EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Insights on European banks' profitability

Bocconi
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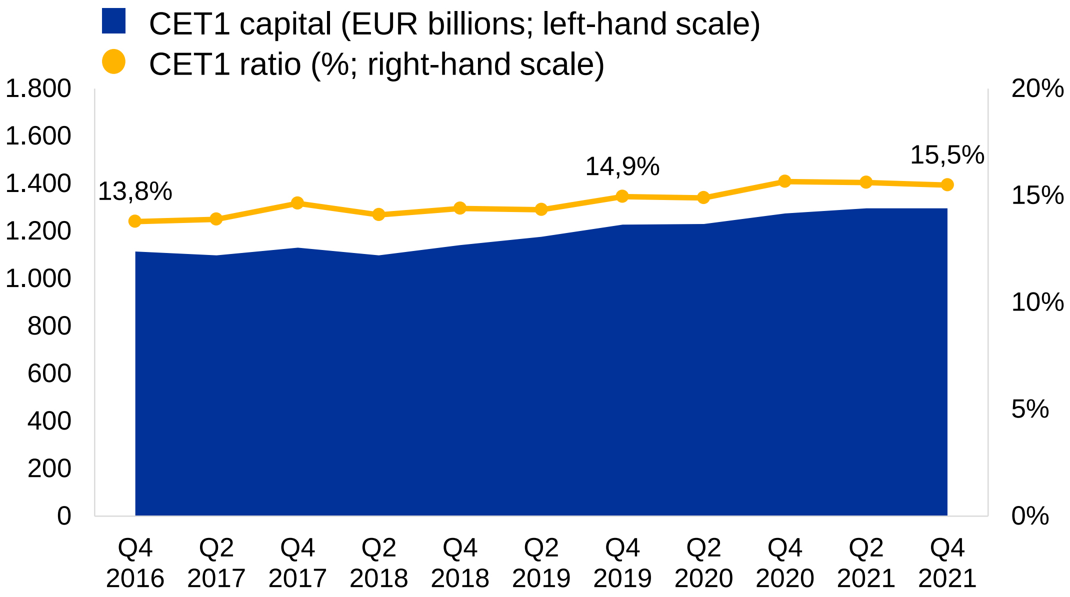
1. A snapshot of European banks’ conditions

Significant institutions' (SIs) regulatory capital proved resilient throughout the pandemic and in the wake of the RU/UA conflict (1/2)

- **Risk-based capital ratios have been on an increasing trend since the SSM inception and increasing further during the pandemic.**

- **CET1 ratio reached historically high levels in 2021 (15.5% in Q4).**

Significant institutions' aggregated CET1 capital and ratio (2016 Q4 – 2021 Q4)



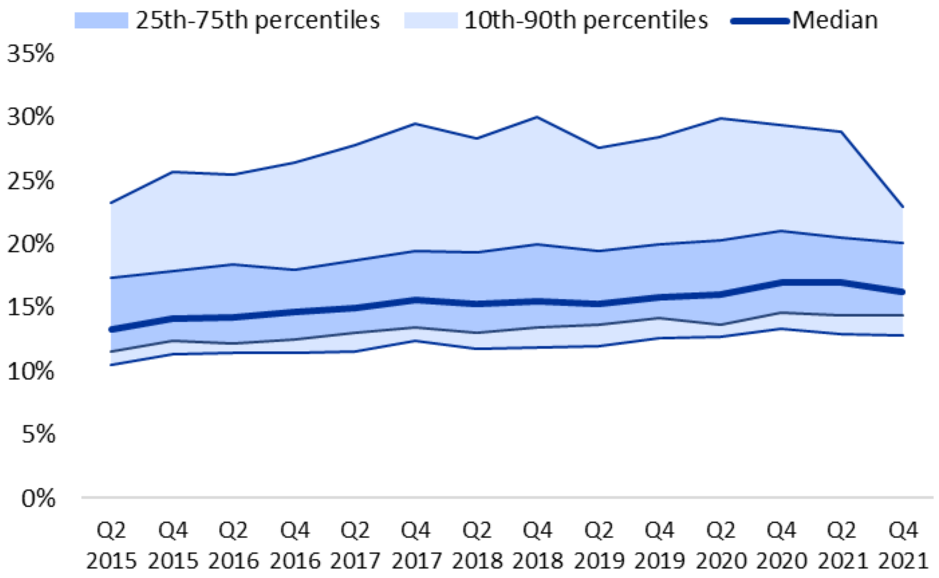
Source: Supervisory reporting. Notes: This chart shows the transitional CET1 ratio. The sample for Q4 2021 comprises 113 SIs. The number of SIs can change from one reference period to another owing to amendments to the list of SIs following assessments by ECB Banking Supervision.

