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The European banking sector: situation and outlook*

"Strategic challenges and priorities for the banking sector in the next European legislative cycle (2024-2029)" conference / Spanish Banking Association (AEB)

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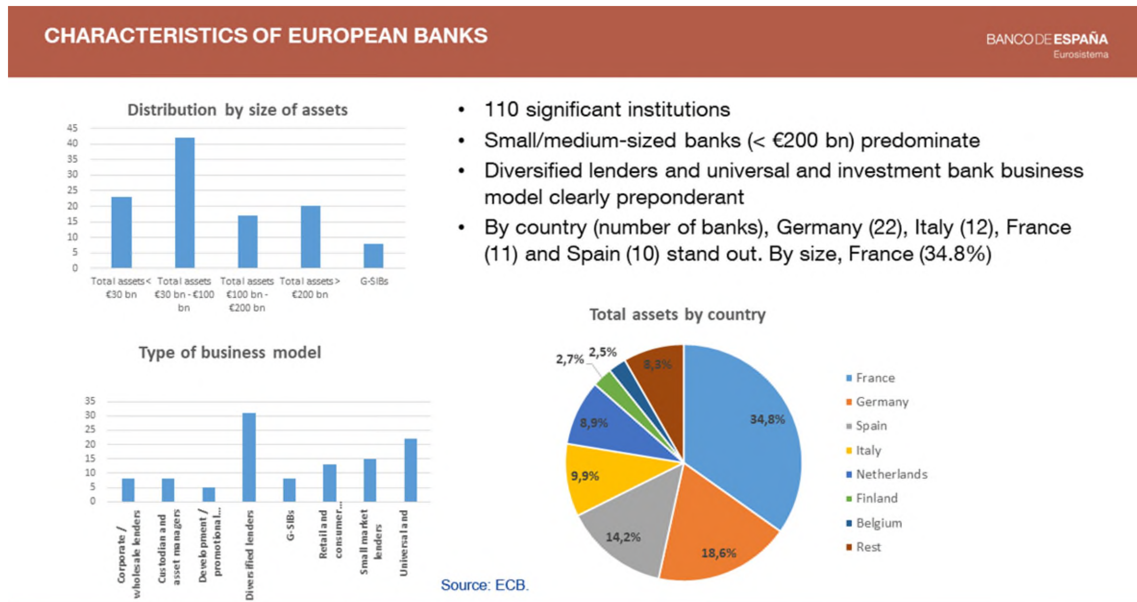
* English translation from the original in Spanish.

Ladies and gentlemen, welcome, and thank you for inviting me to the opening of this conference on the strategic challenges and priorities for the banking sector in the next European legislative cycle.

I would like to begin my address today on the European banking sector's situation and outlook by briefly breaking down the most important characteristics of European banks, drawing on the latest available data (i.e. for 2023 Q2).



First, and to provide some context, there are 110 significant institutions directly supervised by the Single Supervisory Mechanism (SSM), of which 82 are small and medium-sized banks (with less than €200 billion in assets). In total, only eight are deemed global systemically important banks (G-SIBs), although they account for 46.3% of the supervised institutions' total assets.

The European banking sector is characterised by a business model aligned with each country's respective activity. Testament to this is "diversified lenders" being the most common business model (31 banks), followed by 22 universal and investment banks, both types defined as having a mixed business activity and diversified sources of funding.

G-SIBs, universal and investment banks and diversified lenders account for 88.2% of SSM institutions' total assets, with the remainder accounting for a negligible share.

By country, French (34.8%), German (18.6%) and Spanish (14.2%) banks' share of total assets is noteworthy. Italian (9.9%) and Dutch (8.9%) banks form a second group.

