EUROPEAN CENTRAL BANK

EUROSYSTEM

ECB-PUBLIC

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FINAL

Summary of Banking Industry Dialogue on 18 May 2022

Participants

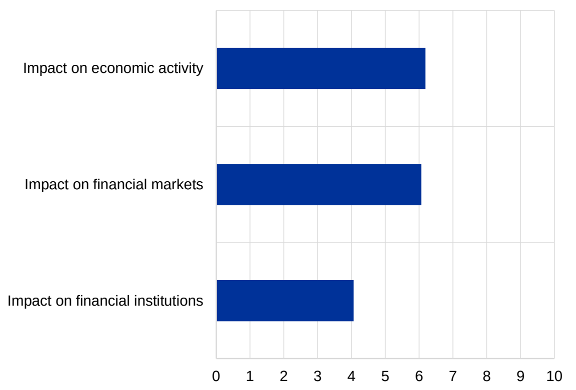
- Members of the Governing Council of the ECB or their alternates.
- Representatives of ABN AMRO, Alpha Bank, Bankinter, Bank of Ireland, BNP Paribas, CaixaBank, Caixa Geral de Depósitos, Commerzbank, Groupe BPCE, Landesbank Baden-Württemberg, Mediobanca, Nordea, Intesa Sanpaolo, Raiffeisenlandesbank Oberösterreich.
- Senior ECB officials from the Directorate General Macroprudential Policy and Financial Stability, DG Market Infrastructure & Payments, Directorate General Secretariat, and the ECB's Chief Services Officer and the Chief Compliance and Governance Officer.

1 - Financial stability challenges in the macro-financial environment and the financial system

Bank participants noted that financial stability conditions have deteriorated in recent months, as the post-pandemic recovery has been tested by higher inflation and Russia's invasion of Ukraine. So far, the war in Ukraine has had a limited direct impact on the euro area financial system, but indirect effects, for example via higher commodity and energy prices, were seen as impacting the growth and inflation outlook, which in turn had also resulted in declining financial asset prices. Bank representatives, therefore, expected the financial stability impact of the Russia-Ukraine war to be most notable in the shorter term, and mainly on economic activity and financial markets. (see Charts 1 and 2).

Chart 1 Channels of impact of the Russia-Ukraine war on financial stability in the near term (less than 1 year), according to bank participants

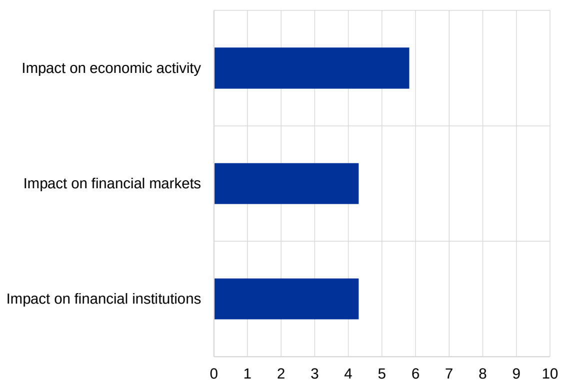
(0 = no impact; 10 = high impact)



Source: ECB survey of bank participants in the Banking Industry Dialogue.

Chart 2 Channels of impact of the Russia-Ukraine war on financial stability in the longer term (over 1 year), according to bank participants

(0 = no impact; 10 = high impact)

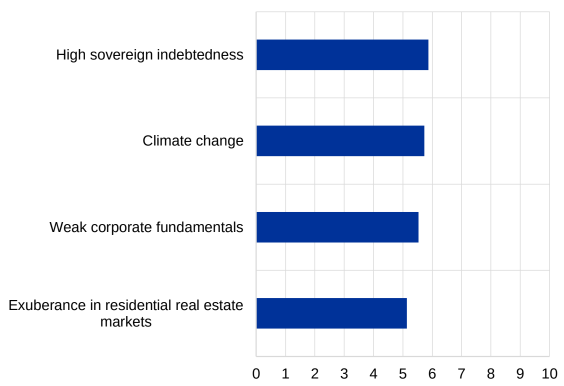


Source: ECB survey of bank participants in the Banking Industry Dialogue.

