ECB Banking Supervision Market Contact Group (BSMCG)

Wednesday, 9 February 2022, virtual meeting

MEETING SUMMARY

The Chair of the ECB's Supervisory Board, Andrea Enria, opened the second meeting of the BSMCG. He welcomed the new members who joined the group following the call for expressions of interest launched in Autumn last year. Mr Enria welcomed in particular the increased diversity of the BSMCG's composition, which now takes in a wider range of market representatives and will enrich the Group's future interactions. Mr Enria recalled that the gathering of market participants' views on the existing and emerging challenges faced by banks is an essential component of ECB Banking Supervision's market intelligence activities, which supports its assessment of the main risks and vulnerabilities of the banking sector.

1. European banking sector outlook

Two presentations kicked off the discussion and highlighted recent developments and key themes shaping the risk outlook for European banks. Key highlights included an overall positive outlook for the European economy and banking sector, with inflation dynamics playing an important role for the near-term outlook. The positive sentiment for the banking sector was underpinned by the strong current capital and liquidity positions of European banks and by expected improvements in banks' profitability stemming from a possible normalisation of monetary policy and interest rate increases. Nevertheless, sudden changes in perceptions about the growth and inflation outlook could trigger higher volatility in financial markets and result in a widening of credit spreads, which might be particularly challenging for more indebted borrowers. In addition, (geo)-political uncertainties have been identified as a further potential trigger for elevated uncertainty and volatility hikes.

Overall, BSMCG members shared the view that the improvements made to the European regulatory framework in recent years and the support measures implemented since the outbreak of the pandemic have resulted in a reinforcement of banks' balance sheets. Asset quality as measured by the non-performing loans ratio has not deteriorated despite the pandemic. Nevertheless, members acknowledged that pockets of risks related to asset quality might emerge in a scenario of increasing interest rates, particularly affecting the capacity of structurally weaker firms and less creditworthy clients in vulnerable sectors to service their debt. This may in turn negatively affect banks' profitability. According to some members, public debt sustainability might also emerge in the medium to longer term if rising interest rates pose challenges to highly indebted countries. In this regard, some members pointed out that the completion of the banking union would be an important milestone in addressing these issues. Risks stemming from excessive leverage were also discussed, although the members expressed the opinion that these risks are more of an issue for the non-bank financial sector, given that on average banks' direct exposures to these market segments (e.g. leveraged loans) are rather limited.

BSMCG members were generally of the view that banks demonstrated strong resilience overall, also thanks to the progress made in implementing regulatory requirements and towards the establishment of the banking union. Furthermore, members expressed views that the recent trend of increasing dividend pay-outs and share buy-backs by banks is a sign of their confidence regarding the robustness of their overall capital levels. This trend is expected to continue in the near future with positive side effects on banks' valuations.

Within the risk landscape for banks, operational risks related to IT and cyber risks are becoming ever more important alongside structural challenges stemming from the digitalisation and transformation of business models (also in view of incorporating the ESG dimension). In this context, some members highlighted the need for banks to increase their efforts to achieve cost efficiencies while at the same time pursuing the necessary investments that would make their profitability more sustainable in future.

2. How the bank of the future will look like?

The second part of the meeting focused on the medium to longer-term opportunities, challenges and risks stemming from the evolution of the European banking sector, particularly in view of recent digitalisation trends. The two presentations introducing the issue highlighted developments such as changing customer preferences, the need to transfer traditional business activities to new digital platforms as business models become more customer-focused, as well as the potential contribution of non-bank business partners and the competition from such parties. The pandemic has accelerated the challenges related to banks' digital transformation from a risk management perspective. Operational resilience (including the management of cyber incidents and outsourcing) has become a key concern given the continuously evolving operating environment.

New non-bank players such as bigtechs and fintechs are increasingly entering into traditional financial services, for example as payment providers or by providing credit to their customers and by targeting the most profitable segments of the market. These players might also be able to build their own ecosystems providing an array of services for clients, in which banking is just one of the products. BSMCG members broadly agreed that a key question going forward is whether banks are able to develop and offer new customer-tailored digital solutions in-house or whether they should instead enter into partnerships for this purpose. The need to transform business models and develop more client-oriented models might also act as a potential trigger for consolidation in the banking sector. Larger banks would have the advantage of being in a better position to afford significant investments and being able to utilise the same technologies in different markets, thereby exploiting economies of scale and aiding their cost reduction efforts.

Additional challenges to banks in this area stem from differences in the demand for more digital services across customer segments, which require banks to develop more tailored solutions. Moreover, talent retention is also seen as an emerging issue as some banks experience difficulties in attracting staff with the adequate skills and experience. A concern was expressed that the ongoing digitalisation of banking services may also result in increased cyber risk.

The money of the future is expected to increase efficiency and reduce frictions and the associated costs, with central bank digital currencies (CBDCs) potentially further driving the unbundling of payments and changing banks' funding models. Members also expressed a view that the implications of introducing CBDCs must be better understood. These implications may in turn depend on the framework to be implemented. However, in general CBDCs enjoy a high level of support from market participants.

3. Concluding remarks

Mr Enria concluded the meeting by thanking the members for their active participation in the discussions and announcing that the next BSMCG meeting will take place towards the middle of 2022.

Furthermore, Mr Enria recalled that according to the BSMCG Terms of Reference membership in the group is subject to an annual review, which will be conducted ahead of the next meeting. The BSMCG Secretariat will notify all BSMCG members in a timely manner about the outcome.