Managing risks in the banking sector

1. The recent banking turmoil and the deteriorating economic environment raise financial stability issues for EU banks

The Chair noted the recent failure of several US regional banks and the rescue of Credit Suisse by UBS. Globally, including in Europe, the economic environment has deteriorated, raising a number of questions regarding economic and financial stability. However, the EU economy and banking sector has shown resilience to these conditions.

The discussion has focused on three sets of issues: the extent to which European banks are immune to the recent banking turmoil, the main risks and vulnerabilities on the balance sheets of EU banks, and what the development of non-banking financial institutions (NBFI) means for the banking sector.

2. The European banking sector is in better shape than parts of the US banking sector regarding the management of interest risk but all banks including EU ones are exposed to the risk of digital bank runs

The Chair stated that the current challenges relate not to capital or even to liquidity, but rather to interest rate risk. Unlike in the US, all banks in Europe are subject to the Basel rules for managing interest rate risk. The single regulatory and supervisory framework provides protection in the EU against the sort of banking events witnessed in the US and Switzerland. Given the speed of depositor flight in the age of digital banking, it is necessary to review the parameters within the Basel Liquidity Covered Ratio (LCR).

2.1 The situation is completely different in Europe compared to the US: contrary to the US, all banks in Europe are submitted to the Basel rules for managing interest rate risk

A Central Bank official noted that European banks are in a stronger position compared to where they were at the time of the global financial crisis. European banks do not share some of the vulnerabilities that have affected US banks. However, European banks are not immune to the recent banking turmoil. The European banking sector has some specific issues, particularly low growth. In some European banks, there is still an issue with low profitability and the prospect of higher funding costs also increases the downside risks to bank earnings.

Sveriges Riksbank was founded 355 years ago as the result of a bank run. In a system based on trust and in which confidence can very quickly disappear, no bank is immune when there is banking turmoil, but there are some important differences between Europe and the US. In terms of management of interest rate risk on the bank's own balance sheet, Europe is clearly in a better position. The regulatory environment is better in Europe in this respect. There is a requirement to hold more liquidity when exposed to interest rate risks. Here, the European banking sector is in better shape than parts of the US banking sector.

To sum up, there has been a lot of progress since the global financial crisis, but there needs to be a regulatory agenda to deal with some of those issues. Nowadays, there are bank runs by Twitter, and this is something the European banking sector will also have to deal with.

An industry representative underlined that, since the last big crisis in 2008, many regulatory requirements on banks have been implemented. Sometimes banks complain about them, but these actions have strengthened the European banking scene. Most European banks have built up a lot of high-quality liquid assets that can withstand a substantial outflow of deposits. Risk appetite statements constrain how much interest rate risk banks can take. The existing Basel regulation gives supervisors ample room to monitor interest rate risks.

A regulator stated that immunity is a difficult concept. Nobody can say they are immune. A good characterisation of the situation is that it is about 'banks in crisis' rather than a 'banking crisis'. This is different from the crisis 15 years ago. The context is now the same on both sides of the Atlantic. Monetary policy has been tightened at a relatively high speed. This could create a number of cracks. The ultimate impact of this tightening should be felt through the real economy, but it also circulates through different channels and ultimately affects the financial sector. The tightening is supposed to bring down direct demand and, ultimately, inflation. That will have an impact on banks' assets and funding conditions.

Having said that, the situation is completely different in Europe compared to the US. Firstly, the tightening of monetary policy started later in the euro area. There have been a great deal of preparations and discussions about how it would impact banks' balance sheets and risk management. There have been many improvements to the regulatory setup for Interest Rate Risk in the Banking Book (IRRBB). There have also been a number of tests run by supervisors. There is no

business model that looks like that of the US banks. Contagion is always a risk. If there are channels that are not fully identified, then that might affect these or other banks, but the banking sector is starting from a very strong position. The regulatory framework is much more systematic in the EU than in the US, with fewer cliff effects.

2.2 The single regulatory and supervisory banking framework provides protection in the EU against similar banking events that we have seen in US and Switzerland

A regulator stated that, for the last 10 years, the EBA has been working on a common rulebook and creating convergence regarding supervisory practices in Europe. The EU banking sector also benefits from the Single Supervisory Mechanism (SSM) within the euro area. There might be nuances and proportionality, but the supervisory reaction functions are very similar. The interest rate risk in the banking book is one of those risks that are monitored on an ongoing basis in the euro area through its impact on both Net Interest Income (NII) and economic value of equity, with limits that trigger corrective action should they be outpaced.

Convergence between the euro area and the non-euro area has been discussed at the EBA table. Topics such as asset and liability management (ALM) and how banks will be able to refund the Targeted Long-Term Refinancing Operations (TLTRO) have been front and centre for more than a year in all those circles. This helps explain why the EU banking sector is in a different position.

2.3 Banks in Europe have built comfortable buffers to face upcoming credit risk

A Central Bank official stated that banks have had to cope with idiosyncratic situations such as a pandemic and a war, as well as a very difficult interest rate environment. The challenges banks were facing during the last 10 years were different from the challenges that are approaching now. The banking sector is seeing a return to traditional vulnerabilities that occur during an increase of nominal interest rates, inflation or the growth cycle, such as credit risks and interest rate risks. Up until now, even during the last 10 years, the European banking sector has managed its books well. The European banking sector has significant buffers in the system to also cover risks that might materialise.