Significant institutions' (SIs) regulatory capital proved resilient throughout the pandemic and in the wake of the RU/UA conflict (2/2)

- **The evolution of the SIs' CET1 distribution reflects banks' very strong fundamentals**

- **However, uncertainties stemming from increasing inflationary pressures and the economic slowdown further fuelled by the current RU/UA conflict may call for enhanced banks' prudence in their capital distribution plans.**

SSM SIs CET1% distribution evolution
(2015 Q2 – 2021 Q4; %)

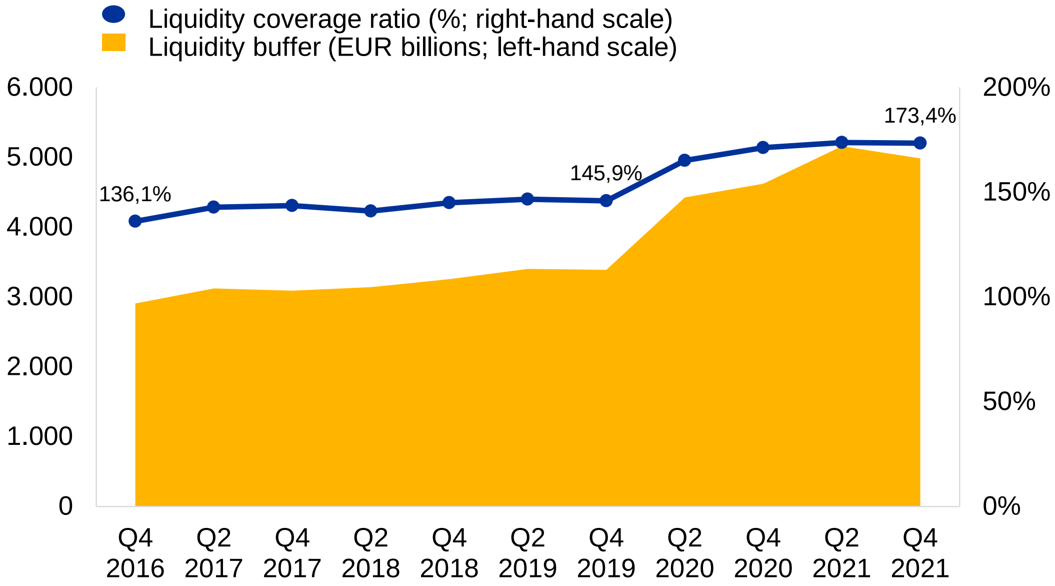


Source: Supervisory reporting. Notes: This chart shows the transitional CET1 ratio. The sample for Q4 2021 comprises 113 SIs. The number of SIs can change from one reference period to another owing to amendments to the list of SIs following assessments by ECB Banking Supervision.

SIs entered 2022 with ample liquidity buffers and available stable funding (1/2)

- **Aggregated liquidity coverage ratio stood at historically high levels (173%) in 2021 Q4.**
- **The exceptional policy measures taken at the onset of the pandemic (e.g., TLTRO III) helped support banks' liquidity positions.**

Significant institutions' aggregated LCR and liquidity buffer (2016 Q4 – 2021 Q4)

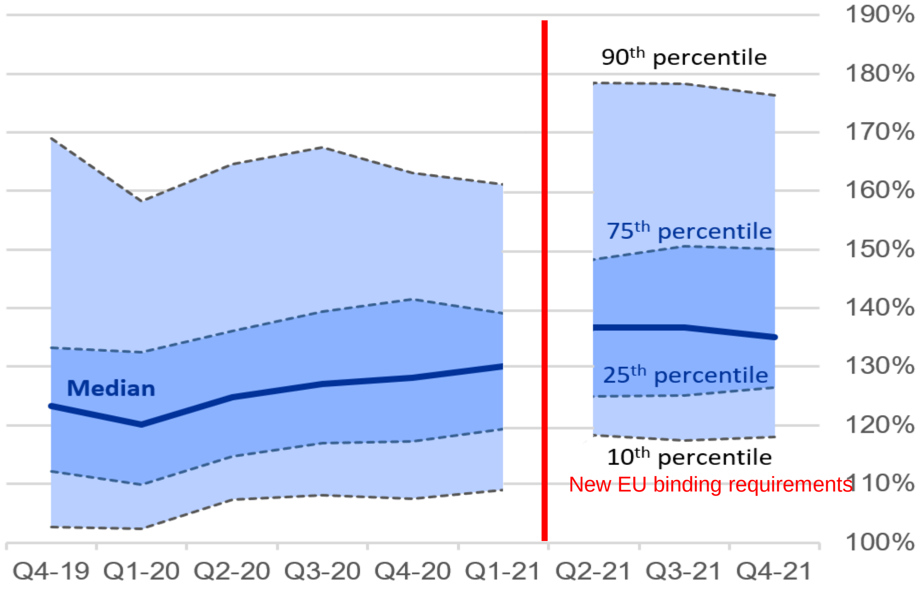


Source: Supervisory reporting. Notes: The sample for Q4 2021 comprises 113 SIs. The number of SIs can change from one reference period to another owing to amendments to the list of SIs following assessments by ECB Banking Supervision.

