Keynote speech of the Chairperson of the European Banking Authority (EBA), in National Bank of the Republic of North Macedonia 8th Research Conference

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Good morning,

I would like to thank you for the invitation to speak at the 8th Research Conference co-organised by the National Bank of the Republic of North Macedonia and the European Investment Bank.

First, I would like to congratulate the National Bank of the Republic of North Macedonia on an important achievement. This year it celebrates 30 years of monetary independence, which is a significant milestone.

In the next one and a half hour we will hear from some very notable panelists their take on the post-pandemic situation in banking and, more broadly, financial stability.

However, as we speak, the post-covid effects are overshadowed by the political and geopolitical developments emanating from the unjustified military aggression against Ukraine. We can only hope that the war ends soon and the suffering comes to an end.

Today, I would like to discuss two major topics. The first one is backward looking, addressing how banks have coped with the covid-effects and the lessons we can draw from the last two years. The second one is more forward looking, discussing how the Russian aggression of Ukraine has affected the overall risk outlook of the EU banking sector.

EU banks have so far overall coped well with the challenges posed by the COVID pandemic. One may well say that banks were part of the solution to address these economic challenges and not part of the problem. This is a major difference compared to the global financial crisis in which the financial sector was at the core of the sources of the crisis.

As the pandemic has not yet fully retreated, the discussion of the post-pandemic effects is not an easy one. There is still a large number of covid-19 related cases reported across Europe, while in Europe the restrictions on economic activity to manage the pandemic have almost disappeared, elsewhere, like in Asia we see that there are still cities in strict lockdowns as a way to tackle the spread of the virus.

During the pandemic, EU banks faced several challenges that extended way beyond operational hurdles. Most importantly, banks were faced with increased demand for liquidity, while at the same time they needed to evaluate promptly and accurately the impact of the shock in their customers' creditworthiness. The biggest challenge was that they had to do this within an environment of heightened uncertainty and very limited visibility on the medium-term macroeconomic outlook.

Exceptional fiscal and monetary support have been vital in absorbing the bulk of the macroeconomic shock, while supervisory and regulatory flexibility provided the necessary breathing space for banks and borrowers to address some of their emerging problems.

In fact, banks entered the pandemic well-capitalised and with sufficient liquidity to weather the upcoming storm. This would not have been possible without the stricter regulation that has been put in place since the 2008 financial crisis.

Since the beginning of the pandemic, capital and liquidity ratios in EU banks have improved further, not least due to the various measures implemented, such as CRR quick fix and restrictions on dividends. The average EU CET1 capital ratio [fully loaded] stood at 15.4% in Q4 2021, up around 40bps from pre-pandemic levels. Banks in Europe have maintained stable capital ratios in the past year which are comfortably above their regulatory minimum requirements.

The results of the EBA 2021 EU-wide stress test also confirmed that banks are well-equipped to withstand a severe macroeconomic downturn. After an assumed 3.6% cumulative drop in EU GDP over a three-year horizon (which is added to the 6% GDP drop registered in 2020), banks' fully loaded CET1 ratio would fall by 485bps to 10.2% on average. Moreover, 90% of the banks in the stress test sample would remain well capitalised relative to minimum requirements.

Banks also maintained strong liquidity positions throughout the pandemic and currently hold substantial liquid assets. The average EU Liquidity Coverage Ratio (LCR) is close to 175%, up from less than 150% in December 2019. Although the LCR ratio is still increasing, the pace has slowed down during recent quarters. No doubt that banks' pre-emptive stance and accommodative monetary policies have helped back this trend.

Their strengthened capital and liquidity positions, coupled with fiscal programs have enabled banks to maintain lending flow towards the real economy, even during the outset of the pandemic which was a period of heightened uncertainty

As a matter of fact, since the beginning of the pandemic EU banks have increased their outstanding loans towards households by around 4%, driven by an increase in lending for housing. Let me make a parenthesis here to mention that I share those concerns about overheating housing markets, at least for some countries. Higher interest rates could cause a slowdown in this market, but it is hard to predict what would be the actual impact on borrowers' ability to repay their mortgage loans as well as house prices.

During the pandemic, banks have also maintained fairly stable exposures towards non-financial corporates, but they have markedly increased lending towards small and medium enterprises (SMEs). In fact, the increase in outstanding loans towards SMEs at the EU level is more than 10%. This is a clear sign that support programs, which in many cases targeted this segment, have achieved their goal.

