MANAGING RISKS IN THE BANKING SECTOR

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EU banks have weathered global storms - EU supervisors keep an eye on waves ahead

External stress factors have accumulated at global level: increases in commodity prices, inflationary shocks, volatility on Gilt and cryptoassets, and the failure of some banks in the context of rising interest rates. Despite this challenging environment EU banks have confirmed their resilience.

Higher interest rates supported EU banks profitability thanks to a diversified business model, credit growth and a large deposit base with a 23% rise in net interest margin (NIM) between the first quarters of 2022 and 2023. Moreover, EU banks have further strengthened their solvency ratios and asset quality in recent quarters. The latest EU-wide stress test exercise shows that even under a severe scenario, featuring a strong decline in GDP as well as high interest rates, EU banks stay resilient thanks to a solid starting capital position which allows them to absorb projected capital depletion. Over the three years of the exercise, this depletion brings the average CET1 ratio of the sampled banks from 15.0% to 10.4%. Banks also maintain their capacity to generate earnings, mainly through higher NIM, which offsets credit losses.

This resilience does not come out of the blue. Recent events show the EU made the right choice in designing a Single Rulebook aligned with international standards and imposed to all banks. In the Banking Union, the role of the single supervisor with intrusive methods of supervision is also key to improve banks' risk management.

Yet, in the current context, there is no room for complacency. First, on the global scene, Basel III standards, especially on liquidity and interest rate risks have proven essential. It is of the utmost importance that they are faithfully and consistently implemented to all banks whose failure could impact financial stability.

Besides, at EU level, despite sound fundamentals, vulnerabilities may arise. Loan demand is set to slow down and funding costs to increase. Higher rates can reduce the value of banks' fixed-income securities, such as government bonds, leading to direct or unrealized losses in banks' balance sheets, although this impact remains limited at EU level (75 bn€ in the EBA ad hoc exercise). As regards credit risk, even though the cost of risk remained low on the first months of 2023, default rates are increasing and banks anticipate a rise in impairments. The tightening access to funding and pricing corrections could in particular put pressure on the commercial real estate segment.

To curb upcoming risks, authorities should leverage on all available tools. Regarding the factors that led to some non-EU banks' demise, existing monitoring and Pillar 2 frameworks can help to mitigate the build-up of excessive exposures to rising interest rates, concentration of depositors and uncertain capacity to monetize liquid assets.

While not calling for a massive overhaul, novel risk features nonetheless invite us to reflect on -proofing banks' regulation and supervision further. For instance, digitalisation of the economy and social networks could accelerate the speed of bank runs, potentially challenging some assumptions on uninsured deposit outflows in times of stress. The supervision of interest rate risk may also need levelling up. However, regulators should remain careful of potential adverse effects; for instance, generalizing full fair value accounting could contribute to procyclicality of own funds and markets in some cases.

Another source of risk could be banks' connections with non-bank financial institutions (NBFI). Since 2008, the size of the NBFI sector has grown from 42% to 50% of global financial assets, while this sector now assumes a larger role in liquidity, credit, and maturity transformation. This growth has been partly beneficial by diversifying the sources of financing for the economy. However, it also creates financial stability challenges as this sector is less strictly regulated.

EU banks' asset exposures to NBFI entities remain high (on average 9% of bank assets), even if some of the credit risk associated is offset by collateral exchange. Banks also act as intermediary in financial markets for clearing and trading in derivatives markets. Liquidity and credit risks may materialize depending on the ability of the NBFI sector to meet margin calls.

Ongoing challenges show EU banks' solidity and the relevance of their regulation and supervision.

Finally, NBFI play a major role in the short-term funding of banks, a key segment in their daily operations, representing more than half of repo funding to EU banks at Q4 2022. These entities are also significant investors in bank debt securities and place deposits which can be volatile and subject to outflows in stress periods. Hence, a withdrawal of NBFI liquidity could jeopardize banks' ability to fund their operations in particular during crisis periods.

For these reasons, we call for monitoring bank exposures to NBFI and making progress on strengthening the micro and macroprudential regulatory framework for NBFI, as per the FSB work program.

MARGARITA DELGADO

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Giving european banking supervision an additional boost

In the last three years we have lived through several challenging events, which have affected the world economy and the European banking system in particular. An unusually prolonged low interest rate environment was followed by two unforeseen shocks – the COVID-19 pandemic and the war in Ukraine, which eventually triggered inflationary pressures and changes to monetary policy, leading to a steep rise in interest rates.

