

Managing uncertainty, ensuring resilience

European bank CROs' outlook on managing the COVID-19 pandemic, the war in Ukraine and high inflation



Building a better working world



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Preamble

Banks are an integral part of the European economy. EY teams and the European Banking Federation (EBF) believe that a strong, resilient and forward-looking banking sector is vital to growth prospects in Europe. This is why we have formed a knowledge collaboration that looks to drive a multi-stakeholder dialogue between regulators, supervisors, consultants, banks and banking associations. This joint collaboration is driven by insight from the persons who are setting direction toward new trends in the banking sector. The partnership covers three topics: first, capital and balance sheet restructuring, to which this report belongs; second, sustainable banking; and third, diversity and inclusion in banking. We believe that these three areas will feature prominently on the agenda in a post-COVID-19 environment.

We would like to thank all the banks who shared their insights and experiences in this report. We hope it helps shed some light on how bank workout approaches evolved during the pandemic, where future issues are likely to arise and some of the operational issues banks now face.



Introduction

The COVID-19 pandemic was a health crisis that impacted millions of individuals. It quickly led to global economic disruption, which saw SMEs and large corporates suffer challenges and losses they had never previously faced.

The start of COVID-19 also marked the beginning of a period of extreme uncertainty for chief risk officers (CROs), with little prospect of a return to the norm in the short term. Banks faced political and public pressure to support individuals, small businesses and large corporates, all at a time when they were being squeezed on capital. For bank CROs, the uncertainty it created was on a scale few had ever contemplated.

There were several key periods for CROs within this timeline:

1. The immediate response to COVID-19 and widescale economic shutdowns

As COVID-19 hit, CROs had to respond to economic-wide shutdowns and an unprecedented pause on activity across sectors. Banks then had to use judgments on the extent of provisions needed using overlays, as models were unable to assess the level of losses in such an atypical scenario.

2. Easing of concerns as stimulus and furlough mitigated worst-case scenarios

The industry responded well through its own forbearance, as well as working with the authorities to ensure stimulus helped keep economies afloat. As defaults failed to reach the levels predicted, bank CROs started to release provisions while focusing attention on sectors most exposed to lockdowns, such as tourism, construction and leisure.

3. Start of the war in Ukraine

CROs had to react to any direct exposure to Russia, as well as consider the impact of sanctions and the impact on sectors hit by disruptions (e.g., energy-intensive sectors or sectors related to food security).

4. Managing the fallout of the war, COVID-19 defaults and higher inflation

Banks are now navigating a complex array of drivers as they look at their loan exposure. As well as inflation, the threat of recession and the impact of high energy costs, they are also having to prepare for defaults finally occurring as a result of COVID-19, as businesses potentially may struggle without government support.

As part of the knowledge partnership between EY and the EBF, we wanted to shed more light on how banks navigated each of these stages. We surveyed 63 banks¹ from 22 European countries as the pandemic eased and ahead of the start of the Ukraine war. We also spoke to banks to gauge how the war has changed the pressures they face and their views on what the future holds.

¹ The survey was conducted from December 2021 to February 2022 (see Appendix 1 for more details)

Executive summary

Today's CROs are facing an era of constant disruption. They have had to manage large macro shocks, including COVID-19, supply chain problems (including the Suez Canal blockage), the war in Ukraine and renewed lockdowns.

At the start of both COVID-19 and the war in Ukraine, CROs acknowledged that each event would have significant consequences for their banks. Yet the extent and scope of that impact has been extremely complex to predict and model for. Economic stimulus and policy responses have softened some of the worst-case scenarios. Global GDP forecasts are still predicting growth despite the impact of the war in Ukraine.

In response, management has relied on overlays to their models – a pattern that started with the pandemic and continues today. That discretion has been invaluable in allowing banks to reflect the risks they identified.

Most severe concerns due to lockdowns did not materialize – with downside risks present

Our research has painted a clear picture of the shift banks experienced in their outlook pre-war to post-war. Pre-war, there was relief that risks from the pandemic had significantly eased. Most banks saw an easing of provisions and a return to the norm.

We found that smaller banks expected the peak of distress to hit them later in the cycle than large banks. This came through strongly from both our survey of CROs and our ECL benchmark analysis of large banks (see Appendix 2). This reflects larger banks generally taking higher provisions much earlier.

Banks also felt more concerned about the fragility of the retail book. This reflects high inflation and the cost-of-living squeeze having increased the pressure on consumers, who are also no longer protected by furlough.

Since the start of the war in Ukraine, the broader macroeconomic picture has become much more challenging – overlays are essential as risks change, but uncertainty remains

The overriding message from CROs is that their direct exposure to Ukraine is limited, but they are concerned around

the risk of recession from indirect impacts – including higher energy costs and inflation.

That risk is difficult to capture in models, so banks are again having to rely on judgment and use of overlays rather than just the outcomes of models. It comes against a backdrop of low historical levels of default, with banks again having to use their judgment around how much of that is due to stimulus and forbearance.

European banks will continue to be tested

Constant disruption has become a fact of life for banks. It requires constant change and adaptation. The number of unforeseen scenarios or themes that banks are being asked to think about has multiplied. For CROs, trying to understand what is happening and the possible impact is a substantial challenge. As the goalposts constantly shift, they must avoid paralysis or inaction and, instead, find practical steps to help their banks manage this disruption. Their success in handling COVID-19 stands them in good stead to handle future challenges such as higher inflation and the cost-of-living crisis.

Looking forward, here are four key takeaways from our research that will shape the next stages for CROs:

1. Continued use of overlays will require more detailed explanation

Increased reliance on overlays over the medium term is a significant change and challenge for banks and regulators. Models were seen as essential in allowing banks to use a wide range of data to give greater accuracy of forecasting, at a much more granular level, across a range of plausible scenarios. It poses a fundamental question around what the increased use of judgment over models means for a robust financial system going forward.

Banks have different levels of disclosure relating to how they have come up with their own overlays. We have already seen a divergence in how banks have communicated a shift in provisioning for COVID-19 and the risks from the war in Ukraine, the increase in the cost of living and inflation.

Banks have so far applied these judgements well. The longer these overlays are used, the more we would expect regulators and the market will want to understand:

- ▶ How banks are making these judgments
- ▶ Whether they are truly transparent in communicating their disclosures
- ▶ What governance they have around their judgments
- ▶ How much sensitivity analysis was undertaken when calculating overlays
- ▶ Whether they are being consistent in their use of overlays

2. Managing constant disruption will continue for CROs

Bank CROs can reflect positively on their response since the COVID-19 pandemic started. The initial few months after the start of the Ukraine war have also been well navigated. However, high inflation, a cost-of-living crisis and continued geopolitical tensions mean the pressure does not ease. Planning will also need to account for a new possible COVID-19 variant leading to lockdowns again. And banks will have to take into account any government measures to support consumers in dealing with increased inflation.

Risk teams will also need to look closely at their ability to manage continued heightened risks and stresses on their systems and people. We have already seen some banks look at their credit origination to help improve their portfolio management of bad debts. Pre-war, many flagged worries about the quality of credit monitoring in the face of continuing credit losses, as well as a lack of talent to manage an increased workload.

As risk managers, CROs need to prepare and have a playbook in place for all these different scenarios. The continued use of overlays is the most visible sign that their judgment will continue to be critical in how banks navigate the months and years ahead.

3. Cautious approach to be welcomed

The positive news is that there is more caution and resilience in the system. Post-2008, we all wanted our banks to hold more capital and book provisions earlier. While the last few months have shown the limitations of modeling in achieving that, CROs are using their judgment to add a layer of caution beyond what their models are saying. Banks using judgments and taking on more provisions is much more helpful than the alternative of booking defaults and incurred losses when they arise.

