Risk assessment report - July 2024

With this edition the European Banking Authority (EBA) resumes the semi-annual publication of its Risk Assessment Report (RAR). It follows the common structure of the RAR, but also includes the analysis of asset encumbrance and funding plan data, which had previously been published in two separate reports.([1]) It furthermore covers an in-depth analysis of EU/EEA banks' commercial real estate (CRE) exposures as well as EU/EEA banks' interconnections with non-bank financial intermediaries (NBFIs) in two separate chapters.

This RAR was prepared by the Economic and Risk Analysis Department.([2]) The report has benefited from input and comments from other Departments across the EBA as well as from members of the EBA's Supervision, Risks and Innovation Standing Committee (SUPRISC), Resolution Committee (ResCo), and Board of Supervisors (BoS). Many thanks as well to the editors of this version of the RAR.

Executive summary

EU/EEA banks face elevated uncertainty. This is not least due to high geopolitical risks as well as an uncertain outlook for economic growth. Despite first cuts in interest rates by central banks in several jurisdictions, they are at elevated levels and expectations on rates are increasingly uncertain.

Loan growth of EU/EEA banks has been negatively affected by the macroeconomic and monetary conditions. Looking forward, banks plan to gradually increase loan growth. On asset quality, the share of non-performing loans (NPLs) increased for all segments amid slightly positive net NPL inflows in 2023. Banks expect asset quality to stabilise and partially even to improve compared to previously subdued outlooks. Banks also anticipate that household NPLs will grow in 2024 and next years, while corporate NPLs will rise more significantly in 2024 and then level off.

EU/EEA banks have more than EUR 1.4tn in loans collateralised by commercial real estate (CRE) following continuous growth in recent years. On average this accounts for less than 100% of banks' capital, yet there are several banks – mainly relatively small in size

– which are particularly vulnerable to downturns in this market. CRE exposures towards non-EEA-domiciled counterparties have been particularly vulnerable to recent downturns. NPL volumes in the CRE segment rose by more than 12% in 2023, yet with divergences across countries reflecting the particularly variant dynamics in the sector.

Deposits remained the most important source of funding in 2023. Central bank funding continued to decrease in 2023 amid targeted longer-term refinancing operation (TLTRO) repayments, mainly being replaced with debt securities issued. Market data shows that issuance volumes increased in 2023 but declined for covered bonds and unsecured debt during the first half of this year compared to last year. Looking forward, significant amounts of maturing minimum requirement for own funds and eligible liabilities (MREL) instruments will require their replacement.

Asset encumbrance data shows that banks increased the availability of collateral that they can use for different means of funding, including from central banks, in 2023. This offers them important room in times of stress when bond issuance might be negatively affected, or when deposits might decline.

Funding plan data shows that EU/EEA banks plan to significantly increase total long-term market-based funding in the period 2024 to 2026. 2024 is expected to be the year with the highest unsecured debt issuance volume. The strong increase in issuance volume is particularly notable for Additional Tier 1 (AT1) and Tier 2 capital (T2) instruments. Banks also plan to strongly increase secured funding issuances in 2024 and keep them at a high level in 2025 and 2026.

Liquidity positions continued to be strong in 2023. Looking forward, EU/EEA banks' liquidity coverage ratio (LCR) is expected to decrease in 2024. The net stable funding ratio (NSFR) is expected to decline in 2024, but to rise again afterwards.

EU/EEA banks' CET1 headroom above overall capital requirements (OCR) and Pillar 2 Guidance (P2G) has remained at comfortable levels. This is due to a nearly parallel rise in CET1 ratios and respective requirements. Banks' plans indicate a further rise in payouts for this year.