The level of uncertainty has increased significantly and several risks to the banking sector have worsened. In the current context, it seems clear that banking business models with poor governance of credit risk, asset liability management, IT or risk data aggregation and reporting, among other areas, are especially exposed.

The banking sector also faces challenges of a more structural nature, including: (i) the impact of growing digitalisation in our society and the financial services industry with the emergence of new technologies, players and business models; (ii) climate related risks – a relatively new area of supervisory focus of increasing relevance; and (iii) the expansion of non-bank financial intermediation since the global financial crisis (GFC), providing credit to the market but also representing additional sources of risk to the banking sector through their interlinkages.

Managing risks in this new uncertain environment has become a complicated task for institutions and poses a significant challenge to regulators and supervisors. Banking regulation, for its part, was significantly strengthened as a result of the GFC, with stricter capital and liquidity requirements that have enhanced bank resilience and made banks much better prepared for turbulent times. These improvements certainly have helped, and continue to help, the European banking system to successfully navigate the storms of the pandemic, the war in Ukraine and the recent US and Swiss banking crises. In addition, the full implementation of Basel III reforms is expected to further reinforce banks' solvency.

Under these circumstances, there seems to be no urgent need for major regulatory changes. Regulatory and supervisory bodies could now rather work towards ensuring that the existing wide-ranging banking rulebook is applied correctly and only make very specific adjustments if needed.

Supervision has also been strengthened since the creation of the Single Supervisory Mechanism (SSM) with the development of a common approach that ensures the consistent application of regulation and supervisory policies and fosters risk-based supervision. Nonetheless, it seems to be the right time to emphasise the role of supervisory activities, which should take full advantage of existing regulations. In this regard, we could focus on the following three areas:

1. **Allow for sufficient flexibility to be able to adequately respond to the current dynamic environment**

Supervision should provide an agile response to an ever-changing environment, finding the right balance between defining a clear strategic plan and allowing for the flexibility needed in the face of the current high level of uncertainty. In essence, the framework should be able to deliver a medium-term plan with relevant activities aimed at improving the structural weaknesses identified and, at the same time, be open to the possibility of shifting gear and deploying resources to address new, unexpected challenges that may emerge.

2. **Advance further in setting risk-based supervisory priorities to achieve greater effectiveness**

Over the last years, the supervisory framework of the SSM has evolved in the right direction by giving increasing prominence to achieving greater supervisory effectiveness with a risk-based approach instead of principally aiming for compliance with a set of methodologies and procedures. Continuing along these lines, the supervisor could further develop and implement a risk tolerance framework to focus on each bank's key vulnerabilities and empower the use of supervisory judgment.

3. **Design more action-oriented supervisory measures to enhance the impact of supervision on banking activities**

Banking supervision has to be intrusive and dig deep into banking operations, structures and decision-making processes. The findings identified should be directly linked to the measures requested, with clear indications to the bank and planned follow-up actions. Furthermore, the supervisor needs to review the actual effectiveness of its activity, with a regular assessment of supervisory results, and draw lessons for the following planning cycle.

It is time to emphasise the role of supervisory activities taking advantage of existing regulations.

In summary, banking supervision and regulation are becoming increasingly complex with the need to deal with emerging and structural challenges. In this context, an enhanced supervisory strategic direction is gaining increasing relevance. We propose the three action areas mentioned earlier as a way to further strengthen European banking supervision.

ELIZABETH MCCAUL

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Current risks and vulnerabilities in the European banking sector

The sound policy decisions implemented following the great financial crisis have brought undeniable benefits. The euro area banking sector remains resilient[1], and thanks to prudential regulation and supervision, banks are in a good position to withstand the three major macroeconomic challenges we now face: rising interest rates, inflationary pressures and subdued GDP growth, and the economic fallout from the pandemic and Russia's war in Ukraine. The aggregate Common Equity Tier 1 ratio of banks directly supervised by the ECB stood at 15.5% in the first quarter of 2023, compared with 15.0% the previous year, and the aggregate liquidity coverage ratio was 161.3%, up from around 140% before the pandemic.

The significant macroeconomic uncertainty has been reflected in financial market tensions, with credit risk, liquidity risk and funding and interest rate risk key areas of concern. The ECB is addressing these issues as part of its supervisory priorities.

The supervisory strategy underpinning our priorities assesses both cyclical and structural challenges amid a risk landscape shaped by three medium-term trends.

