BRIEFING

European Parliament

Public hearing with A. Enria, Chair of the ECB Supervisory Board

Banking Union scrutiny

ECON on 1 December 2022

This note is prepared in view of a public hearing with the Chair of the ECB Supervisory Board, Andrea Enria, scheduled for 1 December 2022.

This briefing addresses:

- *the SSM's ongoing work and current risks of the banking sector,*
- *the SSM and EBA's joint call to "stick to Basel commitments",*
- *the ECB feedback to the EP's 2021 Banking Union report,*
- *the issue of "windfall" taxes on banks,*
- *the ECB's annual report on Sanctioning Activities,*
- *and the EBA report about the dependence on non-EU banks and funding in foreign currency.*

This briefing also includes summaries of an external study about "monitoring complex financial instruments in banks' balance sheets" (so-called level 3 assets), and of three briefings on evolving risks in the banking sector that are specifically relevant for the SSM.

1. SSM's ongoing work and current risks of the banking sector

1.1 Overview

The note that A. Enria has produced for the Eurogroup's meeting on November 7 provides a recent and concise overview of the SSM's work and views on the banking sector. **The note draws a very positive picture of current capital, liquidity and profitability, referring to aggregate numbers for the sector,** and speaks of optimism for the 2023 outlook. Considering Figure 1, it is worth noting that also the less strongly capitalised banks (i.e. the lower end of the boxes and the end point of the lower line in the box plots) among the significant institutions display relatively stable capital levels comfortably above regulatory minimum requirements.

Nevertheless, **Enria recommends vigilance and prudence** against the background of the evolving macro environment. First, he points to the **impact of the economic slowdown on asset quality**. He describes that impact as thus far contained and highlights the continued decrease in non-performing loans overall, but

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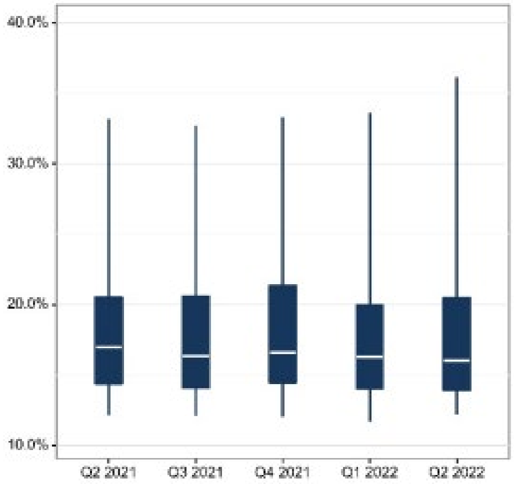
nuances this by pointing out increases in non-performing loans and loans with otherwise significantly increased credit risk (*see Section 1.1 below*). Second, he points to the **potential impact of the financial markets environment** on banks. In that context, he highlights in particular the **counterparty risk** from dealing with non-banks in derivatives markets. The difficulties of the latter in meeting margin calls might, in Enria's view, lead to increased exposures for banks. It may be recalled in this context that the Commission plans to allow non-banks a broader use of guarantees from banks as derivatives collateral. Enria envisages further negative influence from financial markets from increased **funding costs**.

Figure 1 - Distribution of common equity tier 1 capital among significant institutions



Source: ECB banking statistics

Enria reports that the SSM calls on banks to "proactively" monitor those risks and to **update capital projections** under a baseline and an adverse scenario. At the time of the Eurogroup meeting, the SSM was assessing potential vulnerabilities. Other supervisory work as reported in the note includes:

- *a deep-dive into **derivatives exposures** to non-banks and the publication of supervisory expectations on related risk management, which is being followed up with a targeted review of risk management;*
- *a quantification of banks' **leveraged finance** exposures, where the headline figure is that they sum up to more than 60% of banks' common equity tier 1 capital;*
- *a review of banks risk management of **interest rate and credit spread shocks** which exhibited that internal stress tests were not always sufficiently conservative;*
- ***climate risk stress tests** published in July, revealing weaknesses at "most banks";*
- *a thematic review of **climate and environmental risk management practices** that showed "an improvement" since 2021 and allowed identifying a set of good practices, while many banks will reportedly receive comprehensive letters setting out work to do;*
- *various actions regarding **information technology and cyber risks**, reportedly leading to follow-up with banks showing material deficiencies.*

In concluding, Enria considers that the **European banking supervision priorities** for 2022-2024 remain broadly suited, announcing some targeted adjustments to be announced by year-end for 2023-2025.

