



EUROPEAN CENTRAL BANK

BANKING SUPERVISION

European banking supervision: taking stock and looking ahead

Analysis Forum – Milan



27 September 2023

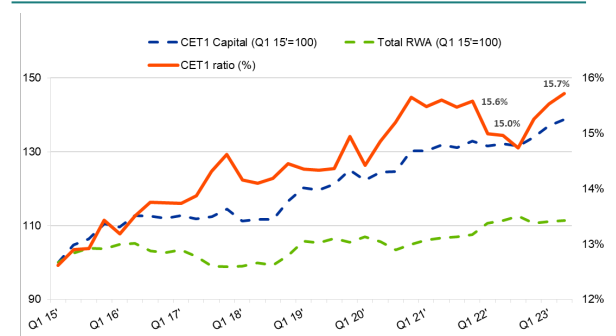
Andrea Enria
Chair of the Supervisory Board of the ECB

Euro area banking sector

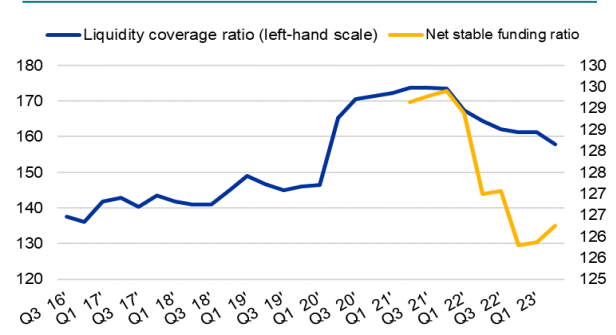
Euro area banking sector repaired its balance sheet and proved resilient to exogenous shocks

- The long journey to repair banks' balance sheets after the great financial crisis made euro area banks more resilient, as shown by their ability to withstand three consecutive shocks (pandemic, geopolitical crisis, failures of a number of US regional banks and takeover of Credit Suisse).
- Results of 2023 EU-wide stress test show that the euro area banking sector could withstand a severe economic downturn (as captured in the harshest adverse scenario used since the start of European banking supervision). Unrealised losses on securities held at book value appear contained.
- Euro area banking sector holds high-quality liquid buffers (cash and central bank reserves) and has a diversified funding base. No business model is like that of Silicon Valley Bank.

Common Equity Tier 1 capital



Liquidity ratios

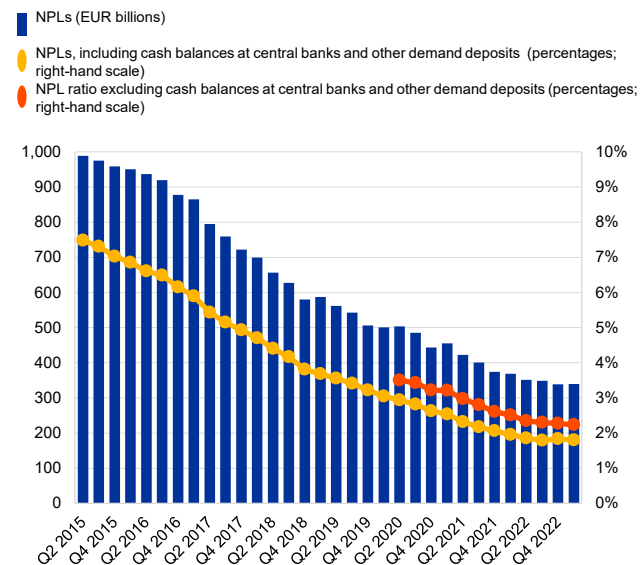


Source: Supervisory reporting.

Legacy asset quality problems have been successfully tackled across the banking union

- Aggregate ratio of non-performing loans (NPLs) at historical lows – number of outlier banks massively reduced
- Key role played by:
 - regulations and supervisory expectations on provisioning
 - supervision of internal workout practices of NPLs
 - sales and securitisations on secondary NPL market
 - national government support (asset management companies, guarantees for NPL securitisations)
- Cycle of interest rate hikes may still affect asset quality, but supervisory scrutiny of credit controls and past experience of NPL resolution leave banks well equipped
- Key to preserve investors' confidence in NPL market and avoid legislative initiatives that undermine effective NPL resolution

NPL stock and NPL ratio

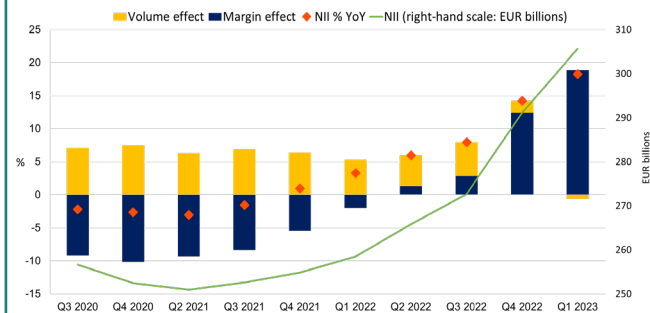


Source: Supervisory reporting.

