EUROPEAN CENTRAL BANK
EUROSYSTEM

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Summary of Banking Industry Dialogue on 5 July 2023

Participants

- Members of the Governing Council of the ECB or their alternates.
- Representatives of Banco Santander, Bankinter, Banque et Caisse d'Epargne de l'Etat, BAWAG, Credit Agricole, Deutsche Bank, DZ Bank, Nordea, Piraeus Bank, Société Générale and UniCredit.
- Senior ECB officials from the Directorate General Macroprudential Policy and Financial Stability, Directorate General Secretariat, and the ECB's Chief Services Officer and the Chief Compliance and Governance Officer.

1 - Key threats to euro area financial stability

The euro area financial stability outlook was seen as still resilient but [of course] also challenging given the complex environment. Pre-existing vulnerabilities could become more prominent and risks could spread across different sectors, should further pockets of vulnerability be revealed in the US or other banking sectors and/or macro-financial conditions worsen. The elevated levels of geopolitical risks and higher risks of cyber-attacks were also seen as challenges in banks' operating environment. It was noted that the materialisation of downside risks to economic growth, more persistent inflation or a disorderly tightening of financial conditions could expose existing vulnerabilities, notably those associated with high levels of debt across the economy as well as the potential for disorderly adjustments in both financial and tangible asset markets. Bank participants therefore remarked that although levels of non-performing loans have thus far not risen materially, the credit quality of borrowers could be expected to deteriorate in the period ahead.

It was noted that profitability in the banking sector had continued improving in recent quarters but that banks will be faced with several profitability headwinds in the period ahead. Such headwinds included diminishing positive effects on interest margins of higher interested rates, weaker loan demand, increased cost of risk and higher funding costs. In addition, bank representatives mentioned business model challenges for banks stemming from competition from less regulated credit providers such as private credit funds and Fintech companies.

Banks' access to capital markets was seen by bank representatives as key for ensuring stability in the banking sector. It was remarked that sharp movements in financial markets during recent turmoil periods had highlighted risks, including from short selling activities by investors. In this context, bank representatives highlighted the importance of building the capital markets union in the EU and further developing securitisation markets.

Bank representatives called for regulatory clarity regarding the financing of the green transition. It was argued that the euro area banking sector is well placed to support the financing of the green transition in response to climate change, but that a clearer and more stable legislative framework which fosters the banking sector's ability to support the transition of all actors of the real economy is needed.

Bank representatives also voiced financial stability concerns regarding the possible introduction of a digital euro. While the benefits of a digital euro were noted, it was argued that a digital euro would need to benefit European citizens and the economy as a whole, while avoiding any destabilising effect on the financial system. In this context, concerns were voiced regarding a digital euro possibly contributing to the disintermediation of bank funding.

2 - Main financial stability lessons from the banking turmoil that started in March 2023

It was noted that the origins of the recent bank turmoil in some advanced economies earlier in 2023 had been partly idiosyncratic but that the episode had exposed possible vulnerabilities of banks in a rising interest rate environment. While bank earnings have benefited so far from higher interest rates, some banks with sizeable asset-liability mismatches had been left exposed to rapidly rising rates. The failure of a few US mid-sized banks also showed that the propagation of stress which stems from bank-level vulnerabilities can be accelerated by structural changes in banks' operating environment, including the impact of social media. From a euro area perspective, banks have proven resilient to this shock given strong fundamentals, with risks mitigated by a more diversified deposit base, robust liquidity ratios and relatively contained unrealised losses on fixed income security holdings.

Bank representatives also argued that the recent bank turmoil had highlighted the importance of trust in the banking sector. When trust evaporates, solid capitalisation and strong regulation might not be sufficient to ensure banking sector stability. This highlights the importance of having profitable banks with transparent and sustainable business models and bank representatives argued that these would be further supported by a more harmonised approach to assessing overall capital requirements in the sector at a European level. The episode had also shown the importance of good communication from both banks and official sectors, especially during periods of turmoil, on the health and issues confronting banks.

All in all, the recent banking turmoil was seen as providing important lessons for banks and policymakers alike. It had highlighted the need for sound corporate governance and effective risk control by banks. It had also been a powerful reminder of the need to complete the banking union, in particular the crisis management framework and a common European deposit insurance scheme, as well as capital markets union and a further developed securitisations market in Europe.