eba European Banking Authority

RISK ASSESSMENT REPORT OF THE EUROPEAN BANKING AUTHORITY

EBA/REP/2024/12 JULY 2024

Abbreviations and acronyms

Abbreviation	Meaning
ABS	asset backed securities
AI	Artificial Intelligence
AML	anti-money laundering
ASW	asset swap
AT1	Additional Tier 1
BCBS	Basel Committee on Banking Supervision
BIS	Bank for International Settlements
bps	basis points
CBDC	central bank digital currencies
CDD	customer due diligence
CET1	Common Equity Tier 1
CFT	countering the financing of terrorism
CIR	cost-to-income ratio
CLO	collateralised loan obligation
CMBS	Commercial Mortgage Backed Security
COREP	Common Reporting
CRD	Capital Requirements Directive
CRE	commercial real estate
CRR	Capital Requirements Regulation
DORA	Digital Operational Resilience Act
EBA	European Banking Authority
ECB	European Central Bank
EEA	European Economic Area
ENISA	EU Agency for Cybersecurity
ESAs	European Supervisory Agencies
ESG	Environmental, Social and Governance
ESRB	European Systemic Risk Board
EU	European Union
EuReCA	European reporting System for material CFT/AML weaknesses
FINREP	Financial reporting
Fintechs	financial technology
FSB	Financial Stability Board
FVtOCI	fair value through other comprehensive income
FVtPL	fair value through profit and loss
GDP	gross domestic product
G-SIIs	Global Systemically Important Institutions
HFT	Held for trading
HNWI	high-net-worth individual
HoldCo	holding company
HQLA	high-quality liquid assets
ICs	Insurance Corporations
ICT	information and communication technology
IFs	Investment Funds
IFRS	International Financial Reporting Standard
IMF	International Monetary Fund
IRB	internal ratings based
US	United States
YE	year end
IRF/IRD	Investment Firms Directive
IRRBB	interest rate risk on banking book
IT	Information technology
ITS	implementing technical standards
LCR	liquidity coverage ratio
LGD	loss given default
LTV	loan-to-value
M&A	merges and acquisitions
MFI	Monetary financial Institutions
ML	money laundering
MMF	money market fund
MREL	minimum requirement for own funds and eligible liabilities
MRO	main refinancing operations
NBFI	non-bank financial intermediaries
NFC	Non-financial corporation
NFCI	net fee and commission income
NII	net interest income
NIM	net interest margin
NPL	non-performing loan
NSFR	net stable funding ratio
NTI	net trading income
NYCB	New York Community Bancorp, Inc.
OCR	overall capital requirement
OFI	Other Financial Institutions sector
O-SIIs	Other Systemically Important Institutions
P&L	profit and loss
p.p.	percentage points
P2G	Pillar 2 Guidance
PD	probability of default
PMI	purchase manager index
QoQ	quarter-on-quarter
RAQ	risk assessment questionnaire
RAR	risk assessment report
REITs	real estate investment trusts
RoA	return on assets
RoE	return on equity
RRE	residential real estate
RWA	risk-weighted assets
SME	small and medium-sized enterprise
SNP	senior non-preferred senior
SWF	sovereign wealth fund
T2	Tier 2 capital
TF	terrorist financing
TLAC	total loss absorbing capacity
TLTRO	targeted longer-term refinancing operation
TT	top tier
UK	United Kingdom
YtD	year to date
YoY	year-on-year

Risk assessment report - July 2024

With this edition the European Banking Authority (EBA) resumes the semi-annual publication of its Risk Assessment Report (RAR). It follows the common structure of the RAR, but also includes the analysis of asset encumbrance and funding plan data, which had previously been published in two separate reports.([1]) It furthermore covers an in-depth analysis of EU/EEA banks' commercial real estate (CRE) exposures as well as EU/EEA banks' interconnections with non-bank financial intermediaries (NBFIs) in two separate chapters.

This RAR was prepared by the Economic and Risk Analysis Department.([2]) The report has benefited from input and comments from other Departments across the EBA as well as from members of the EBA's Supervision, Risks and Innovation Standing Committee (SUPRISC), Resolution Committee (ResCo), and Board of Supervisors (BoS). Many thanks as well to the editors of this version of the RAR.

Executive summary

EU/EEA banks face elevated uncertainty. This is not least due to high geopolitical risks as well as an uncertain outlook for economic growth. Despite first cuts in interest rates by central banks in several jurisdictions, they are at elevated levels and expectations on rates are increasingly uncertain.

Loan growth of EU/EEA banks has been negatively affected by the macroeconomic and monetary conditions. Looking forward, banks plan to gradually increase loan growth. On asset quality, the share of non-performing loans (NPLs) increased for all segments amid slightly positive net NPL inflows in 2023. Banks expect asset quality to stabilise and partially even to improve compared to previously subdued outlooks. Banks also anticipate that household NPLs will grow in 2024 and next years, while corporate NPLs will rise more significantly in 2024 and then level off.

EU/EEA banks have more than EUR 1.4tn in loans collateralised by commercial real estate (CRE) following continuous growth in recent years. On average this accounts for less than 100% of banks' capital, yet there are several banks – mainly relatively small in size

– which are particularly vulnerable to downturns in this market. CRE exposures towards non-EEA-domiciled counterparties have been particularly vulnerable to recent downturns. NPL volumes in the CRE segment rose by more than 12% in 2023, yet with divergences across countries reflecting the particularly variant dynamics in the sector.

Deposits remained the most important source of funding in 2023. Central bank funding continued to decrease in 2023 amid targeted longer-term refinancing operation (TLTRO) repayments, mainly being replaced with debt securities issued. Market data shows that issuance volumes increased in 2023 but declined for covered bonds and unsecured debt during the first half of this year compared to last year. Looking forward, significant amounts of maturing minimum requirement for own funds and eligible liabilities (MREL) instruments will require their replacement.

Asset encumbrance data shows that banks increased the availability of collateral that they can use for different means of funding, including from central banks, in 2023. This offers them important room in times of stress when bond issuance might be negatively affected, or when deposits might decline.

Funding plan data shows that EU/EEA banks plan to significantly increase total long-term market-based funding in the period 2024 to 2026. 2024 is expected to be the year with the highest unsecured debt issuance volume. The strong increase in issuance volume is particularly notable for Additional Tier 1 (AT1) and Tier 2 capital (T2) instruments. Banks also plan to strongly increase secured funding issuances in 2024 and keep them at a high level in 2025 and 2026.

Liquidity positions continued to be strong in 2023. Looking forward, EU/EEA banks' liquidity coverage ratio (LCR) is expected to decrease in 2024. The net stable funding ratio (NSFR) is expected to decline in 2024, but to rise again afterwards.

EU/EEA banks' CET1 headroom above overall capital requirements (OCR) and Pillar 2 Guidance (P2G) has remained at comfortable levels. This is due to a nearly parallel rise in CET1 ratios and respective requirements. Banks' plans indicate a further rise in payouts for this year.

EU/EEA banks’ profitability increased substantially in 2023, driven by a large year-on-year (YoY) rise in net interest income (NII). The latter was mainly supported by a widening net interest margin (NIM). However, following a stabilisation of NII in mid-2023, some profitability indicators have begun to show the first signs of a decline, indicating that banks' profitability may have already peaked. In 2024, banks still expect rate rises for some loan and deposit segments, in particular for loans to and deposits from households and non-financial corporations (NFCs). Based on funding plan data, the spread between these client loans and client deposits is expected to stay nearly unchanged this year. Furthermore, banks still expect a further but considerably smaller increase in costs for market-based funding in 2024 compared to last year, which will increase pressure on NII going forward.

The relevance of operational risk has grown further. The EBA’s Risk Assessment Questionnaire (RAQ) shows that cyber risks and data security rank the highest among operational risks, followed by conduct and legal risks as well as fraud. Indications are that cyber-attacks have been on the rise, including successful ones. RAQ results also show that sanctions are still the most relevant risk relating to money laundering/terrorist financing (ML/TF). Furthermore, with regard to ML/TF risks most deficiencies are related to customer due diligence (CDD).

The activity of non-bank financial intermediaries (NBFIs) has been increasing meaningfully in the EU/EEA and worldwide over the past decade. This increases the risk that such entities might pose to banks either via direct or indirect links. EU/EEA banks’ exposures to NBFIs reached 9.2% of their total assets in 2023. On the liabilities side, the NBFI share of EU/EEA banks’ funding through deposits, repos, etc. amounts to 10.3% of banks’ total balance sheet (without including wholesale market-based funding). Direct lending by NBFIs to non-financial sectors (private credit) has become a particular focus recently amid the rapid expansion in lending volumes. Even though new players in the market offer opportunities and enhance the access to finance, there are also risks, such as operational risks and possible lower lending standards than those applied by banks.

Introduction

This report describes the main developments and trends in the EU/EEA banking sector and provides the EBA outlook on the related main risks and vulnerabilities.([3]) The Risk Assessment Report (RAR) is based on qualitative and quantitative information collected by the EBA. The report's key data sources are the following:

- EU/EEA supervisory reporting([4]);
- the EBA Risk Assessment Questionnaire (RAQ) addressed to banks;
- market intelligence as well as qualitative micro-prudential information.

This report follows the common structure of the EBA's RARs. It is furthermore complemented by two focus topics, covering CRE-related risks, and NBFI interlinkages with banks and related risks. The RAR builds on the supervisory reporting data that competent authorities submit to the EBA on a quarterly basis for a sample of 163 banks from 30 EEA countries (129 banks at the highest EU/EEA level of consolidation from 26 countries).([5]) Based on total assets, the sample covers about 80% of the EU/EEA banking sector. In general, the risk indicators and other supervisory-reporting-based charts and analysis are based on an unbalanced sample of banks, whereas charts related to the risk indicator numerator and denominator trends are based on a balanced sample.([6]) When referring to countries in the following, respective data is based on the sample of banks applicable for this jurisdiction (see Annex I) if not otherwise stated. The data related to MREL in this report is based on reporting on MREL and total loss absorbing capacity (TLAC), which covers a sample of 331 resolution entities or groups.([7]) The analysis in Chapter 3.3 replaces the report on asset encumbrance, which was previously published on an annual basis.([8]) In Chapters 2.2, 3.4 and 5.2, the analysis replaces the report on funding plans, which was previously published on an annual basis.([9]) The text and figures in this report refer to weighted average ratios unless otherwise indicated.([10]) In selected cases, some of the analysis covered in this RAR is based on data from other reporting and data submissions, such as the EBA's EuReCA.([11])

The RAQ is conducted by the EBA on a semi-annual basis, with one questionnaire addressed to banks.([12]) Answers to the questionnaires were provided by 85 European banks (Annex I) during February and March 2024. The report also analyses information gathered by the EBA from informal discussions as part of the regular risk assessments and ongoing

dialogue on risks and vulnerabilities of the EU/EEA banking sector. The cut-off date for the market data presented in the RAR was 15 June 2024, unless otherwise indicated.

Abbreviations and acronyms

[1] With this report, the EBA is discharging all relevant mandates as referred to in the Introduction.

[2] This RAR was prepared by and/or includes contributions from Alessia Benevelli, Olli Castren, Gaetano Chionsini, Valentina Drigani, Francesca Fuser, Thibault Godbillon, Raphael Kopp, Christoph Kuhn, Despo Malikkidou, Angel Monzon, Joana Neto, Achilleas Nicolaou, Andreas Pfeil, Jorge Pinto, Fernando Pires, Aleksandra Potterie, Maria Rocamora, Solene Rochefort, Marco Romeo, Wolfgang Strohbach and Giada Tubiana. Multimedia and production assistance was provided by Franca Rosa Congiu, Salvatore Corvasce, Jana Jaklic, Victoria Montero, Brendan O'Donohue and Maroua Riabi.

[3] With this report, the EBA discharges its responsibility to monitor and assess market developments and provides information to other EU institutions and the general public, pursuant to Regulation (EU) No 1093/2010 of the European Parliament and of the Council of 24 November 2010 establishing a European Supervisory Authority (European Banking Authority) and amended by Regulation (EU) No 1022/2013 of the European Parliament and of the Council of 22 October 2013.

[4] See the EBA's information on supervisory reporting.

[5] Data as of the reporting date 31 December 2023. Supervisory reporting includes, for instance, prudential reporting (common reporting – COREP), financial reporting (FINREP), as well as reporting of funding plan data. It needs to be noted that there are partially certain differences between reporting samples (on the sample of reporting banks see Annex I) and reporting requirements, such as in the level of consolidation.

[6] Being an unbalanced sample, the number of reporting banks per country may display minor variations between quarters, which might accordingly affect quarterly changes in

absolute and relative figures.

[7] Number of banks for which EBA has received both an MREL decision and MREL resources.

[8] Following the publication of the implementing technical standards (ITS) in October 2013, in 2015 the EBA began receiving quarterly data on asset encumbrance. The part covering asset encumbrance and related topics of this report monitor the evolution of asset encumbrance and contribute to the ongoing assessment of the composition of funding sources across EU/EEA banks. With this analysis the EBA discharges its responsibility to closely monitor the level, evolution and types of asset encumbrance as well as unencumbered but encumberable assets at Union level, as described in Recommendation C of the European Systemic Risk Board (ESRB) recommendation on funding of credit institutions from 20 December 2012 (ESRB/2012/2).

[9] The funding plan data is based on projections as of December 2023. See also the EBA's Guidelines on funding plan reporting. With the analysis in this report the EBA discharges its responsibility to coordinate the assessment of funding plans at Union level, including credit institutions' plans to reduce reliance on public sector funding sources, and to assess the viability of such plans for the Union banking system, on an aggregated basis, set out in Recommendation A of the ESRB recommendation on funding of credit institutions from 20 December 2012 (ESRB/2012/2).

[10] There might be slight differences between some of the risk indicators covered in the Q4 2023 version of the EBA Risk Dashboard and this report as a result of data resubmissions by banks. The Annex to the Risk Dashboard also includes a description of the risk indicators covered in this report and their calculations, and further descriptions are available in the EBA's guide to risk indicators.

[11] The EBA's EuReCA is a central database that puts together information submitted by competent authorities on serious deficiencies in individual financial institutions' systems and controls that expose these institutions to money laundering and terrorist financing (ML/TF) risk. Data refers to all sectors within the remit of the EBA's anti-money laundering/countering the financing of terrorism (AML/CFT) mandate, namely: credit

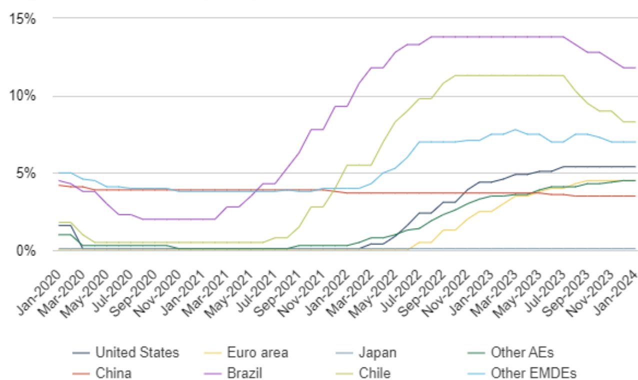
institutions, payment institutions, e-money institutions, bureaux de change, investment firms, fund managers, credit providers (other than credit institutions), life insurance undertakings and life insurance intermediaries, and an additional category of 'others'.

[12] The results of the RAQ are also published separately, together with the EBA's Risk Dashboard, on a semi-annual basis. These published RAQ booklets (latest published version is from spring 2024) also include explanations of the questionnaire and the analysis of the RAQ responses.

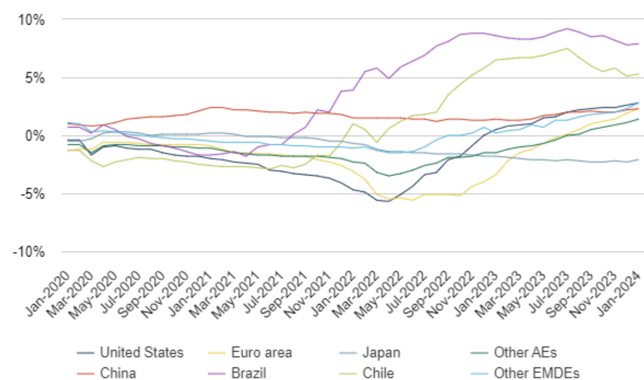
Macroeconomic environment and market sentiment

Elevated uncertainty underpins macroeconomic environment[1]

In a similar way to society and the economy more broadly, EU/EEA banks face elevated uncertainty. This is not least due to high geopolitical risks that also weigh heavily on economic growth. Furthermore, inflationary pressure has remained above central banks' target levels. Although interest rates stopped increasing, they are at historically rather elevated levels (Figure 1).



Source: IMF, May 2024



Source: IMF, May 2024

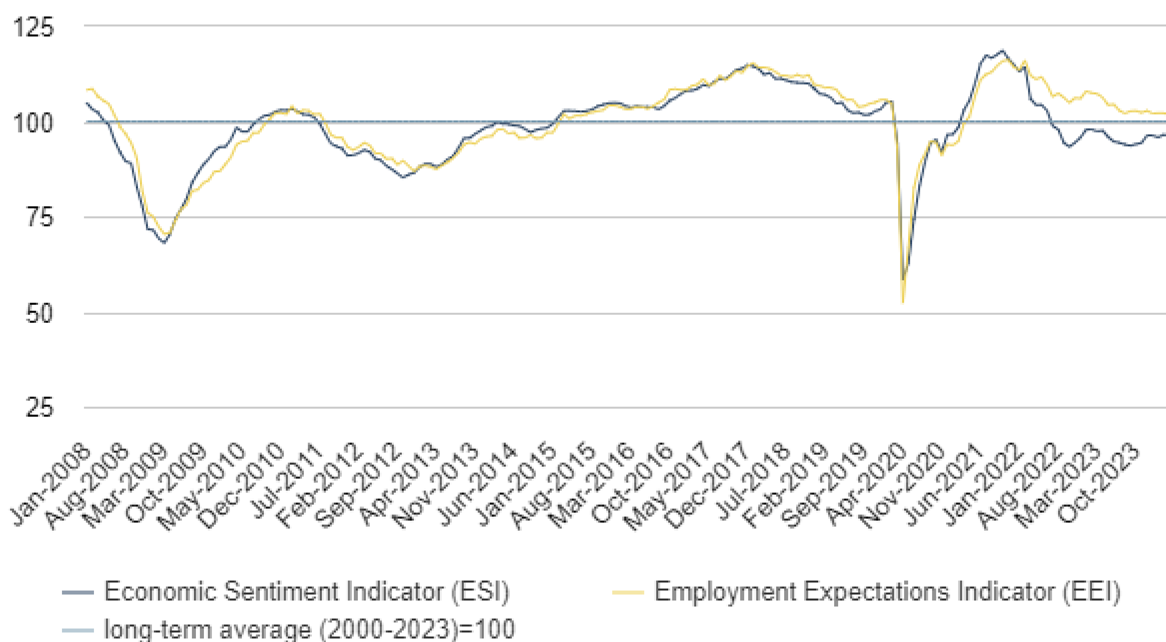
Economic activity in the EU has been subdued for five consecutive quarters, with real Gross Domestic Product (GDP) remaining at similar levels to Q3 2022. The EU economy has just avoided a technical recession. Latest Commission data points to 0.3% growth in Q1 2024 for the EU, with growth projections for 2024 at 1%. This is a slight improvement compared to the previously forecasted 0.9% growth for this year.[2] There is also a slight uptick to 1.6% in 2025. Inflation rates are also expected to ease, dropping from 6.4% in 2023 to 2.7% in 2024 and further to 2.2% in 2025 for the EU, and slightly higher than euro area (EA) expectations.[3]

Despite a rather stagnant economy, the job market remained resilient in 2023. The unemployment rate for the EU has so far also remained at its record low of 6.0% in April this year.[4] In 2023, wages continued to grow, albeit at a slower pace, with a 5.7% increase

in the EU and 5.2% in the EA compared to the previous year, primarily driven by the industrial sector. This deceleration in wage growth was widespread across various sectors and EU Member States. Despite this slowdown, wage growth is expected to continue as workers seek to regain lost purchasing power. This might adversely feed back into inflationary pressures again.

Monetary policy tightening has led to higher mortgage costs. This also caused refinancing challenges, increased bankruptcies, and reduced investment in both business and housing sectors.[5] Public debt remains 4 percentage points (p.p.) above the pre-pandemic level, despite a significant reduction of the debt-to-GDP ratio in both the EU and EA last year, reaching 83% and 90% respectively.[6]Regarding the private sector, the purchasing managers' index (PMI) for the EA increased to 51.7 in April from 50.3 in the previous month. The manufacturing sector continues to suffer, standing at 45.7, below other regions and the global index.[7]

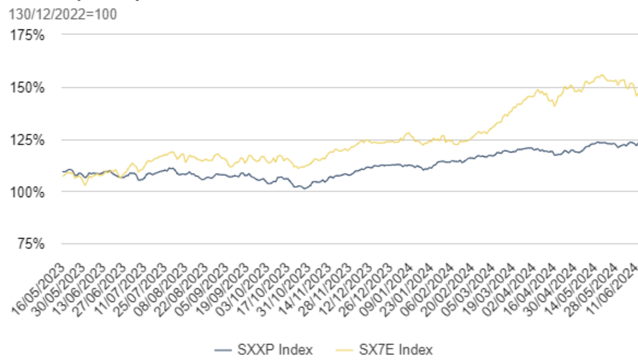
At global level, the PMI remained above 50 (52.4) in April, but still below the survey's long-run average of 53.2. Meanwhile, services, especially travel and tourism, continued to recover, while global manufacturing showed a slight improvement, at 50.3. This is in line with the results of 2023. In Q4, the global PMI for manufacturing remained in contraction at 48.9, weaker than Q3 2023. In accordance with this data, global growth is forecasted to reach 3.2% in both 2024 and 2025, keeping the same pace as the previous year. Expectations are that developed economies will perform slightly better than last year, whereas emerging market economies are expected to perform slightly worse (Figure 2).



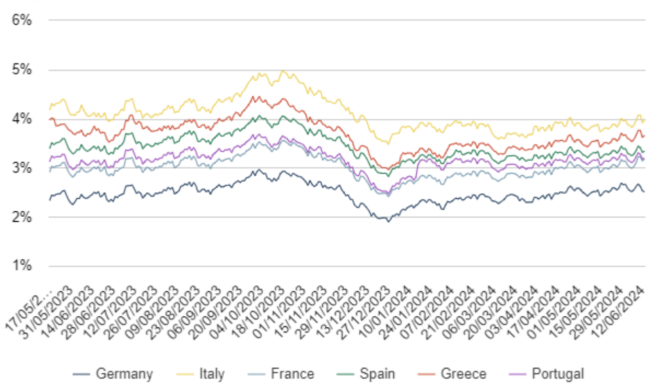
Source: Commission Forecasts, May 2024

Yield contractions

Within this environment, the European sovereign bond market has seen a general decrease in yields and a tightening of spreads, despite significant sovereign debt issuances and the reduction of European central Bank (ECB) asset purchases. As an example, the yield on the German 10-year bund dropped from 2.85% to 2.2%, dipping to 1.9% in late December 2023 (Figure 3).[8] Corporate bond spreads have in general dropped. Equity markets have been on the rise, showing confidence in monetary policy to lower inflation with minimal impact on growth. However, the spreads for the riskiest European corporate bonds have increased a bit, showing worries about the EU's weak economy and low growth prospects, which has had an impact on the credit risk of weaker firms. On interest rates, expectations are now for slower cuts by central banks than previously assumed. This follows rate cuts in the EA, Denmark, Sweden and several central and eastern European (CEE) countries.[9]The future development of monetary policy will be an important driver defining many aspects in banks' risks and vulnerabilities.



Source: Bloomberg



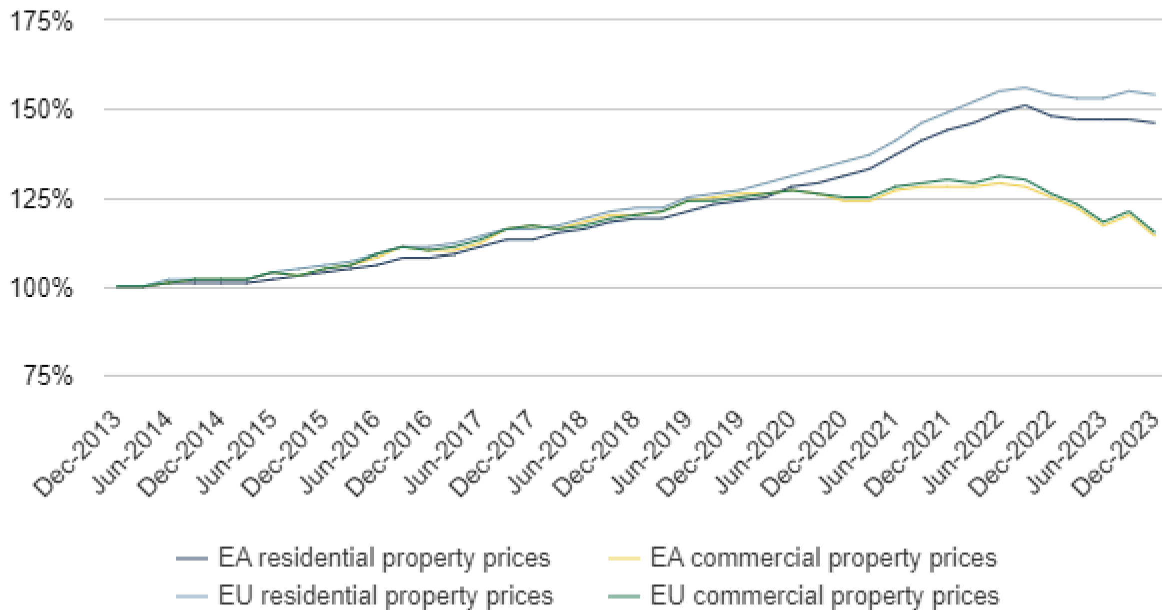
Source: Bloomberg

Real estate under scrutiny

The number of transactions in the CRE sector contracted in recent quarters. The lack of activity might continue affecting the sector in the near future, despite notable price corrections, with a decrease of 8.7% in Q4 2023 YoY.[10] In particular, office space and lower-quality CRE assets are the segments that seem to suffer the most, as a result of a sharp drop in demand. While the office space segment has mainly been affected by the spread of teleworking and the consequent reduction in rental growth expectations, lower-quality CRE assets are not least affected by concerns about stricter energy efficiency requirements and higher capital expenditure costs (see Chapter 7 on CRE-related challenges and risks in more detail). The downturn of the real estate market might also have stronger repercussions on market stability, negatively affecting NBFIs significantly exposed to the segment (see Chapter 8; Figure 4).

Figure 4: Residential property vs commercial property prices in the EA and EU *

Q4 2013 = 100



Source: ECB

*Due to the limited availability of publicly accessible data, slightly different aggregates are used for the EU RRE and CRE lines. More precisely, for RRE the EU changing composition is considered, while for CRE prices the EU27 (fixed composition) as of 31 January 2020 (Brexit) is considered.

The monetary policy tightening also influenced mortgage demand, negatively affected by increased borrowing costs, low consumer confidence and uncertainty in the housing market. In Q4 2023, the EU's housing market saw a slight rise in housing prices of 0.2% YoY with significant variation among Member States. In the same period, the EA saw a contraction in housing prices of 1.1% YoY. Housing prices have returned to a similar level to those in Q3 2022. However, a wide divergence in price trends was observed across EU Member States: the largest declines were recorded in Luxembourg (-14.4%) and Germany (-7.1%), while the largest increases were in Poland (+13.0%) and Bulgaria (+10.1%). From November 2023 to March 2024, borrowing costs have already decreased slightly, with the average interest rate dropping from 4.01% to 3.77%.[11] Nonetheless, the volume of new home loans in 2024 remains low, not surpassing the previous year's levels. The tightening of financial conditions has caused a significant slowdown in residential real estate (RRE) investment, which could negatively impact future supply. Transactions have been low, with no significant increase in activity at the start of 2024.

---

[1] The focus here is mainly on economic and similar risks. There are others, such as environmental, social and governmental (ESG) related risks. They also play a major role for the banking sector, and are accordingly covered by the EBA's work, like in the development of the Guidelines on the management of ESG risks.

[2] See the winter edition of the European Commission Economic Forecast from February 2024.

[3] See the European Commission Spring 2024 Economic Forecast from May 2024.

[4] See Eurostat Unemployment Statistics.

[5] See the IMF World Economic Outlook, April 2024.

[6] See the European Commission Spring 2024 Economic Forecast from May 2023.

[7] See S&P Global Purchasing Managers Index.

[8] See the European Commission Spring 2024 Economic Forecast from May 2023.

[9] On rate cuts, see for instance the European Commission Spring 2024 Economic Forecast from May 2023. As examples for rate cuts, see for instance the Swedish Riksbank's cut in May 2024, the National Bank of Poland rates with the last change in October 2023 and the National Bank of Hungary's rate history.

[10] See the ECB Financial Stability Review, May 2024.

[11] See the European Commission Spring 2024 Economic Forecast from May 2023.

Asset side

The growth of EU/EEA banks' assets has been affected by the weak economic growth, the persistent inflationary pressures – that are still above the central banks' target levels – and the relatively high interest rate levels. Banks have further lowered their cash balances, as they completed the repayments of the ECB's TLTRO, but they still hold relatively high levels of their assets in liquid assets. Expectations in the real estate markets have reduced the demand for housing loans, while geopolitical risks may have also encouraged borrowers to delay long-term investments. EU/EEA banks accordingly reported low loan growth since back in September 2022. This development was additionally affected by banks' limited willingness to take risks and grow their balance sheets, making their credit standards stricter. The effects of this slowdown could feed into an adverse loop of lower economic growth in the medium term and also affect directly (and indirectly) EU/EEA banks' performance. However, data on funding plans from EU/EEA banks shows an intention to gradually increase loan growth for both households and businesses. For the period from 2024 to 2026, banks expect cumulative lending growth of 12.4% for businesses and 7.1% for households.

The signs of worsening asset quality that banks, supervisors and market players anticipated in previous quarters began to appear, although slowly, during 2023. Rising living costs due to inflation and high interest rates have put some pressure on borrowers that have had to cope with lower debt repayment ability. The still strong labour markets may have partly offset the impact of weak economic growth on asset quality. In this context, the share of NPLs increased for all segments, and there was a slightly positive net NPL inflow in 2023. Despite banks' slight improvement in asset quality expectations, especially for households, the increased share of stage 2 loans and the ongoing macroeconomic instability do not permit any relaxation and require a thorough assessment of credit risk.

Assets: volume and composition

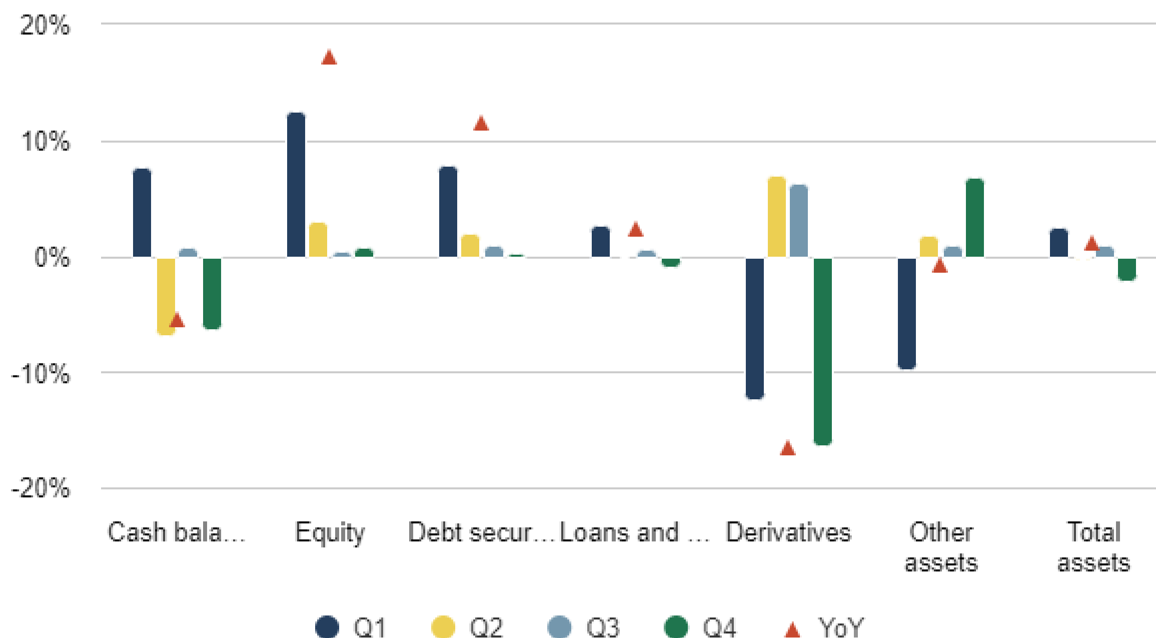
Cash balances and subdued loan growth limit asset expansion

The overall uncertainty in the macroeconomic environment remains elevated and this has impacted EU/EEA banks’ risk appetite to further expand their balance sheets. As of Q4 2023, EU/EEA banks’ total assets stood at EUR 27.3tn. This reflected an increase of +1.1% on a YoY basis.

The assets development in 2023 for the EU/EEA banking sector was mainly driven by the ongoing trend to reduce cash balances (-5.5% YoY), mainly due to the repayment of ECB’s TLTRO facilities. It was also characterised by a lately emerging rise in debt securities (+11.6% YoY), including sovereign exposures. The latter could be explained by banks aim to lock-in higher yields for the medium to long-term, and might also explain partly the reluctance of the sector to expand their loan portfolio aggressively. Despite the higher exposures towards debt securities, the reported unrealised losses of EU/EEA banks’ debt securities recognised at amortised cost were substantially lower.[1] In December 2023, EU/EEA banks reported EUR 52bn of unrealised losses compared to more than EUR 99bn a year earlier. On average unrealised losses represent less than 3.5% of the EU/EEA banks’ capital. Yet, for the smaller 50th percentile of banks, the unrealised losses amount to more than 6.5% of their capital, while for the 10 largest institutions the equivalent is less than 2%.

Loans and advances were only up by 2.4% YoY, significantly below the rise in 2022 (+5%). Total loans and advances accounted for EUR 17.1tn in December 2023 (+0.4tn YoY). Although during the first three quarters of 2023 EU/EEA banks consistently reported increased outstanding loans, in the last quarter of the year there was a significant drop (EUR -153bn) (Figure 5).

Figure 5: Quarterly and yearly growth rates in asset components, December 2022 to December 2023



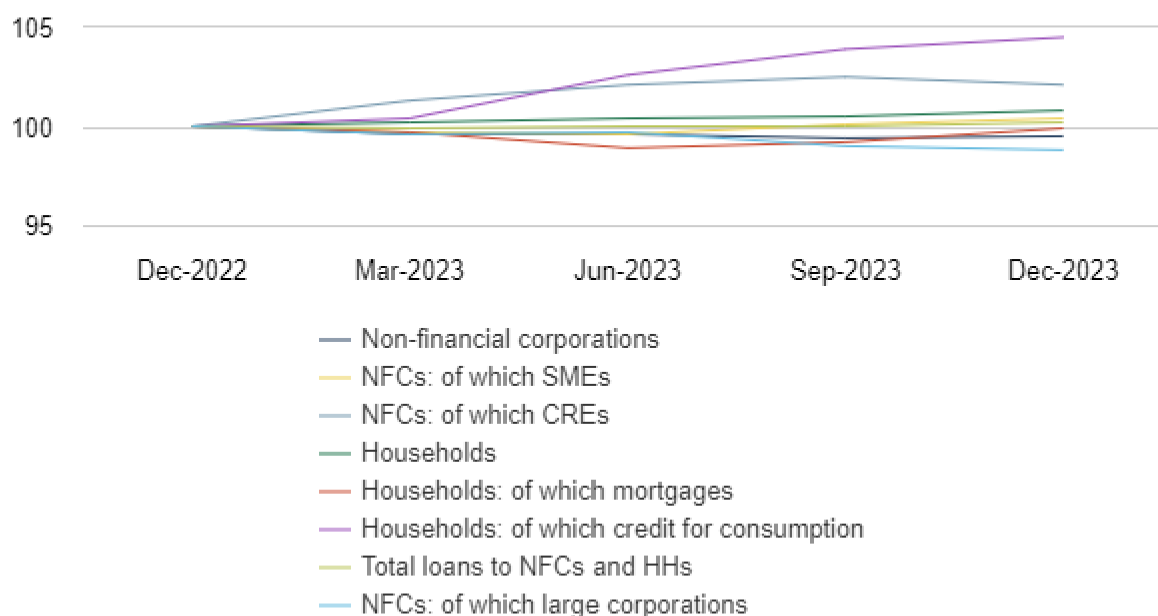
Source: EBA supervisory reporting data

Growth in credit for consumption stands out as consumers keep up with inflationary pressures

Over the course of 2023 outstanding loans towards NFCs and households remained stable at EUR 13.2tn despite the stabilisation of interest rates and increasing expectations for monetary easing. Elevated borrowing costs and economic uncertainty still adversely affected the demand for loans in the second half of 2023, while preeminent macroeconomic uncertainty still affected banks' risk-taking appetite. As of December 2023, EU/EEA banks reported exposures towards small and medium-sized enterprises (SMEs) of EUR 2.6tn (+0.4% YoY), while CRE loans stood at EUR 1.4tn (+2.1% YoY). Total loans towards NFCs accounted for EUR 6.3tn, down by 0.5% YoY. This was mainly driven by a decrease in loans towards non-SMEs (-1.2% YoY), as large enterprises scaled back their investments. Loans to these companies stood at EUR 3.7tn in December 2023. The subdued NFC loan growth in 2023 was not only due to low demand but also supply-driven. In the course of early 2024, the tightening of banks' credit standards seems to have slightly and slowly reversed. This

coincides with a reversal of banks' risk perceptions.

The overall decrease in NFC exposures was underpinned by a substantial setback in outstanding loans towards the manufacturing (-3.7% YoY) and mining and quarrying (-14.8% YoY) sectors. By contrast, NFC lending was supported by an increase in loans in the real estate activities (+2.2%) and information and communication (+5.7%) sectors, which saw the most positive impact across all sectors. EU/EEA banks' total loans towards households accounted for EUR 7.0tn (+0.8% YoY), of which EUR 4.5tn (-0.1% YoY) were loans collateralised by RRE and EUR 1tn (+4.5% YoY) was credit for consumption. Following a decline in the first half of the year, demand for house purchase revived slightly in the second half (+1% in outstanding mortgage loans), as stabilising lending rates helped demand which was also boosted by improving consumer confidence. The latter also facilitated demand for consumer credit, which has increased despite the simultaneous tightening of banks' credit standards. Higher wages and a solid job market offset the increase in living costs. As a result, outstanding credit for consumption increased by close to EUR 50bn in 2023 (+4.5% YoY). Despite related risks, CRE exposures rose by 2.1% in 2023 (Figure 6; on CRE exposures and related risks see Chapter 7).