SOLVENCY: THE SOLVENCY RATIO IS GROWING STRONGER

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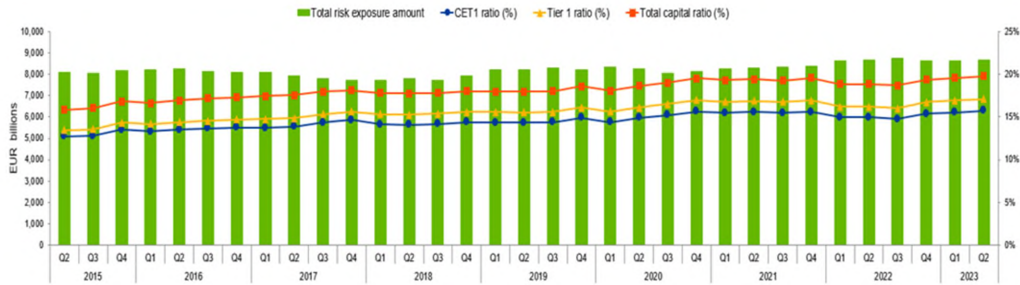
- CET1 ratio up 76 bp in 12 months
- Total capital ratio stands at 19.78%
- Fully phased-in leverage ratio stands at 5.63%

Capital ratios and risk exposure amount by reference period



Source: ECB.

Turning to **solvency,** overall European banks have appropriate capital levels and the CET1 ratio has gradually risen from 12.72% in June 2015 to 15.72% in June 2023. This increase incorporates the transitional adjustments that implementation of Basel III entailed. The banking sector's sound earnings in 2022 and 2023 to date have contributed to the CET1 ratio increasing by 76 basis points (bp) in 12 months.

However, there are considerable cross-country differences: the CET1 ratio stands at 16.4% in Germany and 16.1% in the Netherlands and France, while Spanish banks have lower ratios (12.7%).

This panorama should be analysed in greater depth, as the aggregate data conceal important details, such as potential differences between large cooperative groups, which are very dominant in some countries, and listed banks.

LOWER CET1 RATIO THAN PEERS

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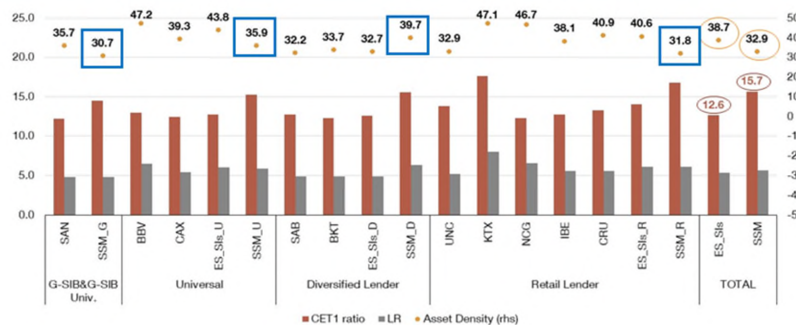
→ Spanish significant institutions have lower CET1 ratios than their peers and similar leverage ratios, with a higher asset density, except for diversified lenders.



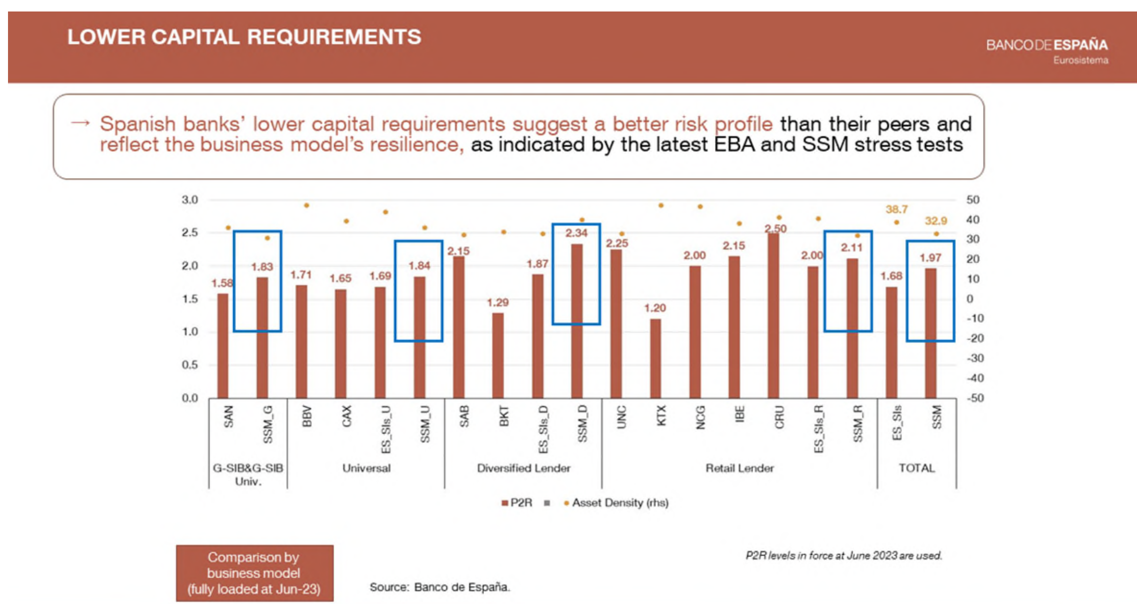
Comparison by SSM Business Model Cluster (BMC)
(Fully loaded Jun-23)

