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# Market developments that could potentially increase macro- and micro-prudential risks in all or most Member States

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1. Every year the European Commission is required to report to the European Council and European Parliament on market developments that would potentially require the use of Article 459 of Regulation (EU) No 575/2013 (CRR). This article empowers the Commission to adopt delegated acts imposing stricter prudential requirements if all Member States face heightened micro-prudential or macro-prudential risks caused by market developments within or outside the Union, and if these risks cannot be sufficiently addressed by the instruments foreseen in CRR and the CRD.
2. For the purpose to fulfil this task, the Commission requested the EBA to provide input on the market developments that could affect the European banking sector. The following contribution provides a summary of the risk and vulnerabilities identified by the EBA currently affecting the European banking sector.<sup>1</sup>
3. Based on this summary, the main risk facing the European banking sector is linked to the current COVID-19 pandemic. The EBA has observed early indications of credit quality deterioration since the beginning of the outbreak. The uncertain economic environment linked to the prolongation of different restrictions at the country level and the real damage that this situation has caused to the productive economy can amplify this deterioration and result in significant losses for banks in the medium term. Nevertheless, and contrary to the situation under the Great Financial Crisis (GFC), the European banking sector has been part of the solution by keep providing lending to the real economy, and particularly towards non-financial corporations (NFCs). Indeed, European banks entered this crisis in a better shape than in previous crises thanks, among other aspects, to the regulation reforms after the GFC. The range of fiscal and prudential measures put in place during 2020 at both the European and national level played also an important role avoiding any disruption of credit supply into the real economy. In particular, the EBA recommended, at the early stage of the crisis, national authorities to make use of the flexibility embedded in the regulatory framework, including the release of macroprudential capital buffers

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<sup>1</sup> The analysis included on this EBA contribution builds on the latest EBA Risk Assessment Report 2020, including the sample of banks used in this note.

as well as encouraged European banks to practice prudent dividend and distribution policies. The main objective was to strengthen the loss absorption capacity of banks and avoid any loss of confidence on the European banking sector.

4. Overall, the funding and liquidity profiles as well as the capital ratios and management buffers of European banks are considered comfortable based on the latest data. Nevertheless, the pandemic is not over yet and the uncertainty around the time and size of loss materialisation for European banks remains high. Against this background, the EBA does not see the need at the current juncture for stricter micro- or macroprudential requirements across the European banking sector.

## Developments in the EU banking sector

5. In 2020, the COVID-19 pandemic generated an unprecedented worldwide shock. In Europe, the number of cases rapidly increased in the second half of February, forcing governments to impose strict containment measures to prevent the collapse of national healthcare systems (first wave). After the summer of 2020, many countries were hit by a second wave of increased cases.
6. The EU GDP recorded a sharp contraction in Q2 (-11.2%), amid strict COVID-19 containment measures, before rebounding in Q3 (+11.6%). In Q4 the resurgence of COVID-19 infections led to a contraction in EU GDP (-0.5%), although contained compared to Q2. Overall, the EU GDP fell by 6.2% in 2020, according to Eurostat.<sup>2</sup> At the country level, Spain experienced the worst GDP drop in 2020 (-10.8%), followed by Italy (-8.9%) and Croatia (-8.4%). The contraction of economic activity is also affecting the job market. In the EU, the number of hours worked declined by 11.2% in Q2. Although this indicator grew by 11.5% in Q3, it fell again by 1.4% in Q4. Nevertheless, thanks to the implementation of employment support measures (e.g. furlough schemes), total employment recorded a smaller contraction in Q2 (-3.0%), and partially recovered in Q3 (+1.0%) and Q4 (+0.3%). Overall, the EU unemployment rate was 7.5% in December 2020, up from 6.5% in December 2019.
7. Movements on financial markets reflected the disruptive impact of the pandemic. Since February 2020, when the COVID-19 outbreak unfolded in Italy, the Euro Stoxx 600 contracted by as much as 35% and started recovering at the end of March 2020. The banking index underperformed the benchmark index, reaching its lowest level in the second half of April, after falling by 50% compared with pre-COVID-19 levels. Nevertheless, by the end of 2020, the financial markets recovered most of the lost ground spurred by news on the starting of the vaccination programmes across Europe. However, as the increasing number of infections after the summer is hindering again the economic recovery, financial markets seem somewhat decoupled from the real economy, thus, entailing a risk of a sudden and abrupt correction.

