Steven Vanackere: One year after the 2023 market turmoil - outlook for banks and key supervisory take-aways

Keynote speech by Mr Steven Vanackere, Vice-Governor of the National Bank of Belgium, at the European Association of Cooperative Banks (EACB) High-Level Roundtable on the occasion of the Eurofi Conference, Gent, 21 February 2024.

* * *

Distinguished guests, ladies and gentlemen, thank you for the opportunity to deliver this speech at the welcome dinner of the EACB high-level roundtable.

I thought it might be a good idea, one year after the banking turmoil of March 2023, triggered by the failure of several US banks and of Crédit Suisse, to give you my perspective on the current outlook for EU banks and more specifically on the lessons to be learnt from this global turmoil.

Last year, the combination of slow growth, high inflation, and a historically very rapid increase in monetary policy interest rates resulted in unrest in the financial markets, with significant impact on the banking sector.

1. The higher rates reduced the market value of fixed-rate, long-term assets and implied unrealised losses on banks' balance sheets.
2. They increased banks' funding costs and created expectations of higher interest rates on deposits, which added to worries about of a potential more volatile behavior of this stable funding source.
3. They impact the debt burden of households and corporates, especially in jurisdictions with more short-term maturity or variable rate loans.

Against this background, the quality of banks' credit portfolios and their interest rate and liquidity risks became important points of attention. Investors viewed with suspicion the impact of interest rate increases on the profitability and solvency of financial institutions.

In the United States, this led to an abrupt and large-scale outflow of deposits from several medium-sized regional credit institutions.

These banks had a number of specific vulnerabilities in common, such as a business model focused on a single economic sector or activity (e.g. start-ups in the tech sector, services related to crypto-assets or banking services for of high net worth individuals) and a large share of uninsured deposits.

Even more importantly, inadequate management of interest rate and liquidity risks forced these institutions to recognize large losses in the profit and loss account, undermining depositor confidence.

Earlier deregulation under the Trump administration no longer subjected these banks to the Basel minimum standards. Finally, it was recognized that also insufficiently decisive supervision played an important role.

To ensure the stability of the US banking system and prevent a further expansion of the crisis, US authorities had to intervene, securing uninsured deposits, providing liquidity, and ultimately taking control of these banks.

Subsequently, Crédit Suisse also lost confidence of financial markets and had to be rescued, through a remarkable, publicly supported 'private' operation, of which the Swiss insisted à la Magritte: "Ceci n'est pas une résolution."

So what happened to the credo "Higher interest rates are good for banks"?

Let's not exaggerate. The long period (2019-2022) with very low (and even negative) interest rates put downward pressure on banks' interest margins, as the cost of a large amount of liabilities reached a floor, while the yield on assets continued to decline. This led to a drop of their net interest margin.

Banks compensated this negative impact on their profitability by boosting lending volumes, which partly compensated declining margins in the core business of banks, and definitely of co-operative banks: deposit-taking from and lending to the retail sector and small businesses and corporates.

But since the second half of 2022, as interest rates increased, there was a significant recovery of the net interest margin. It contributed to a significant increase in bank profitability, to levels not seen since 2014, also driven by a lower than expected repricing of retail deposits in some countries.

So, apart from the accidents in Switzerland and the United States, the credo of higher interest rates being good for banks remained valid, although the current inverse yield curve is not helpful.

Good asset quality and low loan losses also contributed to this increase of bank profitability in Europe. So far, the higher interest rates do not yet seem to have led to an important increase in loan defaults, notwithstanding rising debt service costs for debtors with variable interest rates or for debtors needing to refinance a maturing loan.

The immediate conclusion on the impact of monetary policy tightening on EU banks hence seems to be a message of "so far, so good".

But we might have not yet seen all the consequences of the transition from an ECB deposit facility rate at -0,5% in July 2022 towards 4% in September 2023, in 14 months' time. Transmission to the real economy takes time and is not yet complete. Credit losses related to the increased cost of debt will most probably still materialise in the quarters ahead, even if market interest rates would now stabilise or start decreasing from current levels.

Specific pockets of risks exist in highly leveraged sectors that have been impacted more heavily (or structurally) by Covid or by the increased energy prices, such as for example the commercial real estate sector.

In addition, higher borrowing costs have led to a slowdown in the amount of new lending. As liquidity becomes tighter, competition for deposit funding may intensify and deposit rates might rise, which could reverse to some extent the improvement in the net interest margins that we have seen so far.

Notwithstanding these caveats, European banks seem well placed to deal with potential challenges going forward, given their high profitability and quite comfortable capital and liquidity ratios.

