# The EU Banking Sector – Navigating Challenges

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## ABSTRACT

**The elevated macroeconomic uncertainty due to subdued economic growth, inflationary pressures and increasing interest rates have brought into the forefront some risks in the global banking sector. In the aftermath of the banking crisis in the US and the takeover of Credit Suisse from UBS, EU banks are now confronted with a growing number of challenges. The article examines the level of preparedness of the EU banking sector to navigate these challenges taking into account the robust starting point of the EU banks.**

## Macroeconomic uncertainty and market volatility define confidence in the banking sector

The uncertainty around the macroeconomic outlook defined by high and persistent inflation pressures, rising interest rates and expectations for slower economic growth, or even recession in some jurisdictions, have affected economic sentiment. Although unemployment rates have not peaked up, consumer and business confidence[1] are decreasing which may pose additional pressures in economic growth expectations. These could not possibly leave the banking sector unaffected.

Economic confidence was just recovering from the pandemic hangover before it was hit by the supply shock due to the Russian invasion in Ukraine. The tensions in supply chains due to the pandemic have been exacerbated by the war, the subsequent energy crisis, and the strong inflationary pressures. Central banks reacted to tackle these pressures, yet they had to do so in an unprecedented pace which may have exposed weaknesses of the banking sector.

The crisis of some regional banks in the United States and the subsequent takeover of Credit Suisse have reminded all of us that banking is based on trust and that this can swiftly evaporate. Depositors and investors' trust in the failed banks was quickly lost triggering an abrupt increase in volatility in equity markets, widening spreads in corporate bonds and a flight to safe haven assets to an extent not seen since the outset of the war in Ukraine.

The write-down of Credit Suisse AT1 (Additional Tier 1) holders lead to a severe increase in AT1s spreads and a temporary shutdown of the market for new issuances.

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[1] European Commission on Business and Consumer Confidence Surveys

Although banks' share prices and credit spreads have partially recovered since mid-March, markets remain volatile as confidence has not been fully restored and they remain vulnerable to downside risks.

### Capitalisation of EU Banks is robust helped by rising profitability.

Despite the obstacles faced by the sector in the past decade, banks have managed to increase their capital positions and reported at the end of 2022 an average CET1 (Common Equity Tier 1) (fully loaded) ratio of 15.3%. This compares to 11.5% in 2014. The capital headroom above regulatory requirements (i.e., Overall Capital Requirements – OCR - and Pillar 2 Guidance) is close to 500bp. The average leverage ratio was 5.5%, comfortably above the regulatory minimum. The improvement in capitalisation is also evident in the lower end of the distribution.

In 2022, the strengthening of capital ratios was supported by strong profitability as earning capacity of the banks expanded due to increasing interest rates and widening margins. Average return on equity was reported at 8%, the highest level since EBA started collecting data, while expectations point towards further strengthening. EU banks' profitability was squeezed for many years as low or negative rates impaired their ability to make the transformation from short-term liabilities to long-term assets a profitable business. The increase in interest rates have enabled banks to widen their interest rate margins and increase considerably their net interest income. In the current volatile macroeconomic environment, strong profitability can be the first line of defense for rising provisioning needs.

