EUROPEAN BANKING NEWSLETTER

AUGUST 2022

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EUROPEAN CENTRAL BANK (ECB)

Economy-wide climate stress test - ECB publishes results

8 July 2022 - The European Central Bank (ECB) has published the results of its 2022 Climate Risk Stress Test (CST) exercise for EU banks. The 2022 CST was launched in January 2022 and aims to assess banks' resilience to a short-term disorderly transition risk scenario (assessing banks' short-term vulnerabilities triggered by a sharp, abrupt increase in the price of carbon emissions), a drought and heat scenario (which modelled the economic effects of a severe drought and heatwave, assumed to hit Europe on 1 January 2022), and a flood risk scenario (where it was assumed that severe floods took place across Europe on 1 January 2022). 41 banks took part in the 2022 CST, and the results will inform the 2022 Supervisory Review and Evaluation Process (SREP).

Overall, the 2022 CST shows that banks in the Single Supervisory Mechanism do not yet sufficiently incorporate climate risk into their stress-testing frameworks and internal models, despite some progress having been made since 2020. Key findings from the results include:

- credit and market losses in the short-term disorderly transition and the two physical risk scenarios amount to around EUR 70 billion on aggregate. The ECB states that this is an understatement of the actual climate-related risk, owing to challenges such as the scarcity of available data;
- around 60% of banks do not yet have a climate risk stress-testing framework. Similarly, most banks do not include climate risk in their credit risk models, and just 20% consider climate risk as a variable when granting loans;
- on aggregate, almost two-thirds of banks' income from non-financial corporate customers stems from greenhouse gas-intensive industries. The ECB urges banks to step up their customer engagement to obtain more accurate data and insights into their clients' transition plans; and
- physical risk has a heterogeneous impact across European banks, as their vulnerability to a drought and heat scenario and a flood scenario is highly dependent on sectoral activities and the geographical location of their exposures.

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The ECB will integrate the findings from the 2022 CST into its SREP. There will be no direct impact on capital through the Pillar 2 guidance in 2022. The ECB will conduct follow-up work and produce guidance on best practices in Q4 2022.

ECB 2022 climate risk stress test

Press release

Supervisory banking statistics Q1 2022 - ECB publishes results

11 July 2022 - The ECB has published supervisory banking statistics for significant institutions (i.e. those banks it directly supervises) covering the period Q1 2022. Key points set out in the statistics include:

- the aggregate capital ratios of significant institutions decreased slightly in Q1 2022, while the aggregate Common Equity Tier 1 ratio decreased slightly to 14.98% over the same quarter (compared with 15.57% in the previous quarter);
- the results on asset quality show that the aggregate non-performing loans (NPL) ratio decreased further to 1.95% in Q1 2022, the lowest level recorded since supervisory banking statistics were first published in 2015 (down from 2.06% in the previous quarter). The ECB explains that this decrease was driven by a further decline in the stock of NPLs to EUR369bn compared with EUR374bn in the previous quarter, as well as an increase in total loans and advances to EUR18,963bn, compared with EUR18,138bn in the previous quarter;
- aggregate stage 2 loans as a share of total loans continued to increase in Q1 2022, reaching 9.28%, up from 9.14% in the previous quarter. The ECB also notes that the stock of stage 2 loans amounted to EUR1,311bn (compared with EUR1,261bn in the previous quarter);
- aggregated annualised return on equity decreased to 5.98% in the first quarter of 2022 compared with 6.71% for the full year in 2021, with increases in operating income and administrative expenses, and depreciation, driving aggregate net profit or loss;
- aggregate liquidity coverage ratio stood at 167.46% in Q1 2022, down from 173.49% in the previous quarter. Both the liquidity buffer and the net liquidity outflows increased when compared with the previous quarter, by EUR361bn and EUR319bn respectively; and
- total loans and advances subject to COVID-19-related measures decreased further to EUR421bn in Q1 2022, down from EUR444bn in Q4 2021. This decrease was driven by other

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loans and advances subject to COVID-19-related forbearance measures, which declined to EUR55bn from EUR67bn over the same period.

Press release

Using AI to fight financial crime - ECB publishes speech

13 July 2022 - The ECB has published a speech by Elizabeth McCaul, Member of the Supervisory Board of the ECB, on the use of artificial intelligence (AI) to fight financial crime. Overall, Ms McCaul judges that any technological solution needs to be buttressed by three pillars: an appropriate regulatory framework; sufficient supervisory oversight; and a deep understanding by banks and supervisors of the potential, and the limitations and risks, of new technologies.

In the speech, Ms McCaul discusses the interaction between digitalisation and anti-money laundering (AML) and countering the financing of terrorism (CFT), highlighting challenges posed by the digital transformation of business models, including that:

- some companies, in particular digital platforms or mixed activity groups, may not be fully captured by the regulatory framework and fall outside the scope of AML legislation;
- certain new entrants, such as some FinTech companies, have an insufficient understanding of their AML/CFT obligations and suffer from structural weaknesses in their customer due diligence and know-your-customer frameworks; and
- there may be AML/CFT challenges inherent to the business models of some new entrants, such as in deploying new payment processing methods that don't use traditional identification information.

