ECB Banking Supervision: Risk Assessment for 2019

1 Introduction

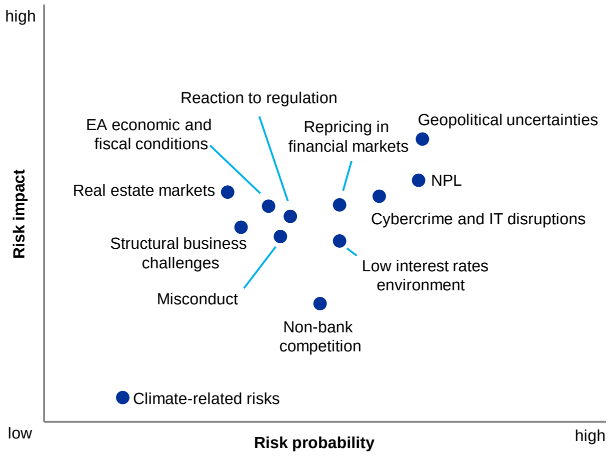
The identification and assessment of the risks faced by supervised entities is crucial for successfully conducting banking supervision. Risk analysis also serves as a basis for defining the supervisory priorities as part of the regular strategic planning process.

ECB Banking Supervision conducts a risk identification and assessment exercise on an annual basis in close cooperation with national competent authorities (NCAs). The analysis draws on inputs from a wide range of contributors, including the Joint Supervisory Teams (JSTs) and horizontal microprudential and macroprudential functions. It is also informed by discussions with banks and other relevant authorities.

2 SSM Risk Map for 2019

Key results of the risk assessment exercise are shown in the SSM Risk Map (see Figure 1). This map depicts the key risk drivers affecting the euro area banking system over a two to three-year horizon along the dimensions of probability and impact. The risk drivers should not be seen in isolation as they may trigger or reinforce each other. The Single Supervisory Mechanism (SSM) Risk Map shows an aggregated picture of the euro area, highlighting only the key risk drivers. It is not intended as an exhaustive list of all risks faced by supervised banks.

Figure 1
SSM Risk Map for 2019



Sources: ECB and NCAs

The three most prominent risk drivers affecting the euro area banking system are: geopolitical uncertainties, the stock of non-performing loans (NPLs) and potential build-up of future NPLs, and cybercrime and IT disruptions. These are followed by repricing in financial markets, low interest rate environment and banks' reaction to regulation.

Compared to last year, there has been a substantial decrease in risks stemming from economic and fiscal conditions in the euro area, mostly due to a favourable cyclical momentum. At the same time, geopolitical uncertainties and risks of repricing in financial markets have increased. Advances in digitalisation exacerbate the risks related to banks' legacy IT systems and cyberattacks.

3 Key risk drivers

Geopolitical uncertainties present a growing risk to global financial markets and to the economic outlook within the euro area. Political uncertainties in some euro area countries have increased in the recent period. As for Brexit, the final shape of the transition and the withdrawal agreements remains to be defined. Banks and supervisors need to continue their contingency planning and preparations, taking into account all possible scenarios. Brexit-related concerns encompass a wide range of risks, such as business continuity and transitional risks, contract continuity, risks of regulatory arbitrage related to national differences in regulation or risks of macroeconomic repercussions. There is limited risk of a significant disruption of access to the financial services for the euro area, but a potential fragmentation of the financial services industry could inhibit its efficiency. In addition, the concerns about rising trade protectionism have intensified. While the tariffs introduced so far should have rather limited direct macroeconomic effects on the euro area, any escalation of trade disputes would impose a substantial risk. Moreover, adverse developments in certain emerging market economies might negatively affect euro area macroeconomic environment or financial markets. Finally, the risk of global regulatory fragmentation imposes an additional vulnerability.

Despite a significant improvement in asset quality over the recent years, **high levels of NPLs** remain a concern for a significant number of euro area institutions. As part of the NPL guidance, high NPL banks were required to agree strategies to address NPL stocks. The work so far has led to significant progress in reducing NPLs with the NPL ratio of significant institutions decreasing from 8% in 2014 to 4.9% in Q4 2017. Nevertheless, the current aggregate level of NPLs remains far too high compared to international standards and further efforts are necessary to ensure that the NPL issue in the euro area is adequately addressed. High stocks of NPLs constrain banks' balance sheets, profitability and capital.[1] Therefore addressing legacy NPLs including the monitoring of banks' progress to reduce NPLs remains amongst the key priorities of the European banking supervision.

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[1] For references on negative impact of NPLs on bank lending please refer to Guidance to banks on non-performing loans, ECB, March 2017.

In addition, the ongoing search for yield might **increase the potential for a build-up of future NPLs**. Euro area banks have reported an easing of credit standards for loans to enterprises and to households for house purchase in the first quarter of 2018.[2] Moreover, lenders seem to be turning to more risky sectors. Leveraged loan issuance in the euro area picked up significantly after the sharp drop recorded during the global financial crisis, with covenant-lite loans representing around two-thirds of the volume. Moreover, some euro area banks report high growth of unsecured loans to households.

Cybercrime and IT disruptions create an increasing challenge for banks and highlight the need for them to invest in IT systems. Banks are under mounting pressure to modernise their core IT infrastructure in order to streamline their structures, reduce costs, enhance the quality of customers' experience and become more efficient, also in order to compete with fintech/bigtech companies. Moreover, banks face a growing number of cyber threats. Cyber incidents can lead to financial losses, further indirect ramifications and can even have a systemic impact, although significant institutions have so far not reported any major incident. However, in some cases, parts of banks' internal systems were reportedly compromised for some time before an intrusion was detected – a situation that could allow malicious agents to cause significant damage.