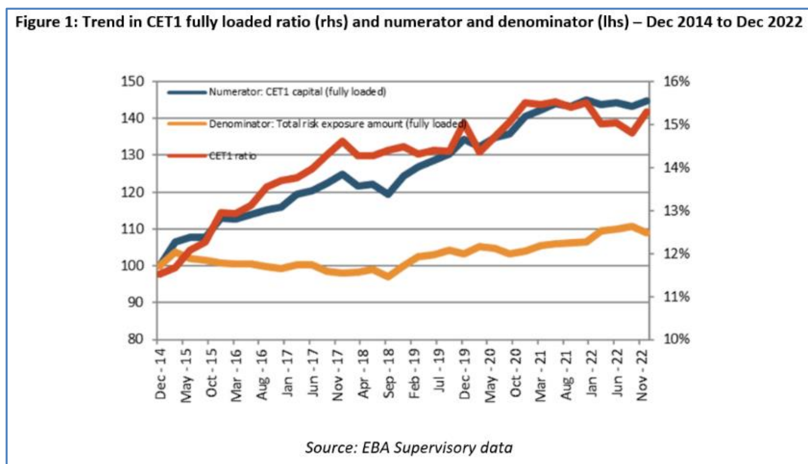



**Figure 1: Trend in CET1 fully loaded ratio (rhs) and numerator and denominator (lhs) – Dec 2014 to Dec 2022**

*Source: EBA Supervisory data*

Following a freeze in distributions during the pandemic, the strengthened profitability of the sector has enabled a large share of banks to distribute earnings through dividends or share buyback programs. In 2022 banks distributed as shareholder remuneration close to EUR 50bn with a payout ratio of close to 45% of total earnings. A number of banks have recently reiterated their intention to further support distribution of earnings either through share buy-backs programs or dividends.

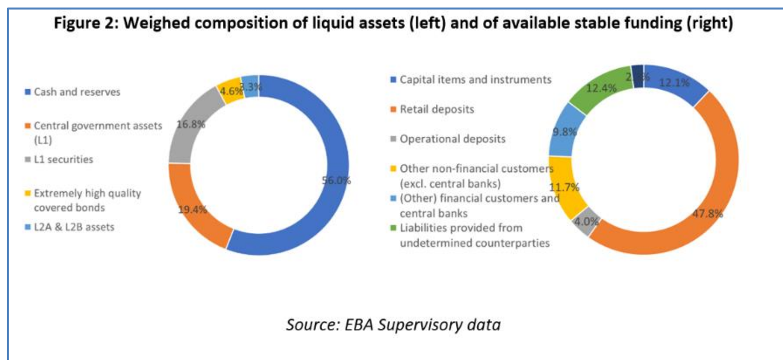
Liquidity is also at a stronghold. The average liquidity coverage ratio (LCR) of the EU banking sector is above 164% with banks at the lower end of the distribution reporting close to 140%. High-quality liquid assets make up more than 55% of the total liquidity reported by EU banks. These are mostly cash and central bank reserves. Other liquidity ratios point to similar direction. The net stable funding

ratio (NSFR) was also comfortably above regulatory minimum, reported at 125%. Available stable funding (ASF) is well diversified, with notably almost half of it contributed by retail deposits which tend to be rather sticky. Despite the healthy status, challenges lie ahead. In the next months EU banks will need to fully repay ECB's targeted longer-term refinancing operations (TLTRO). It is expected that this will be achieved widely using the excess central bank deposits banks held. However some banks may need to refinance parts of maturing TLTRO volumes, driving their funding costs higher.

## Credit risks vulnerabilities likely to emerge

Solvency and liquidity health metrics for EU banks stand on a solid ground. Profitability is at its highest level since the GFC (Great Financial Crisis) and with positive prospects for banks' income to remain high. However, EU banks may be confronted with challenges on several fronts in the coming months.

**Figure 2: Weighed composition of liquid assets (left) and of available stable funding (right)**

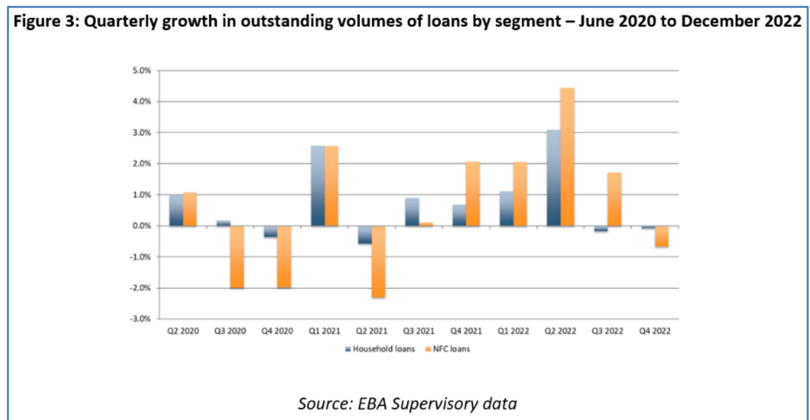



*Source: EBA Supervisory data*

Abruptly increased interest rates to tackle inflation have slowed down lending growth markedly. On aggregate banks reported lower outstanding volume of loans for both households and non-financial corporates in the last quarter of last year. This trend has continued in the first quarter of this year too. The lower lending growth is not only a result of lower demand due to higher interest rates and subdued consumer or business confidence, but also results from banks tighten their credit standards.