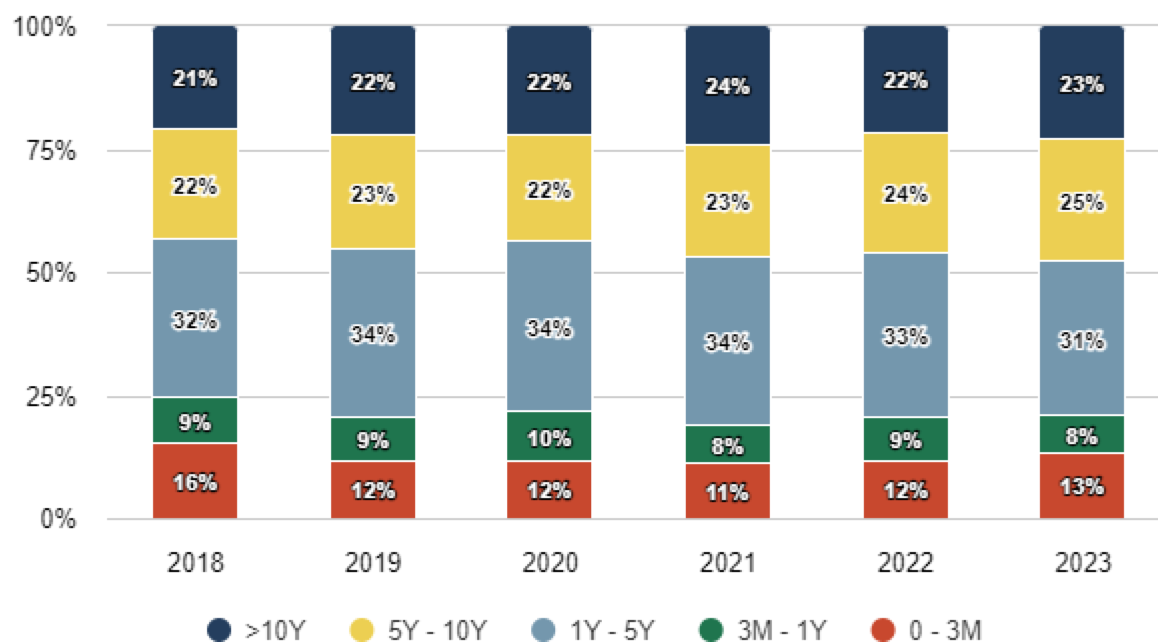


Source: EBA supervisory reporting data

EU/EEA banks further increase their sovereign exposures, tilting the maturity profile to the longer end

The substantial increase in EU/EEA banks' debt securities holdings was mostly driven by sovereign exposures. EU/EEA banks exposures of around EUR 3.4tn towards sovereign counterparties increased by 8% compared to December 2022 (EUR 3.1tn). Almost half of these exposures were towards domestically domiciled counterparties, while 27% were towards other EU/EEA countries. Sovereign exposures towards non-EU/EEA domiciled counterparties were slightly above EUR 810bn, around EUR 80bn more than a year before. Over the last few years, the maturity profile of the sovereign debt held by EU/EEA banks has tilted towards the long end. At least 48% of EU/EEA banks' sovereign exposures had a maturity of more than five years while 31% have a maturity of between one and five years.

Figure 7: EU/EEA banks' sovereign exposures maturity profile trend (year-end)



Source: EBA supervisory reporting data

This preference has been present for some years, as EU/EEA banks have been allocating a higher share of their investments to longer maturities. For example, in 2023 EU/EEA banks reported EUR 300bn more in sovereign exposures with long-term maturities than in 2018 (EUR 1.6tn vs EUR 1.3tn). Although this maturity profile may not offer a swift rollover to

higher-rate investments, it allows locking in of higher rates for a long-term investment period and might serve as a hedging instrument. Yet, it exposes banks to heightened interest rate risk which banks need to manage prudently given the recent abrupt changes in the interest rate environment (Figure 7).

Banks' credit standards ease in some cases and demand partly resurges in the recent quarter

In 2023, macroeconomic uncertainty and monetary tightening concerns led to the adoption of stricter and more prudent lending standards for both loans and credit lines to enterprises and housing loans and consumer credit for households in most EA countries. This tightening, combined with a significant contraction in loan demand, accordingly weighed on loan growth.[2] In the first quarter of 2024, EA banks still reported a slight net tightening of their credit standards for loans or credit lines to enterprises, while keeping terms and conditions broadly unchanged. Meanwhile, credit standards and terms and conditions for housing loans eased for the first time since Q4 2021, while they tightened further for consumer credit and other lending to households. Alongside the overall net tightening of lending policies, higher interest rates, lower fixed investment of NFCs and low consumer confidence of households continued to exert negative pressure on loan demand, which declined further in almost all lending segments.[3]

Outside the EA credit standards seemed to be loosening marginally, while demand is dependent on the country. Denmark's central bank lending survey, for example, reported a significant increase in corporate loan demand but a small decline in private loan demand by both existing and new customers in the first quarter of 2024, after extraordinarily high activity on the housing market at the end of 2023. In Denmark, credit conditions eased for lending to both households and corporates, due to lower risk perception and increased competition, especially in the corporate segment.[4] In Norway, household credit demand fell slightly in the first quarter of 2024, with demand for residential mortgages declining for the third quarter in a row, while corporate demand remained broadly unchanged, as did credit standards overall.[5]

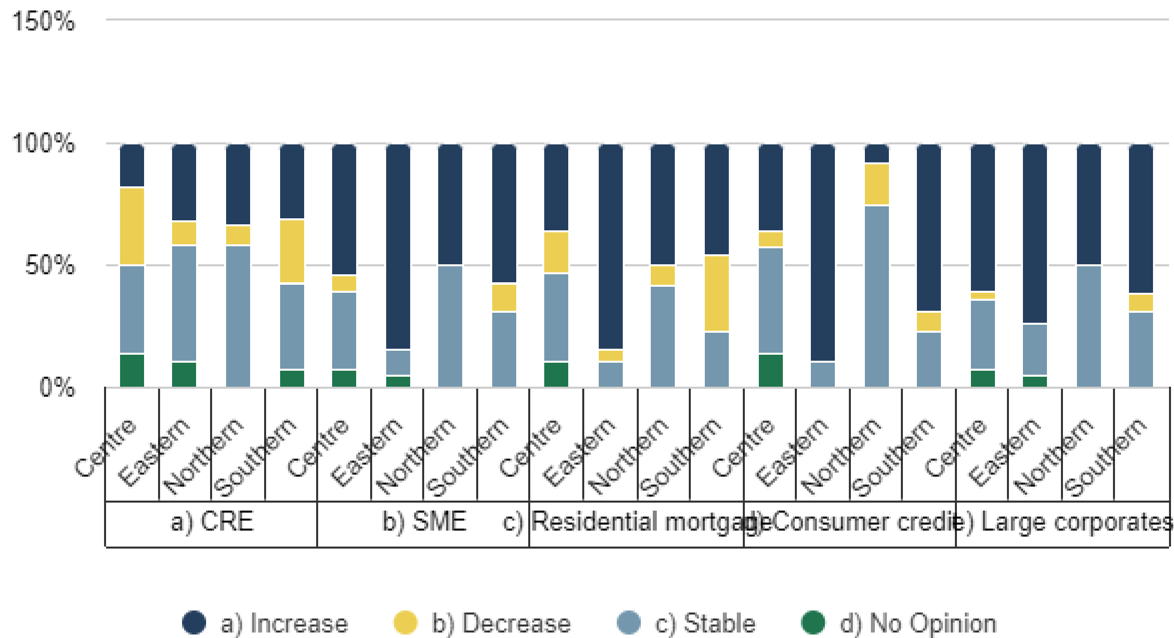
By contrast, Polish banks tightened lending policy in most segments in Q1 2024, mainly due to a reduction in the quality of the loan portfolio and the worsening of the macroeconomic

outlook. Changes in lending policy were accompanied by a significant decline in the demand for housing loans, but an increase in demand for consumer credit and loans to large enterprises.[6] Hungarian banks' willingness to grant loans and credit lines to both households and enterprises is increasing, especially in the consumer credit segment, for which credit standards have remained broadly stable in the first quarter of 2024. Instead, a change in risk tolerance driven by CRE-specific problems and the fear of a real estate bubble has led to a tightening of credit standards for commercial real estate loans, following the deteriorating quality of the loan portfolio, which has been significant for the office segment.[7]

Banks expect rising loan growth in the coming quarters

The bank lending surveys point to a similar conclusion to that of the EBA's RAQ. There is a wide divergence of loan growth dynamics depending on the region and the countries' economic cycle. However, overall loan growth dynamics seem to have shifted in the last questionnaire, as more banks indicate their intention to increase their loan exposures. A larger share of banks in eastern and southern European countries respond affirmatively in this regard compared to the other regions. In addition, certain segment-specific dynamics have emerged. For example, there is a broad consensus for banks to increase their exposures towards the SME segment. Moreover, southern and eastern European banks report overwhelmingly their intention to expand their exposures in the consumer credit space. On the other hand, only 10% of the banks in the Nordics expect to increase their exposures in consumer credit (Figure 8).

Figure 8: Portfolios which banks, by region, expect to increase/decrease in volumes in the next 12 months *



Source: EBA Risk Assessment Questionnaire

*Regions are defined in the following way: a) Northern: Denmark, Finland, Iceland, Norway, Sweden; b) Centre: Austria, Belgium, France, Germany, Ireland, Luxembourg, the Netherlands; c) Eastern: Bulgaria, Czechia, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic; d) Southern: Croatia, Cyprus, Greece, Italy, Malta, Portugal, Slovenia, Spain.

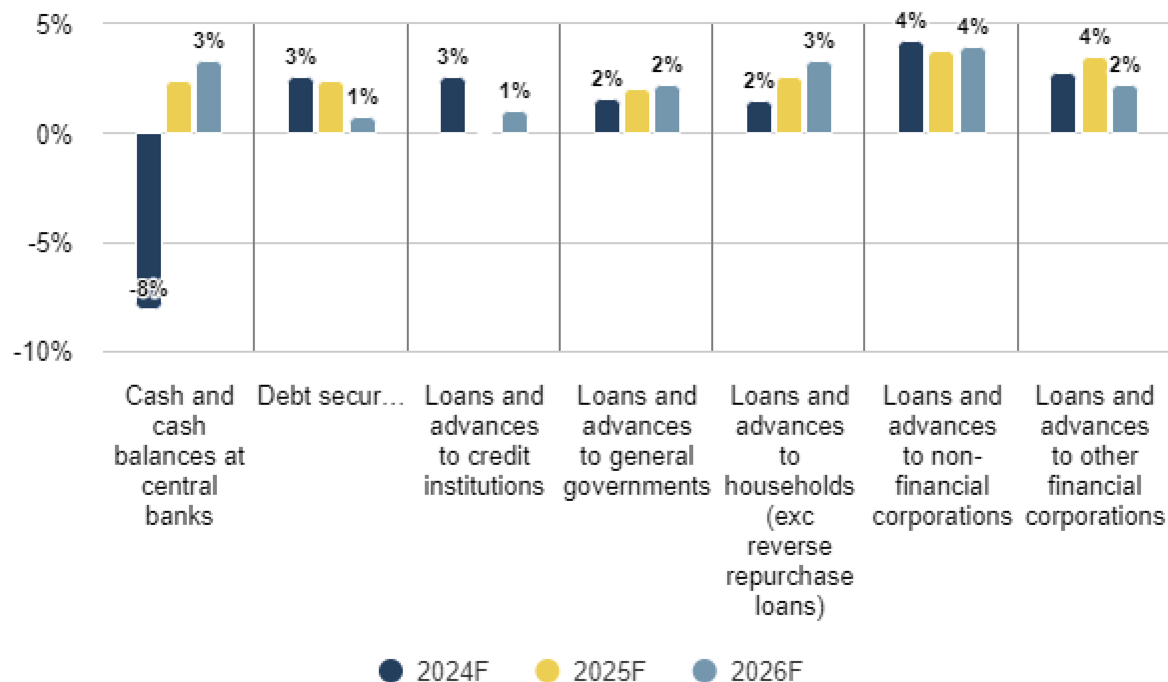
Assets: outlook

Banks forecast recovery of loan growth in the coming years

Based on EU/EEA banks' three-year funding plans, total assets will this year grow by 1.6%, while this growth rate is expected to accelerate in the following two years (2.5% and 2.6% in 2025 and 2026, respectively). In this period, banks expect to reverse the sluggish growth rate in loans towards households and NFCs observed in 2023. These are predicted to grow at 1.5% and 4.3% respectively in 2024. The growth rate will further accelerate for households (2.6% and 3.3% in 2025 and 2026), while for NFC loans the annual growth rate will remain close to 4%. The cumulative growth rate over the three-year forecasted period is 7.4% for household and 12.1% for NFC lending. The reduction of cash and cash balances at central banks is set to continue at a rate of -8.1% this year, but then turn positive again. The growth of debt securities is expected to materially slow down (2.6% in 2024 and 2.4% in 2025 and well below 1% in 2026). Whereas the decline in cash balances can presumably be explained by the remaining TLTRO repayments, the lower growth rates in debt securities going forward might be explained by the expectations that interest rates have presumably

reached their peak. This could disincentivise banks from continuing to increase their debt securities exposures in a declining rate environment (Figure 9; on rate expectations see Chapter 1).

Figure 9: Growth expectations for selected asset classes *

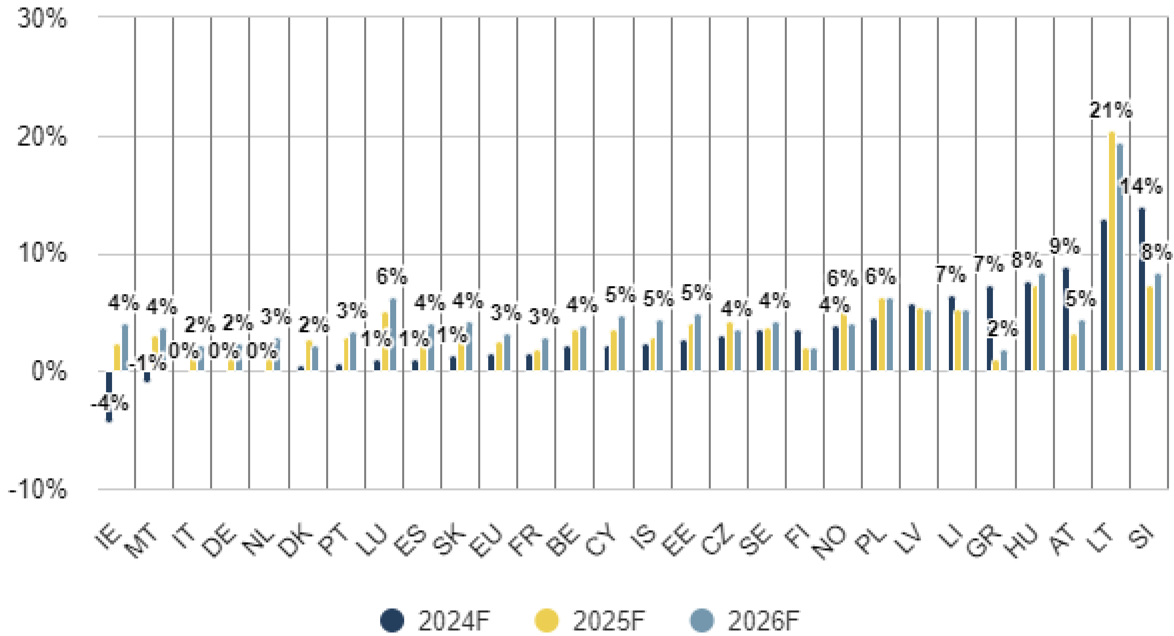


Source: EBA supervisory reporting data (funding plan data)

* 'F' after the years refers to forecasts.

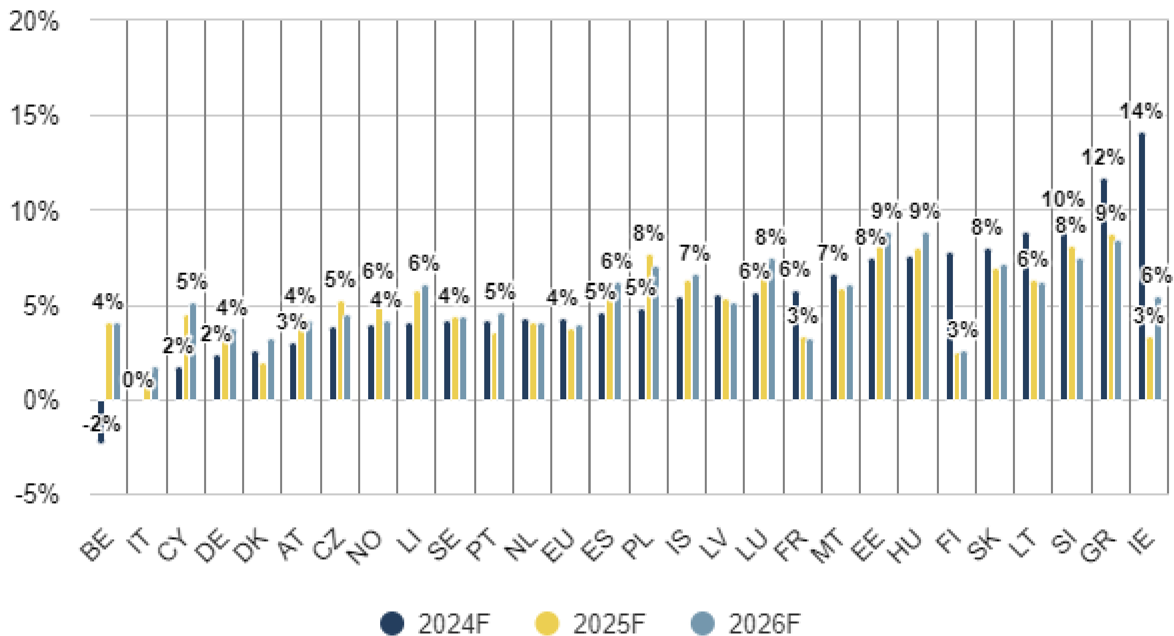
On a country level, banks forecast positive growth in their lending towards households in 2024 in nearly all countries, except for Ireland and Malta. At the same time, Italian, German and Dutch banks expect only marginal growth in 2024. All countries expect at least a 1% yearly growth rate for 2025 and at least 2% for 2026. Banks forecast a more aggressive growth rate for lending towards NFCs. Only Belgian and Italian banks expect a decrease in their NFC lending for 2024. In contrast to household lending, Irish banks expect a double-digit growth rate in 2024 (14%) for their NFC exposures, followed by Greek banks (12%) (Figure 10).

Figure 10a: Growth expectations for lending to households by country



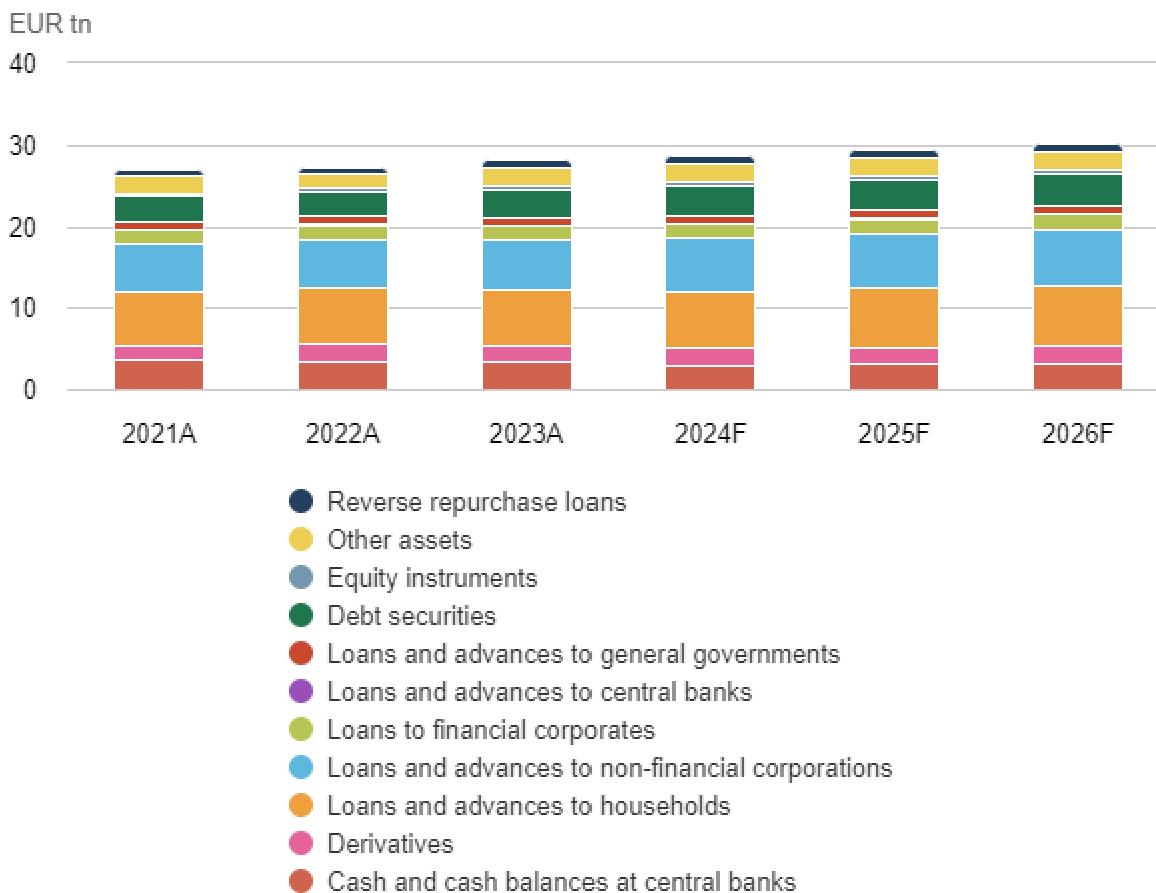
Source: EBA supervisory reporting data (funding plan data)

Figure 10b: Growth expectations for lending to NFCs by country



Source: EBA supervisory reporting data (funding plan data)

For the years 2025 and 2026, banks do not expect significant changes to their overall asset composition. At the end of the forecast period (December 2026), the share of loans to households is set to remain close to 25% of total assets and that of loans to NFCs is expected to increase from 21.8% in 2023 to 22.9%. Banks forecast the share of total assets to debt securities and loans to financial corporates to remain constant, representing 12.4% and 6.2% respectively. Cash balances are expected to remain somewhat elevated at 10.6% of banks' total assets compared to pre-pandemic levels (7.6% in 2019), yet lower than their post-pandemic levels (11.7% in 2023) (Figure 11).



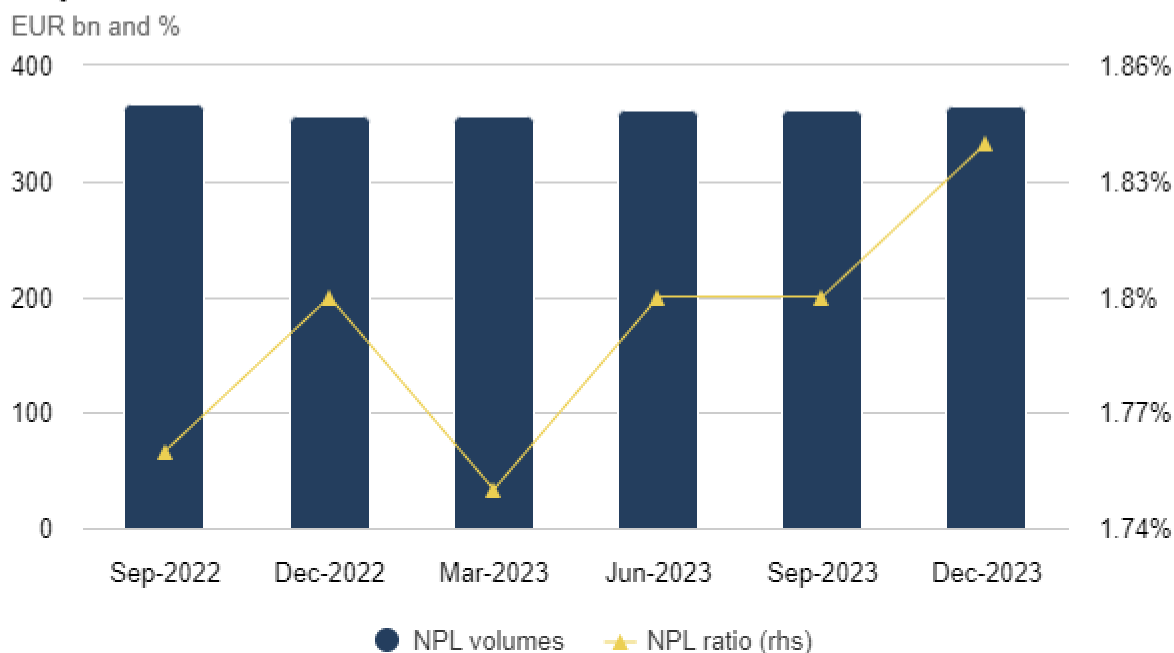
Source: EBA supervisory reporting data (funding plan data)

* 'A' after the years refers to actual numbers, 'F' after the years refers to forecasts.

Asset quality trends

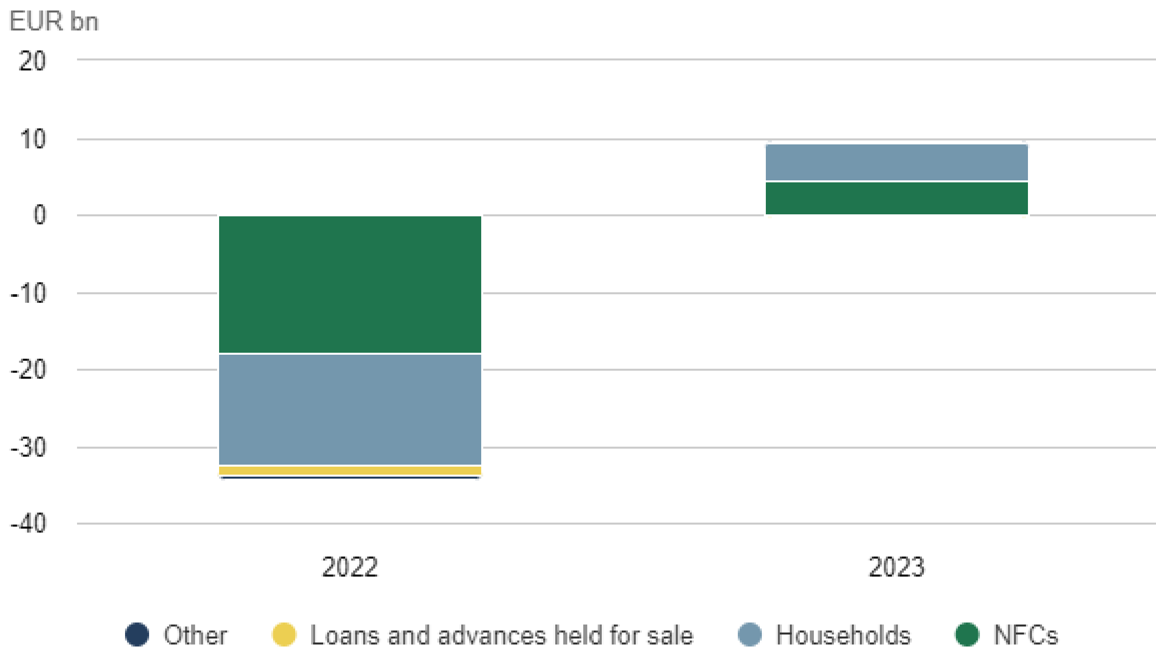
Non-performing loans increase for first time in a decade

In 2023 EU/EEA banks reported an increase in the total NPLs by EUR 7bn (EUR 365bn in December 2023). NPLs were steadily increasing over the year and were +2.1% higher when compared to year-end (YE) 2022 (EUR 357bn in December 2022). The NPL ratio was 1.84% as of YE 2023, similarly increasing over the course of 2023 (+4 bps compared to YE 2022) (Figure 12).



Source: EBA supervisory reporting data

EU/EEA banks not only reported a higher inflow of NPLs in their balance sheets but also reported a lower outflow of NPLs. In 2023, EU/EEA banks reported a total NPL inflow of EUR 187bn (EUR 168bn in 2022) and a total NPL outflow of EUR 178bn (EUR 202bn in 2022). As a result, the net NPL inflow reached around EUR 10bn versus a net NPL outflow of close to EUR 35bn a year earlier (Figure 13).

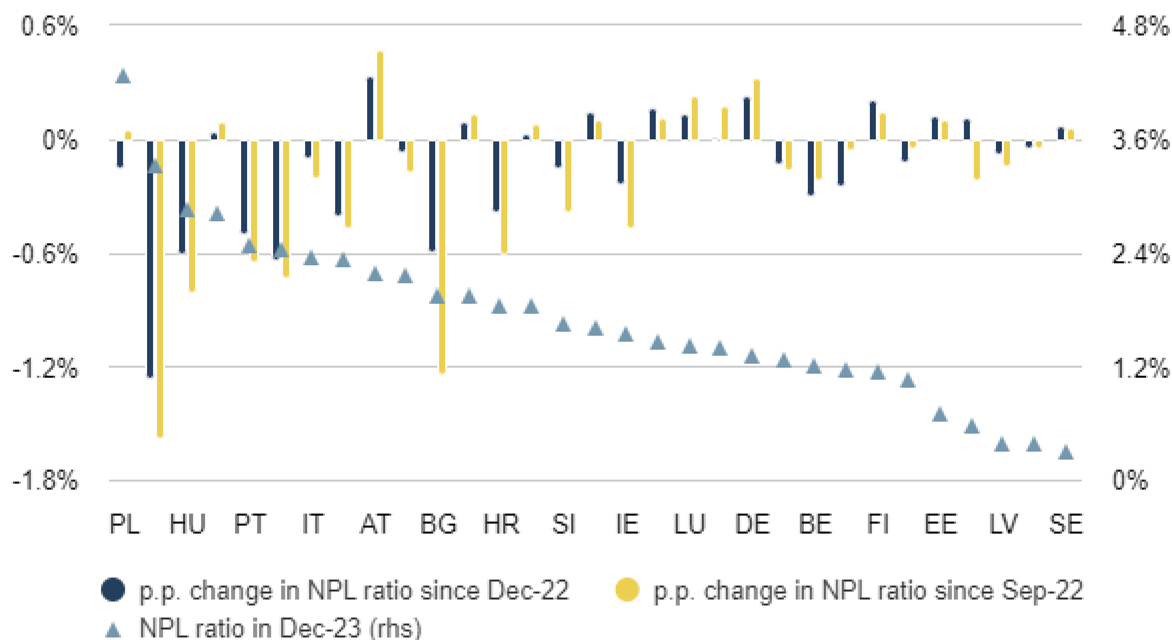


Source: EBA supervisory reporting data

The change in reported NPLs over the last year varied significantly across countries. Despite the overall increase in NPLs, around half of the countries reported lower NPL volumes compared to the previous year. For example, Italian and Greek banks still reported substantially lower NPLs compared to 2022. This is not least due to still ongoing NPL disposals and other measures to reduce their NPL stock. The higher volume of NPLs was therefore attributed to certain jurisdictions such as Austria, France, Germany and Spain. These countries reported a total increase in their NPLs of more than EUR 16bn during 2023. The highest NPL ratio was reported by Polish banks (4.3%) and was followed by Greek banks (3.3%). The biggest increase in the NPL ratio in 2023 was reported by Austrian banks (2.2% in December 2023 vs 1.8% in December 2022) (Figure 14).

At segment level, the biggest increase in NPL ratios was reported for loans collateralised by CREs (4.3% in December 2023 vs 3.9% in December 2022), while for other segments the increase was more moderate (around 10 bps; Figure 15). For example, for loans collateralised by RREs, banks reported only a marginal increase. The share of fixed-rate loans – at least in the biggest jurisdictions – for mortgage loans presumably acts as a safety net for borrowers. At the same time, other borrowers are particularly challenged by rising

interest payments due to their higher usage of variable-rate loans.



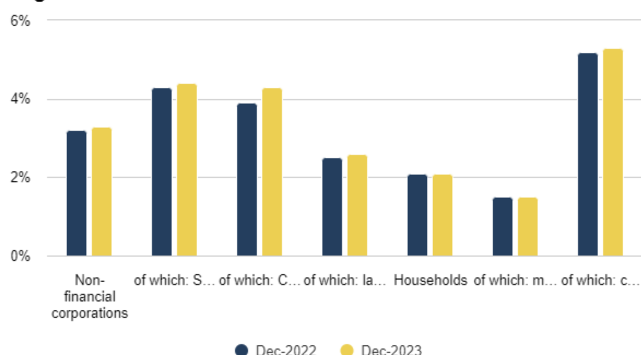
Source: EBA supervisory reporting data

Stage 2 allocation remained stable but at elevated levels

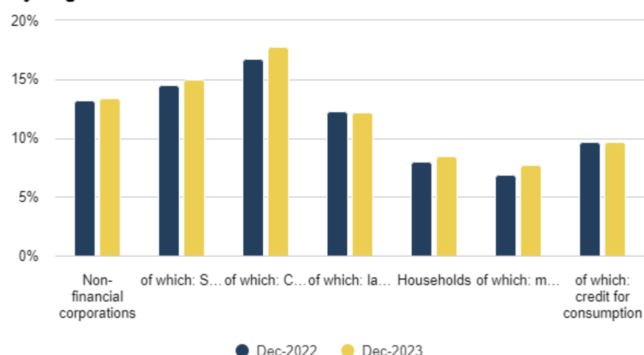
Banks also reported a similar increase in the allocation of loans to higher credit risk stages. Loans allocated to stages 2 and 3 increased by more than 3% in 2023. Stage 3 loans stood at EUR 340bn, like NPLs increasing by close to EUR 10bn in 2023. Stage 2 loans rose by more than EUR 50bn and stood at EUR 1.5tn as of December 2023. The share of stage 2 loans to total loans was at 9.6%, the highest level reported by EU/EEA banks, i.e. even higher than during the pandemic, when it had reached 9.1%.

The deterioration in the asset quality spanned across all segments of NFC and household lending, but was more profound in real-estate-related loans. Allocation to stage 2 for loans collateralised by CRE and RRE assets increased the most during 2023 compared to other segments. For CRE exposures stage 2 allocation reached 17.8% of total CRE loans (16.7% in December 2022), while for RRE exposures it increased to 7.8% (6.9% a year earlier). EU/EEA banks also reported material deterioration in SMEs, which have the second highest stage 2 ratio, reaching 15%, up from 14.5% a year ago (Figure 15). Anecdotal evidence suggests that

in some cases the deterioration of SME exposures is also linked to ending state support measures that had been introduced in recent years.



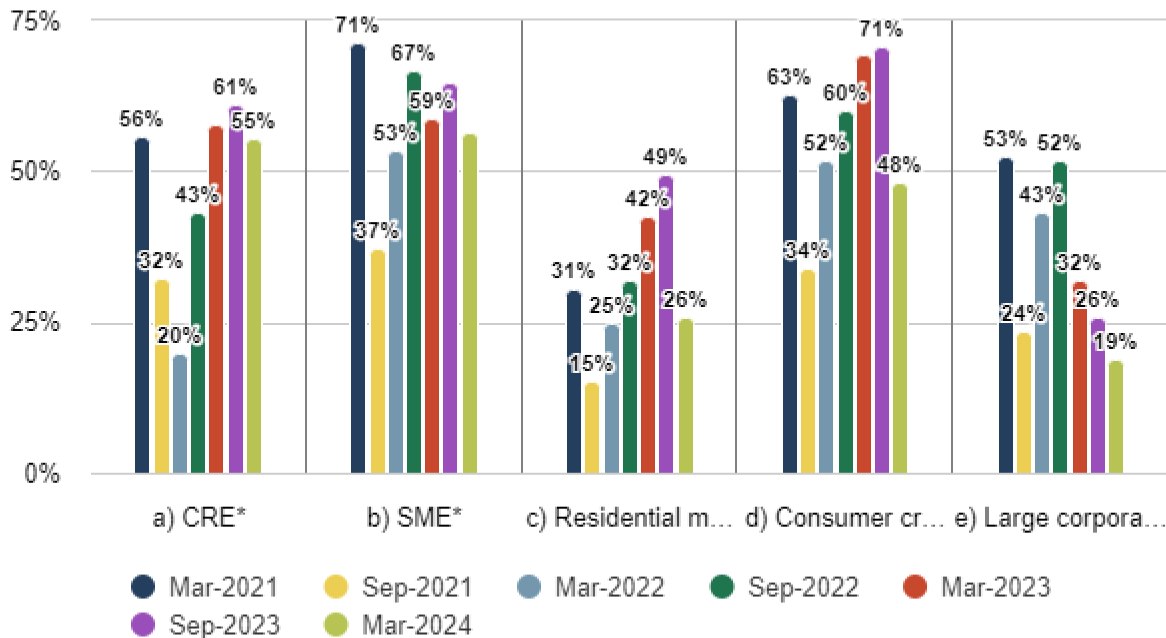
Source: EBA supervisory reporting data



Source: EBA supervisory reporting data

A large share of banks still expect asset quality to deteriorate in several key segments, even though the situation has improved compared to previous expectations

According to the results of the spring 2024 RAQ, banks' expectations for asset quality seem to be stabilising and partially even improving from the subdued outlooks in previous questionnaires. Expectations for asset quality of household exposures have for instance improved significantly, probably supported by still strong labour markets and expectations of declining interest rates. However, for NFC exposures the majority of banks still expect a deterioration in asset quality (for SMEs and CREs), yet the share of banks has stabilised and has not been increasing further. This may indicate that downside risks may be limited (Figure 16). This is partially confirmed by data on funding plans. Banks anticipate that household NPLs will grow by about 3% by the end of 2024, while NFC NPLs will rise by 6%. Household NPLs are projected to keep going up in the coming years, but at a slower pace, while NFC NPLs are anticipated to level off.



Source: EBA Risk Assessment Questionnaire

---

[1] Financial assets held at amortised cost is an accounting classification, which is subject to certain conditions, such as for instance a bank's objective to hold the respective assets in order to collect contractual cash flows (see the IFRS Foundation's overview of IFRS 9 Financial Instruments). This makes it possible to reduce the sensitivity of the accounting profit and loss statement (P&L) to e.g. interest rate changes.

[2] See, for instance, the ECB's EA bank lending survey (europa.eu) editions from October 2023 and January 2024.

[3] See the ECB's Euro area bank lending survey. from April 2024.

[4] See Lending survey (nationalbanken.dk).

[5] See Norges Bank's Survey of Bank Lending (norges-bank.no).

[6] See Senior loan officer opinion survey (NBP).

[7] See Lending survey (mnb.hu).

