The 2023 Regulatory Angle: EBA, ECB and SRB on their supervisory priorities

The European Banking Authority, European Central Bank and Single Resolution Board shared insights into their latest work and priorities in a Crédit Agricole CIB web conference ahead of the new year. *Neil Day* reports their views on the macro outlook, funding conditions, and capital framework, followed by comprehensive details of the regulators' presentations by Crédit Agricole CIB DCM Solutions.

Delphine Reymondon, head of liquidity, leverage, loss absorbency and capital unit at the European Banking Authority (EBA), kicked off the three presentations by saying that while European banks are generally robust in terms of profitability, capital, and liquidity, they face a macroeconomic outlook that is increasingly uncertain — with regard to energy supplies, geopolitics, inflation, monetary policy and a "high risk of recession".

"The first downside risks are materialising," she said, with banks reporting the first signs of a deterioration in asset quality, notably in relation to SMEs, consumer credit and energy-intensive sectors.

Along with Reymondon, Korbinian Ibel, director general, universal and diversified institutions, European Central Bank (ECB), flagged a first increase in Stage 2 loans.

"It's not yet super-worrying," he said, "but it's something we are looking at very carefully. As we all know, when interest rates go up, the first thing that comes for most banks is that interest income increases, but the defaults that might follow the interest rate increases come much later, which is why we look at Stage 2 loans as a leading indicator.

"We believe there is a risk — let's hope it's not going to be realised — that a scenario will develop which leads to a much worse cost of risk in the future. This is why you see us giving so many warnings."

While the regulators noted some parallels between the risks of the pandemic and those faced today, Ibel said there is a big difference between the Covid crisis and the Russia-Ukraine crisis.

"During the coronavirus (Covid-19) pandemic, basically everyone assumed a very, very dire scenario," he said, "and then quarter by quarter you saw improvements in the forecasts because it didn't turn out to be so bad — fiscal, monetary and supervisory measures were successful, and the economy stabilised much quicker than everybody had anticipated.

Korbinian Ibel, ECB, Delphine Reymondon, EBA and Sebastiano Laviola, SRB

"Regarding the current crisis, in 2022 everybody assumed that it was going to be bad economically, but not *so* bad, and then quarter by quarter, with the energy crisis and the supply chain crisis coming in, the forecasts got worse and worse. This should be kept in mind."

Banks should not expect a repeat of pandemic support measures, Ibel stressed.

"When we talk to bankers that we supervise, we sometimes have the feeling that they believe they navigated one of the deepest crises of the past decades without any scratches because everything is so great in banking," he said. "Bankers did an excellent job, of course, and we fully appreciate and acknowledge that, but what should not be forgotten is that many of the positive developments were based on a lot of supervisory support.

"So bankers should not base their modelling on those times."

In light of these considerations, the ECB has been looking anew at banks' capital planning and Ibel said that supervisors will challenge management actions to ensure an appropriate level of conservatism.

He noted that dividend restrictions were a price paid for pandemic support measures, but that the ECB has not asked for an extension of its supervisory powers in this respect, judging its current powers to have proven sufficient. However, during a Q&A session, Ibel again advised prudence in respect of dividends.

"If you see an environment in which you will not only most probably observe a deterioration of the economy, but, on top of that, you know that the forecasts might not be 100% accurate, and they are going in a direction that is getting worse and worse, then what is the right reaction for a bank?

"In that situation, it must be to say,

KEY TAKEAWAYS

- There will be no change to AT1 & T2 criteria any time soon. All focus is on Basel IV implementation (and ESG regulation)
  - AT1/T2 may have lower loss absorbency quality than CET1 but they have their defined role to play and regulators accept that
  - AT1 non-calls and interest cancellation would be welcomed by regulators as this strengthens the loss absorbency argument in favour of AT1s
- We are moving towards an environment with a positive neutral Countercyclical Buffer rate (e.g. 1%-2% as default position rather than 0% as pre-Covid) – this will result in further increase in the capital requirements
- SLBs for MREL/Own Funds purposes – little progress since late 2021 observations from the EBA. Regulators are still in idea generation and evaluation mode
- CMDI (new BRRD/DGSD) proposal to come potentially in Q1 2023 – may include general depositor preference
- ESG capital charges under the current regulatory framework: other than P2R/P2G charges linked to a complete lack of governance under the 2022 ECB Climate Stress Test and Deep Dive in respect of Climate & Environmental risks, P2R and P2G charges linked to C&E risks can become more applicable upon the next C&E Stress Test by the ECB
- Deposit flight from European banks seen as a possible risk in the context of increasing rates that could be destabilising for the European banking sector. But this risk may not eventuate
- Funding risk is a major focus of the ECB in 2023 for banks with large dependence on Central Bank funding and limited market access
- Not calling senior MREL eligible instruments may provide banks with benefits in respect of the resolvability assessment and in respect of the NCWO criterion

'I will keep my capital a bit higher. If I pay out now and later face a difficult situation… We saw after the great financial crisis how difficult it is to raise additional fresh capital. If the environment turns out to be very good, and much better than feared at this point in time, I can still pay out later.'

"That is why we like Common Equity Tier 1 (CET1) capital."

Funding and interest rates: banks must tackle challenges

Reymondon at the EBA warned that the development of interest rates also means a worsening of funding market conditions, just as banks are replacing TLTRO funding. She also elaborated in detail on a specific area of scrutiny for the EBA being the management by banks of the interest rate in the banking book (for example in terms of modifications of assumptions underlying modelling of IRRBB risks, changes in hedging strategies, business model changes if any) and more generally the impact of the increase of interest rates on several prudential aspects.

"Servicing debt will be more costly," she said, "and we are working on this, running some simulations, also to measure the impact on liquidity ratios in particular.

"There will be the need to substitute in particular this central bank funding with market funding," added Reymondon, "and we have of course already seen a widening of spreads in wholesale markets, meaning that as some banks still need to reach final MREL targets arriving in 2024, there might be some more difficulties for banks especially of a smaller size and in certain jurisdictions."

Sebastiano Laviola, director of resolution strategy and cooperation and board member at the Single Resolution Board (SRB), said such a scenario was foreseeable.

"For all the banks that essentially have resolution as a strategy, we always told them to exploit the period when the sun was shining to issue," he said. "Some did. Others did less.

"We are closely monitoring the development of the markets and the funding plans of the banks," added Laviola. "In a period of extreme uncertainty, for lesser known names and those with weaker ratings, it is clearly more difficult to issue, even at higher prices. Notwithstanding that, some banks of this type have issued recently — albeit certainly at higher prices."

In addition to the issue of funding, Ibel at the ECB said the development of deposits and in particular greater deposit outflows is a key question. He noted that deposits are typically invested on the basis of non-maturing deposit models, calibrated in a period in which interest rates were falling or stable.

"Many of these models do not even have the interest rate as an explanatory factor," he said, "meaning that interest rates are not assumed to play a role, which is a very brave assumption for banks to make.

"My biggest concern — which is a scenario that banks should at least consider — would be if interest rates rise further and we suddenly see more and new market entrants with big platforms who see a chance to collect deposits for very low fees and invest them risk-free at a much higher rate. Banks which have invested deposits long term on the basis of their models have no way to counter this, because the assets they have invested in over recent years have relatively low yields.