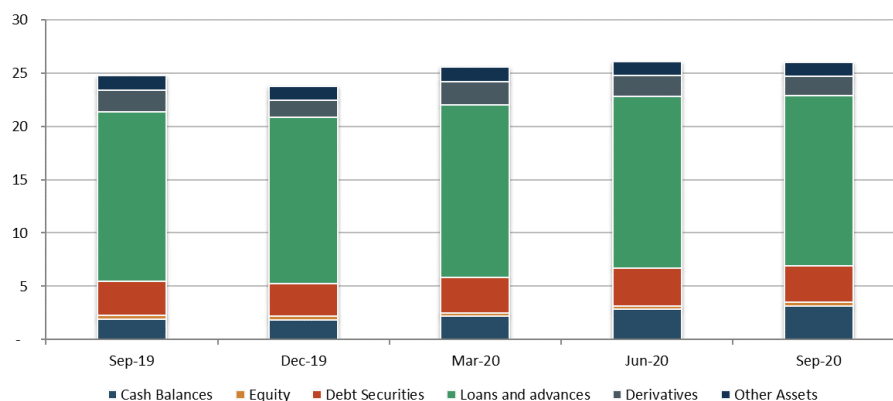
### Asset side

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<sup>2</sup> Please see the related [Eurostat press release](#).

8. EU banks' total assets grew by 5% between September 2019 and September 2020 to EUR 26 trillion (see Figure 1). The increase was concentrated in the first half of the year, when total assets grew by 10% mostly due to the surge in cash balances caused by extraordinary accommodative monetary policies. Loans and advances also contributed to the surge in total assets during the first half of the year as borrowers made use of available loan commitments to secure liquidity and operational continuity in an environment of very high uncertainty. In addition, the roll-out of public guarantee schemes (PGS) has played significant role in providing lending.
9. By September 2020, outstanding loans towards NFCs rose by 2% YoY, driven by the increase in SME lending (+10% YoY), which was not least supported by the introduction of public guarantee schemes (PGS). Part of the increase in outstanding loans might also be explained by moratoria on loan repayments, which preserve the balance of the loan and might add the accrued interest to this balance. Yet during the last quarters of 2020, credit standards have tightened substantially<sup>3</sup> and banks' risk tolerance has diminished.

Figure 1: Trend in asset composition (EUR trillion), Sep 2019 to Sep 2020



Source: Supervisory reporting data.

10. Banks' sovereign exposures rose by 9% from June 2019 to June 2020<sup>4</sup> and stood at EUR 3.4 trillion (13% of total assets). The increase in sovereign holdings might be related to the stabilising role of banks, as they tend to meet the growing needs of sovereign financing during periods of increased uncertainty and stress in the economy. In addition, sovereign exposures are assets to which banks can allocate the large increase in liquidity positions derived from monetary policy measures. In particular, 49% of EU banks' sovereign exposures was to their respective home countries, broadly the same as in June 2019. In addition, banks have extended new loans to NFCs secured by public guarantees, which are not computed as sovereign exposures, yet they may increase the sovereign-bank nexus.
11. Concerning asset quality, supervisory data already show signs of deterioration, despite non-performing loans (NPLs) and stage 3 loans remaining stable. The volume of forborne loans (FBLs)