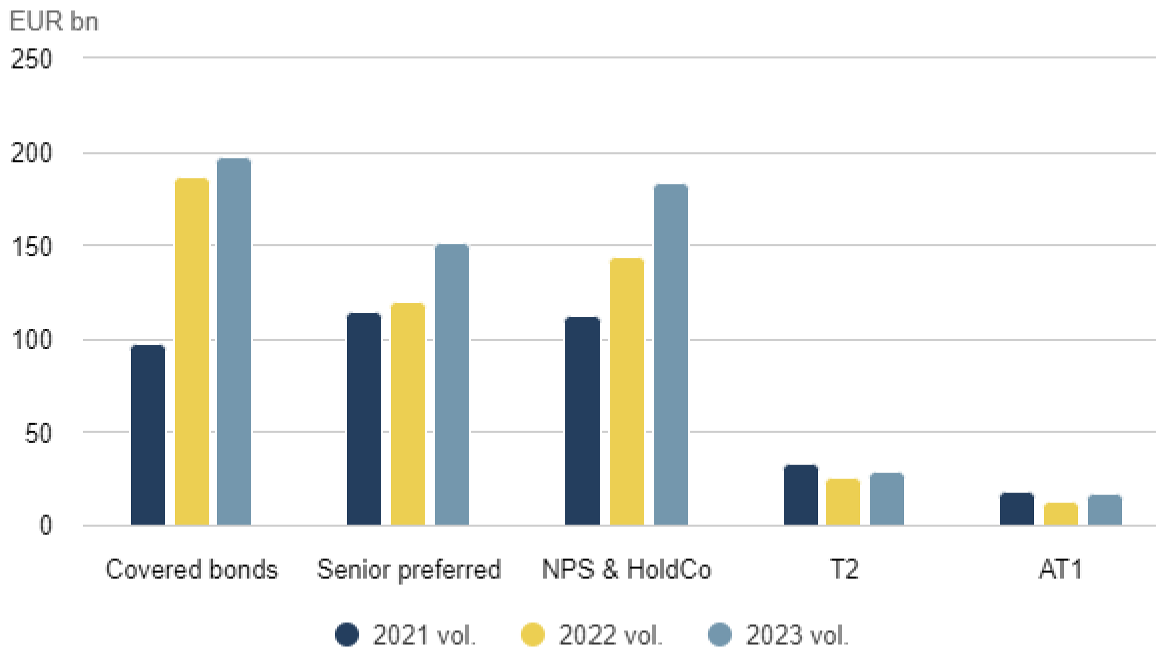
Liabilities: funding and liquidity

Funding

Rising relevance of market-based funding in 2023

On the liability side of EU/EEA banks' balance sheets, deposits remained the most important source of funding. A slowdown of customer deposit volume growth could already be observed in the first half of 2023, after a long period of strong deposit volume growth. In the second half of 2023, diverging trends between different types of deposits were observed. While the household deposit volume remained nearly unchanged, deposit volumes from NFCs and other customer deposits contracted in the second half of 2023. This comes in addition to a move from sight to term deposits.[1]In relative terms – when measured as a share of total liabilities – there have accordingly been no major changes for deposits. Household deposits had a share of 30.7% as of year-end (YE) 2023 (30.6% in 2022), NFC deposits 17.2% (17.1%) and other customer deposits 11.7% (11.1%).

The importance and volume of central bank funding continued to decrease in 2023. Other liabilities, which include deposits from central banks, decreased to a share of 14.4% in total liabilities at the end of 2023, down from 18.4% as of YE 2022. This decrease is not least driven by continued repayments of EA banks' TLTRO funding. Data indicated that the main replacement for repaid TLTRO funding was debt securities issued, whose share in total liabilities rose from 17.4% to 19.7% by YE 2023. The rising relevance of market-based funding is similarly confirmed in market data, which shows that issuance volumes of secured and in particular senior unsecured debt increased in 2023 compared to previous years (Figure 17). However, market data suggests that issuance volumes of market-based funding decelerated in the first half of 2024, except for subordinated instruments (Figure 32).



Source: Dealogic, EBA calculations

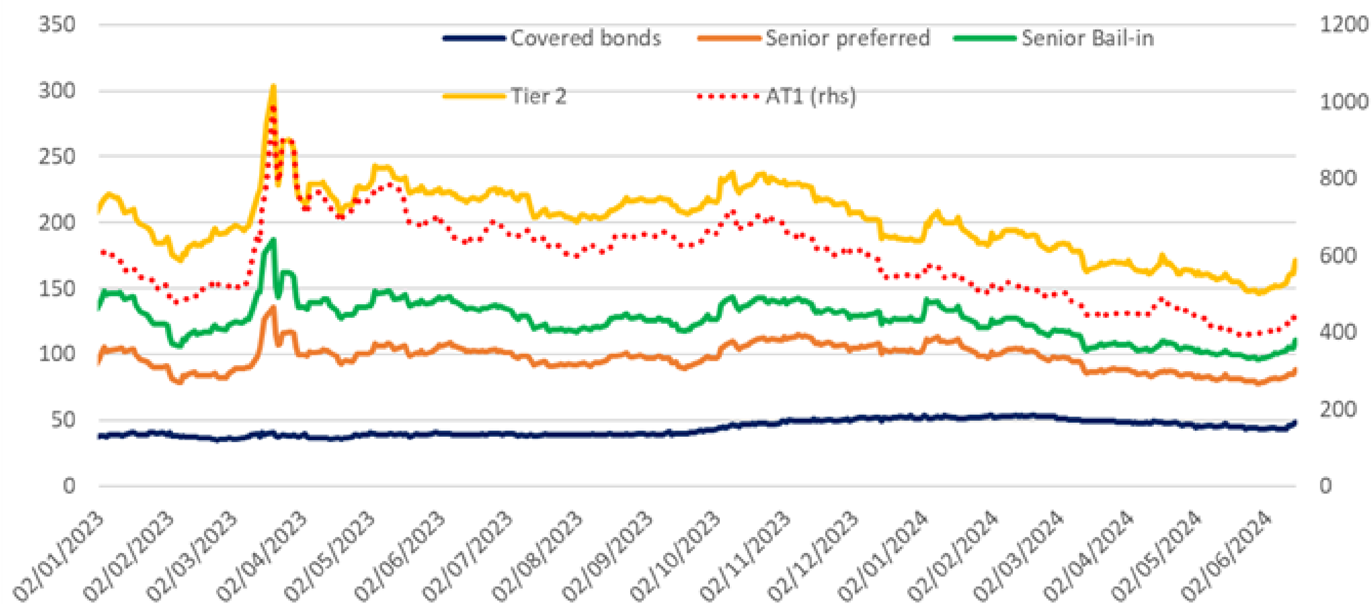
*Based on publicly available market data which may not completely reflect all issuances of the different types of debt and capital instruments.

Positive market sentiment for bank funding so far in 2024

During the first months of 2024, strong fundamentals and high profitability with rising bank equity prices, underpinned by strong investor demand, supported decreasing spreads and had a positive impact on bank funding conditions. Despite some temporarily increasing spreads earlier this year, they steadily tightened for all main types of instruments. In relative terms, spread tightening was most pronounced for senior unsecured and Additional Tier 1 (AT1) instruments. They declined around 16% for the former and 17% for the latter in the year to date (YtD). Similar to AT1s, Tier 2 (T2) pricing also reached levels comparable to those before March 2023. In relative terms, T2 spreads have contracted by slightly more than 10% YtD in 2024. In contrast to unsecured instruments, spreads for covered bonds have contracted the least this year (slightly less than 10%). During the events in January and February 2024 related to New York Community Bancorp, Inc. (NYCB) and Aozora Bank Ltd, which were not least linked to their CRE exposures in the US, spreads of EU/EEA banks have hardly shown any impact. However, spreads showed rising divergence when the crisis materialised in March 2024, with spreads of particularly CRE-exposed banks facing a strong widening for all instruments across the capital stack. EU/EEA banks' spreads

across the board were negatively affected following the results of the European Parliament elections at the beginning of June, and the consequent snap election announcement in France.

Figure_18: Cash asset swap (ASW) spreads of banks' EUR-denominated debt and capital instruments (in bps)



*Source: IHS Markit**

*With regard to IHS Markit in this chart and any further references to it in this report and related products, neither Markit Group Limited ('Markit') nor its affiliates nor any third-party data provider make(s) any warranty, express or implied, as to the accuracy, completeness or timeliness of the data contained herewith nor as to the results to be obtained by recipients of the data. Neither Markit nor its affiliates nor any data provider shall in any way be liable to any recipient of the data for any inaccuracies, errors or omissions in the Markit data, regardless of cause, or for any damages (whether direct or indirect) resulting therefrom.

Banks' focus in market based funding remained on unsecured instruments in the first half of this year (Figure 32). Issuances were placed by stronger as well as less well-known and commonly less active banks on primary markets. Issuance increased for T2 instruments. This was because banks were catching up on deferred T2 and AT1 instrument funding plans since 2023, after their issuance was near a standstill around the time of the bank market turmoil in March 2023 until about the middle of last year. The standstill happened last year when investor concerns about loss absorption of these instruments mounted. Very strong investor demand for higher-yielding instruments additionally supported T2 and AT1 issuance this year.

Issuance volume declined for senior preferred bonds and senior non-preferred (SNP) bonds as well as senior instruments issued from holding companies (HoldCo) in 2024 YtD compared to last year. However, 2024 YtD volumes are still above those seen in 2022 at this

point in time of the year. Since SNP/HoldCo debt is mostly used to meet TLAC/MREL subordination requirements, the fact that banks had to comply with their MREL requirements by January 2024 might have resulted in a slowdown in issuance of these instruments this year compared to previous years (see on MREL-specific aspects Chapter 3.2). The covered bond issuances decreased as well during the first half 2024 compared to last year, but were above 2022 volumes. Factors that might explain covered bond issuances include a high volume of maturing covered bonds, as well as lower costs than for unsecured funding, especially at times of a temporarily more volatile market environment. Continued strong demand for covered bonds, including during periods of temporarily lower issuance volumes, provided opportunities for issuing banks to place covered bonds at comparatively low issuance premia.

MREL-specific aspects

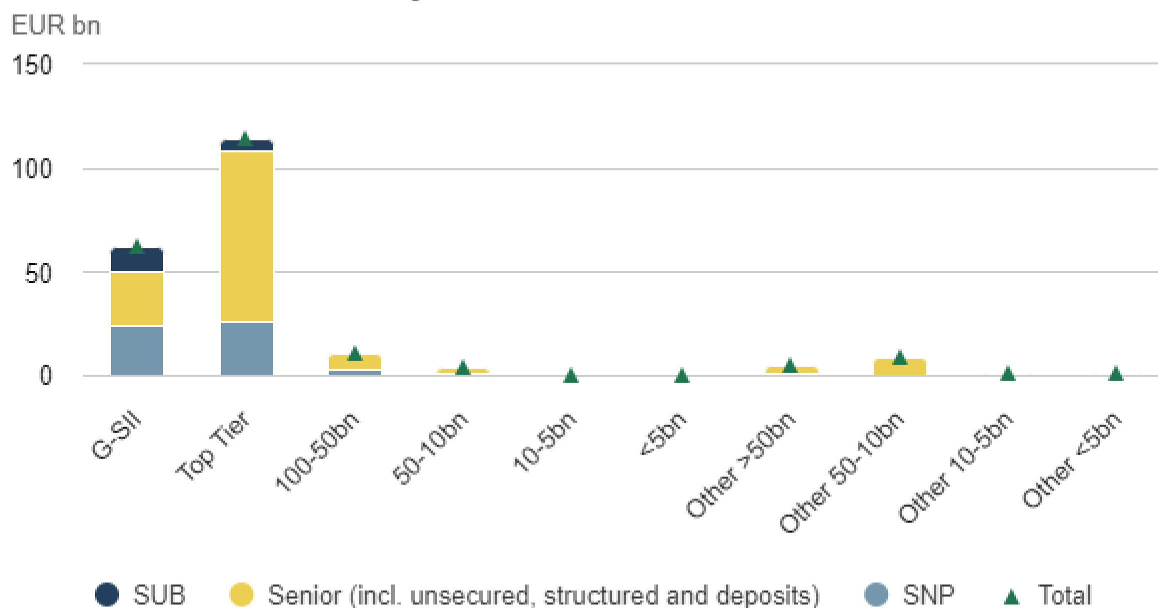
In the EU/EEA, banks with a resolution strategy other than liquidation represent about 80% of total banking sector assets. Resolution strategies other than liquidation entail an MREL above minimum capital requirements, requiring banks to build loss-absorbing capacity, which means respective banks have to issue eligible instruments. Requirements to build loss-absorbing capacity have been an important driver for increased issuance volumes of in particular SNP/HoldCo instruments in recent years (see Chapter 3.1 on primary market developments, incl. continuously increasing SNP/HoldCo issuance volumes in recent years).

For the most part, banks had to meet their requirement by 1 January 2024. And as per the EBA's latest MREL Dashboard as of 31 December 2023, all reporting banks are in compliance with the requirement set by their authority.[2]Still, 23 banks report a shortfall totalling EUR 8.0bn, or 0.1% of total risk-weighted assets (RWAs) in the sample and 1.6% of RWAs of banks in shortfall, as under certain conditions institutions may be granted a longer transition period.[3]In terms of stock, on average, MREL-eligible resources including own funds reached 33.1% of RWAs for global systemically important institutions (G-SIIs), 37.1% of RWAs for Top Tier (TT) and fished banks, and 27.2% of RWAs for other banks, of which

27.8%, 28.7%, 21.2% of RWAs are subordinated, respectively.[4]

On top of any outstanding shortfall, banks in the sample reported EUR 207bn of MREL instruments which become ineligible at the latest at the end of 2023 for falling below the one-year remaining maturity criterion (up 25% from last year's publication but not on a comparable sample), i.e. this is outstanding MREL funding that banks need to refinance during the course of this year to keep their MREL levels (ceteris paribus).[5]Overall, this represents 18.1% of the total MREL resources other than own funds (Figure 19). These figures show that, although the vast majority of reporting banks already met their post-transition period MREL requirements by the end of 2023, issuance needs of MREL-eligible instruments continue to be significant, when taking the maturity criterion for eligibility into account.

Figure 19: MREL-eligible liabilities, by instrument, and by category of banks, for instruments with residual maturities between one and two years



Source: Reporting on MREL and TLAC

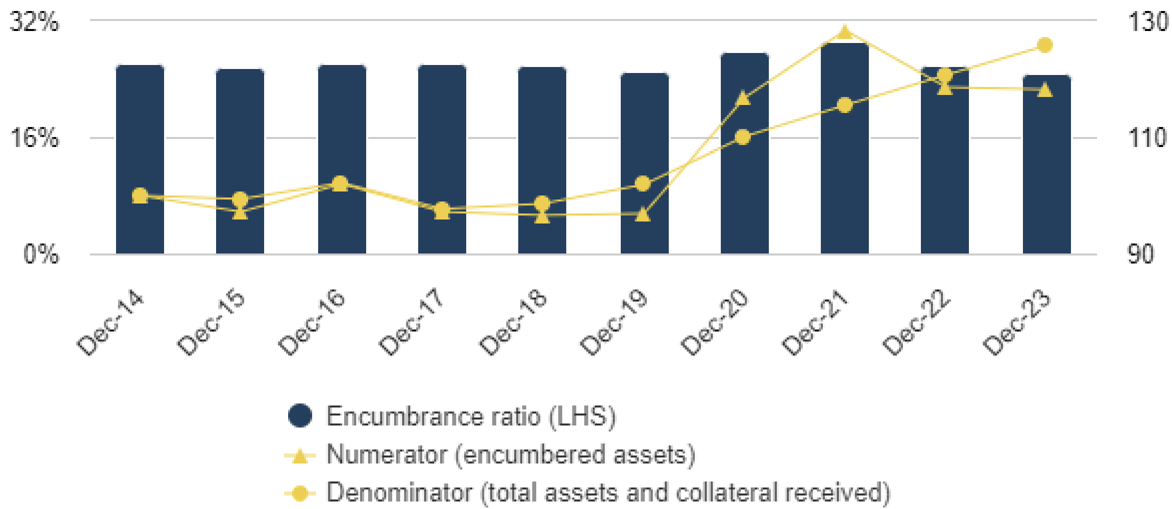
Out of this, EUR 62bn relates to G-SIIs (15.1% of their total MREL resources other than own funds), EUR 126.2bn to Top Tier and fished banks (20% of their total other than own funds) and EUR 20.4bn to other banks (18.9% of their total other than own funds). While those refinancing needs – assuming that banks indeed aim to refinance them as such – of over

EUR 200bn are considerable, banks presumably reflected them in their funding plans. Compared to EU/EEA banks' issuance volumes last year they should be in a position to again place comparable volumes of instruments this year as well, assuming no major market deterioration (see Chapter 3.1. on 2023 and previous years' issuance volumes as well as primary market activity during the first months of 2024, and Chapter 3.4. on funding plans).

Asset encumbrance

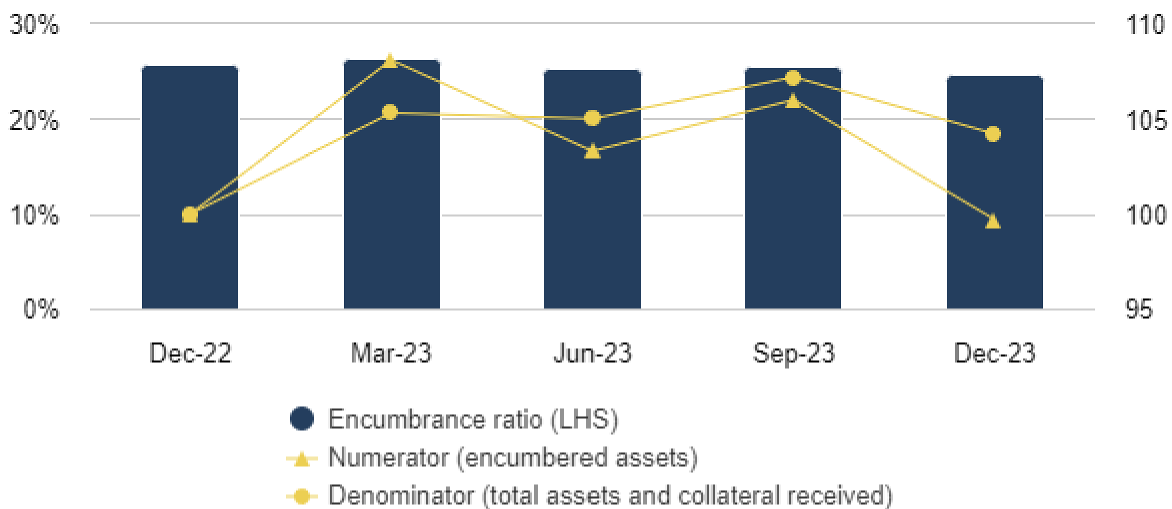
The asset encumbrance ratio (i.e. the ratio of encumbrance of assets and collateral received to total assets and collateral received that can be encumbered) continues its decreasing trend that had started at the end of 2021. At that time it had reached more than 29%, and settled somewhat below 25%. On a YoY basis, the ratio decreased by more than 1 p.p. from 25.8% in December 2022 to 24.7% in December 2023. During the year, the decrease was mostly driven by two quarters of decrease in Q2 and Q4, which is not least supported by TLTRO repayments. Q1 and Q3 are marked by increases, with Q1 reaching the yearly peak of 26.5% (Figure 20).

Figure 20a: YoY evolution of the asset encumbrance ratio of total assets and collateral received, numerator (encumbered assets), and denominator (total assets and collateral received that can be encumbered), between December 2014 and December 2023



Source: EBA supervisory reporting data

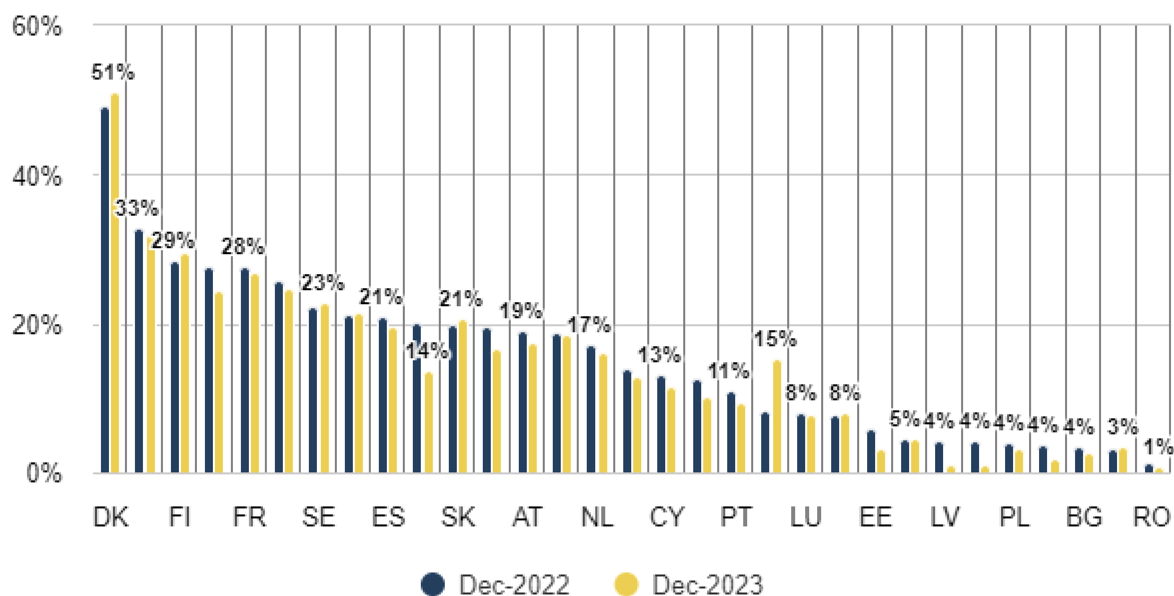
Figure 20b: QoQ evolution of the asset encumbrance ratio of total assets and collateral received, numerator (encumbered assets), and denominator (total assets and collateral received that can be encumbered), between December 2022 and December 2023



Source: EBA supervisory reporting data

Significant divergence between countries continues to be observed. Denmark remains the country in which banks report the most encumbered assets, which is mostly attributable to the large issuance volume of covered bonds for funding purposes. Conversely, many countries have very little asset encumbrance, such as Romania, Latvia, Lithuania and Croatia, where the average asset encumbrance ratio is below 2%. Czechia and Greece display the largest variation YoY, in a positive and negative direction by around 7 p.p. each. In the case of Czechia, the increase in the ratio is due to higher encumbrance of bonds issued by the general government.[6] This comes in parallel to a significantly rising share of deposits, which include repurchase agreements. The latter could explain the rising usage of sovereign bonds and accordingly increasing asset encumbrance ratio. In the case of Greece the decline in the asset encumbrance ratio is due to a decline in encumbered debt securities and loans and advances. The decline in the ratio might be explained by the TLTRO repayments during the course of the year. The EU's/EEA's largest jurisdictions, such as Germany (31.1%) and France (27.5%) continue to have a higher than EU/EEA-average asset encumbrance ratio (Figure 21).

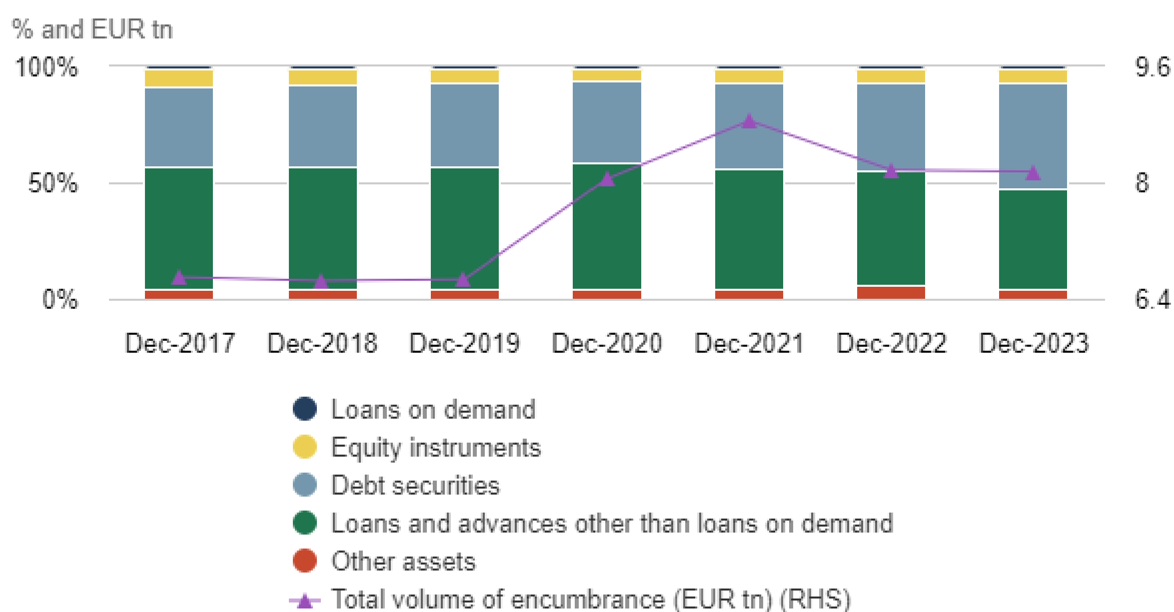
Figure 21: Evolution of the weighted average asset encumbrance ratio by country, between December 2022 and December 2023



Source: EBA supervisory reporting data

Assets and collateral that are most encumbered are almost equally debt securities (45.5%) and loans and advances (43.0%). However, the long-term trend points to a decreasing share of encumbrance stemming from loans and advances and larger encumbrance from debt securities. This might be explained by the fact of declining central bank funding, such as TLTRO, for which certain loans are eligible collateral – in contrast to more market-based funding or other reasons for encumbrance, for which counterparties require debt securities as collateral (Figure 22).

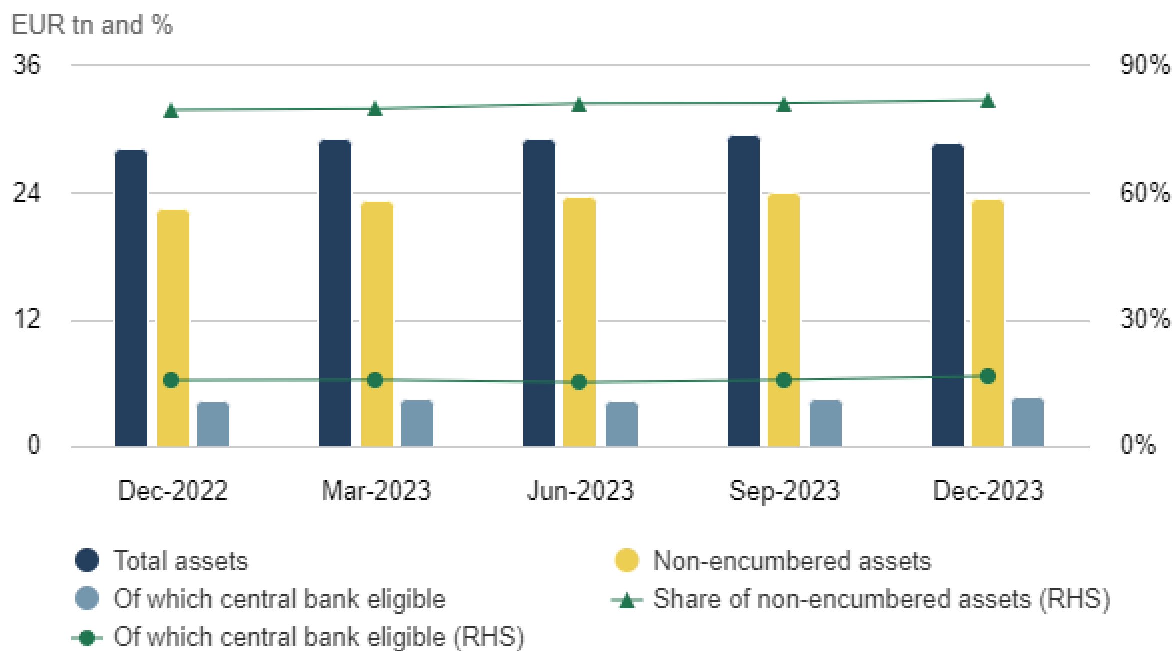
Figure 22: Evolution of the share of the main types of asset encumbrance and total volume of encumbrance, from December 2017 to December 2023



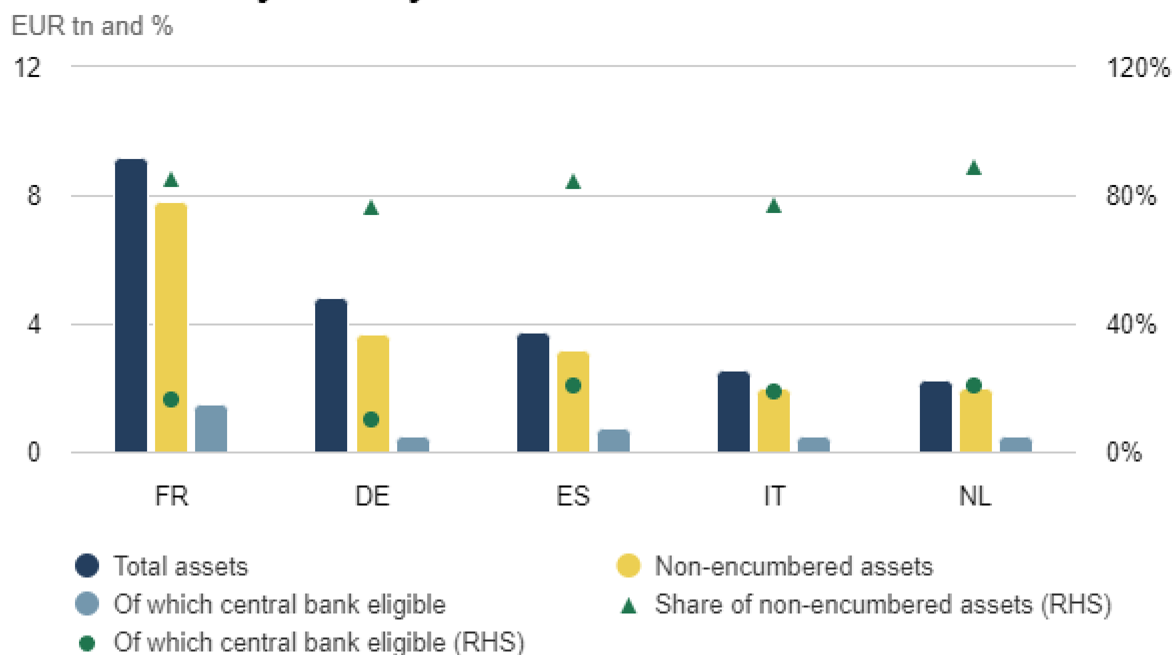
Source: EBA supervisory reporting data

In the EU/EEA on average, a large part of banks' assets is not encumbered and this share has increased over the past year from 79.6% to 81.9%, of which 15.6% were eligible for central bank funding as of December 2022 and 16.6% as of December 2023. This means that banks have increased the availability of assets that they can use for different means of funding, for instance. This can offer them important room for gaining new means of funding in times of stress when bond issuance might be negatively affected or deposits might decline. However, there is wide dispersion among countries in respect of unencumbered assets, and in particular of the share of unencumbered assets that are at the same time eligible for central bank funding. The share of the latter is for instance rather lower in some

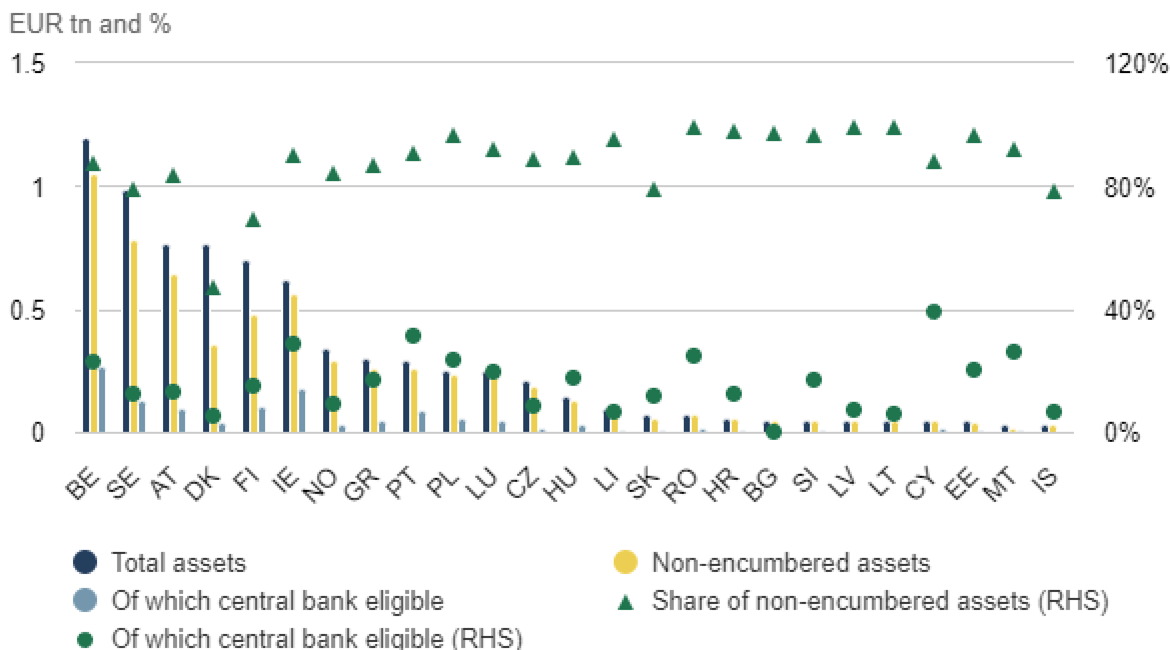
northern as well as some central and eastern European countries, whereas it tends to be in higher southern European countries (Figure 23).



Source: EBA supervisory reporting data



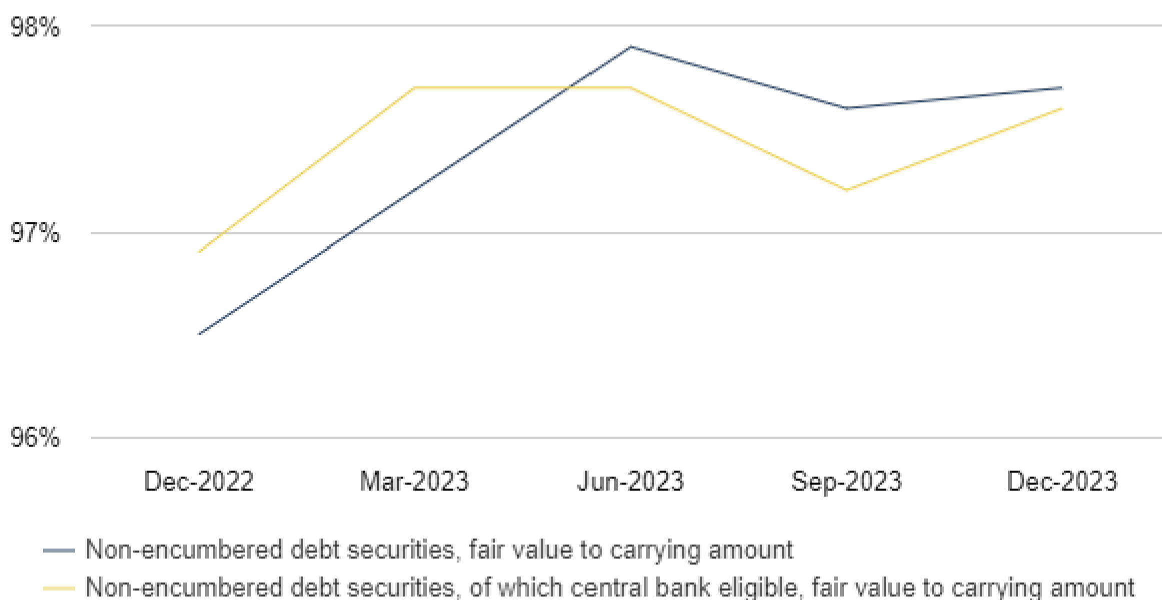
Source: EBA supervisory reporting data



Source: EBA supervisory reporting data

However, it is important to have in mind that for those purposes the fair value of these assets to be encumbered normally needs to be considered, i.e. it is the fair value – normally after additional haircuts – which then provides the room for gaining funding with available collateral. Data shown above is based on carrying amounts of respective assets and collateral. For this reason it is worth checking the difference between the carrying amount and fair value. Such analysis shows that, despite the rate rise of the past two years, the fair value of debt securities of which those eligible for central banks is largely unaffected. Over the past year, the unrealised losses on non-encumbered debt securities is not material, standing below 3%. A key reason might be that a certain share of the respective assets is already recognised at fair value through profit and loss (FVtPL) or fair value through other comprehensive income (FVtOCI) (Figure 24).[7]

Figure 24: EU/EEA average fair value to carrying amount of non-encumbered debt securities from December 2022 to December 2023



Source: EBA supervisory reporting data

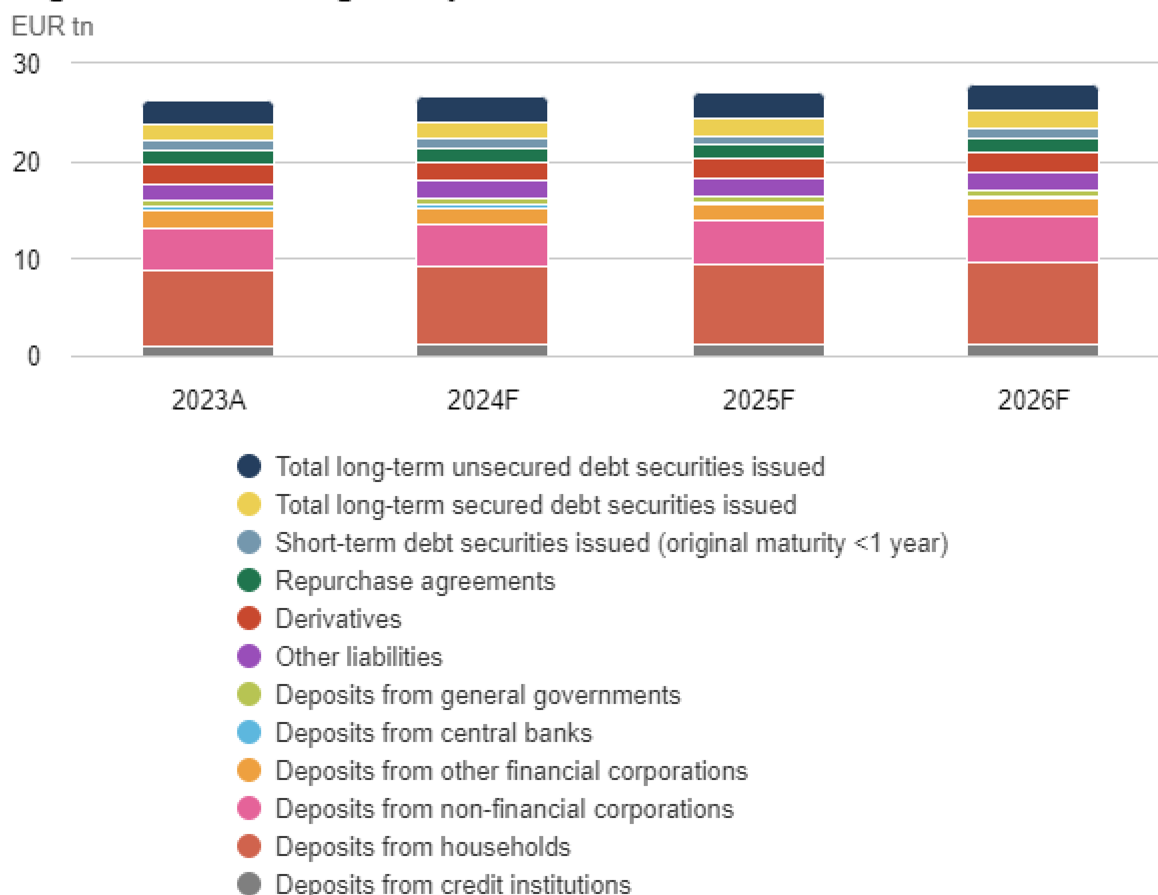
Funding plans

Forecasted changes in banks' funding mix, with a rising share of deposit and bond issuances

Tightening monetary policy and the expiry of extraordinary central bank support measures led to a gradual substitution of central bank funding by market-based funding in the last two years. This trend is expected to continue in 2024 with banks forecasting deposits from central banks to drop significantly. By the end of 2024, central bank deposits are expected to represent 1.1% of banks' total funding (down from 2.3% in 2023 and 5.6% in 2022). To compensate for declining central bank funding, banks intend to rely more on market-based funding and client deposits (Figure 25). The share of total debt securities issued over total funding is set to increase from 22.7% in 2023 to 23.5% in 2024. Client deposits are expected to represent 54.1% of total funding by the end of 2024 (53.6% in 2023). In 2025 and 2026,

the withdrawal of central bank support measures will no longer have a significant impact on banks' funding composition plans. The focus on client deposits is set to continue and banks are targeting a share of 54.9% of total funding by the end of the forecast period. Total debt securities are expected to represent 23.2% of total funding by 2026.[8]

Figure 25: Funding composition 2023 to 2026

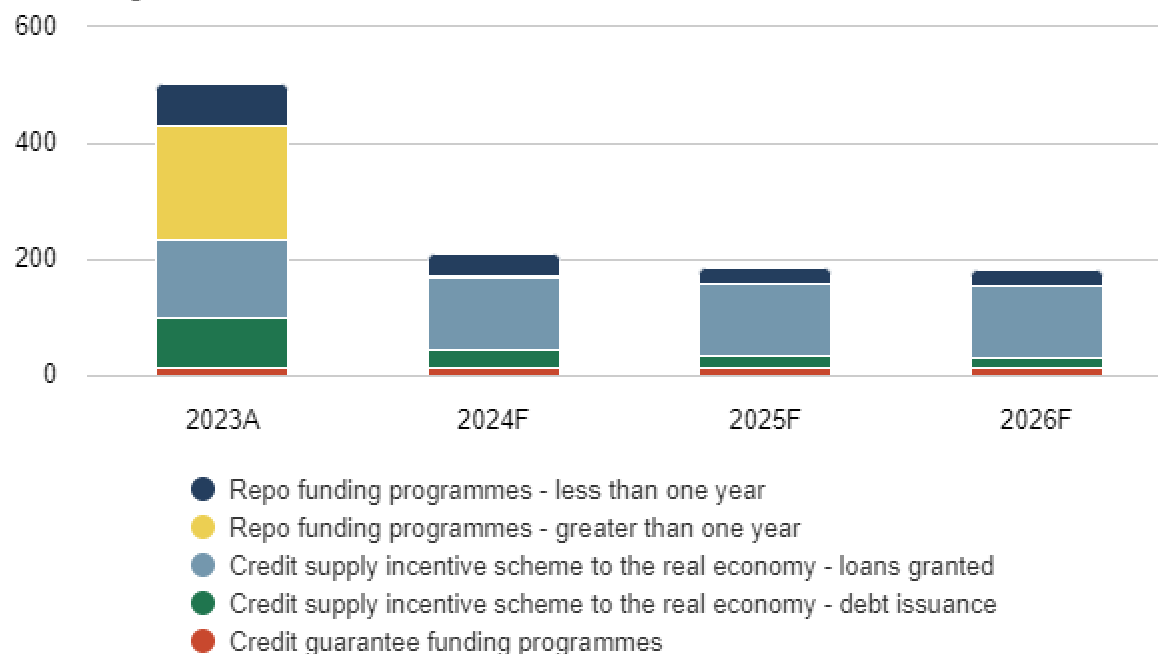


Source: EBA supervisory reporting data (funding plan data)

Declining relevance of public sector funding

As of December 2023, banks' total public sector funding in the EU/EEA amounted to EUR 503bn. Among the different types of programmes, long-term repo funding programmes – which include the ECB's TLTRO programme – represented the biggest share with about 40% of the total public sector funding. According to banks' plans, both the volume and composition of public sector funding are going to change substantially in 2024, with repos

of more than one year almost completely disappearing due to the TLTRO funds reaching maturity (Figure 26).[9] Repos of less than one year, which cover central bank funding instruments like common LTRO and Main Refinancing Operations (MRO), as well as credit supply incentive schemes are also forecasted to decline. In contrast to long-term repos, however, these public funding sources will play a diminished but still existing role going forward. By the end of the forecast period in 2026, the public sector funding volume is expected to decline to EUR 182bn, less than 1% of banks' total funding. Credit supply incentive schemes are set to become the dominant public funding support from 2024 onwards, reaching 80% of total public funding by 2026.