SIs entered 2022 with ample liquidity buffers and available stable funding (2/2)

- **Ample net stable funding ratio (129% in 2021 Q4) reflects the overall strong funding profiles of SIs.**
- **No bank was in breach with the NFSR requirements during the past year.**
- **Deposit volumes kept increasing during the past quarters, despite the low and sometimes negative remuneration provided to customers.**

SSM SIs NSFR distribution evolution
(2019 Q4 – 2021 Q4; %)

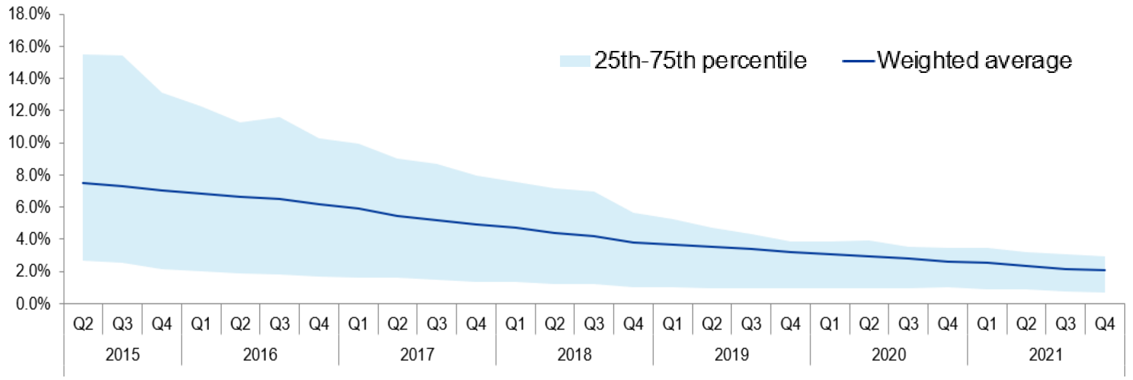


Source: Supervisory reporting. Notes: The sample for Q4 2021 comprises 113 SIs. The number of SIs can change from one reference period to another owing to amendments to the list of SIs following assessments by ECB Banking Supervision.

SIs started 2022 with record-low NPL levels, but some segments seem particularly vulnerable to asset quality deterioration

- **NPL ratio kept improving in 2021 (c. 2.1% in 2021Q1) driven by the economic recovery, support measures and high-NPL banks' disposals.**
- **Early signs of credit quality deterioration reported in sectors more sensitive to the impact of the pandemic (e.g., travel and accommodation sectors) and might further expand on the back of the RU/UA conflict and related economic uncertainty**

SSM SIs non-performing loans (NPL) ratio distribution evolution
(2015 Q2 – 2021 Q4; %)



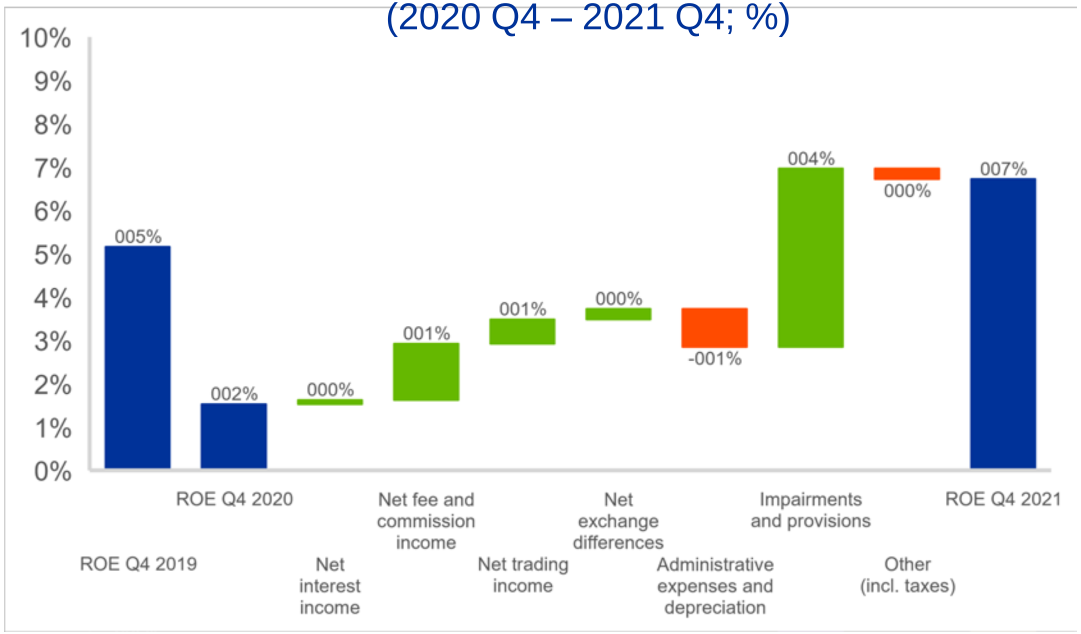
Source: Supervisory reporting. Notes: The sample for Q4 2021 comprises 113 SIs. The number of SIs can change from one reference period to another owing to amendments to the list of SIs following assessments by ECB Banking Supervision.

