Deloitte Consultanta SRL
The Mark Tower, 84-98 Grivitei Road,
10th Floor
Bucharest, District 1, Romania, 010735
Tel: +40 21 222 16 61
Fax: +40 21 222 16 60
www.deloitte.ro

Deloitte Banking Alert

September 2023

ESAs Raise Red Flags Regarding a Fragile Economic Forecast

In recent years, Europe has faced a series of extraordinary events, testing the resilience of EU Financial Institutions, which have maintained **strong capital positions**. However, prolonged economic uncertainty presents significant **financial stability risks**. Rising interest rates impact various sectors and warrant attention for their medium-term implications, including increased funding costs and liquidity risks. Deteriorating asset quality is a looming concern due to macroeconomic uncertainty**, inflation and interest rate hikes**. Inflation risk is substantial, affecting asset quality, expenses, and funding costs, requiring judicious premium adjustments and consideration in product testing. Recent banking challenges in the US and Switzerland highlight the critical **importance of effective risk management and governance**, especially regarding liquidity and interest rate risks.

Uncertainties:

Despite ongoing **uncertainties**, high inflation, and the fallout from Russia's actions in Ukraine, the global financial landscape eased in H1 2023. The IMF predicted a decline in global GDP growth from 3.4% in 2022 to 2.8% in 2023. In the EU, the European Commission anticipated 2% growth in 2023 and 1.7% in 2024, reflecting an upward revision, though a Q1 2023 technical recession revealed differing growth patterns among Member States. Unemployment remained low at 6.1% in H1 2023, with a 1.7% GDP growth expectation for 2024. Inflation, peaking at 11.5% YoY in the EU in Oct 2022, declined to 6.4% in June 2023, with forecasts indicating 6.4% for 2023 and 2.8% for 2024. **Global financial conditions** mirrored higher borrowing costs, driven by tighter monetary policies, leading to reduced credit flows. The banking sector turmoil in March 2023, triggered by issues at mid-sized US banks, and Credit Suisse, resulted in temporary market volatility and a dip in European bank share prices, though less severe than in the case of US regional banks. This highlighted **EU's Financial System vulnerabilities to external shocks** and ongoing market unpredictability.

Market Developments:

In the first half of 2023, **European equity markets** surged by 19%, mirroring the global uptick in equity markets. Notably, this growth occurred despite the market jitters stemming from the March turmoil in

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as "Deloitte Global") does not provide services to clients. Please see www.deloitte.com/ro/about to learn more about our global network of member firms.

the US banking sector. During this turmoil, EU equity market valuations experienced declines of -6.5%, with the EU banking sector witnessing falls of -17.5%. Confidence rebounded thanks to revised growth expectations and abating energy concerns, propelling European valuations in all sectors above their 2022 year-end levels. Surprisingly, European banking sector valuations increased by 16% in H1 2023, driven by improved earnings. March's volatility had a temporary impact on equity markets. However, market liquidity concerns endured, evidenced by increased bid-ask spreads above their 5-year averages.

Fixed income markets, while showing resilience after the banking sector stress, remained volatile. **European Sovereign bond** yields stabilized below end-2022 levels, and temporary drops in yields followed market tensions in March as investors sought refuge in sovereign bonds. **Corporate bond markets**, both investment-grade (IG) and high-yield (HY), experienced volatility but recovered.

The market for **ESG** (Environmental, Social, Governance) products and sustainable investments in Europe continued to thrive, with **ESG bonds** outstanding reaching EUR 1.7tn in June 2023, a 28% increase in a year. However, issuance slowed, particularly in the private sector. Despite this, public sector issuance grew, led by green bonds, which still dominated the ESG bond market. Assets under management of EU ESG funds rebounded in H1 2023, reaching a 20% share of the EU fund industry. Sustainable investment products remained popular, especially those with stronger ESG credentials.

European Financial Sector Update H1 2023:

In H1 2023, the **European investment fund sector** recovered by 3%, remaining EUR 1.4tn below its end-2021 size. Equity funds showed improved performance with a 12-month average monthly return of 0.9%, bouncing back from the -1.3% registered in December 2022. Bond and mixed funds also reported positive returns. However, commodity funds experienced negative returns (-1%) due to declining commodity prices. Equity fund flows were uncertain, contrasting with significant ETF inflows and mixed fund outflows.

EU banks exhibited resilience among uncertainties in March 2023, supported by strong capital and liquidity positions. **Regulatory frameworks and Basel III** implementation contributed to their stability. Rising interest rates boosted profitability and capital ratios. Deposit volumes at EU banks stabilized, with some increases in deposit rates. However, macroeconomic uncertainty, high inflation, and rising interest rates affected lending, particularly in residential real estate and SME lending. Despite the challenging environment, EU banks increased profitability, with return on equity (RoE) reaching double digits for the first time since the global financial crisis.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as "Deloitte Global") does not provide services to clients. Please see www.deloitte.com/ro/about to learn more about our global network of member firms.