- Persistently high inflation, the unprecedented pace of monetary policy tightening and the difficult geopolitical situation could lead to new shocks and, in turn, further asset price corrections, while the uncertain economic outlook may give rise to asset quality concerns.
- The digital transformation of the financial sector is challenging banks' business models, underscoring the need to strengthen governance. With the ongoing geopolitical uncertainty and banks relying more heavily on third-party providers for their digital strategy, cyber risk is on the rise.
- Climate risks have become more pronounced since the start of the war, with Europe facing an "energy trilemma", i.e. how to make energy secure, affordable and sustainable.

We are keeping a weather eye on the potential for market dislocation effects. The fast-paced normalisation of monetary policy is leading to asset price adjustments and higher debt servicing costs. This may result in further market corrections and/or increasing credit, market liquidity and funding risks. Short-term fiscal pressures remain contained, but the outlook for sovereigns may deteriorate if financial conditions tighten and additional fiscal support is needed.

Asset price corrections, while the uncertain economic outlook may give rise to asset quality concerns. Cyber risk is on the rise.

The recent market turmoil highlights how important it is for banks to be able to withstand unexpected short-term liquidity shocks and to have sound and prudent asset liability management (ALM) frameworks. Even if a bank has excess liquidity, it could still fail owing to shortcomings in ALM practices. A bank runs a reputational risk if its management and internal controls are perceived to be weak. And when there are also doubts about the business model, market confidence may erode, potentially exposing the bank to capital and liquidity vulnerabilities.

Asset quality concerns rise as the economic cycle weakens, making credit risk one of the most pronounced risks. Inflation and interest rate increases have not resulted in a material deterioration in asset quality, but there have been growing signs of this over the last three quarters. We have observed a – so far orderly – turn in the real estate cycle, particularly in commercial real estate markets. Our recent stress test also showed that leveraged finance exposures carry a high degree of credit risk and market risk which could materialise in a downturn.

We are also keeping a close eye on emerging risks in the non-bank financial intermediation (NBFI) sector. In the current environment, if liquidity risks in this sector were to materialise, it could lead to a drop in the funding NBFI entities provide to banks. As this type of funding is relatively more sensitive to the credit quality of banks, and since market sentiment remains fragile, the strong links between banks and the NBFI sector could amplify banks' funding pressures if the soundness of their fundamentals was somehow called into question by the market.

Changing customer preferences and increasing competition from new entrants is another area of attention. Banks are under increased pressure to speed up their digital transformation strategies and rethink their business models, and they also face fierce competition for IT talent. Moreover, surging cyber and IT-related risks stemming from the geopolitical situation and banks' increasing reliance on outsourcing are also considered among the most pronounced in our assessment.

Finally, amid the current energy trilemma, banks face medium-term transition risk as they shift to a green economy. Tackling climate-related and environmental risks must be a priority, and banks need to incorporate these risks adequately within their business strategy, governance, and risk management frameworks.

The risk landscape is constantly evolving, and we will adapt our supervisory strategy in line with it.

1. *ECB (2023), 2023 stress test of euro area banks – final results, July.*

JOSE MANUEL CAMPA

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EU/EEA banks: potential pressure from the asset and liability side

The macroeconomic outlook has remained highly uncertain, with high and persistent inflation, rising interest rates and slower economic growth. It has impaired consumer and business confidence while at the same time pushing banks' risk appetite lower. Macro-economic uncertainty not least affects banks' loan growth as well as asset quality. Latest EBA data shows that outstanding loans towards households and non-financial corporates (NFCs) remained stable over the first quarter this year. Going forward, EBA risk assessment questionnaire (RAQ) results point towards slower lending growth rates. A rising share of banks aim to, e.g., decrease their real estate related exposure as well as consumer credit. This might in turn negatively affect GDP growth, as well as banks' net interest income.

The challenging economic environment was not yet mirrored in asset quality metrics. However, the EBA RAQ indicates that banks expect asset quality to deteriorate in the next 12 months across all segments. The outlook for residential and commercial real estate, as well as SME and in particular consumer credit seems to be more negative than for other exposures. These are loan segments in which sticky inflation and increasing interest rates could particularly challenge overindebted borrowers. It remains to be seen how asset quality will further evolve, after it had demonstrated resilience, but the outlook tends to be rather deteriorating than improving.