Banks' profitability recovered from the pandemic in 2021, driven by the reversal of credit impairments and an increase in non-interest income

- **In 2021, ROE rebounded and fully recovered from the pandemic.**
- **Lower credit impairments were the main driver, raising concerns about medium-term sustainability as, amidst rising uncertainties, economic growth slowdown is expected to weigh on banks.**
- **However, enhanced revenue diversification is a positive sign.**

ROE annualised decomposition

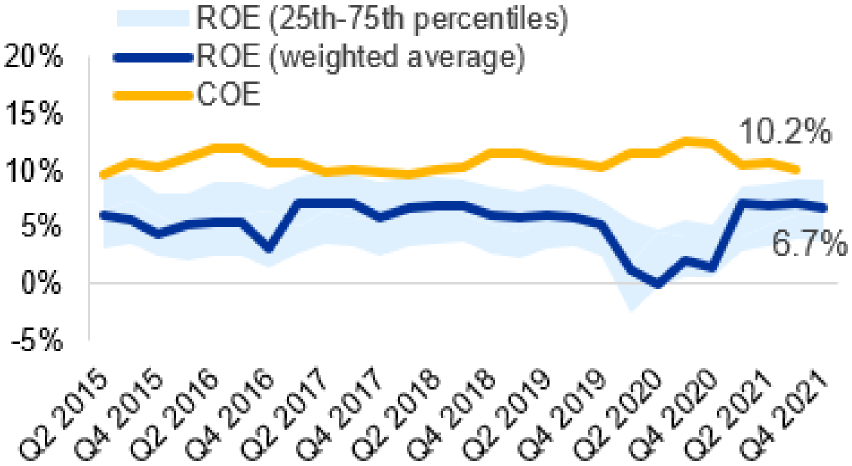
(2020 Q4 – 2021 Q4; %)



Source: Supervisory reporting. Notes: The sample for Q4 2021 comprises 113 SIs. The number of SIs can change from one reference period to another owing to amendments to the list of SIs following assessments by ECB Banking Supervision.

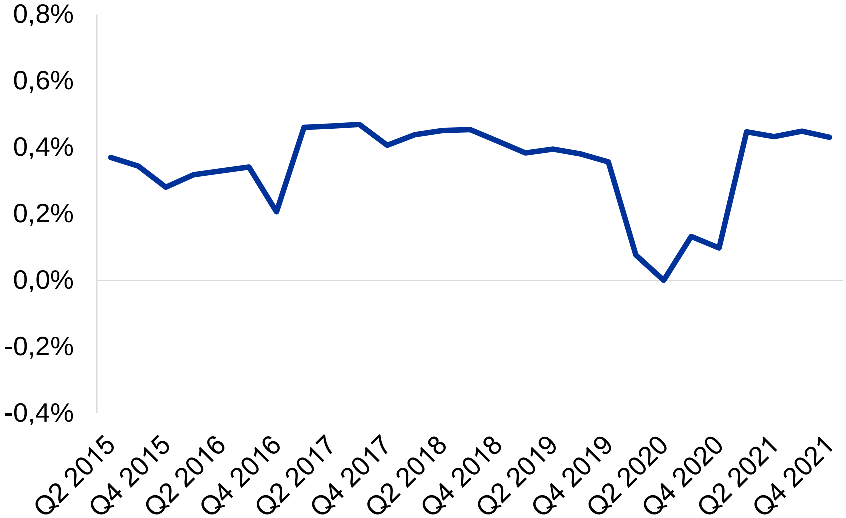
Despite the recent recovery, SI's profitability is still low overall and remains below cost of equity

ROE and COE evolution
(2015 Q2 – 2021 Q4; %)



Source: Supervisory reporting. Notes: The sample for Q4 2021 comprises 113 SIs. The number of SIs can change from one reference period to another owing to amendments to the list of SIs following assessments by ECB Banking Supervision.

ROA evolution
(2015 Q2 – 2021 Q4; %)



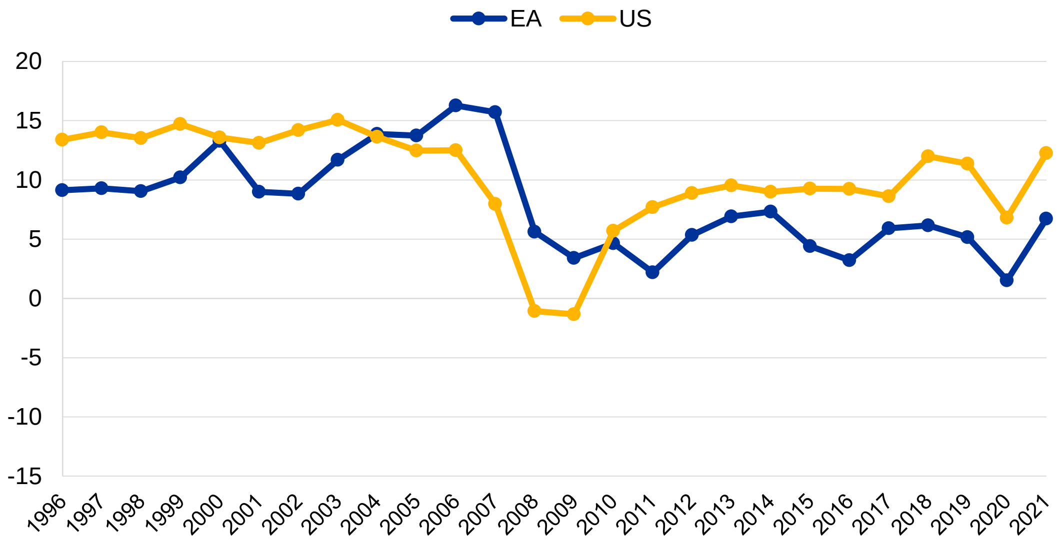
Source: Supervisory reporting. Notes: The sample for Q4 2021 comprises 113 SIs. The number of SIs can change from one reference period to another owing to amendments to the list of SIs following assessments by ECB Banking Supervision.