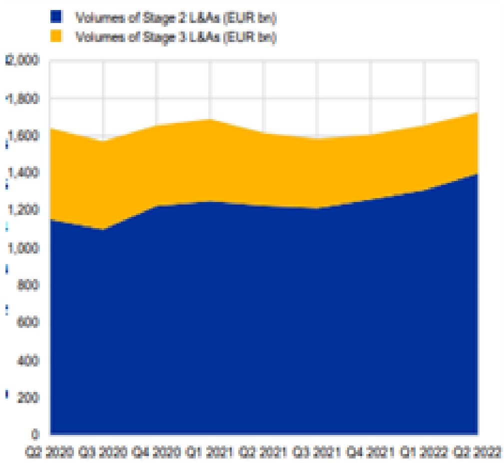
In addition to the developments reported by Enria, we also noted two fresh **press reports that concern the supervisor/bank relationship**, and in particular, the ECB's stance on earnings distribution to shareholders and the ECB's supervisory processes. In the former case, the reporting hinted at strains in the relationship between UniCredit and the ECB over dividend distributions and business in Russia. In the latter case, the reporting suggested Société Générale questioned the presence of ECB staff at the bank's internal meetings. The reporting, without being more specific, also insinuated **other banks, too, being critical** of the ECB's processes and decisions. Notably, this **reporting bases on leaked information** on which the parties declined to comment and on anonymous sources. Meanwhile, in August, the ECB confirmed decisions of 2018 fining banks of the Crédit Agricole group for classifying shares as capital without prior approval. The banks had challenged the decisions in court, and the court had partially annulled the decisions requiring the ECB to justify the amounts of the fines better.

Comprehensive financial information on Euro area banks can be found in the latest ECB banking statistics for the second quarter 2022, summarised in a press release, and in the ECB's semi-annual Financial Stability Review.

1.2 Credit risk

A slide deck that Enria presented on November 4 shows that **Euro area banks felt a steady increase of credit risk since mid-2020**. The growing blue area in Figure 2a shows the loans about which banks, reporting under International Accounting Standards, say that they are more risky now than when they had been granted. These so-called stage 2-loans are loans to which no actual credit event, such as a default on a payment due, has occurred. By contrast, the yellow area shows so-called stage 3-loans that have already been subject to a credit event. The width of the yellow area has not visibly widened in the first half of 2022. In other words, banks think that defaults of their borrowers could increase, but this has not yet materialised. The ECB's November 2022 Financial Stability Review provides an additional perspective on this development. Figure 2b, modified from that report, highlights how this overall build-up of credit risk entails a **marked divergence** of the ratio of non-performing loans ("NPL ratio") on the one hand, a welcome development essentially reducing the stock of older problem loans, and the share of stage 2-loans on the other hand. The latter signals a more recent increase in perceived credit risk above the peak reached in the first pandemic year. It seems however that **this overall increase of credit risk has not been fully matched by a proportionate increase of provisions for future losses**. Figure 2c from the same report shows how coverage ratios on both stage 2-loans and non-performing loans declined in the second quarter of 2022, however following an increase in the previous quarter. In other words, while banks appear in aggregate to think that more loans are at risk, their performance outlook for those riskier loans must have improved of late.

Figure 2a - Volume of stage 2 and 3 loans

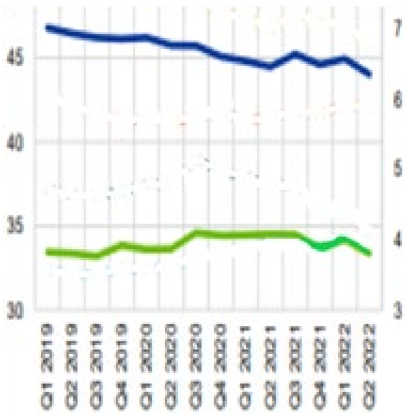


Source: ECB

Figure 2b - Stage 2 (green) and NPL ratios (blue)

Source: ECB

Figure 2c - coverage by provisions in percent for Stage 2 (green, right-hand scale) and NPLs (blue, left-hand scale)

