MANAGING RISKS IN THE BANKING SECTOR

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EU banks' strengths for a challenging future

The EU banking sector is facing strong headwinds in 2023 with heightened geopolitical risks, high inflation, rising interest rates, high debt levels, the phasing-out of accommodative monetary policy and a deteriorated economic outlook. Against this challenging background, EU banks appear quite resilient, thanks to the strengthening of their financial structure and risk management following the great financial crisis. Nevertheless, some key areas of focus are bank funding and liquidity risks as well as credit risk.

With the failure of several US regional banks and the rescue of Crédit Suisse by UBS, the focus on bank funding and liquidity dramatically increased in March leading to significant stress. Bank funding and liquidity conditions have indeed been changed by the normalisation of the monetary policy that will be achieved, in the euro area, via a combination of a rise of key interest rates, the winding down of asset purchase programmes and the reimbursement of the TLTROs. This will tighten further funding conditions by three levers simultaneously, with potentially overlapping impacts:

i. rising key interest rates could increase the costs of short-term borrowing as well as deposit funding while reducing the valuation of fixed income assets;
ii. winding down asset purchases programmes could raise the cost of longer-term borrowing;
iii. TLTRO repayments could lead to a decline in excess liquidity raising the cost of short-term borrowing (in the interbank market) and long-term borrowing (by necessitating more market issuance by banks).

Yet, the ECB has committed to ensuring that its "balance sheet is normalised in a measured and predictable way"[1] thereby allowing banks time to adapt to this new environment.

Although not yet materialised, credit risk is an increasing area of attention due to the deteriorating economic environment: inflation (that affects consumer goods, energy and wage costs) and rising rates (especially in countries where loans are variable-rate) put pressure on the repayment capacity of borrowers. Banks have already translated this heightened credit risk in their accounts through material transfers of exposures from stage 1 to stage 2, and posted additional provisions accordingly; this comes on top of the reserves built up during the Covid crisis, which most banks have kept unchanged given the persistent uncertain global outlook.

Finally, the current volatile market environment also bears higher market and counterparty credit risks, which could be amplified by the procyclical behaviour of some less regulated non-bank financial institutions (NBFIs). The collapse of Archegos has shown that banks should manage their counterparty credit risk adequately when dealing with less transparent counterparties. Participants with high leverage, including through derivatives, liquidity mismatch or low cash buffers are especially vulnerable to adverse market movements which can lead to large deposit outflows or spikes in margin requirements; and these liquidity strains can contribute to disorderly increases in volatility in certain market segments, as the UK pension funds crisis in late September 2022showed.

When facing these challenges, European banks can however rely on robust levels of profitability along with solid capital and liquidity positions, while some areas of the NBFI ecosystem are now better regulated.

- The increase in interest rates has already started to foster net interest income (NII), which is traditionally the core source of banks' revenues. While higher interest rate may also mean value adjustments of fixed income assets, it is worth reminding that the EU accounting framework requires negative unrealised losses on available for sale securities to be recognised in banks' own funds.
- Thanks to the Basel III reform that apply to all EU institutions, banks now hold more and better capital buffers. In addition, su-pervisors are regularly assessing banks' risk profile, requiring when needed an extra layer of capital to absorb foreseeable shocks. The interest rate risk in the banking book is one of those risks that are monitored on an ongoing basis, through its im-pact on both NII and economic value of equity, with limits that trigger corrective action should they be outpaced.
- Irrespective of their size, EU banks also have to comply with short- and long-term liquidity requirements. These have led them to build comfortable buffers that prevent them from fire-selling held to maturity securities should they face a quick and mas-sive withdrawal of deposits; it has also reduced excessive maturity mismatches that have been at the roots of some US banks' recent troubles.

Finally, derivatives markets are much more resilient, which should greatly reduce contagion risks from NBFIs to banks. However, the recent turmoil shows that there is no room for complacency. In particular, we should now make progress on international regu-lation on the NBFI sector, both from micro and macro prudential perspective.

1. *Monetary policy in a new environment (europa.eu)*

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Risks and vulnerabilities of the EU banking sector

Since the great financial crisis, and driven by changes in the regulatory framework, banks' financial positions have improved significantly. Capital ratios for European banks have increased steadily over the past 10 years and the average CET1 ratio stood above 15% in December 2022, well above regulatory requirements (around 10%). With an average capital headroom of 5%, Europe's banks are in a much better position compared to 2008/2009. Similarly, the liquidity ratios have improved over the past years with the average liquidity coverage ratio (LCR) for the European banking sector at above 160% and the net stable funding ratio (NSFR) at 125% in December 2022.

The exit from the pandemic, geopolitical developments, and the energy crisis have pushed up inflation at levels not seen since the 1980s. Central banks across the world have responded with successive interest rate rises to tame inflation, which will transmit to economic growth, debt and equity valuations and house prices. Market expectations have pointed that this could continue into 2023, albeit at a slower pace than in 2022.