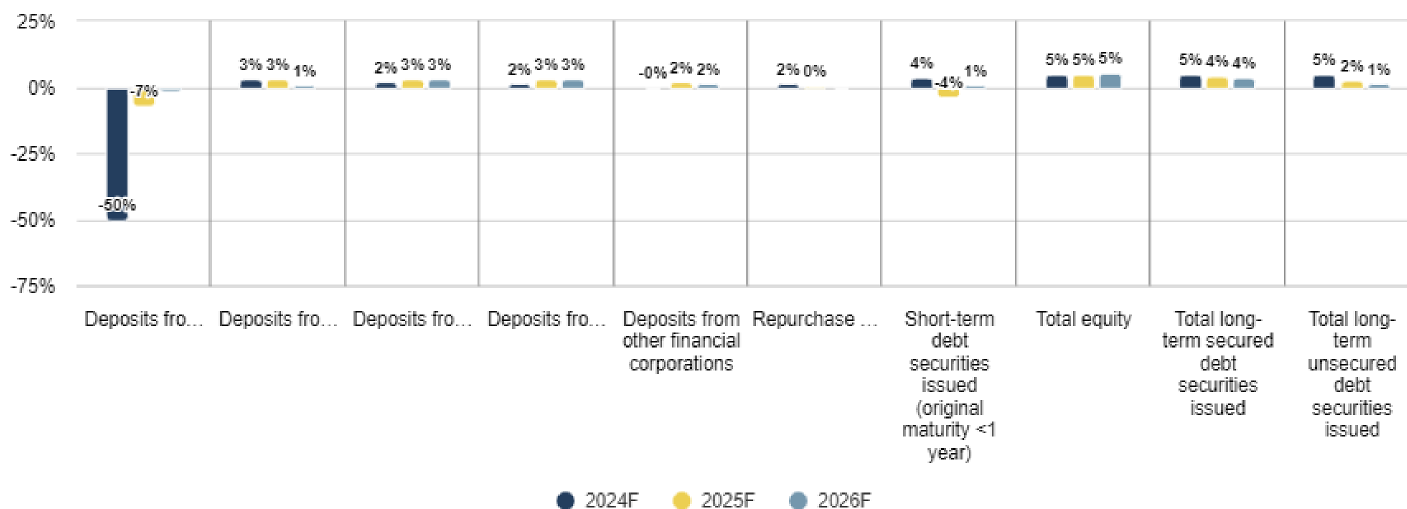


Source: EBA supervisory reporting data (funding plan data)

Banks are focusing on other liability classes to make up for the loss of central bank funding. The fastest growing liability class in 2024 is set to be debt securities. Within that class, long-term unsecured instruments are expected to increase by 4.9%, followed by long-term secured instruments at 4.6%. Banks also plan for an increase in short-term debt securities of 3.9%. Deposits, on the other hand, are forecasted to grow at a slower pace in 2024. Deposits from households, the biggest liability segment, are set to grow by 2.2% and deposits from NFCs are expected to grow by 1.4% in 2024 (Figure 27). Furthermore, banks

this year plan for an increase in equity instruments of 4.6%.

Figure 27: Growth expectations for selected liability classes



Source: EBA supervisory reporting data (funding plan data)

Looking into 2025 and 2026, banks expect equity instruments to grow the most (4.9% in 2025 and 5.2% in 2026). Expectations for deposits from households and from NFCs are more optimistic compared to 2024 and banks plan an annual increase of 3.2% to 3.3% for both deposit segments in 2025 and 2026. After a strong increase in the previous years, short-term debt securities are expected to decrease by -3.9% in 2025 and slightly increase by 0.9% in 2026. Long-term secured and unsecured debt securities are expected to increase in 2025 by 4.1% and 2.3% respectively, with slightly lower growth rates in 2026 (3.9% and 1.2%).

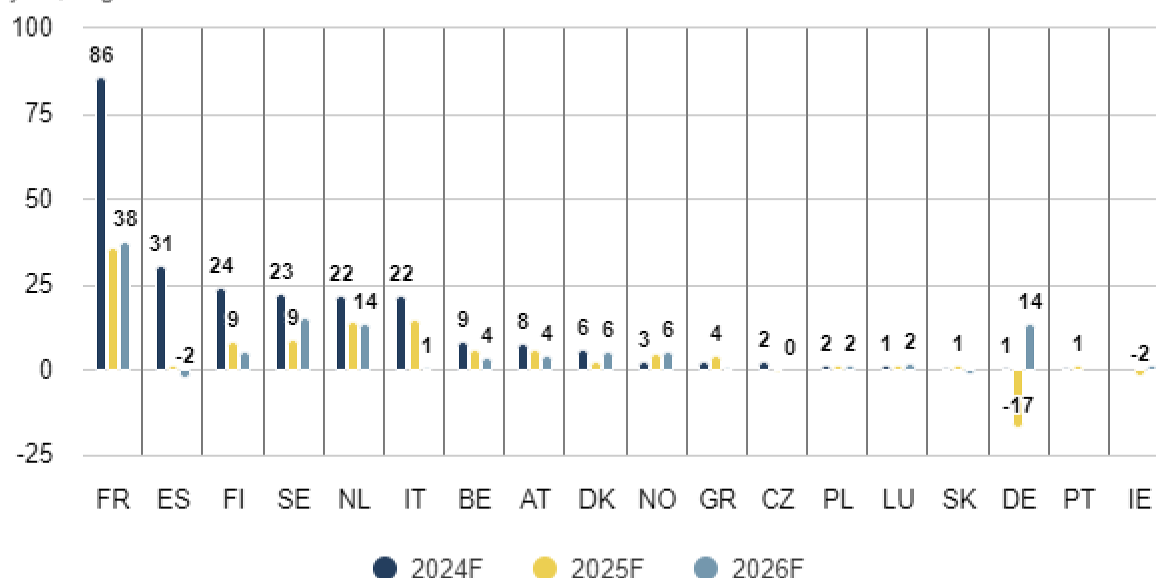
Trends in market-based funding: rising issuance volumes

Over the three-year forecast period, EU/EEA banks plan to increase total long-term funding by 10%, reaching a total outstanding volume of EUR 4.6tn in 2026 (EUR 4.1tn in 2023). For 2024, banks in all countries plan for a significant net issuance volume, with banks in Finland,

France, Italy, the Netherlands, Spain and Sweden reporting the highest planned net issuance volume. High net issuances are probably not least due to the need to cover large amounts of maturing TLTRO funding. In 2025 and 2026, banks expect net issuance volume to be significantly lower. For most countries, banks still plan for positive net issuance volume. Banks in several countries expect a negative net issuance volume in either 2025 or 2026. In most cases this either follows or is followed by a year of positive net issuances (Figure 28).

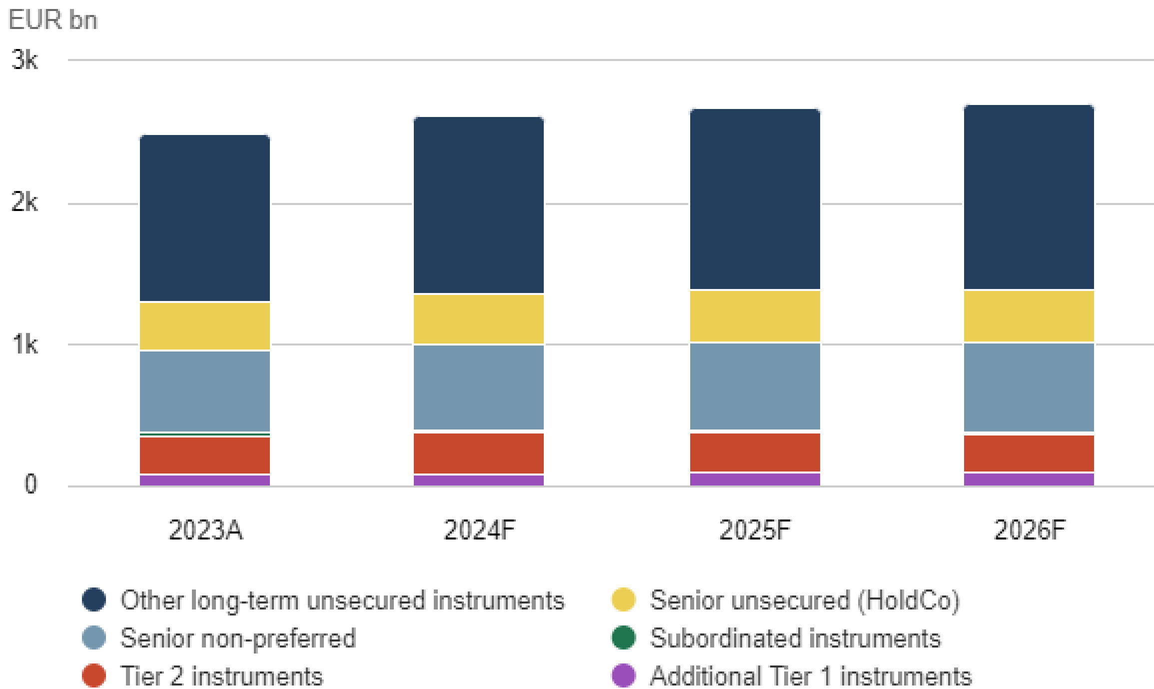
Figure 28: Net issuance volume by country and year (short and long-term debt securities)

EUR bn; positive difference means that gross issuances are larger than redemptions for that year, negative difference vice versa



Source: EBA supervisory reporting data (funding plan data)

Zooming in on unsecured debt securities, the total outstanding volume is expected to increase by 8.6% over the forecast period, to EUR 2.70tn in 2026 compared to EUR 2.49tn in 2023. For each year of the forecast period, banks plan to issue more unsecured debt than will mature. Net issuance volume is highest in 2024, and particularly so for senior non-preferred and senior preferred debt (Figure 29).



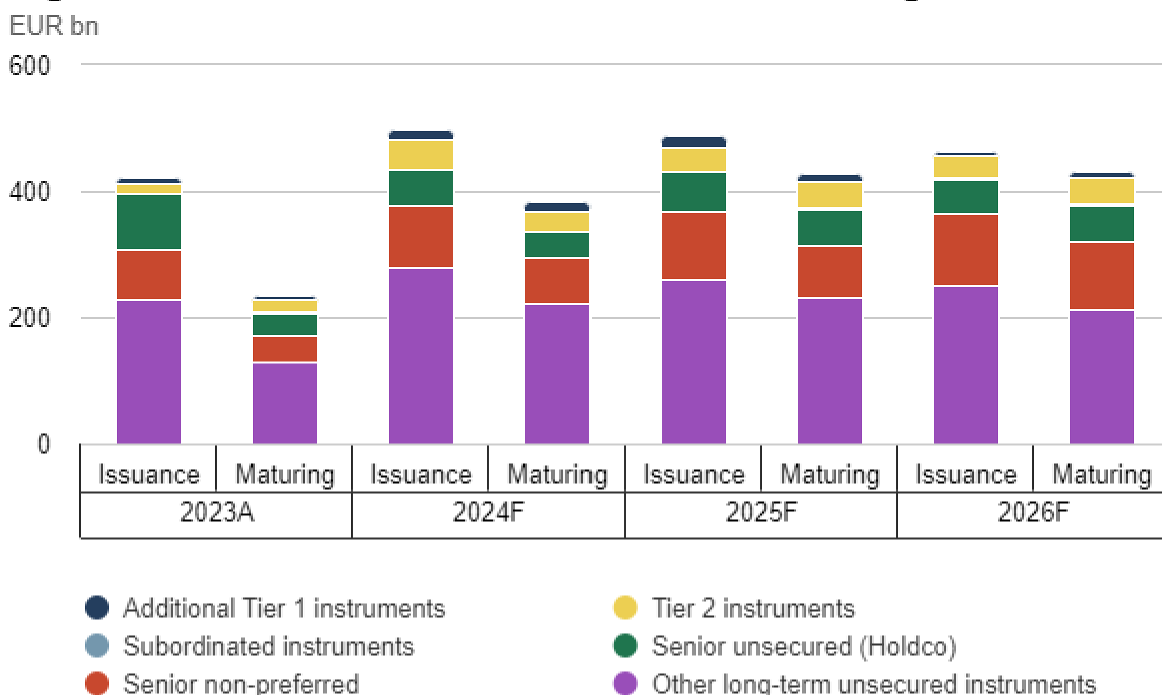
Source: EBA supervisory reporting data (funding plan data)

Banks plan to issue a significant volume of unsecured debt in each year of the forecast period. 2024 is expected to be the year with the highest issuance volume, reaching almost EUR 500bn. With banks planning to issue EUR 278bn of senior preferred, EUR 100bn of SNP and EUR 55bn of senior Holdco instruments, the total unsecured issuance volume in 2024 is set to be almost 20% higher than in 2023. The strong increase in issuance volume is particularly notable for AT1 instruments and T2 instruments. With a combined volume of EUR 62bn planned for the two capital instruments, the previous year's volume would be surpassed by EUR 38bn, an increase of 158% compared to 2023. The rise in issuance volume of AT1 and Tier 2 instruments relates to rather low volumes in 2023 and 2022, with both years impacted by central bank rate hikes and events with a major impact on these debt classes (e.g. Credit Suisse, as also covered in the last edition of the EBA's Risk Assessment Report).

Issuance volume of unsecured instruments is set to stay high in 2025, mainly driven by a high volume of maturing debt. Banks plan to issue EUR 262bn of senior preferred, EUR 107bn of SNP and EUR 62bn of senior Holdco instruments in 2025, resulting in a positive net issuance volume for each of the debt classes. For AT1 instruments, banks

expect another year of strong issuance volume with EUR 18bn (vs EUR 11bn maturing). For Tier 2 instruments, the planned 2025 issuance volume of EUR 37bn is below the maturing volume of EUR 41bn. In 2026, banks' forecasts point to another year of high issuance volume and positive net issuances for the two main debt classes, senior preferred and SNP instruments. For the other debt classes including AT1 and Tier 2 instruments, issuances are expected to fall below maturing volumes.

Figure 30: Unsecured debt issuance and maturing volume

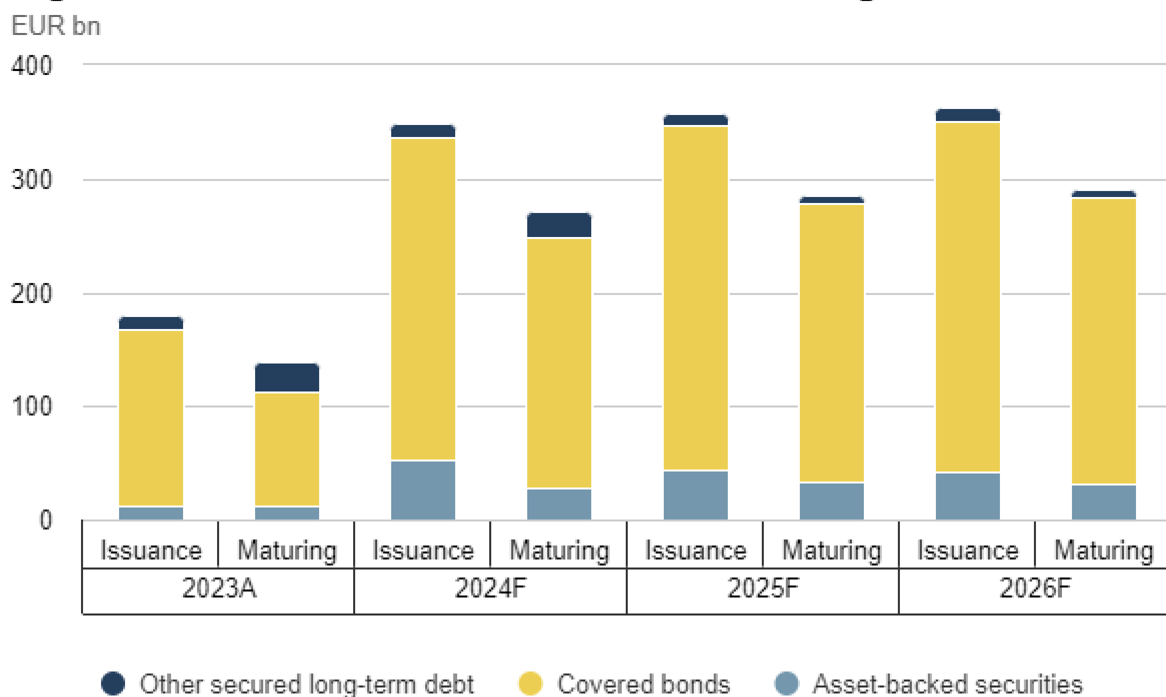


Source: EBA supervisory reporting data (funding plan data)

Banks plan to strongly increase secured funding issuances in 2024 and keep them at a high level in 2025 and 2026. Compared to 2023, the total issuance volume of long-term secured debt is expected to almost double to about EUR 348bn in 2024 (EUR 179bn in 2023). The issuance volume of covered bonds is expected to reach EUR 284bn in 2024, followed by EUR 303bn in 2025 and EUR 309bn in 2026. The strong increase in covered bond issuance in the forecast period is largely driven by a high volume of maturing covered bonds in this period. Yet the issuance volume of covered bonds is forecasted to substantially exceed the volume of maturing covered bonds in each year of the forecast period, representing a total net issuance volume of EUR 220bn for the forecast period. This indicates banks' plans to replace maturing central bank funding with covered bonds and may reflect the fact that covered

bonds can offer a cheaper source of funding than unsecured funding.

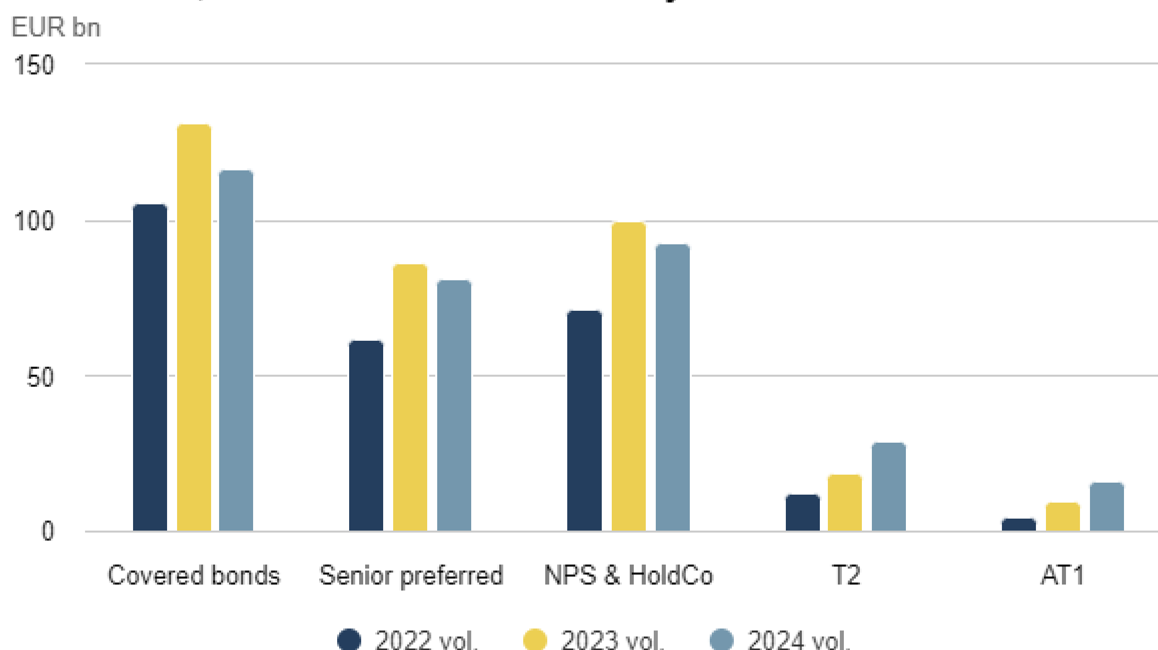
Banks also expect a very strong increase in issuances of asset-backed securities (ABS), to EUR 53bn in 2024, EUR 45bn in 2025 and EUR 42bn in 2026, from about EUR 12bn in 2023. Regulatory and policy initiatives to facilitate and promote securitisations could contribute to banks' plans for strongly increased ABS issuance. Issuance volumes of other secured long-term debt are expected to stay close to the 2023 level of EUR 12bn throughout the forecast period.



Source: EBA supervisory reporting data (funding plan data)

Banks' planned issuance volume for 2024 can be compared with actual bond issuances recorded in the first three months of 2024. While the coverage of banks and issuances differs for the two data sets, a comparison of trends in actual versus planned bond issuances can provide an indication on the feasibility of banks' issuance plans. Primary market data shows that banks placed a high volume of bonds across all bond segments (see Figure 32 and Chapter 3.1 on primary market activity last year and in the first months of 2024). Despite their decline compared to last year, issuance volumes were still high in the first half of this year. If full-year 2024 plans are to be met, bond markets will need to show

high activity levels for the remainder of the year. This is particularly true for covered bond markets, given the planned increase in issuance volume for 2024 (Figure 31). Planned high issuance volumes might become more difficult if financial markets show elevated levels of volatility as it was the case in June. It will also be important that banks use windows of opportunity for their issuances, to avoid bond placements in times of high prices, for instance.



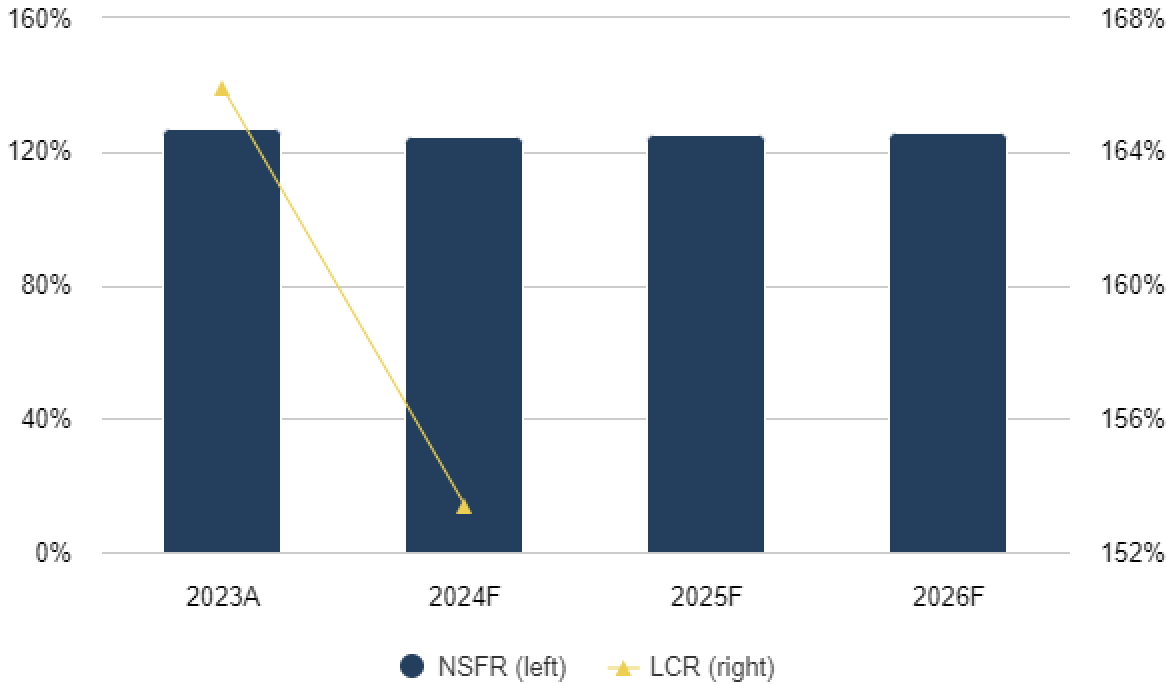
Source: Dealogic

*Based on publicly available market data which may not completely reflect all issuances of the different types of debt and capital instruments.

Liquidity positions

Liquidity positions continued to be strong in 2023, and well above minimum requirements, with a LCR of 166% and an NSFR of 127% in 2023.[10] Funding plan data indicates that liquidity positions are expected to remain solid over the funding plan horizon. However, EU/EEA banks' LCR is expected to decrease to 153% in 2024. Outstanding TLTRO amounts

that EA banks took up from the ECB were at around EUR 400bn at the beginning of 2024 but need to be repaid by the end of this year. Since a declining LCR according to funding plans is mainly driven by declining liquidity buffers (high-quality liquid assets – HQLA), the LCR numerator, it can be expected that a declining LCR is not least driven by these TLTRO repayments, which are presumably at least in part served from cash held at central banks, for example.[11] The expected decrease in the NSFR in 2024 is mostly driven by higher net stable funding needs, presumably driven by higher growth in respective assets compared to the smaller rise in related liabilities. The NSFR is expected to increase again in 2025 and 2026, driven by a stronger increase in available stable funding (the numerator) – presumably explained by the bigger rise in deposits and bond issuances in those years again – than in the required stable funding (the denominator).



Source: EBA supervisory reporting data

[1] This was, for instance, also covered in the last edition of the EBA's Risk Assessment Report from December 2023.

[2] Four banks report a technical shortfall, two of them already solved and no more in shortfall and two pending entry into force of CRR3. MREL dashboard Q4 2023

[3] The shortfall is calculated the same way as in the EBA's MREL Dashboard, using weighted averages of the higher of the MREL requirements calibrated using (i) total risk exposure amount + combined buffer requirement and (ii) total exposure measure.

[4] Top Tier banks are non G-SIIs with total assets above EUR 100bn, and fished banks are non G-SII, non Top Tier banks selected by the relevant resolution authority as being likely to pose a systemic risk in the case of failure.

[5] There are other drivers for potential changes in MREL levels, such as a rise in assets or RWAs, changes due to new MREL decisions of resolution authorities, etc.

[6] According to the supervisory reporting instructions, general government includes central governments, state or regional governments, and local governments.

[7] See, for instance, data on sovereign exposures in the EBA's Risk Dashboard, according to which around 35% of these exposures are measured at fair value (FVtPL, held for trading [HFT] and FVtOCI).

[8] As described in the Introduction, there are partially certain differences between reporting samples and entities as well as reporting requirements, such as in the level of consolidation. This is the reason why, for example, the funding composition data based on funding plan reporting in this chapter differs slightly from the data shown in Chapter 3.1, which is based on FINREP.

[9]It is also important to be aware of the potentially negative impact from the cessation and wind-down of the ECB's different asset purchase programmes, which might affect market liquidity.

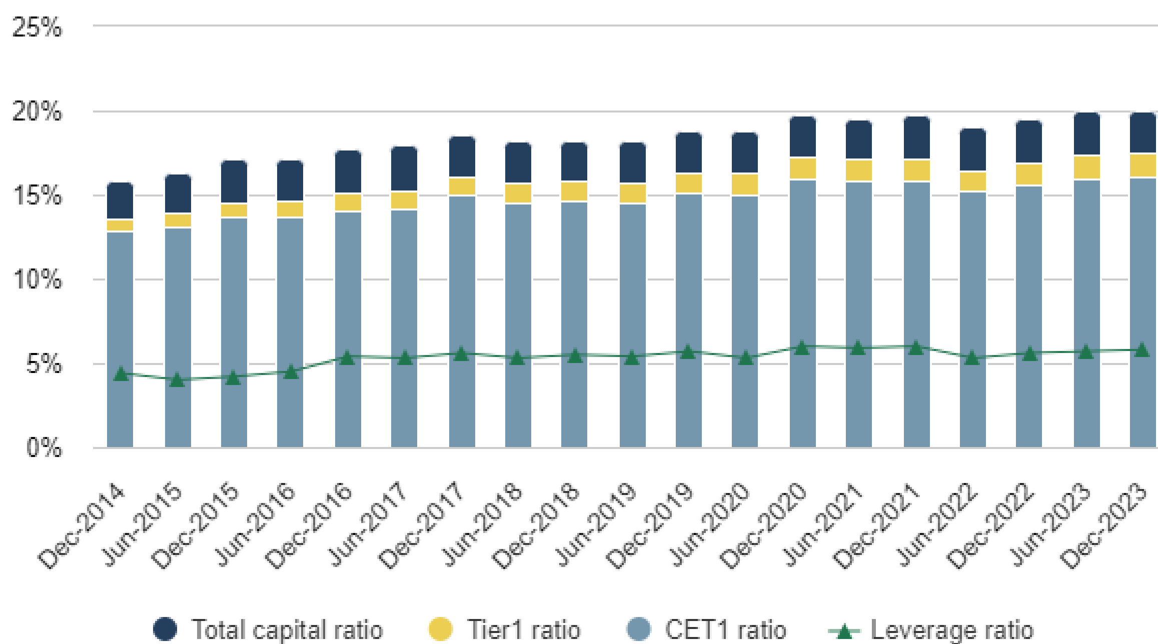
[10] Based on funding plan data which cannot be fully reconciled with EBA liquidity reporting data (see explanations in the Introduction).

[11] The repayment of TLTRO will also release previously encumbered assets. However, these are presumably only in part HQLA-eligible assets. According to an ECB article from 2021 on TLTRO III and bank lending conditions the encumbered non-HQLA collateral reached nearly 75% of banks’ TLTRO.

Capital and risk-weighted assets

Capital ratios have remained at record levels. The total capital ratio reached 20.0% as of year-end 2023, which is a YoY increase of around 45 bps. This was primarily driven by the CET1 component, which rose from 15.6% in Q4 2022 to 16.1% one year later. The latter is an all-time high (capital ratios transitional definition; the fully loaded CET1 ratio stood at 16.0% as of YE 2023; Figure 34). Overall, the volume of CET1 capital rose from around EUR 1.4tn in Q4 2022 to around EUR 1.5tn as of YE 2023. The increase in capital and respective ratios was supported by rising retained earnings and comparatively slower growth in RWA, and despite rising payouts.

Figure 34: Capital ratios (transitional definitions) and leverage ratio



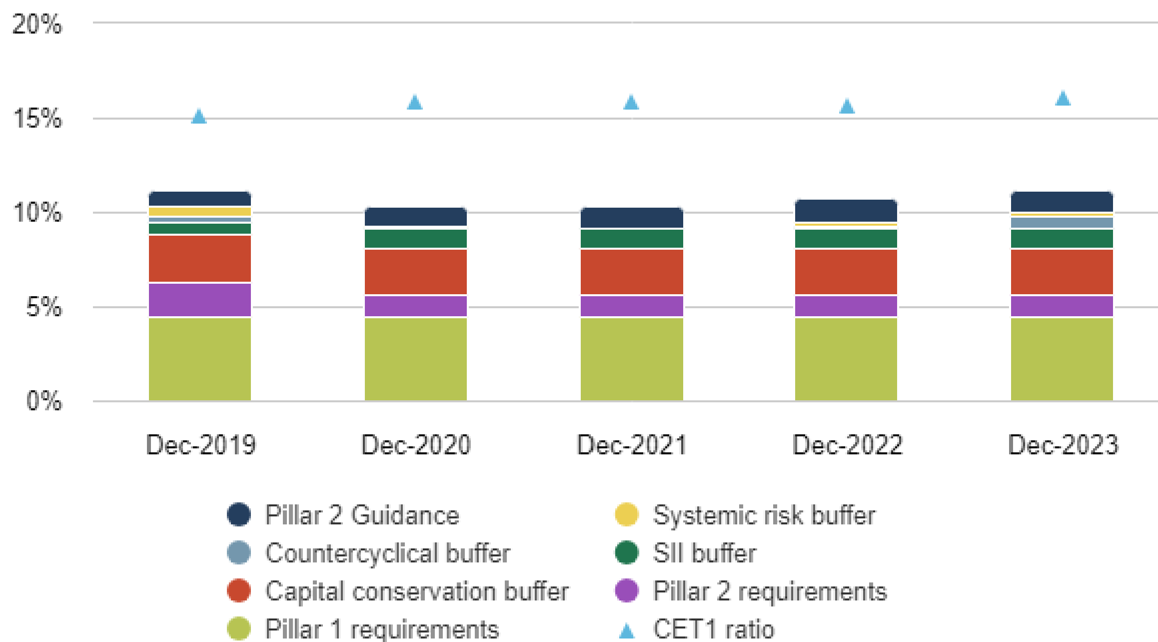
Source: EBA supervisory reporting data

High capital buffers and profits enable high payouts – but going forward caution might be needed

EU/EEA banks' CET1 headroom above OCR - which consist of Pillar 1, Pillar 2 and the combined buffer requirements - and P2G, have remained at comfortable levels. They rose

slightly YoY, reaching nearly 500 bps as of Q4 2023 (around 490bps in Q4 2022). Such a stable headroom is a result of a slightly stronger increase in CET1 ratios (transitional definition) than respective OCR plus P2G. The rise in the OCR was primarily due to an increase in the countercyclical buffer (CCyB) component, which rose from on average 20 bps in Q4 2022 to 56 bps in Q4 2023 (Figure 35). A country-by-country analysis shows a relatively big dispersion of the available headroom, but also confirms that there is in most cases comfortable headroom of CET1 ratios above capital requirements (Figure 36).

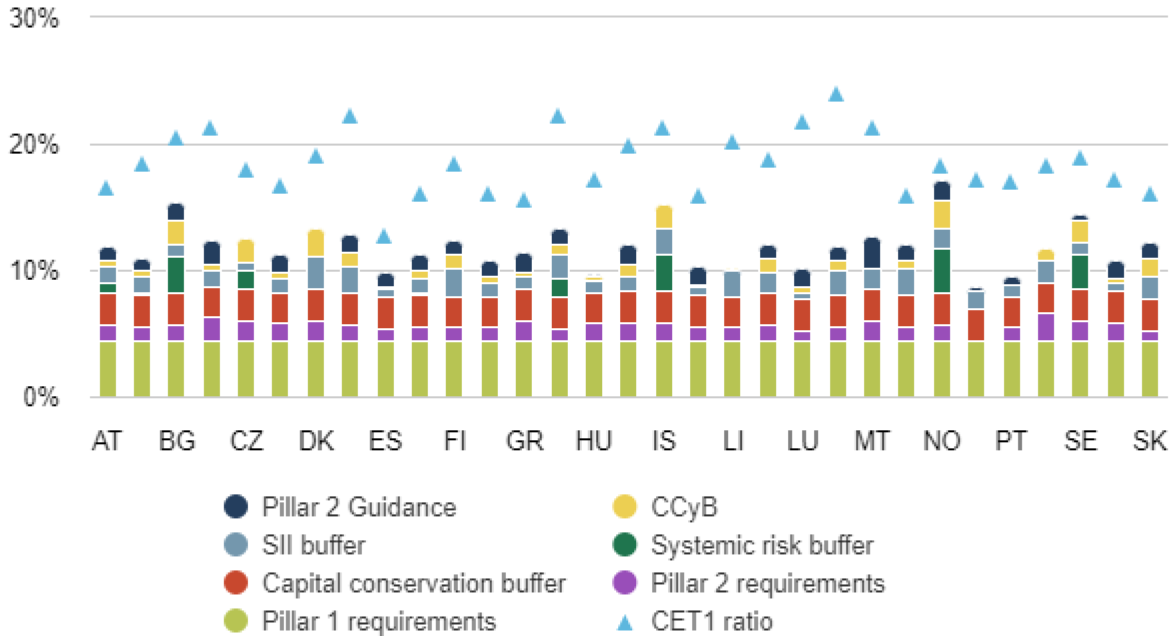
Figure 35: CET1 requirements and Pillar 2 Guidance vs CET1 ratio (transitional definition) *



Source: EBA supervisory reporting data

* SII buffer refers to G-SII and other systemically important institution (O-SII) buffers.