2. SIs profitability – a comparison with US peers

Since the Global Financial Crisis (GFC), European banks' profitability has lagged behind that of US peers

- **After the GFC, the US economy rebounded strongly, while the EU entered in a double-dip recession.**
- **Since then, profitability has strongly differed among jurisdiction, being considerably lower for the latter.**

US vs EA Return on Equity
(full banking system, 1996 – 2021, %)

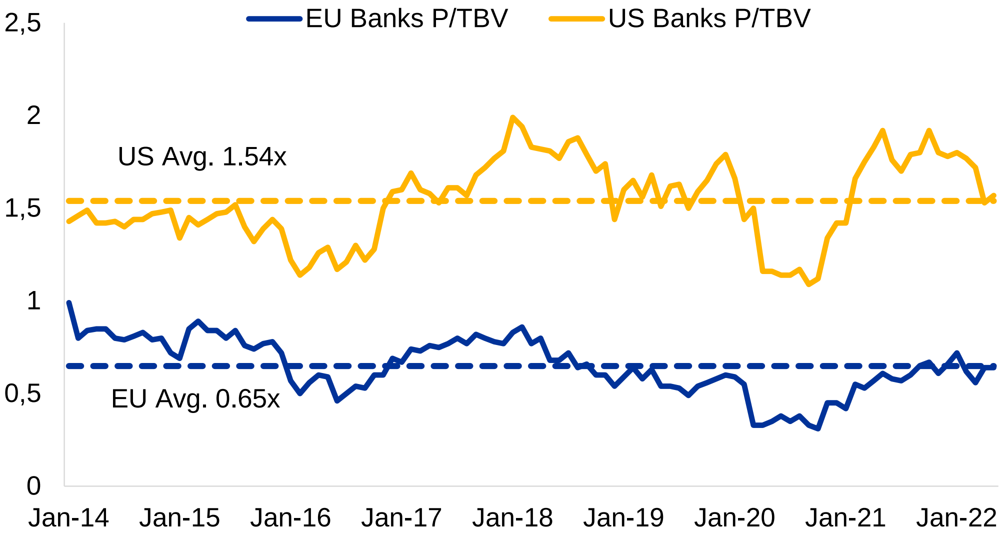


Sources: FDIC data for US banks, FRED (1996–2014) and ECB supervisory data (2015-2021H1) for EA banks.
Note: FRED data includes a sample of all US banks whereas ECB supervisory data includes a changing composition of EU banks participating in the SSM.

Investors also appear to be less optimistic about EU banks still today

- **According to market valuations, investors are far less optimistic when compared to US peers, and expect this relative underperformance to last, as shown by the gap in the P/TBV ratio.**

US vs EU Price to Tangible Book Value
(Jan-2014 – Apr-2022; multiplier)

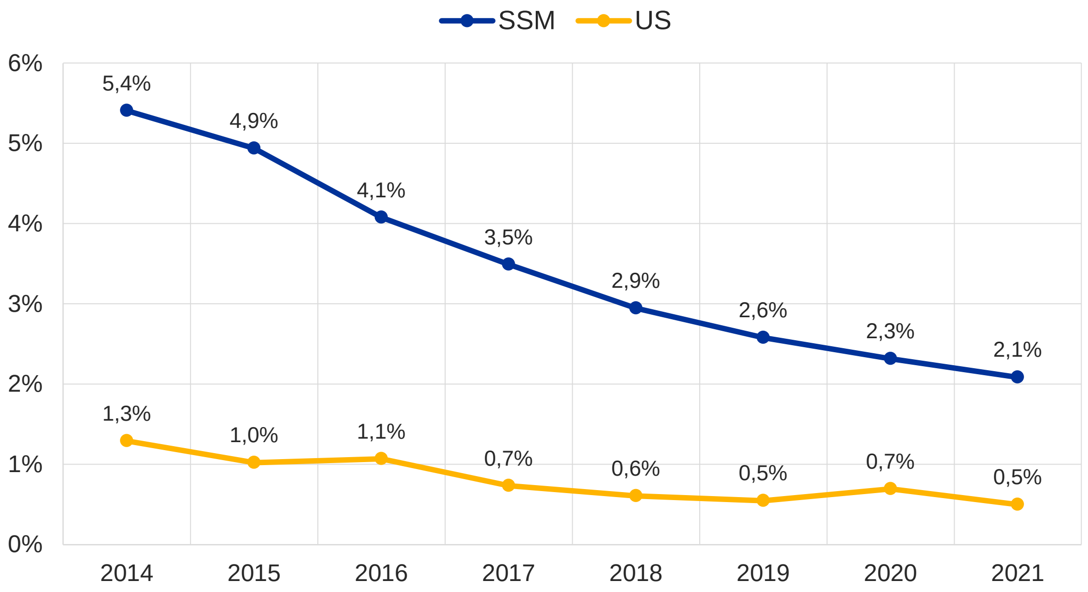


Source: Bloomberg, SDW, and ECB staff calculation. EU is built with EUROSTOXX Banks. Note: Cut-off date is 28 April 2022.