The weaker growth and higher inflation environment was seen as impacting conditions in the macro-financial environment, where important vulnerabilities remain (see Chart 3). Bank participants noted that the impact of climate change remains an important vulnerability in the macro-financial environment. The severity of vulnerabilities across sovereigns, corporates and households were seen by bank representatives as rather evenly split (see Chart 3). It was noted that corporate and household leverage levels could be expected to increase, and debt-servicing capacity to deteriorate, due to weaker growth and higher interest rates. It was argued that a key task for banks in the period ahead will be to properly manage exposures to increasingly leveraged corporates and risks surrounding possibly declining real estate prices. In this context, bank participants called on regulators and supervisors to develop and implement regulation in a way that allows for banks to properly manage lending exposures through the economic and financial cycles by keeping exposures with deteriorating asset quality on banks' balance sheets. It was argued that current loan-loss provisioning rules do not encourage banks to support corporates with deteriorating credit quality, which incentivises banks to sell such loan exposures.

Chart 3 Ranking of vulnerabilities in the macro-financial environment according to bank participants

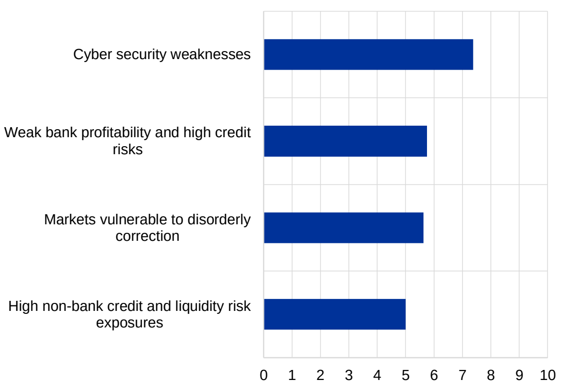
(0 = low concern; 10 = high concern)



Source: ECB survey of bank participants in the Banking Industry Dialogue.

Chart 4 Ranking of vulnerabilities within the euro area financial system according to bank participants

(0 = low concern; 10 = high concern)



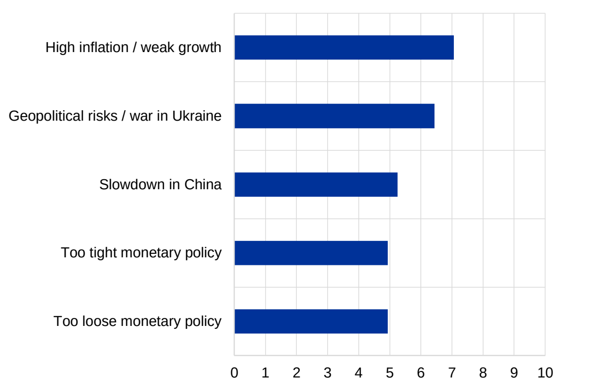
Source: ECB survey of bank participants in the Banking Industry Dialogue.

Important vulnerabilities within the financial system were also noted by bank representatives (see Chart 4). In particular, cyber security weaknesses were seen as a key vulnerability for banks and the wider financial system. It was noted that a cyber attack on a large financial institution could create significant contagion across the financial system and lead to lower trust in financial services provision. Bank representatives also expressed concerns about vulnerabilities in financial markets, and for banks and non-bank financial intermediaries (see Chart 4). For banks, it was noted that asset quality could be expected to deteriorate, given the weakened economic outlook. On the other hand, bank representatives argued that the direct impact for banks from higher (expected) interest rates should be positive, as it in general supports interest income. However, the impact of higher interest rates will differ across countries and banks and will depend on, among other things, the share of fixed- versus floating-rate lending and the level of interest-rate risk hedging. It was also noted that higher interest rates could also indirectly have a negative impact in case they aggravate the economic growth slowdown.