Perhaps somewhat surprisingly, bank asset quality improved during the pandemic.

Banks on average report a lower ratio of non-performing loans (NPLs) to total loans than before the pandemic. The NPL ratio maintained a decreasing trend throughout the pandemic and currently stands at 2%. It is true that asset quality deterioration anticipated at the outset of the pandemic has not materialised. This was also due to the sharp decrease in corporate bankruptcies, as a result of temporary suspension of insolvency regimes and other fiscal support programs. In fact, the cost of risk now hovers close to pre-pandemic levels around 0.47%.

Nevertheless, there are some signs of concern as regards asset quality that can't be overlooked.

For example, the sectors most affected by the pandemic such as hospitality related industries show rising volumes of NPLs. Moreover, the increase in forborne loans indicates that a growing share of lenders needs concessions because they are experiencing or are likely to experience difficulties in meeting their financial commitments. Even though the cost of risk has returned to pre-pandemic levels, the overall share of loans classified under IFRS 9 stage 2 remains more than 2pp higher when compared to December 2019 (9.0% in December 2021 vs 6.8% in December 2019). Although these trends seem to have stabilised in the last quarters, their evolution needs to be closely monitored going forward.

Those loans that had benefited from some concessions during the peak of the pandemic, such as moratoria on loan repayments or loans backed by public guaranteed schemes, show a higher deterioration in credit quality. The asset quality of the loans that benefited from EBA-compliant moratoria is significantly lower compared to total loans. For example, around 25% of these loans is classified in stage 2 loans and more than 5% as non-performing loans. A similar deteriorated asset quality is observed in the loans backed by public guaranteed schemes. Around 20% of them are classified under Stage 2, and their NPL ratio, is above total average (3.1%), with an increasing trend.

To a certain extent this is expected, as support measures were rather used by borrowers impacted the most by the pandemic. This is also a positive sign that supervisory and other measures have really addressed the liquidity issues faced by many borrowers during the pandemic. Still, one needs to be vigilant, and banks need to identify and address promptly present vulnerabilities in these portfolios. The way to do this is by engaging early with their struggling borrowers.

Profitability suffered a lot during the pandemic.

In 2020, during the first year of the pandemic, banks reported return on their equity (ROE) of just 1.9%, with many banks reporting substantial losses due to increased provisioning needs. Last year, though, banks' revenues were boosted by increasing fees and commissions due to revamped economic activity and lower impairment costs. The latter was also helped in some cases by the write-back of provisions as initial fears for asset quality deterioration did not actually materialise. On average banks reported ROE more than 7% which is a bit higher than pre-pandemic levels.

EU banks faced a low profitability challenge already before the pandemic due to more structural deficiencies that need to be addressed. Having said that, I would expect an orderly increase in policy interest rates to prove beneficial for the banks as their net interest margins and net interest income could increase as central banks raise their base rates. Nevertheless, if EU banks were to stay competitive in the global environment, they need to address inefficiency and overcapacity issues in a more aggressive and clinical manner.

The pandemic also tested and accelerated banks' technological transformation, with more client operations moving inevitably towards online transactions and wide application of teleworking arrangements. On the one hand, technological transformation is central for banks' competitiveness. It allows employees and clients to benefit from the use of digital solutions in terms of better cost, increased accessibility. However, the transformation also increases technology-related risks, as it leaves banks vulnerable to hardware, software and telecommunication incidents which might disrupt operations.

Cyber-attacks have become more frequent and aggressive. Although the banking industry has still not experienced major ransomware episodes – which were mainly observed in other economic sectors for the moment – we cannot rule out the possibility that such incidents reach banks.

Let me move forward to more recent developments in addition to the post-covid effects.

In the past two months **uncertainty around the macroeconomic outlook has risen substantially** just like the **medium and longer-term risks for the banking sector**.

The Russian invasion of Ukraine is the main driver of this uncertainty. The invasion of Ukraine has taken a heavy toll on the Ukrainian population, society and economy. It has escalated geopolitical tensions and a series of unprecedented sanctions have been imposed by the EU, the US and other countries on Russia and Belarus.

Our initial risk assessment shows that first-round effects are small and broadly manageable for EU banks as aggregate direct exposures towards Russian and Ukrainian counterparties are rather limited and they do not pose a fundamental threat to financial stability.