EU/EEA banks' profitability increased substantially in 2023, driven by a large year-on-year (YoY) rise in net interest income (NII). The latter was mainly supported by a widening net interest margin (NIM). However, following a stabilisation of NII in mid-2023, some profitability indicators have begun to show the first signs of a decline, indicating that banks' profitability may have already peaked. In 2024, banks still expect rate rises for some loan and deposit segments, in particular for loans to and deposits from households and non-financial corporations (NFCs). Based on funding plan data, the spread between these client loans and client deposits is expected to stay nearly unchanged this year. Furthermore, banks still expect a further but considerably smaller increase in costs for market-based funding in 2024 compared to last year, which will increase pressure on NII going forward.

The relevance of operational risk has grown further. The EBA's Risk Assessment Questionnaire (RAQ) shows that cyber risks and data security rank the highest among operational risks, followed by conduct and legal risks as well as fraud. Indications are that cyber-attacks have been on the rise, including successful ones. RAQ results also show that sanctions are still the most relevant risk relating to money laundering/terrorist financing (ML/TF). Furthermore, with regard to ML/TF risks most deficiencies are related to customer due diligence (CDD).

The activity of non-bank financial intermediaries (NBFIs) has been increasing meaningfully in the EU/EEA and worldwide over the past decade. This increases the risk that such entities might pose to banks either via direct or indirect links. EU/EEA banks' exposures to NBFIs reached 9.2% of their total assets in 2023. On the liabilities side, the NBFI share of EU/EEA banks' funding through deposits, repos, etc. amounts to 10.3% of banks' total balance sheet (without including wholesale market-based funding). Direct lending by NBFIs to non-financial sectors (private credit) has become a particular focus recently amid the rapid expansion in lending volumes. Even though new players in the market offer opportunities and enhance the access to finance, there are also risks, such as operational risks and possible lower lending standards than those applied by banks.

Introduction

This report describes the main developments and trends in the EU/EEA banking sector and provides the EBA outlook on the related main risks and vulnerabilities.([3]) The Risk Assessment Report (RAR) is based on qualitative and quantitative information collected by the EBA. The report's key data sources are the following:

- EU/EEA supervisory reporting([4]);
- the EBA Risk Assessment Questionnaire (RAQ) addressed to banks;
- market intelligence as well as qualitative micro-prudential information.

This report follows the common structure of the EBA's RARs. It is furthermore complemented by two focus topics, covering CRE-related risks, and NBFI interlinkages with banks and related risks. The RAR builds on the supervisory reporting data that competent authorities submit to the EBA on a quarterly basis for a sample of 163 banks from 30 EEA countries (129 banks at the highest EU/EEA level of consolidation from 26 countries).([5]) Based on total assets, the sample covers about 80% of the EU/EEA banking sector. In general, the risk indicators and other supervisory-reporting-based charts and analysis are based on an unbalanced sample of banks, whereas charts related to the risk indicator numerator and denominator trends are based on a balanced sample.([6]) When referring to countries in the following, respective data is based on the sample of banks applicable for this jurisdiction (see Annex I) if not otherwise stated. The data related to MREL in this report is based on reporting on MREL and total loss absorbing capacity (TLAC), which covers a sample of 331 resolution entities or groups.([7]) The analysis in Chapter 3.3 replaces the report on asset encumbrance, which was previously published on an annual basis.([8]) In Chapters 2.2, 3.4 and 5.2, the analysis replaces the report on funding plans, which was previously published on an annual basis.([9]) The text and figures in this report refer to weighted average ratios unless otherwise indicated.([10]) In selected cases, some of the analysis covered in this RAR is based on data from other reporting and data submissions, such as the EBA's EuReCA.([11])

The RAQ is conducted by the EBA on a semi-annual basis, with one questionnaire addressed to banks.([12]) Answers to the questionnaires were provided by 85 European banks (Annex I) during February and March 2024. The report also analyses information gathered by the EBA from informal discussions as part of the regular risk assessments and ongoing dialogue on risks and vulnerabilities of the EU/EEA banking sector. The cut-off date for the market data presented in the RAR was 15 June 2024, unless otherwise indicated.