Although subdued lending growth could pose a more medium-to-long-term challenge for banks' profitability, credit risk seems to be a more imminent challenge. The deteriorated macroeconomic environment due to rather sticky inflation along with the abrupt increase in interest rates and the ongoing geopolitical tensions have increased downside risks on economic growth. This presents outright risk for several portfolios as borrowers' repayment capacity is impaired due to the higher interest payments as well as the higher energy cost – albeit the latter have somewhat retreated in the last months. This effect is likely to be felt more on highly indebted borrowers who may struggle to meet their debt obligations.

**Figure 3: Quarterly growth in outstanding volumes of loans by segment – June 2020 to December 2022**

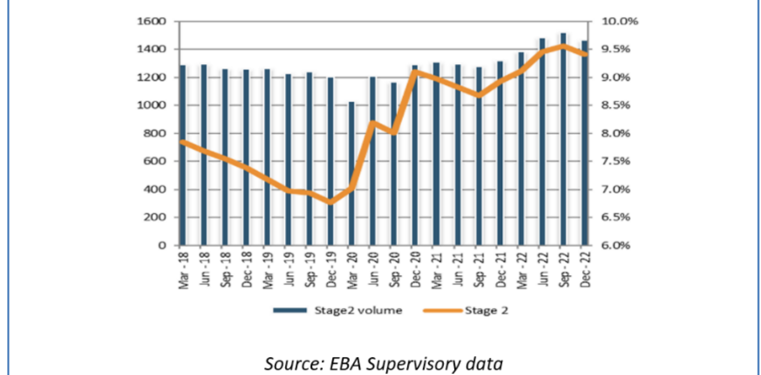



*Source: EBA Supervisory data*

Although asset quality deterioration has not yet materialised in the data reported by the banks, there are some signs that point towards this direction. For example, banks now allocate a higher share of loans in stage 2 and they have increased provisions for performing loans. The share of stage 2 loans is 9.4% which is higher than the pandemic peak yet it has stabilised. Another sign of credit quality deterioration are the rising insolvencies, which are picking up at a steady rate in several EU countries, yet they remained lower than pre-pandemic levels.

Given the current macroeconomic context, some exposures may be more vulnerable and prone to credit quality deterioration than others. Small-medium enterprises (SMEs) are challenged by rising interest payments due to their higher usage of flexible interest rate loans, while also exposed to higher input costs (e.g., energy supply and raw materials). Banks also report an increased rejection rate for corporate loans[2]. Demand for loans is anyhow subdued, with SMEs using credit to fund mostly their working capital and less for investing, a consideration that may have a longer-term impact on their growth prospects.

**Figure 4: Stage 2 allocation volumes (right) and ratio (left) – Mar 2018 to December 2022**




*Source: EBA Supervisory data*

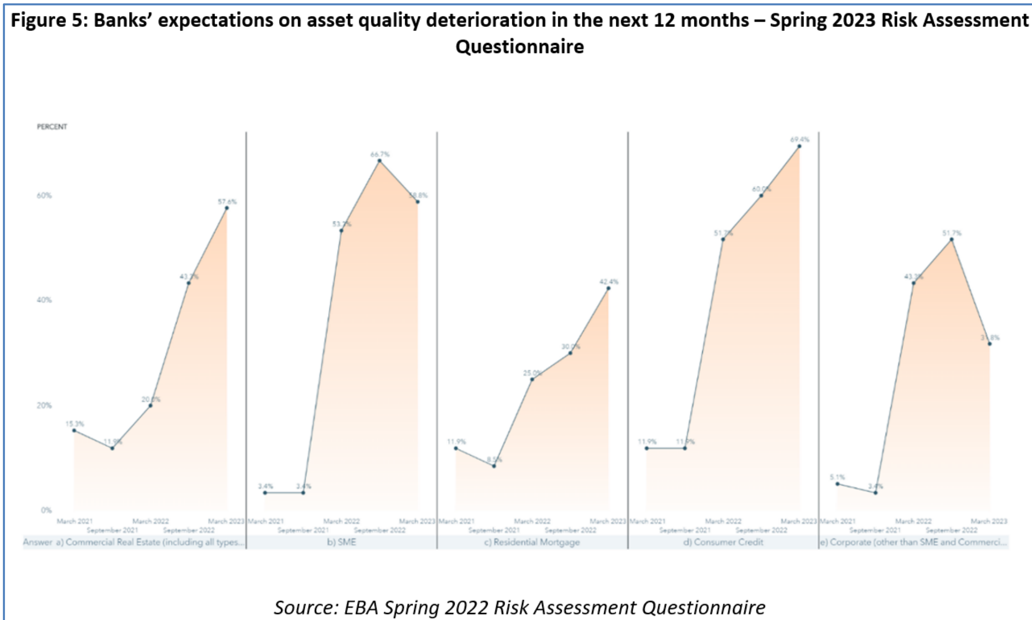
Credit exposures prone to cyclical fluctuations, such as consumer credit, are also more vulnerable. Yet unemployment which a major driver for the performance of these exposures is still falling in the EU. Although NPLs (Non Performing Loans) volumes is a lagged statistic, there has been a marginal increase in NPLs of consumer credit already in Q4 2022. As macroeconomic uncertainty remains elevated impacting consumer confidence and perhaps unemployment rates, we would expect the quality of these exposures to be the first to deteriorate.