The EU banking sector's capital position is stronger than ever before and should help absorb any potential deterioration in asset quality. At the end of the first quarter 2023 EU/EEA banks reported an average CET1 fully loaded ratio of 15.7%. The capital headroom above Overall Capital Requirements – OCR – and Pillar 2 Guidance is close to 500bp.

The strong capital position is also reflected in the 2023 EU-wide stress test, whose sample covered 70 banks. The results of the exercise show that European banks remain resilient under an adverse scenario which combines a severe EU and global recession, increasing interest rates and higher credit spreads. Under the adverse scenario, the capital depletion is 459 bps. Higher earnings and better asset quality at the beginning of the 2023 both help moderate capital depletion under the adverse scenario. Despite combined losses (credit, market and operational risk losses) of EUR 496bn, EU banks remain sufficiently capitalised to continue to support the economy also in times of severe stress.

Banks' loan growth and asset quality as well as funding costs might face challenges going forward.

With the events at SVB, interest rate risk in fixed income portfolios has moved into the focus. Banks apply many different approaches to interest rate risk management, including for instance hedging of open position through derivatives or other instruments, usage of replicating portfolios, structural hedges and fund transfer pricing (FTP). The topic has always been part of supervisors' work. Looking at EU banks these bonds represent about EUR 1.3trillion as of February 2023 (data for the EBA's stress test sample, i.e. 70 banks). The EBA estimates aggregated net unrealised losses of EU banks' bond holdings at amortised costs at around EUR 75bn. These potential losses are not expected to be realised in the absence of a liquidity shortfall. Banks actively manage these portfolios as part of their interest risk management.

Another recent focus are risks related to non-bank financial institutions' (NBFI). Credit risk associated with the exposures towards NBFIs is one interlinkage between banks and NBFIs. Additionally, if asset values drop and investors start to withdraw funds from NBFIs, the latter might need to look for liquidity by either selling assets or withdrawing deposits they hold with banks which might affect banks' funding composition, and not least banks' funding costs. To mitigate such risks, the regulatory landscape should evolve towards a further assessment of the risks arising from NBFI to financial stability.

Furthermore, operational risks have not abated. Key risk drivers for operational risks include information and communication technology (ICT) as well as cyber related risks. They also comprise circumvention of anti-money laundering and counter financing of terrorism (AML/CFT), including sanction related breaches. Results of the EBA's latest RAQ show that nearly two third of banks agree that cyber risk if a key driver for operational risks. It is followed by conduct and legal risks.

ESG related risks also need to remain high on banks' agendas. EU/EEA banks already offer a wide range of green and sustainability-linked loans, with for instance proceeds-based green loans and sustainability-linked loans being the most common products in banks' lending to large corporates. On the liability side, the share of green bonds in non-preferred senior and HoldCo issuances reached 24% YtD, whereas the share in preferred senior was 12%. For both sides of the balance sheet there is still a long way to go until ESG related products and financing are much broader reflected in banks' daily business.

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Navigating the shift in the environment

Over the past year and a half, the global macro environment has undergone a fundamental shift away from the conditions that prevailed over the previous decade. The era we have entered is dominated by monetary tightening, growing digitalisation, and climate change. And while it initially appeared that this shift was progressing smoothly, we have now seen a number of crystallised risks – most recently the failures of Credit Suisse and Silicon Valley Bank in March – belying the notion that we can leave a decade of benign economic conditions without any bumps along the way.

Annually, the Bank of England publishes the letters we send to bank CEOs about our supervisory priorities for the year ahead. This year, for international banks, those priorities included counterparty risk, and financial risks arising from climate change. They have never been more important.

Though the collapse of Silicon Valley Bank and Credit Suisse earlier this year shook markets, as at time of writing the consensus outlook in many economies remains positive. The US in particular has proved resilient, with falling inflation, a robust labour market, and growing GDP.

But there are risks to this consensus. As the IMF note, a 'plausible alternative scenario' is that credit conditions in the US tighten significantly. And idiosyncratic events, be they natural or cyber, are never far away.

Such consensus breakdown can manifest itself through counterparty risk, which is a particular focus for us.

The past decade has seen non-banks increase their share of direct risk taking in the economy, with market risk morphing into counterparty risk. We have repeatedly called out many banks' tendency to sleepwalk into large and concentrated counterparty exposures. Archegos was an example, but last year's disruptions to the nickel and gilt markets highlighted this issue too. So although it is interest rate risk that happens to have crystallised earlier this year, our focus on counterparty risk as another symptom of the ongoing macroeconomic shift is undiminished.