4. Increased stresses could materialize at some point

The full impact of Covid-19 is unlikely to have worked its way through the banking sector due to the success of the various stimulus measures. Any subsequent impact will be difficult to correlate. With the latest strains following the war in Ukraine, high inflation and a possible recession, we are seeing a potential build up of risk in the system. This risk is hard to model, so we will see more reliance on judgment while models adapt over time.

The banking sector continues to be resilient. Various regulatory exercises and stress tests around the world all indicate that banks remain strong and able to withstand the various shocks impacting our economies. Banks must now look forward and consider how to manage the risk around stress building in the system, as they look to prepare for the long-term. Customers took on debt during COVID-19, and they must now pay it back. At the same time, the war in Ukraine is leading to possible higher inflation, energy costs and prices. Combined, they may have significant credit impacts over the medium term.

Section

1

Response to the COVID-19 pandemic

In this section, we explore the different approaches and sentiments of banks around the impact of COVID-19.

Key findings

- ▶ The pandemic is an event outside of European banks' recent experience.
- ▶ The impact of shutdowns, regulatory forbearance and government support was not something that existing models could easily assess.
- ▶ Judgment had to be applied, and we observed differences in banks' approaches.
- ▶ Smaller banks took fewer provisions at the onset of COVID-19 and now expect defaults and provisions to peak later than large banks.
- ▶ Banks with large retail lending exposure are significantly more negative about their portfolios going forward than banks with corporate lending.
- ▶ Before the war in Ukraine, the credit environment was more benign than expected, with banks starting to release provisions.

1.1 Initial response

The COVID-19 pandemic saw economies completely shut down on an unprecedented global scale. No one knew how credit would be affected, and many feared a severe impact on business viability.

We saw banks use judgments and overlays in the absence of their models providing an answer they felt would sufficiently reflect how bad things could become. Against a background of regulatory forbearance and government stimulus, banks had to use judgment to come to a probability weighted outcome, as required by IFRS 9. The uncertainty we saw at the time resulted in a wide range of outcomes and approaches.

This was all tracked by the EY benchmarking study of IFRS 9 ECL disclosures for 19 large European banks; the study has run since the start of the crisis (see Appendix 2 for more details).

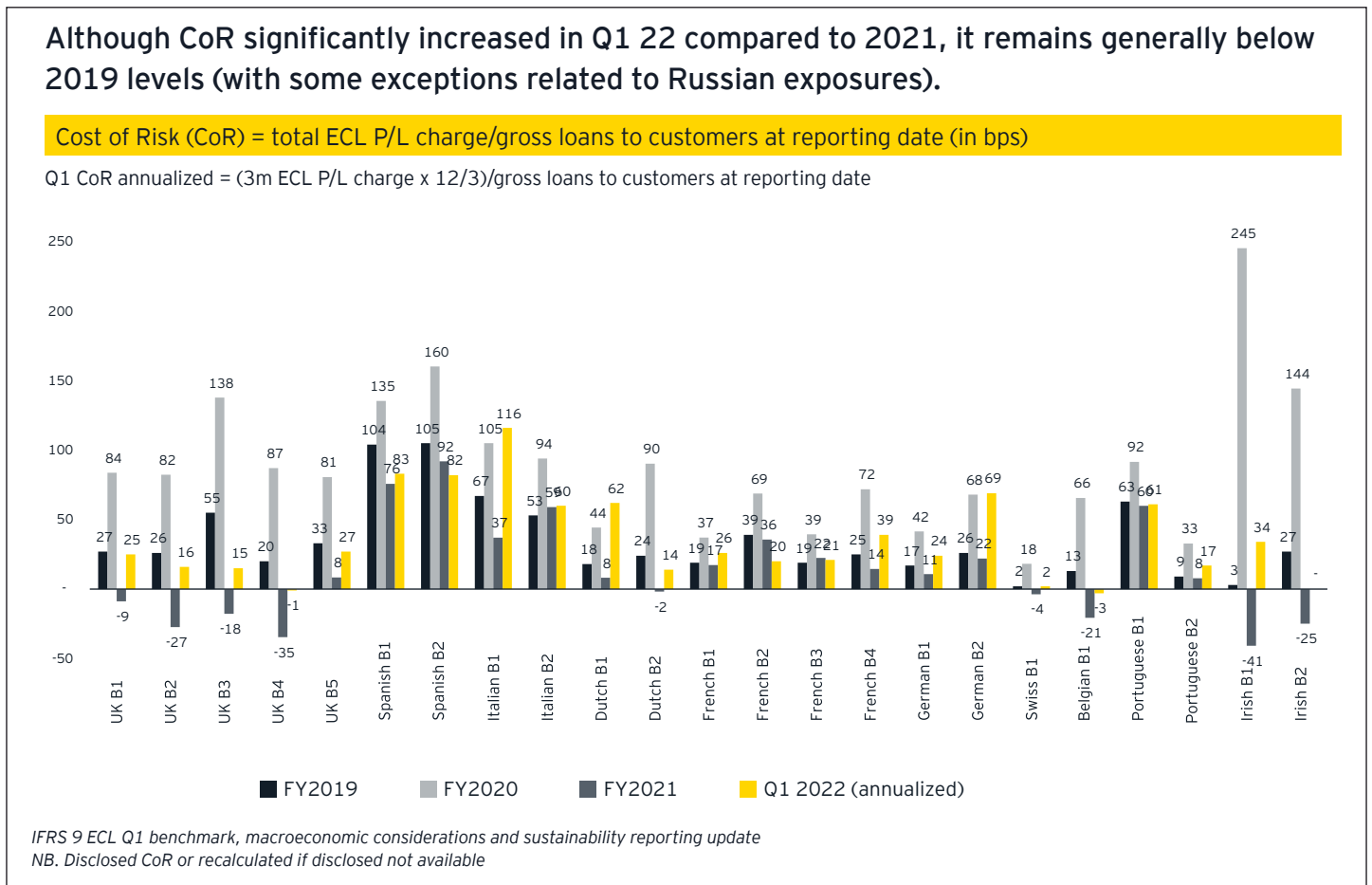
1.2 Easing of concerns pre-war

Toward the end of 2021, it was clear that the expected wave of defaults was not materializing. This reflected huge stimulus programs from the authorities, and the return of consumer demand as lockdowns were eased. Our pre-war in Ukraine survey of European banks found sentiment was of a much more benign economic environment. This meant many had either already rolled back provisions or were expecting to do so soon.

This was further demonstrated by the Q1 2022 EY ECL benchmarking, which found that for year-end 2021, a number of large banks had either significant ECL net releases, or close to nil or slightly negative ECL charges. It found that banks in Spain, Italy, France (and, to a certain extent, Germany) now show “normal” levels of cost-of-risk ratios (ECL losses or gross loans).

The benchmark confirmed banks were prudent and generally had not needed to use all of their provisions. In our survey of banks, we examined banks’ sentiment in more detail and saw two key trends emerge.

Figure 1



1.3 Larger banks were more prudent at the start of COVID-19

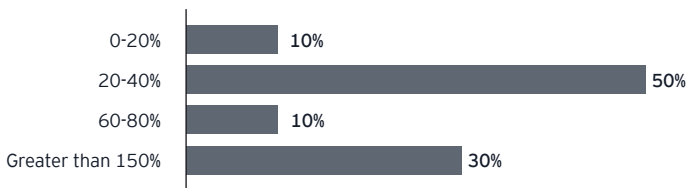
Our survey pointed to a clear split between large and smaller banks in their approach during the pandemic, with small banks expecting to see the peak of distress later.

When asked about ECL provisioning in relation to performing loans (Stage 1 and Stage 2) between December 2019 and December 2020, a third (30%) of big banks had increased provisioning by over 150%, whereas only 10% of small banks had done the same. Regardless of size, over half of the banks we surveyed had increased their provisioning by only 0% to 20%.