"It's not clear whether this will hap-

Crédit Agricole CIB hosts Michael Benyaya, co-head of DCM solutions and advisory, Doncho Donchev, DCM solutions, and Gwenaëlle Lereste, senior credit analyst, bank analyst.

pen," added Ibel. "The complexity of the regulatory framework, which is mostly seen as a burden by bankers, also gives the system strong protection. But there may be a trigger point where the benefits of entering the market for new players are very large and this is not included in the multi-year business plans of banks, so we have already had this in focus and will keep a close eye on any such developments in future."

Capital framework: handle with care

While acknowledging that the capital framework for banks has become very complex, Reymondon at the EBA said it is not the time to be making changes to it.

"Some work is being done at the Basel table in terms of buffer usability, the role of AT1 and these types of aspects, and we are also doing some work there, but with a different perspective," she said. "Our perspective is more to gain a better understanding of how all the different bricks in this framework are working together, and we are making some comparisons between different international frameworks to see what could be learned to maybe one day simplify the framework.

"But not today. When we replied to the Commission call for advice on reflections to amend the macro-prudential framework, our view was that we should not do it now. The current framework was not properly tested even during the Covid-19 pandemic, particularly in view of all the government support measures, and it is not even fully implemented yet.

"Simplifying the framework would also involve big hurdles," added Reymondon. "Since it's so complex, if you wanted to simplify it, you would need to restart from… I wouldn't say zero, but it's really difficult to just touch some bits and pieces — it would be quite long term work. Stability in the regulatory framework is also key from an EBA perspective."

Ibel echoed Reymondon's sentiments, while highlighting that, in its response to the European Commission's call for advice, the ECB had recommended other changes.

"The most important thing, and a lesson from the pandemic, is that it would be beneficial to have more macroprudential policy space via larger releasable capital buffers," he said. "When we entered the pandemic, the buffer that was supposed to do that was the countercyclical buffer (CCyB), but there was not enough capital in the CCyB to be really impactful. This is why we had to use other measures, but that was a patch and not an optimal solution.

"There are different policy options to do this. You could have a fully or partially releasable capital conservation buffer. You could have a higher CCyB in normal times, so basically a positive neutral rate. Or you could have a core rate for the systemic risk buffer."

Ibel then turned to the revised Capital Requirements Regulation (CRR3), reiterating the ECB's opposition — shared by the EBA — to proposed deviations from Basel III.

"There is an international standard," he said. "It was negotiated with the Europeans in the room — I'm the representative of European banking supervision at the Basel table — and this was already a compromise. Deviating from it now will most probably just lead to scepticism among international investors about the viability of European banks and whether or not they can trust the numbers — which is, of course, the worst thing we can do, because in the end it will increase funding costs and just make European banks less investible.

"So, from a bankers' perspective, one might consider it a little bit short-sighted — all this lobbying to deviate here and there and get a little relief on different aspects. International investors are fully aware that Europe was and is materially non-compliant with the Basel framework. So please understand the importance of deviating as little as possible — it's an issue that's really dear to our hearts." ●

Comprehensive details from Crédit Agricole CIB DCM Solutions

Delphine Reymondon, European Banking Authority

European banks: state, risks and vulnerabilities: EBA's view

- Banks face increasingly uncertain outlook due to energy situation in Europe, geopolitical uncertainties, inflation and monetary tightening, reputational and legal risks tied to sanctions, cyber risks
- On the positive side, capital and liquidity ratios remain robust, in spite of some decreases, and also profitability is strong (as more fully described in the in the 2022 EBA Risk Assessment released on 9 Dec 2022, data as of Q2 2022, covering 122 banks in the EU)
  - Some signs of asset quality deterioration, particularly in energy-intensive sectors (e.g. Stage 2 loans close to 10%, highest since reporting began in 2018)
  - CET1 > 15%, LCR ~160%
  - *See table below*

- Rising rates do not necessarily mean substantial improvement in NIMs, especially in stagflation periods
  - Rising rates may increase NII, but they can result in a decrease in the economic value of equity (PV of future net income)
  - Focus on risk from RE exposures
  - Funding risks: higher wholesale funding costs, TLTRO repayment, and still need to finalise MREL in some cases
    - The EBA also warns that especially smaller banks may continue to face some difficulties in raising wholesale market funds for MREL purposes

Present areas of prudential focus

- The EBA is producing a "Covid-19 Exit Report" on the exit from prudential standards relaxation decided at the eruption of the Covid-19 crisis (e.g. IFRS 9 phasing and reserving criteria, suspension of capital and liquidity buffers, etc, of course linked with the dividend ban recommendation)

- The EBA message is to exercise prudence in terms of shareholder distributions given heightened uncertainty on economic and market developments at present

- Capital buffers/stacking order/interaction of micro and macro prudential measures
  - BCBS work to be finalised soon: role of AT1
    - The BCBS published on 14 Dec 2022 its evaluation report on AT1 instruments following the lessons learned from the Covid-19 crisis – relevant paragraphs are 118-135 and 141 last sentence
    - Para 141, last sentence: *Likewise, increased standardisation of the criteria qualifying instruments as CET1 and AT1 instruments has strengthened banks' capital base. However, robust empirical conclusions regarding the loss-absorption capacity of AT1 instruments cannot be drawn at this stage.* => CACIB view: unlikely to result in reforms to AT1 in the near term
      - The BCBS notes that there have been few examples of AT1 loss absorption through write-off/conversion and some examples of coupon suspension, including for an internationally active bank
      - The BCBS also notes that coupon suspension is not seen as a probable scenario by market participants given the likely adverse consequences for the bank which may outweigh any benefits
      - The BCBS notes also that few banks have not called their AT1s but most have called at the first call date which is seen as due to the mostly decreasing rates and spreads until recently
      - Finally, the BCBS observes that the 5.125% loss absorption trigger may be too low relative to the current capital requirements (i.e. the bank may hit the Point of Non Viability prior to hitting the contractual trigger)
  - EBA work in this area:
    - How the different elements/MDAs of the prudential framework interact with each other (e.g. MDA on RWA or LR basis, interaction with MREL/TLAC requirements)
    - Mapping and benchmarking of prudential frameworks

(%)	CET1 (transitional)	CET1 (fully loaded)	Leverage Ratio (fully phased-in)	Liquidity Coverage Ratio	NPL Ratio	Share of Stage 2 loans	Return on equity
June 2022 ratio	15.2	15.0	5.2	165.1	1.8	9.5	1.8
Change from June 2021	(-0.6)	(-0.5)	(-0.5)	(-9.4)	(-0.5)	(+0.7)	(+0.4)

Source: EBA, Crédit Agricole CIB

across Basel, EU, US, UK, etc. and seeing what can be learned from different frameworks, with the objective of potentially simplifying the EU framework in the longer term, not a short term project

- Liquidity and funding risks
  - TLTRO – the EBA is running simulations on the impact of TLTRO repayment on the LCR/NSFR ratios of banks and its replacement with market funding
  - Liquidity portfolios – impact of increasing rates on the values of these portfolios and reflection in the regulatory ratios, impact on outflows under derivative instruments and impact on collateral values in repo transactions
  - Accounting aspects on liquidity portfolios – accounting reclassification of liquidity portfolios, accounting overlays

