ECB Banking Supervision: Assessment of risks and vulnerabilities for 2021

1 Introduction

The coronavirus (COVID-19) pandemic has had an unprecedented impact on the global economy over the course of 2020. However, thanks to exceptional monetary, fiscal, regulatory and supervisory measures, together with stronger capital and liquidity positions built up since the Great Financial Crisis, the banking sector has played a crucial role in the overall response to the crisis. It has supported the real economy by continuing to provide credit and meeting the liquidity needs of households and non-financial corporations (NFCs).

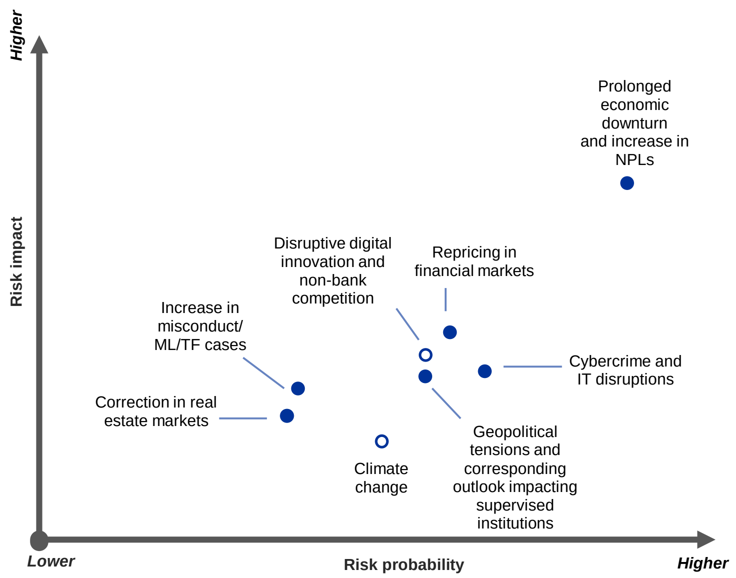
The overall risk landscape has undergone rapid and material change over the past few months, with uncertainties remaining high in the short to medium term. Against this background, and in accordance with its mandate, ECB Banking Supervision has identified, assessed and monitored existing and emerging risks and vulnerabilities in the banking sector. ECB Banking supervision seeks to tailor and prioritise its supervisory actions to enable resources to be shifted in a dynamic risk-based manner whenever this is considered necessary.

In close cooperation with the national competent authorities (NCAs)[1], ECB Banking Supervision has assessed the main challenges expected to affect supervised institutions over the next two to three years. The key results of this assessment are presented in the Single Supervisory Mechanism (SSM) Risk Map for 2021 and the table of vulnerabilities (see Figure 1). The SSM Risk Map shows the key risk drivers affecting the banking sector, defined as shock-type events along the dimensions of probability and impact. These risk drivers can have an impact on supervised institutions through existing internal and external vulnerabilities prevalent in the banking system itself or in the economic environment in which banks operate. Based on the current risk picture, the identified key vulnerabilities have shaped the priority areas for supervision in 2021, as also outlined in SSM Supervisory Priorities for 2021.

[1] The analysis draws on a wide range of contributions, including from the Joint Supervisory Teams and the ECB's microprudential and macroprudential functions. It is also informed by discussions with banks and other relevant authorities. The SSM Risk Map identifies the issues that are most relevant from a microprudential supervision perspective, while the ECB's biannual *Financial Stability Review* focuses on systemic risks from a financial stability and macroprudential policy perspective.

Figure 1
SSM Risk Map and table of vulnerabilities for 2021

The risk picture shaped by the COVID-19 pandemic and the high uncertainty about the macroeconomic outlook…



… will affect banks through existing vulnerabilities requiring supervisory action

Internal to banks	Weaknesses in management and coverage of credit risk	Structurally low income levels and profitability	IT deficiencies
	Weak governance, including weak strategic steering	Lingering cost Inefficiencies	
External to banks	High public and private debt levels in the euro area	Overcapacities in banking	Fragmentation in the regulatory and legal framework

Sources: ECB and NCAs.
Notes: Risk drivers and vulnerabilities should not be seen in isolation, as they may trigger or reinforce one another.
Top panel: Dots with a white fill denote risk drivers that are expected to increase strongly over the next five years; "ML/TF" refers to money laundering and terrorist financing; "NPLs" refers to non-performing loans.
Bottom panel: internal vulnerabilities can be addressed by the banks themselves, while external vulnerabilities refer to the environment in which banks operate.

2 Key risk and vulnerabilities in the banking sector

The pandemic and the high uncertainty surrounding the macroeconomic outlook are the predominant forces shaping the risk picture for supervised institutions.

There are three concerns informing ECB Banking Supervision's assessment of key risks and vulnerabilities in the banking sector.

First, the outbreak of the pandemic and the related lockdown measures triggered an **unprecedented fall in euro area economic activity** in the second quarter of 2020.[2] Activity is projected to remain below pre-pandemic levels until mid-2022 and the recovery is forecast to be asymmetric across countries and sectors.[3] The resurgence of the virus towards the end of 2020 and the implementation of additional lockdown measures, albeit on a more targeted regional basis, has increased uncertainty surrounding the economic outlook and the risk of a **prolonged economic downturn**, at least until an effective vaccine becomes widely available.