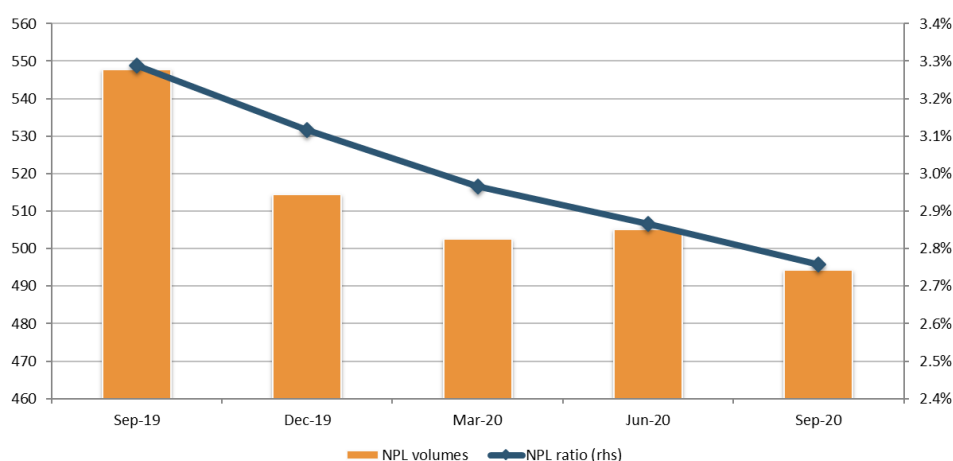
<sup>3</sup> ECB Bank Lending Survey 2020Q4

<sup>4</sup> This information is only reported every half a year.

increased by around 11% in the first three quarters of 2020 driven almost exclusively by forbore performing loans. Accumulated impairments for performing loans increased 28% YoY, driven by the increase in provisions booked during the first half of 2020. Banks in a number of countries have increased the share of loans allocated to stage 2 (8.0% in September 2020 vs 6.8% a year before) and have increased provisions accordingly. However, there are still substantial differences in provisioning across banks that warrant attention to ensure banks adequately measure the credit risk of their exposures. To some extent, this heterogeneity in the provisioning policies may be also driven by an uneven impact of the crisis – due to differences in the exposures towards affected countries and sectors - or different accounting policies and practices undertaken by banks.

12. The NPL ratio stood at 2.8% in September 2020, around 50 bps lower than in June 2019 and 20 bps lower than in December 2019 (see Figure 2). EU banks also reported an increase in NPLs volumes of around 5% to sectors particularly affected by confinement measures, such as hospitality, transport and education. The aggregate coverage ratio of NPLs stood at 45.5% in September 2020 (45.8% in September 2019).

Figure 2: Evolution of NPL ratios (%) and NPL volumes (EUR billion)



Source: Supervisory reporting data.

13. Banks have made use of supervisory COVID-19 supporting measures. As of September 2020, banks had EUR 587 bn of loans under moratoria. Around 40% of these loans were towards households and close to 60% towards NFCs. Although the NPL ratio of loans under moratoria stood at a level similar to the overall NPL ratio (3%), the share of these loans classified under IFRS 9 stage 2 was significantly higher (20%). As of September 2020, around EUR 350 bn of loans had exited moratoria. The NPL ratio of the loans under expired moratoria was 2.6% and the share of these loans allocated to stage 2 was 17%.

14. In the same period, close to EUR 290 bn of newly originated loans were subject to PGS. These have been an important supporting factor of lending to the real economy, especially towards SMEs and in particular to those sectors that have been mostly hit by the pandemic and the imposed confinement measures. Although these loans bear lower credit risk for the banks (and

as such reduce average risk weights) due to the attached public guarantee, yet they may enforce the sovereign-bank nexus.