Despite comfortable buffers on the whole, some banks might face challenges going forward amid a potentially worsening economic environment or due to spill over effects from challenges that the global banking sector currently faces.

Asset quality

So far, EU banks' asset quality has remained good overall with a non-performing loan (NPL) ratio remains at historically low levels and only a handful of banks now report NPL ratios of more than 5%. In December 2022, the overall cost of risk in the EU banking sector stood below pre-pandemic levels. First impacts of higher rates are already visible in banks' outstanding loan volumes, which declined in the fourth quarter 2022. This reflected a slowdown in the demand for loans while banks have also been tightening their credit standards. Signs of a slight deterioration of asset quality could also be perceived, with a share of stage 2 loans at a very high level and an increase in provisions for performing loans. Bankruptcies, which were at a low level during the pandemic, have increased in several European countries. The EBA stress test results to be published in July will shed useful light on EU banks' resilience in a baseline as well as in a very severe adverse economic scenario.

Recent development reminded of the importance of risk management.

Profitability

Strong net interest income, driven by increased margins, helped banks to improve their profitability in 2022. European banks reported a return on equity of 8.1%, on average. This is the highest profitability ratio banks have reported for many years. After the lifting of pandemic-related restrictions, banks generally returned to elevated pay-out ratios (around 50%). Lower growth can be expected to result in reduced lending volumes and rising impairments, while higher rates will increase funding costs and higher inflation will increase operating costs.

Funding risks and costs

Banks with sound business models and an ability to keep costs under control during downturn periods will naturally be better placed to navigate challenging market conditions. Indeed, higher rates will also increase funding costs and banks must adjust to a changing environment. This includes possible higher expectations from clients on the remuneration of their deposits. Banks also have to factor in the repayment of the substantial amounts of funds obtained via the ECB's longer-term refinancing operations (TLTRO), either thanks to their large central bank reserves, issuing additional debt or competing to attract more deposits. Some banks also need to keep building up capital buffers or eligible liabilities (MREL).

Risk management and supervision

Maturity transformation is at the heart of banking, and managing interest rate risk is key in banks' risk management. The recent situation of Silicon Valley Bank (SVB), the 16th largest bank in the US, was a clear illustration of the possible challenges for asset-liabilities management in a context of rapidly rising rates, especially for a bank displaying a very concentrated depositors' base. While SVB admittedly had a peculiar business model, it also triggered a series of market developments across the banking sector globally and beyond. This showed -if needed- that confidence remains key and reminded of the importance of adequate risk management and demanding supervision. Market participants should take comfort from the regulatory reforms implemented since the Great Financial Crisis, which have massively increased banks' shock absorption capacity.

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Bank risks in an environment of rapidly rising rates

After seven years of low rates, since last Summer, central banks on both sides of the Atlantic have been raising rates at a pace not seen in many decades. This has brought new challenges for banks. The recent turmoil is witness to that. This time, the challenges do not relate to capital, not even to liquidity. They relate to interest rate risk.

Managing interest rate risk is one of the core competences of a bank. It is about managing the mismatch in duration of assets vs liabilities, setting a risk appetite for this mismatch, and then managing the mismatch within appetite.

On the asset side of a bank's balance sheet, duration is mostly laid down in contract terms of loans and bonds. Of course there are uncertainties like early repayments and other options and contract triggers. Those have to be modelled and estimated, which works quite well at portfolio level.

Things look different for bank liabilities. Duration here is much more driven by behaviour. When a bank issues bonds, it pretty much has duration management in its own hands. But I want to focus on deposits, which after all are the dominant liability for most banks. With deposits, it's depositor behaviour that drives duration. Many deposits are overnight, or redeemable at notice, giving them a very short duration in theory. But while individual balances fluctuate, the aggregate is remarkably stable. So in practice, current accounts in particular are quite insensitive to interest movements – or in bank parlance, they have longer duration than their overnight label suggests. But what duration exactly? It is up to banks to model depositor behaviour. This may differ per bank, as clients profiles and characteristics may also differ.

Depositor behaviour can be modelled quite effectively at portfolio level, leading to an estimate of the duration of a bank's liabilities on that basis. This is then put next to assets' duration. The mismatch between the two should not grow too large, as that enlarges interest rate risk. The duration of assets (the loan and securities books) can partly be hedged through "natural" offset from the modelled duration of customer deposits. Natural hedging may not reduce the duration mismatch completely to fall within risk appetite: many people still want to be able to take out a 30-year mortgage. Remaining mismatches are thus hedged by interest rate swaps. Next to that, marketable securities are typically hedged by swaps also to reduce capital volatility.

The best defence against a bank run is a strong viable business model combined with customer trust.

For the modelled deposit duration, it matters whether the portfolio consists of many small deposits, or of a few large ones. And it matters whether the depositor base is very diversified, or concentrated in one economic sector, or in other ways might experience correlated shocks. Estimates depend on the assumption that individual depositor shocks and actions roughly cancel out at portfolio level. That ceases to be true when depositors all of a sudden start to behave in synchronous, correlated ways. At such times, the duration of funding could suddenly turn out a lot shorter than estimated, leading to a larger duration mismatch and bigger interest rate risks.