The risk of an abrupt and significant **repricing in financial markets** has increased since last year. The global search for yield has continued, supported by the buoyant global economic conditions and outlook, and ample liquidity. This has further pushed up asset valuations, which are stretched in certain market segments, especially in the US equity market. At the same time, risk premia remain compressed. The market turmoil related to the February 2018 spike in volatility in US equities has shown the current sensitivity of market sentiment, but also its capacity to assimilate rapid adjustments. This was also visible in the Italian sovereign market tensions triggered by political pressures in Italy in May 2018, which spilled over to certain euro area sovereign yields and banks' equity prices. Higher geopolitical risks may elevate the risk of a potential repricing. Banks would be affected mostly through their holdings of instruments recognised at fair value, collateral requirements and costs to raise capital or liquidity. However, repricing could also have second-round effects through an adverse impact on the macroeconomic and fiscal situation in the euro area. Moreover, in an extreme case, if a major repricing coincided with other major events, it could also threaten the **solvency of central counterparties**, thereby posing a systemic risk.[3]

Several years of **low interest rates** have put banks' interest margins under pressure and triggered changes in their customers' behaviour, impacting the banks' balance sheet structure.[4] While on aggregate the net interest income (NII) of euro area banks

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2 See euro area bank lending survey.

3 In this year's SSM Risk Map, the "CCP solvency" risk driver has been merged with "Repricing in financial markets".

4 Some examples of developments that are changing the shape of banks' exposure to interest rate movements are the shift from term to sight deposits, more early repayments of house loans and a preference among home buyers for fixed rather than floating interest rates.

was rather resilient over the last year, banks with certain business models experienced significant declines in NII. Aggregate NII is forecast to pick up in 2019 and 2020, driven both by volume growth and improving margins. However, many SIs expect their profits to remain low over the next few years.

As most of the post-crisis financial **regulatory initiatives** are now being finalised, the pace of regulatory reform has somewhat slowed. However, some regulations still need to be implemented in EU law. While regulatory uncertainty has decreased, banks still need to further adapt their business models in order to operate in the new environment. Tighter regulation helps to safeguard a resilient and stable banking system in the medium and long term. In the short term, however, it can challenge banks' profitability and impose risks on the banking sector, such as banks failing to adapt on time or postponing strategic decisions or investments.

Economic growth prospects improved significantly in the euro area, supporting the reduction of risks to the banking sector. While the economic expansion is forecast to continue over the medium term, low potential output growth prospects constitute an increasing vulnerability as labour supply shortages and production constraints may slow down the current upswing, and implementation of structural reforms in euro area countries needs to be stepped up. **Public sector debt sustainability** has improved on average in the euro area, mainly as a result of rising GDP. Despite the current cyclical recovery, stock imbalances still remain elevated in several countries, leaving them vulnerable to potential repricing of sovereign risk.

Lending for **residential real estate** (RRE) remains a key activity for euro area banks, accounting for about 40% of euro area GDP in 2017. At euro area level, RRE lending developments have been stable since last year, with a slightly positive trend. However, pockets of vulnerabilities leave some euro area banks exposed to risks. In many euro area countries, borrowers have recently shown a tendency to move towards shorter interest rate fixation periods. This shifts interest rate risks to borrowers, increasing credit risks for banks if borrowers face higher interest charges. Additionally, high or rising borrower indebtedness is casting doubt on borrowers' ability to repay when the cycle turns. Loan-to-value (LTV) ratios remain high, leading to potentially high losses in case of default. Some relaxation in lending standards regarding LTVs and debt service-to-income ratios on new loans may have resulted in higher credit risk.

SSM banks are exposed to a number of further risks that deserve supervisory scrutiny:

- **Misconduct risk:** although the losses related to conduct risk showed a downward trend, the number of conduct risk events was higher in 2017. The combination of tighter data protection regulation and the ongoing search for yield could lead to more conduct risk events.
- **Structural business challenges** relate to structural weaknesses in the SSM banks' business operating environment, as well as to the rigidity of the banks' cost structures weighing on their efficiency. The euro area banking system is still not fully integrated. This may create impediments to cross-border

consolidation or to the optimal allocation of capital and liquidity and prevent euro area banks from taking full advantage of economies of scale, resulting in an uneven playing field within the EU and internationally.

- **Non-bank competition** is increasing as fintechs, insurers and other firms enter lending markets. However, the impact on lending margins seems to be contained so far and is expected to stay low over the risk assessment horizon. There are also concerns about potentially greater competition from bigtechs (i.e. large technology companies with access to vast client databases and the capacity to enter the financial services industry).

- **Climate-related risks** do not pose a threat to the financial stability in the euro area in the short term, However, banks can be impacted indirectly, but nonetheless materially, by more frequent and severe extreme weather events or by the ongoing transition to a low-carbon economy. Weather phenomena could cause destruction in business sectors to which banks are exposed (e.g. agriculture) or destroy their collateral holdings. In addition, the transition to a low-carbon economy could impact certain economic sectors (e.g. fossil fuel companies, energy-intensive sectors, utilities, transport and building companies). Banks therefore need to take adequate action to manage their exposures to such sectors.

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For specific terminology please refer to the SSM glossary.