## Liability side

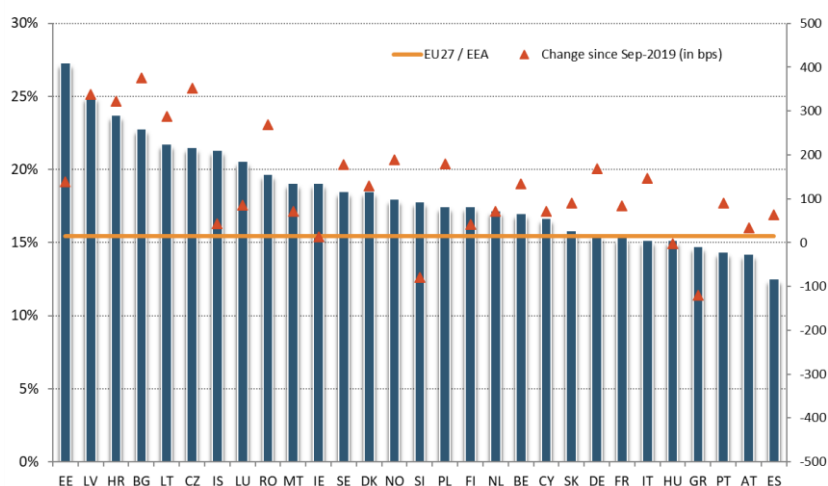
15. The volumes of central bank funding for banks increased significantly. As an immediate response to the unfolding COVID-19 crisis, central banks introduced new facilities, aimed at ensuring sufficient liquidity during the pandemic period, that banks extensively used. For instance, the total outstanding balance of TLTRO programmes reached a record high of about EUR 1.75 trillion in September 2020. The share of other financial liabilities, which includes central bank funding, strongly increased to 20.5% in September 2020, compared with 19.3% in September 2019.
16. The pandemic crisis did not materially affect deposits. Deposit volumes continued to grow strongly in 2020 (even faster than loans), in spite of no or little remuneration for depositors and an increasing usage of negative interest rates. The share of customer deposits in banks' liability structures stood at 55.1% in September 2020 (53.5% in September 2019). The share of customer deposits from NFCs in total liabilities increased from 13.9% in September 2019 to 15.5% in September 2020. This increase may be attributable to efforts of NFCs to improve their liquidity positions in the light of the high level of uncertainties in the COVID-19 pandemic.
17. The liquidity coverage ratio (LCR) shows a solid short-term liquidity position. Central bank measures, increase in deposits and strong issuance activity at the beginning of the year allowed banks to improve their LCRs. In September 2019, the weighted average LCR was equal to 146.9% and remained roughly stable up to June 2020, when the LCR jumped to 165.7%. As of September 2020, the LCR stood at 171.3%. However, USD and GBP LCRs are only slightly above 100% with relatively wide interquartile ranges.

## Capital

18. European banks have increased their capital ratios due to a higher pick-up in own funds than RWAs in the past year (see Figure 3). In September 2020, the average CET1 ratio stood at 15.4% (15.1% on a fully loaded basis), an increase of more than 80 bps compared with September 2019 even though the CET1 ratio fell by 40 bps in the first quarter of 2020. One of the reasons for the increased capital ratios was regulatory measures that either preserved capital resources, such as restrictions on dividend payments, or reduced RWAs, mainly in credit risk due to PGS and supporting factors. The leverage ratio, however, decreased by roughly 10 bps from September 2019 to June 2020 to 5.3%. However, in the third quarter of 2020, regulatory reforms related to the leverage ratio started to apply and this metric went up to 5.6% as banks were allowed to exclude central bank balances from the calculation of this ratio.
19. The level of CET1 capital in September 2020 had increased by 2% compared with September 2019. The main drivers of the overall increase were a rise in retained earnings (+4% YoY) and other reserves (+9% YoY) and a reduction in various items that are deducted from CET1 capital. In particular, goodwill-related deductions were 20% lower than their 2019 level.

20. European banks' RWAs decreased by 4.1% compared with September 2019. Credit risk, which makes up 82.8% of total RWAs decreased by 4.7% despite the increase in total assets and loans and advances. The decoupling of RWA trends from those in assets is not least the result of a change in the composition of banks' assets and various measures introduced in the wake of the COVID-19 crisis that affected the calculation of RWAs. Operational risk, the second most important RWA component representing 10.2% of total RWAs decreased by almost 3% since September 2019, while market risk, which makes up 3.4% of total RWAs, decreased by 1.4% after registering a YoY increase in June of more than 20% amidst high market volatility.

Figure 3: CET1 ratio, by country, in September 2020 (left-hand side), and change in bps since September 2019 (right-hand side)



Source: Supervisory reporting data.