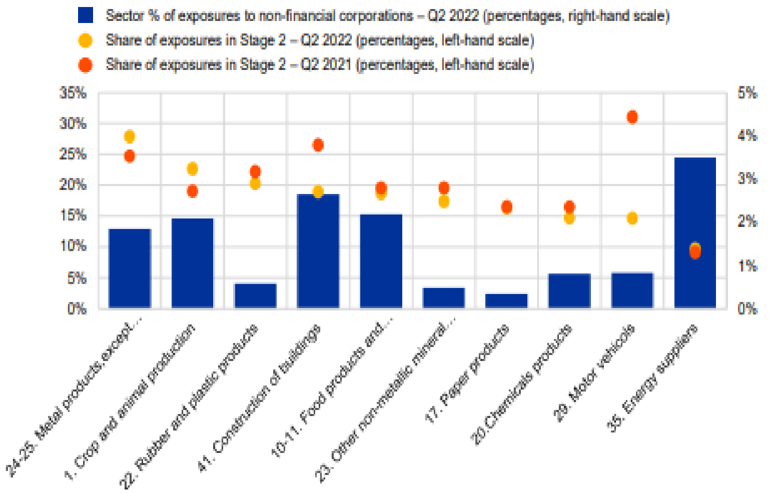


Source: ECB

Figure 3 - again from Enria's presentation - illustrates, for loans to companies, where the increase in credit risk comes. Banks see a higher credit risk comparing mid 2022 with mid 2021 when the orange dot shows above the yellow one (see Figure 3). It appears that the increase in risk is not a universal phenomenon but that two sectors have been particularly affected in the second quarter 2022, namely **motor vehicles and construction**. While the former suffers from the larger increase in risk, the latter constitutes the larger share of banks exposures, as shown by the blue bar. Interestingly, energy suppliers and energy intensive industries like chemicals and metal products do not particularly stand out. Note that the figures show the situation by mid-year and how banks reported it at the time. In fact, in the slide deck, Enria says that Euro area banks have considerable exposures to sectors vulnerable to the energy crisis.

Enria points to two further concerns in the presentation. First, he sees the **residential real estate market at risk of an abrupt correction**, which means a reduction in the value of the collateral that banks have accepted. Note that as long as borrowers continue to service their loans, such development would not as such lead to loan impairment. Nevertheless, corporates' and households' ability to service their debts has been [negatively affected](#) by increasing prices and rising interest rates, which is visible in the increase of stage 2 loans and a correction of real estate collateral values could indeed aggravate an emerging problem.

Figure 3 - stage 2 loans for vulnerable sectors



Source: ECB, data for those banks that report to Anacredit

Second, Enria points to the **sustained origination of leveraged loans** "despite" (his words, ed.) the ECB's [supervisory guidance](#) of 2017. This concerns loans where the corporate borrower is subject to a high level of leverage. The high leverage of the borrower typically shows in a high indebtedness compared to the cash flows from the borrowers business. This in turn means that in situations such as today's, where a deterioration of the economy coincides with higher interest cost for their loans, such borrowers can quickly be challenged in their capacity to service debt from cash flows. In its guidance, the ECB had not directly aimed at a reduction of the exposures or their riskiness, but had set certain expectations for risk management.

The **ECB's initial guidance** was issued in 2017 against the background of, already at the time, increased leveraged lending by the ECB's directly supervised banks. Enria's presentation shows that since the beginning of 2018, leveraged lending has further grown from around 45% relative to common equity tier 1 capital to around 65%. The presentation also shows that the ECB's expectations on risk management seem not to have influenced the level of leverage risk in the individual loans newly granted; rather, the share of loans with particularly high leverage is greater now than in early 2018.

Adding leverage to leveraged finance

A [recent Financial Times article](#) (*"Collateralised fund obligations: how private equity securitised itself"*) points to a recent development in the leveraged finance industry that somehow reminds developments in the pre-2006 re-securitisation industry. The article draws attention to **Collateralised Fund Obligations**, a product that is not new, but has been rather less visible in the past. The newspaper considered one specific transaction that came with higher transparency and visibility since it was open to retail investment.

The notion of a "leveraged loan" traditionally refers to the leverage resulting from the high indebtedness of a company that closed-ended funds invest in. Now, one channel for creating additional leverage are securitisations of such leveraged loans through Collateralised Loan Obligations. Collateralised Fund Obligations take another route for achieving additional leverage, by **creating tranched exposures to a diversified portfolio of interests in closed-ended funds**.

As Elizabeth McCaul, Member of the ECB Supervisory Board, set out in a speech held in September this year, the ECB has once again addressed concerns about leveraged lending in "[Dear CEO letters](#)", which were sent to banks that specifically engage in leveraged lending activities. According to McCaul, based on the responses received to those letters, **the ECB found that**, by and large, banks' risk appetite frameworks are overly simplistic, insufficiently granular, while the **risks posed by leveraged transactions are inadequately captured, understood and managed.** The ECB will therefore work closely with individual banks to discuss how they can close the identified gaps.

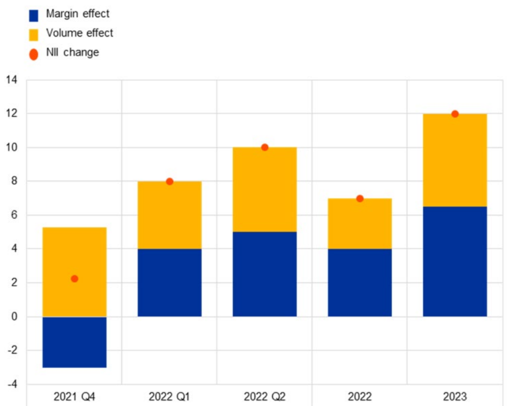
In a wider context, considering the **global nature** of the market on the one hand and the fact that **supervisory authorities have adopted different approaches** to supervising banks' exposures to leveraged loans on the other, the **Basel Committee** on Banking Supervision (BCBS) has highlighted in its August newsletter that continuous information-sharing among supervisors on leveraged loans remains a priority.