EU/EEA banks reported exposures around EUR 76bn towards Russian counterparties at the end of last year. The biggest part of these exposures were loans towards non-financial corporates mainly in manufacturing (EUR 16 bn), wholesale and retail (EUR 10 bn) and mining and quarrying (EUR 9 bn). Loans towards Russian mining and quarrying NFCs made up more than 10% of the total exposure of EU/EEA banks towards this sector. Sanctions imposed on Russian entities and further disruptions in the supply chain due to the war are expected to have an adverse impact on these.

These exposures are actually concentrated in a few banks[1]. Although these exposures are channelled mainly through their local subsidiaries, managing these positions should still be a challenging task. We already saw a number of European banks exiting the Russian market, while at the same time European subsidiaries of Russian banks, such as Sberbank Europe or Russian Commercial Bank were wound down.

As an immediate result of the geopolitical tensions and the military aggression, EU/EEA banks have faced an increase in market risk. Heightened volatility and sudden adjustments in risk premiums affects mark-to-market exposures. This includes, for instance, derivative exposures and sovereign exposures recognised at fair value. Positions of EU/EEA banks towards Russian and Ukrainian sovereigns are rather limited. Although, in the last few weeks volatility has retreated, the nervousness in the market is still obvious, with quick and sudden reactions to news flows.

The most abrupt pricing moves were seen in commodity markets. Since the start of war, specific commodities have traded near or above historic prices with heightened volatility. This also caused an increase in margin calls. Exposure of EU/EEA banks towards commodity-

[1] As of Q4 2021, EU/EEA banks reported exposures (loans, advances and debt securities) of EUR 76bn and EUR 12bn towards Russian (RU) Ukrainian (UA) counterparties, respectively. Exposures are concentrated in a few countries, and few banks, mainly by loans provided though subsidiary entities, although no bank reports more than 10% of total exposure towards Russian and Ukrainian counterparties

related derivatives is low. However, exposure from some non-financial corporates may be significant and, to the extent that their overall credit quality may be affected, this may also have an indirect impact on banks' exposures. Overall, as volatility in these markets remains elevated, idiosyncratic vulnerabilities cannot be ruled out.

We still expect to see second round macroeconomic effects from this situation. We are already seeing lower consumer and business confidence, disruptions in supply chains and inflation pressures also caused by the increase in commodity and energy prices.

These developments could translate to even higher inflationary pressures and impair economic growth. Inflationary pressures add to the pre-existing pressures on prices also caused by global supply bottlenecks due to the backlog of orders, coupled with factory closures, labour issues, and equipment shortage – which are not unrelated to the post-pandemic effects of course. The recent IMF projections for GDP growth reflect these dynamics as they were adjusted downwards.

As a result of these dynamics, the EU economy could be challenged with a macroenvironment of lower economic growth and a higher inflation. This, I believe, is also reflected in banks' equity prices, which have materially corrected since the outbreak of the war.

There are other pockets of risks that are assessed elevated due to the Russia's unprovoked invasion of Ukraine and may adversely affect banks' balance sheets.

These are, for example, the elevated operational risks, including reputational and legal risks because of the unprecedented reach of the sanctions imposed. Strict adherence to imposed sanctions is of outmost importance for banks in order to manage these risks. Cyber risks are also related due to presumably cyber-attacks reported in the past few months due to the Russian aggression against Ukraine.

Sanctions may also expose banks to several operational challenges that need to be steered with care. To address these, proper sanction screening systems must be in place. Banks should also be cautious for any sanctioned entities attempting to circumvent sanctions.

Looking ahead, banks may face challenges due to rising geopolitical risks and the resulting shift from essentially a long period of peace, at least in Europe, towards a highly uncertain and volatile environment. I assume this could affect various policies that also determine the macroeconomic environment in the long-term. For example, I am thinking of the likely increases in defence spending, fiscal costs linked to investments in the energy sector and broader efforts to redesign global supply chains. For the banking sector, this means designing and executing strategies within a highly uncertain environment.

Although the EU banking sector shows improvement in terms of profitability, solvency and liquidity, EU banks and their stakeholders, including supervisors, need to remain alerted. There are looming risks both related to the pandemic but also more prominent risks from the escalated geopolitical tensions and the Russian war of aggression against Ukraine.