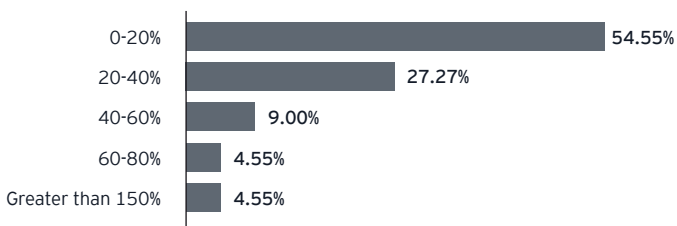
Figure 2

What was the increase in your ECL provisions in relation to performing loans (Stage 1 and Stage 2) between December 2019 and December 2020?

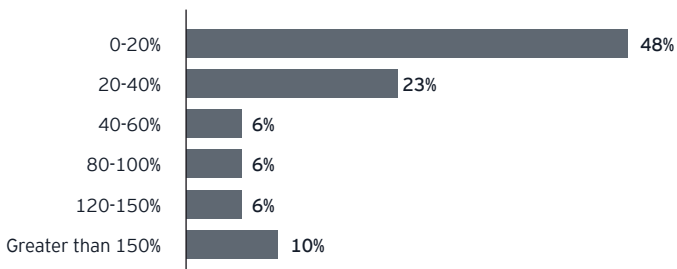
Large banks



Medium banks



Small banks

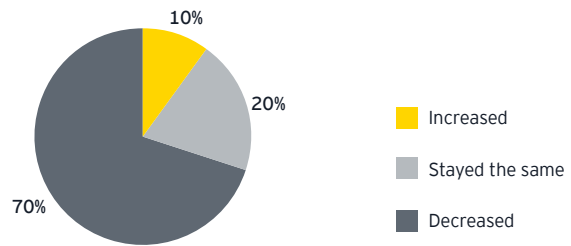


When asked about the same provisioning for the following year (December 2020 to December 2021), seven out of 10 large banks said they would reduce their levels, while only a fifth (19%) of small banks said they would do the same. Indeed, nearly half of small banks (45%) projected increases in provisioning, of which nearly a third (28%) expect to increase levels by over 15%.

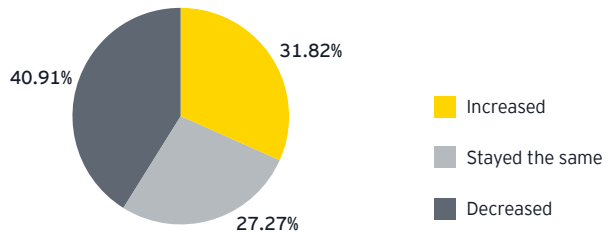
Figure 3

How do you project your ECL provisions in relation to performing loans (Stage 1 and Stage 2) as at December 2021 compared to December 2020?

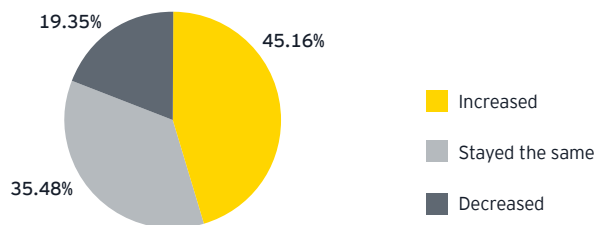
Large banks



Medium banks



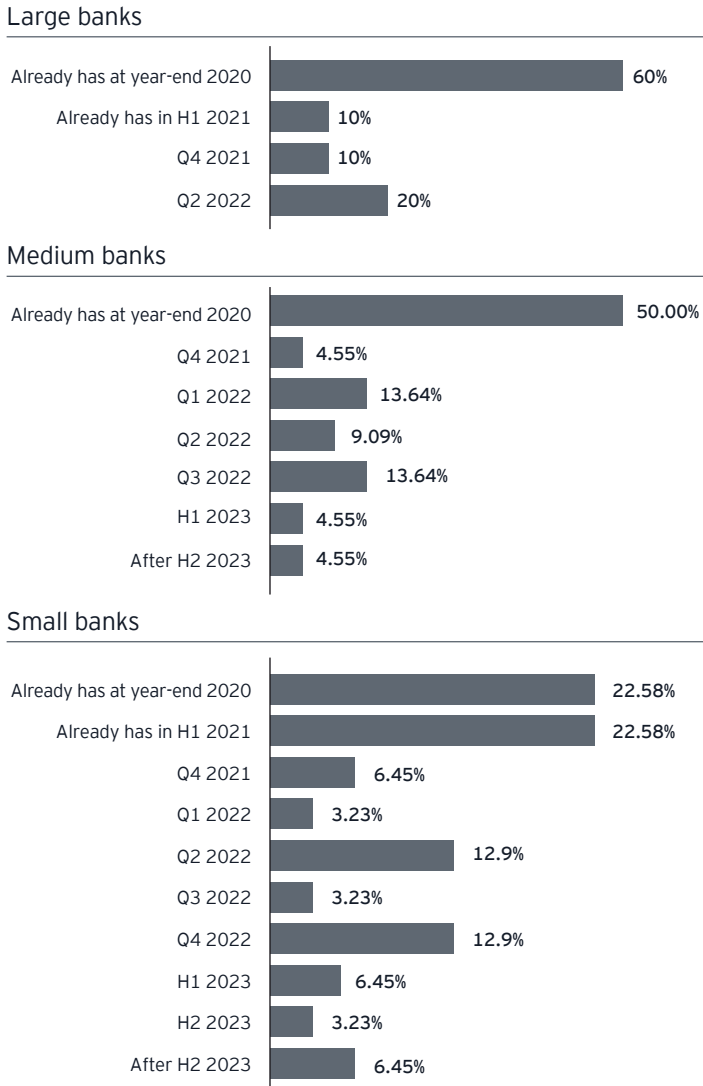
Small banks



This trend was reflected in the differing views in the survey on when the peak of ECL provisions following the pandemic would be. Eight out of 10 larger banks said the peak was reached by Q1 2022, while approximately half of small banks felt the same, with a notable 15% of small banks expecting it to hit in 2023 or later.

Figure 4

When do you think the level of ECL provisioning against loan losses will peak?

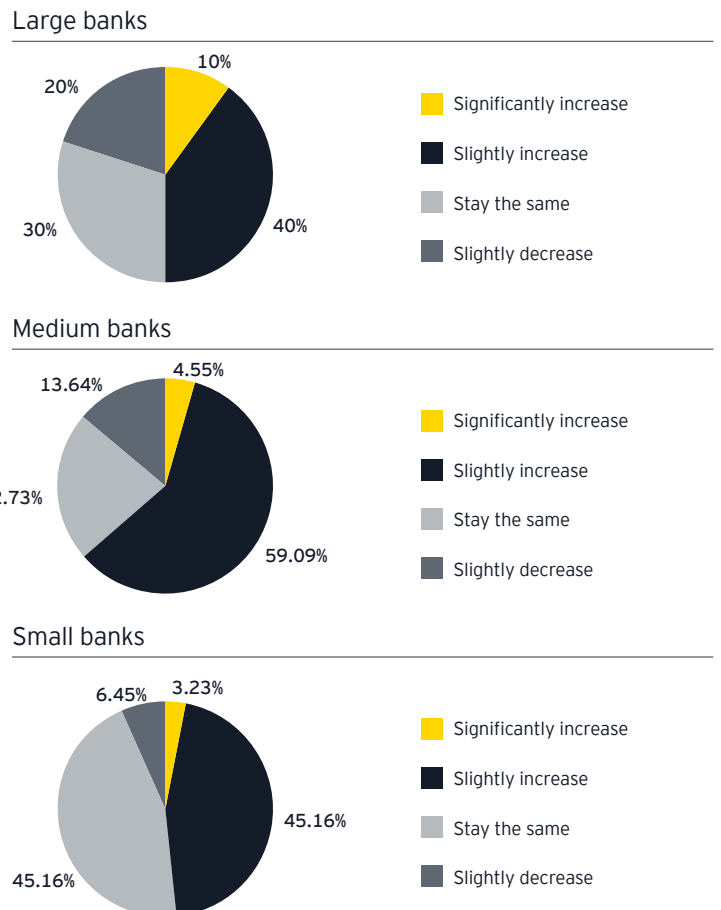


Other findings also pointed to the fact smaller banks are expecting to see a peak later than bigger banks. Six out of 10 larger banks expect to see some improvement in their portfolio in the next two to three years, but only a quarter (26%) of small banks and only a third (36%) of medium banks are as positive.