- Interest rate risk in the banking book (IRRBB)
  - Big focus from the EBA on this area as all necessary texts have now been put in place (Guidelines on IRRBB and Credit Spread Risk in the Banking Book, RTS on Supervisory Outlier Test (SOT) and Standard Approach, etc.)
  - The message to banks is that the current methodology may not be perfect, but that the banks must implement the new methodology and then there will be discussions with the banks
    - Focus on how banks adapt their IR modelling (e.g. hedging and depositor behaviour)
    - Big QIS to be sent to banks in a selected sample with reference date end-Dec 2022 (in the absence of regulatory reporting)
    - EBA working on regulatory reporting aspects – Consultation Paper in Jan 2023 to replace national approaches with a harmonised EU approach

- Interest rate (and FX) impact on the valuation of Own Funds and MREL items
  - Recently, a questionnaire sent to ~60 banks on the topic:
  - How it is accounted (amortised cost/FVTPL/FVOCI) and how it is hedged?
  - What would be the impact of changing rates/FX on the balance sheet and prudential values of the instruments?
  - Of particular interest for the EBA: FX treatment of AT1 instruments in accounting and prudential terms

- Macro hedging
  - EBA may contribute to the Macro Hedging work at the IASB currently undertaken (EU benefits from a carve out for macro hedging)

- IFRS 9
  - IFRS 9 models are not validated by the supervisors, yet model performance and choices made by the banks impact directly the levels of (i) equity, i.e. CET1 and (ii) provisions – hence, IFRS 9 is closely monitored by the regulators
  - The EBA observed differences between the banks on the IFRS 9 implementation, e.g. limited use of collective (i.e. portfolio-based) rather than individual exposure assessments, increased reliance on overlays as models working outside boundaries (Covid-19 no precedent, similar for the stagflation environment we are in now)
    - Good governance required in terms of overlays, need to explain overlays versus e.g. back-testing results
  - IFRS 9 benchmarking extended to High Default portfolios (SMEs, mortgages, consumer finance) – Consultation Paper by the end of the year
  - 3rd ad hoc exercise: as previously, collection of information on modelling practices (IFRS9 and IRB, Significant Increase in Credit Risk (i.e. Stage 1 to Stage 2/3 migration) assessment, incorporation of forward looking information) with more specific questions: nature/impact of overlays as of Dec 21, treatment of 2020/2021 default rates for the purpose of ECL models, implications related to Covid-19 and other emerging risks (e.g. high inflation scenario), back-testing

CRR3/CRD6 and next 1-2 years priorities

- Once the final Basel 3 (aka Basel IV in the market) is finalised in EU legislation, the EBA will be busy working on implementing close to 100 mandates given by the co-legislators to the EBA
  - Main focus is on credit risk
  - 3rd country groups and branches – new supervisory powers
  - Following negotiations
  - Timely and faithful implementation of the package

- Stress testing for 2023

- Pillar 3 data hub – on the EBA website, integration of Pillar 3 data for all banks (reconnecting prudential with Pillar 3 data)

- Markets in crypto-assets (MiCA), digital operational resilience (DORA) mandates

- ESG:
  - Roadmap to be published before year-end
  - Recently work completed on ESG disclosure
  - Discussion Paper on integrating ESG risks in the Pillar 1 RWA framework
    - EBA working on feedback received
    - Banks supportive of the EBA's proposals and shared the EBA's concerns to integrate ESG risks directly in Pillar 1
    - The EBA is cognisant of the ongoing CRR3 discussions in the European Parliament to introduce already Brown Penalising or Green Supporting Factors – the EBA thinks it is better to await the final EBA report in this re-

spect, in order to avoid constraining factors in the Level 1 text (the banks must be able to finance the transition)
- Sustainability-linked bonds and prudential treatment
  - Progress has been more limited, but the EBA continues to gather possible structures and ideas and regularly exchanges with international regulators
  - The EBA at present does not know if and when it will take a final decision on the topic, but it may put together a summary of the situation in order to have internal positions readily available if and when need be

- Maintain vigilance and capacity to act/react as needed in the face of ongoing crises, direct and indirect effects, and update prudential framework if/where necessary

Q&A session

- Buffer framework (CCyB, G/OSII & SyRB buffers) – What is your view on the functioning of the buffers thus far? Is the practical implementation of a relatively simple and robust concept becoming too complex?
  - Publication from the BCBS
    - Keep in mind that the framework as it is ensured the maintenance of high level of capital -> banks were in a good situation when entering the Covid-19 crisis
      - Regulators view this situation positively, as the systemic risk of banking was decreased
      - But also keep in mind that Covid-19 was not a full test of the buffer framework given all the forbearance measures
    - Less positive side: after the Great Financial Crisis (GFC), the buffer framework was invented and well designed in the EBA's view. However, later on complexity increased materially with the introduction of parallel requirements via resolution and leverage ratio regulations
      - It cannot be denied that the framework is highly complex today
      - Some regulators are, however, accepting of the complexity as they think that over time it is becoming well understood by all key stakeholders
    - Also, when one starts with a complex framework, it is a high hurdle when wanting to simplify it
      - Real simplification may require starting from scratch rather than just selecting bits and pieces of the current framework
      - A wholesale review of the framework is not planned for the time being
        - Re-assessing the whole framework would require also re-assessing the role of certain instruments, e.g. AT1, but also Tier 2 vs TLAC/MREL instruments – would both layers of Tier 2 and TLAC/MREL instruments be needed?
        - It may come, but rather in the longer term (5+ years?)
      - What can be done is to work on certain aspects only and try to harmonise their usage and implementation
        - Define certain buffer rates or define certain indicators used in the determination of certain buffer rates

- AT1 – Any new work at the level of Basel or other supervisory fora? How do you see the performance of AT1s thus far, e.g. in the context of extensions and coupon cancellations?
  - 1st paper by the BCBS on the Covid-19 crisis and performance of various aspects of the regulatory framework already published. 2nd concluding paper should be forthcoming, including the role of the AT1s
  - The EBA reminded that it did not mention AT1s in its reply to the Commission's Call for Advice on the Macro Prudential framework
  - The EBA view on AT1 is that the instrument is part of the current regulatory framework
    - The EBA's AT1 Monitoring Reports are aimed at achieving a well-framed complexity of the instrument, whilst maintaining harmonised high standards for the instrument
    - The EBA confirmed the role of the instrument in its final rules on the P2G for Leverage Ratio purposes where the numerator includes AT1s
    - AT1 cannot be cast aside without re-assessing the regulatory framework as a whole
    - AT1s should be left for the time being as they are and the eligibility criteria should not be revised, though if there are renewed discussions at e.g. the BCBS, the EBA would be happy to contribute

- AT1 – How do you see the performance of AT1s thus far, e.g. in the context of extensions and coupon cancellations?
  - Received a lot of questions following the recent APRA statement on calls for AT1/T2
  - The EBA reminded listeners that in the EU the situation is already different, in that the notion of cost sustainability of the replacement instrument is already embedded in the CRR and the RTS on Own Funds
  - Also, the last AT1 Monitoring Report reminded that AT1s are perpetual instruments and that certain non-calls were seen positively by the regulators
  - EBA makes difference between AT1 and Tier 2 – Tier 2 are not perpetual instruments and certainly not priced so
  - In the context of the "exceptional circumstances" justifying a call 5 years since the issue date, the EBA reminded that they did not see the cost as being an "exceptional circumstance". However, the EBA acknowledged that cost will always be one of the key considerations for regulators when deciding on whether to authorise a call. However, such a decision is always a case-by-case decision reflecting the individual circumstances of each bank and where many factors play a role for the final decision