Deloitte.

Risks:

The ESAs (EBA, EIOPA and ESMA) emphasize three main risks in the financial sector: **interest rate risk**, **liquidity risk**, and **credit risk**, which are significant across various financial sectors. Managing these risks is vital for **financial stability** and **systemic risk mitigation**. European financial institutions have shown preparedness for foreseeable risks, but sudden, unanticipated shocks, as seen in events like liability-driven investment (LDI) stresses or the US banking turmoil, could still pose systemic stress challenges.

Interest rate risk in the financial sector is a significant concern as the shift from a low-interest rate environment to higher rates poses challenges. Rising interest rates lead to declining bond prices, impacting financial institutions' balance sheets, especially for life insurers and defined benefit pension funds with longer-dated liabilities. Insurers hedge interest rate risk with derivatives, but large rate swings can lead to variation margin calls and potential losses. Investment funds are adjusting to lower interest rate risk by reducing bond portfolio maturities. EU banks holding debt securities at amortized cost have unrealized losses of EUR 75 billion, but these are not expected to realize in the absence of liquidity issues. Higher interest rates are expected to improve profitability, but challenges remain, including deposit pricing, credit risk, market funding costs, and subdued loan growth. Effective interest rate risk management, guided by EBA standards and guidelines, is crucial for banks.

Liquidity risk in the financial sector has become more prominent due to recent events like deposit outflows at mid-sized US banks and the case of Credit Suisse. All financial institutions must effectively manage liquidity risk as ample liquidity phases wane. In the banking sector, liquidity positions, while generally strong, slightly decreased, with the Liquidity Coverage Ratio (LCR) falling from 167.9% in Q1 2022 to 163.7% in Q1 2023. Digitalization has accelerated the movement of information and deposits, underscoring the need for rigorous liquidity position oversight. Beyond LCR, supervisors should monitor maturity mismatches and funding concentration. Bond funds faced liquidity challenges in 2022 due to high redemption requests but improved in H1 2023. High-yield bond funds reduced portfolio liquidity, while investment-grade bond funds saw enhanced portfolio liquidity. Corporate bond funds lowered cash holdings in H1 2023.

Credit risk in European debt worsened in H1 2023, particularly for sovereigns like France, Hungary, the Czech Republic, and Poland. There was a slight increase in "fallen angels," companies downgraded from investment grade to high-yield, though below historical averages. Some high-yield corporate ratings defaulted, raising short-term credit risks due to possible interest rate hikes and refinancing challenges. Though bank asset quality remained stable, the potential for deterioration looms with rising interest rates and persistent inflation, especially in real estate portfolios. EBA Risk Assessment Questionnaire (RAQ) results highlight banks' expectations of declining asset quality in most large loan segments, emphasizing the need for provisioning and timely recognition of loan losses, with many banks already employing provisioning overlays to mitigate increased risk costs.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as "Deloitte Global") does not provide services to clients. Please see www.deloitte.com/ro/about to learn more about our global network of member firms.

Conclusion:

In summary, European Financial Institutions have weathered **significant challenges**, maintaining strong capital positions. Yet, enduring economic uncertainty poses substantial stability risks. Rising interest rates raise concerns, impacting funding costs and liquidity. Deteriorating asset quality is a looming issue due to economic uncertainties, inflation, and rate hikes. Inflation risk affects various aspects, demanding careful adjustments. Recent banking challenges emphasize the importance of risk management. While recent trends hint at easing, geopolitical risks persist. Credit risk indicators deteriorate, impacting investment funds and insurers, while monitoring interest rates, liquidity, and credit risks is essential. In essence, the European Financial landscape **remains resilient** but faces ongoing **uncertainties and the need for vigilant risk management**.

For further questions regarding the aspects mentioned in this alert, please don't hesitate to contact us.

Dimitrios Goranitis
Deloitte Global leader FSI Risk and Regulatory
Central Europe FSI leader
Tel: +40 751 250 884
Email: **digoranitis@deloittece.com**

Source: **https://www.eba.europa.eu/esas-warn-risks-resulting-fragile-economic-outlook**

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee ("DTTL"), its network of member firms, and their related entities. DTTL and each of its member firms are legally separate and independent entities. DTTL (also referred to as "Deloitte Global") does not provide services to clients. Please see www.deloitte.com/ro/about to learn more about our global network of member firms.