Asset quality could become an issue

A regulator underlined that developments in this year's market could affect other instruments or segments. Banks could be impacted by macro developments such as inflation tightening and monetary policy tightening, but also by unexpected shocks, channels or contagions that are not fully identified within the system. In that context, one key element is transparency. The EBA publishes a lot of data and is already seeing that, on the macro side, asset quality is deteriorating. The EBA sees a rise in bankruptcies and a gradual increase in Stage 2 loans in particular for consumer and other non-mortgage household loans. Within the corporate sector, concerns are mounting about the outlook for commercial real estate (CRE) loans amid falling valuations and investor demand in CRE markets.

In that context, everything that can be done by banks and the public sector to explain where they are will be helpful. That is why the EBA has beefed up the stress test conducted every other year. The EBA included sectoral breakdowns to explain the potential exposures of banks in different sectors and to see which banks might be exposed to types of counterparties that may not fare so well in the new environment of rising rates. The EBA is also collecting additional data to shed even more light on the health-to-maturity portfolios of banks. Everything that aids transparency will also create more market discipline and help people and limit contagion risks.

2.4 Against the challenging economic environment, EU banks appear resilient

The Chair noted that, in Europe, inflation is higher, growth is weakening and there is a high level of indebtedness, both on the private and the public side. This is unusual for the balance sheets of banks.

An industry representative stated that banks are prepared to face this challenging economic environment. Banks have gone through a cyclical change. Whether what happened with quantitative easing and negative rates was good or bad, most banks recognise it as an asset bubble that needs to be gradually released. This transition to a higher, more normalised interest rate has already been anticipated by banks. Banks have already adjusted their risk appetite statements. Most European banks are at a historically low level of Stage 3 non-performing loans, so there is an ability to absorb much more. It is important to consider whether banks are healthy enough to generate new capital to cover what is coming. Given where interest rates are, banks are much more able to generate additional capital to cover any bad loans. The three important aspects are good, strong capital to start, low non-performing loans, and the ability to generate capital going forward.

2.5 No war on deposits in Europe so far

An industry representative stated that, while a war on deposits has not yet been seen, the peak of net interest margins (NIM) has already been reached. Deposit betas are, to different degrees, on the rise across different countries, largely depending on local market competition. Also, the deposit mix is shifting quite fundamentally. Some banks are reporting a shift from sight deposits to term deposits, which has an impact on funding costs.

There has not been a shift into money markets at the same levels as in the US. In the US over the last two months, 900 billion left the banking sector and went into money market funds. Given the lower liquidity and the lower established capital markets in Europe, that has not happened to the same extent. For once, there is a benefit to not having the depths of the Capital Markets Union compared to the US. This also implies that what the banks are working on at the moment is strengthening their deposit gathering strategy. It is

about understanding the behaviour of different depositors and then developing the corresponding pricing strategies. Banks are also working on their fund transfer pricing models and incentivising relationship managers accordingly.

A Central Bank official stated that the situation looks a little different from the perspective of a central bank. There is no war because there is no scarcity of liquidity at all. There has been no uptake in the traditional tenders, which would have been a sign of scarcity. What we see is the traditional competition for funds to refinance banks' lending operations. The banking sector has slightly lost familiarity with this in the time of zero interest rates, but competition picks up as interest rates rise.

2.6 Given speed of depositor flight in age of digital banking, there is a need to review parameters within the Basel Liquidity Covered Ratio (LCR)

The speed and size of deposit outflows has been a surprise issue of the recent turmoil

A Central Bank official stated that the European banking sector is diverse and has fewer banks with a high number of uninsured deposits. In that respect, the European banking sector is in a better position than the US banking sector. However, the other issue in relation to SVB and Signature Bank was the extraordinary speed of withdrawals that happened in the US. In an era of digital banking, all banks are equally exposed. This is a new phenomenon that will have to be looked into more deeply.

A Central Bank official stated that each crisis brings about lessons for supervisors. In the case of SVB and Credit Suisse, the key element is pace. It is no longer the case that bank runs involve people lining up in front of branches to withdraw money. Money can be withdrawn within minutes using online banking. For instance, SVB lost $40 billion, 23% of its total deposits, in a single day. This is not taken into consideration when calculating liquidity ratios. Also, the liquidity ratio is calculated based on assumptions of the time within which a certain percentage of the deposits is withdrawn in a severe supervisory scenario that combines bank-specific and market-wide stress. These assumptions may need to be reassessed. Another lesson is that the rapid spread of information leads to an immediate reaction by market participants. In Silicon Valley, venture capitalists instructed the companies they were invested in to withdraw the money within minutes. This is not the type of information European banks base their supervisory and regulatory activities on.