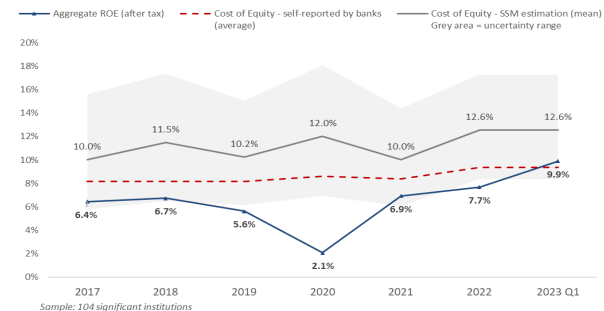
Normalisation of interest rates eased a long-lasting struggle for profitability

- Fast-paced interest rate hikes boosted net interest income, net interest margins and return on equity to levels not seen in a long time
- Current hiking cycle characterised by slower pass-through to deposit rates relative to past cycles – potential catch-up following period of negative rates
- Competition for deposits and higher funding costs, falling lending volumes and higher cost of risk expected to exercise downward pressure on net interest income
- Addressing the slow pass-through of higher interest rates to depositors via price constraints and bank levies is potentially distortive, also on prudential grounds
- Euro area sector somewhat improved in terms of cost efficiency and business model adjustment. Governance of environmental and digital transformations key challenge to earn cost of equity on sustainable basis

Decomposition of net interest income



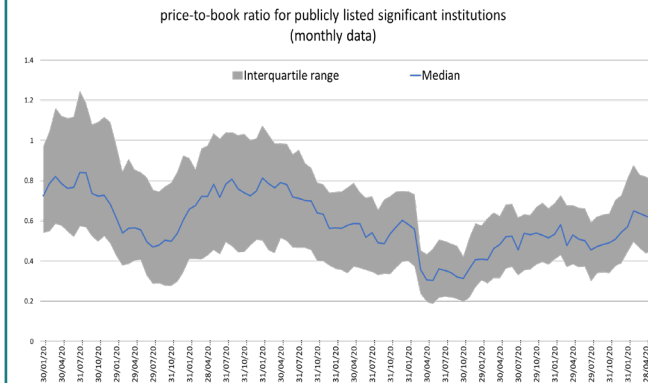
Return on equity vs cost of equity



Market valuations recovered from historical lows but investors not yet convinced that new profitability level is sustainable

- Increased profitability, higher dividend payments and share buy-backs supported a significant recovery in market valuations, but price-to-book ratios remain well below 1 – average euro area bank still struggling to earn its cost of equity
- Banks need to continue their efforts to stabilise profitability on a higher level and to enhance the sustainability of their business model. Good governance crucial in steering this transition
- Essential to preserve legal and regulatory stability after the close of the post-crisis reforms, as surprise initiatives reinforce negative sentiment among investors and hinder the necessary reduction in the cost of equity

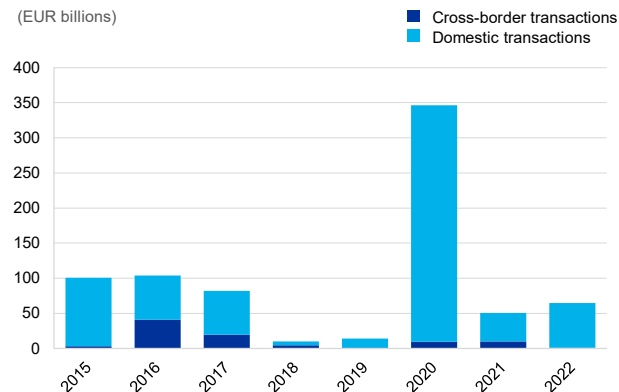
Price-to-book ratio



Little to no progress in market integration in the banking union

- Euro area banks have not strengthened their EU footprint and the banking union is not yet seen as an enlarged domestic market
- Mergers and acquisitions remain mostly oriented towards the domestic market, while national markets are increasingly concentrated and locked-in
- National authorities keen to preserve capital and liquidity safeguards for legal entities of foreign groups. Unlike third-country groups, euro area groups are not inclined to use a branch structure or provide cross-border services directly
- Potential for positive developments thanks to further improvement in market valuations and the rollout of digitalisation strategies. So far, banks have favoured capital distributions over growth investments and diversifying their revenue sources, but cross-border M&As could come back onto the agenda due to higher profitability and higher valuations

Total assets of M&A target banks in the EA



Source: ECB calculations based on Dealogic and Orbis BankFocus.