(*See previous EGOV briefing for a more detailed background on leveraged financing*)

1.3 Interest-rate risk

Since inflation and interest rates have increased, too, interest rate risk receives renewed attention. On November 8, Enria gave a speech to banks on **monitoring and managing interest rate risk along what he calls the "normalisation path"**. As a preliminary remark, note Figure 4, which reproduces a graph also shared by the ECB on different occasions. Albeit only for a sample of listed banks, it shows how banks have been able to benefit and are expected to continue to benefit from the changes interest rate environment - or conversely how the previously prevailing low interest environment was detrimental to banks net interest income. On the one hand, higher interest rates allow banks to expand the margins between lending rates and their funding cost. On the other hand, higher interest rates and the clouding economic context do not depress lending volumes so that **overall interest income continues to drift upwards in projections for 2023**. At the same time, the present value of banks assets diminishes when they are valued at higher interest rates, and the more so, the longer the duration of the assets. This manifests to varying degrees in earnings and capital, since only a part of the assets are fair valued and thus subject to updated valuation using current interest rates. Whether manifest in accounting or not, such **losses to what is called the economic value of equity** are over the longer term a charge on a bank's profitability and capital adequacy.

Figure 4 - Drivers of net interest income quarterly changes



Source: ECB, using data from Refinitiv for 38 listed banks. 2022 and 2023 are averages of stock broker estimates

Against this background, Enria's speech expresses a concern that **banks tend to focus too much on a short-term earnings perspective** and too little on such changes in the economic value of equity, even though this is a perspective that regulation and guidelines require. As regards quantitative effects, the speech confirms that a standard 2 percentage points upward movement of interest rates would likely have a beneficial impact on banks' medium term profitability and a "marginal" negative impact on capital adequacy, the latter resulting from partial revaluation of assets and increased default risk of borrowers. Enria however notes that the **impact on capital varies considerably across banks**. The risk is generally greater for certain business models (he mentions consumer lenders and promotional banks) and for other business models, a significant subset of banks is more affected (he mentions retail lenders and diversified lenders. Unsurprisingly, Enria further reports these **impacts are considerably higher if the economic value of equity perspective is considered**. In this respect sovereign debt measured at cost - which is 75% of banks' sovereign debt holdings - rather than at fair value receives a particular mention since it is considered to be vulnerable should the economic outlook worsen. In **concluding**, the speech points out that the “normalisation” of the interest rate environment is **overall good news for banks**, but it recalls the need for monitoring and managing risks duly and sees **weaknesses** at banks in this respect. More generally, Enria points out the **risk of having to revise the positive outlook** in a difficult macroeconomic environment.

2. Joint call to “stick to Basel commitments”

In a November 4 blogpost together with J.M. Campa of the EBA and L. d Guindos of the ECB, A. Enria wrote that he is **very concerned about numerous calls to deviate from the Basel standards** in the ongoing legislative discussions about the Banking Package. The Banking Package of October 2021 proposed *inter alia* to implement the modified Basel III framework. EBA had shown earlier on that the Basel III framework may increase tier 1 minimum capital requirements of European banks by 15% and that the deviations of the proposed banking package reduce this increase by a bit more than 4 percentage points. Already at the time, the ECB warned that this difference can expose European banks to uncovered risks.

Against this background, the blogpost mentions four additional deviations under discussion - related to intra-group equity exposures, subordinated debt, certain real estate lending and certain trade-finance exposures - that would increase this differential. However, it does not suggest a quantification by how much.

The blogpost draws particular attention to the **reputational risk of receiving a “non compliant” rating by the Basel Committee** for a reform endorsed by the G20. This hints at the Regulatory Compliance Assessment Process of the Basel Committee, which grades jurisdictions for their implementation of Basel’s standards as “compliant”, “largely compliant”, “materially non-compliant or “non-compliant”. The worst of these grades gets assigned for non-implementation, or if the Committee considers that differences in the implementation could severely impact financial stability or the competitive level playing field among international banks. A key input into this grading is by how much the differences in the implementation reduce capital requirements for the large internationally active banks that Basel focusses on. This is assessed per risk area (such as credit or market risk) and in aggregate.

Europe’s bank capital requirements currently base on the implementation of the previous version of Basel III. This implementation is graded in the second-to-last category, “materially non-compliant”. Therefore, it is indeed conceivable that the cumulative effect of additional deviations leads to a further downgrade. However, neither is the published data of the EBA detailed enough nor is the Basel Committee’s methodology sufficiently transparent for us to make any serious assessment at this point. In this context, it may be worth recalling the previous reaction of MEPs to the Basel Committee’s compliance assessment in 2014.