When it comes to default rates, only 6% of small banks expect their rate to decrease over the next 12 to 24 months, compared with 20% of the largest banks. Medium banks split the difference, with 13% expecting defaults to fall over the next two years. This comes in the context of various support measures, which has meant default rates are at historically low levels. Larger banks clearly felt more confident with their portfolio. This reflects them having a more diversified customer base, as well as a broad range of income.

Figure 5

How do you expect your firm's default rate to evolve in the next 12-24 months?



The results show that smaller banks mainly expected losses to emerge over a longer period. This reflects retail customers not defaulting in any large numbers, as furlough and stimulus schemes cushioned the impact, combined with a benign macroeconomic environment. This lack of defaults meant small banks did not introduce significant provisioning. Instead, smaller banks expected the peak to follow significant job losses in a weakened macroeconomic and business environment.

In contrast, large banks took significant provisions early and began to release them ahead of the war as macro conditions eased. This difference is likely to be more to do with how forward-looking their ECL estimate was and how they incorporated uncertainty, than as a result of their size. It is also possible that affordability was a factor, with large banks having more capital to absorb larger write-downs.

Without the war in Ukraine, these two different approaches may have achieved the same outcome. Large banks that took provisions early could have continued to release them as more favorable conditions returned. For smaller banks, the positive outlook at the start of 2022 suggested that higher provisions may not be needed after all.

1.4 Fragility in the retail book

55% (retail) vs. **27%** (corporate)
expect increase in default rate over next 12 to 24 months

40% (retail) vs. **13%** (corporate)
expect deterioration in portfolio over next 2 to 3 years

We also looked at how confidently banks with differing exposures viewed their current portfolio. Of those with a largely corporate loan book, 60% expected their default rate to stay the same, with a quarter (27%) expecting rates to increase over the next two years. Yet the picture is much more pessimistic for those institutions with their main exposure to retail lending. Over half (55%) felt defaults would increase over the next 24 months.

Forty percent of banks with majority retail lending expected their portfolios to deteriorate in the next two to three years, more than double the 13% of banks exposed to corporate lending.

These results indicate a high level of concern that retail loans may deteriorate faster in the coming years. To date, we have not seen significant retail credit deterioration, with retail customers being largely protected during the initial phase of the pandemic.

As forbearance and stimulus roll off, the retail customer is more exposed. Higher inflation and the cost-of-living squeeze facing consumers is likely to put significant pressure on retail portfolios, as customers' ability to service their loans falls. We may also be seeing a period of higher personal taxation, as governments look to raise revenue. Banks will clearly have to manage these increased risks in their retail lending over the next 12 to 24 months.

1.5 Other key trends

Some other key trends that emerged from our survey included the following:

- ▶ Banks ranked rescheduling payments as the most frequently used forbearance measure followed by an extension of maturity, an interest rate reduction and additional collateral to help with loan to value (in that order).
- ▶ For SME and corporate customers, banks looked at several areas to assess viability. The key focus was a credible business plan, followed by capacity to repay after the moratoria ends. Interestingly, the results from countries with high non-performing loans (NPLs) found that the top two areas they look at are capacity to repay after the moratoria ends and a clean payment record before COVID-19.
- ▶ Banks felt governments stimulus support schemes were the most important factor in mitigating losses, followed by the economic recovery and regulatory forbearance.

Section

2

The war in Ukraine and inflation

This section explores sentiment around the war in Ukraine and the increased threat of inflation.

Key findings

- ▶ Pre the war in Ukraine, there was an awareness of inflation risk, but it did not rank as significant a concern as it does today.
- ▶ There was a short-lived window of optimism about economic growth returning as COVID-19 pressures eased, before the war in Ukraine.
- ▶ While direct exposure to Russia is limited, banks are planning for reduced economic activity because of macro trends exacerbated by the war in Ukraine.
- ▶ The war has also changed banks' sentiment around which sectors are most likely to be impacted by defaults.

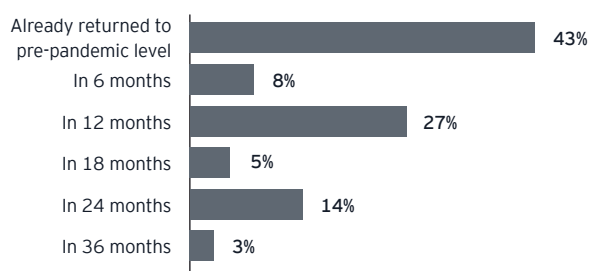
2.1 From optimism to a new reality

Our pre-war in Ukraine survey found only 6% of banks expected significant impacts on the credit quality of their portfolios over the next 12 months – citing higher energy prices and inflationary pressures. A further 16% expected slight or partial sector-limited impacts, while nearly half (41%) said they expected no significant impact.

This optimism is also seen in the 43% of banks that said their host country had already reached pre-pandemic growth levels, with a further 35% expecting a recovery within the next 12 months. This again aligned with the 'EY ECL' benchmarking report, which found banks reported improvements in the macroeconomic outlook.

Figure 6

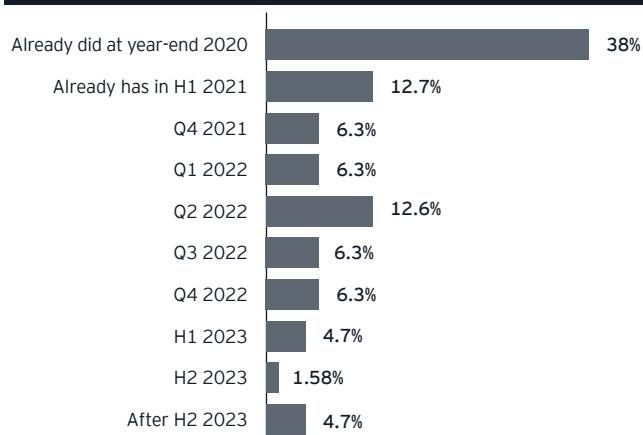
When do you expect your host economy to recover to pre-pandemic levels (return to pre-2019 growth rates)?



That positivity was supported by 57% of all banks saying the peak level of ECL provisioning against losses would not be later than Q1 2022.

Figure 7

When do you think the level of ECL provisioning against loan losses will peak?



Post-war, the OECD² models that global growth could be reduced by over 1 percentage point, and global inflation raised by close to 2.5 percentage points in the first full year after the start of the conflict. Oxford Economics also sees downward projections for GDP (see figure 8). So, for banks, while the direct credit exposure to Russia is limited, the second-order impacts from a weaker economy and higher costs are likely to impact credit performance more widely.

