EUROPEAN CENTRAL BANK

BANKING SUPERVISION

ECB PUBLIC

ECB Banking Supervision Market Contact Group (BSMCG)

Monday, 6 February 2023, physical meeting

MEETING SUMMARY

Andrea Enria, Chair of the Supervisory Board, opened the fourth meeting of the BSMCG. Mr Enria outlined the agenda and recalled that the exchanges of views with market participants are an essential component of the market intelligence activities conducted by ECB Banking Supervision to support its assessment of the main risks and vulnerabilities of the banking sector.

1. European banking sector outlook

BSMCG members broadly agreed that the European banking sector had proven to be resilient to recent crisis episodes and was in a much better position to withstand potential future shocks, also thanks to the robust capital positions and comfortable liquidity buffers built up after the Great Financial Crisis (GFC) and the actions undertaken by regulators and supervisory authorities. However, BSMCG members noted that, while the direct fallout on the banking system from Russia's invasion of Ukraine remained contained, asset quality deterioration remains one of the main risks for the banking sector for 2023 and beyond, especially for banks exposed to more vulnerable economies and sectors. In this regard, BSMCG members considered that, while the headline non-performing loan ratio had remained on its downward path in recent months, high inflation, tightening financing conditions and a deteriorating growth outlook would weigh down on banks' customers' debt servicing capacity. Non-financial corporates are expected to be relatively more affected than households, with small- and medium-sized enterprises deemed to be especially vulnerable on account of more limited funding sources and the phasing-out of government guarantees. Separately, many BSMCG members pointed out that the public support measures, which have limited the negative impact of rising costs to consumers, have also indirectly reduced the risks to the banking sector.

BSMCG members noted that the ongoing normalisation of monetary policy supports banks' profitability through higher net interest margins. Members expected this trend to remain robust going forward notwithstanding expectations of a counterbalancing impact in future from increasing cost of risk. However, most BSMCG members still considered that increasing net interest margins on their own would not suffice for most banks to meet their cost of equity, which was generally deemed to be too high in light of banks' actual risk profiles. In this regard, some members noted that building confidence vis-à-vis investors would take time and that the ample monetary and fiscal measures deployed by official institutions and governments during the pandemic to support the economy at large meant that a true test of banks' resilience had yet to take place. Other members stressed the role which ECB Banking Supervision had to play in restoring investors' confidence by providing clarity on the supervisory agenda and expectations on ion banks' capital trajectories.

Looking further ahead in terms of emerging risks, some BSMCG members pointed to the build-up of leverage in the non-bank financial sector and the potential consequences for banks stemming from an increased level of interconnectedness. Uncertainties about future monetary policy tightening and the interplay between monetary, fiscal, and regulatory policies were also highlighted in this regard. Lastly, a few BSMCG members mentioned sovereign risk as a potential re-emerging issue, although fragmentation risk within the euro area was generally expected to remain contained.

2. Liquidity and funding risks in the current environment

BSMCG members pointed to the strengthening of banks' liquidity and funding risk profiles of euro area banks since the GFC, with the growth of banks' customer deposits outpacing that of banks' loans amid supportive monetary policies leading to a large excess liquidity in the system. Members thus generally agreed that, in the absence of new macroeconomic shocks, the liquidity and funding outlook for the next two years seemed to be manageable for the European banking sector as a whole, with large banks expected to cope more comfortably with TLTRO repayments and the progressive phasing-in of MREL requirements than medium-sized and smaller banks. BSMCG members also concurred with the view that the expected increase in banks' funding costs would be largely compensated by a corresponding or even faster repricing of their assets. In this context, some members suggested that while the pass-through of higher key central bank policy rates to household deposit rates had been relatively limited so far, this might change in the future on account of renewed competition for deposits and the emergence of alternative and more attractive investment opportunities. Some members also pointed out that a potential risk to banks might emerge in the future should non-banking financial institutions participate more actively in deposit-taking businesses. Separately, some BSMCG members stressed the significant hurdles which remain in place for banks to operate efficiently in a cross-border dimension within the European Union, pointing to the importance of completing the Banking Union and developing the Capital Market Union in Europe.

3. Concluding remarks

Mr Enria concluded the meeting by thanking the members for their active participation in the discussions and noting that membership in the group will be again reviewed before the next meeting in July 2023 in order to ensure rotation and broad representation.