3. Feedback of the ECB to the European Parliament’s 2021 report on Banking Union

On 28 October, the ECB Supervisory Board submitted its feedback to the European Parliament on the input provided by the “Resolution on Banking Union – Annual Report 2021”, after having considered the comments and suggestions raised therein.

The feedback is well structured and comprehensive, addressing all points where the ECB was specifically called on to take some form of action in its role as banking supervisor, for example to closely monitor the impact of the war in Ukraine on the EU banking sector, to base climate-related stress tests on realistic data and assumptions, and to ensure the early identification and proactive management of stranded investments in fossil fuels assets.

While the ECB overall concurs with most of the points raised in the Banking Union Report, it responds to the call to consider measures to ease the burden on mortgage holders and small and medium-sized enterprises

(SMEs) in Member States with higher lending rates, to ensure that all citizens and businesses can access funding at fair and competitive rates, by pointing to the limits of its specific mandate (emphasis added):

"*ECB Banking Supervision would like to point out that the primary purpose of the prudential framework is to* ***ensure the safety and soundness of banks****. Therefore, it is* ***outside the mandate*** *of banking supervisors* ***to ease the burden on mortgage holders*** *and SMEs in Member States with higher lending rates. Against the current backdrop of increasing real estate and corporate vulnerabilities, any* ***prudential relaxations would unduly increase the risks for the financial system****. Regarding mortgages, for instance, there is strong evidence from both the European Systemic Risk Board (ESRB) and the ECB of increasing residential real estate overvaluation and household indebtedness, which are making mortgage loans riskier. Similarly, loans to SMEs are somewhat riskier (as can be seen, for example, in firms' financial ratios and observed default rates) than other types of lending, such as to larger companies, which might be reflected in higher expected losses and hence in higher interest rates. Supervisors' prudential decisions should remain risk-based and not target lending conditions.*"

The ECB adds that, irrespective of its mandate, bank lending rates are not determined by regulatory and/or supervisory measures, but rather reflect the economic and technical conditions, including the creditworthiness of borrowers, interest rate fixation periods, loan maturities, and potentially also the lack of competition in the banking sector, acknowledging that further progress towards a genuine banking union would be very helpful to overcome a lack of competition.

4. Inflation, bank profitability and a draft "windfall" tax on banks

As mentioned in section 1.2 and illustrated in Figure 4, the changed interest environment, following developments in inflation and monetary policy, makes a **positive contribution to banks profitability**, even if that finding is not completely unambiguous and even if there are connected risks for banks.

On 23 September 2022, Banco de España presented a Spanish draft law **on the imposition of temporary levies** on the energy sector, credit institutions and financial credit establishments, requesting an opinion. *Inter alia*, this draft law would impose in 2023 and 2024 a temporary levy on banks when total reported interest income and commission income for 2019 is EUR 800 million or more. This levy would be 4.8% of the previous year's net interest income plus net fees and commissions. The draft law reasons that inflation may increase the banking sector's profitability - while for wages, the situation is different as they are increasing below the inflation rate. Thus, the draft law intends to contribute to ensuring an equitable distribution of the burden of inflation across the Spanish society. Finally, the draft law entails a provision banning banks from passing on the cost of the levy to their customers.

In its opinion, the ECB expresses **a range of concerns with the draft law**. The ECB emphasises that in practice, the levy would affect only the SSM's directly supervised banks in Spain. The ECB considers it **"undesirable" to use the proceeds from taxes levied against credit institutions** (probably meaning bank specific taxes) **for general budgetary purposes** since doing so could make credit institutions less resilient to economic shocks and limit their ability to provide credit.

Similar to the discussion on interest rate risk in section 1.2, the ECB's opinion points out that the net effect of monetary policy normalisation on bank profitability over an extended horizon may be ambiguous. In this context the ECB highlights that the levy, the way it is designed, may also accrue when a bank is not profitable and that impaired bank capital positions endanger a smooth transmission of monetary policy to the economy. The ECB also thinks the levy **might not be commensurate with profitability** and impinge on some banks ability to absorb the risks of an economic downturn. Regarding the ban on passing on the levy to clients, the **ECB recalls that it generally expects banks to reflect all relevant costs in loan pricing** and remarks that whether necessary price increases relate to the levy or other costs passed on is difficult to discern.