Source: Banco de España.

As regards solvency, a rigorous analysis needs to focus on more than just the CET1 ratio, as it is but one of several indicators. In my opinion we must consider the different

management buffers that measure banks' ability to adapt and manage their business models, matching their capital needs to capital generation. Solvency must also be analysed together with profitability over time (in other words, banks' ability to generate funds and organic capital in a sustained manner). Among these indicators, stress tests also play a pivotal role. These tests simulate how banks are expected to perform under normal conditions (baseline scenario) and their resilience to adverse shocks.

In this respect, it must be highlighted that the Spanish average is highly influenced by the two major banks, which, as you are aware, have a significant international presence and a business model that generates considerable recurring funds and lower capital requirements. This argument is borne out by Spanish banks having lower requirements on average than European banks. We could perhaps infer that, on average, the risk profile is lower than their peers', for the different business models, which would be reflected in the higher resilience displayed in the European Banking Authority (EBA) and SSM stress tests.



The differences could also be partly explained by the lower use of internal ratings-based (IRB) models to calculate capital. In this regard, on June 2023 data, of the total capital requirements for credit risk, which account for 84.4% of the total, in Spain 46.5% were calculated using advanced models, compared with 69.3% in Germany, 86.6% in the Netherlands and 60.8% in France.

Predictably, it is the biggest banks that make greater use of advanced capital calculation models. Indeed, for banks with assets of over €200 billion, use of IRB models accounts for 68% of the capital requirements for credit risk. For G-SIBs, it amounts to 65.2%. At the other extreme, banks with assets of less than €30 billion have IRB coverage ratios of under 20%.

In the case of Spanish significant institutions, asset density is higher than the SSM average (38.7% versus 32.9%). As I mentioned earlier, this is partly because of the lower use of internal models. These higher densities are observed in all business model segments, except for diversified lenders.

That said, and with all the caveats, Spanish banks are still far from bringing their capital ratios close to the European average. Therefore, in our opinion, they should capitalise on the sound short-term earnings and bolster their capital ratios in order to be better placed to tackle the challenges they face as a result of both the impacts of interest rate rises and the uncertain macroeconomic situation.

CREDIT QUALITY (I)

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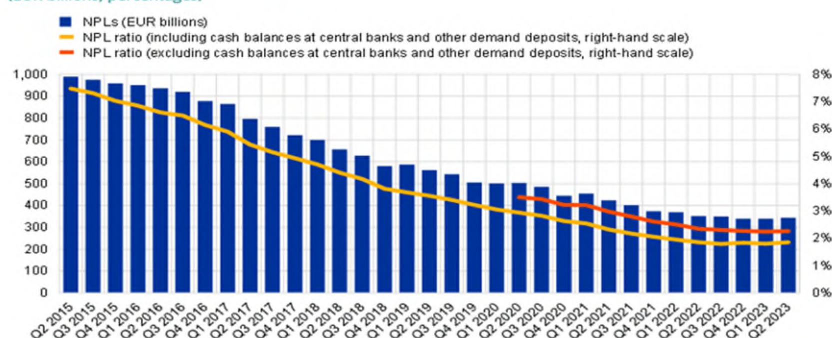
- Due to the deteriorating economic environment in Europe, the NPL ratio has increased slightly to 2.26% (2.24% in 2023 Q1)
- Sharp decrease in NPLs since the SSM became operational

NPL stock and NPL ratio

(EUR billions; percentages)



Source: ECB.