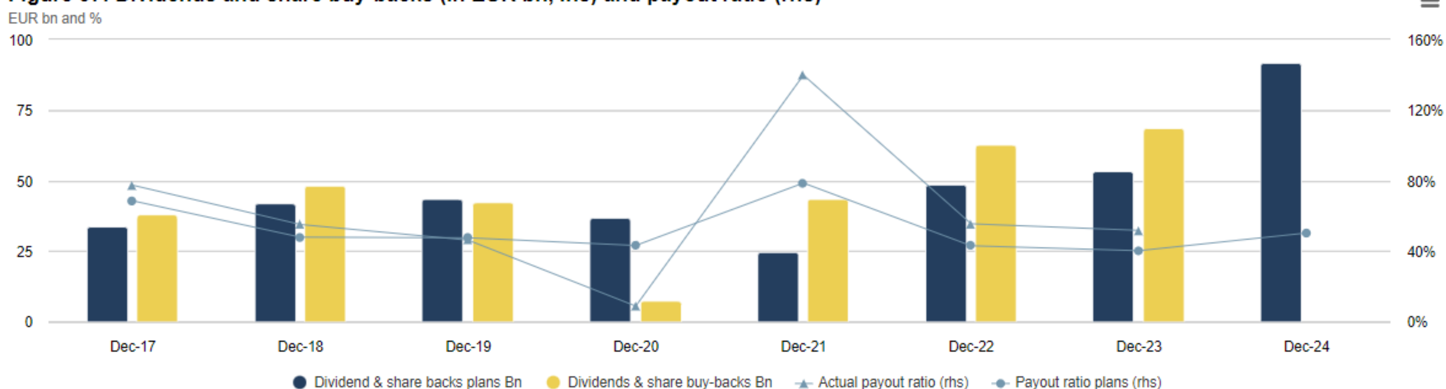
Figure 36: CET1 requirements and Pillar 2 Guidance vs CET1 ratio (transitional definition) by country



Source: EBA supervisory reporting data

Amid elevated capital buffers and high profitability compared to the past, banks' plans indicate a further rise in payouts for this year. Planned payouts in 2024 reach nearly EUR 100bn for the covered sample of banks, which is the highest volume for years. It is also more than 30% above last year's payouts, which is at the same time slightly higher than the YoY increase in net profits of around 32% (on the rise in net profits, see Chapter 5.1). The planned payouts in 2024 would correspond to a payout ratio of around 50% (Figure 37).

Figure 37: Dividends and share buy-backs (in EUR bn, lhs) and payout ratio (rhs)



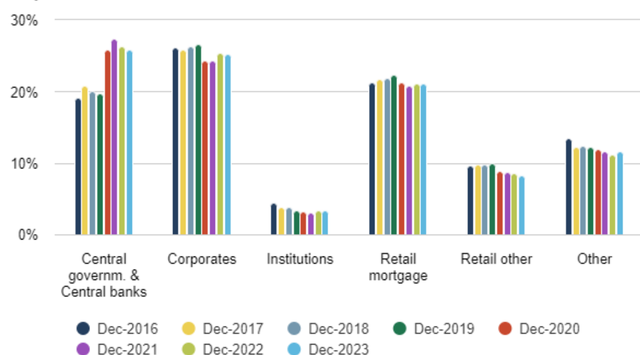
Source: EBA supervisory reporting data

Looking forward, amid rising risks, a continuous cautious stance in respect of payouts is paramount. Banks need to be prepared to weather a range of events including deterioration in asset quality at least in some segments, with some of them more difficult to anticipate, such as any impact from geopolitical risks, which can materialise through many different channels in credit, market or operational risks. However, in any case and as in the past, also going forward, case-by-case assessment of payouts remains important for supervisors. Another forward-looking aspect is that, amid high capital ratios, only 2% of the banks participating in the RAQ aim to focus on CET1 instruments in their issuance plans for the next 12 months.

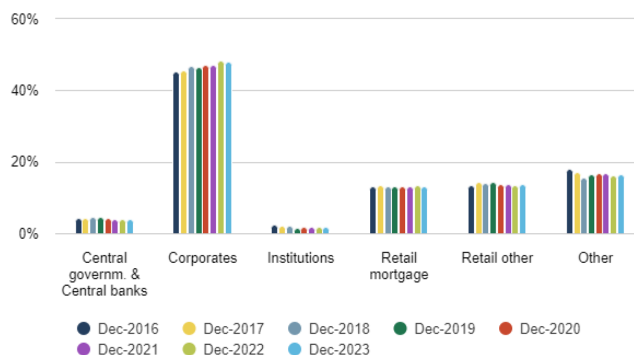
Rising risk in asset quality not (yet?) reflected in capital parameters

RWAs showed an increase of around 2.4% YoY. Credit RWAs as its main component rose by 2.0%, which compares with total asset growth of 1.1% during the same period (see Chapter 2.1 on asset volumes and composition). Whereas market RWAs have remained flat, operational RWAs increased by around 7%. However, they are less relevant as drivers for overall RWA developments (credit RWAs with a share of 81.8% in total RWAs, 3.7% for

market and 10.2% for operational RWAs, as of YE 2023). Within credit RWAs, other retail exposures (i.e. those that are not retail mortgage exposures) rose the most (+3.0%). This rise is in contrast to a decline in exposure amounts, which went down by nearly 1.5% YoY (Figure 38).[1]

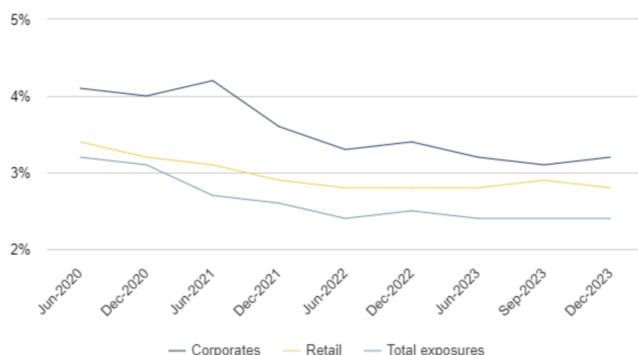


Source: EBA supervisory reporting data

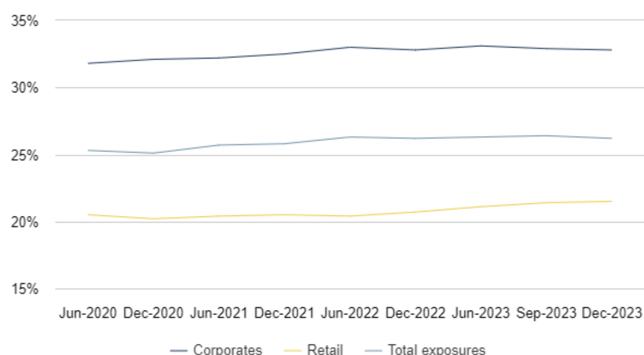


Source: EBA supervisory reporting data

Besides trends in exposure amounts, credit RWAs also depend on other parameters, such as probability of default (PD) and loss given default (LGD) when the internal ratings based (IRB) approach is applied. At banks using internal credit risk models, total average PDs declined on a YoY basis, continuing a trend of previous years. However, they recently showed some diverging trends. Corporate PDs increased slightly in Q4 last year, whereas retail PDs declined again in the last quarter, after having increased in the previous ones. These developments reflect the overall limited asset quality deterioration during 2023. They also reflect that comparatively, for corporate exposures the deterioration in asset quality has been worse, as also seen in stage 2 ratios. RAQ results also point into this direction, according to which banks' views are more negative for NFC than for household exposures (on asset quality see Chapter 2.3).[2] LGDs remained stable on a YoY basis for corporates but rose slightly for retail exposures. The increase in LGDs of retail exposures might not least explain the diverging trends in other retail RWAs versus respective exposure amounts (Figure 39). Going forward, amid expectations of a further deterioration in asset quality, including potential further declines in real estate prices, PDs and LGDs might be accordingly affected (on asset quality expectations see Chapter 2.3 and on real estate prices see Chapters 1 and 7).



Source: EBA supervisory reporting data



Source: EBA supervisory reporting data

---

[1] It needs to be noted that portfolios/segments are differently defined in financial reporting (FINREP), which forms the basis for the analysis in Chapter 2.1, and in common prudential reporting (COREP), which forms the basis for the analysis in this chapter. These different definitions of portfolios/segments are the reason that the respective data cannot be fully reconciled with each other. Furthermore, the concept of the carrying amount of loans differs from the concept of exposure amount. The latter, for instance, also includes loan commitments after a certain weighting etc.

[2] See also the EBA's report on the 2023 credit risk benchmarking exercise from April 2024, e.g. paragraphs 10ff..

Profitability

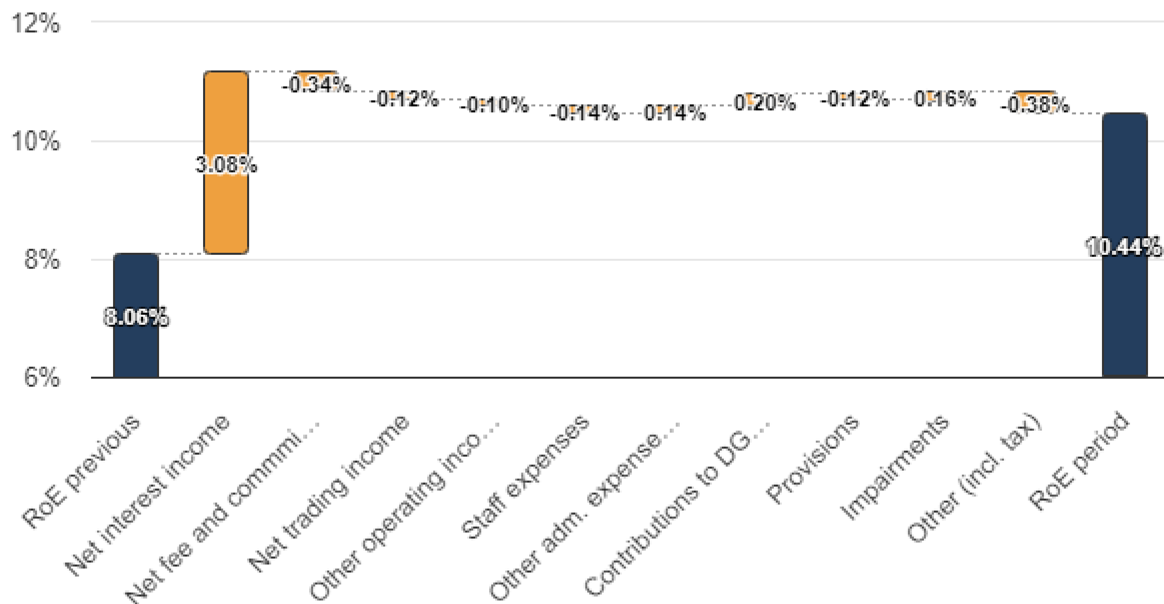
Key drivers and developments in EU/EEA banks’ profitability

EU/EEA banks’ net profits increased by around 32% YoY in 2023, driven by a large YoY rise of NII. The NII increase, which was particularly significant in the first half of the year, was mainly supported by a widening NIM rather than loan growth. On average EU/EEA banks were able to take advantage of the rising interest rate environment and expand their margins, as the repricing of the asset side was faster than the repricing of the liability side. However, following a stabilisation of the NII in mid-2023, some profitability indicators have begun to show the first signs of decline, albeit from extraordinarily high levels, indicating that banks' profitability may have already peaked. As rates have presumably reached their plateau, it is plausible to expect that going forward the interest rate environment will negatively affect the interest income and overall profitability of banks (on rate expectations see Chapter 1).

An NII-driven profitability boost

The return on equity (RoE) of EU/EEA banks grew substantially from 8.1% in December 2022 to 10.4% in December 2023. This increase was almost entirely driven by higher NII, whose positive contribution to the RoE rose by 308 bps compared to the previous year. Conversely, net fee and commission income (NFCI) and, to a lesser extent, net trading income (NTI) made negative contributions (34 bps and 12 bps respectively). Despite the inflationary pressures on wages in the economy, banks managed to limit the increase in their staff expenses (negative contribution of 14 bps), while also reducing other administrative expenses (positive contribution of 14 bps). Although provisioning-related costs adversely affected profitability (negative contribution of 12 bps), lower impairment charges entirely compensated for this increase (positive contribution of 16 bps) (Figure 40).

Figure 40: RoE and contribution of the main P&L items to the RoE, comparison between December 2022 and December 2023



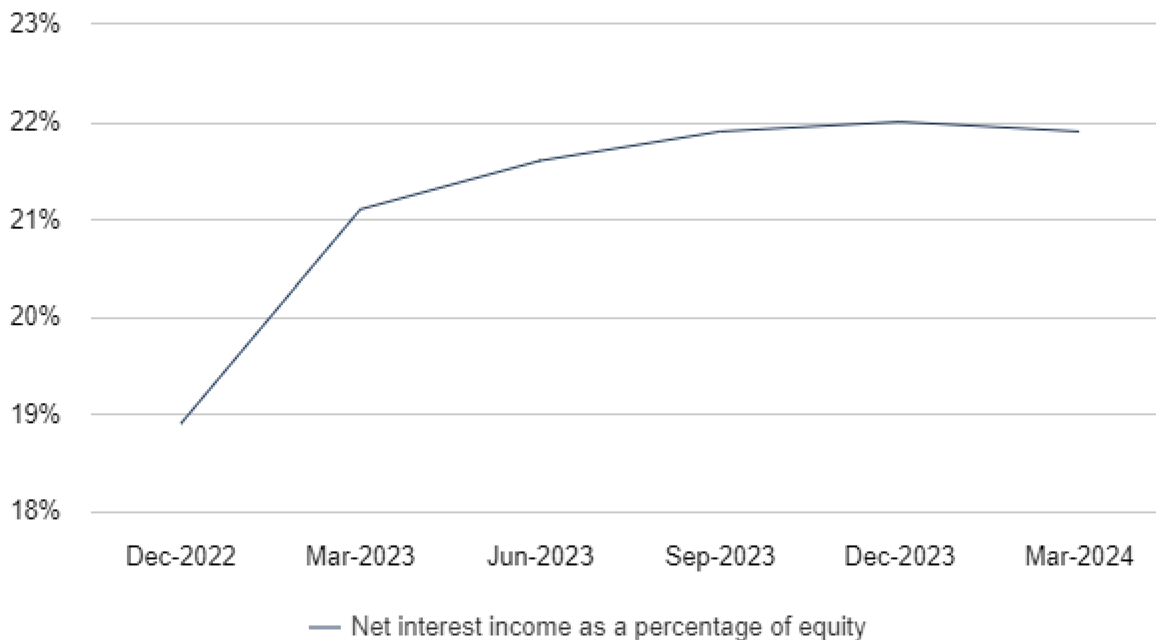
Source: EBA supervisory reporting data

Return on assets (RoA) of EU/EEA banks also showed material YoY growth, reaching 0.69% in December 2023 from 0.52% in December 2022. The increase over the previous year in the RoA was even more pronounced compared to the RoE, as total equity displayed a more steady and significant increase than total assets during the period. Nevertheless, after an increase in the first two quarters of 2023, the indicator reached its peak (0.72%) in the third quarter and then started to decline in the last quarter of 2023. While the overall increase in RoA is linked to the rising NII, the small decrease recorded in the fourth quarter could be attributable to the slower growth of NII when at the same time other sources of income continue their previous decline. This stabilisation followed by a slight decrease of RoA would support the idea that profitability may have reached its peak before possible policy rate cuts by central banks (on rate expectations see Chapter 1, Figure 41). However, it should be noted that this might at least partially also be due to seasonality, with fourth-quarter profitability often being lower than in the third quarter. NII represented a bit less than 19% of total equity as of Q4 2022 but it increased materially in March and June 2023 to reach more than 21.5%. Since this uptick, NII broadly stabilised throughout the remainder of the year 2023 (Figure 42).

Figure 41: Evolution of EU/EEA RoA, between December 2022 and December 2023

Source: EBA supervisory reporting data

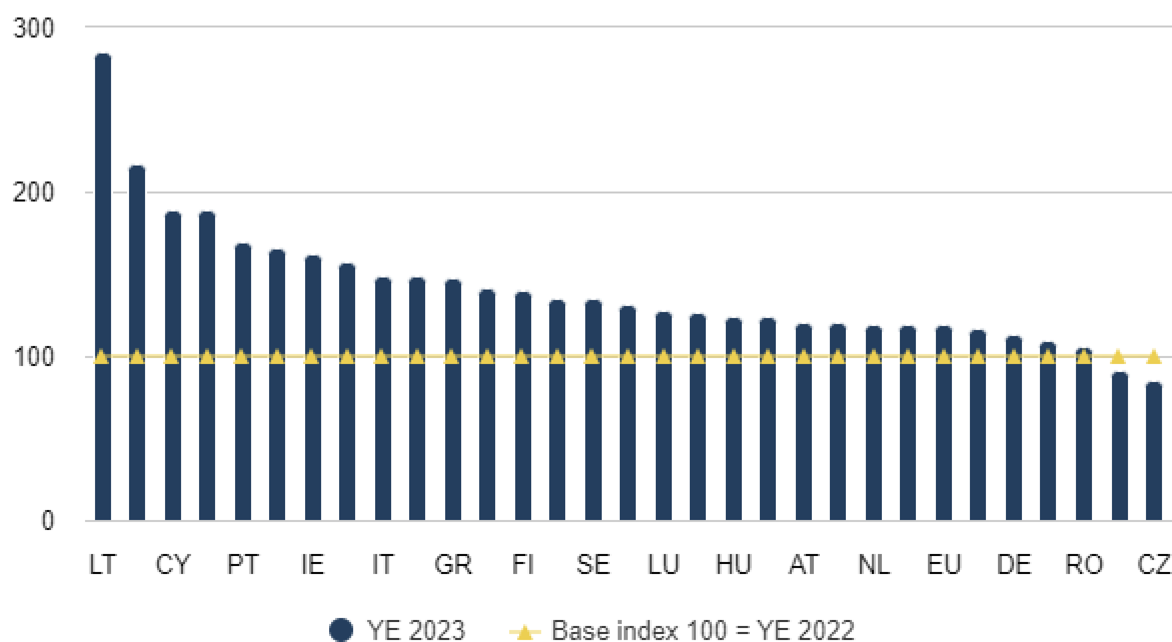
Figure 42: Year-on-year variation of NII as a percentage of equity, between December 2022 and December 2023



Source: EBA supervisory reporting data

In a context in which the growth of interest-earning assets is limited due to a challenging macroeconomic environment, with only 1.4% YoY growth in 2023, the increase in NII is driven by more than 90% by widening margins. While most countries are benefiting from last year's NIM movement, some countries show greater benefit than others. In particular, the Baltic countries have almost doubled their NIM, while the EU/EEA weighted average points to a 19% increase. Conversely, some countries have seen either limited growth in NIM or an overall decrease in NIM, as in the case of France and Czechia. In the case of France, this is not least due to the balance sheet structure, which is composed notably of a high share of fixed-rate assets, and certain rules and regulations, such as, for instance, those on regulated saving (e.g. Livret A), affecting both the asset and liability sides on e.g. mortgage and deposit pricing. In the case of Czechia, this is mainly due to the rising average cost of deposits amid a continued move of customer deposits from current to term and savings accounts, and stable and even slightly declining loan yields, as well as the end of remuneration of mandatory reserves at the Czech National Bank (Figure 43).[1]

Figure 43: Year-on-year variation of net interest margin by country



Source: EBA supervisory reporting data

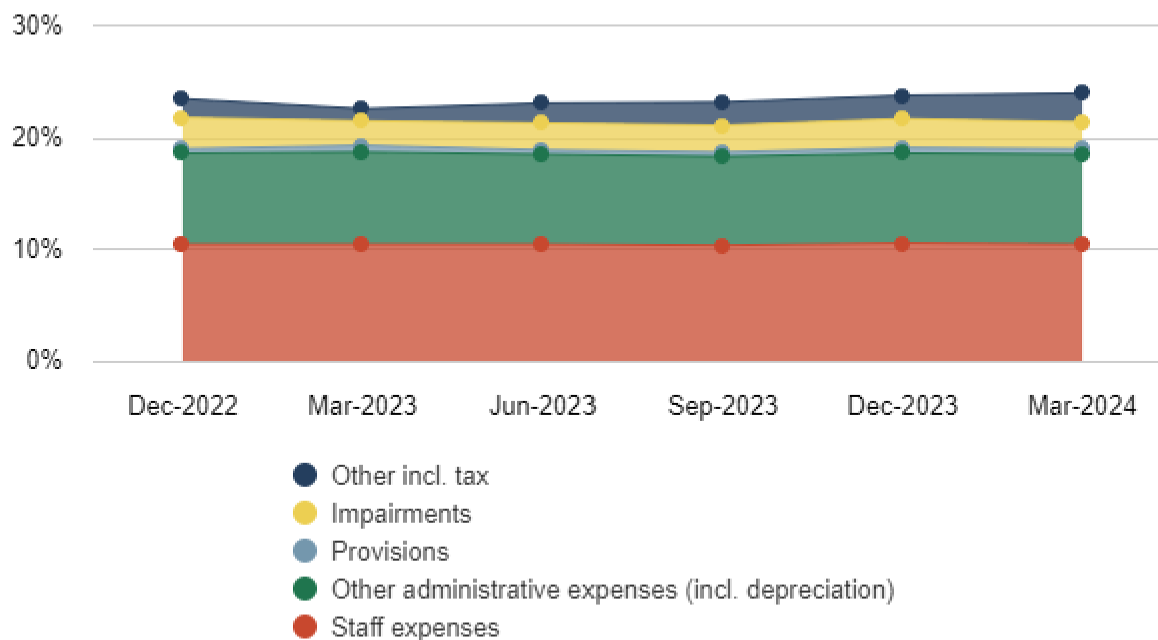
These differences among countries largely point to national specificities in terms of business models. On a more granular basis, a bank-by-bank view highlights the importance

of a sound interest rate risk on banking book (IRRBB) management and hedging policy in order to steer the banking book in a direction that will generate profits in line with expected changes in interest rates. Banks have to ensure that they manage interest rate risk and their NII cautiously and be prepared for a higher for longer rate environment as well as potential rate cuts. Hedging, including, for instance, through structural hedges, is one means to address these challenges.

A stable cost base

In a context in which inflation has been strong, albeit declining throughout the year, banks have managed to keep their cost base at a stable level, at around 25% of their equity. Such stability is remarkable as some costs tend to appear with some delay, of which notably staff expenses, which were flat over the period. Therefore, the cost picture in general did not change in terms of the share of the main costs (Figure 44). The cost-to-income ratio (CIR) accordingly reached one of its lowest levels reported, declining by 4.9 p.p. YoY to 55.6% as of Q4 2023. This was due to a bigger increase in total net operating income (denominator) compared to the rise in costs (numerator).

Figure 44: Evolution of cost base on equity, between December 2022 and December 2023



Source: EBA supervisory reporting data

Longer-term challenges to profitability

In the medium term, assuming that interest rates will continue their declining trend going forward, the contribution of NII to overall profitability will presumably go down (on the expectation of declining rates see Chapter 1). The fact that banks have locked in higher rates for their securities portfolios might help to buffer the impact of declining rates on NII at least to some degree (on the rise of banks' debt securities holdings see Chapter 2.1). However, as was the case in the low rate environment, banks will have to rely more on fees and commissions to generate profits, in a context where this source of income will be directly challenged in the coming years by the advent of new players.

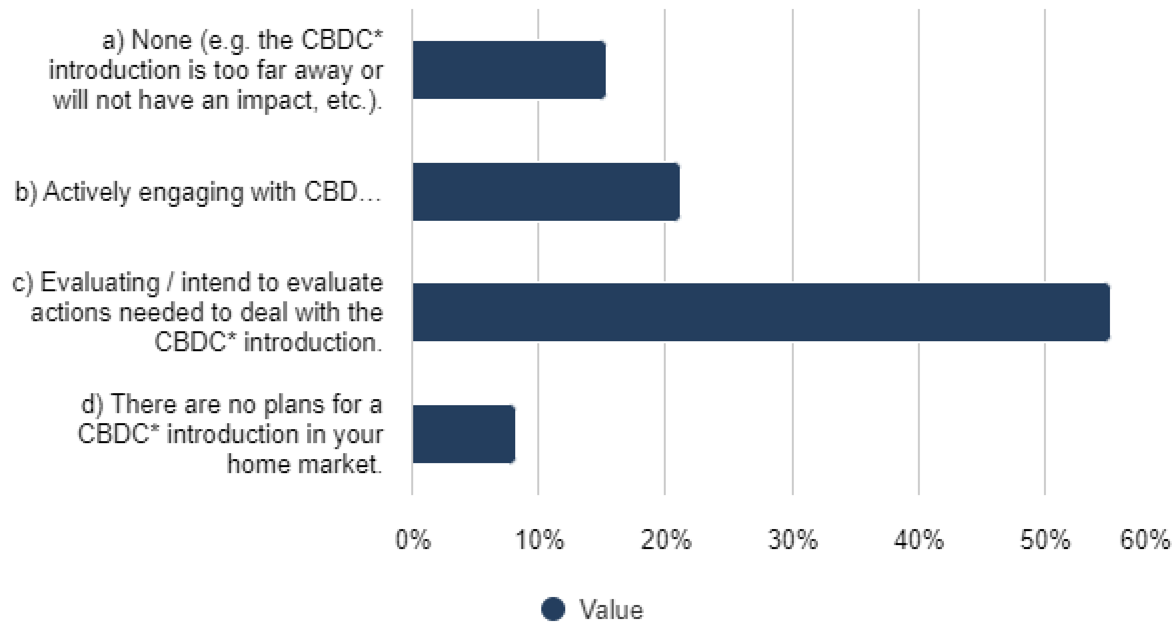
The onset of FinTechs, incl. BigTech, and central bank digital currencies (CBDCs) is poised to significantly reshape the landscape of EU/EEA banking, with potentially profound implications for profitability (on CBDCs see also the textbox within this Chapter). FinTechs, leveraging advanced technologies, might, for instance, provide personalised financial services, faster transactions and often an improved customer experience. As customers increasingly gravitate towards these digital platforms, traditional banks may face a decline in their income. However, whereas banks might also try to replicate FinTechs, other banks acquire FinTechs to add respective experience to their business. Looking at the introduction of CBDCs, they could have negative and positive impacts on the profitability of European banks. CBDCs could lead to a decrease in banks' transactional revenues and e.g. household bank accounts, thereby affecting their profitability through reduced activity and higher funding costs amid decreasing deposit volumes, which tend to be the cheapest source of funding. At the same time, they might have the possibility to offer new products, which could result in new revenue streams, or they could improve banks' ICT, which might reduce related 'running' costs. While these projects are still in the early stages, it is important that banks remain agile and flexible to sustain or even improve their profitability in an ever changing environment.

Thoughts on potential impacts of CBDCs on banks

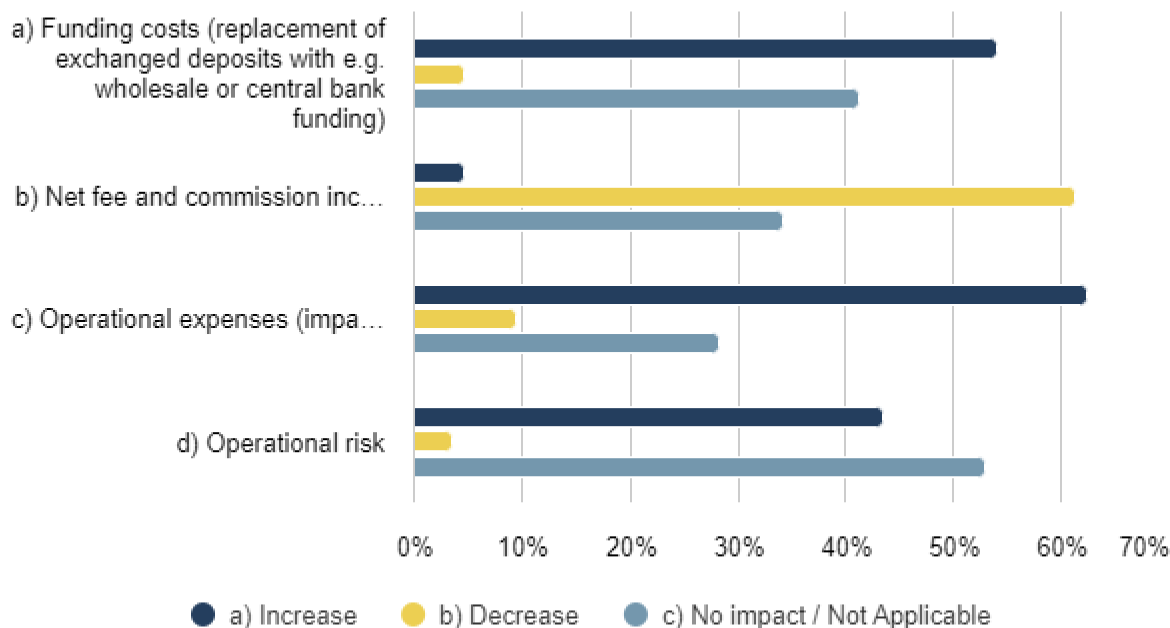
Projects related to the introduction of retail CBDCs have gained pace inside and outside the euro area. The introduction of a retail CBDC is expected to also affect banks, in particular their funding and liquidity. This would happen because the CBDC might result in a certain outflow of household deposits, as households might change parts of their deposits into the CBDC. However, in general banks should be able to replace such potential CBDC-driven deposit outflows with other funding sources. Banks should also be able to disincentivise potential CBDC-driven deposit outflows, considering that the CBDC would not be remunerated. However, if need be, they can also tap central bank funding. In this respect, preliminary and indicatively calculated analysis shows that on average banks should have enough collateral available to pledge it with central banks (see Chapter 3.3 on asset encumbrance and available collateral for central bank funding). CBDCs might accordingly affect banks' profitability amid the replacement of client deposit funding with more expensive funding sources. Fee income might also be affected as well as operational expenses and operational risks. The latter includes, for instance, technology-related risks, and including fraud and similar risks.

However, it needs to be stressed that CBDCs will also have positive implications for banks. Banks might, for instance, generate fee income on CBDC-related products or services. They might also gain new clients if they offer attractive CBDC-related products or services, for instance. There might also be positive impacts on operational risks, for instance resulting from fewer cash withdrawals or the replacement of legacy systems and processes with new technology. The concrete impact will depend on many parameters, some relating to the design of CBDCs (holding limits, limitation by type of customers, waterfall mechanisms to deposit accounts, compensation scheme, etc.) and others relating to the adoption rates of customers, be they households or corporates. One also needs to differentiate between normal times and times of stress. In a stress scenario the availability of CBDCs might exacerbate the potential risk of systemic bank runs, as CBDCs might be considered safer assets.[2]For normal times, preliminary and indicatively calculated analysis shows that CBDCs might have only limited impact on the banking sector, even though some banks might show stronger or even severe impacts on either their liquidity and/or their profitability. RAQ results indicate that banks are particularly concerned about CBDCs' negative impact on their net fee income, operational expenses and funding costs. Only

around 40% expect a negative impact on their operational risks, which might also indicate that banks have not yet fully assessed the risks related to CBDCs. The fact that only around 20% have so far actively engaged with CBDCs might confirm this finding (Figure 45).



Source: EBA Risk Assessment Questionnaire



Source: EBA Risk Assessment Questionnaire

Banks' forecasts of client rates

The interest rate hikes of the past two years have led to a repricing of banks' assets and liabilities. For loans, banks reported a significant increase in interest rates for all loan portfolios in 2023, with interest rates received on loans and advances to central banks recording the highest rise (on average +272 bps to on average 4.32%), followed by interest rates earned on loans to other financial corporations (+182 bps to 4.69%). Interest rates on loans to NFCs and on loans to households, which represent the biggest segments, increased by +166 bps to 4.63% and a smaller 84 bps to 3.69%, respectively.

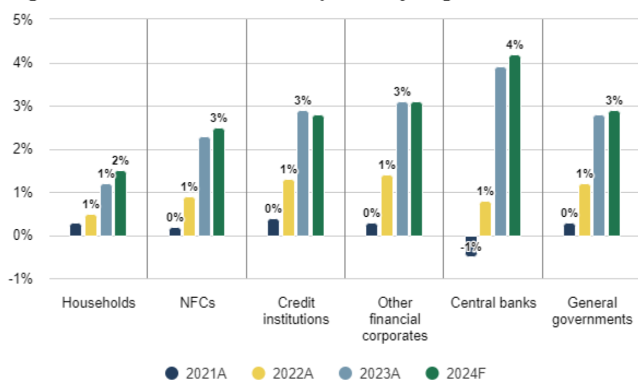
With regard to deposits, by far the biggest liability class, banks recorded a significant increase in interest rates across all types in 2023. The largest rise was observed for interest paid on deposits from central banks (on average +305 bps to on average 3.87%), other financial corporations (+176 bps to 3.15%), credit institutions (+164 bps to 2.94%) and governments (+151 bps to 2.76%). Interest rates on deposits from NFCs rose by +132 bps to 2.25%. The lowest increase in interest rates was reported for household deposits (+67 bps to 1.18%). The latter is similarly reflected in so-called deposit betas (see on deposit betas a

more detailed analysis in the [last edition of the EBA's Risk Assessment Report](#)).

Expectation of still rising loan and deposit rates for some portfolios in 2024 with client spread widening coming to a halt

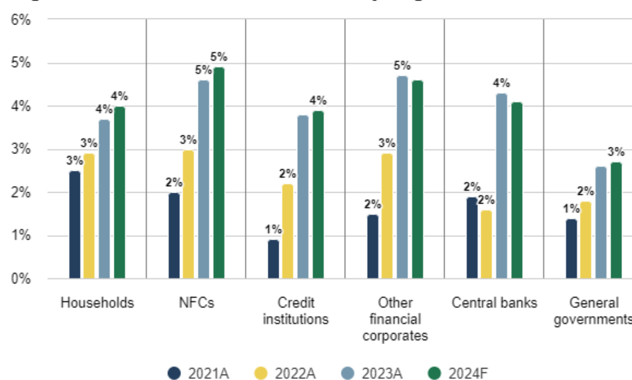
In 2024, considering that central bank policy rates should have already peaked, banks expect a reduction of interest rates on loans to central banks (-24 bps) and other financial corporations (-9 bps) on the asset side (on interest rate expectations see Chapter 1). On the liability side, they expect a decline in interest rates on deposits from credit institutions (-10 bps) and other financial corporations (-4 bps). For other loan portfolios and other types of deposits, banks anticipate further rate increases, albeit at a significantly slower pace compared to the previous year. This is presumably due to the replacement of maturing fixed-rate loans from times of (ultra) low rates, with loans that bear higher interest rates. The highest increases are planned for household loans (+30 bps to 3.99%) and NFC loans (+29 bps to 4.92%), as well as similarly for household deposits (+34 bps to 1.52%) and deposits from NFCs (+29 bps to 2.54%; Figure 46).

Figure 46a: Interest rates on deposits by segment



Source: EBA supervisory reporting data (funding plan data)

Figure 46b: Interest rates on loans by segment



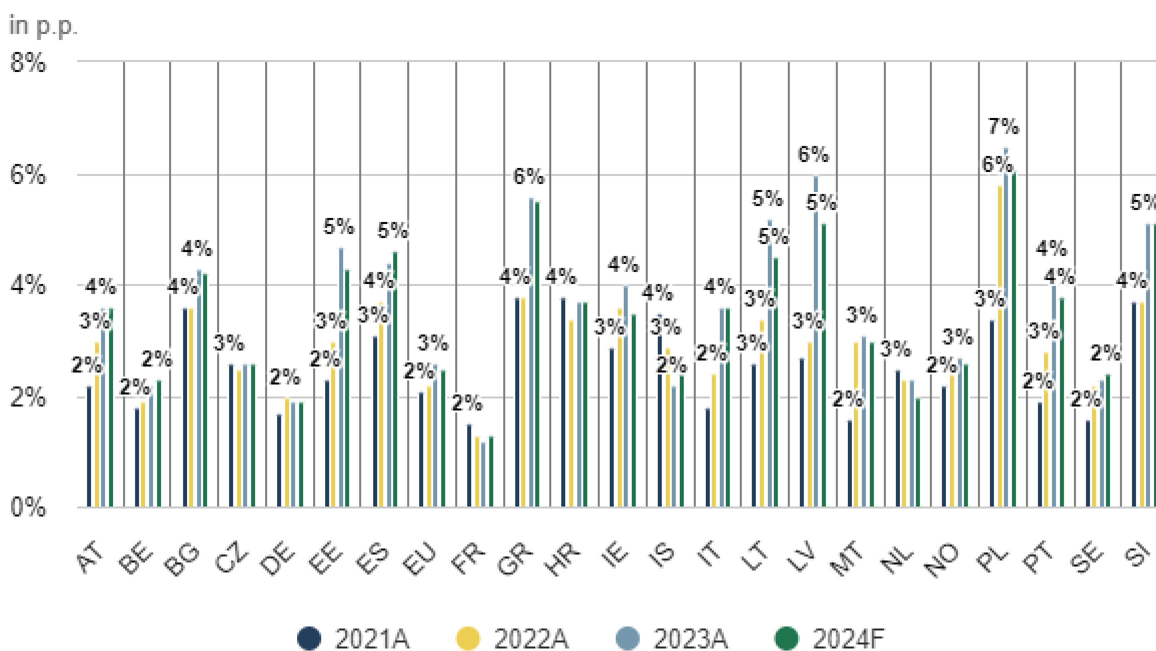
Source: EBA supervisory reporting data (funding plan data)

In 2023, spreads between interest rates for loans and deposits to/from household and NFC clients generally kept their upward trend, due to the increase in interest rates on loans, which continued to outpace the rise of deposit rates. As of December 2023, the EU/EEA average client spread was 2.57%, 32 bps above the spread observed one year earlier (2.25%). This YoY change was even more pronounced than the one recorded in 2022 (+19 bps). The largest yearly increases were reported by banks in Latvia (+293 bps), Lithuania

(+184 bps) and Greece (+175 bps). In a limited number of countries, including Iceland (-65 bps) and Germany (-9 bps), the client spread instead decreased in the last year.

Amid the expected changes in client loan and deposit interest rates, banks anticipate a stabilisation of respective spreads in 2024, with an average reduction of 2 bps in the EU/EEA. A certain divergence in client spread developments can, however, be seen at country level, with major reductions – albeit from extremely high levels – in Latvia (-91 bps) and Lithuania (-72 bps) but further increases in Iceland (+18 bps) and Spain (+18 bps) (Figure 47). These numbers confirm the idea that client spreads have presumably plateaued and could for now stay stable, before they might come under pressure.