Non-performing loans originated during the GFC are still weighing on European SI, although the gap vis-à-vis US is closing

- **Significant institutions have been dealing with the burden of legacy NPLs built up during the Global Financial Crisis and the sovereign debt crisis.**
- **The repair process started earlier in the US. Banks have dealt more efficiently with their non-performing exposures (also supported by positive cyclical factors)**
- **Over time, this gap has been narrowing.**

Non-performing loans (NPL) ratio (2014-2021, %)



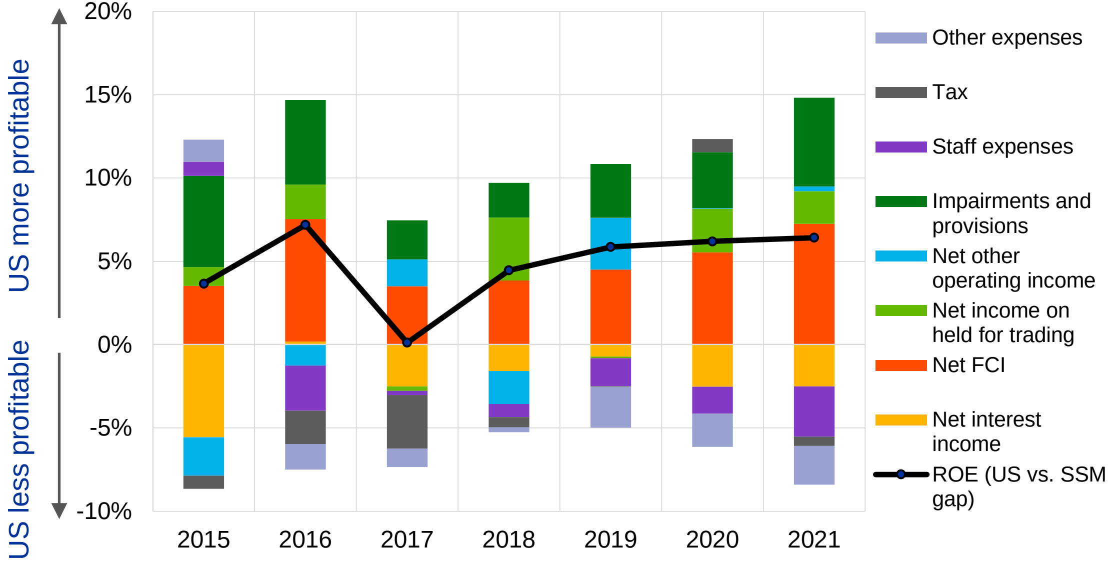
Sources: ECB Supervisory data and ORBIS.
Note: Sample comprises SSM and US G-SIB banks, using total assets as the defining metric.

Non-core revenues and provisions stand out as the main drivers explaining the EU vs. US banks' profitability gap

- **There are three P&L items that structurally contribute to the differences in ROE: NFCI, NTI, Impairments and provisions.**
- **This analysis also reveals a negative contribution of staff and other expenses, as these costs seem to be higher for US banks.**
- **The negative sign in the impact of NII results from European banks being more reliant on lending activities than better diversified US peers.**

Decomposition of the US vs SSM SIs ROE gap

(2015 – 2021; %)



Sources: FINREP and ORBIS.

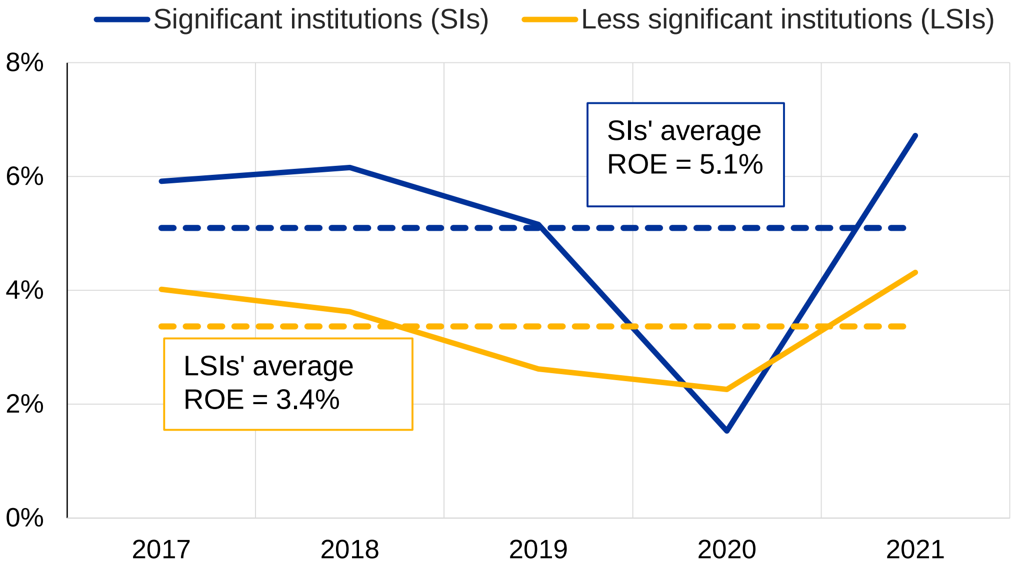
Notes: Sample comprises SSM and US G-SIB banks. Net other operating income includes net insurance income, net gains on real estate, net gains on securities at FV (through P&L and OCI), and other operating income.