Meanwhile, **asset quality** is good on average, although the latest non-performing loans (NPL) ratio for 2023 Q2 interrupted the downward trend of recent years. The latest euro area NPL ratio (excluding cash balances at central banks and other demand deposits) was 2.26% (€386,920 million), up slightly from 2.24% (€383,110 million) in 2023 Q1. By country, most of this type of exposure is concentrated in France (32.7% of the total), Spain (21.5%) and Italy (13.5%). In relative terms, the countries with the highest NPL ratios[1] are Greece (5.70%), Portugal (3.84%), Spain (3.22%) and Italy (2.78%).

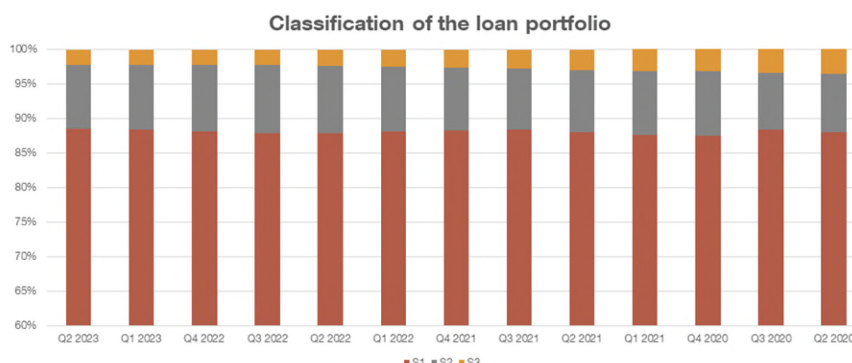
This asset quality analysis should be fleshed out with an analysis of the collateral securing the loans, especially in those countries where alarms have been sounded over real estate market overheating.

The NPL coverage ratio amounts to 41.1%, albeit with cross-country differences. Thus, in Portugal and Italy the ratio stands at 54.4% and 50.6%, respectively, compared with much lower ratios in the Netherlands (23.9%) and Germany (30%). In Spain the coverage ratio is 41.7%.

[1] Excluding cash balances at central banks and other demand deposits.

CREDIT QUALITY (II) BANCO DE ESPAÑA Eurosistema

- Since 2022 Q3, Stage 3 has remained largely unchanged, at around 2.2%, increasing slightly in 2023 Q2
- Stage 2 has decreased slightly. Does this make sense in the current macro environment?



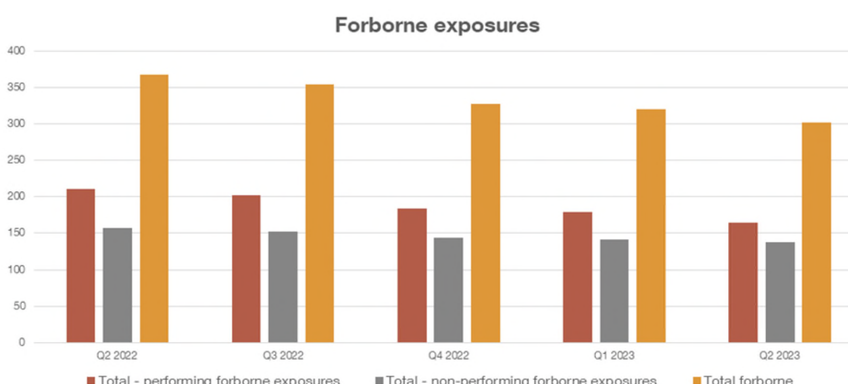
Source: ECB.

Performing a more in-depth analysis of the portfolio, we see that Stage 2 loans have tended to fall slightly from the 2022 Q3 peak (9.82%) to 9.19% in 2023 Q2. This might prompt us to consider whether banks' early warning systems are properly capturing the downturn in economic and financial conditions. In the current economic slowdown, or even technical recession in some European countries, this segment of borrowers should be higher, or its share of the total should at least be increasing.

Modelling and performing projections is increasingly difficult in such an uncertain and changing environment, just like predicting the length and frequency of a wave is increasingly complex. Historical data, the core of the models, should be accompanied by complementary analyses and adapted so that they have greater predictive power. This is not a simple task. We should therefore think about and analyse how to improve the current models' methodology to reduce the degree of judgement for their calibration, in line with the recent EBA report,[2] and so that they are better adapted to the increasingly unstable environment.