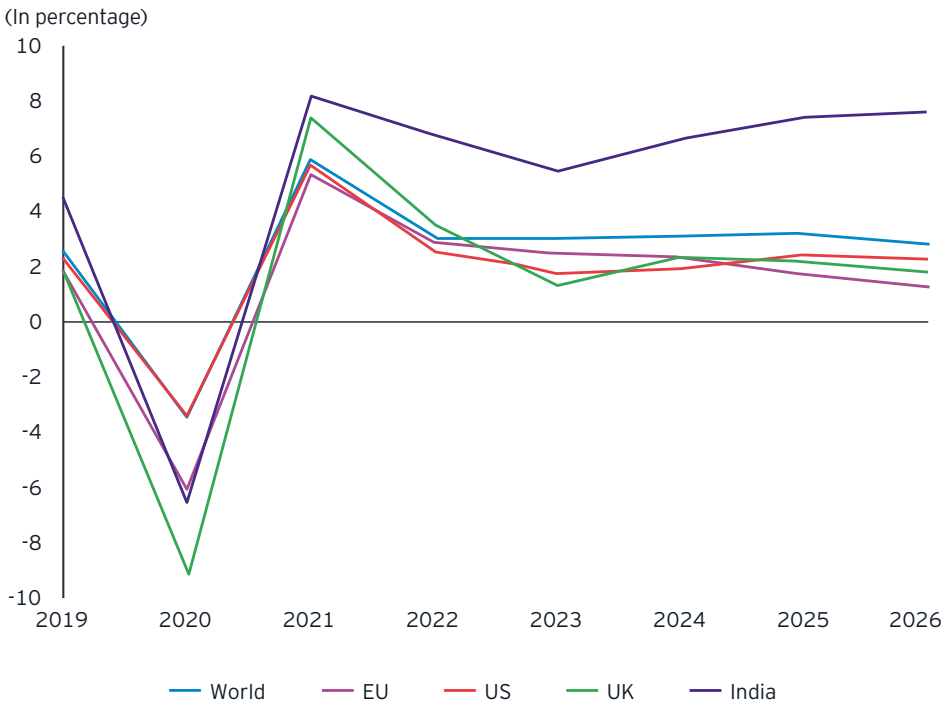


² <https://www.oecd.org/economy/Interim-economic-outlook-report-march-2022.pdf>

Figure 8

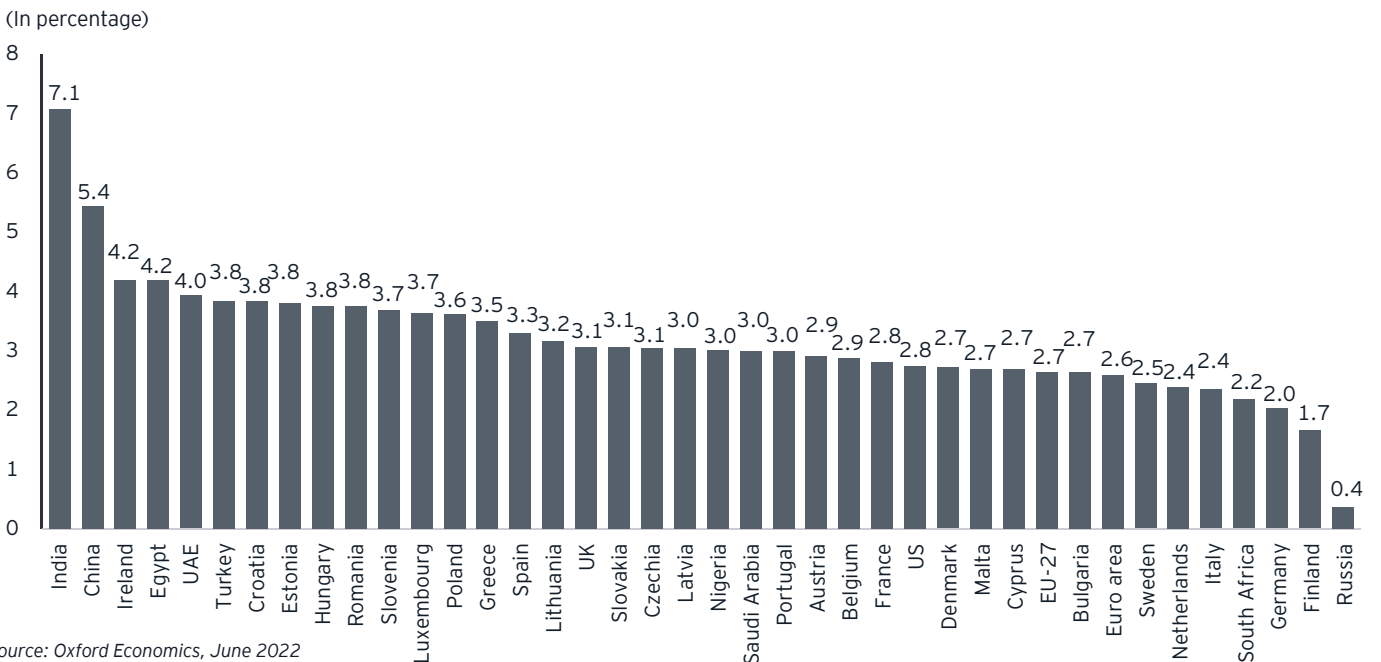
Most economies are expected to continue growing at a healthy rate in 2022, although projections are being revised downward (especially for European countries) on the back of the war in Ukraine.

GDP growth forecasts for world economies (year over year)



Annual GDP growth (In percentage)			
	2020	2021	2022
EU	-6.1	5.3	2.9
UK	-9.3	7.4	3.6
US	-3.4	5.7	2.6
China	2.2	8.1	4.0
India	-6.6	8.3	6.8

Forecast GDP growth, CAGR* 2020-26



Source: Oxford Economics, June 2022
* CAGR = compound annual growth rate

2.2 CROs' response to the war

That change in outlook, combined with fears that we may still see defaults from the COVID-19 pandemic, presents real challenges to CROs. We are seeing a huge surge in inflation, and a squeeze on living standards and costs. These extra costs are directly hurting businesses' and people's personal pockets, through higher fuel and food costs.

Speaking to banks following the war in Ukraine, several trends emerged:

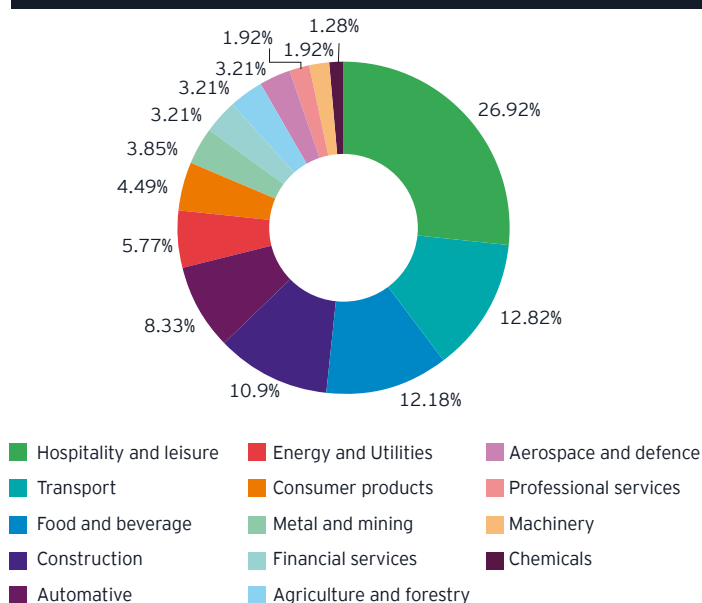
- ▶ There is, once again, a belief that models won't give the right answer and we have seen banks hang on to overlays, as they err on the side of caution. Overlays offer protection in an environment where credit is likely to be weaker going forward. Overlays have also been maintained because there was a certain opacity in the behaviors of customers due to COVID-19 and moratoria. Banks simply don't have the right tools to identify customers who may deteriorate, so have sensibly managed this risk through using their judgement.
- ▶ Use of overlays also reflects some of the limitations of modeling – for example, many models would mark a rise in oil price as a positive sign of global demand, rather than reflecting supply disruption.
- ▶ Government intervention may also represent a significant mitigating factor. Retail and customer lending is likely to be impacted by how much is done by authorities to mitigate the effects of inflation and decreases in disposable incomes.
- ▶ In an environment of higher interest rates, restructuring and forbearance could be more useful to navigate through the crisis than they were in times of low or negative rates.
- ▶ Banks reported that they are being cautious with lending to avoid building up future problems.
- ▶ Banks told us that certain countries in Central and Eastern Europe are likely to be more impacted, so they will be closely examining them for early signs of distress.
- ▶ Banks are looking at alternative sources of data, such as origination trends, to inform decision-making.