Private equity and private credit markets are a particular case in point. Traditional leveraged finance has stuttered lately, and there is an emerging trend toward illiquid private equity financing and private credit. This has created a complex web of exposures, and a risk that banks underestimate their aggregate direct and indirect exposures to underlying counterparties and connected collateral. That is not a good place to be should credit conditions begin to deteriorate, or should those counterparties start to feel the squeeze of the tighter monetary environment.

> **The past decade has seen non-banks increase their share of direct risk taking in the economy.**

Repo matched books are of equal concern. The notional size of these books makes them important for sovereign debt markets and the wholesale financial system in general. But events have shown that in the current environment, even 'safe' securities can see volatility that was historically unimaginable, resulting in large collateral and margin flows that can shake unprepared counterparties.

Last year also highlighted the risks that can materialise for banks with commodities exposures, notably in metals such as nickel and rare earths, as well as energy markets. Climate change – and the energy transition – is now an integral feature of the environment banks operate in. The green transition could see commodities markets and their associated risks change drastically, as demand rises for supplies to produce clean energy.

When banks interact with the commodities sector, especially when providing hedges, it is vital that they do not yield to commercial pressure by agreeing to unsuitably low levels of initial margin – giving their counterparties the mistaken impression that such hedges are cheaper and less risky than they truly are. And jolting margins up or turning the taps off at the eleventh hour on those counterparties is certainly not conducive to financial stability. So this is a risk that firms must handle carefully, ensuring that while they'd want to avoid hedging costs becoming prohibitive, the cost should always reflect the risk that actually remains with them.

Whilst I have touched here on a handful of specific supervisory priorities, an on-going focus of ours is firms' business model and culture. In this tougher environment, it will be more challenging for bank business models to remain sustainable. That means not trying to pick up pennies in front of a steamroller. This year showed that confidence in the viability and credibility of a bank's business model is crucial for its clients and for the market. Because once that credibility is lost, there is only so much that healthy capital and liquidity ratios can do to save you.

And how can banks achieve sustainability and inspire confidence? By ensuring they have competent people with integrity who create a sound risk culture. It all starts or ends with people. And that is a good thing.

FERNANDO VICARIO

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EU banks' vulnerabilities can be resolved at supervisory level

Europe's banking system is stronger now than it has been for a generation. The post-euro crisis reforms have generally worked, with significant improvements across capital, liquidity, and asset quality. Even profitability – for a long time the weak spot of European banks – has been recovering, showing double-digit return on equity in 2023, the best since 2007. Banks have also managed the sudden reversal of central bank rate and liquidity policies well.

At the same time, the monetary and macroeconomic environment is exposing the balance sheets of European banks to new and additional risks, which have become apparent during the recent banking turmoil.

First, the risk of unrealised mark-to-market losses on bond holdings has been under the lens of investors and supervisors. Even if securities held at amortised cost can be used to obtain central secured funding without crystallising losses and EU banks' liquidity coverage ratios show a sizable buffer of high quality liquid assets, a shift in the market perception can rapidly cause an impact on the stock price and, in turn, depositors' behaviour. The reality is that any assessment of unrealised losses needs to be made in conjunction with the diversity, stability and 'stickiness' of the institution's deposit base – those with a high proportion of retail, insured deposits and commercial operational deposits are less prone to experience stress.

Second, while higher interest rates are generally positive for NIM, higher rates also have an impact on banks' funding costs. Competition can cause deposit rates to rise, catching-up with the asset side. This is combined with a general surge in wholesale funding costs caused by the replacement of TLTRO financing with a higher amount of bond issuance. It should also be clear that this rise in rates has led to lower profits for banks, but it should also be recognised that banks have remained at healthy profitability levels.

Finally, tighter credit standards may curb demand, as seen with commercial real estate, residential mortgages and leveraged finance, offsetting some of the above mentioned benefits on margins.

In addition to the above, EU banks are also exposed to other, hard-to-quantify risks, which should not be disregarded. This includes geopolitical risks (such as unpredictable outcomes from the war in Ukraine), cyber attacks and climate change related financial risks, the consequences of which are starting to become directly observable on banks' balance sheets.

Many of these vulnerabilities in the banking system can arguably be addressed by supervisors.

One of the lessons from the market turmoil experienced by specific small regional banks in the US is the need for greater focus on risk management and operational readiness. Each institution needs to apply internal liquidity stress testing assumptions that are tailored to their deposit mix, which are evaluated by their supervisors. The institutions also need to assess whether they have access to the full range of facilities in their treasury functions, so they can respond swiftly in times of stress to the changing market environment.

