that a decline in their market value does not translate to the P&L account and does not impact supervisory capital[1]. However, market

[1] (Deutsche Bundesbank 2022) provides an interesting example concerning German savings banks and credit cooperatives: while explicit write-downs on securities amounted to €12.3 billion in 2022H1 (corresponding to around 5.6% of common equity Tier 1 capital), changes to valuation

participants are aware of such losses and might start dumping a lender's shares if they feel that its true equity value is falling. Additionally, any drop in the fair value of securities booked at amortised would become immediately apparent if banks were forced to sell them, e.g., due to liquidity shortages that require them to turn their sovereign bond holdings into cash.

The fair value of some Treasury bonds held by banks may also suffer from an increase in the issuer's credit spread. Indeed, in 2022, several Member States have witnessed a rise in the risk premiums requested by investors, as higher rates make their debt-servicing costs less sustainable. When it comes to a bank's net economic value, an increase in credit spreads works exactly as an increase in (risk-free) interest rates, as it leads to a drop in the bonds' market value that does not go unnoticed by investors (although it may not be immediately visible in the next quarterly accounts).

The ECB has recently carried out an ad hoc review of interest rate risk (and spread risk) on the banking book, finding that a shift in the yield curve would have consequences that are manageable for most euro area lenders[2], and would not impair their ability to operate with adequate capital cushions. Still, the survey has shown that some business models may prove especially vulnerable to this kind of scenarios, including consumer lenders (where funding mostly relies on wholesale markets and therefore gets repriced almost instantly as rates increase).

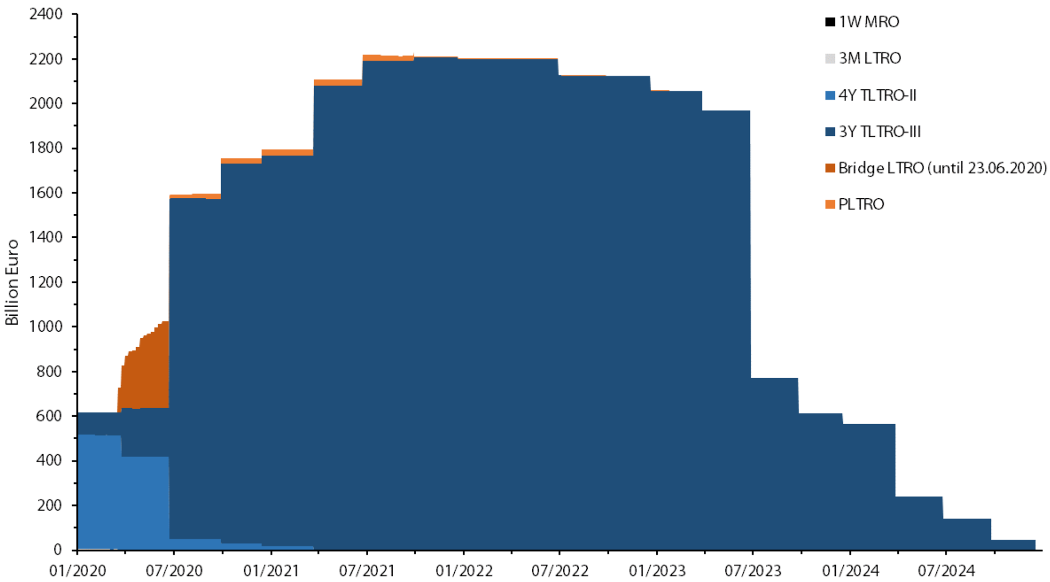
2.3. Liquidity risk

After more than a decade of abundant liquidity, euro area banks might suffer from a drop in cheap funding sources, including the extraordinary long-term facilities that used to be provided by the ECB to support monetary easing and incentivise bank lending. This includes the so-called TLTRO III programme ("Targeted Long Term Refinancing Operations"), a series of ten 3-year refinancing facilities starting in September 2019 at a quarterly frequency, where borrowing rates could be 50 basis points below the average interest rate on the ECB deposit facility (with the actual cost depending on the receiving banks' ability to increase loans to households and non-financial companies). TLTRO III facilities are expected to provide substantial liquidity to the banking system (close to €2 trillion) until next June (see Figure 7).

reserves that do not need to be reported separately in the financial statement (so-called "hidden reserves") accounted for another €21.8 billion in the first half of 2022.

2 See again (Enria 2022b).

Figure 7: ECB refinancing, outstanding amounts



Source: University of Leipzig's TLTRO Tracker, https://www.wifa.uni-leipzig.de/institut-fuer-wirtschaftspolitik/forschung/tltro-tracker

On 27 October 2022, the ECB has announced that the cost of existing TLTRO III operations would be fully indexed to the average applicable key ECB interest rates, making this source of funding less attractive. At the same time, banks have been provided with additional early repayment dates. As of November 23, early repayments were limited to €296,3 billion[3], a small fraction of the outstanding amount and less than expected by most bank analysts[4]. This might mean that banks do not see many affordable alternatives to ECB funding (even as it becomes less cheap) and prefer to keep that channel open.