Figure 47: Actual and forecasted spread between client loans and client deposits (households and NFCs)

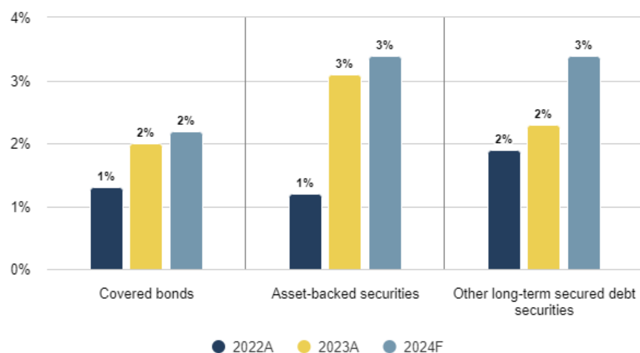


Source: EBA supervisory reporting data (funding plan data)

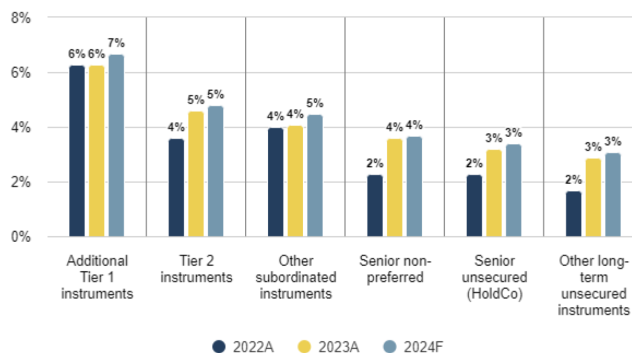
Further increases in pricing for banks' market-based funding instruments, forecasted mixed developments for next year

After the long trend of decreasing funding costs ended in 2022, the cost of market-based financing increased further in 2023. The actual cost of long-term funding in 2023 was reported on average at 2.95% in the EU/EEA, 98 bps higher compared to an average of 1.97% in 2022. The increase in funding costs could be seen at most banks in the sample. In

2024, most banks expect costs for long-term market-based funding to increase further, albeit to a lesser extent. On average, banks plan for a rise of on average 28 bps at EU/EEA level, with bigger differences between countries than in 2023.



Source: EBA supervisory reporting data (funding plan data)



Source: EBA supervisory reporting data (funding plan data)

As regards secured debt instruments, on average banks reported an increase in funding costs of 76 bps in 2023. The increase was notable for all categories of secured funding instruments. Funding costs for covered bonds rose by 70 bps to reach 2.03% in December 2023, while costs for asset-backed securities recorded a sharper increase of 187 bps, reaching 3.11% in December 2023. In 2024, banks expect a further, but considerably smaller increase in costs for secured debt instruments (covered bonds +18 bps, asset-backed securities +12 bps).

As regards unsecured debt instruments, on average funding costs went up by 97 bps in 2023. Mixed developments were, however, observed across the different unsecured funding instruments. On the one hand, some categories experienced significant cost rises, with the highest increases being recorded by NPS bonds (+128 bps to 3.58%), followed by T2 instruments (+108 bps to 4.64%) and senior unsecured (HoldCo) bonds (+88 bps to 3.18%). On the other hand, costs for AT1 instruments slightly decreased (-5 bps to 6.27%), after strong growth in the previous year. In 2024, banks anticipate further but generally moderate cost increases for all categories of unsecured debt instruments. The expected increase is stronger for AT1 instruments (+47 bps) and subordinated instruments (+36 bps), whereas cost rises are very modest for other categories of unsecured debt instruments,

including T2 instruments (+16 bps) and NPS bonds (+17 bps) (Figure 48). These expected developments add to the idea that there is increasing pressure on EU/EEA banks' NII going forward.

---

[1] See the Czech National Bank's statement on ending the remuneration of minimum reserves, starting at 5 October 2023.

[2] Currently applicable financial stability, central bank and bank risk management limits and tools should, however, help to prevent a CBDC from increasing the latent risk of systemic bank runs during periods of stress.

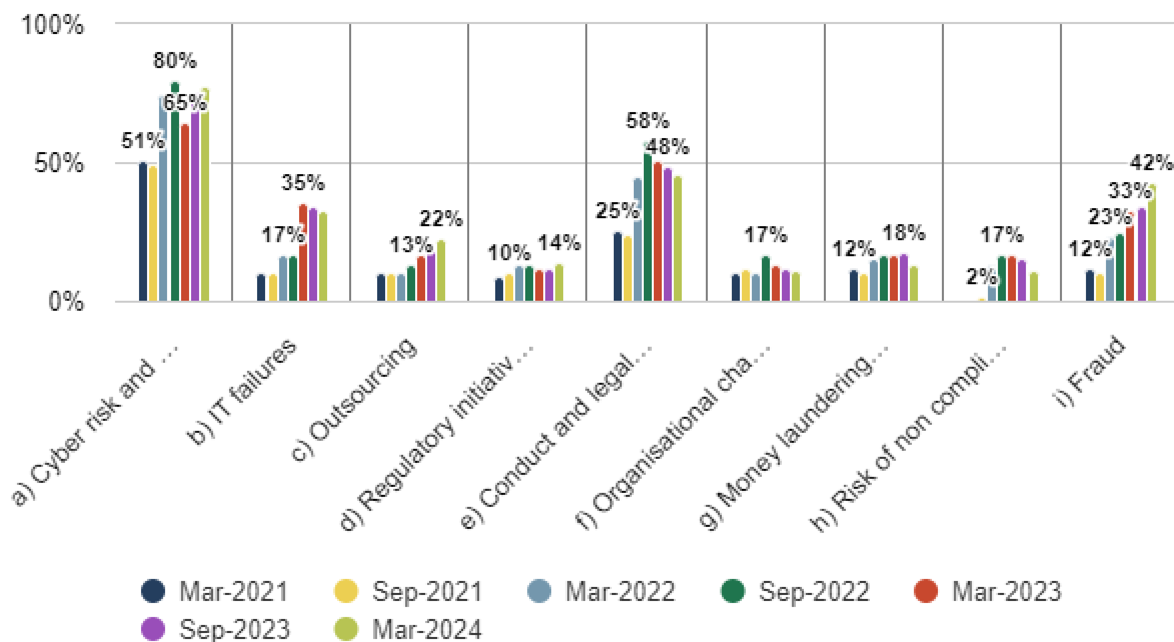
Operational risks and resilience

General trends

The relevance of operational risk and operational resilience for the banking sector has grown further. Operational risk capital requirements have been rising and account for over 10% of total capital requirements for the first time since December 2020, when operational risks were high amid the pandemic. The scope and relevance of operational risk expanded in recent years, and this is not least driven by technological advances and digitalisation.[1] Financial institutions and supervisors also continue to monitor closely reputational challenges and the risk of financial crime, including anti-money laundering (AML) risk and further conduct-related and legal risk that banks have been exposed to. More recently, fraud risk is increasingly coming to the fore.

Potentially very severe implications of this broadened scope of operational risk underline the importance of ensuring operational resilience. This is not least reflected in RAQ responses, according to which cyber risks and data security rank the highest of the operational risks (78%). Risk of ICT failures as a related risk remains high as well. Conduct and legal risks are the second most relevant drivers of operational risk, at 48% agreement. They have become key operational risk drivers for banks in the past years, albeit slightly decreasing since September 2022. Risks related to financial crime, but also further digitalisation and technical innovation, including growing usage of artificial intelligence (AI) in financial crime, may have contributed to a continuously growing risk of fraud. At 42% agreement (10% agreement in autumn 2022), risk of fraud has become the third most relevant driver of operational risk, according to the RAQ. On fraud, already last year the Basel Committee on Banking Supervision (BCBS) pointed to rising fraud risks following the pandemic and amid rising digitalisation.[2]The EBA has also identified new types and patterns of payment fraud, and proposes measures to mitigate underlying risks and protect customers from resulting losses.[3] Outsourcing risks also continue to increase in banks' perceptions, according to the RAQ, as reliance on outsourcing business activities and data

has grown (Figure 49). Beyond existing risks in this area, CBDC-related operational risks linked to e.g. ICT failures as well as fraud or cyber risks might arise with the introduction of CBDCs (see the textbox on CBDCs in Chapter 3.4).



Source: EBA Risk Assessment Questionnaire

* Agreement to up to three options was possible for respondents.

Digitalisation and ICT-related risks

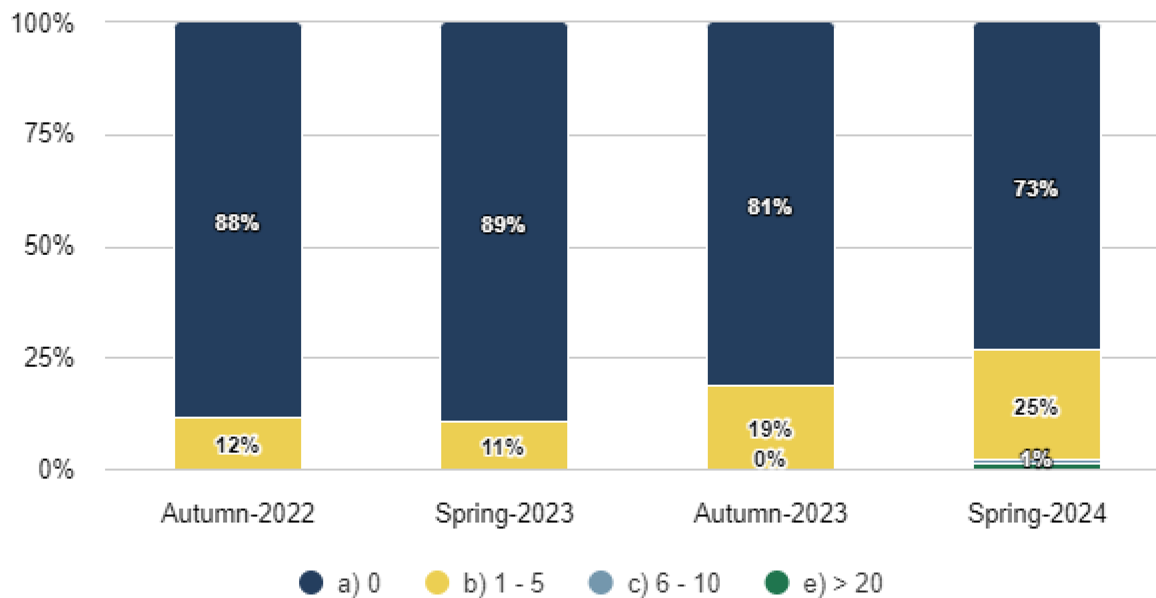
Cyber risk and data security continue to be by far the most prominent driver of operational risk for banks as the digital transformation continues. Technological advances with increased sophistication of ICT, growing reliance on digital and ICT solutions, but also growing capabilities of cyber offenders, which might not least increasingly find support through AI, have all resulted in enhanced risk exposure for banks, including vulnerability to sophisticated cyber-attacks. As a related risk, 38% of respondents in the RAQ also point to ICT failures as a main driver of operational risk. ICT failures and cyber incidents can affect financial entities' operational capabilities to provide critical and important functions and services, which ultimately might affect financial stability. The European Union Agency for Cybersecurity (ENISA) observes a dynamic cyber threat landscape and points out that threats rapidly evolve. They identify dynamic threats marked by evolving attack vectors,

including advanced persistent threats, nation-state actors and complex cybercriminal organisations. They also caution against increasingly technology-driven challenges whereby the adoption of emerging technologies introduces both opportunities and vulnerabilities. ENISA calls for proactive cybersecurity measures to address risks.[4] Regulators and banks are accordingly prioritising ICT and cyber risks in operational risk management. For the Financial Stability Board (FSB), to enhance cyber and operational resilience is one of the priority areas for its work in its 2024 work programme.[5]

Vulnerability to cyber-attacks has grown further

Indicating a materialisation of high risks, more than half of banks noted that they had been victim of at least one cyber-attack in the second half of 2023 in their RAQ responses. The share of banks having been victim to up to ten cyber-attacks steadily increased since 2022, to 48% now, while the share of banks falling victim to more than 10 cyber-attacks remained stable. RAQ responses also suggest that, while the volume and frequency of cyber-attacks as such are unabatedly high, a strongly growing share of responding banks (27% compared to 11% one year ago) report that they faced at least one successful attack which resulted in an actual major ICT-related incident (Figure 50). These figures indicate that the scope, sophistication and impact of successful cyber-attacks across the banking system have increased further in spite of further investments in ICT security infrastructures.

Figure 50: Number of successful cyber-attacks resulting in ‘major ICT-related incidents’ in the last semi-annual assessment period *



Source: EBA Risk Assessment Questionnaire

* This relates to an ICT-related incident with a potentially high adverse impact on the network and information systems that support critical functions of the financial entity (Article 3(7) DORA).

Publicly available data also indicates a continued high frequency of cyber incidents impacting the financial sector. For example, the ECB observes a significant increase of cyber incidents reported in 2023 on a year-on-year basis.[6] The International Monetary Fund (IMF) cautions that financial institutions are uniquely exposed to cyber risk, and highlights that the risk of extreme losses from cyber incidents is increasing, with an estimated quadrupling of the size of extreme losses since 2017 to ca. USD 2.5bn in 2023.[7] High vulnerability to cyber-attacks highlights the relevance of further investments in ICT and in related security, not least as digitalisation and ICT usage will further expand.

Enhancing operational resilience with DORA implementation

Further effort is therefore required at banks to manage and address ICT security risk. Not least in response to the growing risk of cyber-attacks and threats, Digital Operational Resilience Act (DORA) will apply from 2025, with the purpose of establishing a comprehensive framework on digital operational resilience for EU financial entities. The EBA in January published a first set of rules under DORA aimed at enhancing digital operational resilience by strengthening financial institutions’ ICT and third-party risk management and

incident reporting frameworks. In May, the ESAs launched a voluntary ‘dry run’ exercise for the collection of the registers of information on contractual arrangements for the use of ICT third-party service providers by the financial entities.

Financial crime risks

The high number of cases of ML/TF involving European banks in recent years has caused substantial reputational damage to the banking system and undermines the integrity of the EU/EEA banking sector. A comprehensive legislative package to address these risks and strengthen the EU’s legal and institutional framework on AML/CFT was adopted in April with the approval of the European Parliament. It includes a single rulebook on AML/CFT systems and controls, a revised directive that sets out requirements for supervisors and Financial Intelligence Units and a regulation establishing an EU Anti-Money Laundering Authority, which will be established this year. At the same time, the EBA has continued to address ML/TF-related risks through regulation, including two sets of guidelines on internal policies, procedures and controls to ensure the implementation of Union and national restrictive measures, and guidelines on the ‘travel rule’, i.e. information accompanying transfers of crypto assets and funds. It has also extended its Guidelines on ML/TF risk factors to crypto-asset service providers.

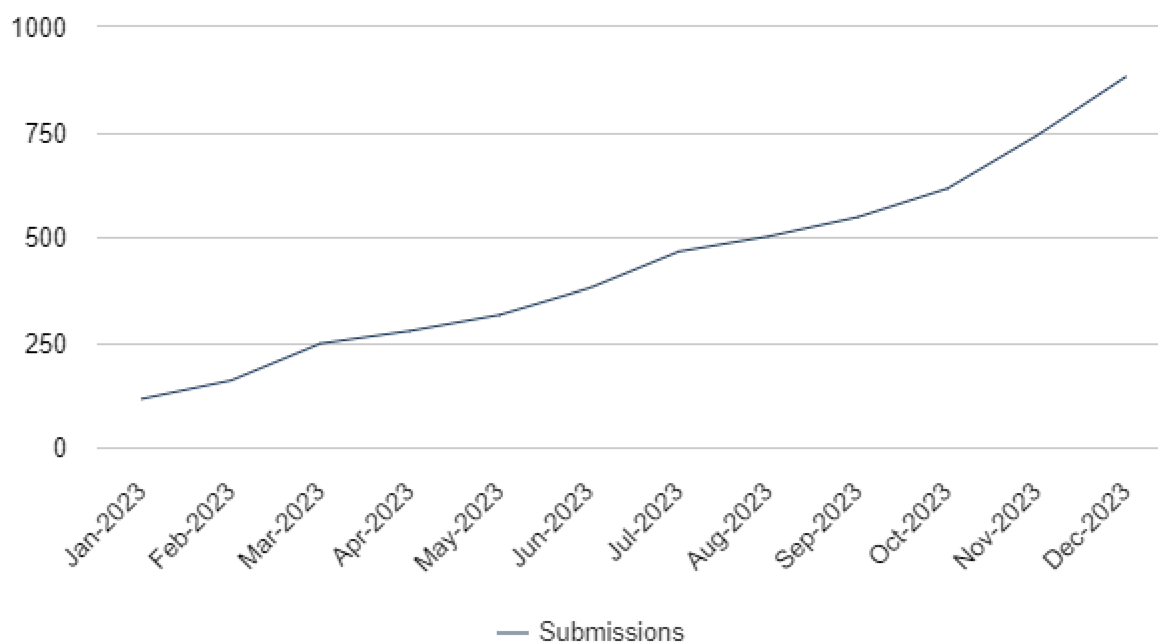
Based on the RAQ results, banks appear to attribute decreasing significance to ML/TF risk, with 13% agreement that it is a main driver of operational risk (18% agreement in autumn 2023). Risks related to the implementation of restrictive measures in connection with the Russian war of aggression against Ukraine continue to be a priority for banks. According to the RAQ, risks related to customers’ transactions received from, or sent to, jurisdictions that are subject to international sanctions remain the most relevant financial crime risks for banks, although with a decreasing trend.

Reporting of AML/CFT weaknesses through EuReCA

The EBA has further developed its AML/CFT database, EuReCA, and in May 2024 started to collect information on natural persons directly associated with AML/CFT material weaknesses. In 2023, 37 national competent authorities reported to EuReCA 601 serious deficiencies, or ‘material weaknesses’, that they had detected in 216 credit and financial

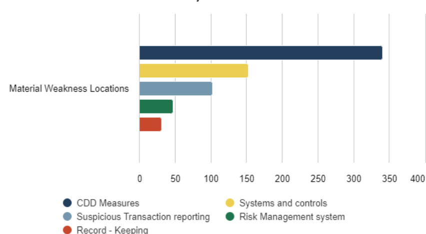
institutions' systems and controls. These material weaknesses expose those institutions to ML/TF risks. Most reports concerned credit institutions, but there is an increasing trend in the submissions related to payment and e-money institutions. This reflects the high ML/TF risk EU competent authorities identified within these sectors, which in turn informed their supervisory priorities.[8] Most deficiencies reported in 2023 related to institutions' approaches to CDD. The large majority of measures reported in 2023 were designed to correct the deficiencies themselves through orders to comply, orders to implement measures and orders to put in place a remediation plan. Also, a large number of measures were punitive and included fines or administrative pecuniary sanctions (Figure 51).

Figure 51a: Financial crime risks in 2023 (cumulative numbers per month)



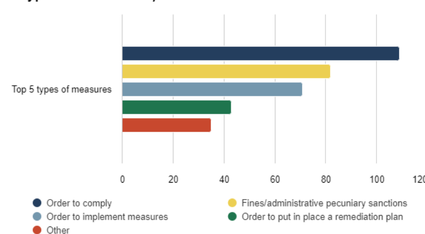
Source: EuReCA (EBA's AML/CFT database)

Figure 51b: Financial crime risks in 2023 (Where do material weaknesses occur?)



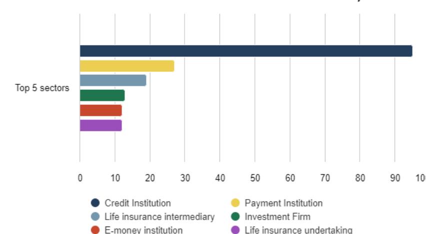
Source: EuReCA (EBA's AML/CFT database)

Figure 51c: Financial crime risks in 2023 (What are the top 5 types of measures?)



Source: EuReCA (EBA's AML/CFT database)

Figure 51d: Financial crime risks in 2023 (What are the top 5 sectors where material weaknesses are identified?)



Source: EuReCA (EBA's AML/CFT database)

Further legal and reputational risks

Conduct and legal risk continues to be the second most relevant operational risk to RAQ respondents, and its relevance remains high with 46% of RAQ respondents considering it as the main operational risk. New cases of past misconduct causing considerable redress costs and reputational damage continued to emerge in the first half of 2024. Legal and reputational risks go beyond those related to digitalisation and ICT-related risks as well as ML/TF risks, and include reputational damage for the banks concerned. Misconduct costs stemming from legal or reputational damage, including from exposures to Russia and other 'rogue states', have been substantive for banks concerned. They also indirectly affect banks' ability to extend lending to the real economy. Misconduct can, moreover, undermine trust in the banking system and the proper functioning of the financial system.

---

[1] See BIS definition of operational risk in BIS Principles for the Sound Management of Operational Risk.

[2] See the BCBS's discussion paper on digital fraud and banking from November 2023. They also point to analysis from LexisNexis, whose latest report points to rising human-initiated attacks in financial services, whereas automated bot attacks declined in 2023.

[3] See the EBA Opinion on new types of payment fraud and possible mitigations.

[4] See ENISA report Foresight Cybersecurity Threats for 2030 – Update 2024 from April 2024.

[5] See the FSB Work Programme for 2024 from January 2024.

[6] See the ECB SSM annual report on supervisory activities in 2023.

[7] See the IMF blog 'Rising cyber threats pose serious concerns for financial stability' from April 2024.

[8] See, for instance, also the EBA's report on ML/TF risk associated with payment institutions from 2023, which, for instance covers that supervisors should do more in light of the high risks.

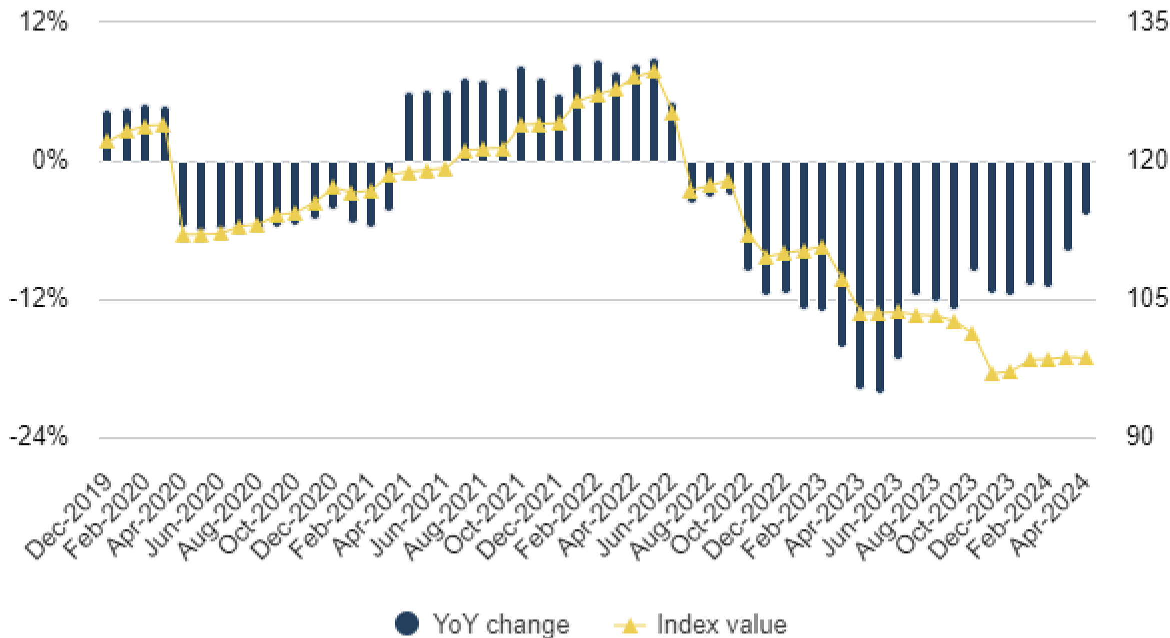
Special topic – CRE-related risks

Structural and cyclical factors have caused cracks in commercial real estate markets

The pandemic had manifold impacts on societies, business, economies more broadly and many other parts of life. This includes the working environment which has changed significantly since the pandemic, affecting workplaces and offices. Significant changes in consumption have also occurred affecting shopping experience. Nearly all of these changes have had an impact on the CRE market. For example, office vacancy rates have increased in some European cities, as fewer employees commute to offices on a daily basis.[1] At the same time, vacancy rates of retail shopping buildings also increased because of lower demand for physical stores. To add to these challenges, the CRE segment is also confronted with other structural changes including climate transition risks, with the pressure to move to more sustainable and more energy-efficient buildings. Cyclical developments have also had an impact on the CRE market. Tighter financial conditions and the abrupt increase in borrowing costs have made refinancing existing debt more challenging for CRE firms, while inflation has contributed to rising construction costs for new developments. Anecdotal evidence indicates an increased demand for bank loans from CRE firms to refinance or restructure their maturing debt, as access to capital markets financing became increasingly challenging.

As a result of these structural and cyclical changes, CRE firms have become increasingly motivated to raise capital through asset sales, often at a discount, either to manage refinancing risk or reduce pressure from leverage. Although the stabilisation of borrowing costs, lower inflation expectations and the flattening of risk-free yields may reduce the upward pressure on yield expectations for CRE assets (e.g. cap rates)[2], spreads between CRE asset yields and risk-free yields remain at heights not seen since the monetary easing began in 2012. All these dynamics are mirrored in a correction in CRE prices. According to the IMF, CRE prices globally dropped by 12% in 2023.[3] The adjustment in CRE prices was more intense in the US (ca. -23% YoY), while for Europe the correction was around 17%. Nevertheless, this decline seems to have slightly eased in the first quarter of 2024. Since its

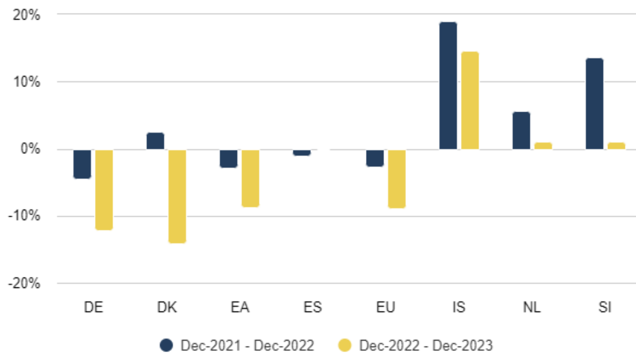
last peak in May 2022 prices were down by around 25% (Figure 52).



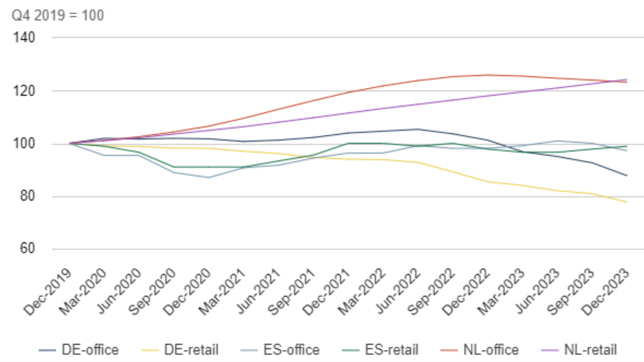
Source: Green Street

* The Green Street Commercial Property Price Index is a time series of unleveraged property values across the industrial, office, residential, and retail property sectors in 30 of the most liquid European RE markets. The index captures the prices at which CRE transactions are currently being negotiated and contracted.

There are, however, large divergences in CRE pricing trends between countries, as well as asset classes and locations. The price corrections were, for instance, more pronounced in Germany and some other northern countries, whereas in other jurisdictions, including Spain and Slovenia, there were not any major corrections in CRE prices. Moreover, while the industrial premises segment showed a certain resilience, the office sector broadly suffered a particular price erosion due to lower income expectations, as a result of a sharp drop in demand, especially for non-prime assets. Property prices in the retail sector tend to be less affected than office prices, even though they show similar wide dispersion among countries (Figure 53).



Source: BIS Data Portal, ECB Statistical Datawarehouse (SDW), EBA calculations



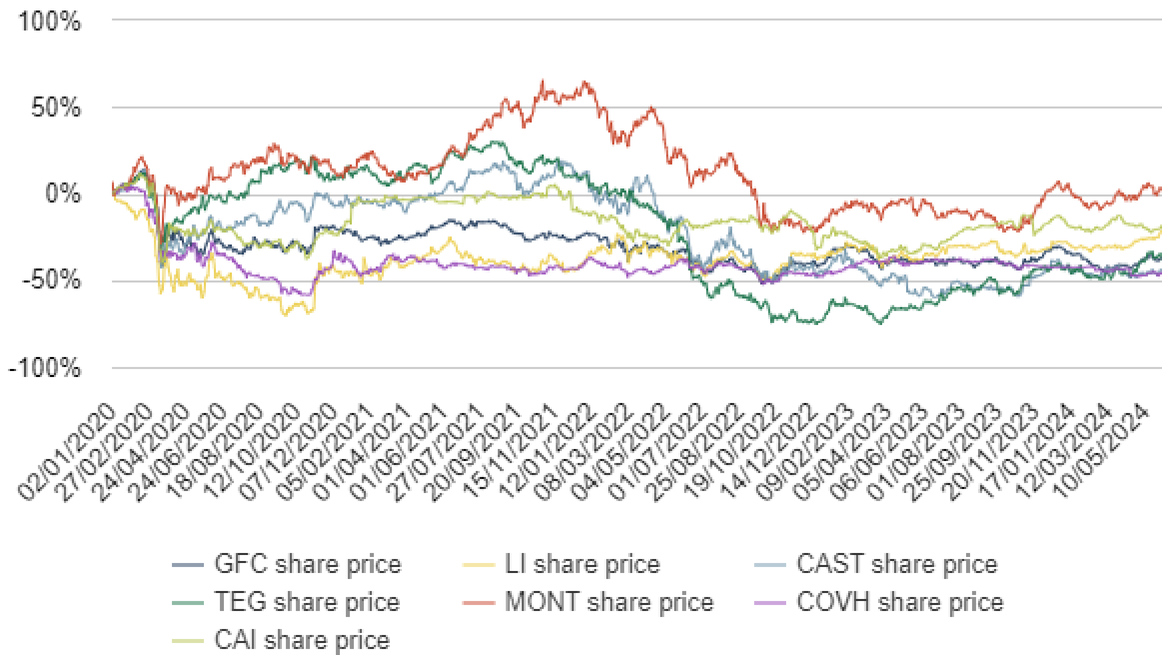
Source: BIS Data Portal, ECB Statistical Datawarehouse (SDW), EBA calculations

* The selection of the reported countries is not the result of a choice based on relevance or representation considerations, but is merely determined by the limited availability of publicly accessible data on CRE and CRE segment prices for individual jurisdictions. The countries reported are indeed those for which detailed data can be found on the BIS Data Portal or ECB SDW website.

Market data also suggests that the combination of cyclical and structural challenges faced by the CRE sector has caused European real estate investment trust (REIT) share prices to generally decline over the last two years, compared to pre-pandemic levels. The adjustments were significant across all REITs and reflected, at least in part, the trends observed in different CRE segments and in different countries. Nonetheless, in the first months of 2024, the share price of even those funds that had experienced a broader downward correction would appear to have stabilised at slightly higher levels, albeit at much lower levels from those prior to Covid-19 (Figure 54).

Figure 54: Share prices of selected European REITs

relative, since 2 January 2020, YtD



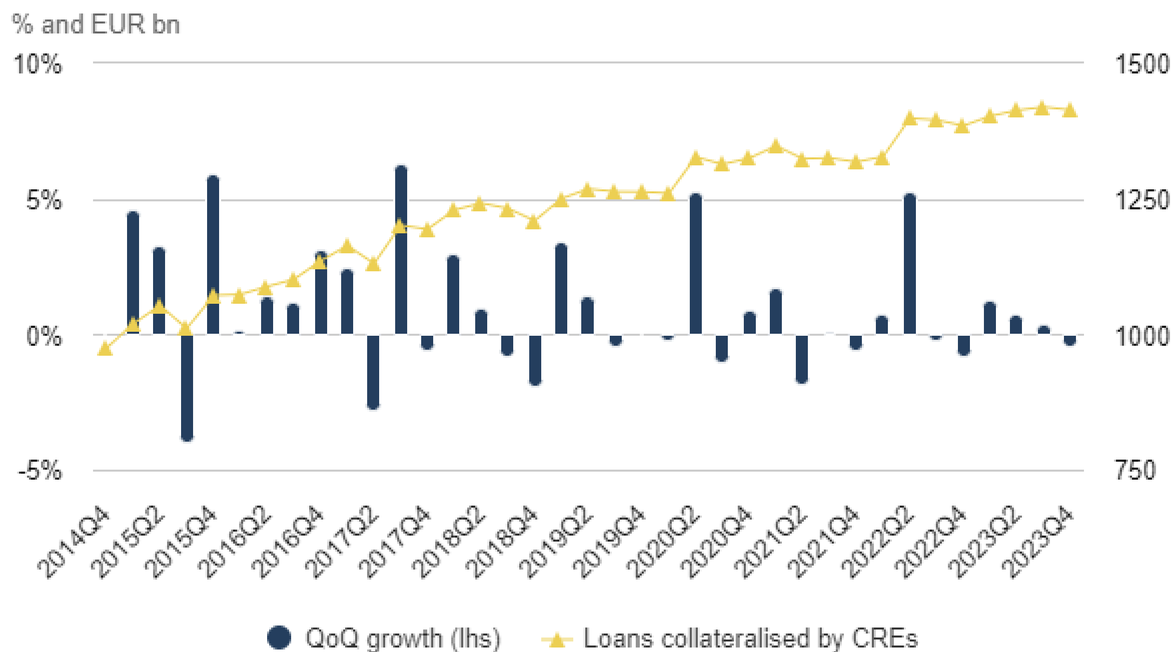
Source: S&P Capital IQ

* Abbreviations of REIT names: LI-Kleppiere, CAST-Castellum, MONT-Montea NV, TEG-TAG Immobilien, COVH-Covivio, GFC-Gecina, CAI-CA Immo. These REITs are examples and might be considered for indicative trends of different CRE segments and different countries. They also inherit idiosyncratic risks, for which reason they cannot be considered as fully representative, though. Kleppiere tends to focus on the shopping malls segment; Castellum is a REIT in the Nordics; TAG Immobilien is a REIT with a focus on German real estate; Montea tends to focus on logistics real estate; Covivio tends to focus on the hotel segment; Gecina tends to focus on Paris in the residential/student houses sector; CA Immo is an Austrian RE company with investments in selected CEE countries. This information is indicative only.

Banks in the EU/EEA have considerable CRE exposures

EU/EEA banks have more than EUR 1.4tn of loans collateralised by CREs, which accounts for close to 23% of the total loans towards NFCs (or 11% of total loans if household loans are included). CRE-related exposures were less than EUR 1tn in 2014, signalling a more than 40% increase in these exposures within less than a decade (4.2% annual growth rate). Although loan growth had slowed post-pandemic (2.9% annual growth rate), and was even slower in 2023 (2.2%), it remained above other segments. This was the highest growth rate for NFC-related exposures. This might indicate that, despite banks' tightening of lending standards, the sector has stepped up to fill to some extent the funding gap that CRE firms might have faced on capital markets or the like (see Chapter 2.1). Anecdotal evidence indicates that banks have been more willing to support existing clients by refinancing debt than providing credit facilities to new clients. This is broadly confirmed by the EBA's RAQ results, which show that the majority of banks expect their CRE portfolio to remain stable. However, around 30% of the banks reported their intention to increase their exposures to CREs, while around 20% indicate their plan to deleverage their portfolio from CRE-related

loans (Figure 8 and Figure 55).

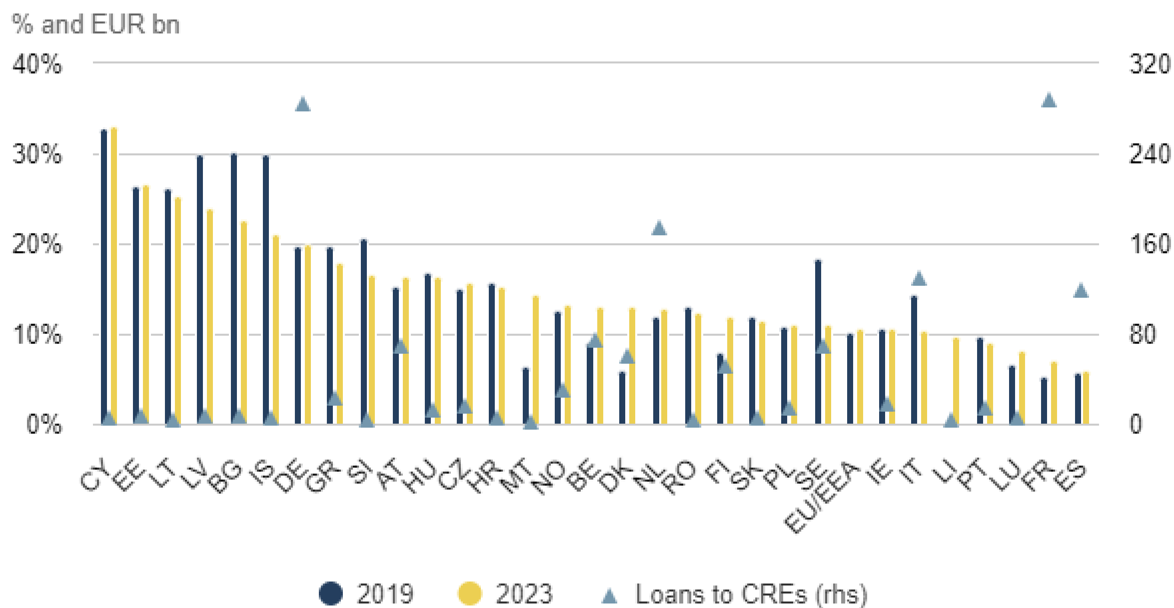


Source: EBA supervisory reporting data

On average, EU/EEA banks' CRE exposures are less than 100% of their equity. However, several banks, mainly smaller in size, have CRE exposures that reach multiple times their equity, which makes them increasingly vulnerable to downturns in CRE markets. These banks are mostly specialised CRE lenders, and therefore have a large portion of their loan portfolio geared towards CRE firms. They also tend to be smaller in size. Zooming in on the relevance of CRE exposures by bank, out of the 10 banks with the largest loan portfolio volumes only 1 bank reported CRE exposures of more than 20% of its total loans. The share of CRE exposures to total loans is a proxy of potential idiosyncratic risks. Although banks domiciled in France and Germany reported the largest exposure, exceeding EUR 280bn, followed by banks in the Netherlands that reported EUR 175bn, only German banks reported an elevated share of their total client lending towards CREs. However, banks in smaller jurisdictions also reported a higher share of their total lending being towards CREs. This is particularly evident in banks in eastern European countries and a few southern European countries which had relatively high exposures to CREs. The Baltics, Bulgaria, Cyprus, Iceland, and Germany were among the countries with elevated CRE exposures,

reporting more than 20% of their total client loans being towards CREs (Figure 56).