Korbinian Ibel, European Central Bank

European banks: state, risks and vulnerabilities

- At the beginning of the presentation, the ECB presented key solvency, liquidity and profitability metrics for banks and the good news is that they are all at good or acceptable levels as of now

Q2 2022 prudential statistics	
CET1 ratio	15.00%
Leverage Ratio	5.30%
Liquidity Coverage Ratio	164.40%
Net Stable Funding Ratio	127.00%
Return on Equity	7.60%
	Source: ECB, Crédit Agricole CIB

- The CET1 ratio is slightly down compared to Q2 2021, reflecting mostly dividends/share buybacks post the expiration of the ECB dividend ban, and some organic growth/rating migration. But 15% is a high level already
- Taking a step back, the CET1 ratio has increased materially over the last few years (e.g. from below 13% at Q2 2015 to 15% Q2 2022) and this is welcomed by the supervisor
- No concerns on LR, LCR ad NSFR. RoE of 7.6% is far from stellar, but much better than in the past
- Banks experiencing material uplift in NII until Q2 2022, ahead of analyst consensus, based on both margin and volume expansion
- However, banks did a good job to achieve these positive statistics, but they also got there thanks to material supervisory support (making available capital worth €140bn for additional lending)
  - Release of various capital buffers (CCyBs, O-SIIs, SyRBs)
  - Usability of P2G and the CBR
  - Beyond supervisory measures outlined above: State guarantees on selected loans, IFRS phasing-in and benign guidance on modelling, etc.
  - In quid pro quo: dividend ban recommendation
- **The ECB's main message to bankers: Do not assume that these material support measures will be repeated in the future.** This is particularly relevant for IFRS 9 provision modelling (not to take the results from 2019-2021 for the projections and apply them unfiltered)
- A second warning from the ECB to banks: difference between the Covid-19 crisis and the current situation:
  - After a deep initial shock, macroeconomic forecasts in the middle of Covid only got better
  - Since the beginning of the Ukraine war, macroeconomic forecasts have only worsened
- However, asset quality has not been adversely affected yet
  - NPL ratio decrease and low Cost of Risk over the last years a big success of the European bank sector
- Nevertheless, the ECB is looking at the Stage 2 loans as a leading indicator
  - Initially, increasing interest rates lead to margin expansion and only much later to defaults – hence, the focus on Stage 2 loan development, which has been increasing as of late
  - There is a one possible scenario under which the Cost of Risk increases materially – hence, the ECB's forceful warnings to the bank sector on provisioning and payout discipline

- The ECB is scrutinising banks on their exposures to sectors defined as "vulnerable to the energy [and supply chain] crisis" – these are diverse and include energy producers, real estate construction, food production and then various basic material or advanced manufacturing industries
  - The ECB observes that Stage 2 ratios are lower YoY in many of the vulnerable sectors
  - This observation leads to intensive discussions between the banks and the supervisor to understand the drivers of the provisioning choices made and to institute correction measures, if and where needed

- Bank capital trajectories over the next 3 years (April 2022 data):
  - Banks focus on retained earnings as growing materially and being the main driver of the capital numerator (but also strong growth of the denominator (RWAs) expected as a result of organic growth)
  - Banks' own capital projections suggest that 75% of them estimate that they will be more than 3% above their own CET1 target by end-2024 (the CET1 target is already above all regulatory capital requirements and P2 Guidance, plus a management margin)
    - **Between end-2022 and end-2024 banks assume to keep CET1 ratios constant**
  - Given the adverse development of economic projections between April 2022 and now, the ECB asked banks to share updated capital projections, including consequences from the Russia-Ukraine war/energy crisis and including also a stress scenario (apart from the base case scenario)
    - The capital distribution plans submitted by the banks in March-April 2022 did not include the Russia-Ukraine war and the energy crisis, as these geopolitical shocks just materialised at the time or were to yet materialise
    - Data received by the ECB by the end of October 2022
    - ECB analysing this data which will be incorporated into share buyback and dividend decisions (the bank projections will determine which banks are prudently managing capital)

EU capital framework

- The ECB presented briefly the framework below and did state that in order to invest and understand the risks, one has to be an expert in this matter, e.g. interactions between CET1, AT1, T2 and what kind of restrictions can be triggered (MDA framework)

- The ECB also referred to its answer to the Commission's Call for Advice on the Macroprudential framework:
  - It agreed with the EBA that the framework has become highly complex and that it may need to be reviewed at some stage in the future, not now (long term project)
  - The most important aspect for the ECB, as a take-away lesson from the Covid crisis, is to create more "macroprudential policy space":
    - The ECB has here in mind foremost a **positive neutral Countercyclical Buffer (CCyB) rate** (e.g. 1%-2% versus 0% pre-pandemic) which can be activated based on more indicators than currently in the framework and with a shorter delay than the current 12 months
      - The ECB did also mention a positive rate Systemic Risk Buffer or releasable Capital Conservation Buffer
    - The ECB did not ask for additional legal powers to curb dividend payments, having been satisfied with the following of the dividend ban during the pandemic

- The ECB also addressed the final Basel 3 (aka Basel IV)/CRR - here the ECB reminded that it is for full, timely and faithful implementation of the Basel accord, so as to avoid Europe being labelled materially non-compliant:
  - European banks must avoid a situation where international investors do not trust the numbers of European banks anymore as this would result in higher funding costs