3. Zooming in into LSIs

Concerns about low profitability remain when looking at Less Significant Institutions (LSIs)

- **During the past five years, average profitability have remained around 1.7pps lower for LSIs when compared to SIs.**
- **However, larger banks have also witnessed more volatile profitability figures during the COVID-19 crisis.**

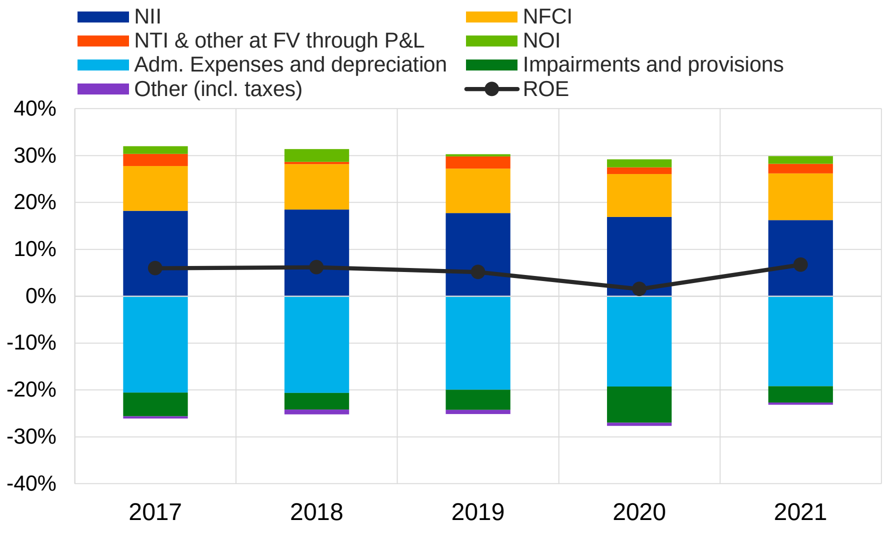
Return on equity for SIs and LSIs
(2017 – 2021; %)



Sources: Supervisory data and ECB calculations. Notes: The number of banks considered within each group can change from one reference period to another, also owing to amendments to the list of SIs following assessments by ECB Banking Supervision.

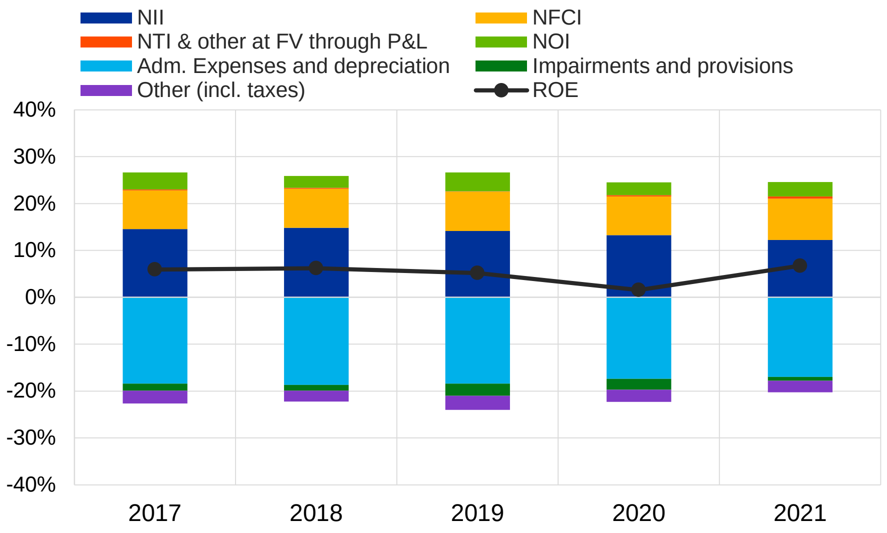
Core revenues seem to be the main driver behind over-profitability of SIs

ROE decomposition for SIs (2017-2021)



Source: Supervisory reporting. Notes: The sample for Q4 2021 comprises 113 SIs. The number of SIs can change from one reference period to another owing to amendments to the list of SIs following assessments by ECB Banking Supervision.