But no room for complacency. In the weeks after the interventions by the US and Swiss authorities, there was great nervousness amongst financial market players, looking for vulnerabilities in the banking sector, with a focus on those exposed by the US problems. Concentration of business models and depositors was scrutinised, as well as the size of the amounts not covered by deposit insurance. Institutions with a concentrated deposit base or a high percentage of uninsured deposits were seen as more vulnerable.

The crisis of confidence did fortunately not spread further to other European countries' banking sectors. It is true that the situation of European banks differs in many ways from those of banks like SVB or Crédit Suisse. And the supervisory framework also differs, particularly from that which applied in the United States to medium-sized banks that were not subject to the Basel standards (while they apply to all European banks).

Yet, and that is my basic message of tonight's talk, introspection following these turbulences is also needed for European banks, supervisors, and regulators, be it in terms of the regulation in force, the effectiveness of the banking supervision and the framework for resolving failing banks.

The crisis highlighted that we need to remain committed to a rigorous and credible regulatory and supervisory framework. It strengthens the stability of the banking system and contributes to the confidence of investors and depositors. The adoption of the final elements of the reformed and tightened Basel-III standards into European banking regulation under the form of the Banking Package is therefore more than welcome.

It is regrettable, however, that European regulators have once again inserted a number of significant deviations from the Basel standards have inserted and provided for very long transition periods. This is all the more regrettable as the EU is currently already the sole jurisdiction of the Basel Committee whose regulations deviate materially from the global Basel standards in terms of capital requirements. These deviations dilute the rules applicable to European banks and have the potential to set in motion a global 'race to the bottom' in terms of banking standards.

The Basel Committee will also consider the impact of the crisis and the adequacy of its internationally applicable standards. The Committee already published a report and analysis of events with reflections on the impact on supervision and regulation.

- Among these, attention was paid to liquidity regulation in the context of the possible increased volatility of certain funding sources and deposits in the digital age and the lack of rules around deposit concentration.

- The regulatory approach to interest rate risk management comes under scrutiny, while it currently includes many regulatory degrees of freedom (as it remains subject to a so-called pillar 2 approach without one-size-fits-all minimum capital standards for IRRBB).
- The report also looked into loss absorbency capacity of AT1 bonds.

Also, the SSM has reviewed its priorities against this challenging backdrop. The postmortem analyses of the problems at some US banks by US regulators refer inter alia to poor risk management and governance at the management of the credit institutions concerned and to inefficiencies in the supervision and applicable regulation of these institutions.

I also firmly believe that good corporate governance and an adequate risk culture lay at the heart of a stable and robust banking - and by extension financial - system. The European supervisory authorities have stepped up their monitoring of banks' sensitivity to rising interest rates and liquidity position. The adequacy of interest rate risk management, funding plans and potential emergency liquidity measures to be taken by banks will also remain a prudential priority in the short term, and rightly so in my view.

Last but not least, the bank failures in the first half of 2023 (in the United States and even more so in Switzerland) were the first real large-scale test of the international resolution framework established in the wake of the 2008 financial crisis. The lessons learnt are hence very relevant for the operation of the European resolution regulatory framework.

The ability of resolution authorities to deal with the failure of systemically important banks must be further developed. The measures by the Swiss authorities served as a reminder that, in the event of the failure of a large group, sufficient alternatives must be available.

Secondly, the action of resolution authorities must remain sufficiently predictable. In this context, ECB, SRB and EBA quickly reaffirmed in a joint communiqué the sequence that would prevail in the event of a bail-in within the Banking Union, thereby helping to strengthen understanding (among banks, authorities, markets) on how the bail-in instrument would be used.

Finally, the crises of 2023 showed how sudden liquidity withdrawals can very quickly weaken a credit institution. The speed with which the depositors of Silicon Valley Bank depositors withdrew their assets was unprecedented. This reminds us of the need to provide a decisive response, within the framework of the European Banking Union, to the issue of liquidity provision in resolution, which to date remains insufficiently addressed.

Dear ladies and gentlemen, this brings me to the end of my talk. The banking sector has weathered the recent storm on financial markets quite well, but weather predictions continue to be far from rosy. So, precautionary measures should stay on the top of both regulators' and banks' minds.

The tightening of monetary policy has to some extent "normalised" the interest rate environment, which forms the setting of your core businesses, retail and corporate deposit taking and lending, but the sheer speed of adjustments to interest rates coupled to the unstable macro-economic and geopolitical conditions will continue to prove challenging.

The bread and butter interest income business of co-operative banks might have become more profitable but credit, interest rate and liquidity risks, as well as risk culture in general deserve particular attention, more than ever.

Enjoy your meal and I wish you a wonderful rest of the evening and an interesting set of meetings here in the beautiful city of Ghent.