A regulator stated that a traditional bank run has played out in an unconventional manner. The speed of this was new, partly due to the impact of social media. The report from the US authorities is expected to be published tomorrow, so this will certainly be discussed further in different regulatory circles in the coming months. These factors will play out differently depending on the business model and what types of activities a bank might be doing. The public also needs to be informed that there are protection mechanisms for them. Deposit insurance is important. There is also a lot of communication from the public sector side to facilitate differentiation and prevent similar cases in the future.

3. Addressing the vulnerabilities in the European banking sector

3.1 There are differences between markets and countries

A Central Bank official stated that some of the shocks in the past year have been relatively unknown risks. For example, what happened with the UK pensions system was not well understood in advance. SVB was known in some parts of the system, but there was not a lot of transparency. In the Nordic countries, there are well-known vulnerabilities such as high household debt, variable rate mortgages and commercial real estate. Where there is a high level of transparency and risks are well-known, there is preparedness. Both households and firms have prepared for today's situation. A push towards transparency is always welcome.

An industry representative noted that one of the biggest asset classes for financial institutions is mortgages. Structurally, consumers are protected from rising interest rates in markets such as Germany, Belgium and the Netherlands. These are principally fixed-rate mortgage markets, so impacts are on new originated loans. In other markets such as Poland or Spain, the stress is more prevalent. There is probably some more vulnerability in areas of wholesale banking, particularly commercial real estate loans. That is where some discontinuity may happen with rising non-performing loans.

An industry representative stated that low unemployment in Europe is another important aspect. There is a recessionary environment, but unemployment has not gone up. Usually, defaults coming through on mortgages and credit card books are highly correlated with unemployment in Europe.

The first-order impact is fewer transactions on commercial real estate. The leveraged debt capital market is dead, and that has a second-order implication for the back-book of institutions.

There are a few other vulnerabilities to think through in terms of contagion or distortion risk. The view that the crypto world lives entirely separately from the rest of the financial markets is not correct. A significant or further drop in crypto values could have an impact in more regulated asset classes, leading to a flight in safety and further distorting prices in currencies or asset classes that are seen as safe. There is counterparty credit risk that needs to be understood for underlying assets that are not going through central clearing houses. There is also a leverage risk, often driven by high-volume, low-margin products.

In this post-SVB, post-Credit Suisse environment, there will be questions around regulation for banks, but the non-regulated part of the sector, such as credit default swaps (CDS), can also create vulnerability for the

regulated sector. Most CDS markets are not highly liquid or frequently traded, so a couple of firms trading in CDSs can trade up the CDS spread, leading to a bank run.

3.2 The two principal model risks for most European banks are around client behaviour on savings and client behaviour on mortgages

An industry representative stated that, with a strong, credible and explainable business strategy and business relevance, there will always be a confidence level in the banking system. There are likely to be good results, resilient balance sheets, good capital and good profits coming out of the Q1 season for European banks. Ultimately, bank runs are largely a symptom of an underlying problem. The best defence against a bank run is a strong, viable business model combined with customer trust. Part of that viable business model is managing interest rate risk to prevent problems when rates rise quickly. It is important to account for potential concentrated or correlated exposures. This is a lesson that was learned long ago for bank assets but is increasingly relevant for liabilities. This is especially important given the substantial sums of deposits in the European banking system, partly caused by past monetary policies such as quantitative easing.

3.3 Quantitative tightening may enhance the competition for deposits by two to three years

A Central Bank official stated that monetary policy tightening is not just about rate hikes but also quantitative tightening (QT). For example, Sveriges Riksbank has relatively short maturity on bonds held and started active QT by selling government bonds. In the coming years, there might be more competition for deposits and an increased focus on the topic of QT.

3.4 Reducing contagion risks from NBFIs to bank requires more transparency on non-bank financial institutions

An industry representative stated that, during the Covid crisis, the cycle was incredibly short. People were concerned about private equity exposure and write-downs, but this did not happen because there was an incredibly quick market recovery. The EU financial sector is now in an environment where more private equity exposures are being written down. There is still a significant amount of money on the sidelines, creating vulnerabilities. Also, hedge fund volumes are higher and the financial capacity that sits behind them is significant.

A Central Bank official explained that the purpose of regulation and supervision is to protect the public good, which is the deposits of the ordinary citizen. One of the lessons from the Credit Suisse case is that there is interconnectedness between the NBFI sector and banks. This may also justify a stricter regulatory environment for these entities. The Chair added that financial stability is also a public good, which justifies a broad look at what happens in this area.

An industry representative underlined that, considering the annual reports of banks and the Pillar 3 disclosures, there is very little that cannot be found on banking transparency. From an industry perspective, anyone doing banking or near-banking should have the same transparency as financial institutions do today. There should be much more transparency so that risks can be managed. Public sector decision-makers should start with more regulation on transparency in non-bank financial institutions. The Chair observed that some would argue that, as the counterparty, this should be the job of the bank.

An industry representative stated that people sometimes expect a lot from banks. Some regulatory support or framework could be put in place. Banks have no regulatory basis to get all the information needed and therefore require back-up from the public sector. Another industry representative noted that aggregation would take a while if every bank was to report. A Central Bank official stated that the vulnerability of non-bank financial institutions is a source of concern. Since financial stability is a public good, moving forward with this will be crucial.