Ms McCaul highlights that the potential of AI in banking goes beyond AML and CFT, noting that many banks already use it for credit scoring, algorithmic trading, robo-advice or chatbots. She cautions that two of the most important challenges for AI are transparency and explainability, and concludes that particular attention must be paid to the programming of AI, its governance and quality assurance or backtesting.

ECB speech by Elizabeth McCaul: Technology is neither good nor bad, but humans make it so

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No relevant items

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2021 bank resolvability assessment - published by SRB

13 July 2022 - The Single Resolution Board (SRB) has, for the first time, published its assessment of the resolvability of banks in the Banking Union. The resolvability assessment and 'heat-map' for 2021 shows that banks have made significant progress in the SRB's priority areas. Banks have improved their ability to absorb losses and recapitalise in the case of failure, and most banks already meet the final minimum requirement for own funds and eligible liabilities (MREL) target to be complied with at the end of the transition period, on 1 January 2024.

The SRB observes, however, that progress is needed by all banks on the swift mobilisation of liquidity and collateral in resolution, the further automation of the management information systems for the purposes of valuation in resolution, as well as the further operationalisation of restructuring and separation capabilities post-resolution.

The SRB will communicate its 2023 priorities to banks in Q3 2022. They will include finalising the work on liquidity and other remaining capabilities, as well as ensuring full compliance with the final MREL targets.

SRB Resolvability of Banking Union Banks: 2021

Press release

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ABLV Bank AS v Single Resolution Board (SRB) EUECJ T-280/18,

6 July 2022 - Decision of the SRB not to adopt a resolution scheme - Action for annulment - Article 18 of the Single Resolution Mechanism Regulation (806/2014/EU)

The General Court of the Court of Justice of the EU has dismissed an application by ABLV Bank AS (the Applicant) seeking an annulment of the SRB's decision not to adopt resolution schemes within the meaning of Article 18(1) of the Single Resolution Mechanism (SRM) Regulation (806/2014/EU) for the Applicant or its subsidiary, ABLV Bank Luxembourg S.A. (the Banks). The SRB's decision was made following the European Central Bank's (ECB's) decision to declare the Banks as 'failing or likely to fail'.

Dismissing ABLV's action, the judgement affirmed that the SRB has the power to take a formal decision not to adopt a resolution scheme within the meaning of Article 18(1) SRM Regulation, and that it did not err by taking the ECB's assessment that ABLV was failing or likely to fail as the basis for its own decision. The judgement also confirmed that the ECB and the SRB are not required to take account of factors such as the coverage ratio or the level of capitalisation of a credit institution before being able to conclude that a credit institution is failing or is likely to fail under Article 18(4) SRM Regulation; in this instance, focus on the temporary cash-flow shortage affecting the Banks was sufficient.

ABLV Bank AS v Single Resolution Board (SRB) EUECJ T-280/18

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Our European Financial Institutions Group, consisting of 'Best Friends' BonelliErede, Bredin Prat, De Brauw Blackstone Westbroek, Hengeler Mueller, Slaughter and May and Uría Menéndez, brings together market-leading lawyers with corporate and financing experience and financial regulatory skills.

We have unrivalled coverage of regulatory developments in the EU, which enables us to provide pure regulatory advice on the interpretation and application of EU directives and regulations. We also have strong connections with the best financial institutions lawyers in the United States, Asia and South America.

Our many years of experience of advising a diverse range of major financial institutions allows us to offer the most incisive advice available.

f you would like to discuss any of the developments in this update, or any other financial regulatory matter, please contact one of the following or your usual EFIG contact.

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BONELLIEREDE

Stefano Micheli
stefano.micheli
@belex.com

HENGELER MUELLER

Dirk Bliesener
dirk.bliesener
@hengeler.com

BONELLIEREDE

Giuseppe Rumi
giuseppe.rumi
@belex.com

HENGELER MUELLER

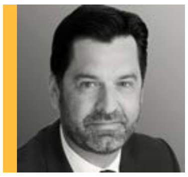
Christian Schmies
christian.schmies
@hengeler.com

BREDIN PRAT

Didier Martin
didiermartin
@bredinprat.com

SLAUGHTER AND MAY

Jan Putnis
jan.putnis
@slaughterandmay.com



BREDIN PRAT

Matthieu Pouchepadass
matthieupouchepadass
@bredinprat.com

SLAUGHTER AND MAY

Nick Bonsall
nick.bonsall
@slaughterandmay.com

DE BRAUW

Mariken van Loopik
mariken.vanloopik
@debrauw.com

URÍA MENÉNDEZ

Pedro Ravina
pedro.ravina
@uria.com

DE BRAUW

Pete Lawley
pete.lawley
@debrauw.com

URÍA MENÉNDEZ

Carlos Costa Andrade
carlos.andrade
@uria.com

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