There is a growing concern about real estate exposures . Prices in the real estate markets across Europe had a rally since the outset of the pandemic, yet they have slowed down substantially in the second half of 2022. This slowdown has been widely expected as interest rates rose, and it has been to some extent comforting the orderly shift to a correction mode in the residential real estate prices, albeit with major differences between countries and regions. European authorities, including the EBA, have been raising their concerns on the possible consequences of an abrupt price correction in residential real estate markets. A housing price correction will increase the non-performing loans and the outright impact on banks' profitability and solvency ratios . Such price correctioncould also have a more broader effect on economic growth creating an adverse loop that could feed back to banks' performance. Although risks stemming from these exposures are material, there are several factors

[2] ECB Lending Survey

that mitigate the impact on banks. Loan to value ratios have been decreasing, as banks adhered to stricter and more prudent lending standards in the recent years.

**Figure 5: Banks' expectations on asset quality deterioration in the next 12 months – Spring 2023 Risk Assessment Questionnaire**




*Source: EBA Spring 2022 Risk Assessment Questionnaire*

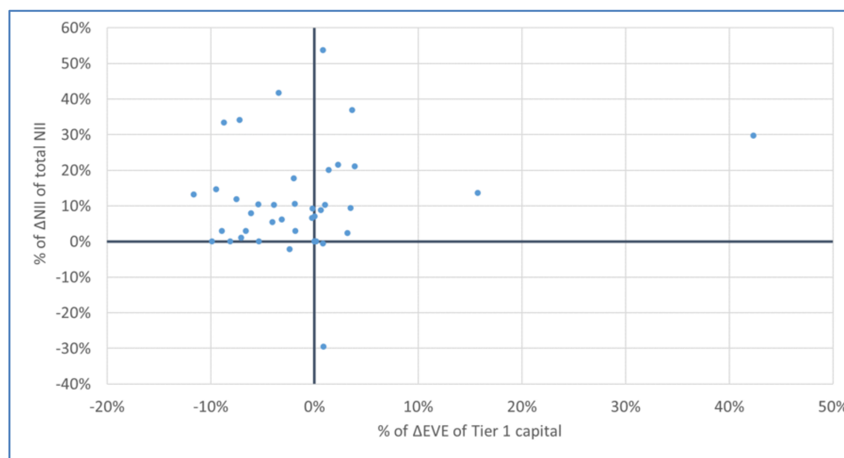
The price correction in commercial real estate markets seems to have gathered already some pace, at least in some jurisdictions. Vulnerabilities for the sector started piling up during the pandemic and these have been intensified as higher interest rates added refinancing pressures to the sector, while inflation has added to construction costs. The sector is also confronted by low demand, especially in office and retail segments, and more structural issues such as changes in work practices or climate transition. At the same time as capital markets require a higher premium to refinance maturing debt, banks have been tightening their credit standards becoming more selective in their investments, making access to funding more difficult. EU banks have more than EUR 1.4tn of commercial real estate exposures, or around 10% of their total loans towards households and NFCs (Non Financial Corporations). Around 63% of these exposures have a loan-to-value (LTV) of less than 60%, with only a very small share reported with an LTV of more than 80%. This provides some cushion for banks in case of a wider and deeper correction in the CREs (Commercial Real Estate) markets.