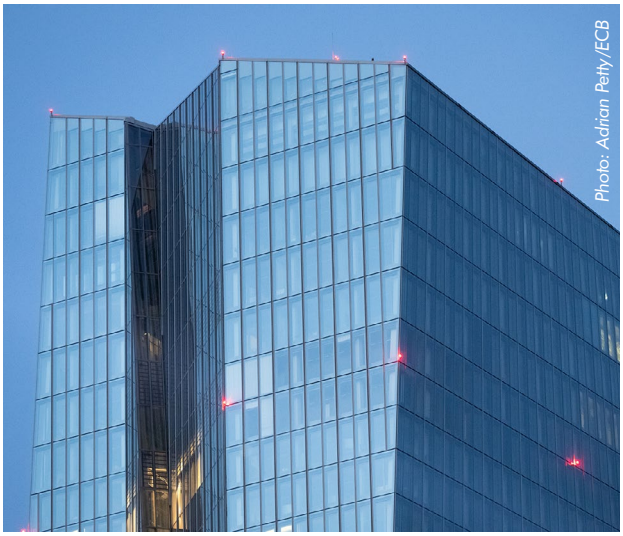
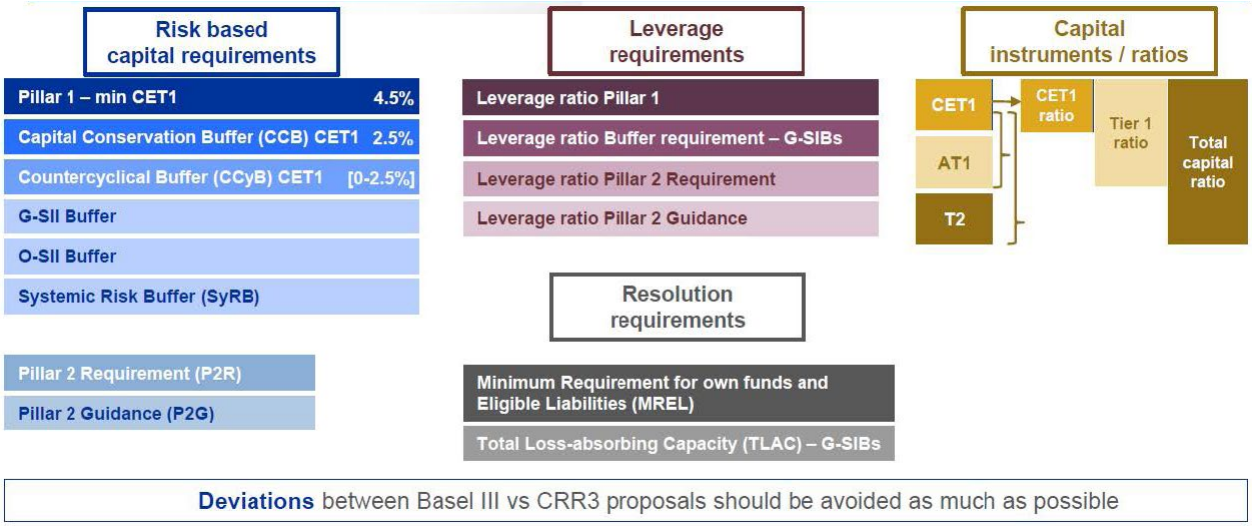


Photo: Adrian Petty/ECB

ECB supervisory priorities

- The ECB presented the supervisory priorities for 2022-2024 as presented in Dec 2021
- The ECB supervisory priorities for 2023-2025 were published on 12 Dec 2022 (main themes and priorities for the ECB's banking supervision for 2023-2025 (and here))
- In a nutshell, among the priorities that could impact bank resilience in the short term, the ECB now focuses on exposures to energy-intensive sectors, as opposed to Leveraged Finance and interest rate exposures in the banking and trading book (work continues here, but also EBA priority now) and funding risks (higher TLTRO dependence for funding and more difficult markets, focus on subset of banks that are particularly impacted). Longer term, strategic priorities, such as digitisation, governance, cyber security and C&E risk management remain the same as in 2022-2024.

The current EU capital framework (simplified)



Source: ECB

ESG

- Two exercises by the ECB on Climate and Environmental (C&E) risks – ECB Thematic Deep Dive on C&E risk management and ECB Climate Risk Stress Test

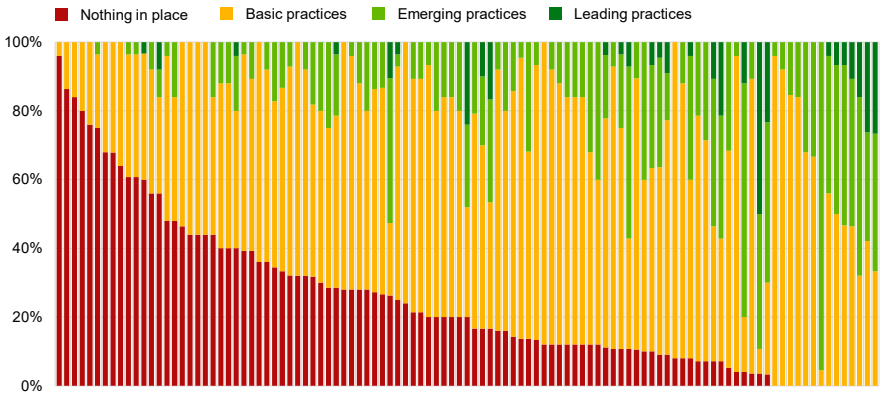
- **ECB Thematic Deep Dive on C&E risk management**
  - 186 banks (107 significant and 79 less significant institutions) covering €25tn of assets
  - However, not a single bank covers all areas of C&E risk management
  - The ECB published a Compendium of Good Practices for the banks to see in which direction the ECB expects them to go

- Results of the Thematic Deep Dive – in some cases only deep red (no idea of what C&E risks are), in some cases dark to light green (on the way to proper capture of C&E risks), with lots of yellow (basic architecture for C&E risk management being put in place):
  - Over 85% of banks have now at least basic practices in place for most of the areas addressed by the expectations
  - All 107 significant banks fail to completely correspond to the ECB's expectations in respect of (i) soundness and (ii) comprehensiveness of practices in respect of C&E risks
    - However, a few years back the shortcomings would have been complete for all banks and banks have come a long way
    - Also, Europe is seen as a leader in the context of C&E risk management

- **ECB Climate Risk Stress Test**
  - The Stress Test was a discovery exercise to see if banks can project realistic scenarios of stress due to the materialisation of C&E risks
  - Results – from 1 being Excellent to 4 Fail
    - Most banks were rated 2 and 3, with the majority in (>50 banks) scoring 3, or just a Pass mark, with also ~15 significant institutions receiving a Fail mark – overall ~65% of banks scored poorly
  - The regulator was clearly not happy with these results
  - As a remedial measure, the regulator will push banks to integrate C&E risks in the ICAAP stress testing framework
  - At this time there was no direct impact on the SREP for the banks (only indirect impact, on scores for e.g. governance), but in the future one has to expect that C&E risks will be included in the P2R and in the SREP because of the importance that this factor deserves

- Following the Deep Dive and the Stress Test, all banks have received individualised feedback telling them in which areas are the weaknesses, how this has to be improved and clear deadlines

The level of maturity of practices across areas of supervisory expectations (bank-by-bank)



Source: ECB

Q&A session

- **Structural position of the EU banks:** The last decade was spent by banks on ensuring robust through-the-cycle profitability through restructuring: build out businesses with strong market share, reinforce fee income, rationalise costs. How do you see the position of banks now? What about the challenges of digitalisation and green transition? Can we consider national and cross-border consolidation as a part of the solution?
  - If you look at RoE for European banks and their market valuation, with a P/B ratio on average below 1.0x, this limits the European banks' ability to raise equity and hinders their ability to finance the economy
  - Banks made a lot of progress in the last years and this is to be lauded, but many challenges remain. E.g. digitisation investment cannot be offset against short term cost savings, or such banks will have a difficult future
  - The European bank market is one of the biggest markets in the world, but still fragmented (banks operate mainly within national borders) and cannot realise economies of scale, for instance from digital investments (the larger the customer base, the more the IT investments are leveraged operationally)
  - Banks must continue to invest to get operationally stronger and more efficient
  - Cross-border mergers can help to leverage economies of scale
  - Strategically, it is important that banks must bear in mind that their future competitors may not be other banks, but new players or platforms