The ECB opinion does not quantify the possible impact on bank profitability. **The ECB opinion calls on the Spanish government to accompany its legislative proposal with a detailed analysis of potential negative consequences for the banking sector.** It may be noted that, considering a profitable bank that only generates income from interest margins, the levy essentially reduces the return on equity by 4.5%, other things equal. As the draft law reasons, the interest margin may increase with interest rates, and indirectly, in practice, also with inflation. However, together with all interest rates and market yields, also the cost of equity may increase. The impact on banks' access to capital markets depends consequently on the effect of interest rates on the return on equity after the 4.5% reduction, and on whether that is more or less than the increase of bank cost of equity.

Press had reported that the Spanish government thought **the risks warned of by the ECB had already been taken into account**. They consider that "*the banks' room for manoeuvre is large because they have record profits*" while the levy proposed by the government was "*limited*". Accordingly, in the meantime it is reported that the bill had been proposed and that on Thursday last week, approved by Congress, the lower house of parliament, which will now send the bill to the Senate for a final vote.

5. ECB Annual Report on Sanctioning Activities

On 12 August, the ECB published its Annual Report on Sanctioning Activities in the SSM in 2021. One may specifically note in this context that breaches of the prudential requirements set out in European Union law are not always sanctionable under the national law of participating Member States, as CRD IV only ensures a **minimum harmonisation** with regard to sanctioning.

The Annual Report shows that in 2021, 259 **new formal sanctioning proceedings** were opened during the year, a **considerable increase** (plus 50%) if compared to the number in last year's Annual Report (169 newly opened proceedings).

In terms of area of infringement, **most breaches were related to internal governance** (43%) and reporting obligations (23%), or were related to breaches of rules for large exposures (6%) or liquidity requirements (5.5%). Based on those findings, the ECB expects in any case that governance issues will remain in the spotlight of future sanctioning activities in the SSM, **one of the SSM Supervisory Priorities** for the period 2022-2024.

Of all cases completed in 2021, more than 40% were closed without a penalty, either because the proceedings concluded that no breach had been committed, or because the wrongdoer was just given a warning, or because breach was not found to be not sufficiently severe, or for some other uncommon reasons.

Overall, 142 administrative penalties were imposed in 2021, amounting to around **EUR 31.7 million in total**[1]. More than **75% thereof**, however, were imposed on **just one significant institution** not disclosed in the Annual Report on Sanctioning Activities (the related information can nevertheless be found in the publicly available list of "sanctions imposed by the ECB" and "sanctions imposed by the NCAs in proceedings opened at the ECB's request"; the institution fined EUR 24,5 million was Bank of Ireland for breaches pertaining to its IT service continuity framework and related internal controls failings).

[1] The overall amount of fines is, broadly speaking and taking the somewhat different sizes of the EU and US banking sector into account, comparable to those imposed in the US in relation to retail banking activities (compare the section "Office of Inspector General Activities" in the Annual Report of the Board of Governors of the Federal Reserve System for 2021). Fines imposed by the Securities and Exchange Commission (SEC), however, usually related to misconduct or fraud in the wider context of trading securities, tend to be significantly higher, though.

6. EBA report: Dependence on non-EU banks and funding in foreign currency

On 3 October, the European Banking Authority (EBA) published a report on the reliance of the EU financial sector on funding in foreign currencies and the relevance of foreign banks (or: counterparties, operators, and financing originating from outside the Single Market).

As regards the question what role **non-EU credit institutions** have in the EU banking market, the EBA found that as of June 2021, 360 foreign banks were operating in the EU that hold 12% of the total banking assets (banks with parent companies headquartered in the United States, the United Kingdom, Switzerland, Japan and China represent more than half of the sample). Those entities are **mainly active in wholesale banking**, like investment banks or clearing houses, and they usually interact with EU credit institutions and other financial corporations as their main counterparties, with fee and commission income their most important source of revenue.

The EBA also looked into the question to what extent **EU credit institutions rely on funding denominated in foreign currencies**. It found that as of June 2021, EU banks had on average 19% of their total funding denominated in significant foreign currencies. Matching foreign currency assets with liabilities denominated in the same currency is generally considered prudent risk management. The EBA report notes, however, that many EU banks fund at least some of their assets in a different currency than the one in which the assets are denominated, thus creating a risk of **currency mismatch in the overall Liquidity Coverage Ratio** (LCR). The average LCR in USD was 88.6%, thus below 100% and significantly below the LCR in all currencies. EU Banks hold higher liquidity buffers in their domestic currency than in foreign currencies. At the aggregate level, the surplus in liquidity coverage in all currencies offsets the liquidity shortfall in significant foreign currencies. The EU liquidity regulation does in any case not require banks to hold LCR levels in foreign currencies above 100%. However, the EBA cautions that low LCR ratios in foreign currencies may cause problems during stress periods when liquidity becomes scarce and foreign exchange swap markets are difficult to access.