Many of these vulnerabilities in the banking system can arguably be addressed by supervisors, without requiring a broader regulatory overhaul. The ECB supervisory arm has been scrutinising banks' interest rate risk positions well before the emergence of the Silicon Valley Bank case earlier this year, and the 2023 EU-wide stress test will also provide an opportunity to understand the health of the banking sector.

Supervision can also be a tool to address exposures to Non-Bank Financial Institutions (NBFI) vulnerabilities through sound counterparty credit risk management, without the need to increase banks' capital requirements, which might instead be counterproductive.

The recent banking turmoil can be an important reminder of the need to complete the Banking Union, starting from the recently proposed crisis management framework review, considering the visible consequences of weak resolution frameworks for smaller banks.

More broadly, the completion of the Banking Union is also needed to enable European banks to compete globally, and indirectly, have the Euro take its proper place in global reserve currencies. There is currently a large gap between European and US banks, with European players modestly scaled compared with the five largest US institutions, with revenues and profitability being consistently lower.

KRISTINE BRADEN

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The EU financial system is well positioned to face a challenging environment

Since the last Eurofi conference in Stockholm, the macro-economic outlook has remained challenging, with geopolitical risks and inflationary pressures weighing on GDP growth. At the same time, the resilience of corporates, households and sovereigns has been tested by higher interest rates and the financial sector has proven resilient. Spillover effects from recent market turmoil have remained limited and yet, we should be watchful for where risks may arise as the high inflationary environment persists.

First, liquidity risks. While bank liquidity ratios remain robust in Europe, the past months have shown that in the age of online banking, deposit withdrawals can occur at a speed not seen before. This raises questions for policymakers about the current outflow factors under the Liquidity Coverage and Net Stable Funding Ratios. It has also led policymakers to re-assess the European toolbox for emergency liquidity support. The Chair of the Single Resolution Board, Dominique Laboureix, recently highlighted that while the Single Resolution Mechanism provides the necessary powers and tools to restore solvability of failing institutions, it falls short in effectively handling liquidity stress during resolution actions. He has therefore called for new powers for the European Central Bank to fund banks in resolution, potentially backed by an EU government guarantee. Finally, in an environment of high volatility, market liquidity is often impacted, with composite indicators for the bond markets performing below trend.

Second, credit risks. On the one hand, the ECB's monetary tightening helps to increase bank profitability and improve capital ratios. This is particularly true for banks with large retail operations. On the other hand, it has pushed real estate markets into correction mode and tightened the financing conditions for companies and consumers. Inherently, rate increases increase the costs for borrowers to service their debt. While this may lead to an increase in non-performing loans in the coming months as higher costs impact borrowers with weaker repayment profiles, it is unlikely to pose a major threat to the banking sector's financial stability.

In July, the European Banking Authority reported that non-performing loans remained stable at around 1.8% of total loans. This does not relieve banks of their duty, however, to plan for every scenario. In this sense, the increases in loan loss provisions we have seen across the sector are helpful to prepare for the potential deterioration in asset quality. Many consumers and companies successfully managed to build up a cushion during the past years of more accommodative monetary policy. Furthermore, Europe's labor market remains very strong. While masking important regional differences, the EU unemployment rate of 5.9% is at an all-time low. This should continue to positively impact consumers' ability to spend and service their debts.

The European economy faces numerous challenges but has proven strong and resilient.

Third, risks from the non-banking sector. The economic slowdown and tightening financial conditions also create liquidity and credit risk for Non-Bank Financial Intermediaries (NBFIs). These institutions play an increasingly important role in financing the real economy and in managing the savings of households and corporates. The financial assets of the sector accounted for 49.2% of the global financial system in 2021, compared to 42% in 2008. They certainly are an important part of a diversifying capital market ecosystem in Europe, though they typically fall outside the supervisory mechanisms in place for the banking system. Non-bank financing may become a source of systemic risk if it involves maturity/liquidity transformation or leads to the build-up of leverage. The diversity and growing involvement of NBFIs in credit provision, including on a cross-border basis, may result in stress in the sector being transmitted to other parts of the financial system and to the broader economy. Both the European Systemic Risk Board and the Financial Stability Board will continue to play an important role in monitoring these risks in the coming years.

