EUROPEAN CENTRAL BANK
BANKING SUPERVISION

ECB Banking Supervision: SSM Supervisory Priorities for 2021

The establishment of supervisory priorities each year provides an important mechanism for coordinating supervisory actions across the Single Supervisory Mechanism (SSM) in a harmonised, effective and proportionate way. A clear set of supervisory priorities transparently communicated to the public contributes to enhancing the supervisory impact on banks and the overall level playing field.

The supervisory priorities for 2021 draw on an assessment of the key risks and vulnerabilities in the banking sector. So far the coronavirus (COVID-19) pandemic has been an unprecedented event affecting the real economy and testing the resilience of European banks. Uncertainty about the ultimate depth and breadth of the overall impact of the pandemic remains high in the short to medium term.

ECB Banking Supervision assesses risks on an ongoing basis and may adapt its supervisory priorities and actions in line with developments in the economic environment in which the supervised institutions operate. Against this background, ECB Banking Supervision will be focusing its upcoming supervisory efforts on four priority areas that have been materially affected by the current crisis. The four priority areas for 2021 are:

- credit risk management;
- capital strength;
- business model sustainability;
- governance.

In addition, further supervisory activities related to other medium and longer-term structural risks to European banks, beyond the impact of the COVID-19 pandemic, will be carried out in 2021. Supervisors will also focus on banks' alignment with expectations set out in the ECB Guide on climate-related and environmental risks, prudential risks emanating from money laundering, cyber and digitalisation risks and banks' preparedness for the final stages of the implementation of Basel III. Depending on how the crisis develops, specific supervisory activities may be adjusted and tailored according to banks' specific risk profiles.

1 Credit risk

The COVID-19 pandemic and the deteriorating macroeconomic environment will have a direct impact on banks' asset quality, as further credit downgrades, an increase in distressed borrowers and impaired collateral values are likely to materialise. Public support measures, including monetary, fiscal, regulatory and supervisory actions, have had the intended effect of averting a financial crisis:

liquidity strains on banks and borrowers were alleviated, ensuring that liquidity issues did not turn into solvency issues. A lesson learned from the Great Financial Crisis, when non-performing loans built up over time, clogging up bank balance sheets, is that recognising and differentiating between purely temporary financial difficulties caused by the pandemic and credit deterioration of a more lasting economic nature is essential. Making adequate provisions and recognising losses before moratoria and fiscal support measures end will help to avoid cliff effects and pro-cyclical effects which could amplify the economic cost of the pandemic.

In this respect, it is important to further strengthen the initiatives already launched in 2020 to ensure that banks have adequate risk management practices in place to identify, measure and mitigate the impact of credit risk, as well as the operational capacity to manage the expected increase in distressed borrowers.

Furthermore, ECB Banking Supervision will focus its efforts on the adequacy of banks' credit risk management, operations, monitoring and reporting. Particular emphasis will be placed not only on banks' capacity to identify any deterioration in asset quality at an early stage and make timely and adequate provisions accordingly, but also on their capacity to continue taking the necessary actions to appropriately manage loan arrears and non-performing loans. The Joint Supervisory Teams (JSTs) will scrutinise banks' practices in these areas and, if needed, targeted deep dives and on and off-site inspections will also be conducted.

2 Capital strength

The enhanced level of credit risk, along with potential market adjustments, may impair banks' capital ratios. It will be important to ensure the adequacy of banks' capital positions and to identify bank-specific vulnerabilities at an early stage in order to take any remedial actions, as appropriate.

Consequently, it is essential that banks follow sound capital planning practices based on capital projections that are able to adapt to a rapidly changing environment, particularly in a crisis situation. The JSTs will therefore scrutinise the appropriateness of banks' capital planning and challenge the adequacy of their dividend and share buyback policies in this respect. Furthermore, the EU-wide stress test coordinated by the European Banking Authority will be conducted in the course of 2021 and will be an important element in gauging banks' capital resilience as part of the supervisory dialogue on capital planning.

3 Business model sustainability

Banks' profitability and business model sustainability remain under pressure from the current economic environment of low interest rates, excess capacity, low cost efficiency, and competition from banks and non-banks. The COVID-19 pandemic is exacerbating these pressures.

In the course of 2021, ECB Banking Supervision will continue its efforts to challenge banks' strategic plans and the underlying measures taken by banks' senior management to overcome existing shortcomings. Moreover, since the pandemic has accelerated the process of digital transformation, supervisors will be assessing banks' progress in response to these developments. Where appropriate, JSTs will engage in a structured supervisory dialogue with banks' management on the oversight of their business strategies.[1]

4 Governance

Sound governance practices and robust internal controls are crucial for mitigating the risks that banks face during normal times, and even more so in times of crisis. The strength of board governance is an essential driver to overcome a crisis, and in this context assessing governance will be a focus of supervision. In addition, supervisors will continue to focus on the adequacy of banks' crisis risk management frameworks and their ability to adapt and implement them appropriately in the context of the current crisis. Management bodies will be expected to have access to, evaluate, and effectively challenge the accuracy of risk information, especially information related to credit risk management practices, including about operational capacity and the adequacy of provisioning mechanisms in the current environment. ECB Banking Supervision will challenge banks on their risk data aggregation capabilities and the risk information reported to management. Furthermore, supervisors will follow up on banks' IT and cyber risk management practices and governance, including risks resulting from the outsourcing of services to third-party providers. Finally, ECB Banking Supervision will continue its assessment of the prudential impact of money laundering and terrorism financing risks, particularly in relation to banks' internal control frameworks.

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For specific terminology please refer to the SSM glossary (available in English only).

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[1] In line with the supervisory approach to consolidation, banks' profitability and business model sustainability will be carefully assessed in the event that banks submit a consolidation project to the ECB.