European banking supervision

European banking supervision is agile and able to adapt to a fast-evolving risk environment

- **Pandemic shock**
 - Recommendation to limit dividend distributions and buy-backs (lifted promptly when uncertainty receded)
 - Flexibility around capital buffers
 - Supervisory flexibility – pragmatic SREP, adapted deadlines and processes, postponement of stress test
 - Dear CEO letters on credit risk controls (banks were “flying blind” on risk levels due to moratoria)
 - Sectoral credit risk analysis
- **Geopolitical shock (Russian invasion of Ukraine)**
 - Adapted analysis of sectoral credit risk and counterparty credit risk
 - Supervisory scrutiny of euro area banks’ presence in Russia
 - Focus on cyber and IT risk
- **Monetary policy normalisation**
 - Timely scrutiny of management practices around interest rate risk and credit spread risk
 - Prioritised focus on banks’ liquidity and funding risks

Supervisory risk-focus and discretion enhanced while allowing for increased consistency, transparency and predictability

- **Greater focus on risks**

- Supervisory priorities
- Risk tolerance framework – work in progress
- Multi-year Supervisory Review and Evaluation Process (SREP) – work in progress

- **Enhanced consistency**

- Second line of defence

- **Increased transparency and predictability**

- Publication of methodologies – SREP methodologies, calibration of Pillar 2 guidance
- Publication of supervisory approaches and guides – internal models, bank consolidation, qualifying holdings, leveraged transactions, fit and proper assessments, bank-specific scrutiny of distribution policies (post-pandemic)
- Publication of supervisory outcomes – annual SREP results press conference, bank-specific Pillar 2 requirements, stress test results, on-site supervision newsletter, Supervision Blog
- Communication with banks – letters to CEOs, letters to banks accompanying the SREP decision (“Executive Letter”)
- Dialogue with market stakeholders – Banking Supervision Market Contact Group

Challenges ahead

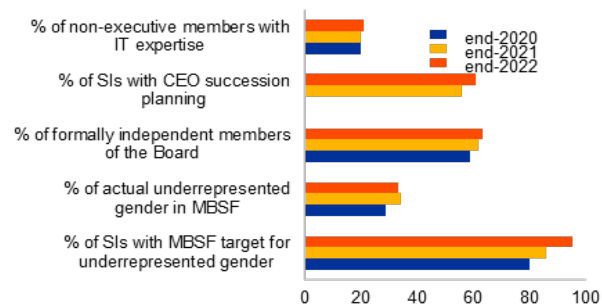
Corporate governance in banks will continue to be challenged by cyclical risks and structural transformations

- US regional banks and Credit Suisse – investors and depositors quickly react to weak governance, particularly in times of uncertainty and structural change. No need for major regulatory reforms, but there are lessons for effective supervision

“The crisis at Credit Suisse has shown that meeting capital requirements is necessary but not sufficient to ensure market confidence” [Swiss National Bank 2023]

- Climate and environmental risks – physical, transition, litigation and reputational
- Digital transformation – IT and cyber risk management, operational resilience, strategic steering in the face of competition from tech companies
- Underlying drivers of good governance:
 - Risk data aggregation capabilities (BCBS 239 standard)
 - Board composition and functioning – diversity, independence, steering capability

Banks made progress but some weaknesses remain in how boards function

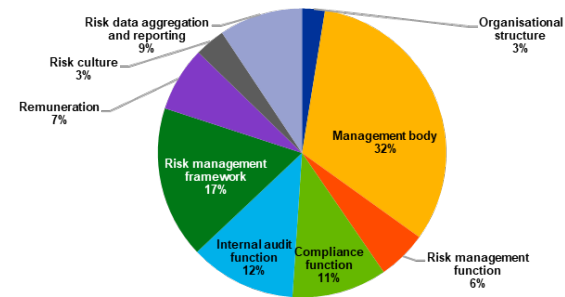


Source: Internal governance data collection.
Note: No data for succession planning in 2020.

European banking supervision must become even more effective and efficient

- External reviews of SREP:
 - “ECB’s supervisory approach appears to be too capital centric” [Wise Person Group Report]
 - “it is more effective to rely on other instruments to address identified weaknesses in governance and business models” [Wise Person Group Report]
 - ECB to use full range of supervisory powers when persistent deficiencies not addressed by banks [European Court of Auditors]
 - ECB to streamline SREP [European Court of Auditors]
- Too many findings and qualitative measures are open for too long (SVB implications)
- Stronger supervisory escalation capacity and increased reliance on wider enforcement toolkit,— periodic penalty payments, business restrictions, sanctions, fit and proper reassessments, etc.
- Stronger framework for qualitative measures does not imply a lower capital bar

SREP 2022 qualitative measures relating to internal governance



Source: SREP 2022.