A high inflation/weak growth environment and geopolitical risks were seen by bank representatives as possible key triggers for the materialisation of systemic risk (see Chart 5). A slowdown in China could also impact vulnerabilities within the euro area. Views among bank participants on the possible effects of monetary policy on financial stability differed as "too tight" and "too loose" monetary policy were seen as equally likely to potentially trigger the materialisation of systemic risk.

Chart 5 Possible developments that could lead to the materialisation of system risk in the euro area according to bank participants

(0 = low concern; 10 = high concern)



Source: ECB survey of bank participants in the Banking Industry Dialogue.

Bank representatives also highlighted some key challenges and opportunities for banks in the longer term. Challenges included competition from non-bank financial intermediaries and new digital competition, euro area fragmentation given cross-country economic growth and sovereign indebtedness differences, cyber risks and climate change. A return to a positive interest rate environment, well capitalised banks, digitalisation and demographic changes, including the retirement of baby boomers, were seen as opportunities for banks.

2 - Why are euro area banks lagging behind US peers?

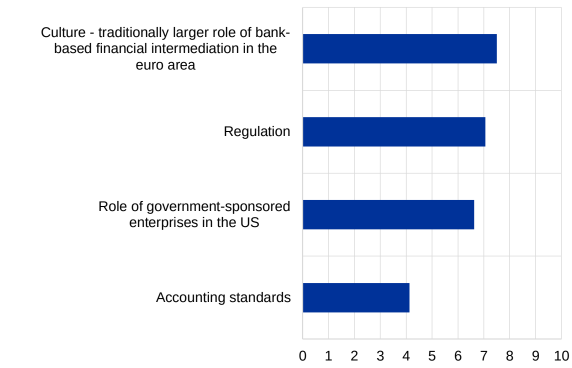
It was noted that profitability of euro area banks has been lagging behind that of US peers for ten years. While the impact of the euro area sovereign debt crisis explains the underperformance of euro area banks at the beginning of this period, profitability has remained below that of US banks, as well as many other global banks, in recent years. This weaker performance has also been reflected in bank valuations, with price-to-book ratios for euro area banks remaining well below one for the past ten years.

Bank participants noted that structural differences between the euro area and US banking sectors need to be taken into account when discussing performance differences. Such key structural differences include a traditionally greater reliance on bank financing in the euro area, regulation and the role of government-sponsored enterprises in the US, which allows banks to transfer loans off balance sheet more easily (see Chart 6).

In terms of factors explaining the weaker profitability of euro area banks compared with US peers in recent years, bank participants noted lower levels of interest rates and weaker economic activity in the euro area, as well as regulatory differences (see Chart 7). Leverage-focused regulation after the global financial crisis was seen as favouring more capital-market focused bank business models in the US. In this context, it was noted that an active securitisation market is a key differentiator for the US banking market, with more than 70% of global asset-backed security issuance being in the US. It was also mentioned that higher profitability of US banks in recent years had allowed them to invest more in their digital transformation.

Chart 6 Factors explaining the differences in the structure of the euro area and US banking sectors according to bank participants

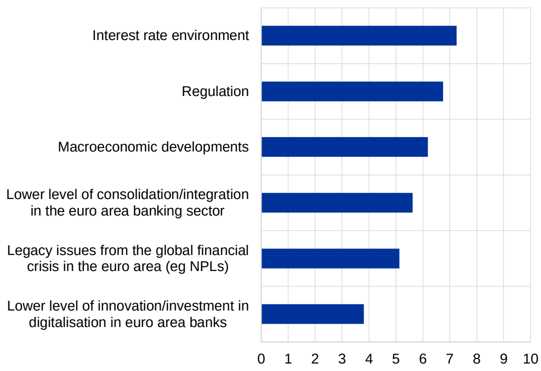
(0 = does not explain; 10 = strongly explain)



Source: ECB survey of bank participants in the Banking Industry Dialogue.

