5th ECB Banking Supervision Market Contact Group (BSMCG) meeting

Friday, 14 July 2023, physical meeting

MEETING SUMMARY

Andrea Enria, Chair of the Supervisory Board, opened the fifth 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. Mr Enria also remarked that this is the last BSMCG meeting he is chairing before his term as Chair of the Supervisory Board of the European Central Bank comes to an end.

1. European banking sector outlook

BSMCG members agreed that, when seen in aggregate, European banks were showing a strong profitability trend in 2023, boosted by higher interest rate margins and lower impairments. However, members still noted that the return on equity remained below the cost of equity, which has risen. Members expected that going forward profitability could be negatively affected by an uncertain macroeconomic environment and by decreasing loan volumes due to tightening financing conditions. Members also discussed the different degrees of interest rate pass through to deposits, also across member states, and debated the potential policy and supervisory implications associated with this trend. While asset quality was not seen as being at the top of investors' attention currently, BSMCG members noted that high inflation and increasing debt servicing costs could affect negatively corporate credit quality going forward. In addition, commercial real estate was also mentioned as a business segment more vulnerable to current circumstances, along with floating interest rate loans.

BSMCG members highlighted the rebound in European banks' equity prices after the recent turmoil in the US and Swiss banking sectors. In this context, members stressed the differences between European and US regulatory and accounting regimes, considering that such factors coupled with diverging liquidity and funding positions for banks on different sides of the Atlantic implied that there should be no direct read across from US events to European banks. Members also broadly agreed that the recent turmoil highlighted the importance of sound business models, strong governance and risk management culture, and adequate liquidity and diversified funding structures, respectively. In this regard, members stressed the need for supervisors to look beyond the usual financial and prudential metrics to inform their assessment. Some members expressed concerns with respect to a potential recalibration of the Liquidity Coverage Ratio (LCR). Members also highlighted the importance of banks being able to quickly assess and timely report their liquidity positions.

Members also discussed the extent to which digitalisation can play a role in increasing the speed of bank runs. While it was recognised that digitalisation might facilitate a faster withdrawal of deposits, members noted that recent bank run episodes still showed that lack of confidence remained the driving factor behind such events. In this context, some members highlighted the importance of central banks fulfilling their traditional lender of last resort function for solvent banks. More broadly, members also deemed that a potential increase in the threshold for insured deposits would not *per se* prevent bank runs from occurring, as important uninsured segments (such as corporate deposits) would remain.

2. Challenges for banks stemming from structural changes in the competitive landscape and concentrated exposures towards non-bank financial institutions (NBFIs)

BSMCG members pointed to the consolidation of the European banking system since the Global Financial Crisis (GFC), as could be seen from the increased market share of some large players, noting that digitalisation and automation had helped banks to reduce costs (e.g. through a reduction in the number of branches). At the same time, members broadly considered that, contrary to initial expectations, new digital players such as FinTechs, had not yet grown to be a disruptive force to the banking landscape. Members generally considered high market entry costs (e.g. higher funding costs, licensing and regulatory requirements) as a factor in this regard, combined with customers' reluctance to enter a banking relationship with less-known and less trusted providers. In this regard, members also noted that banks had been investing in digitalisation and had bought out or partnered with some interesting FinTechs.

However, members pointed out that going forward BigTechs would still pose a large competitive threat to banks, because those firms could rely on their vast customer bases, known brands, capital means and digital power to enter the banking business with competitive product offers. In this context, it was noted that BigTech firms were still focusing on the more lucrative parts of the business, such as payment systems, but that a decision to develop a fully-fledged banking offer could not be ruled out in the future, for example, when the growth potential of a large customer base would be exhausted. Some members also noted that potential customers for such firms would come more from premium, younger and higher-income segments, respectively.

Overall, while members generally considered that Big Techs had the potential to disrupt the banking market over a longer time horizon, members also thought that such firms might end up partnering with banks, playing the role of a distributor, such that a smoother outcome may be achieved instead. In this context, members noted that some of this partnering was already taking place. Members also discussed the benefits of digitalisation for banks noting that a potential bifurcation in cost to income ratios between smaller and larger institutions may ensue as large banks have the means to design their own solutions and undertake large IT investments, while smaller banks need to mostly rely on third-party service providers.

BSMCG members also discussed the increasing role of non-bank financial institutions (NBFIs) in the provision of private credit. This trend was partly attributed to a decreasing risk appetite by banks following the GFC, thus leaving space in the competitive landscape to new competitors. Some members noted the increase in the share of private credit in leveraged finance over the recent years and expected this trend to continue in the future. However, members generally agreed that both public and private lending can coexist, with banks playing a substantial role in financing M&A activities which were expected to pick up after a slowdown over the last year. In this context, it was noted that banks were also present in private credit by lending to private credit funds (asset-based lending and subscription lines) and taking part in private credit origination. Some members also mentioned that certain banks were said to be considering options to enter private credit secondary market trading, which was assessed as being a more risky and less liquid market. Overall, members generally agreed that bank exposures to NBFIs were significant, being concentrated among larger banks, but noted that a lack of more granular data did not provide enough visibility on counterparty credit risk. Coupled with the risks stemming from banks' exposures to NBFIs, members also highlighted risks stemming from the corporate loan book, as the sector was being affected by both high inflation and high debt servicing costs.

3. Concluding remarks

Mr Enria concluded the meeting by thanking the members for their contributions and active participation in the discussions. The next meeting is expected to take place in early 2024.