- **Capital targets & MDA buffer:** Given the cost, some banks use CET1 to cover for shortfalls in the their AT1 & Tier 2 buckets. When considering banks' capital positions, how do you take this into account? Do you prefer for banks to optimise their AT1 and T2 buckets? Would you consider a 200bp-250bp distance to MDA (this includes P2G) as sufficiently high?
  - AT1 and Tier 2 instruments are in the regulation and banks can use them. Having said that, there are doubts as to whether AT1 is really a loss absorbing instrument given that the triggers are set so low that banks would become non-viable prior to reaching them
  - A bank that elects to fill its AT1 or T2 buckets with CET1 would be supported in this decision by the ECB. From a profitability point of view, the ECB understands that banks may want to leverage their capital base with AT1/T2, but from a prudential perspective CET1 is the highest quality capital (absorbs losses on ongoing basis, if there are losses, there are no dividends)
    - AT1 coupons can in theory also be cancelled, but in reality this is much more difficult. Should a bank want to cancel AT1 coupons, it certainly will not get any restrictions from the ECB
  - Size of the management buffer:
    - Not a one-size-fits all approach
    - Many different bank business models in Europe, with different business profiles and a business environment that is changing rapidly
    - But clearly a bank with stable, predictable earnings can afford a buffer above P2G and CET1 requirements that is much smaller than for a bank with volatile results operating in a volatile part of the industry
    - There are intensive discussions with each and every bank on this question and it is always an individual decision

- **Bank resilience and payouts:** Eurozone banks remain resilient in terms of profitability, capital and liquidity. However, the ECB recommends banks to preserve capital as the economy slows and restrict payouts. In your view, are the banks sufficiently robust to the risks in the real economy and why do they need to exercise caution on payouts?
  - Whilst in the Covid 19 crisis, there was an initial shock and then projections only got better, in the current situation the forecasts keep getting worse and there is a lot of uncertainty
  - In such a context it is better to have the banks keep capital at somewhat higher levels and then to have a catch-up later in terms of dividends and share buybacks (another reason why the ECB likes CET1 is this capacity to time pay-outs in line with the prevailing macro environment)
    - On the other hand, if a bank pays out now, then there is a crisis and the bank is short of capital, it is much more difficult to raise equity then rather than to preserve it now
  - One has to find balance between the two alternatives above. The pendulum is now swinging towards capital preservation which may have been different if there were no Russian invasion and jump in energy costs

- **C&E risks and P2R/P2G charges:** Could P2R/P2G charges be imposed on banks with C&E risk management shortcomings?
  - It was not part of the 2022 C&E Stress Test, but could be part of the next C&E Stress Test/Deep Dive (will be a bit further in the future, with the generic EBA Stress Test taking place in 2023)

- **Deposits situation:** Can we see deposit outflows in the changed interest rate environment?
  - Banks' models of non-maturing/transactional deposits have been calibrated during a long period of low, stable interest rates – these models do not reflect a period of increasing interest rates and some of these models do not even have interest rates as an explanatory factor – hence, the regulator is concerned about these models and their outputs and makes appropriate inquiries
  - When the interest rates increase further, will there be new players/platforms that could collect deposits at a cheap cost and invest them in higher yielding assets with low risks, thereby putting the stability of the whole banking system at risk? It is not a scenario that will happen, but something that can happen
  - On the other hand, the complex regulatory requirements also act as a barrier to entry and thereby (partially) protect the banking system. However, there could come a trigger point where external players could consider that the regulatory investment/cost is worth it, given the size of potential returns
  - Also, banks could not respond in a cost-covering manner as over the last years they have invested in low yielding long term assets
  - So the deposit question could become a liquidity and solvency question (banks can always keep the deposits if they pay enough (above what they earn, if necessary), but so far not something that is reflected in the banks' models)
  - Thus, the ECB is very focused on this question

Sebastiano Laviola, Single Resolution Board

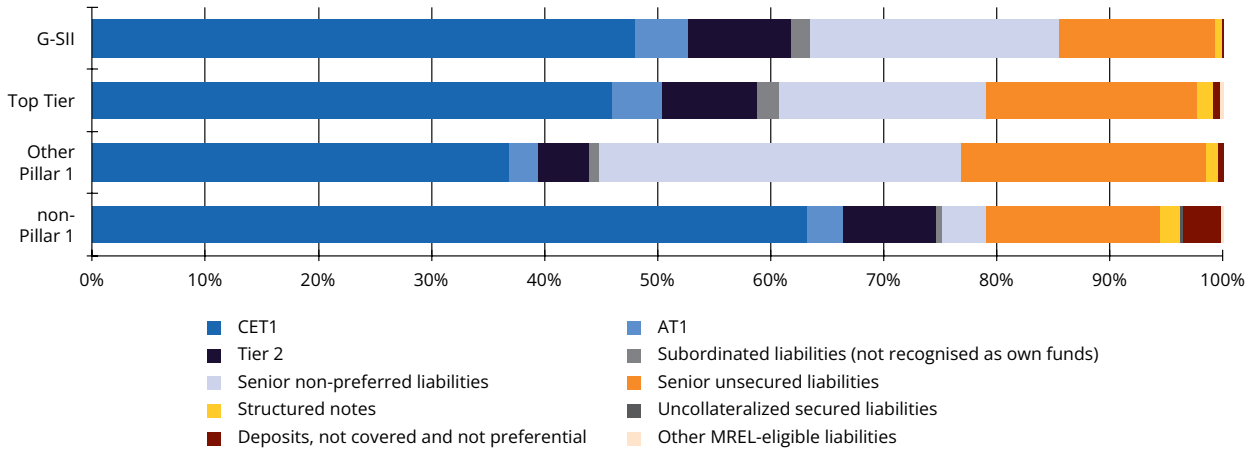
SRB priorities for 2022 & 2023

- The SRB's overarching priority remains to make banks fully resolvable by end-2023
  - Here the focus is on three common priorities: (i) liquidity and funding in resolution (mobilisation of collateral, sources of funding), (ii) work on a Separability Analysis Report (SAR/transfer playbook) when the strategy envisages a transfer tool, and on reorganisation capabilities when the strategy is bail-in, and (iii) IT capabilities for valuation and bail-in execution
  - Complemented by bank-specific priorities to ensure resolvability (e.g. build up MREL for certain banks). SRB subjecting the banks to more targeted monitoring (e.g. on-site visits, dry runs)
  - MREL: (i) end of LR transitional measures, (ii) internal MREL and MPE MREL computation of surpluses in other resolution entities, (iii) more dynamic subordinated MREL policy (evolution of balance sheet prior to resolution taken into account)
    - MPE resolution strategies: capital surpluses in third country subsidiaries no longer recognised as TLAC/MREL resources unless there is a resolution regime in place recognised as equivalent by the EU authorities – transitional period applies
    - Internal MREL: holdings of MREL instruments issued indirectly to the resolution entity shall be deducted fully from the intermediate entity's internal MREL capacity – from 1 Jan 2024
  - Monitoring of eligibility of MREL instruments reported to be further strengthened – sign-off by Senior Management of bank, eligibility checklist, SRB to strengthen monitoring
  - Prior permission regime for redemptions – where redemption without replacement, there must be a sufficient Margin on top of MREL + CBR. The amount allowed under the prior permission regime must be deducted (the Pre-Determined Amount). The SRB policy now is that the Margin will be equal to the lower of the Pre-Determined Amount and Pillar 2 Guidance.