7. External paper "Monitoring Complex Financial Instruments in Banks' Balance Sheets"

Executive summary of the research paper by Bischoff, Haselmann, and Tröger (emphasis added):

"***European banks have substantial investments in assets that are measured on a mark-to-model basis without directly observable market prices***. *These assets represent 6.5% of total assets and 118.0% of CET1 on average. However, the most significant share of these assets (more than 85%) is attributable to level 2 fair values. These level 2 fair values rely on observable and verifiable inputs, e.g., market interest rates or credit spreads. Against this background, evidence suggests that investors perceive the* ***level 2 fair values*** *as being as* ***reliable*** *as level 1 mark-to-market fair values.* ***Comparability is a concern for level 3 fair values*** *and evidence shows that many banks are using their discretion in estimating these fair values opportunistically. Yet, the use of level 3 fair values is not widespread in the European banking industry. For the median bank, the level 3 fair values represent 6.4% of CET1. Therefore, comparability concerns are confined to a small subset of European banks that extensively rely on these level 3 estimates.*

International rules require fairly extensive disclosures *when banks are using level 3 fair value estimates. These disclosures include both qualitative information about the valuation models and quantitative information about the inputs in these models.* ***Compliance with disclosure rules is generally diverse***. *For a representative sample of IFRS-adopting banks from Germany, we show that only about half of the banks provide fully detailed disclosures in accordance with IFRS 13. Other banks refer to a lack of materiality of their level 3 fair values and avoid a similar level of detail.*

*IFRS 13 does not prescribe a specific reporting template. Therefore, **the reporting formats of our sample banks vary widely**. It becomes evident that banks are using different valuation models and, especially, different inputs into these models when estimating level 3 fair values for the same class of instrument. This divergence of estimation procedures reduces the comparability of level 3 fair values. The **lack of standardization** in the disclosures also **fails** to provide users of financial statement information with the opportunity to infer **whether the different inputs** are due to fundamental differences in the level 3 portfolios (and, thus, **economically justified**) **or due to different assumptions and estimates** in the internal generation of level 3 fair values for highly similar assets.*

Prudential regulation is taking the valuation risk inherent to banks' use of unobservable inputs into level 2 and level 3 fair values into account. Under the framework of the Basel Committee on Banking Supervision, chapter CAP50 regulates the prudent valuation of assets measured at fair value and requires prudential valuation adjustments. Specific adjustments have to be made for less liquid assets and those for which marking-to-model is used (i.e., levels 2 and 3 according to the IFRS fair value hierarchy). Standardized disclosure templates are embedded in banks' Pillar 3 reports and make these adjustments transparent and relatively easy to compare.

Level 2 and level 3 fair values play a minor role on the balance sheets of banks outside the ECB's direct supervision. This is for at least three reasons. First, many of these banks do not adopt IFRS at all. Second, by definition, the magnitude of their portfolios is systematically smaller. Third, the relative fraction of their investments in assets that require a level 2 or level 3 valuation also tends to be lower. Public data suggests that 84.5% of all level 2 and level 3 fair value estimates in the Eurozone are made by banks that are under direct ECB supervision."

Note: SAFE ("Sustainable Architecture for Finance in Europe") is the Leibniz-Institut für Finanzmarktforschung. The authors of the paper are Jannis BISCHOF (University of Mannheim), Rainer HASELMANN (Goethe University Frankfurt and LawFin), and Tobias H. TRÖGER (Goethe University Frankfurt, LawFin and SAFE)

8. Three external papers on evolving risks in the banking sector & priorities for the SSM

a) Andrea Resti: underappreciated risks and ECB's supervision of dividend policies and governance

The author **highlights the concern that the banking sector may not fully appreciate the challenges of the worsening macroeconomic environment**. Coming out of Covid times, that had an overall benign impact on banks, the "first-round" impact of the current environment has been rather positive overall; banks accounts show an increase of credit risk, but also gains from increasing interest rates. Against this background, the author points out foreseeable increases in:

- credit risk due to higher interest rates, prices and probably receding demand, while banks do not generally show an increase in provisioning for many "vulnerable" sectors;
- interest rate risk, which may be slow to materialise due to accounting at amortised cost;
- liquidity risk, as banks may have to compete for retail deposits picks up and as expensive wholesale may regain prominence in funding strategies;.
- geopolitical risk, as the global balance of power shifts and crisis may crystallise elsewhere, exposing banks directly or indirectly, for instance through supply-chain dependencies of their customers;

The author is concerned that banks and supervisors seem to disagree on the severity of the dangers that lie ahead. In his view:

- banks may feel that higher net interest margins cover higher loan loss provisions and that growth should pick up again in late 2023;
- some argue that public sector interventions may be likely to address extreme, low-probability scenarios, shielding banks from life-threatening losses.