The ultimate unexpected correlated depositor behaviour is a bank run. That outflows can turn into uncontrollable runs, has been known for centuries. But one of the surprising things of the recent turmoil has been the speed and size of deposit outflows. It appears that the availability of digital tools for clients to manage their bank deposits, combined with the speedy propagation of news, rumours and communicated responses brought by online communication platforms (both closed groups and open social media) have made possible even faster run dynamics. it would be good to thoroughly evaluate the run dynamics observed in the recent turmoil, and to review our tools. Yet we also should not be obsessed by bank run risks. In the end, they are mostly the symptom of, or response to, an underlying problem. We'd do better to focus our attention to prevent those problems, and manage them well when they occur. The best defence against a bank run is a strong viable business model combined with customer trust.

Part of such a viable business model is managing interest rate risk, to prevent problems when rates rise fast, as they have been doing in the past year. And the conclusion I draw here is not that we should revisit interest rate risk regulation, or the ways in which European banks hedge them or account for them. Existing regulation gives supervisors ample room to monitor interest rate risks, review the models concerned and require refinements where desired.

It is however important to account for potential concentrated or correlated exposures in e.g. stress testing. That is a lesson that was learnt long ago for bank assets, but is increasingly relevant for liabilities as well. This is especially important given the substantial sums of deposits in the European banking system, partly caused by past monetary policies (quantitative easing).

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Vulnerabilities in the European banking sector - And how to address them

The past few weeks have shown that rapid rate hikes come with consequences and that, despite the regulatory overhauls after the global financial crisis, banks can still fail. While some of the ingredients of those failures were US- or bank-specific, contagion worries have hit European banks, wiping out almost a quarter of their market cap since the recent peak in 2022.

Rate-increase cycles play out for banks in different ways over multiple horizons.

Phase one, the short-term, is typically beneficial: Deposit betas remain low, net interest margins (NIM) increase, earnings improve, and valuations rise accordingly. That was a main driver of market cap gains for European banks last year.

Phase two, the medium term, is more balanced. Deposit betas go up as customers hunt for better rates—and recent bank failures have accelerated that journey, with some depositors fleeing to safety and banks pricing up. In addition, the active side of the balance sheet starts to feel the impact of higher rates. Corporate defaults increase, particularly among those most exposed to inflationary drivers such as energy-intensive sectors. As incomes lag rising inflation, housing affordability decreases and mortgage volumes come down, offsetting NIM gains. And rate increases impact the banking book, resulting in mark-to-market losses if banks are forced to sell assets.

In phase three, the longer term, NIM volatility increases, because interest rates can go up or down in the future. The recent bank turbulence may have accelerated the journey toward this phase; while the ECB and the Fed went ahead with rate hikes, markets are uncertain on future central bank decisions.

To manage through this crisis, banks should embrace three short-term priorities.

The GFC led to big divergence between banks; that will play out again now.

First, they should reactivate their deposit gathering muscle, through better understanding of deposit behaviour and advanced pricing capabilities supported by models that inform volume and margin trade-offs and liquidity positions aligned with bank targets. This requires targeted, client segment specific commercial actions, revisiting fund transfer pricing and relationship manager incentives supported by marketing campaigns.

Second, banks should ensure their interest rate risk in the banking book (IRRBB) setup is fit for purpose in the new environment to deliver balance sheet and earnings stability. Given the speed of rate hikes, this requires increased management attention and reinforced governance.

Third, banks should examine liquidity reserves, including the ability to monetize securities positions under stress scenarios, and revamp their crisis preparedness, including revisiting resolution and recovery plans and running tabletop exercises that address the potential impact of social media in a bank run.

In terms of strategic agendas, European banks have been returning capital to shareholders through buybacks and dividends to boost valuations; price/book ratios were at approximately 0.6 at the beginning of 2022 and rose to about 0.8 before the crisis unfolded in early March. This can't endure in the long term. Banks need to convince shareholders that some of this capital is better used invested in business model transformation and a move toward more efficient client-centric platforms.

Many banks have failed to deliver on that front and now need to ramp up their performance transformation capabilities to succeed. Some banks could use this capital to expand their footprints through M&A for scale and diversification — both in terms of funding and lending/investment choices.

The ECB's thoughtful application of the Liquidity Coverage Ratio and the Net Stable Funding Ratio has proven critical so far, but there are other areas policymakers and regulators to review. While the ECB has been welcoming of cross-border M&A, more may be needed to help banks pull the trigger. Regulators should consider creating a "European Banking Label" based on providing financing in multiple European economies to incentivize banks to make these moves. This should be done jointly with the banking and capital markets union, which are needed to help banks diversify funding bases and manage exposures more actively via a vibrant securitization market.

If the global financial crisis showed anything, it is that there was a huge divergence between banks that adjusted business models quickly and those that didn't. It is likely this movie will play out again.