MREL state of play (levels, shortfalls, cost of funding)

- The Single Resolution Board published the MREL Dashboard for Q2, 2022 *(link here – see also chart below)*:
  - **Final targets:** The average final 2024 MREL target for resolution entities under the SRB's remit was 23.2% of the Total Risk Exposure Amount (TREA) (€1,736bn) and 26.4% (€1,970bn) including the Combined Buffer Requirement (CBR). Both were stable from Q1. The average final subordination target was 19.1% (€1,431bn), down marginally from 19.4% (€1,442bn) in Q1.
  - **Intermediate targets:** The average 2022 intermediate target was 21.9% TREA (25.1% including CBR), 18.1% subordinated.
  - **MREL stock:** The MREL stock was broadly stable from Q1, up 1.7% (€38.3bn). The subordinated MREL stock was also broadly stable, up 1.5% (€29.2bn) in the quarter.
  - **Shortfalls:** The shortfall against final 2024 targets was 0.2% TREA (€18.3bn), 0.4% (€32.2bn) including the CBR. The 10 Other Pillar 1 banks (i.e. banks with less than €100bn Balance Sheet, yet subject to full MREL rules, including MREL subordination, typically located in the Benelux,

MREL composition by bank category as of 30 June 2022



Source: SRB

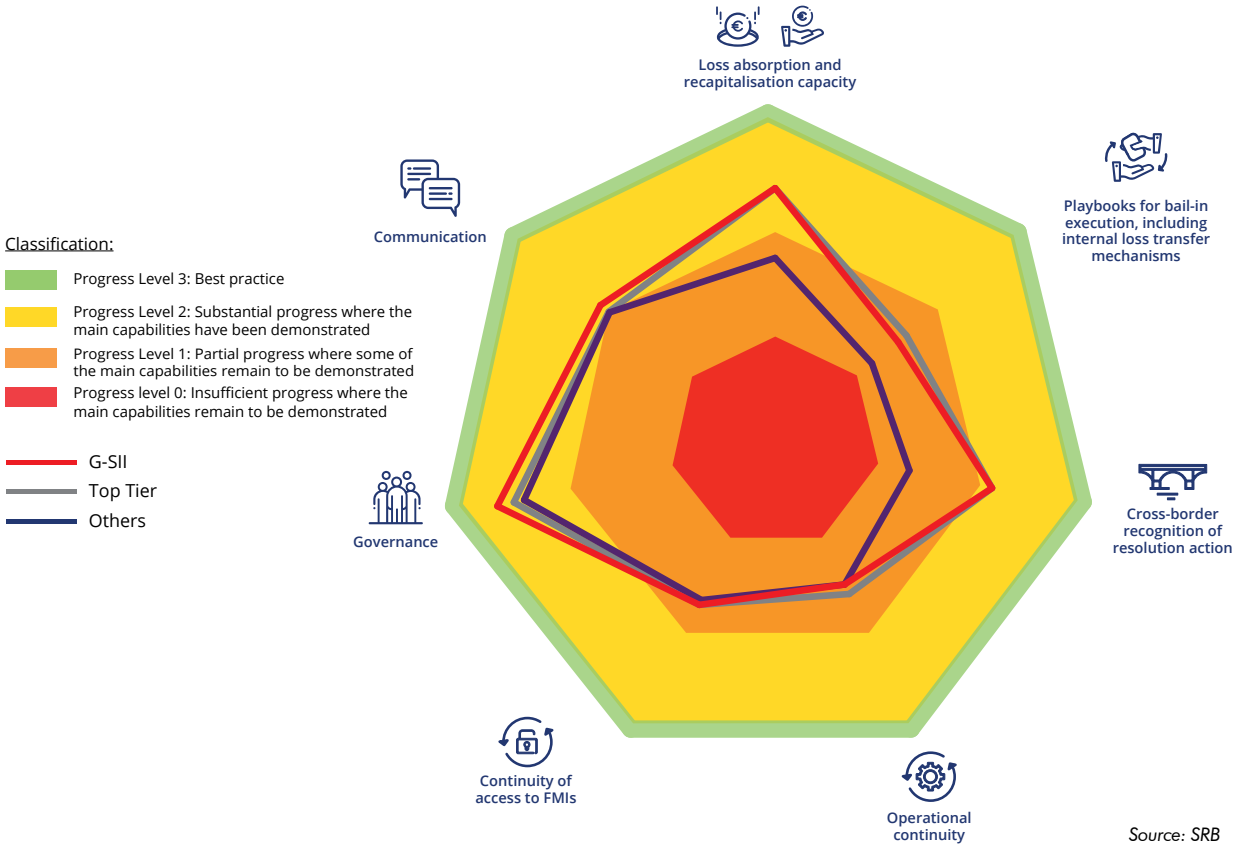
Austria, Germany and Finland/some CEE countries) were the only category to show an overall increase in shortfall (including CBR) during the quarter; their targets are in most cases almost fully subordinated due to the 8% TLOF adjustment and lower risk density.

- **Issuance:** MREL issuance was €67.3bn (0.9% TREA) in Q2, around 20% lowered than in Q1, but broadly stable with respect to the same period of 2021. 41% of total issuances were senior preferred and 31% SNP, a shift towards the former since Q1.
- **MREL stock composition:** Senior non-preferred (SNP) liabilities made up 19% of MREL resources for banks in scope, with substantial variation between categories of bank. Senior bonds made up 16% of the MREL stock, ranging from 14% for global systemically important institutions (G-SIIs) to 22% for Other Pillar 1 banks.
- **Maturity profile:** Around 49% of MREL-eligible instruments were perpetual, around 7% had residual maturities of more than 10 years, 37% of 2-10 years, and 7% of 1-2 years. The proportion of instruments with residual maturities of 1-2 years ranged from 5% for non-Pillar 1 banks to 9% for Top Tier and Other Pillar 1 banks.
- **Governing law:** Of the overall MREL stock, around 18.5% was made up of instruments issued under non-EU law, of which 95% were governed by either US or UK law. From securities under foreign law, 20% were Tier 2 and 10% AT1 (both mostly under UK and US law), with remainder senior instruments (70%).
- **By resolution strategy:** Banks under a Single Point of Entry (SPE) resolution strategy had an average target of 25.8% TREA, compared to 29.9% for those under a Multiple Point of Entry (MPE) strategy, due to the add-ons required for the latter. Banks under the bail-in tool averaged a target of 26.5% TREA and those under a transfer tool 23.5%, due to the potentially lower need for recapitalisation.

