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EBA European Banking Authority

Report on Risks and Vulnerabilities of the European Banking System

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1 Executive summary

The current conjuncture

EU banks have undergone significant changes since 2007, with an accelerated pace in 2011 and 2012. Funding structures have shifted considerably, towards the predominance of official and retail sources of funding. Capital levels have strengthened whilst profits have reduced, leading to significantly lower returns on equity.

Business models are adapting as banks retreat from some areas of business – such as investment banking or global finance – particularly where economically affordable funding is no longer available and regulatory changes require more risk protection. Further adjustments are likely. The re-segmentation of banking markets within national boundaries, particularly interbank funding, will significantly impact business models going forward.

During 2011 and 2012 significant efforts have been made to strengthen the EU banking sector in terms of both capital and funding/liquidity. The EBA's 2011 EU wide stress test reviewed credit soundness, sovereign holdings and funding costs. However, as the situation deteriorated additional measures were required, leading among other steps to the EBA's December 2011 Recapitalisation Recommendation. The Recapitalisation entailed a system wide strengthening of participating banks' capital bases to 9% core tier 1 and thus their ability to absorb losses. It was not a stress test, but was a necessary step in the progress to restore banks balance sheet. National authorities will continue to pursue the process of balance sheet repair by assessing individual banks' asset valuations, especially for specific credit segments with a focus on geographies and sectors such as property loans.

Market participants and rating agencies continue to see banks and sovereigns as inextricably interlinked, leading to acute pressure on funding costs. The ECB's LTRO has meant that funding pressures have eased somewhat following the ECB's action but further measures will be required to return to sustainable funding. Policy announcements as of June 2012 to potentially inject capital directly into banks and undertake EU wide supervision appeared to improve market sentiment in this regard.

Nonetheless, as of mid-2012 the situation remains extremely fragile with increasing uncertainty on asset quality, funding capacity and concerns over the possibility of extreme events. Banks and supervisors are considering, and putting in place, relevant emergency actions as a rapid deterioration of events could lead to further significant change in the banking landscape.

Beyond 2012 – medium term supervisory risks

A return to sustainable funding, beyond the temporary solution brought by the LTRO, will require (i) restoring market confidence in EU banks, (ii) a recalibration of banks strategies, business models, asset-liability mixes and risk-tolerance levels, and (iii) forward-looking and close monitoring by supervisors in 2012 and beyond. Lengthening maturity profiles, diversifying funding sources and meeting the new liquidity requirements must all be balanced with the challenges of increasing usage of collateral, rising asset encumbrance and changing market views on banks' unsecured liabilities. The focus on secured and retail funding all create potential challenges on the prudential and consumer protection front. These issues will absorb the efforts of both bank management teams and supervisors in the years to come. For the larger EU banking groups with material cross-border activities these efforts will have to continue to expand well beyond national borders.

As banks adjust to the changing environment, further restructuring of their activities and business models is expected. Moreover, the need to address more vigorously asset quality deterioration – particularly (i) where economies are in recession and (ii) for higher-risk credit sectors like real estate – will come to the fore.

A number of tools are being used by banks and supervisors to address deteriorating asset quality. For example, higher provisioning levels are being demanded and some supervisors and banks are strengthening their loan-modification and arrears management monitoring capacity to help identify inflection points where forbearance on potentially problematic loans moves from being a risk mitigant to being a risk in its own right.

Lower returns on equity, tougher funding conditions, and the segmentation of the single market, are all key drivers for change in banks business models. Heightened supervisory attention will be paid to these developments to understand changes both within the banking system and to monitor aspects of traditional banks which move to other areas of the financial system.

Table 1 summarises the EBA's views regarding the main risks and vulnerabilities in the EU banking sector in the short and medium terms.

Table 1: Main risks facing the EU banking sector

	Bank risk	Risk drivers	Level of risk	Trend	Contributing factors / interactions
Short-run	Sovereign risk	Sovereign deficits, sovereign/ bank link, lack of market confidence, political uncertainty		↑	Macro-economy conditions
Short-run	Funding and liquidity risk			↑	Volatile market sentiment, risk of banks' downgrades, national compartmentalisation and ring-fencing
Medium term	Deteriorating asset quality	Macroeconomic conditions		↑	Loan restructurings and modifications, uncertainty on timely recognition of problem loans, dynamics of real estate
Medium term	Business model changes			↔	More robust capital levels and deleverage
Medium term	Capital levels and Deleverage	Regulatory and market expectations on desirable target levels		↔	Business model changes, macro-economic condition, volatile market sentiment, risk of banks' downgrades
Medium term	Asset encumbrance	Frozen unsecured funding markets		↔	Funding and collateral risk
Medium term	Fragmentation of the single market	Sovereign/ bank link, lack of confidence, national-only regulatory/policy initiatives		↑	Funding and liquidity risk
Medium term	Challenge of shadow banking	Lower returns and heightened prudential requirements on banks		↔	National-only regulatory/policy initiatives. Lower regulation of other financial sectors

Level				The level of risk summarises, in a judgmental fashion, the probability of the materialisation of the risk factors and the likely impact on banks. The assessment takes into consideration the evolution of market and prudential indicators, NSAs and banks' own assessments as well as analysts' views.
	High	Medium	Low	
Trend	↑	↔	↓	
	Increasing	Stable	Decreasing	

Source: EBA Staff Assessment

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