In conclusion, as the European economy faces a higher rate environment and lower growth, it could lead to liquidity risks and credit risks for banks, NBFIs, corporates, and consumers. However, Europe's resilience remains strong and could be strengthened further through greater openness and diversification. Policymakers should focus on monitoring risks and increasing the sophistication and depth of European capital markets.

For the banking sector, continued integration of supervision and resolution mechanisms will further improve its strength. The recent proposal for a Crisis Management and Deposit Insurance (CMDI) framework is a useful step in that direction. Over time, further measures to complete the Banking Union will reinforce Europe's leading role in financial services.

OLIVIER VIGNERON

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European regulation undermines the basis for European strategic autonomy

The turmoil of March and April 2023 was an important test case for European banks, big and small, and the European regulatory framework. It showed that European banks were resilient to shocks, given their strong fundamentals, with risks mitigated by a diversified deposit base, robust liquidity ratios and relatively contained unrealised losses.

However, the current direction of travel of European policymakers, especially in the areas of digitalisation and payments, will leave the European banking sector less financially stable and prepared for future challenges. All of this leads to the biggest risk, which is that Europe will not be able to have a financial sector capable of supporting the sustainable and digital transition and achieve wider Open Strategic Autonomy.

The European Commission has stated that Europe requires € 620 bn of investments annually to meet the Green Deal objectives and € 125 bn annually to close the investment gaps for digital transformation. This aside from the € 384 bn that is needed for the reconstruction of Ukraine.

The vast majority of this funding will need to be provided by European capital markets. Banks and governments can only provide part of it. The latest data (New Financial Research) show, however, that the share of EU27 capital markets globally has fallen from 19% in 2006 to 10% in 2020 and to 9% in 2022. While it is encouraging that many policymakers, and the Eurogroup, prioritise the topic of capital markets, it will still take years for European capital markets to develop and catch up.

European banks therefore remain the main source of private funding in Europe. Against this background, the European banking sector should be considered as strategically important for the challenges facing Europe.

Unfortunately, European policymakers are designing the future regulatory framework without taking these strategic considerations into account, making it even more challenging for European banks to perform their core function: transformation of financing. Most recently this can be seen in the areas of digitalisation and payments:

- **Digital euro:** the ECB and European Commission are on a path that will limit the funding power of European banks, funding power that is needed to finance the sustainable transition. This would be due to the ECB extracting deposits from banks balance sheets, deposits that banks consequently cannot use to turn into lending for the economy.

- **Payment Services Directive 3 (PSD3):** the implementation of PSD2 was a large-scale deliverable for all European banks. It imposed an open banking concept and new rules for access to account information with a legal prohibition to charge for that access. Current proposals on PSD3 will further increase these operational costs and continue to assist third parties in competing with banks at zero costs of their own. These costs prevent investments in making EU banks themselves more efficient.

- **Open Finance**: this proposed framework will increase mandatory data access of third parties to banks' data across products. Data access includes account information for mortgage, credit and savings accounts, savings and investments data, and input data related to firms' creditworthiness assessments. Again, this increases operational investment, and it will be essential to ensure that sustainable business models and adequate compensation remain possible.

- **Retail investment Strategy:** the EC package aims to improve the distribution of financial products to retail investors by focussing primarily on the price of these products. Other important aspects, such as risk, return or sustainability preference are neglected. This will lead to a much more cost sensitive market with reduced product diversity and innovation for the benefit of retail investors.

- **Politically-driven restrictions on cloud service providers:** proposals for an EU framework for cloud security may close EU banks and corporates across critical sectors off from best-in-class cloud services. Use of U.S. Hyperscalers (Google, Microsoft, AWS) may no longer possible or only through EU cloud service providers such as Telekom/T-Systems, Orange, OVH. The same would apply for Software-as-a-Service (SaaS) providers, such as Adobe. While we support developing European alternatives to the Hyperscalers, the result would be not only higher cost, but also a limited offering of applications and services, including AI applications which are offered in the cloud – with implications for efficiency, profitability and innovation.

While we understand the rationale behind many of these proposals individually, it is important not to lose sight of the bigger picture. Policy options may achieve individual goals at first glance, such as improving comparability for retail investors or reducing reliance on third country technology while increasing business opportunities for local providers; however, they all come at a cost. When seen in the broader context of the economic and sustainable transition and Open Strategic Autonomy, these costs, especially when added, weaken the funding capacity of European banks and their competitiveness within the global banking community.