21. On average, banks' excess capital over and above capital requirements increased substantially in the past year and stood at above 360 bps in September 2020 (roughly 300 bps in December 2019). The increase was due to the above mentioned increase in capital resources and a decrease in capital requirements. Overall, CET1 capital requirements including P2G<sup>5</sup> stood at 10.3% in September 2020, a decline of almost 1 p.p. in the past year (11.2% in December 2019). The decline was mostly due to a reduction in Pillar 2 requirements, which decreased by 70 bps and stood at 1.1% in September 2020 and was driven by ECB's decision in March 2020 to change the P2R composition rule. According to the new rule, banks are allowed to partially cover P2R with capital instruments other than CET1 (change from 100% CET1 to a minimum of 56.25%). Also the combined buffer requirement fell by 30 bps and stood at 370 bps of RWAs in September 2020. The countercyclical capital buffer (CCyB) has been reduced to close to 0% of RWAs due to the release of this buffer requirement in many countries and the Systemic Risk Buffer has also been reduced in several countries. Other buffer requirements have remained largely unchanged in the past year. Overall the capital conservation buffer (CCB) stands at 2.5% of RWAs according

<sup>5</sup> On March 12 2020, the SSM announced that they will allow banks to operate temporarily below the level of capital defined by the Pillar 2 Guidance (P2G) and the capital conservation buffer (CCB).

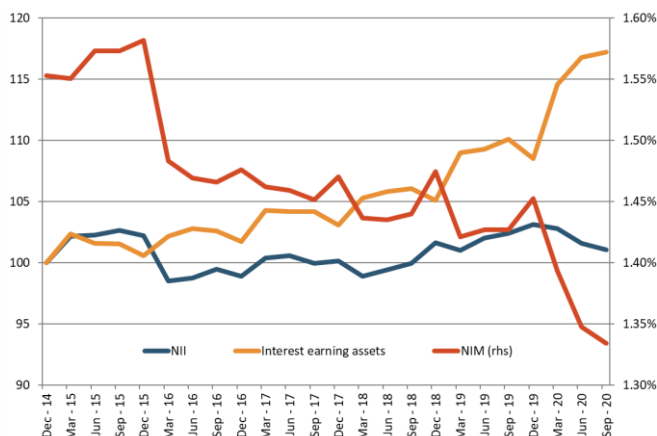
to primary legislation and the buffers for global and other systemically important institutions (G-SIIs and O-SIIs) and systemic risk amount to 1.2% of RWAs.

## Profitability

22.The COVID-19 outbreak has just heightened the profitability challenge. Since the GFC, average profitability levels have been below the estimated cost of equity (CoE), which is estimated at between 8% and 10% by the majority of the banks responding to the EBA Risk Assessment Questionnaire. In September 2020, the average return on equity (RoE) of EU banks stood at 2.5%, down from 6.5% in September 2019. The decline is largely explained by the surge in impairment costs and, to a lesser extent, by the contraction in revenues. In contrast, operating expenses have registered a positive contribution to the RoE due to their contraction YoY.

23.The sharp GDP contraction and the lingering low interest rate environment have driven net operating income (NOI) down by 1.9%. Net interest income (NII) contracted by 1.5%, dragged down by decreasing margins, despite rising loan volumes (see Figure 4). The low interest rate environment and the lower interest rates of loans with embedded public guarantees are presumably hampering banks' margins. Moreover, banks whose loans under moratoria do not accrue interests during the moratorium period might be additionally hit. Net fee and commission income (NFCI) has also gone down in 2020 (-1.3%).