### Higher interest rates stress market valuations of financial assets

EU banks report over EUR 1.5 trillion of debt securities held at amortised cost, representing around 5% of their total assets. An increase in interest rates can cause their market value to fall. Debt securities with longer maturities have a higher duration and hence are more sensitive to interest rates moves. The unprecedented pace in hiking central bank interest rates has underscored the importance of managing interest rate risk prudently and proactively. As part of their interest rate management, banks hedge their positions to reduce their duration mainly through derivatives such as interest rate futures or credit risk swaps.

In doing this, European banks also comply with EBA guidelines on interest rate risks in the banking book (IRRBB). In fact, the EBA published last year two Regulatory Technical Standards (RTS) specifying technical aspects of IRRBB positions. The first RTS outlines criteria for evaluating risks arising from changes in interest rates that affect both economic value of equity and net interest income. The second RTS specifies modelling and parametric assumptions and supervisory shock scenarios for identifying institutions at risk of significant declines in Economic value of equity (EVE) or net interest income. The universal application of EBA's IRRBB guidelines to all banks have ensured banks' actively management of interest rate risk and its expected impact on their profitability and EVE. The EBA is committed to closely monitoring the implementation and application of these guidelines.

**Figure 6: Effect on economic value of equity and NII (Net Interest Income) in a 200bp "parallel up" shock scenario[3]**




*Source: EU banks' pillar 3 disclosures and EBA calculations*

## Funding risk needs to be managed carefully

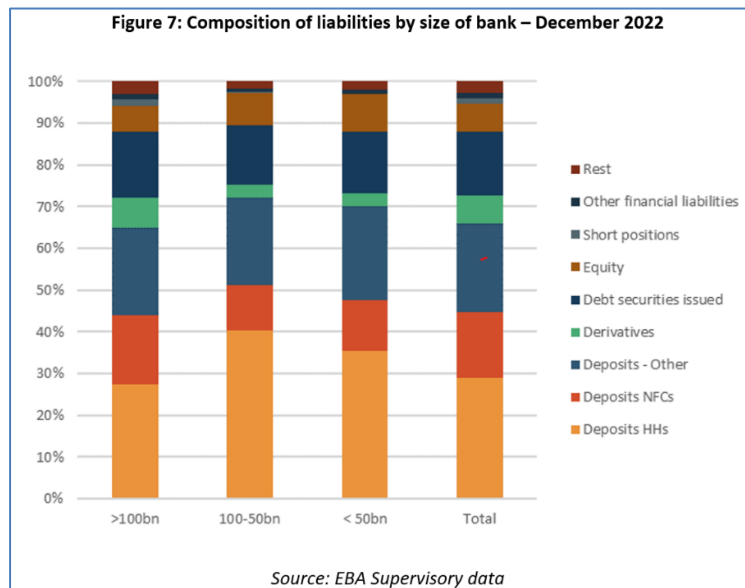
EU banks also have well diversified funding mix. EU banks have a great reliance on retail deposits (around 30% of total liabilities is household deposits), which have proved very stable, and around 17% are deposits from NFCs. EU banks have also the ability to execute securities financing transactions such as repurchase agreements (repos) to avoid fire-selling their assets should they need liquidity. As of end 2022, EU banks had only 25.8% of their assets encumbered.

Banks have up until now benefitted from increasing rates and widening margins, which have helped them to increase their net interest income and profitability. Interest rates have started passing through to Banks liabilities too. Deposit rates have started picking up as depositors demand higher compensation and competition among banks intensified. There are also indications of behavioural change as depositors move from sight/demand deposits to fixed term deposits. Although there are

[3] Based on a selected sample of 47 banks

differences in practices across EU countries on how quickly deposit rates are repriced (i.e., different deposit betas across countries), the general trend points to an increasing cost of deposits. It is however comforting that EU banks have not seen any material deposit outflows so far. They should however be cognisant of the role of social media and the effect on banks' liquidity may have. The digital era enables not only information but also money to move fast in a less predictable way which requires banks and supervisors to find effective ways to monitor and model.