CREDIT QUALITY (III): FORBORNE EXPOSURES BANCO DE ESPAÑA Eurosistema

- Decreases in forborne exposures, especially due to performing forborne exposures
- Forborne exposures account for 1.9% of total loans



Source: ECB.

2 https://www.eba.europa.eu/eba%E2%80%99s-monitoring-ifrs-9-implementation-eu-institutions-confirms-need-timely-address-practices

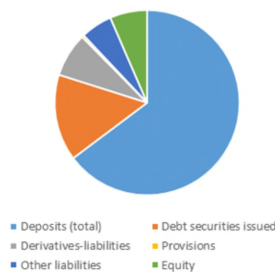
Forborne exposures amounted to €302,487 million at June 2023 (1.9% of total euro area loans) and have fallen 17.8% over the last 12 months, mainly due to those classified as performing, which are down 21.5%.

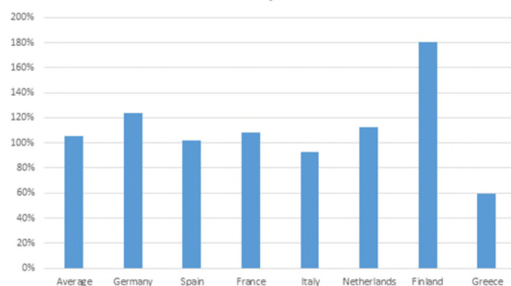
By country, the highest rates of forborne exposures are in Greece (7.6%), Portugal (3.89%) and Ireland (3.19%). The average euro area coverage ratio for these loans is 20.15%, with a coverage ratio of 38% in Portugal versus 13.6% in Germany. In Spain the ratio stands at 25%. Considering only those classified as non-performing, the coverage ratios range from 62.6% in Portugal to 22.6% in Finland, although also noteworthy among the major euro area economies is the low coverage in the Netherlands (24.5%), Germany (33.1%) and France (36.4%). The coverage ratio in Spain for this type of exposure is 42.9%.

These falls, combined with what I have just mentioned about Stage 2 loans, should make us think about whether they are the result of the strength of employment and business activity and are therefore still not reflecting the full force of the effects of interest rate rises. This is very important looking ahead to the 2023 financial close, in which banks should pay close attention to credit quality against a background of weak growth, high inflation and heightened geopolitical tensions.

BANKS' FUNDING BANCO DE ESPAÑA Eurosistema

- Banks have improved their funding and their ratios are more balanced
- The NSFR and LCR are comfortably higher than required
- Deposits account for a large share and deposits from central banks have fallen





Source: ECB.

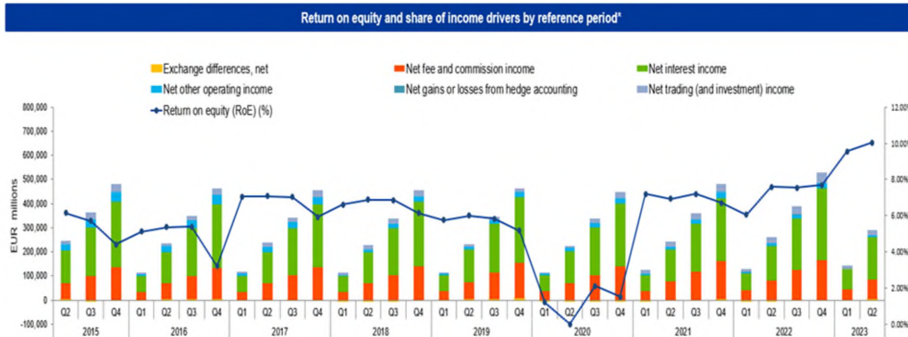
Meanwhile, the **funding structure** has gradually balanced out over the years and the loan-to-deposit (LTD) ratio has converged towards 100% from 126% in 2015 (it currently stands at 105%), with some convergence among the major countries (although Germany differs slightly with a ratio of 124%). Finland and Greece are at the two ends of the scale, with ratios of 180% and 59.6%, respectively.

Deposits account for 64.8% of total liabilities, with a large share of retail deposits from households (27.9%) and firms (14.7%). The considerable reduction in deposits from central banks since monetary policy began to be tightened, falling from €2,125 billion to €816 billion (7.9% of total liabilities to 3.1%) is worth highlighting. In second place, and a long way behind, we find other debt securities, which account for 15.1% of the total.