Many believe that large Euro area banks are not facing liquidity constraints and might choose to use – conditional on the evolution of funding rates and asset returns – the next repayment dates provided by the ECB (January and February 2023). Still, some lenders might have to significantly adjust their net interest margin forecasts for 2023 as competition for retail deposits picks up and expensive wholesale borrowing regains prominence in their funding strategies.

2.4. New geopolitical risks

The Ukraine war came as a largely unexpected event, leading to accelerated risk building for institutions having local subsidiaries in the belligerent countries and/or exposures to companies with a significant presence in Russia. From a geopolitical point of view, the war led to deep changes in the global balance of power, giving an edge to countries, such as India and China, whose availability to distance themselves from Vladimir Putin's regime might play a decisive role for the outcome on the ground.

3 See https://www.ecb.europa.eu/mopo/implement/omo/html/communication.en.html.

4 E.g., JP Morgan had forecasted that €500-700 billion would be paid back (Jones 2022).

It is unclear whether such a seismic shift might lead to aftershock, including e.g. local conflicts in Kosovo, Taiwan or Korea, as well as to unrest in regions – including parts of Africa and the Middle East – which might be threatened by food insecurity (Kammer et al. 2022; Sciences Po 2022). This would certainly have deep repercussions for banks exposed to those areas, either directly or indirectly (e.g. to semi-conductor manufacturers depending on Taiwanese production facilities). Such bank-specific scenarios are certainly part of the ECB periodic reviews of the lenders' business models and vulnerabilities, including under its annual supervisory review and evaluation programme ("SREP").

2.5. Banks and supervisors: different feelings?

A further factor, which might exacerbate the threats discussed above, is that banks and supervisors seem to disagree on the severity of the dangers that lie ahead.

According to banks, higher loan loss provisions can be expected to absorb only "part of the positive revenue impact from higher rates"[5]. Before higher net interest margins fade away, growth should pick up again in late 2023, following a V-shaped profile (i.e., a short-lived downturn). This feeling is somehow reinforced by the fact that, at the outset of the Covid-19, the SSM seems to have somehow underestimated the possibility of a quick economic recovery. Additionally, after the extraordinary measures deployed in response to the pandemic, some argue that any extreme, unexpected scenarios (e.g., a widening of the energy/food crisis triggered by the Ukraine war) are likely to be addressed by public sector interventions, shielding banks from life-threatening losses (although one might object that tax budgets look considerably more strained than three years ago, and public debt sustainability is key to avoid a spiral in borrowing costs).

Some risk managers have informally expressed concerns that an over-conservative attitude by supervisors might end up compounding the recessionary effects of tighter monetary policies, e.g. by introducing new bans on bank dividends or by constraining loan supply through higher capital ratios and buffers (e.g., through Pillar 2 surcharges, including non-binding expectations based on a new round of stress tests). If such beliefs are correct, then the SSM's stance may prove unduly cautious, and end up making things worse rather than safer. However, if supervisors are right in believing that euro area lenders are vulnerable to second-round effects, then the banks' unwillingness to fully share such concerns (Mr. Enria's "worrying dissonance") might impair their capacity to prepare for, and react to, an unfavourable context.

[5] (ING Bank - Economic and Financial Analysis 2022).

3. QUESTIONS FOR THE SSM CHAIR

3.1. New informal capital conservation constraints

In 2020, the ECB issued a dividend ban in order to ensure that profits were retained and used by euro area banks to improve capital adequacy and withstand the adverse effects of the pandemic. In hindsight, such an extraordinary measure may have unnecessarily penalised investors, while making bank equity less attractive in the eyes of market participants. Last year, the ECB has been seconding a wave of large share buybacks, including by Intesa Sanpaolo, Unicredit, La Caixa and ING. Since March 2022, as part to its response to the current deteriorating macroeconomic framework, the SSM – while refraining from issuing formal bans and *ad hoc* supervisory expectations[6] – is said to have resumed some moral suasion on lenders to slow down plans for share buybacks and hefty dividends (Noonan 2022). Could you discuss these rumours and the rationale behind the ECB's stance?

3.2. Participation of ECB representatives to board meetings

In view of the challenges facing banks in 2023, safe governance practices are key to financial risk management and bank stability; the work done by ECB in this area over the last four years must be duly acknowledged. Nevertheless, some banks have been voicing concerns about the intrusiveness of the SSM's practices in this area[7], arguing against JST members attending board-of-directors meetings, as this would reduce the room for frank, informal discussions. Could you comment on this approach? How often do ECB representatives attend board meetings and based on what kind of concerns and situations? Do you believe that this practice should be extended or, instead, that it should only be used to face extreme scenarios where there is reason to believe that the board's ability to challenge the top manager's views looks seriously impaired?

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6 See (Noonan and Arnold 2022).

7 See (Sirletti, Comfort, and Rajbhandari 2022).

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