EBA EUROPEAN BANKING AUTHORITY

2021 EBA Policy Research Workshop
The new normal in the banking sector – reshaping the insights

Online, 16/11/2021 (date of delivery)

(Workshop date: 16 and 17 November)

Welcome speech of José Manuel Campa, Chairperson of the European Banking Authority

Check Against Delivery
Seul le texte prononcé fait foi
Es gilt das gesprochene Wort

Good afternoon and welcome to our tenth EBA Policy Research Workshop.

Our annual event is not least intended to bring together economists and researchers from supervisory authorities and central banks as well as leading academics to discuss how the banking sector is evolving and challenges from a regulatory and supervisory perspective. It always generates rich discussion, and new ideas and insights.

This year we host the event for the second time via an online format. This format offers the considerable advantage of enabling many more of you to join us from across the EU than if the event would take place in themanner we were used to before the Covid-19 pandemic.

We have more than 350 registered participants, which demonstrates the clear interest in the theme of the Workshop as well as the quality of the work that will be presented and discussed during the coming 2 days.

Conducting international events like our Workshop remotely or in a hybrid format is increasingly becoming the new normal in the evolving post pandemic world.

This brings me to the theme of this Workshop, which is how the banking sector will develop following the Covid 19 pandemic. In this Policy Research Workshop, we will have keynote speeches and dedicated sessions to discuss topics such as: COVID-19; Insolvencies and respective policy actions; Financial Services Disruptions; Competition and Profitability; and Pricing on Climate Risks.

Most immediate responses to the pandemic concerned the way banks operate. We have witnessed how banks adapted their internal procedures and technologies and established a remote-working environment for their employees. They also adapted their ways of doing business with their customers – and were broadly successful in their responses. While accelerating the use of technology originally was among measures in response to the pandemic, it has by now become evident that the pandemic has fast-forwarded technological transformation towards a new normal. Reliance on digital solutions by banks as well their customers has grown rapidly during the pandemic. This trend is expected to continue as banks seek to their service offering to both retail and business customers.

We have learned how technology can serve to the benefit of banks and their customers in terms of cost, accessibility and convenience. However, the growing reliance on technology and digital solutions challenges operational resilience and may well have increased operational risks. The financial sector is the second biggest target of cyber events after the health sector, with payment institutions and credit unions being among most affected. We now expect financial institutions to intensify their efforts in managing ICT security risk. In this regard, we welcome the legislative files DORA and MiCA, which will contribute to substantially strengthen operational resilience of banks. We especially welcome intended mandates for the EBA and its sister ESAs about the collection of ICT risk data through harmonized incidence reporting, on concerning digital operational resilience testing, and on oversight of critical ICT third party providers. The EBA stands ready to assume the tasks DORA and MiCA might entrust to us.

In their responses to the pandemic supervisors acted fast to provide to ensure that bank lending continued. Public guarantee schemes (PGS) and extraordinary central bank liquidity facilities were important in this regard, as was the recommendation to banks to follow prudent dividend distribution policies the EBA issued along with the ECB and the ESRB. The Guidelines on payment moratoria the EBA had introduced made it clear that payment moratoria would not automatically trigger forbearance classification. Further response measures included, e.g., the release of countercyclical capital buffers by several macroprudential authorities, to allow banks to operate below their Pillar 2 Guidance, and the CRR 'quick fix' with a revised and more generous supporting factor for SME lending introduced ahead of the original schedule.

In the second year of the pandemic EU banks appear to be coping well overall. They have in most cases been able to preserve healthy levels of capital and strong liquidity positions. On the side of the public sector, there has been very limited need to apply recovery and resolution frameworks. The average CET1 ratio now stands at 15.6%, while the average liquidity coverage ratio - or LCR - is above 179%. At the same time banks continue to provide adequate lending to their customers. EU banks' loans and advances have increased by 2% since before the pandemic (since December 2019), and lending volumes to SMEs and households have slightly increased in H1 2021.