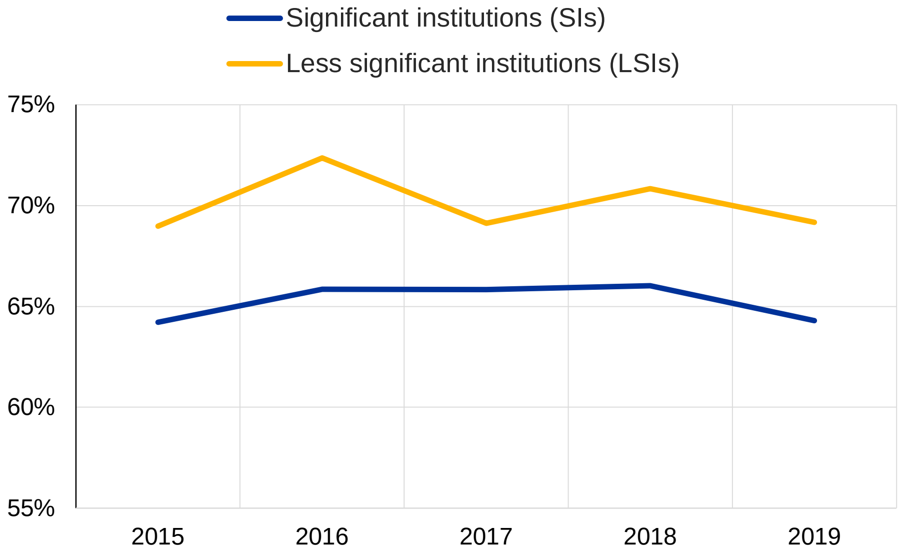
ROE decomposition for LSIs (2017-2021)



Source: Supervisory reporting. Notes: The sample for Q4 2021 comprises 2105 LSIs. The number of institutions in this group can change from one reference period to another.

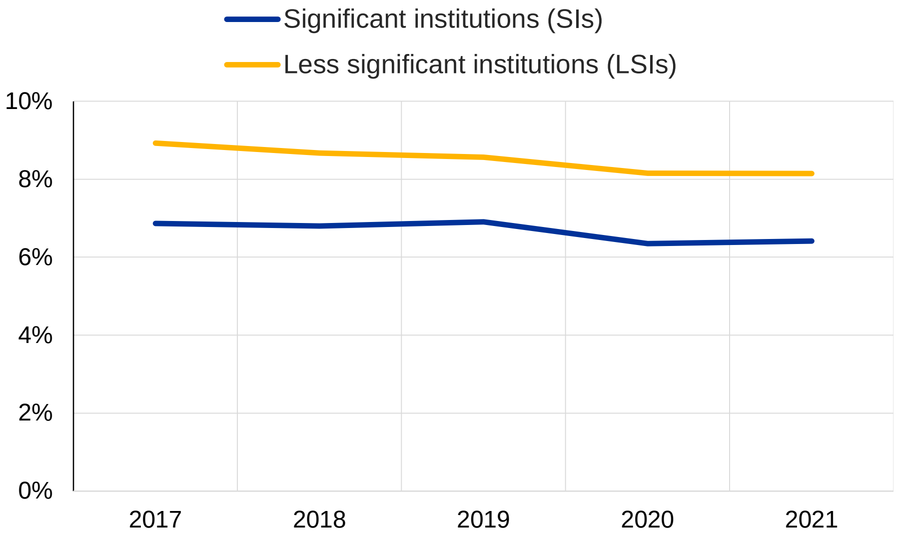
Subsequent differences in income-led cost efficiency plus leverage (both higher for SIs) help explain the bulk of the profitability gap

Cost-to-income ratio (2017 – 2021; %)



Sources: Supervisory data and ECB calculations. Notes: The number of banks considered within each group can change from one reference period to another, also owing to amendments to the list of SIs following assessments by ECB Banking Supervision.

Total Equity as a percentage of Total Assets (2017 – 2021; %)



Sources: Supervisory data and ECB calculations. Notes: The number of banks considered within each group can change from one reference period to another, also owing to amendments to the list of SIs following assessments by ECB Banking Supervision.

Conclusions

- **Euro are banks continue to show low profitability, hardly covering the cost of equity**
- **Profitability remains lower than for US peers, as also reflected in market valuations**
- **There are several reasons, partly exogenous and partly endogenous**

The SSM is acting in order to strengthen business model sustainability for our supervised institutions. Special attention is paid to the following areas.

1. **Technological innovation.** SSM Supervisory Priorities for 2022 include the digitalisation of the banking system as one of the key areas of concern. In this regard, supervisory activities are being carried out to ensure adequate digitalisation strategies, which would improve cost efficiency and profitability.
2. **Overcapacities.** The SSM is using its supervisory tools to facilitate sustainable consolidation projects. Last year, the publication of the Guide on the Supervisory Approach to Consolidation helped clarify key aspects related to capital requirements and the temporary use of existing internal models.

Overall, the application of SSM's Supervisory Priorities, that aim at a more healthy and resilient banking system, will ultimately also contribute to improve business model sustainability and hence profitability.