Figure 4: Evolution of NII, NIM and interest earning assets (December 2014 = 100)



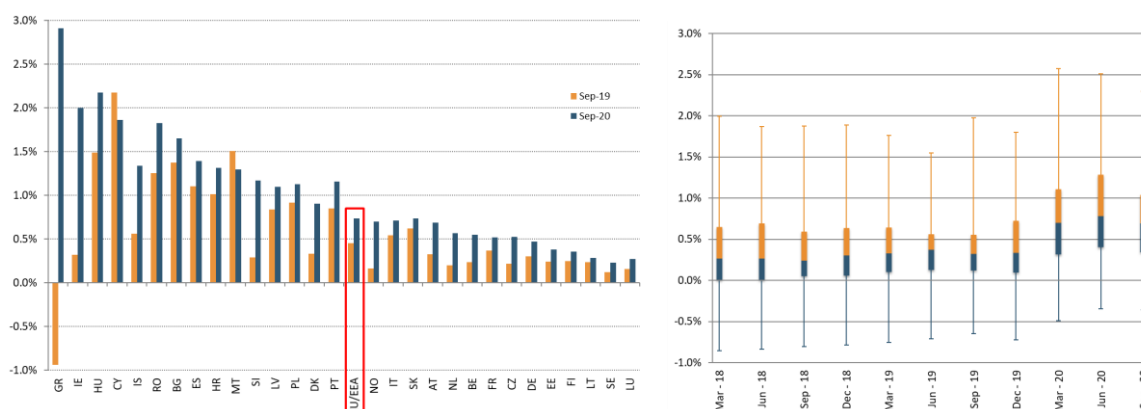
Source: Supervisory reporting data.

24.Impairments have risen sharply and are responsible for a RoE contraction of 5.6 p.p., compared with 2.7 p.p. in 2019. Banks allocated their new provisions mainly to stage 1 (+27% YoY) and stage 2 loans (+30% YoY) between September 2019 and September 2020. Impairments for stage 3 decreased during the same time horizon by 10%.

25.The cost of risk (changes in allowances for credit losses in a given period)increased in 2020, reflecting prospects of asset quality deterioration. It jumped from around 50 bps in 2019 to

81 bps in March and 86 bps in June 2020 (see Figure 5). In September of the same year, it fell again to 74 bps after some relaxation in containment measures during the summer. This indicator also shows a significant dispersion across countries, which can be attributed to several factors, such as the differences in banks' exposures to the sectors and countries most affected by the pandemic or to a variety of IFRS 9 provisioning models, which under the current uncertain environment yield different results.

Figure 5: Cost of risk by country (left) and dispersion (right)



Source: Supervisory reporting data.

26. The increase in impairments has been partially offset by the decrease in operating expenses, (-6.9% YoY). However, the decline was concentrated in the second and third quarters of 2020. As in previous years, banks domiciled in northern European countries have the lowest operating expenses to total assets ratios (below 0.8%).

## Operational risk

27. Critical functions have been largely unaffected by containment measures introduced in response to the crisis. Banks' strategies to cope with lockdowns included the introduction of extended remote working for staff, strengthening cybersecurity, splitting up teams in critical units, and deploying new digital and remote business channels for clients. Operationalised business continuity plans have mostly demonstrated their effectiveness. Only in the early stages of the crisis, temporarily high volumes of applications for moratoria and government-guaranteed loan schemes implied some challenges for banks. Going forward, the uncertainty about the further evolution of the pandemic, along with measures introduced to address the crisis, may provide opportunities for the emergence of new types of misconduct, to the detriment of customers, and for further potentially fraudulent activities. For example, increased digitalisation and customer use of digital channels might give opportunity for new fraudulent activities, and various public support measures introduced in response to the pandemic may render them vulnerable for illicit use.



28. The usage of information and communication technologies (ICT) and digitalisation has further increased with the pandemic. While digital transformation is vital for the future competitiveness and efficiency of banks, it also increases technology-related risks. Cyber risk has become increasingly relevant with the outbreak of the pandemic. The surge in customer usage of digital solutions and technology may, at the same time, lead to an increasing risk of digital fraud. Moreover, technology for fraud detection may not keep up with ICT trends, which, together with the outdated data sets used to train the alert systems, may not adequately flag the range of fraudulent activity online.
29. The number of high-profile cases of money laundering involving European banks in recent years have highlighted the importance of effective AML/CFT supervision. In some of these cases, the volumes of illicit and allegedly illicit transactions concerned were substantial. This leads to reputational risk and costly legal settlements for the financial institutions concerned and ultimately undermines the integrity of the EU banking sector as a whole.