It is essential that the next European Commission reverses this direction of travel and takes a more holistic and future-oriented approach, which allows the European banking sector to contribute to the strategic priorities of the EU. This must include targeted adjustments to remove barriers, incentives for innovation, and ensuring resilience while stepping away from far-reaching business model interventions which lack clear benefits.

HANNES FROTZBACHER
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Banking in times of inflation – new risks on the horizon

Long gone are the times when the world was complaining about record low inflation rates. For the banking sector this exceptionally long period was marked by an abundance of liquidity and record low (and negative) interest rates, as central banks hoped to grease economic activity and to avoid a Japan-like deflationary low-growth scenario.
Following the last act of this period, the covid pandemic, when markets were again flooded with liquidity, the long-forgotten textbook case of inflation resurfaced with vengeance: way too few goods (and services) met way too much liquidity. Seemingly making up for the preceding decade, the developed world suddenly found itself in double-digit inflationary terrain.

Within a year and a half, the "low-for-ever-narrative" was history and replaced with a "back-to-the-70s narrative", which was aptly underpinned with sky-rocketing energy prices triggered by the Russian war. Central banks in the high-income countries quickly swung into action and hiked rates at a yet unheard-of pace. For banks this resulted in several challenges.

Monetary policy: Credit indicators show that monetary tightening is finally starting to bite, as banks in the EU are facing slowing credit demand. In the non-euro areas of emerging Europe (such as CZ, HU, RO & PL) private sector credit growth has turned negative. Calls for a relaxation of household loan regulations are getting louder. Given the very aggressive rate hiking cycle in the Euro area and in Central and Eastern Europe (CEE), there is a risk of asset quality deterioration, not least because real estate prices in many EU markets are now stagnating or even falling. This development could, however, be mitigated by rising expectations for monetary easing along with income stability thanks to tight labor markets.

Economic risks: A renewed jump in energy prices would be a high-risk event for corporates and subsequently for banks. While inflation has been falling, there is a risk of "higher for longer" as inflation might turn out to be stickier than anticipated. Along with elevated inflation levels, the engine of the European recovery after the global financial crisis - DE - is showing signs of weakness. Lacking demand from Europe's biggest economy would be a severe problem for all countries which are part of the DE value-chain and consequently for exposed financial institutions.

> **Monetary tightening is starting to bite, but we are also moving in direction of a "soft landing".**

More broadly speaking not only DE, but the entire EU manufacturing sector is currently in contraction. If this trend persists, it could sooner or later spread out to the EU's services sector. This would most probably also affect the labor markets, which usually lag the economic cycle. Slowing economic growth and a jump in unemployment rates mean for banks that the risk of worsening NPL ratios would rise.

Political risks: Banks are facing rising populism in several countries which includes measures like bank taxes as well as regulatory measures directed at banks which are harmful to credit growth. This situation could worsen, depending on the outcome of several elections due in the upcoming months (including SK, PL, AT & at EU level). Risks on public debt will also have to be monitored, given the reduced support from the ECB and the uncertainty of fiscal consolidation plans.

Funding & liquidity risks: At the same time funding and liquidity risks are back on the agenda due the ECB's quantitative tightening as well as the increased levels of uncertainty related to the collapses of the Silicon Valley Bank and Credit Suisse. Following the repayment of the still outstanding TLTRO facility banks' funding costs could face more pressure. Although most EU banks' liquidity ratios are expected to stay at comfortable levels, liquidity dynamics will receive more attention. Some selected players in the market might have challenges to keep their desired ratio (LCR/NSFR) levels, which also means, that competition for deposits could increase. Finally, the US banking crisis is not over yet. Equity prices and CDS spreads of regional banks have remained at elevated levels and contagion risk to Europe are limited but non-negligible.

In conclusion, the resurgence of inflation has forced central banks to hike rates at record pace. This policy change has now started to unfold its desired effects: economic activity is slowing, and inflation rates are coming down. For banks the situation is currently still well manageable from a risk perspective. If the slowdown goes far beyond a "soft-landing" scenario the pressure from factors such as asset quality deterioration, rising NPL ratios, political risks or higher funding costs could increase significantly.

On a positive note, we should, however, not ignore that the latest forecasts clearly point in the direction of a "soft landing": forecasts see the Eurozone as whole growing in 2023 & 2024. Inflation is declining and labor markets continue to be extremely resilient. Growth in the EU will be driven by Southern Europe and CEE, with HR taking the lead in 2023 with a growth forecast now at 2.6%.