Figure 56: Loans collateralised by CREs and share of loans collateralised by CREs to total NFC and household loans by country – December 2019 and December 2023



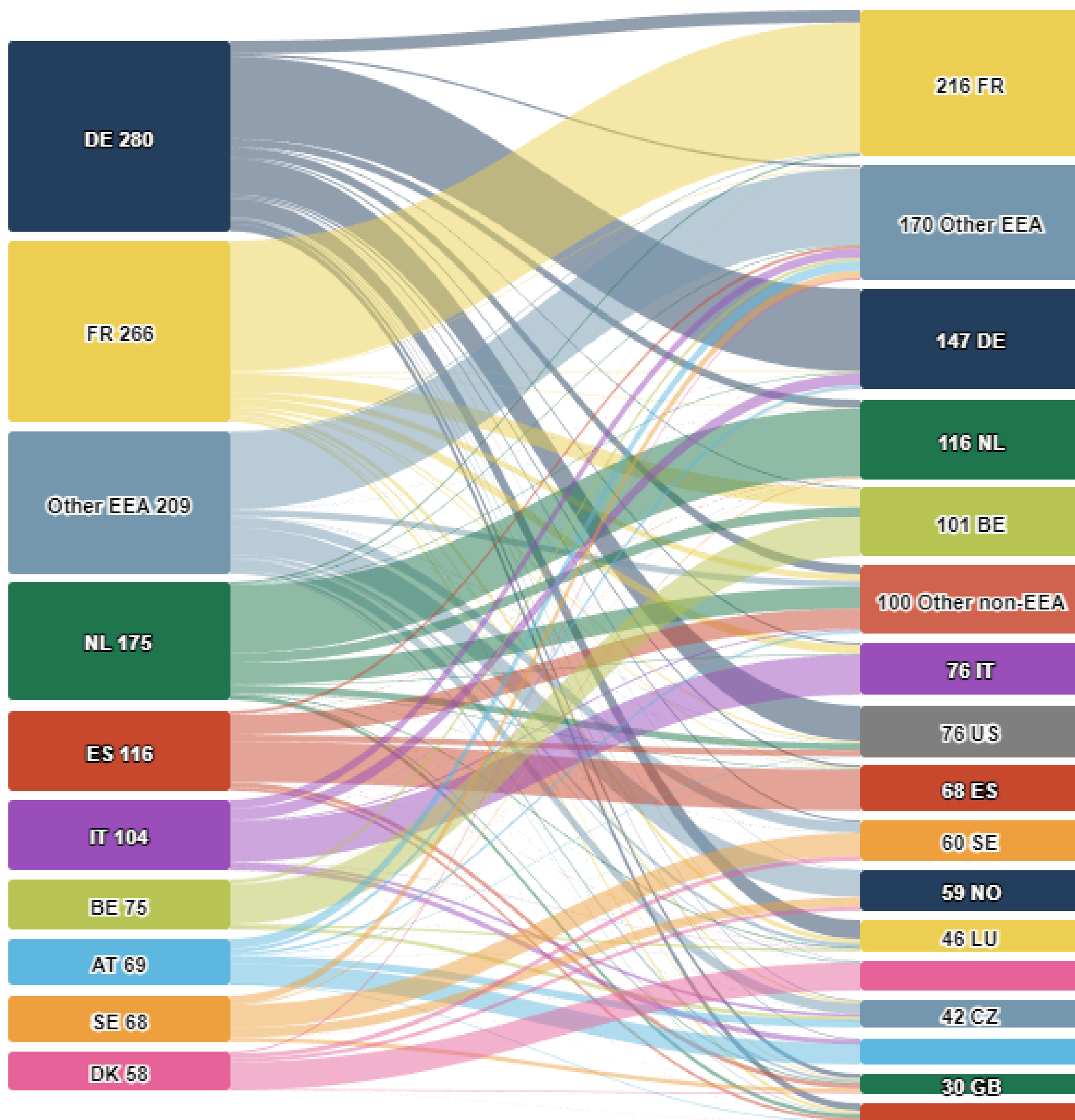
Source: EBA supervisory reporting data

* For Swedish banks, the decline can to a large extent be explained by a change in the classification of loans by one of respective banks. As of 31 December 2022 (and thereafter), CRE exposures do no longer include loans collateralised by residential immovable property. Before that date, loans collateralised by residential immovable property were included in CRE exposures for this bank.

The performance of CRE loans is not only defined by the type of the underlying asset, such as office or retail etc., but is also dependent on its location. Although the correction in European CRE prices has been notable, elsewhere it was even more acute, as shown above. More than EUR 200bn of CRE-related exposures were towards non-EEA-domiciled counterparties. German, Spanish and Dutch banks reported the highest non-EEA exposures. Of these, EUR 75bn were towards counterparties domiciled in the US, and EUR 30bn to UK counterparties. German banks reported more than EUR 50bn US CRE exposures, while Dutch banks reported around EUR 10bn. These were concentrated in a small number of banks, exacerbating the potential idiosyncratic risks. A number of these banks have increased markedly their provisioning levels against these exposures in the last quarters (Figure 57).

Figure 57: Loan collateralised by CREs towards the country of domicile of counterparty – December 2023

EUR bn



Source: EBA supervisory reporting data

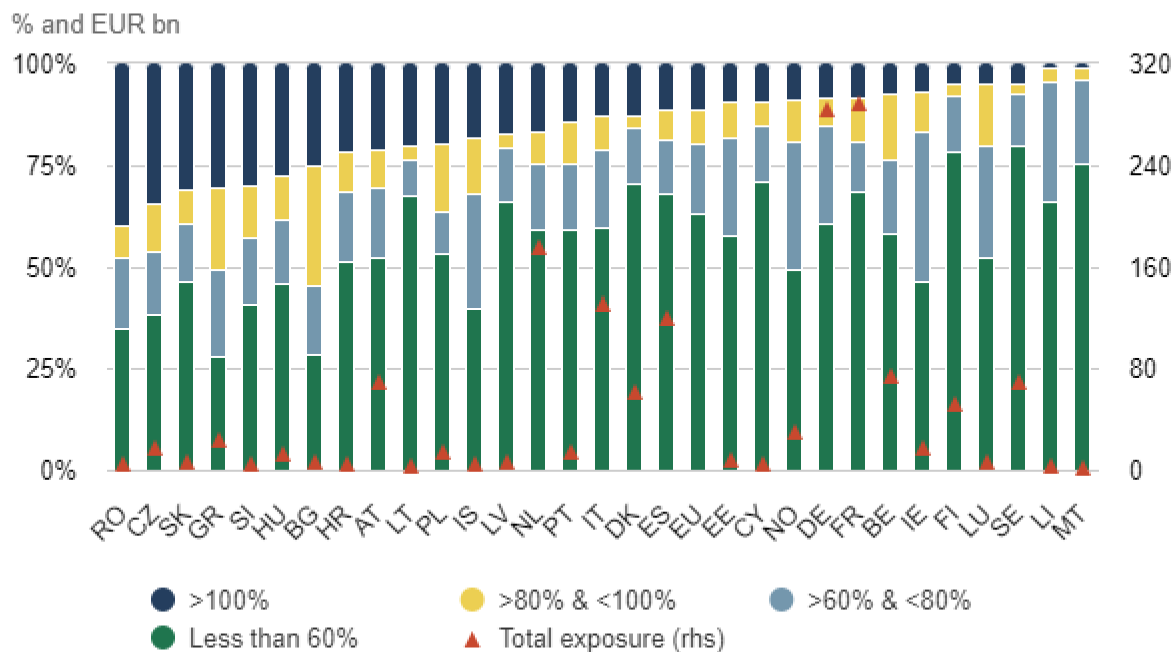
Loan-to-value ratios provide an initial shield against collateral valuation correction, yet banks should ensure accurate and up-to-date valuations and prudent risk management

The banks that lend to CREs rely on the value of respective properties as collateral to protect them from loan losses when the lenders default. However, if the value of the CRE

collateral drops significantly, the chances for a full loan recovery might become worse and may feed into an adverse loop. As such, the effect of worsening conditions in the CRE market on banks goes beyond their direct exposures to CRE firms only.

One important metric used to assess the risk associated with CRE loans is the loan-to-value (LTV) ratio. The LTV ratio represents the percentage of the loan amount relative to the appraised value of the property. CRE loans often come with a decent cushion against property price declines due to their relatively low LTV ratios. This protective cushion is especially valuable during economic downturns or market corrections. EU/EEA banks reported that approximately 63% of CRE exposures have an LTV of less than 60%. These loans provide a buffer for banks in case of adverse market conditions. Yet, close to EUR 160bn of CRE loans have an LTV of more than 100%. This means that the loan amount exceeds the appraised value of the property. The highest concentration of 'high LTV values' is reported in central and eastern European countries. These loans pose a greater risk to banks if property prices decline and therefore banks need to particularly closely monitor their exposure to high LTV loans, especially in regions where such loans are prevalent (Figure 58).

Figure 58: Loan-to-value ratios of loans collateralised by CREs by country and total CRE loans – December 2023

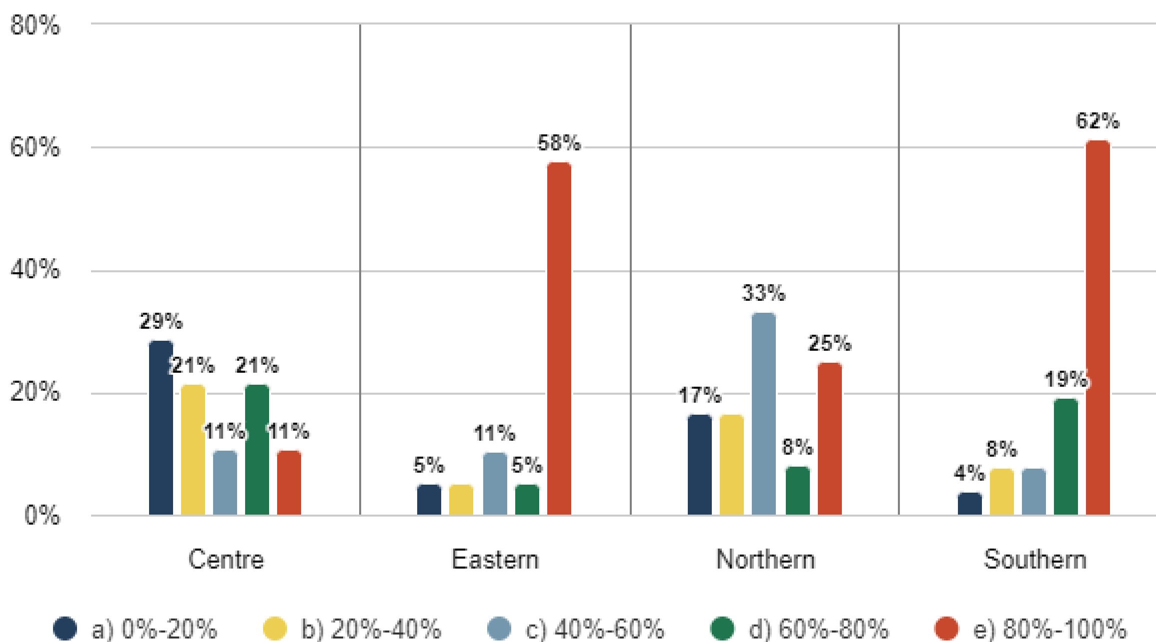


Source: EBA supervisory reporting data

Given the limited visibility, a number of banks particularly exposed to the sector have provided some transparency with more detailed breakdowns of their CRE exposures, e.g. into the different sub-segments, like office, retail, hotels, warehouses, etc., showing that exposures towards office properties seems more prominent rather than retail exposure. As these exposures could potentially lead to elevated risks associated with collateral valuation, analysis of these risks has become a priority for supervisors. For instance, in the August 2022 edition of its Supervision Newsletter, the European Central Bank (ECB) highlighted collateral valuation as an area of concern for various banks. On-site inspections revealed issues related to the updating of appraisal reports in accordance with the Capital Requirements Regulation (CRR) and ad hoc revaluations based on changing market conditions. The ECB also expressed concerns that valuation methods and inadequate parameters could result in significant overstatements of asset values.[4] This underscores the importance of robust risk management practices in the CRE sector, particularly when it comes to collateral valuation, to ensure accurate assessments and mitigate potential risks.

As interest rates have moved to a higher level in the current macroeconomic situation, CRE firms that relied on floating-rate financing structures are exposed. The higher interest rate environment affects negatively the interest coverage ratio (ICR), an indicator that measures how comfortably the borrower can pay interest with their operating income (on rate expectations see Chapter 1). According to RAQ data, about 45% of the CRE loans have a fixation period shorter than one year and will quickly reprice, while only 25% have a fixation period longer than five years. In addition, the maturity structure of the loans could sometimes mask their underlying risks. For example, a significant share of CRE loans are bullet loans.[5] These are loans in which the repayment of the principal (and sometimes with the interest too) of the loan is at its maturity.[6]The challenge of offsetting higher financing costs is also dependent on the possibility to increase rents for related property. CRE firms have to manage debt service and deal with market uncertainties at the same time.

Figure 59: Share of outstanding CRE loans repricing in less than 12 months

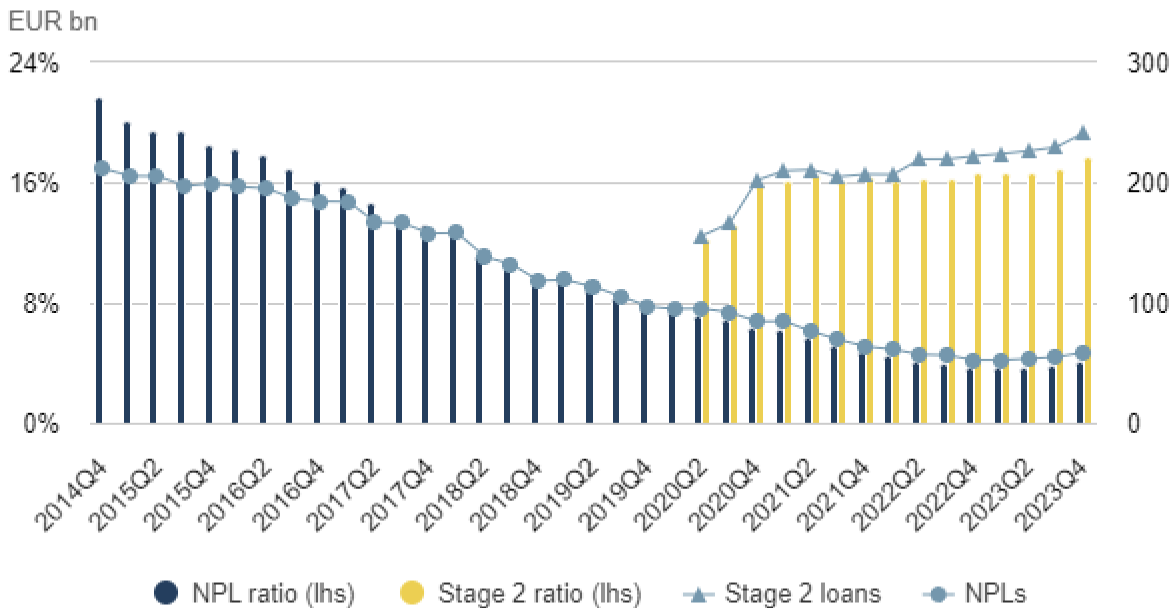


Source: EBA Risk Assessment Questionnaire – spring 2024

Asset quality indicators send mixed signals on the performance of CRE exposures

Despite the elevated uncertainties in the CRE segment, EU/EEA banks report that asset quality of their CRE loans has so far remained solid. In December 2023, EU/EEA banks reported EUR 58bn of NPLs. Although the volume of NPLs dwarfs the one reported nearly a decade ago (EUR 211bn in December 2014), it has increased by more than 12% in the last year (EUR 52bn in December 2022). The NPL ratio was at 4.1% in Q4 2023, down from 22% in 2014, but marginally higher than a year ago. At the outset of the pandemic the share of CRE loans allocated to Stage 2 rapidly increased. In December 2023, EU/EEA banks reported more than EUR 240bn in IFRS 9 stage 2 (+8.6% year-on-year increase). In the last quarter of 2023 alone, EU/EEA banks increased them by more than EUR 10bn, signalling a rising pace in this trend. The share of stage 2 allocation was last reported at 17.8% (16.7% in December 2022) (Figure 60).

Figure 60: Trends in NPL and IFRS 9 stage 2 allocation volumes and ratio of CRE exposures – December 2014 to December 2023



Source: EBA supervisory reporting data

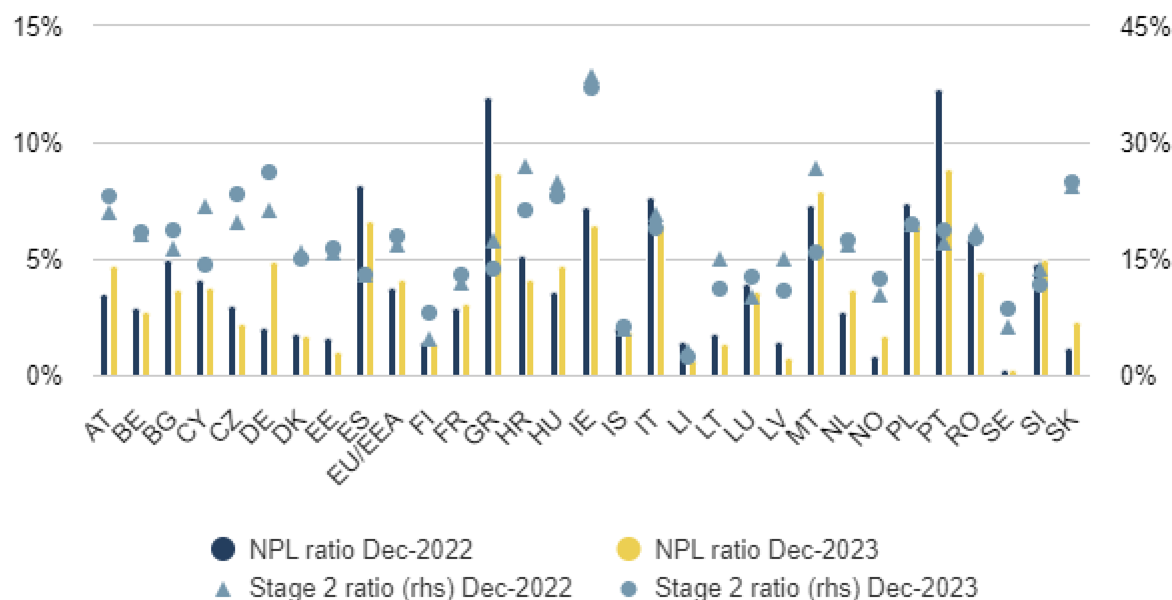
* Stage 2 data for CRE only available since 2020, for which reason there is no earlier comparison available.

The trajectory of non-performing commercial real estate (CRE) loans has varied significantly across countries. Banks in southern European countries have notably decreased their CRE NPLs over the past five years, and continue to clean up their balance sheets, not only through organic means (e.g. cures) but also through non-organic means (e.g. securitisations, NPL sales, etc.). Still, the highest NPL ratio in CREs is reported by Portuguese and Greek banks (8.9% and 8.7% respectively). However, banks in both countries reported a substantial decrease in the NPL ratios compared to a year earlier. In contrast, French banks reported a slight increase, while German banks have encountered a more substantial rise, even though it started from historically low levels. The latter's CRE NPL ratio surged to 4.8% in the last year (2.1% in December 2022). Other countries such as Austria and the Netherlands reported a meaningful increase, too.

The disparity between countries in the stage 2 allocation of CRE loans is even more pronounced. Country averages range from as low as 2.3% (Liechtenstein) to up to 36.9% (Ireland). German followed by Czechian banks increased the most the allocation of CRE loans to stage 2 during the last year. In both countries the allocation to stage 2 is one of the

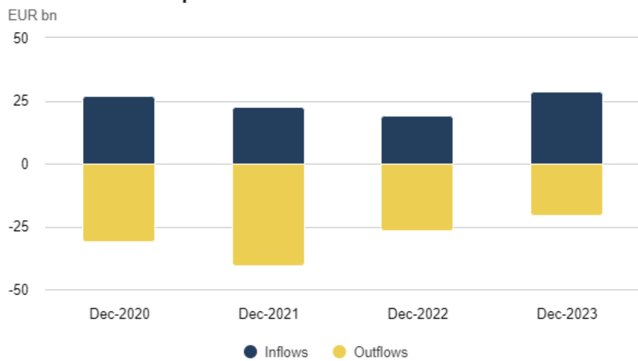
highest, exceeding 20%. Yet, similarly to the reported NPL ratios, despite the overall worsening conditions in CRE markets banks in several countries reported lower stage 2 allocation than in December 2022. This highlights the heterogeneity of the performance of CRE assets (Figure 61).

Figure 61: NPL and IFRS 9 stage 2 allocation ratio by country for CRE exposures – December 2022 and December 2023

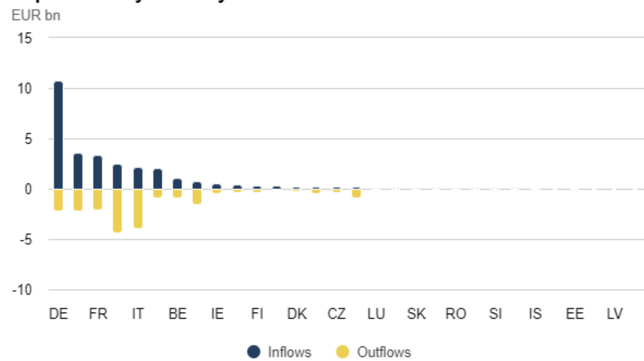


Source: EBA supervisory reporting data

During 2023 NPL inflows exceeded outflows for CRE exposures, albeit marginally. EU/EEA banks reported NPL inflows of EUR 29bn and outflows of around EUR 21bn. The reported net inflow of EUR 8bn was in contrast to the net outflow reported in the previous three years. The net inflow increase was mainly attributed to German and Dutch-domiciled banks (Figure 62).

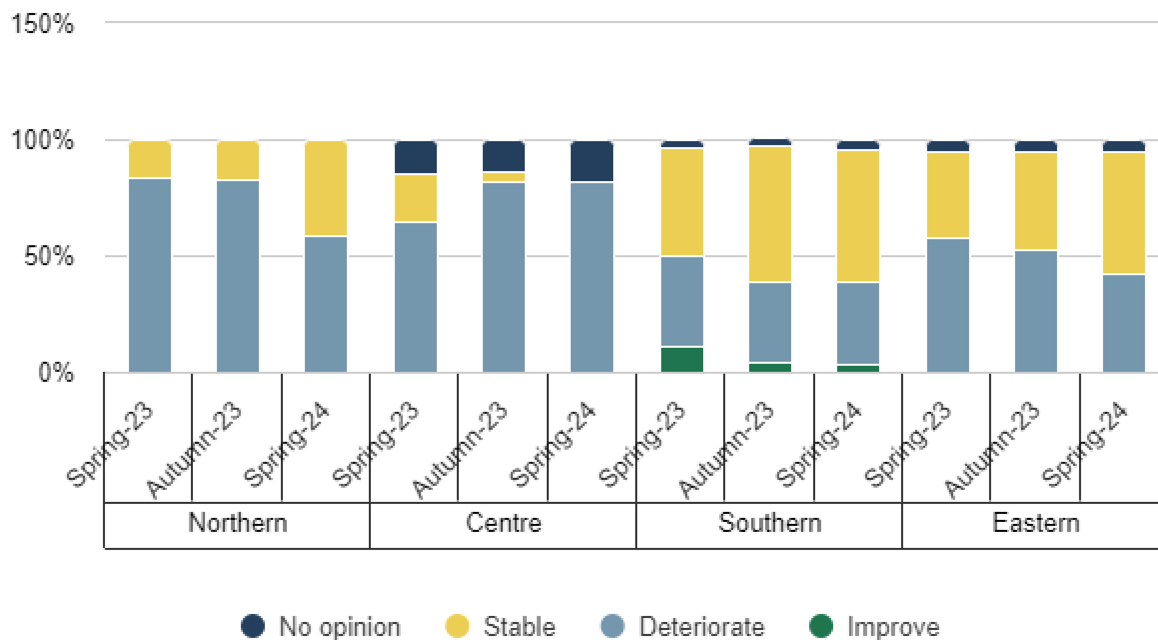


Source: EBA supervisory reporting data



Source: EBA supervisory reporting data

Banks anticipate further asset quality deterioration of CRE loans across all regions according to the RAQ results. This is especially true for central European countries (80%) and the Nordics (60%). Meanwhile, more banks than before expect the asset quality of CRE loans to stay the same for most regions, +20 p.p. on average, suggesting a possible easing of the asset quality decline (Figure 63).



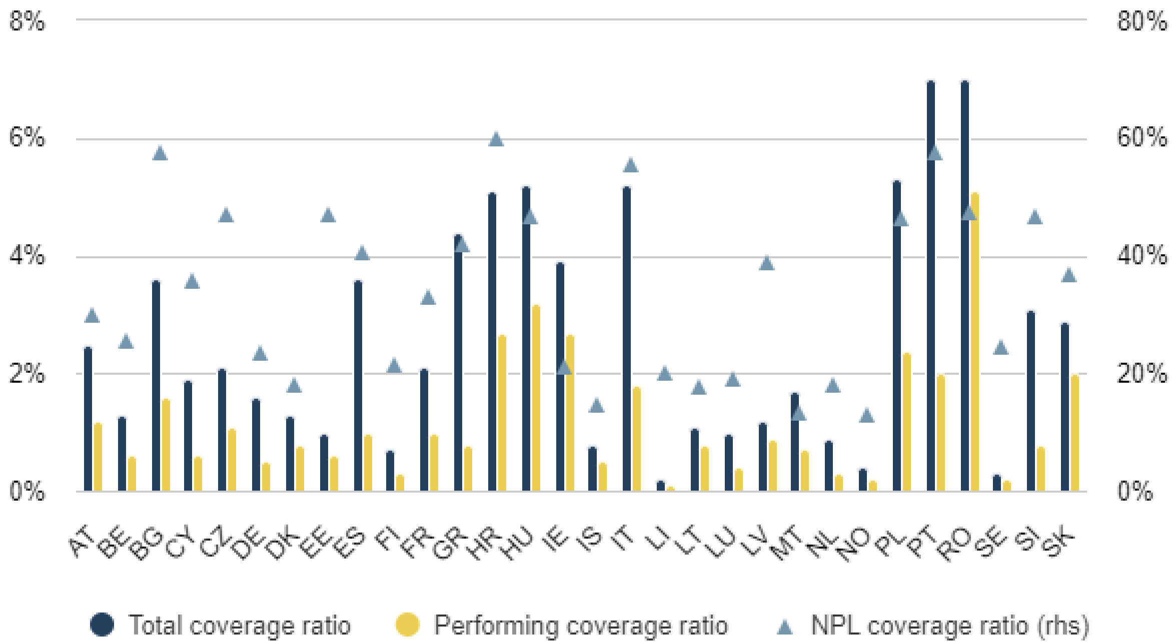
Source: EBA Risk Assessment Questionnaire

Provisions and targeted macroprudential measures can protect banks from a further downturn in CRE markets, as does active portfolio management

EU/EEA banks have set aside quite sizeable provisions to cover non-performing CREs. In total, banks had provisions against CRE loans of EUR 31bn, of which EUR 19bn were against NPLs. Provisions were slightly lower than a year earlier, although there was a substantial differentiation in the change of provisioning levels by country. For example, German banks increased their provisions against CRE loans by close to EUR 1.7bn (+58% YoY). Banks in other countries, mainly from the Nordics or eastern Europe, have also increased their provisioning levels. By contrast, banks in southern Europe decreased the provisioning levels against CRE exposures substantially. For instance, Italian banks decreased provisioning levels by more than EUR 1.2bn (or -15%), mainly driven by provisions against NPLs.

The weighted coverage ratio of CRE loans of EU/EEA banks stood at 33.5% as of December 2023, while for performing only loans it stood at 0.9%. NPL coverage ratio was lower than a year earlier (37.9%), while the coverage ratio for performing loans remained the same. Coverage ratios differ widely across countries. Levels of provisions are widely dependent on the underlying asset; therefore, a certain degree of divergence can be expected. Yet some countries report very low coverage ratios against NPLs. These ratios range between 13% and 59.8%. Similarly, for performing loans the provisioning levels are as low as 0.1% of total performing CRE loans and up to 5.1% (Figure 64).

Figure 64: Coverage ratios of performing and non-performing CRE loans by country – December 2023



Source: EBA supervisory reporting data

The strong capital and liquidity position of EU/EEA banks should on average make risks stemming from CREs for the banking sector manageable. In the 2023 EU-wide stress test conducted by the EBA, larger institutions demonstrated resilience against an assumed scenario that included a 30% downturn in CRE markets.[7] There are, however, idiosyncratic risks which need to be closely monitored by banks and their supervisors. These idiosyncratic risks have prompted authorities across Europe to take precautionary measures to safeguard financial stability. For example, macroprudential authorities in Europe have put in place capital-based measures against real-estate-related cyclical risks such as risk-weighted floors on commercial real estate exposures implemented in Sweden or a higher risk weight for CRE exposures set in Latvia.[8] In addition to these, sector-specific systemic risk buffers are under discussion and being proposed. For instance, in Denmark the Systemic Risk Council has recommended the introduction of a 7% sector-specific systemic risk buffer for bank exposures to real estate companies.[9] By implementing such measures, regulators seek to mitigate risks associated with CRE and maintain a robust financial system.

[1] See Savills research – European Office Outlook – December 2023.

[2] Cap rate can be calculated by dividing a property's net operating income by its asset value. It provides an assessment of the yield of a property over one year.

[3] See IMF: Financial stability and risks – April 2024.

[4] See the ECB's Supervision Newsletter: Commercial real estate: connecting the dots (europa.eu).

[5] See Scope Rating's report on extension risks of CRE loans in commercial mortgage-backed securities (CMBS) from May 2024, according to which refinancing for CRE loans has increased this year.

[6] See, for instance, the article 'Commercial real estate: connecting the dots' in the ECB's Supervision Newsletter from August 2022, according to which a big share of CRE loans have major instalments that are due at maturity.

[7] See EU-wide EBA stress test July 2023.

[8] See, for instance, the notification for the measure applied in Latvia from December 2023.

[9] See the ESRB's Overview of national capital-based measures (regularly updated).

Special topic –EU/EEA banks’ interconnections with NBFIs and private credit

Financial intermediation in the EU/EEA has traditionally been a business for banks. In the years after the global financial crisis, technological innovation, regulatory reform and the urge to bolster EU/EEA capital market activity have contributed to growth in financial intermediation outside the banking system, where parts of the activity may remain less regulated. Several types of interconnections can be identified between banks and NBFIs, with both benefits and risks arising from such linkages. In terms of volumes, non-bank intermediation in the EU/EEA remains moderate compared to some other major jurisdictions.[1] That notwithstanding, ongoing monitoring of the sector is necessary to identify emerging risks and vulnerabilities which, if crystallised, could propagate to the banking sector via both on and off-balance-sheet channels. Special attention should be paid to non-bank lending activity, a relatively novel area for non-banks which has seen particularly dynamic growth recently.

EU/EEA NBFIs are inexorably intertwined with banks and non-financial sectors

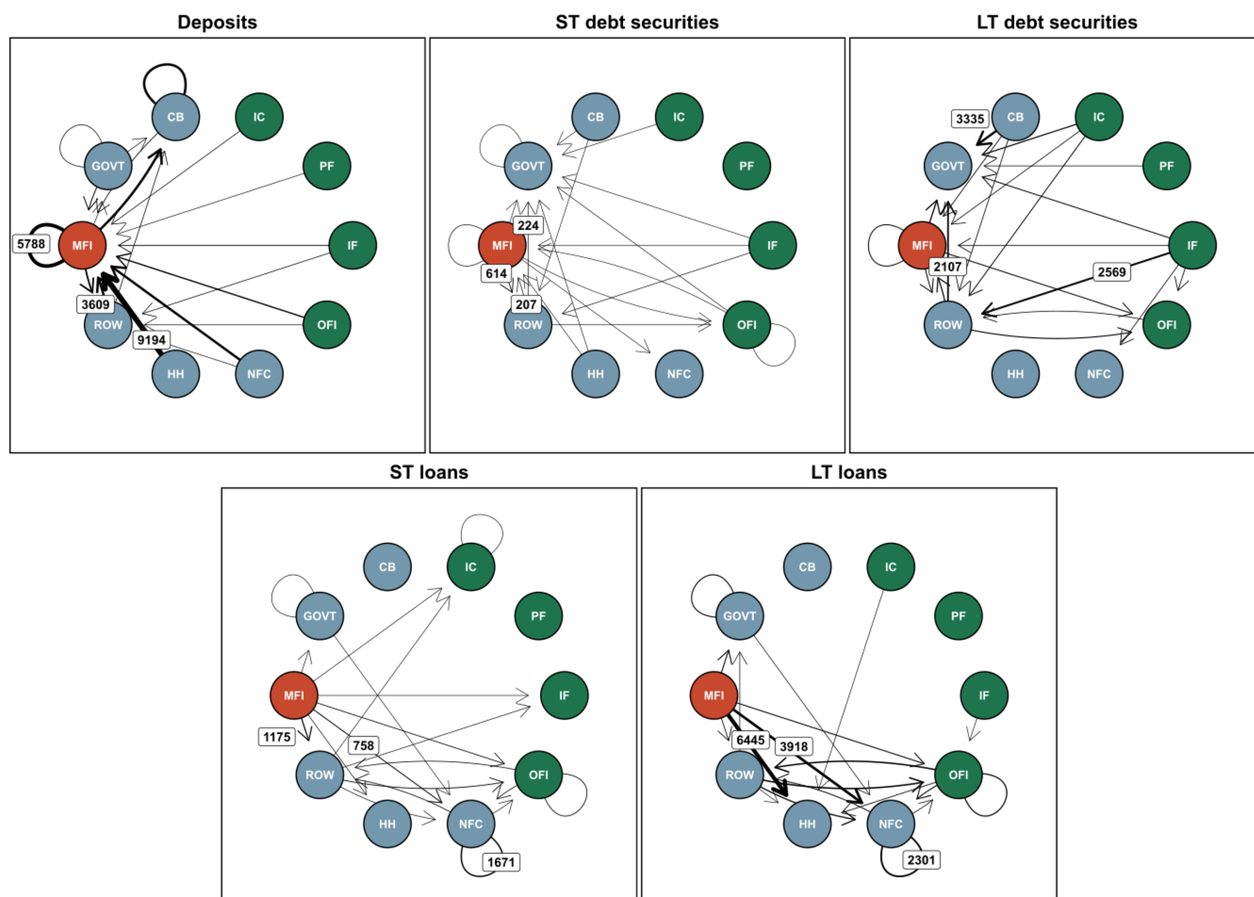
The landscape of the EU/EEA financial system is characterised by complexity and interconnectedness. Financial linkages serve to improve risk-sharing, which makes the financial system safer, less concentrated and more efficient. At the same time, cross-funding links also provide channels of contagion and propagation that could be activated in periods of stress. Identifying sources of systemic risk therefore requires detailed understanding of the financial flows in various instruments among the different sectors of the economy. Quarterly sectoral accounts (i.e. the ‘who-to-whom’ data from national accounts) and detailed EBA supervisory reporting data provide useful insights into the interconnectedness of the EU/EEA financial system, including links of NBFIs to both banks and the non-financial sectors.

The sectoral accounts data, such as the System of National Accounts, provides a coherent, consistent and integrated set of macroeconomic accounts for an economy using

internationally agreed definitions and accounting rules. Who-to-whom data tracks the flows between different sectors of an economy (i.e. here the EA), and covers the balance sheets of ten sectors on an unconsolidated basis, including the real economy (i.e. households and NFCs), the public sector (i.e. general government and central banks) and the financial sector (i.e. monetary financial institutions (MFIs), insurance corporations (ICs), pension funds, non-money market fund (MMF) investment funds (IFs) and other financial institutions(OFIs)). An additional sector is the rest of the world, which includes all countries outside the EA.

The EA banking sector provides financial intermediation services to the other financial and non-financial sectors through a variety of instruments, including loans, deposits, securities and derivatives. Based on sectoral accounts data, banks are mostly linked to non-banks via asset and liability exposures in loans and deposits, whereas NBFIs are major holders of bank-issued debt securities. The links of the banking sector to the NBFIs are somewhat more pronounced on the banks' liabilities side (i.e. funding links) (Figure 65).

Figure 65: Network of the EA financial system comprising links between the banking sector and other sectors of the economy, December 2023 (the values of the three largest exposures are shown next to the respective arrow in each of the charts) (EUR bn)



Source: ECB/Eurostat and EBA calculations. Arrows run from assets to liabilities. Data reflects EA 20 exposures. Only the 20 (3) largest links are shown (highlighted) in each chart, respectively. Charts are represented on a common scale, with thicker arrows indicating higher exposures. MFI: Monetary financial institutions (excl. central bank); GOVT: General government; CB: Central bank; IC: Insurance corporations; PF: Pension funds; IF: Non-MMF investment funds; OFI: Other financial institutions; HH: Households incl. non-profit institutions serving households; ROW: Rest of the world.

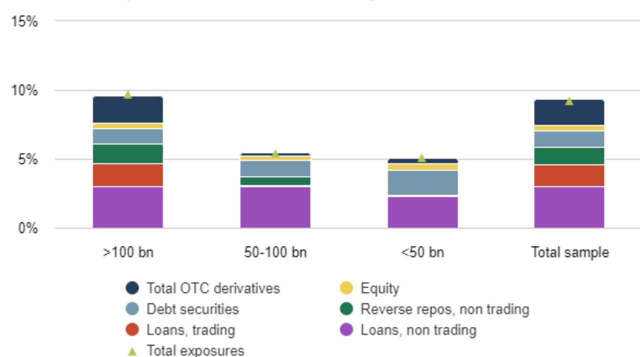
As of December 2023, NBFI holdings account for more than a quarter of total bank-issued debt in the EA. Among the NBFI sectors, the OFIs sector and the IFs sector each hold some 12% of all bank-issued short and long-term debt securities. However, banks also have important exposures to NBFIs on the asset side, as they provide short-term loans (such as [reverse] repos) to NBFIs. Of all short-term loans originated by EA banks more than one-fifth are extended to NBFIs.[2] From a holistic perspective, the OFI sector is most extensively linked to MFIs, especially in terms of deposits, short-term debt securities and short-term loans, while IFs and ICs are mainly interconnected through the holding of long-term debt securities issued by MFIs; the total assets of the OFI sector are almost 1.4 and 2.6 times

larger than those of IFs and ICs, respectively.