Increased lending to households is mostly due to growth in mortgage lending. While continuing to provide adequate lending, asset quality in banks' loan books has improved slightly – likely in part due to the substantial fiscal and monetary support provided by policy makers.

The NPL ratio has maintained its longer-term decreasing trend in the pandemic, albeit at a slower pace, and currently stands at 2.3%.

The 2021 EU-wide stress test provides us with some assurances of banks' preparedness should the journey to a new normal be less smooth than we expect. The results show that many – but not all - banks should be able to withstand a severe economic scenario characterised by a prolonged pandemic in a 'lower for longer' interest rate environment[1]. While macro-economic uncertainty persists, it is key that banks continue to be prudent when comes to dividend and share buy-backs even though restrictions on capital distributions have been lifted.

Asset quality vulnerabilities can be observed despite benign headline numbers. Rising volumes of NPLs can be observed for the sectors most affected by the pandemic, namely for the leisure and hospitality related industries. Also, the share of Stage 2 loans is particularly high among loans that are still under moratoria, as well as for those loans that have already exited them. The NPL ratio for moratoria loans moreover is almost double that of the average at 4.5% (vs 2.3%).

We observe a similar deteriorating quality for PGS loans. About 18% of them are classified under Stage 2, and their NPL ratio while still below the average continues to increase. Vulnerabilities are also looming in traditionally safer loan portfolios. Very low interest rates coupled with unusually high household savings due to an absence of spending opportunities during the pandemic, and abundant liquidity have contributed to notable housing price increases in many member states. Exposure to commercial real estate (CRE) may pose additional vulnerabilities - although banks have already increased their provisions related to CRE exposures substantially during 2020.

As economic restrictions are being lifted, it is important for banks to differentiate between viable and non-viable companies in the emerging new normal environment. Some businesses have suffered more than others in the pandemic, some may not be fast enough to adapt to the changing economy, and others again may have no future because of structural changes.

Banks also need to be proactive in identifying struggling borrowers and non-performing exposures and address related challenges. The single rulebook with its harmonised definitions of default and forbearance should help ensure that banks set aside sufficient buffers in case financial difficulties emerge. Borrowers experiencing financial difficulties and banks should proactively work together to find the most appropriate solutions for their specific circumstances. Regulators and other authorities concerned should support banks' efforts in managing loan restructuring and forbearance, as well as potential inflows of new NPL after the pandemic. At the EBA, we are contributing to the Commission action plan on NPL from December 2020 by, for instance, improving data standardisation to facilitate sales of NPLs and the functioning of secondary markets for NPLs, and by looking at the regulatory treatment of sold defaulted assets.

Bank profitability increased in 2021, with a RoE of 7.4% in Q2 2021, driven mainly by lower impairments but also increasing fee income. The latter derived mainly from asset management. However, current EU bank profitability may prove too low should asset quality deteriorate and cost of risk rise. Lending margins continue to be compressed in current low interest rate environment. Operating costs remain rather high still high - despite cost savings already achieved and achieving further cost reductions appears difficult. Further expenditures are needed to meet the need for technological transformation in order remain competitive and to strengthen operational resilience.

Should yields rise, net interest margins will decline further if repricing of bank funding takes place

[1] See the EBA 2021 EU-wide stress test results. https://www.eba.europa.eu/eba-publishes-results-its-2021-eu-wide-stress-test#:~:text=Under%20a%20very%20severe%20scenario,most%20of%20the%20capital%20depletion.

faster than the repricing of assets.

Subdued prospects for profitability which seems a structural weakness, will be a challenge as competitive dynamics play out in the emerging new normal. New competitors as well es effective incumbent banks should excel on the banking market while less successful banks should exit in an orderly manner. Consolidation could also play an important role in this process.