2.3 Shift in sector focus

Pre-war, banks expected hospitality and leisure, and transport, to be the most impacted sectors in terms of defaults in the next 12 to 24 months (see figure 9).

Figure 9

Which sectors do you expect to be most impacted in terms of defaults in the next 12 to 24 months?



Post-war, the impact on gas and oil prices is impacting sectors with high energy use, such as transport, manufacturing, construction and raw materials. In addition, the agricultural sector has been impacted, given Ukraine is a large wheat producer and Russia is a massive exporter of fertilizers. Figure 10 outlines the dependence of European economies on key commodities from Russia, Ukraine and Belarus. The imposition of sanctions will mean that the pre-war outlook on sectors is very different today.

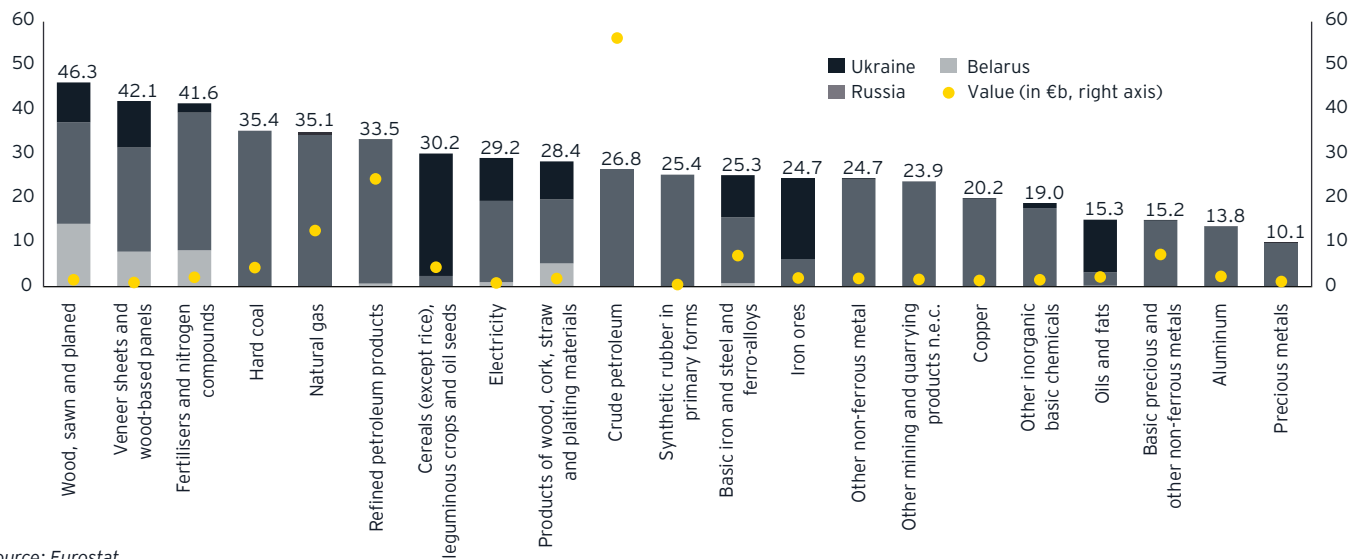
As banks look to model their risks, the impact by sector remains key, and we are seeing some banks move to a more granular subsector view to achieve a richer and more accurate picture. A wider sectorial approach may catch the trend but penalizes companies that are doing well despite operating in harshly hit sectors.

Figure 10

From the EU perspective, European economies are quite dependent on imports of wood, fertilizers, energy commodities, cereals, rubber and metals from Russia, Ukraine and Belarus.

EU-27 commodity imports from Russia, Belarus and Ukraine in 2019 by product

(In percentage of total extra-EU-27 imports)



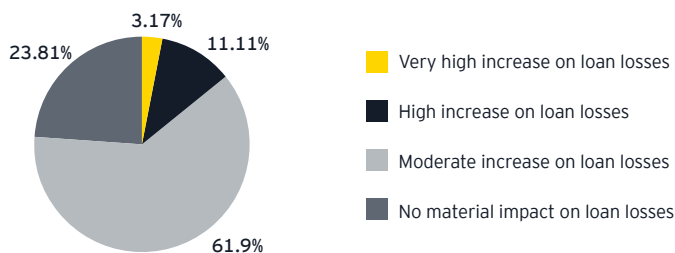
Source: Eurostat.

2.4 Inflation – a bigger perceived threat post-war in Ukraine

We also see a marked difference in sentiment around inflation from before and after the start of the war in Ukraine. Before, our survey showed only 14% thought inflation would have a more than moderate impact on loan losses, with a quarter of all banks (24%) feeling it would have no impact.

Figure 11

To what extent do you think high inflation will either increase or decrease loan losses?

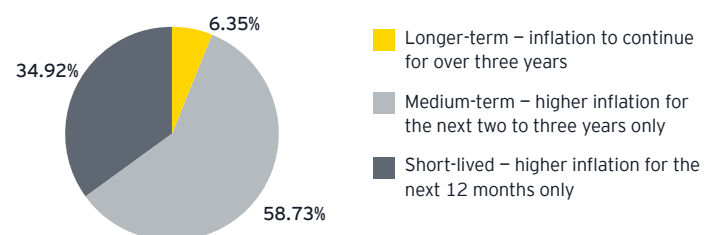


In addition, over a third of banks (35%) were basing their modeling on inflation having only a 12-month short-term impact, with over half (59%) seeing it as medium-term issue and only 6% seeing it as a long-term phenomenon.

Since the outbreak of the war, while some feel inflation will only be short-term, banks are increasingly modeling for sustained, higher inflation. This reflects the pressure on energy prices, continued supply chain disruption and rising food prices.

Figure 12

Are you basing your modeling assumptions on any increase in inflation being short-lived or having a longer-term impact?



Section

3

Navigating the future

This section explores how banks' workout operations and models changed as a result of the COVID-19 pandemic and what challenges they may face in the light of likely increased volumes of defaults caused by the Ukraine war.

