Eurozone bank assessments reveal resilience, but classic risks remain lurking

19 Dec 2023 | 17:21 GMT | **Insight**
By Abhishek Kumar

Eurozone banks' profit levels are at decade highs in an environment of rising interest rates and high inflationary pressures, but the sector should be prepared for risks to reassert themselves, the European Central Bank has said after unveiling supervisory review results today.

Eurozone banks' profit levels are at decade highs in an environment of rising interest rates and high inflationary pressures, but the sector should be prepared for risks to reassert themselves, the European Central Bank has said after unveiling supervisory review results today.

Sound capital positions, liquidity buffers, and lower levels of non-performing loans helped banks tackle the challenges stemming from the coronavirus pandemic-related supply chain disruptions, Russia's war in Ukraine and the subsequent energy supply shock, and the recent failures of US and Swiss banks, the ECB said.

"In the current hiking cycle, euro area banks have been slower in passing policy rate increases to depositors than they were in previous cycles … partly driven by the availability of excess central bank liquidity at the start of the rate hiking cycle," Andrea Enria, the chair of the ECB's Supervisory Board, told reporters.

"In the second quarter of 2023, banks' average return on equity reached double digits for the first time since the start of the banking union, largely due to wider net interest margins resulting from the rate hikes," Enria said.

The ECB noted a considerable increase in the profitability of banks led by a rapid transition from a prolonged period of low interest rates to a consistent fast-paced increase over the past 18 months.

"Change in interest-rate environment has not translated into asset quality problems, as asset quality of banks remained strong and the aggregate non-performing loan ratio of banks remained near historical lows," the ECB said.

But, it cautioned, "the effect will diminish as banks pass higher interest rates on to depositors." The current strength needs to be balanced against persistent concerns about the quality of their governance and risk management practices in the face of a deteriorating risk outlook, Enria said, adding that profitability will also be challenged by emerging downside risks, including credit risk and fair value losses as monetary policy normalizes.

The ECB's annual supervisory review and evaluation process, or SREP, found that eurozone banks continue to face risks due to geopolitical concerns and tight financing conditions. SREP is a core activity aimed at assessing risks faced by banks. Based on the results, the ECB specifies capital requirements and issues qualitative measures to remediate deficiencies for each bank. They also feed into the ECB's supervisory priorities for the next three years.

Banks' average SREP scores this year remained broadly stable with 70 percent scoring the same as in 2022, 14 percent worse and 15 percent better.

"The average Common Equity Tier 1 (CET1) ratio stood at 15.7 percent in the second quarter of 2023, up from 15.0 percent in the same quarter of the previous year. All significant banks have reported CET1 ratios that exceed the requirements and guidance applicable in 2024," Enria said.

A diversified depositor base shielded the sector from the banking turmoil seen in the spring, the ECB observed, highlighting the importance of a "prudent supervisory approach" and the need for the banking sector to manage interest rate risks effectively to address downside risks.

Higher interest rates have also added to credit, valuation and liquidity risks despite banks maintaining solid capital and liquidity positions, the ECB said. Downside risks for banks are growing due to a subdued macroeconomic outlook and tighter financial conditions.

On risks to profitability, Enria said monetary policy normalization would weigh on banks' cost of funding and interest margins in the future and profitability would also be challenged by emerging downside risks, including credit risks and fair value losses.

Despite banks not being keen to pass high-interest rates on to depositors in the current environment due to their reliance on central bank liquidity through "targeted longer-term refinancing operations," as banks complete their repayments there, competition for depositors would intensify and push deposit rates up in the future, the regulator said.

The ECB also highlighted investor pessimism about European banks, especially in the wake of tax levies and other government policies adversely affecting banks' net profits. “Notwithstanding the progress made in recent years, persistently low price-to-book ratios indicate that investors remain skeptical about the long-run sustainability of banks' elevated earnings,” Enria said. In August, Italy had imposed a windfall tax of 40 percent on the profits of its banks.

On asset quality risks, potential geopolitical concerns, higher inflation and tighter financing conditions may affect the ability of households and non-financial companies to service their debts, Enria cautioned. There are emerging indicators that asset quality is already starting to deteriorate, and the Euro area real estate sector is also experiencing a downturn, he said.

“Although non-performing loan ratios within the banking union remain low, rising borrowing costs and weaker demand could broadly affect credit quality,” he said.

“Similarly, corporate bankruptcies and default rates have increased, moving up from the record low levels seen during the pandemic,” he added.

Please e-mail editors@mlex.com to contact the editorial staff regarding this story or to submit the names of lawyers and advisers.

Related Portfolio(s):
[Financial services - stress tests (EU)]

Areas of Interest: Sector Regulation

Industries: Banking & Finance

Geographies: Europe, European Union Member States

Topics:

Bank supervision | Stress tests | Sustainable finance