He fears that while supervisors appreciate the above-mentioned risks, banks unwillingness to fully share such concerns might nevertheless impair their capacity to prepare for, and react to, an unfavourable context.

The author suggests **two questions to the SSM chair** (*see also the reference to supervisor/bank relations in Section 1 of this briefing; emphasis added)*:

- *In 2020 the ECB issued a dividend ban in order to ensure that profits were retained and used by euro area banks to improve capital adequacy and withstand the adverse effect of the pandemic. In hindsight, such an extraordinary measure may have unnecessarily penalised investors, while making bank equity less attractive in the eyes of market participants. Last year the ECB has been seconding a wave of large share buybacks, including by Intesa Sanpaolo, Unicredit, La Caixa and ING.* ***Since March 2022, as part to its response to the current deteriorating macroeconomic framework, the SSM –while refraining from issuing formal bans and ad hoc supervisory expectations – is reported in the press to have resumed some moral suasion on lenders to slow down plans for share buybacks and hefty dividends.*** *Could you discuss these rumours and the rationale behind the ECB's stance?*
- *In view of the challenges facing banks in 2023, safe governance practices are key to financial risk management and bank stability; the work done by ECB in this area over the last four years must be duly acknowledged. Nevertheless,* ***some banks have been voicing concerns about the intrusiveness of the SSM's practices in this area, arguing against JST members attending board-of-directors meetings****, as this would reduce the room for frank, informal discussions among board members. Could you comment on this approach? How often do ECB representatives attend board meetings and based on what kind of concerns and situations? Do you believe that this practice should be extended or, instead, that it should only be used to face extreme scenarios where there is reason to believe that the board's ability to challenge the top manager's views looks seriously impaired?*

b) Alexander Lehmann: focus on cyber risk, corporate loans and energy-market volatility

Alexander Lehmann's paper is geared to show which implications the identified key risks, in particular geopolitical risks, could or should have for supervisory priorities in the SSM.

Alexander Lehmann finds that geopolitical risk is routinely incorporated in capital market portfolio allocations and should also be more central in bank risk management and supervision. His paper assesses four specific aspects of elevated geopolitical risk: the increased incidence and more disruptive nature of cyberattacks; loan defaults driven by the energy shock; the changed outlook for energy-intensive and trade-dependent companies; and the deepening interlinkages between banks and derivative markets where energy contracts are traded.

In his view, ECB bank supervision will hence need to implement three crucial transitions:

- First, a shift of focus from the credit risk legacy of the COVID-19 pandemic to the fallout from new macroeconomic and geopolitical risks, amid the rapidly tightening financial conditions;
- Second, the ECB will need to reflect the ESRB's macroprudential recommendations relating to cyber risks and energy-price volatility in its own bank-specific supervision, reflecting both direct and second-round effects;
- Third, the ECB should become more assertive as a proactive, perhaps even intrusive, supervisor, which will alert bank boards to the new risk environment.

The following adjustments could be reflected in a new set of supervisory priorities: Putting a stronger emphasis on cyber attacks, pressing institutions under direct ECB supervision to step up preparations; keeping credit risk management in focus, yet reviewing corporate loan portfolios more frequently; reinforcing the application of the EBA Loan Origination Guidelines; and monitoring banks' exposures to energy and derivative markets amid heightened energy-market volatility.

c) Thorsten Beck, Brunella Bruno and Elena Carletti: tail risk scenarios and scenario analysis

The authors **highlight the extreme uncertainty of the current environment and see new sources of risks and challenges for supervision**:

- credit risk and effects on corporate and consumer lending business,
- market risks and effects on trading,
- fiscal policy support resulting in sovereign debt increases and a renewed doom loop between bank and sovereign fragility,
- climate risk including the risk of backtracking on commitments with stranded asset risks materialising even more strongly later,
- risk of cyber-attacks against financial institutions and critical infrastructure,
- geopolitical tensions beyond Ukraine and consequent negative effects on international trade and economic recovery,
- the risk of financial market disruptions related to increasing interest rates and imbalances in asset holding,
- spill-over effects from fragility in the crypto-market, and
- risks arising from financial sanctions against Russia.

The authors argue that the resulting challenges for banks' risk management and for bank supervisors require new approaches to risk management, combining quantitative and qualitative assessment. The suggest **scenario analysis as a more effective way to address multifaceted tail risks**.

In terms of supervisory actions, the authors recommend a bank-specific monitoring approach and that banks should act prudently in light of the potential future economic deterioration. The authors note the experience from the past few years, showing the important role of the government as insurer of last resort against extreme tail risks (e.g., Covid, energy price hike). Nevertheless, they emphasise the **challenge for banks and supervisors to be prepared for tail-risk scenarios** and call for banks' strategic plans that set a course towards long-term objectives to be adjusted to allow for the possibilities of tail risks.

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