Key findings

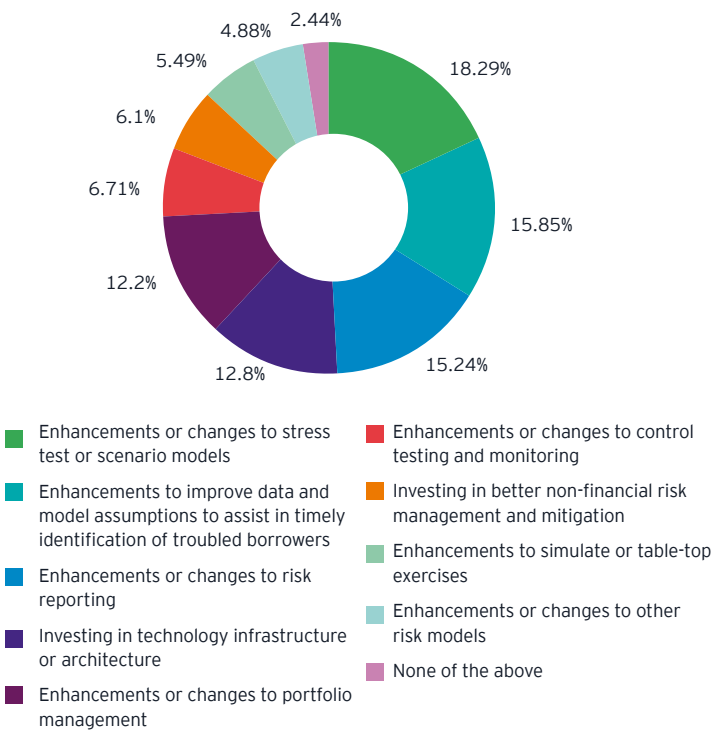
- ▶ Banks will need to consider how effective their models are as they face further shocks after dealing with COVID-19 – the fallout from the war in Ukraine, high energy costs and high interest rates.
- ▶ Banks are most worried about the quality of credit monitoring in the face of credit losses sustained in the future.
- ▶ NPL sales are the most popular way banks will look to manage increased NPL stocks, with banks starting to release provisions.

3.1 Model problem

Banks reported that the biggest change they made in their systems after COVID-19 was enhancing their stress models, followed by changing their risk reporting. Interestingly, only 13% have invested in their technology infrastructure or architecture.

Figure 13

What were the most significant changes triggered by COVID-19 in your institution?

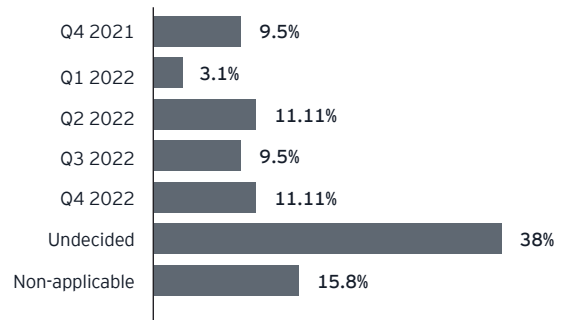


Banks are also uncertain about what the future holds and what it means for their current modeling approach. Over a third (38%) had yet to decide when to reverse overlays added on top of modeled outcomes. That decision has become even more complex as they started to look into the impact of the war on Ukraine and its secondary impacts on the global economy.

We have already seen some banks make clear where they are releasing provisions linked to COVID-19 and where new provisions are being taken to account for the war in Ukraine, higher inflation and cost-of-living impacts. Others have simply “rolled over” provisions that were booked against COVID-19 to the impact from the war in Ukraine. We can expect much more pressure for transparency if these overlays and provisions continue for the medium term.

Figure 14

When do you expect to reverse overlays added on top of modeled outcome to reflect uncertainties around potential default suppression due to support measures?



EY-ECL benchmarking, as per figure 15 found significant overlays have been maintained or increased from 12 months ago, reflecting uncertainties on delayed defaults.

It is not surprising that changes to stress testing or macroeconomic models are such a high priority. The events of recent years have been unprecedented and made current models less useful in projecting possible defaults. Banks simply do not have the right data or experience to be able to model a pandemic or high levels of sustained inflation that haven't occurred for over 30 years. The flexibility and accuracy of models are therefore under real stress. We are now seeing some banks look to use more challenging models to determine the use of overlays. We can expect that to continue as the impact of the war in Ukraine continues.

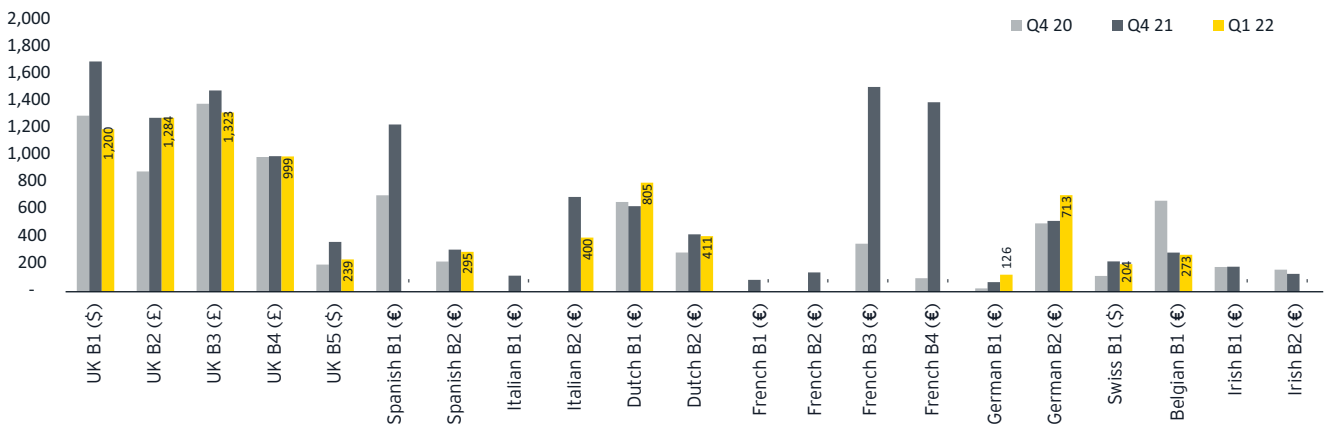
Figure 15

In Q1 2022, overlays have largely been maintained, although the reasons for the overlays have partly been changed.

Overlays as disclosed by banks (in millions; in reporting currency)

After decreases in overlays in the second half of 2021, most banks reported relatively stable overlays for Q1 2022, with two different patterns:

- ▶ Banks more exposed to Russia have replaced significant COVID-19 pandemic overlays with new overlays related to Russia and/or new macroeconomic uncertainties.
- ▶ Other banks have mostly maintained their existing overlays as a result of increased concerns arising from the war and rising inflation (UK and Spain). Only a few of them show a net release of (some of) their COVID-19-related overlays.



Note that not all banks disclose their overlays at each reporting date
IFRS 9 ECL Q1 benchmark, macroeconomic considerations and sustainability reporting update

3.2 How prepared are banks for handling future credit losses?

Looking forward, banks are gearing up to deal with three uniquely interacting trilemmas:

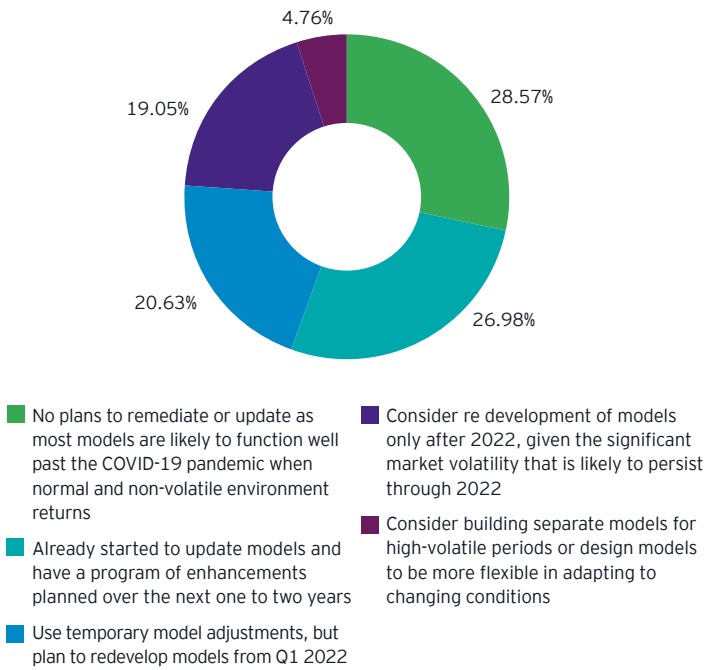
- 1. Money trilemma:** the combination of rising interest rates and inflation with Quantitative Easing wind down, is squeezing consumers and creating uncertainty in capital markets.
- 2. Energy trilemma:** businesses need to plan for increased energy costs with a backdrop of further instability, while striving for lower carbon solutions.