Through mergers and acquisitions (M&As), banks might be able to eliminate redundancies in operating expenses and enhance their management and competitive position. Recent domestic-oriented merger and acquisitions may already have the potential to help eliminate duplications in branch networks and to release resources to speed up restructuring. Consolidation might also take place through restructuring or liquidation of incumbent banks which are unable to modernise their operating structure. We should be prepared to accept such structural changes and even encourage them if they foster efficiency, financial stability, and better customer service.

Finally, it is a great pleasure to see our workshop close tomorrow with the final agenda item on climate change risk. The implications of climate change for the global and EU economy, and hence the banking sector, are of paramount importance. The COP26 (the 26th United Nations Climate Change Conference) held in Glasgow over the past weeks as well as the EU's Green Deal set out goals for making the EU climate neutral by 2050, clearly demonstrate the importance the subject has gained at EU as well as international level.

Climate change and its associated risks impact every agent in the economy. They have implications for the macro economy, the industry, households and the financial sector. The scientific evidence provided in the recent Intergovernmental Panel on Climate Change (IPCC) indicates that human-induced climate change is already resulting in more extreme climate events across the globe. It also shows that significant reductions in CO_2 and other greenhouse gas emissions are needed in coming decades.

The climate goals the EU is working towards, such as the EU's climate neutral status by 2050 or the Paris Climate Accord's agreement to limit global temperature increases to below 2 degrees Celsius, will require substantial investments. These investments cannot be shouldered by public sector funding alone. Bank financing and the key role played by banks in transforming savings into investments will be crucial.

Continued focus on and understanding of risk is paramount in ensuring banks continue to play a role in supporting the transition to a climate-neutral economy. The EBA in its mandates emphasises the need for a risk-based prudential approach. Any changes in the prudential framework should be based on risk arguments which is key to ensuring the stability of the financial system. A thorough understanding of where (climate) risks lie and in how far they are accounted for by the banking sector or the prudential framework, will be key in the first instance.

Pricing of climate risk is key in providing incentives and ensuring an appropriate allocation of capital along the path towards a more sustainable economy. Fortunately, research on climate risk and pricing is growing. A recent survey involving 861 finance academics, professionals, public sector regulators and policy economists, found that respondents are at least 20 times more likely to believe that climate risk is currently being underestimated by asset markets as opposed to overestimated.[2] It will be crucial to continue research efforts and exchange of views on this topic.

[2] Stroebel and Wuergler (2021): What do you think about climate finance?, NBER Working Paper 29136

I am delighted to see three papers in this workshop that analyse the reflection of climate risk in the pricing of specific assets. One paper provides first-time evidence on whether aggregate climate risks are priced in U.S. stocks, using various proxies for both physical and transition risk. The second paper considers the impact of the introduction of the Emission Trading System (ETS) on the financing costs for polluting firms. Last but not least, the third paper considers what research tells us on the impact of energy efficiency on the collateral value of houses. I very much look forward to hearing the findings and discussion around these three papers. This is important work and highly relevant for efforts to address the challenges posed by climate change.

As a final remark, I would like to highlight that continuous dialogue between the industry, supervisors, regulators and other stakeholders is very important for our shared goal of making the emerging new normal to be most beneficial for financial institutions and consumers alike, while mitigating risks effectively.

This brings me to the importance of events such as our policy research workshop. We hope it will be valuable to you all to share ideas away from the immediate pressing aims of policy and supervision. I can assure you that events like ours today are immensely valuable in bringing together different perspectives and stimulating a policy debate when we contribute to shape the new normal in the banking sector. I am sure we all look forward to an interactive and lively discussion of the excellent papers which will be presented over these two days.

I conclude by thanking all of you who have contributed papers for this workshop and to EBA colleagues for the excellent organisation.

It is a pleasure to be able to welcome Hyun Song Shin, Economic Adviser and Head of Research at the BIS, for his keynote speech reflecting on insolvencies and policy actions amid COVID-19.

Thank you very much for your attention.