Abbreviations and acronyms

[1] With this report, the EBA is discharging all relevant mandates as referred to in the Introduction.

[2] This RAR was prepared by and/or includes contributions from Alessia Benevelli, Olli Castren, Gaetano Chionsini, Valentina Drigani, Francesca Fuser, Thibault Godbillon, Raphael Kopp, Christoph Kuhn, Despo Malikkidou, Angel Monzon, Joana Neto, Achilleas Nicolaou, Andreas Pfeil, Jorge Pinto, Fernando Pires, Aleksandra Potterie, Maria Rocamora, Solene Rochefort, Marco Romeo, Wolfgang Strohbach and Giada Tubiana. Multimedia and production assistance was provided by Franca Rosa Congiu, Salvatore Corvasce, Jana Jaklic, Victoria Montero, Brendan O'Donohue and Maroua Riabi.

[3] With this report, the EBA discharges its responsibility to monitor and assess market developments and provides information to other EU institutions and the general public, pursuant to Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority) and amended by Regulation (EU) No 1022/2013 of the European Parliament and of the Council of 22 October 2013.

[4] See the EBA’s information on supervisory reporting.

[5] Data as of the reporting date 31 December 2023. Supervisory reporting includes, for instance, prudential reporting (common reporting – COREP), financial reporting (FINREP), as well as reporting of funding plan data. It needs to be noted that there are partially certain differences between reporting samples (on the sample of reporting banks see Annex I) and reporting requirements, such as in the level of consolidation.

[6] Being an unbalanced sample, the number of reporting banks per country may display minor variations between quarters, which might accordingly affect quarterly changes in

absolute and relative figures.

[7] Number of banks for which EBA has received both an MREL decision and MREL resources.

[8] Following the publication of the implementing technical standards (ITS) in October 2013, in 2015 the EBA began receiving quarterly data on asset encumbrance. The part covering asset encumbrance and related topics of this report monitor the evolution of asset encumbrance and contribute to the ongoing assessment of the composition of funding sources across EU/EEA banks. With this analysis the EBA discharges its responsibility to closely monitor the level, evolution and types of asset encumbrance as well as unencumbered but encumberable assets at Union level, as described in Recommendation C of the European Systemic Risk Board (ESRB) recommendation on funding of credit institutions from 20 December 2012 (ESRB/2012/2).

[9] The funding plan data is based on projections as of December 2023. See also the EBA's Guidelines on funding plan reporting. With the analysis in this report the EBA discharges its responsibility to coordinate the assessment of funding plans at Union level, including credit institutions' plans to reduce reliance on public sector funding sources, and to assess the viability of such plans for the Union banking system, on an aggregated basis, set out in Recommendation A of the ESRB recommendation on funding of credit institutions from 20 December 2012 (ESRB/2012/2).

[10] There might be slight differences between some of the risk indicators covered in the Q4 2023 version of the EBA Risk Dashboard and this report as a result of data resubmissions by banks. The Annex to the Risk Dashboard also includes a description of the risk indicators covered in this report and their calculations, and further descriptions are available in the EBA's guide to risk indicators.

[11] The EBA's EuReCA is a central database that puts together information submitted by competent authorities on serious deficiencies in individual financial institutions' systems and controls that expose these institutions to money laundering and terrorist financing (ML/TF) risk. Data refers to all sectors within the remit of the EBA's anti-money laundering/countering the financing of terrorism (AML/CFT) mandate, namely: credit

institutions, payment institutions, e-money institutions, bureaux de change, investment firms, fund managers, credit providers (other than credit institutions), life insurance undertakings and life insurance intermediaries, and an additional category of 'others'.

[12] The results of the RAQ are also published separately, together with the EBA's Risk Dashboard, on a semi-annual basis. These published RAQ booklets (latest published version is from spring 2024) also include explanations of the questionnaire and the analysis of the RAQ responses.