Chart 7 Factors explaining the weaker performance of euro area banks compared to US peers according to bank participants

(0 = does not explain; 10 = strongly explain)



Source: ECB survey of bank participants in the Banking Industry Dialogue.

Bank representatives noted that fragmented euro area markets hinder euro area banks' ability to operate across borders and compete internationally. The importance of completing banking union and building a capital markets union were, therefore, highlighted as they would strengthen crisis management and facilitate cross-border activity.

In addition to these challenges in euro area banks' operating environment, it was noted by bank participants that euro area banks need to continue improving their businesses, also to catch up with their global peers. Operational and cost efficiency, discipline when allocating capital and sufficient investment in digitalisation were seen as key issues to focus on.

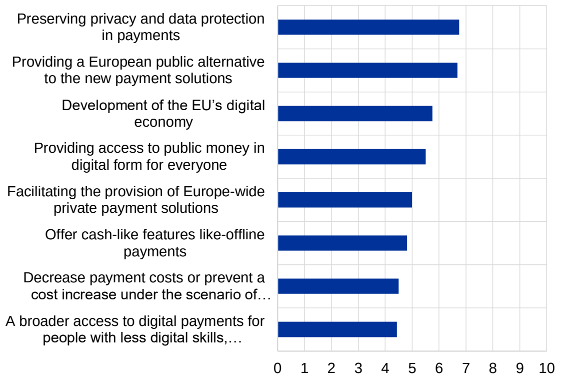
3 - Digital euro

Bank representatives acknowledged various important policy considerations related to the possible issuance of a digital euro (see Chart 8)**.** Such policy considerations relate to preserving privacy and data protection in payments and the possibility of providing a public alternative to new payment solutions.

Some bank representatives called for the introduction of a digital euro to be a joint undertaking between the Eurosystem and the banking industry, just as the current two-tier system of private and public money is a common undertaking. They argued the case for defining clearly to citizens what added value a digital euro may provide, while acknowledging the need for a monetary anchor. They cautioned against giving the impression that commercial bank digital money was less safe than central bank digital money. Digital euro should come as an additional payment instrument on which banks could build to offer additional services, but not replace existing private payment solutions or bank deposits. It was argued that bank lending is deposit based and banks have an important role in financing the economy which should not be jeopardised. It will be important, therefore, to have safeguards in place against bank disintermediation and deposit outflows, in particular in a crisis situation.

Chart 8 Importance of different policy considerations related to the possible issuance of a digital euro, according to bank participants

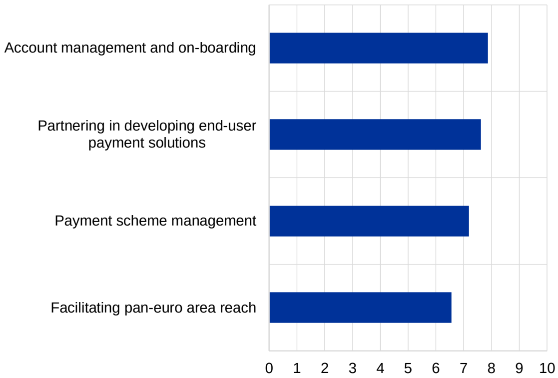
(0 = not important; 10 = very important)



Source: ECB survey of bank participants in the Banking Industry Dialogue.

Chart 9 Possible roles for banks in the distribution of a digital euro, according to bank participants

(0 = not important; 10 = very important)



Source: ECB survey of bank participants in the Banking Industry Dialogue.

Bank representatives argued that the current payment system in Europe is working well, while acknowledging that a digital euro could support the development of pan-European payment solutions. They also saw a role for a digital euro in supporting financial innovation and for banks in providing customer-facing services and developing end-user payment solutions (see Chart 9). In this regard, bank representatives noted that connecting a digital euro to national eID-solutions could improve processes for compliance checks.