**Figure 7: Composition of liabilities by size of bank – December 2022**




*Source: EBA Supervisory data*

In addition to increasing cost of deposits, banks are now challenged by risk premia requested on their debt issuances. The banking turmoil in United States and in Switzerland have had a negative impact on capital markets. As a result, risk premium demanded by investors for banks' issuances have materially increased. This is considerably evident in lower tier issuances, such as AT1s. It is comforting that banks have managed to front load funding needs during the early months of the 2023, taking advantage of the tailwinds in the banking sector.

The banking crisis have not only increased funding costs but has also caused temporary market closures. While markets have now reopened, they remain vulnerable to hick-ups. There is no doubt that some banks will be challenged as they are not only confronted with a volatile market but also faced with maturing of ECB's Targeted Longer-Term Financing Operations (TLTRO) and their need to meet MREL targets. For all these reasons, banks need to be prepared for an increase in the cost of funding and ready to adjust their funding plans.

### Operational challenges have become more relevant.

The digital era has brought in the forefront the need to effective monitor and manage operational risk. This is widely considered a priority given the rising challenges for the banks in this area, which also includes IT (Information Technology) and cyber risk. In addition, the geopolitical tensions have increased the likelihood that other risks such as fraud, anti-money laundering, sanctions compliance, increasing dependency from third party providers, and other legal and reputational risks may materialize.

The pandemic accelerated the brewing changes in the digitalisation and the use of communication technology (ICT) at banks and their customers. Digitalisation has now become a core need for banking as banks battle to remain competitive against rising threats from non-traditional banking entities. Moreover, reliance of banks on digital and remote solutions to perform their daily operations, to

deliver their services to customers, and to conduct business has resulted in an enhanced exposure and vulnerability to increasingly sophisticated cyber-attacks. Banks are facing increased operational challenges since geopolitical tensions are playing an increasing role in the technological and digital space.

It is important that banks – and supervisors – use the whole toolbox available to them to minimise operational risk and cyber risk. These include for example incident reporting, on-site inspections, simulations, framework for ethical hacking, horizontal analysis (to e.g., assess the level of digitalisation and DORA (Digital Operational Resilience Act) related considerations), and industry coordinated customer awareness campaigns in order to inform customers of relevant cyber risks.

**EU banks remain strong, but we should remain vigilant**

The high capital and liquidity ratios in EU banks provide comfort that banks will be able to navigate the upcoming challenges. However, as the recent banking crisis in the US has demonstrated, there is no room for complacency. The collapse of a number of mid-sized US banks as well as the events leading to the takeover of Credit Suisse (CS) by UBS has led to a significant rise in uncertainty and have changed market perceptions of banks. It has also demonstrated the importance of appropriate and adequate risk management. The abrupt increase in interest rates does not only stress borrowers with potential effects on banks' asset quality but has also put in focus the management of interest rate risk. Diversified funding is also vital as it shields banks from over-reliance to one funding source, while concentration of depositors in inter-related segments or economic activities can be a source of vulnerability. At the same time the digital era and the wide use of social media has changed the "rules of the game" as money can now move even faster than information.

Under this environment, the ongoing EBA EU-wide stress test will help to shed light on the possible existence of idiosyncratic and systemic vulnerabilities in banks' balance sheets. The exercise is only one part of the toolbox used by supervisors to assess banks' resilience, while helping to identify vulnerabilities to specific risk drivers. The EBA will publish the individual results for each bank in the sample at the end of July.
The EBA stress test is a dynamic exercise that needs to develop according to the relevant risks. The adverse scenario of the exercise set out a severe downturn in line with current macroeconomic uncertainties around the persistency of inflation, increasing of interest rates as well as elevated geopolitical tensions. In addition, the covid-19, the war in Ukraine and its subsequent consequences, demonstrated the need to have a more insight view on targeted sectoral analysis to assess better banks' credit risk. As part of this, banks will have to provide a breakdown of their exposures towards firms and the related impairment by sector of economic activity. The main purpose of the breakdown by sector is to ensure that the results of the stress test reflect banks' exposures towards different sectors, thereby increasing the credibility and realism of the exercise.

In essence, the stress test will allow supervisors to assess if the capital that banks have accumulated in recent years is sufficient to cover losses and support the economy in times of stress. The results of the exercise will feed into the supervisory decision-making process which will allow the EU banking sector to better shield from rising risks going forward.