- 3. Supply trilemma:** supply chain cost and complexity caused by geo-political pressures and tougher environmental regulations call for different supply chain models.

Banks will clearly need to review their current operations. For example, three in ten (29%) had no plans to remediate models that failed during the COVID-19 pandemic, as they expected normal market conditions to return.

Figure 16

In many cases, historical correlations underpinning models used for risk management purposes broke down during COVID-19. How and when are you planning to remediate or update your models?



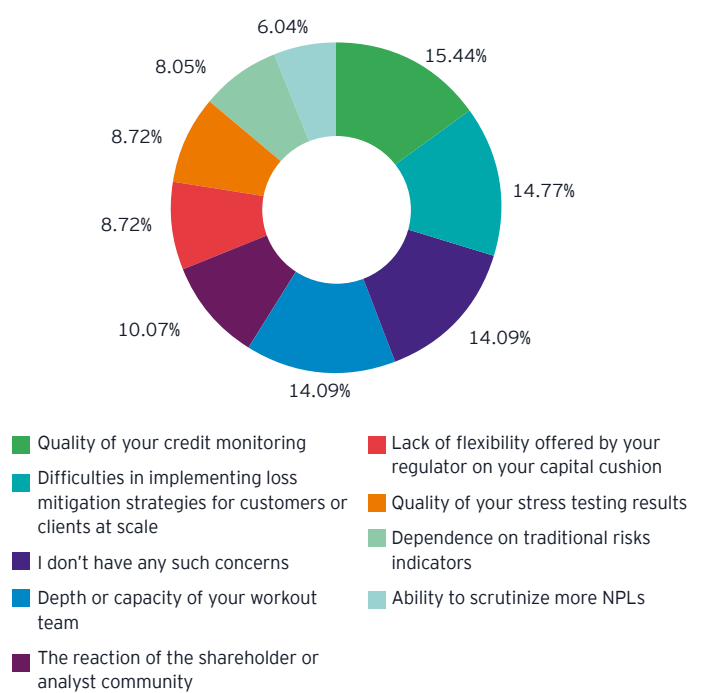
Banks also made clear the scope of concerns they would have if they experienced significant credit losses over the next 12 to 18 months – a scenario now more likely than in January 2022. Their top three concerns were as follows:

- 1. The quality of credit monitoring (15%)** – this is unsurprising, given the difficulties experienced in the last two years.
- 2. Difficulties in implementing loss mitigation strategies for customers at scale (14%)** – this reflects both the volume and diversity of sectors impacted by the pandemic.
- 3. The depth and capacity of workout teams (14%)** – while banks expected to deal with high volumes of NPLs from the COVID-19 pandemic, defaults did not crystallize in 2020 and 2021. Yet some banks still feel they may soon be facing significantly higher volumes.

How they manage this expected extra workload should be a key area of focus for management: for example, whether to use outsourcing. This is less of an issue for banks from high-NPL countries, as only 8% found this to be a concern versus 21% from low-NPL countries, reflecting their volumes from previous years. Fourteen percent said they would look at growing their workout capacity. Interestingly, the joint third-highest response was from banks that had no concerns.

Figure 17

What would be your key concerns if your institution experiences significant credit losses over the next 12 to 18 months?



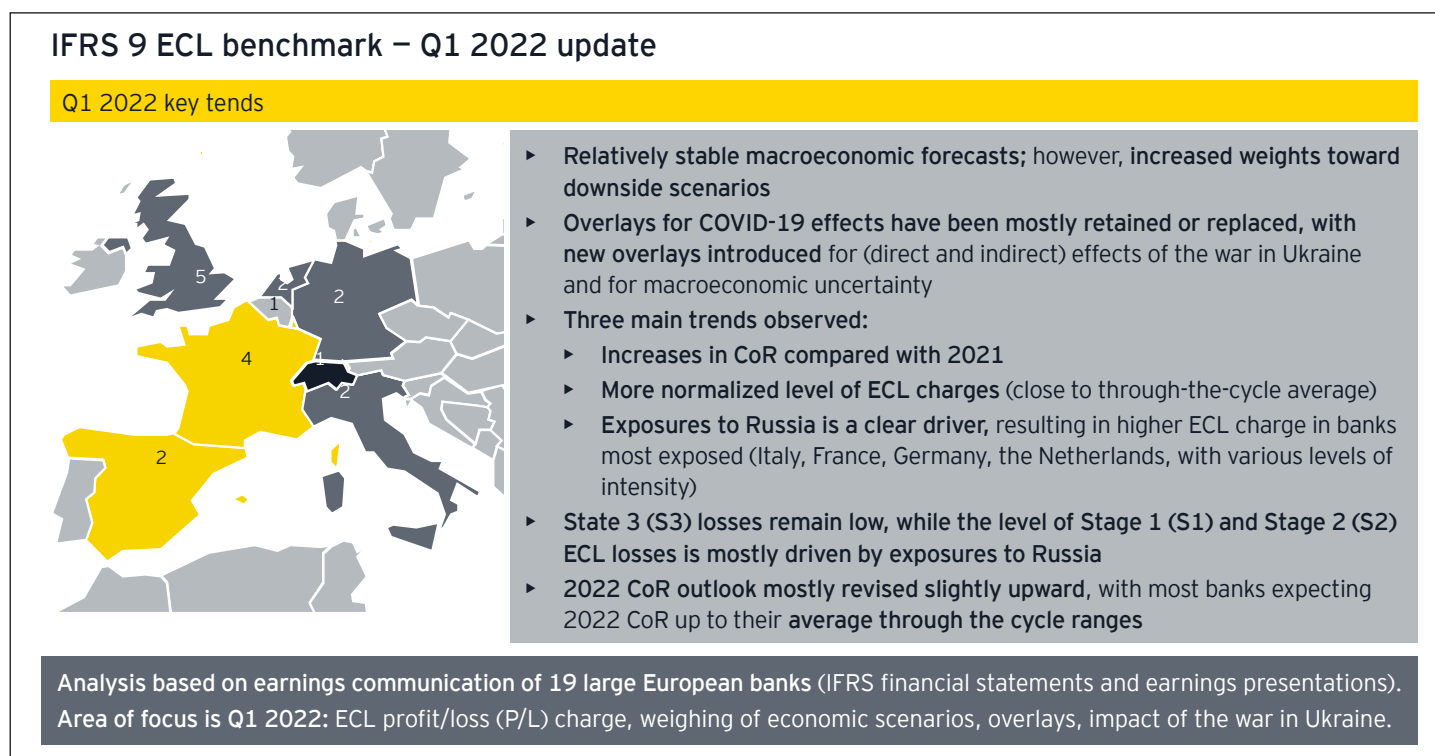
Appendix 1

Methodology

The survey was conducted between December 2021 and February 2022, capturing a total of 63 responses across a range of banks. Large banks are those with a loan book size greater than €100b, and small banks are those with less than €5b.

We also split the results by banks that had over 60% of their loan book allocated to either retail activities (customers, residential mortgages and SMEs) or corporate activities (corporate and commercial real estate). Any responses that did not have a minimum of 60% were tagged as a “mixed model.”

Figure 18



Appendix 2

EY benchmark key findings

Since the start of the COVID-19 pandemic, EY teams have regularly performed a review of IFRS 9 expected credit loss (ECL) disclosures published by 18 banking institutions headquartered in Europe. The purpose of this analysis is to provide a broad view of how the data gathered compares across banks, to present our observations on the comparisons, and to test different ideas to analyze the data and identify possible drivers of the trends. To find out more about the benchmark, please contact Laure Guégan.

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