The net stable funding ratio (NSFR) (126%) and liquidity coverage ratio (LCR) (158%) also comfortably exceed minimum requirements.

EARNINGS: IMPROVEMENT IN TANDEM WITH MONETARY POLICY TIGHTENING BANCO DE ESPAÑA Eurosistema

- Clear improvement in ROE as a result of the normalisation of monetary policy
- Greater impacts on net interest income, given that monetary policy has passed through to loans quicker than to deposits



Source: ECB.

In terms of **earnings**, the rise in key European Central Bank (ECB) interest rates since July 2022 (450 bp to date) has had a generally positive and significant effect on European banks' bottom line. First, the transmission of monetary policy via interest rates has been quicker on the assets side than on the liabilities side. This has raised unit margins (particularly net interest income), boosting profit in banks across Europe. Second, tighter financing conditions have not yet translated into further impairment of the credit portfolio and, therefore, higher provisions. Indeed, cost of risk was 0.45% in Q2, less than in the same quarter of 2022 (0.52%).

EARNINGS BANCO DE ESPAÑA Eurosistema

- Spanish banks' net interest margin is noteworthy, although their CoR remains higher
- Among the most important business models, diversified lenders' RoE stands out (12.92% versus 9.01% for G-SIBs)

	Average	Germany	Spain	France	Italy	Netherlands
Net interest margin (NIM) (%)	1.53%	1.13%	2.54%	0.89%	2.02%	1.59%
Cost-to-income ratio (CIR) (%)	57.32%	63.26%	47.22%	71.37%	52.11%	51.96%
Cost of risk (CoR) (%)	0.45%	0.33%	1.09%	0.40%	0.34%	0.11%
Return on equity (RoE) (%)	10.04%	6.59%	12.07%	7.55%	13.73%	12.34%
Return on assets (RoA) (%)	0.65%	0.38%	0.75%	0.48%	1.04%	0.70%

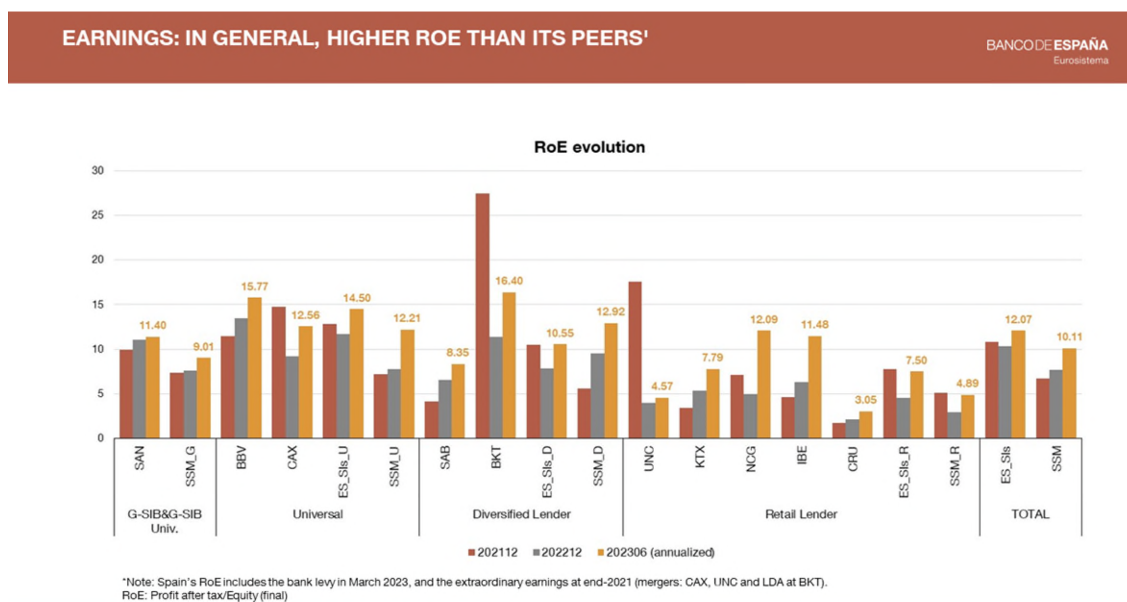
Source: ECB.