Bank-level information shows that EU/EEA banks' NBFI linkages are concentrated on specific instruments and business models

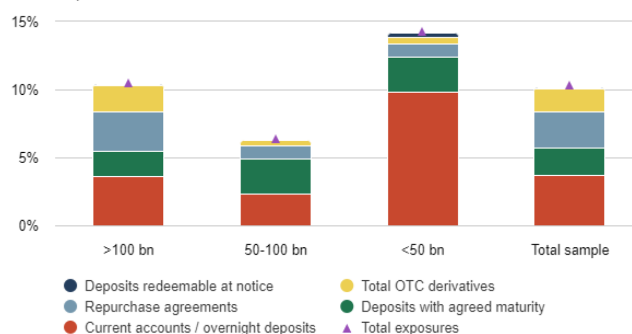
Supervisory data at individual institution level provides further details about the links between banks and NBFIs.[3] EU/EEA banks' exposures to NBFIs amount to 9.2% of consolidated bank assets as of December 2023 (Figure 66). Large banks are generally more connected to the non-bank sector, with exposures amounting to 9.7% of total consolidated assets, followed by medium-sized banks (5.4% of total assets), and small banks (5.1% of total assets).[4] Exposures to NBFIs show an increasing trend since the end of the pandemic. Among individual asset categories, OTC derivatives have seen the highest growth rates with rather substantial fluctuations in volumes. However, those changes in respective exposures are not necessarily driven by rising OTC derivatives business between banks and NBFIs, but also, for instance, valuation effects. Exposures in trading loans also showed major volatility between 2021 and 2023 (which might equally be explained by valuation effects) whereas other loans (i.e. those not classified as trading) rose in the past and then showed a more stable trend (Figure 67). Going forward, banks indicate that they plan to increase lending to other financial institutions by ca. 2% annually in 2024-2026 (see on EU/EEA banks' asset growth plans Chapter 2.2, including Figure 9 with a breakdown of banks' forecasts).

Figure 66a: EU/EEA banks' asset exposures to the non-bank sector, as share of total assets, December 2023



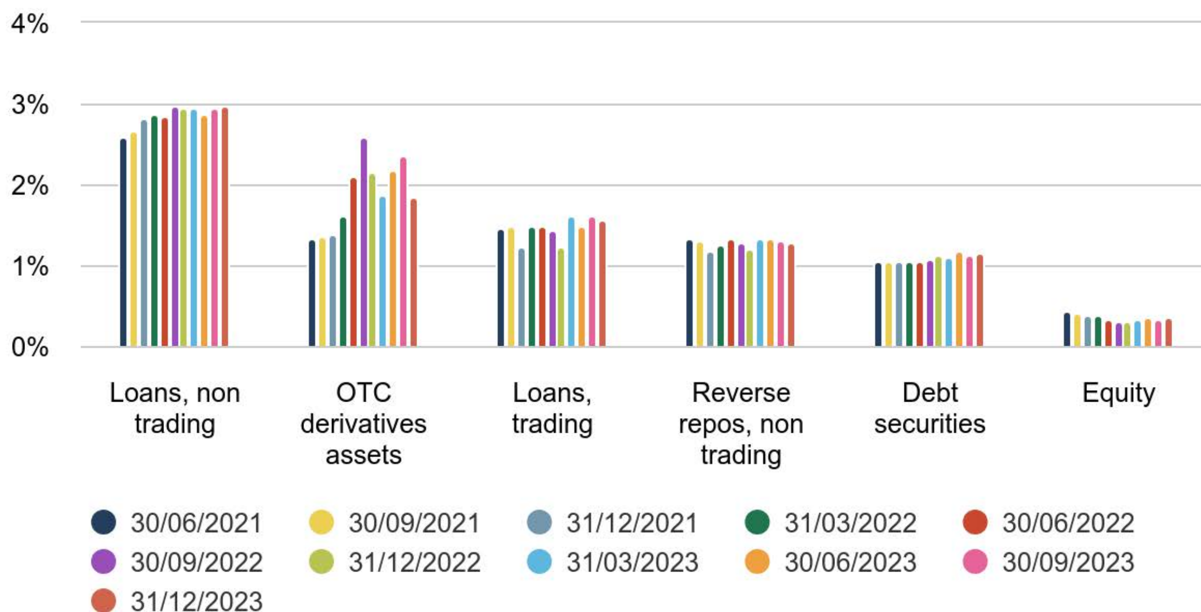
Source: EBA supervisory reporting data

Figure 66b: EU/EEA banks' liability to the non-bank sector (excluding market-based funding), as share of total assets, December 2023



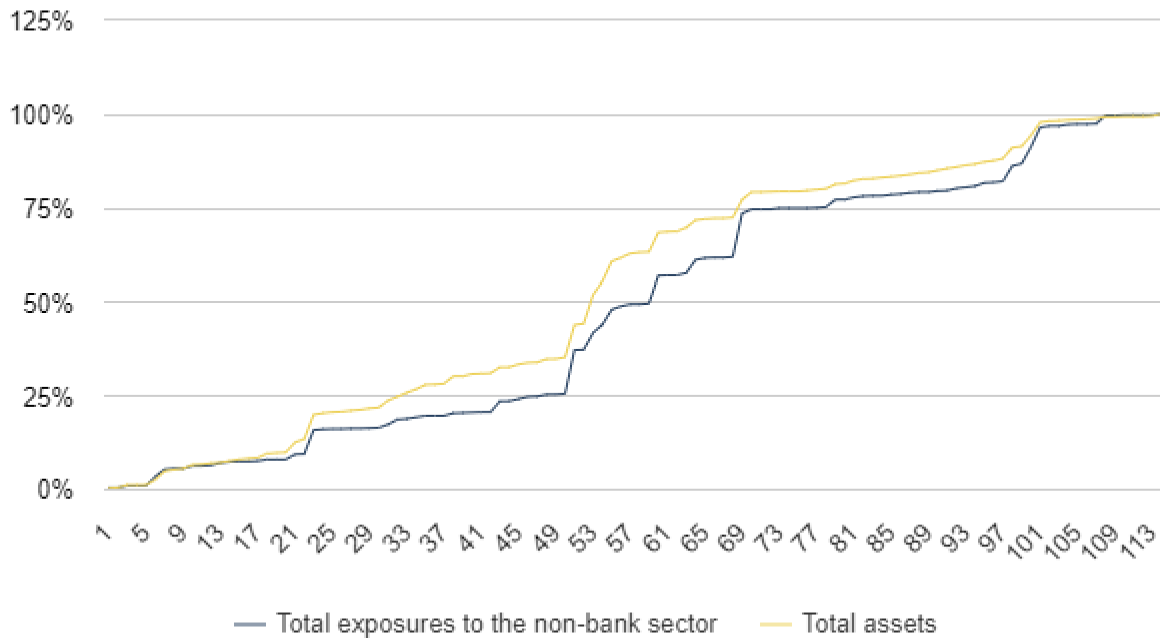
Source: EBA supervisory reporting data

Figure 67: Evolution of EU/EEA banks' asset exposures to the non-bank sector, as share of total assets, June 2021 to December 2023



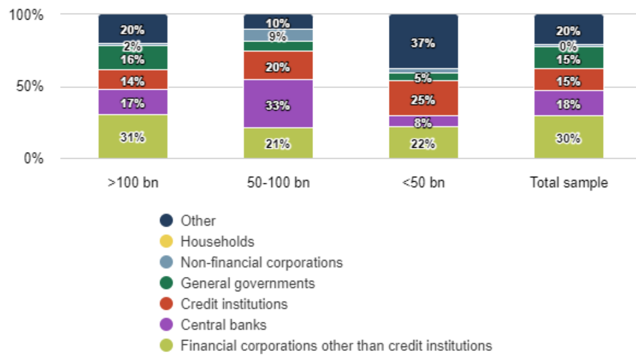
Source: EBA supervisory reporting data

A closer look at the distribution of banks' non-bank exposures reveals that asset linkages are concentrated in few institutions with specialised business models: twenty banks which represent 38% of the total assets of the sample cover 62% of the exposure to the NBFI sector. Although the amount of the exposures towards the non-bank sector is concentrated in these few banks, their individual exposures relative to their balance sheet sizes are not amongst the biggest of the sample. Banks with outsized exposures to NBFIs are medium-sized institutions with specialised business models, such as investment banking, market making and (reverse) repo lending, whilst the largest banks report exposures that are closer to the EU/EEA average (Figure 68).

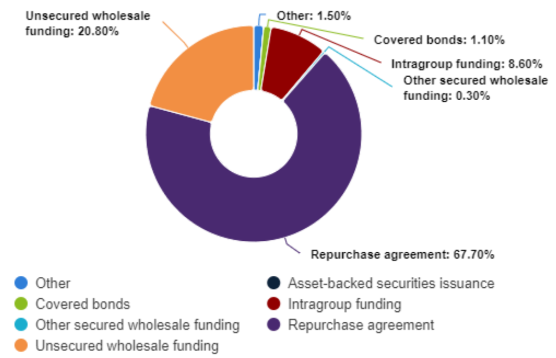


Source: EBA supervisory reporting data

On the liability side, NBFI funding for EU/EEA banks – excluding wholesale market-based funding, such as through debt securities issued –amounts to 10.3% of total assets. For large banks, these links are mostly repo funding, whereas for small and medium-sized banks they are mostly through term deposits. Unlike the asset exposures, EU/EEA banks' respective liabilities to NBFIs have remained broadly stable on aggregate, as the drop in current account deposits has been offset by a moderate upward trend in other liability items (Figure 66 and Figure 67). In terms of wholesale market-based funding, NBFIs are also amongst EU/EEA banks' main funding counterparties.[5] Based on the reporting on main funding counterparties, repurchase agreements represent 67.7% of the total funding received from NBFIs classified as main funding counterparties, followed by unsecured wholesale funding (20.8%) and intragroup funding (8.6%) (Figure 69).[6]



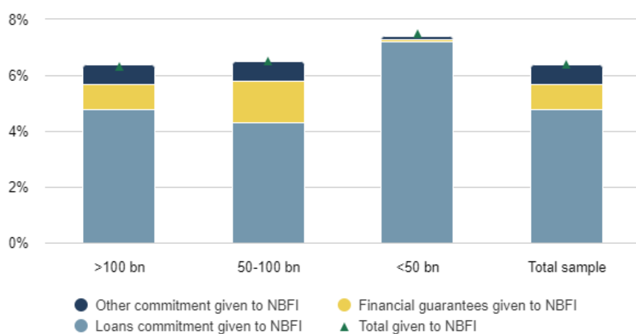
Source: EBA supervisory reporting data



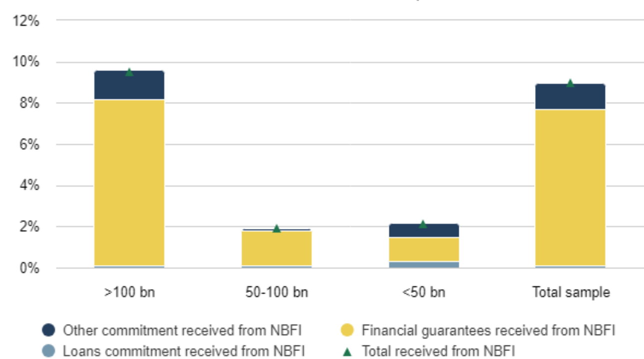
Source: EBA supervisory reporting data

* The group of 'other' funding counterparties includes those items for which banks did not report any specific counterparty classification.

EU/EEA banks also have important links to NBFIs via off-balance-sheet exposures. As of December 2023, undrawn loan commitments, financial guarantees and other commitments extended to NBFIs amounted to 6.4% of all off-balance-sheet items (Figure 70). The share of off-balance-sheet exposures to NBFIs is higher and less diversified in type for smaller banks compared to medium-sized and larger banks. At the same time, the NBFI sector is an important provider of financial guarantees to EU/EEA banks. The share of undrawn loan commitments, financial guarantees and other commitments received from NBFIs amounted to 9.0% of EU/EEA banks' total off-balance-sheet items as of December 2023 (Figure 70). Large banks are more frequent users of financial guarantees and other off-balance-sheet commitments from non-banks (9.5% of total off-balance-sheet items), while medium-sized and smaller banks receive only a small share of their total off-balance-sheet items from NBFIs (1.9% and 2.1%, respectively).



Source: EBA supervisory reporting data



Source: EBA supervisory reporting data

Off-balance-sheet exposures could become a channel of contagion from non-banks to banks if credit lines were drawn simultaneously by several large NBFI counterparties. Since NBFIs lack the access to public safety nets, such as public deposit guarantee schemes and central bank liquidity facilities, they may have an incentive to access support indirectly via off-balance-sheet links to regulated credit institutions which are covered by such emergency facilities.

Direct lending by NBFIs (private credit) creates novel challenges for EU/EEA banks

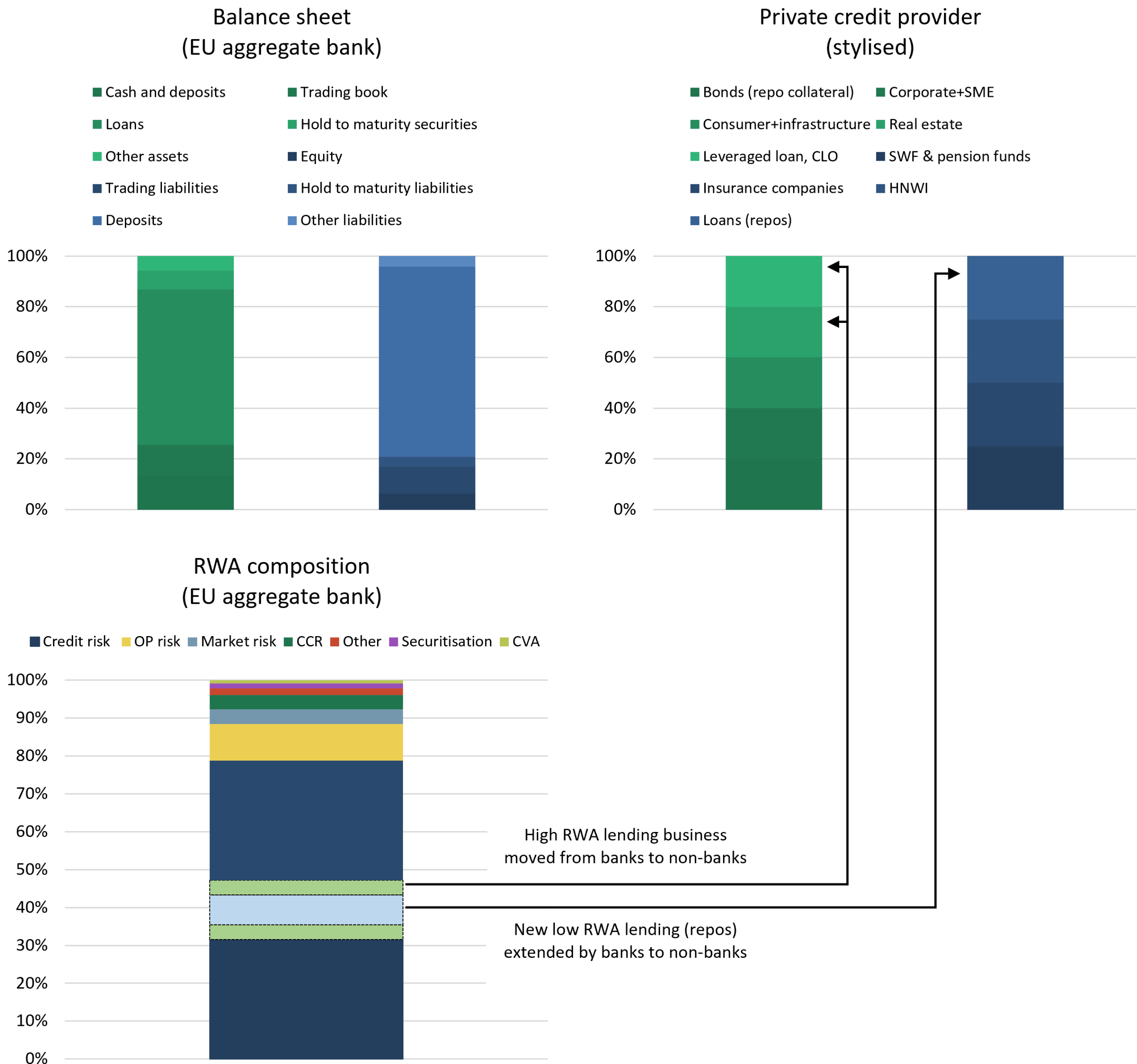
The empirical interconnections illustrated above identified loans as one of the growing areas of non-bank finance. Such direct lending by non-banks to households and firms is also loosely called 'private credit'. In the EU, the volumes of direct non-bank lending remain relatively modest in comparison with some other major jurisdictions, notably the US, but the growth rates have been rapidly accelerating in several Member States.[7]

The growth in private credit in the EU/EEA has coincided with several ongoing trends. From the EU/EEA banking sector perspective, the Basel III regulatory reform agreed at the global level in 2017 and currently being implemented by Member States may have created incentives for banks to adjust balance sheets to comply with the new requirements.[8] For individual banks, the adjustment process may have involved refocusing of activities and/or reducing certain more capital-intensive practices. From the borrowers' perspective, the pandemic, the sharp increase in interest rates to offset the global inflation shock, and the subsequent tightening of bank lending standards created challenges especially for firms and households with weaker balance sheets. Many borrowers also faced sudden refinancing needs due to specific business model issues (e.g. CRE) or inability to access the public equity markets as planned (e.g. private-equity-owned portfolio companies). The higher interest rate environment also adversely affected the cost of debt financing for funds active in the mergers and acquisitions (M&A) and buyout markets, pushing asset managers and private equity funds to seek alternative ways of deploying capital. Finally, the arrival of new players in the lending market, including FinTech companies, has added to the supply of loanable funds competing for profitable projects.

This combination of developments has contributed to an environment where (i) banks were looking to reduce their activities in certain, more capital-intensive businesses, (ii) many borrowers with higher risk profiles were facing steeply higher financing costs and (iii) new alternative credit providers were looking to enter the lending market. But the spectrum of borrowers and lenders has gradually widened and now covers lending by specialised funds and firms to areas such as SMEs, infrastructure projects, real estate and consumer credit.

The links between the banks and the non-bank lenders can be illustrated by a simplified balance sheet of the EU/EEA aggregate bank, using the EBA Transparency Exercise data, as well as the balance sheet of a stylised non-bank lender.[9] The lending on the private credit providers' asset side is financed by funds raised from investors — including insurance firms, sovereign wealth funds, pension funds and family offices — which themselves seek to match long-term liabilities with long-term assets, such as loans to non-financial sectors. Importantly, the liabilities of the private credit providers also include leverage (debt financing) to enhance the returns to their investors. Although such leverage is typically only a fraction of the proportion incurred by banks, for non-banks the leverage is mostly created by short-term borrowing from the repo market instead of more stable deposit funding in the case of banks. The latter also benefit from partial protection of deposit guarantee schemes.

Figure 71: Illustrative examples of a bank's and a private credit provider's business and how they are linked*



*Source: EBA, using, for instance, anecdotal evidence, EBA Transparency Exercise data and further market research/analysis***

* A potential additional link is that the final borrower from the bank and the private credit provider might be the same in which case financial distress experienced by the borrower would affect all lenders depending on the seniority of their exposures.

** CLO – collateralised loan obligation, SWF – sovereign wealth fund, HNWI – high-net-worth individual.

Banks may achieve capital relief by deprioritising activity in high-RWA businesses (or by selling loan portfolios outright) and in this way either shrink their balance sheets or replace the assets with lower-risk-weight exposures.[10] For a bank, one possibility to compensate for the high-risk-weight activities is to increase short-term lending to non-bank counterparties which, depending on their type, may qualify either as ‘institutions’ (like

banks, if they are classified as investment firms) or ‘other corporates’. In both cases the risk weight assigned to the new exposures is likely to be lower than the original exposures.[11] To complete the circle of exposures, non-banks — which above were shown to be significant holders of bank-issued debt securities — could then post banks’ bonds as collateral in the secured borrowing (repo) transactions with banks, thus creating both on- and off-balance-sheet links between the two types of lenders. Such two-way links in bank-issued debt securities would give rise to a funding liquidity risk for both parties of the transaction.

Banks may also decide to set up explicit partnerships with non-bank lenders and in that way remain involved in lending activities that they prefer not to grow on their own balance sheets. Such partnerships can take the form of joint ventures or direct equity ownerships.[12]Partnerships are beneficial to both banks and non-banks as they combine the banks’ strengths in infrastructure, experience, risk management and regulatory issues with non-bank partners’ strengths in customer acquisition, product development and user experience. However, they also establish channels through which shocks can be transmitted to banks in ways which may not be fully foreseen by the banks’ stakeholders and counterparties.

From the broader financial stability perspective, it should be emphasised that the arrival of new players in the lending market is a welcome development. For the borrowers, increased competition should improve access to finance and reduce financing costs. For the wider economy, better risk sharing and more projects getting financed means more investment at the macro level, which is particularly relevant in areas like green transition, ageing societies, economic security and other current and future policy objectives.

At the same time, there are also risks. First, lenders which are not regulated as credit institutions might not apply lending standards that are as prudent as those of their competitors in the banking sector. On the one hand, credit may be extended to less creditworthy borrowers, creating higher default risks in a downturn. On the other hand, creditworthy borrowers may be charged excessively high fees and interest rates, leading to lower investment and slower economic growth. In this vein, one key area to be monitored is whether at the aggregate level the potential shift in lending from banks to non-banks

contributes to increased or reduced lending to the non-financial sectors. Second, if non-banks were to capture meaningful market share in some lending segments, such as consumer credit or SME lending, in the event of economic downturn or market stress several of them could withdraw simultaneously, leaving borrowers stranded and creating unforeseen financial stability risks. Third, questions can be asked about the resilience of non-banks to cyber-attacks, and their ability to protect sensitive customer data and to comply with anti-money laundering and customer identification rules. Fourth, the shareholders of some non-bank lenders may follow more short-term incentives than their peers in the banking industry. The ability to provision for expected losses and to withstand unexpected losses may be weaker than that of banks which have the experience of managing risks throughout the full credit cycle. Finally, both on and off-balance-sheet linkages may allow non-banks to indirectly access the public safety nets through banks, such as central bank liquidity facilities, that at present are exclusively available for regulated credit institutions. It is important that the clients of non-bank lenders are fully aware that these players — although typically less leveraged than banks and often funded by long-term investors in closed-end structures — are not protected by the same emergency facilities as credit institutions. All in all, close monitoring of these developments and cooperation between regulators, supervisors and central banks are necessary to ensure that the risks in private credit are fully identified and appropriately dealt with.

Finally, it is important to note that in the EU most non-bank lenders are regulated even when they are not classified as credit institutions. Insurance companies, which are regulated under Solvency II, have taken on some lending activities. Investment firms are covered by the new Investment Firms Directive (IFR/IFD), with the largest ones being classified as credit institutions. And alternative investment firms have their own standards and rules, including recently updated loan origination guidelines. But some of the new players in the market, including FinTechs, may not be regulated as financial intermediaries. Going forward — and keeping in mind proportionality and the specificities of the non-bank sector that distinguish it from the banks — the usual catchphrase of 'same risks, same regulation' serves as a useful guidepost. This is to guarantee that a level playing field between banks and non-banks is preserved, that consumer protection and access to finance at a fair price are respected, and that financial stability risks are identified and

properly addressed.

---

[1] Amid lack of evidence for certain parts of the following analysis, this chapter is partially also based on schematic presentation. The growth and relevance of the sector is reflected by the fact that several new EU regulatory initiatives, including the (Alternative) Investment Firms Directive, Payment Services Directive and Markets in Crypto-Assets Regulation, have been introduced to provide a sound regulatory basis for specific areas of non-bank finance.

[2] There are also significant exposures of the EU/EEA IF sector to the rest of the world (ROW) sector, suggesting that investment funds provide an important vehicle for EU/EEA residents to access debt and equity markets outside of the EU/EEA internal market.

[3] To provide further details on the interconnections between EU/EEA banks and NBFIs, bank-level consolidated data from FINREP is used. This data provides a more granular breakdown in terms of financial instruments, but treats the NBFIs as one aggregate sector, including insurance, pension funds, other financials and investment firms.

[4] The asset exposures are concentrated in loans classified in non-trading portfolios (3% of total assets), followed by OTC derivative assets (1.9% of total assets), loans for trading activities (1.6% of total assets), reverse repos (1.3% of total assets), debt securities (1.2% of total assets) and equity exposures (0.4% of total assets).

[5] The main funding counterparties cover the top 10 counterparties where the funding obtained from each counterparty or group of connected clients exceeds a threshold of 1% of total liabilities. The funding provided by the main funding counterparties represents 6.1% of consolidated bank assets.

[6] Unsecured wholesale funding includes debt securities issued, but also loans and deposits received.

[7]Chapter 2 of the spring 2024 IMF Global Financial Stability Report focused on the rise and risk of private credit from the global perspective. The ECB spring 2024 Financial Stability Review included analysis of non-banks as funding providers to EA banks. The focus here is on the interactions specifically between banks and non-bank lenders, including not only funding links but also ownership, lending, and off-balance-sheet interconnections. Since non-bank lending/private credit is a new area of activity and carried out by various types of NBFIs, precise statistical information about its size is still difficult to obtain. The ECB estimates that as of the third quarter of 2023, assets under management of euro area private market funds (including private equity and private credit) stood at EUR 960bn, or 6% of the euro area investment fund sector's total assets, which is substantially smaller than in the US. The compounded annual growth rate of the private credit segment is estimated at 14% (see e.g. ECB Financial Stability Review from May 2024 and ECB IVF statistics).

[8] The comprehensive EBA impact assessment published in 2019 on the impact of Basel III quantified the estimated increases in bank capital requirements. Using data as of June 2018, the estimated increase in Tier 1 minimum required capital amounted to 24.4%, on average, for all banks in the sample. The estimated Tier 1 capital shortfall amounted to EUR 127.7bn. The 2023 regular EBA Basel Monitoring Report, using data as of December 2022, estimated that the adjustment had been practically completed.

[9] See the EBA's Transparency Exercise from December 2023.

[10] If the lending activity deprioritised by the banks is taken up by private credit providers, the outcome may resemble a transfer of credit risk out of the banking sector without explicit securitisation arrangements.

[11] In practice, the short-term lending would often take the form of reverse repurchase agreements whereby the banks would extend short-term loans to borrowers who post securities as collateral. For example, a bank could reduce lending to commercial real estate, project financing, or SMEs, with typical risk weights ranging from 85-130%, and replace it with repo lending to an investment firm with a risk weight of 5-10%, or a fund classified as "other corporate" with risk weights ranging between 10-66%. The banks' risk-based capital ratio would then improve whereas its total assets or leverage ratio may remain unchanged.

[12] In the EU, many large asset managers already tend to be parts of banking groups. This is different to the US and the UK, where large asset management companies are mostly independent and sometimes also major shareholders of banks.

Policy implications and measures

Banks need to be flexible and agile and have proper plans and processes in place to address unexpected manifold challenges within the short term. This includes in particular geopolitical risks, which can materialise through many channels, such as credit, market and operational risks. It also includes proper management of sanctions, which can pose challenges for banks.

Robust management of credit risk remains key, including up-to-date collateral valuation. Adequate and timely loan provisioning can protect banks from negative hits to profitability. The latter can happen if asset quality deterioration is addressed too late. Banks need to provide lending to the economy, but at the same time need to apply proper lending standards, including in the CRE segment when other lending providers step out from respective financing.

Funding and liquidity risks seem to be low for the moment, but they might suddenly again come to the fore. Banks are planning for heightened issuance volumes, not least driven by replacement of maturing MREL debt and presumably influenced by final TLTRO repayments. Banks need to use windows for their issuances and be flexible in this respect, not least amid elevated funding costs in times of higher yields. It is important that banks have sufficient central-bank-eligible collateral available if need be.

Even though capital headroom above requirements stands at comfortable levels, cautious management of payouts is important. This is to be prepared for potential major negative impacts on capital. Supervisors' case-by-case assessments of payouts remain a key means in this respect.

Banks' profitability might have peaked amid rising pressure on NIMs. Banks need to have an adequate revenue mix going forward. Despite potential pressure on profitability amid inflation and the rising cost of risk, investments connected with information and communication technology (ICT) should not be postponed. Banks also need to be prepared for different interest rate scenarios going forward. M&A might be one means to also

address profitability-related challenges. Windfall taxes should avoid compromising banks' long-run viability.

Banks need to be prepared to address technology-related challenges. Banks need to address cyber risk, which might increase even further, in volume as well as sophistication. Technology-related challenges also include the rising usage of new technological solutions, such as AI, and products, such as CBDCs. Developments like the so-called T+1 settlement for securities, as it was introduced e.g. in the US, are also part of such challenges.

NBFIs and in particular non-bank lenders have increased in relevance recently. Transparency for NBFIs should be improved. The risk management and loan origination standards applied by some NBFIs might also require further scrutiny, to make sure that expected and unexpected losses are sufficiently covered and that credit allocation to the economy remains efficient. In addition, to detect potential contagion channels early on, supervisors and macroprudential authorities also need to have a particular focus on the direct and indirect linkages between banks and NBFIs. Better data that allows for identification of such linkages at different levels of aggregation is needed.

Risks related to ESG challenges should also stay high on banks', regulators' and supervisors' agenda. ESG risks are increasingly materialising and require diligent consideration as part of banks' risk management. Regulatory and supervisory initiatives, such as under the revised CRR/Capital Requirements Directive (CRD) package, are also going in this direction to ensure that banks take necessary steps to incorporate ESG risk considerations as drivers of traditional risk categories.

Annex I: Samples of banks

Name	Country	Supervisory reporting	Funding Plans	RAQ
BAWAG Group AG	Austria	X	X	X
Erste Group Bank AG	Austria	X	X	X
Raiffeisen Bank International AG	Austria	X	X	X
Raiffeisenbankengruppe OÖ Verbund eGen	Austria	X	X	
UniCredit Bank Austria AG	Austria	X	X	
Volksbanken Verbund	Austria	X	X	
Belfius Bank	Belgium	X	X	X
BNP Paribas Fortis	Belgium	X	X	
Crelan	Belgium	X		X
Dexia	Belgium	X		
Euroclear Holding	Belgium	X		
Investeringsmaatschappij Argenta - Société d'investissements Argenta - Investierungsgesellschaft Arg	Belgium	X	X	
KBC Groep	Belgium	X	X	X
The Bank of New York Mellon	Belgium	X	X	
DSK Bank AD	Bulgaria	X	X	X
First investment Bank AD	Bulgaria			X
UniCredit Bulbank AD	Bulgaria	X	X	
United Bulgarian Bank AD	Bulgaria	X		
Erste&Steiermärkische Bank d.d.	Croatia	X		
Privredna Banka Zagreb d.d.	Croatia	X		X
Zagrebačka banka d.d.	Croatia	X		X
Bank of Cyprus Holdings Public Limited Company	Cyprus	X	X	X
Eurobank Cyprus Ltd	Cyprus	X	X	
Hellenic Bank Public Company Ltd	Cyprus	X	X	X
The Cyprus Development Bank Public Company Ltd	Cyprus	X		
Česká spořitelna, a.s.	Czechia	X	X	X
Československá obchodní banka, a.s.	Czechia	X	X	X
Komerční banka, a.s.	Czechia	X	X	X
Danske Bank A/S	Denmark	X	X	X
Jyske Bank A/S	Denmark	X	X	X
Nykredit Realkredit A/S	Denmark	X	X	X
AS LHV Group	Estonia	X	X	X
AS SEB Pank	Estonia	X	X	
Luminor Holding AS	Estonia	X	X	X
Swedbank AS	Estonia	X	X	
Kuntarahoitus Oyj	Finland	X	X	
Nordea Bank Abp	Finland	X	X	X
OP Osuuskunta	Finland	X	X	X
Banque centrale de compensation	France	X		

BNP Paribas	France	X	X	X
BofA Securities Europe SA	France	X	X	
Bpifrance	France	X	X	
Confédération Nationale du Crédit Mutuel	France	X	X	X
Groupe BPCE	France	X	X	X
Groupe Crédit Agricole	France	X	X	X
HSBC Continental Europe	France	X	X	
La Banque Postale	France	X	X	X
RCI Banque	France	X	X	
SFIL S.A.	France	X	X	
Société générale S.A.	France	X	X	X
ATLANTIC LUX HOLDCO S.A R.L.	Germany	X		
Bayerische Landesbank	Germany	X	X	X
Citigroup Global Markets Europe AG	Germany	X	X	
COMMERZBANK Aktiengesellschaft	Germany	X	X	X
DekaBank Deutsche Girozentrale	Germany	X	X	
DEUTSCHE APOTHEKER- UND ÄRZTEBANK EG	Germany	X	X	
DEUTSCHE BANK AKTIENGESELLSCHAFT	Germany	X	X	X
Deutsche Pfandbriefbank AG	Germany	X	X	
DZ BANK AG Deutsche Zentral-Genossenschaftsbank, Frankfurt am Main	Germany	X	X	X
Erwerbsgesellschaft der S-Finanzgruppe mbH & Co. KG	Germany	X	X	
Goldman Sachs Bank Europe SE	Germany	X	X	
Hamburg Commercial Bank AG	Germany	X	X	
HASPA Finanzholding	Germany	X	X	
J.P. Morgan SE	Germany	X	X	
Landesbank Baden-Württemberg	Germany	X	X	X
Landesbank Hessen-Thüringen Girozentrale	Germany	X	X	X
Morgan Stanley Europe Holding SE	Germany	X	X	
Münchener Hypothekenbank eG	Germany	X	X	
Norddeutsche Landesbank - Girozentrale -	Germany	X	X	X
State Street Europe Holdings Germany S.a.r.l. & Co. KG	Germany	X	X	
UBS Europe SE	Germany	X	X	
Volkswagen Bank Gesellschaft mit beschränkter Haftung	Germany	X	X	
Wüstenrot Bausparkasse Aktiengesellschaft	Germany	X		
ALPHA SERVICES AND HOLDINGS S.A.	Greece	X	X	X
Eurobank Ergasias Services and Holdings S.A.	Greece	X	X	X
National Bank of Greece, S.A.	Greece	X	X	X

Piraeus Financial Holdings	Greece	X	X	X
Kereskedelmi és Hitelbank csoport	Hungary	X	X	
MBH bankcsoport	Hungary	X	X	X
OTP-csoport	Hungary	X	X	X
Arion banki hf.	Iceland	X	X	X
Íslandsbanki hf.	Iceland	X	X	X
Landsbankinn hf.	Iceland	X	X	
AIB Group plc	Ireland	X	X	X
Bank of America Europe Designated Activity Company	Ireland	X	X	
Bank of Ireland Group plc	Ireland	X	X	X
Barclays Bank Ireland plc	Ireland	X	X	
Citibank Europe plc	Ireland	X	X	X
Ulster Bank Ireland Designated Activity Company	Ireland	X		
BANCA MEDIOLANUM S.P.A.	Italy	X	X	
Banca Monte dei Paschi di Siena S.p.A.	Italy	X	X	X
BANCA POPOLARE DI SONDRIO SOCIETA' PER AZIONI	Italy	X	X	
BANCO BPM SOCIETA' PER AZIONI	Italy	X	X	X
BPER Banca S.p.A.	Italy	X	X	X
Cassa Centrale Banca	Italy	X	X	
CREDITO EMILIANO HOLDING SOCIETA' PER AZIONI	Italy	X	X	
FINECOBANK SPA	Italy	X		
ICCREA BANCA SPA	Italy	X	X	X
Intesa Sanpaolo S.p.A.	Italy	X	X	X
Mediobanca - Banca di Credito Finanziario S.p.A.	Italy	X	X	
UNICREDIT, SOCIETA' PER AZIONI	Italy	X	X	X
Akciju sabiedriba "Citadele banka"	Latvia	X	X	
AS "SEB banka"	Latvia	X	X	X
Swedbank Baltics AS	Latvia	X	X	X
LGT Group Foundation	Liechtenstein	X	X	
Liechtensteinische Landesbank AG	Liechtenstein	X	X	
VP Bank AG	Liechtenstein	X	X	
“Swedbank”, AB	Lithuania	X	X	
AB SEB bankas	Lithuania	X	X	
Akcinė bendrovė Šiaulių bankas	Lithuania	X	X	X
Revolut Holdings Europe UAB	Lithuania	X	X	X
Banque et Caisse d´Epargne de l´Etat, Luxembourg	Luxembourg	X	X	X
Banque Internationale à Luxembourg	Luxembourg	X	X	X
BGL BNP Paribas	Luxembourg	X		
CACEIS INVESTOR SERVICES BANK S.A.	Luxembourg	X		
Quintet Private Bank (Europe) S.A	Luxembourg	X	X	
Société Générale Luxembourg	Luxembourg	X		

Bank of Valletta Plc	Malta	X	X	X
HSBC Bank Malta p.l.c.	Malta	X	X	X
MDB Group Limited	Malta	X	X	
ABN AMRO Bank N.V.	Netherlands	X	X	X
BNG Bank N.V.	Netherlands	X	X	
Coöperatieve Rabobank U.A.	Netherlands	X	X	X
de Volksbank N.V.	Netherlands	X	X	X
ING Groep N.V.	Netherlands	X	X	X
LP Group B.V.	Netherlands	X		
Nederlandse Waterschapsbank N.V.	Netherlands	X	X	
DNB Bank ASA	Norway	X	X	X
SpareBank 1 SMN	Norway	X	X	
SPAREBANK 1 SR-BANK ASA	Norway	X	X	X
Bank Polska Kasa Opieki S.A.	Poland	X	X	X
Powszechna Kasa Oszczednosci Bank Polski S.A.	Poland	X	X	X
Santander Bank Polska S.A.	Poland	X	X	
Banco Comercial Português, SA	Portugal	X	X	X
Caixa Geral de Depósitos, SA	Portugal	X	X	X
LSF Nani Investments S.AR.L	Portugal	X	X	
SANTANDER TOTTA, SGPS, SA	Portugal	X	X	
Banca Comerciala Romana SA	Romania	X		X
Banca Transilvania	Romania	X	X	X
BRD-Groupe Société Générale SA	Romania	X	X	
Slovenská sporiteľňa, a.s.	Slovakia	X	X	X
Tatra banka, a.s.	Slovakia	X	X	
Všeobecná úverová banka, a.s.	Slovakia	X	X	X
AGRI EUROPE CYPRUS LIMITED	Slovenia	X		
Nova Ljubljanska Banka d.d., Ljubljana	Slovenia	X	X	X
OTP LUXEMBOURG S.A R.L.	Slovenia	X	X	X
SKB BANKA D.D. LJUBLJANA	Slovenia	X	X	
Abanca Corporacion Bancaria, S.A.	Spain	X	X	
Banco Bilbao Vizcaya Argentaria, S.A.	Spain	X	X	X
Banco de Crédito Social Cooperativo	Spain	X	X	
Banco de Sabadell, S.A.	Spain	X	X	X
Banco Santander, S.A.	Spain	X	X	X
Bankinter, S.A.	Spain	X	X	X
Caixabank, S.A.	Spain	X	X	X
Ibercaja Banco, S.A.	Spain	X	X	
Kutxabank, S.A.	Spain	X	X	
Unicaja Banco, S.A.	Spain	X	X	X
Aktiebolaget Svensk Exportkredit	Sweden	X	X	
Kommuninvest - Grupp	Sweden	X	X	
Länsförsäkringar Bank AB - gruppen	Sweden	X	X	
SBAB Bank AB - Grupp	Sweden	X	X	

Skandinaviska Enskilda Banken - gruppen	Sweden	X	X	X
Svenska Handelsbanken - gruppen	Sweden	X	X	X
Swedbank - Grupp	Sweden	X	X	X

Tour Europlaza, 20 avenue André Prothin CS 30154
92927 Paris La Défense CEDEX, FRANCE
Tel. +33 1 86 52 70 00

E-mail: info@eba.europa.eu

https://eba.europa.eu