Progress on resolvability

- Results from Sep 2021 (can have improved in the meanwhile) – Most progress has been achieved on the resolvability conditions related to loss-absorbing capacity, bail-in recognition, governance and communication. G-SIBs more resolvable than other types of banks
- *See chart below*
- By the time the assessment took place (Q3 2021), most banks still needed to complete the work on the quantification of their liquidity needs in resolution and a self-assessment of the capabilities to produce the datasets for valuation or for bail-in execution

Progress made by type of bank on the resolvability conditions prioritised by the SRB



Source: SRB

Q&A

- SRF completed by end-2023 – Is there any other contribution expected from banks after that date? Can we consider that EDIS will never happen and that developing something else would be a good idea?
  - SRF transition period ends 2023YE. Now SRF at €66bn, target ~€80bn by 2023YE. But legislation requires the SRF to correspond to 1% of covered deposits – so it is a dynamic threshold that must be maintained. Hence, contributions will depend on covered deposits developments and also if there is no utilisation of the SRF, e.g in the context of a failing bank
  - On EDIS – the SRB strongly disagrees that EDIS has been abandoned, there has not been any official communication to this extent. Instead, the focus is on making use of the available resources in the SRF and DGSs more efficient in the context of resolution
    - CMDI legislative project (BRRD3 and new DGSD) to be presented in Q1 2023 by the European Commission
  - Why is EDIS needed?
    - To avoid further fragmentation in the Banking Union
    - To treat all depositors of a cross border bank in the same way
    - To finally cap the sovereign-bank feedback loop (if DGS insufficient, the State has to step in to reimburse covered deposits up to €100k)
  - Beyond this, in the medium term, the SRF and EDIS should be merged and the system should become more similar to the US FDIC system
    - There is no distinction in the US between usage of funds for depositor reimbursement and resolution/liquidation funding, the FDIC chooses the most cost-efficient route

- For banks with difficulties accessing the wholesale debt markets, could a lowering of the MREL requirements be a solution?
  - The SRB was encouraging the concerned banks to come to the market when the "sun was shining" – some did and others did not
  - The impacted banks are mostly banks with less than €100bn B/S size (i.e. banks already subject to lighter MREL requirements) and with limited domestic capital markets base
  - The SRB already provided relief – by e.g. deciding on transitioning periods for 13 banks for final MREL compliance beyond 1 Jan 2024
  - The SRB follows the funding plans and market conditions very closely – for unknown issuers and for lower ratings, market access is more difficult, but has improved as of late
    - The higher cost of funding is an issue, but these banks will also earn more money from higher rates (however, this needs to be monitored closely because the profitability improvement may not be long-lasting)

- What about lowering MREL requirements for smaller banks via greater role for DGS resources? Clearly, under the condition of necessary legislative changes
  - The SRB reminded that one of the thoughts behind the CMDI project of the Commission is to push more banks into resolution rather than liquidation strategies (lower disruption, lower costs to the whole system)
  - However, these banks would have to have MREL resources in place and there is unwillingness to lower the 8% TLOF condition for access to the SRF – hence, the DGS could act as a "bridge" between available MREL resources and the SRF
  - To enable the intervention of the DGS, then there are a couple of reforms needed:
    - Harmonisation of the Least Cost test (cost of paying out all covered depositors and then recuperating funding from bank liquidation versus "alternative" measures, such as financing resolution)
    - All depositors to rank pari passu: DGS only covers the most senior depositor layer, which makes intervention in a resolution remote or it needs the situation to worsen to such a degree that covered depositors are the only unsecured liability left -> by that time the bank is likely to be beyond the point of successful resolution
    - Introduce general depositor preference: to avoid NCWO and potential moral hazard of the DGS having to intervene to support also senior preferred holders (because of pari passu ranking and NCWO obligations)

- What, if any, are the benefits for banks of not calling Senior MREL instruments (if call is skipped, the bond is no longer included in MREL)?
  - It still remains a bail-inable resource, so it can contribute to meeting the objective of resolvability
  - Not calling a Senior (preferred) instrument can contribute to resolving a No Creditor Worse Off issue
  - Then there are liquidity and funding benefits
  - Banks must be mindful of signalling effects of not calling to the market and how they communicate
  - The biggest benefit of a non-call is clearly for AT1 instruments, as they keep their capital benefit into perpetuity versus diminishing capital/MREL content for Tier 2 and senior instruments

Disclaimer

This material has been prepared by a member of the Front Office department of Crédit Agricole Corporate and Investment Bank or one of its affiliates (collectively "Crédit Agricole CIB"). Front Office personnel are not part of the research department and this material does not constitute "Investment Recommendations" as defined under the Market Abuse Regulations (MAR). It does not constitute research as considered by the Markets in Financial Instruments Directive II (MiFID II). This material is provided for information purposes only. It is not to be construed as a solicitation or an offer to buy or sell any financial instruments and has no regard to the specific investment objectives, financial situation or particular needs of any recipient. It is not intended to provide legal, tax, accounting or other advice and recipients should obtain specific professional advice from their own legal, tax, accounting or other appropriate professional advisers before embarking on any course of action. The information in this material is based on publicly available information and although it has been compiled or obtained from sources believed to be reliable, such information has not been independently verified and no guarantee, representation or warranty, express or implied, is made as to its accuracy, completeness or correctness. This material may contain information from third parties. Crédit Agricole CIB has not independently verified the accuracy of such third-party information and shall not be responsible or liable, directly or indirectly, for any damage or loss caused or alleged to be caused by or in connection with the use of or reliance on this information. Information in this material is subject to change without notice. Crédit Agricole CIB is under no obligation to update information previously provided to recipients. Crédit Agricole CIB is also under no obligation to continue to provide recipients with the information contained in this material and may at any time in its sole discretion stop providing such information. Investments in financial instruments carry significant risk, including the possible loss of the principal amount invested. This material is not intended to forecast or predict future events. Past performance is not a guarantee or indication of future results. Any prices provided herein (other than those that are identified as being historical) are indicative only and do not represent firm quotes as to either price or size. Financial instruments denominated in a foreign currency are subject to exchange rate fluctuations, which may have an adverse effect on the price or value of an investment in such products. None of the material, nor its content, nor any copy of it, may be altered in any way, transmitted to, copied or distributed to any other party without the prior express written permission of Crédit Agricole CIB. This material, in whole or in part, is not directed at, or intended for distribution to or use by, any person or entity domiciled or resident in any jurisdiction where such distribution, publication, availability or use would be contrary to applicable laws or regulations of such jurisdictions. No liability is accepted by Crédit Agricole CIB for any damages, losses or costs (whether direct, indirect or consequential) that may arise from any use of this material.

United States of America: The delivery of this material to any person in the United States shall not be deemed a recommendation to effect any transactions in any security mentioned herein or an endorsement of any opinion expressed herein. Recipients of this material in the United States wishing to effect a transaction in any security mentioned herein should do so by contacting Credit Agricole Securities (USA), Inc.

Regulatory Disclosure: Crédit Agricole Corporate and Investment Bank is authorised and regulated by the Autorité de Contrôle Prudentiel et de Résolution (the "ACPR") and supervised by the European Central Bank (the "ECB"), the ACPR and the Autorité des Marchés Financiers (the "AMF") in France. Crédit Agricole Corporate and Investment Bank London is authorised by the Prudential Regulation Authority and subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. Details about the extent of our regulation by the FCA and the PRA are available from Crédit Agricole Corporate and Investment Bank London on request.

Crédit Agricole Corporate and Investment Bank is a public limited company ("société anonyme") under French law, incorporated in France under SIREN number 304187701 at the Nanterre Trade and Companies Registry, with limited liability and its head office address at 12, Place des États-Unis, CS 70052, 92547 Montrouge Cedex, France. It is registered in England and Wales as an overseas company at Companies House under company number FC008194, with a UK establishment at Broadwalk House, 5 Appold Street, London, EC2A 2DA, United Kingdom (UK establishment number BR001975).