Return on equity (ROE) has risen to 10% on average, significantly above its pre-pandemic average (of 5% to 6%).

Net interest income is notably high in Spain, but is partly offset by a higher cost of risk.

Although in general the entire sector has benefited from higher margins, there are differences depending on the type of business model. Among the main business models, banks in the "diversified lenders" category have the highest net interest income and ROE. Conversely, G-SIBs are slightly below average.

By asset size, the most profitable banks in terms of ROE would be those with balance sheets below €30 billion (14.35%), followed by those with total assets of more than €200 billion (11.28%). Of note among the euro area's largest economies are the ROEs for Italy (13.7%), the Netherlands (12.3%) and Spain (12.1%).



An analysis focused on Spain shows that, in general, Spanish banks' ROEs are higher than its peers' for all business models, except diversified lenders. Spanish banks have obviously benefited from the rise in interest rates, although this is perhaps not clear in the chart, as it is slightly distorted by several banks' extraordinary earnings in 2021.

FUTURE CHALLENGES BANCO DE ESPAÑA Eurosistema

- **Uncertain macroeconomic environment with additional geopolitical tensions**
  - Potential deterioration in credit quality. Impact on employment and activity?
  - Decrease in lending. Impact on investment?
- **Pass-through of monetary policy tightening is not complete**
  - Around 30% of variable-rate mortgages will see their interest rates revised upwards by more than 1 pp between June 2023 and June 2024
  - Deposits: greater competition as excess liquidity dries up
- **Current increase in margins and profitability is unsustainable**
  - Unit margin growth will peter out
  - Expected increase in provisions

In the **short term**, the current improvement in margins should enable banks to absorb the possible **deterioration** in credit quality and, …

… in the **medium and long term**, to make the investments necessary to tackle the challenges of **digitalisation and business model transformation**

And what about the future outlook? As we have seen, European banks are in good health and have weathered successive stress episodes in recent years. The improvements in banks' governance and risk control frameworks put them in a good starting position. However, banks face major challenges stemming from various sources of uncertainty (ranging from geopolitical tensions to the impact of technological transformation on business models).

THE PASS-THROUGH OF HIGHER INTEREST RATES TO HOUSEHOLD AND NFC DEPOSITS WITH AGREED MATURITY HAS PICKED UP IN 2023 TO DATE

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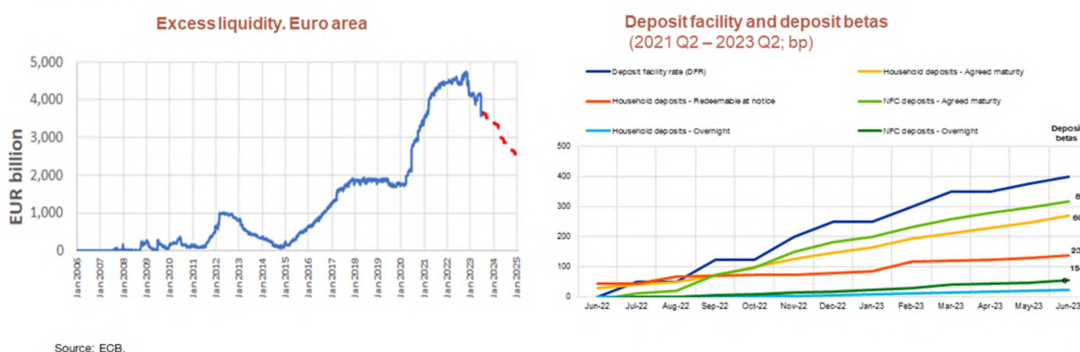
- In the euro area, excess liquidity amounts to some €3.6 trillion. It is expected to decrease by 30% at end-2024 to €2.5 trillion.
- In 2024 competition for deposits is expected to heat up, pass-through to customers to accelerate and deposit betas to gradually increase.



Source: ECB.

In the short term, given that the monetary tightening has still not been passed through completely, the recent increases in net interest income are not expected to be sustainable. Lending rates are rising faster than deposit rates because of the sector's excess liquidity, which has made it less necessary or urgent to remunerate deposits.

Interest rate rises have also been passed through to loans to a lesser extent than in the past, particularly for households. However, this pass-through is markedly higher than in the case of deposits, as mentioned earlier. Thus, in Spain, while the pass-through for loans for house purchase and corporate lending was around 50%, it was only 29% for households' time deposits and 45% for firms' time deposits.

Furthermore, the relative share of time deposits is currently very small compared with sight deposits, where higher interest rates have barely been passed through. In other words, in practice there is a large difference between the pass-through to lending and to deposits.

However, this situation may change in the future as liquidity in the system dries up. Moreover, in this new interest rate environment banks need to pay close attention to interest rate risk management. Not managing it properly could lead to the kind of turbulence we experienced a few months ago caused by the US mid-size banking crisis.

This sharp interest rate rise has also heaped further pressure on some economic sectors. As supervisors, we are paying attention to the commercial real estate sector (particularly offices and commercial premises), which is already strained in some European countries. The profitability of some of these projects could be affected and this could lead to further

impairment. In the euro area this sector accounts for almost 26% of exposures to non-financial sector firms, of which 32% relates to offices and commercial premises.

This situation could be extrapolated to the entire portfolio, in an environment in which firms' and households' disposable income and, in turn, their ability to pay could be affected by the higher interest rates. All this will no doubt depend on economic and, in particular, labour market developments.

Let me also refer to leveraged loans, which have grown by 80% in the past four years, to over €500 billion. Their current default rate stands at 3% and is expected to rise, as around half of these exposures have a leverage ratio of more than six.

Credit risk management systems, particularly early warning systems, are therefore particularly important in these uncertain times. They allow banks to anticipate potential increases in the NPL ratio and adapt the management of their portfolios more efficiently.

Banks also need to closely monitor liquidity conditions in this new framework.

Over the medium term, banks will continue to need to invest heavily in digitalisation to accommodate their business models to the new technological environment. First, they must set out a clear strategy for doing this and make the necessary investments to adapt their activity to the new ecosystem, which will bring new products, new distribution and customer communication channels and more competition.

A recent horizontal SSM exercise concluded that digitalisation is important for banks and showed that most of them have a strategy in place. In general, projects are aimed at cutting costs and improving the customer experience. However, very few banks have developed metrics to measure their impact, and it is therefore hard to monitor and quantify the effectiveness of these investments.

Being able to attract and retain customers in a digital environment is considered a success for banks, yet their monitoring of the use of these channels is still very limited. Meanwhile, investments and resources for digitalisation remain low. Only 2.8% of operating income and 5.2% of FTEs are devoted to digitalisation (on 2021 data). As we can see, theory is one thing and practice is another.

Banks should also set up robust operational risk frameworks to mitigate digitalisation-related risks. Increasingly sophisticated and harmful cyber attacks and the growing dependence on external providers are examples of issues that European banks will have to address within these strengthened operational frameworks. Technology, artificial intelligence and big data analysis will also be key to tackling another challenge for banks: financing the transition to a more sustainable economic model.

Banks will play a fundamental role in channelling funds. They will have to face the new challenge of properly identifying, analysing, managing and mitigating climate risks and other transition-related elements. As you know, the authorities have long been focusing on this element through numerous supervisory activities (specific stress tests, thematic reviews and on-site inspections) to assess the performance of banks in the face of these risks. As we

are all aware, this is a big challenge, since at present not all elements of climate risk are fully defined and agreed.

Conclusions

The European banking sector is strong and has proven this in the face of the different episodes of turmoil in the first few months of the year. Thanks to its improved capital ratios, a sound liquidity position and, above all, good governance, the European banking sector has been able to successfully navigate an uncertain macroeconomic environment.

However, a deterioration in credit quality is to be expected, given the prevailing uncertainty. Supervisors therefore recommend that banks strengthen their provisioning policies.

Meanwhile, the challenges for the sector require strategic investments in technology and digitalisation so that the new environment can be faced from a stronger position.

Banks should also continue to strengthen governance, which still presents some weaknesses despite having improved substantially. As we recently saw, a good governance and risk management framework is the best shield against a crisis. This framework should allow all the risks and trends in the financial market to be properly monitored, so that decisions can be taken swiftly and wisely.

Thank you.