Second, other prominent downside risks to the recovery stem from potentially **renewed geopolitical tensions**, in particular resulting from re-emerging trade conflicts. Such tensions might have a negative impact on the growth outlook and thus could threaten financial fundamentals. Broadly speaking, the impact of the end of the Brexit transition period on the euro area economy is expected to be contained and relatively limited for the banking sector owing to preparations made by affected banks, although some institutions are still expected to intensify their efforts in this regard.[4] In the worst case scenario, however, trade conflicts and other geopolitical tensions could result in an abrupt reassessment of risk premia and a sharp **repricing in financial markets**.

Third, financial asset prices have rebounded strongly since the repricing episode in March 2020, raising concerns about the possibility of a disconnect from underlying economic fundamentals in some equity markets, thereby increasing the risk of corrections should investor sentiment change. Furthermore, as credit spreads have recovered to pre-pandemic levels, the high-yield segment of the corporate bond market seems particularly vulnerable to potential repricing, given the weak and uncertain economic outlook. Therefore, the pricing of credit and the adequacy of the assessment of market and credit risk remain areas of supervisory focus.

Credit risk management and capital strength

The weaker economic environment caused by the pandemic is expected to lead to a deterioration in asset quality, although any such deterioration is likely to be episodic and sectoral in nature. Temporary financial difficulties affecting NFCs and households stemming from the pandemic must be differentiated from longer lasting economic effects emanating from structural or more persistent changes in the real economy. Credit downgrades for NFCs and a weakened debt servicing capacity of households could thus materialise.

In this context, credit risk is considered one of the main challenges for the banking sector and supervisors over the coming months. Pronounced external vulnerabilities, such as persistently **high private debt-to-GDP ratios**, are further amplifying the

2 See “GDP main aggregates and employment estimates for the second quarter of 2020”, *Eurostat news release*, No 133/2020, 8 September 2020.

3 See the December 2020 Eurosystem staff macroeconomic projections.

4 See “Brexit: banks should prepare for year-end and beyond”, *Supervision Newsletter*, ECB, 18 November 2020.

potential negative impact on banks, which may impair the future sustainability of some NFCs and households. NFCs in some sectors have seen a sharp deterioration in profits as a result of the lockdown measures, and hence a higher risk of insolvency, particularly in the sectors that have been most heavily affected. At the same time, households exposed to these sectors are likely to face the prospect of a worsening labour market situation, which could, in turn, affect their debt servicing capacity. These developments are accompanied by a growing **risk of correction in real estate markets**. Residential real estate markets in the euro area have remained resilient thus far, although house prices have continued to increase despite signs of overvaluation. By contrast, activity in the commercial real estate sector has already fallen significantly.[5]

Governments have introduced various protection schemes with a view to limiting the impact of the crisis on the private sector, but these have resulted in **surging public debt ratios**.[6] Furthermore, a significant increase in banks' exposures to domestic government debt has reinforced the sovereign-bank nexus, which could potentially revive adverse feedback loops in some countries, should public debt sustainability concerns emerge.

The policy measures that have been taken have been crucial in supporting the real economy and alleviating the adverse shock to the banking sector. However, these measures will end when the pandemic no longer poses an economic threat, and banks therefore need to prepare for an **increase in non-performing loans** and, as a minimum, need to mitigate cliff effects resulting from the temporary nature of the support schemes. Compared with the last financial crisis, European banks entered this crisis with stronger capital positions, as well as improved asset quality and resilience to shocks. Banks' capital positions were also supported by the ECB's recommendation to banks to temporarily suspend dividend payments in 2020, to refrain from or limit such payments until September 2021 and to apply extreme moderation in variable remuneration.[7] Looking ahead, a potential deterioration in asset quality once support measures have ceased could also pose a challenge to banks' capital adequacy. Banks therefore need to ensure that they have a comprehensive credit risk strategy firmly in place to promptly address any weaknesses in the **management and coverage of credit risk**. Furthermore, banks need sound monitoring, with credit quality deterioration being identified in a timely manner, to ensure adequate provisioning and the efficient management of deteriorating asset quality.

Business model sustainability and governance

The cyclical challenges posed by the COVID-19 crisis are affecting banks primarily through increased provisioning needs. However, the pandemic is also undermining

5 See Financial Stability Review, ECB, November 2020.

6 See the December 2020 Eurosystem staff macroeconomic projections.

7 See "ECB asks banks to refrain from or limit dividends until September 2021", press release, ECB, 15 December 2020.

their income generating capacity and weighing further on their already **low income levels and profitability**. Interest income will remain under pressure, as increased cash holdings at the ECB, the effects of certain loan moratoria and lower lending rates, fuelled by the lower-for-longer interest rate environment, are reducing interest margins. Although high loan volumes have partially mitigated some of these pressures, a potential tightening of lending standards and the phasing-out of state guarantees constitute downside risks going forward. At the same time, fee and commission income is declining amid strong competition. These factors, together with the parallel surge in provisions, reduced the return on equity of supervised institutions to close to zero in the first half of 2020. The future path will depend on how the crisis unfolds.

Following the decline in profitability in 2020, banks expect a moderate rebound in 2021 to a continued low level, but these projections are subject to downside risks relating to a potential resurgence of the pandemic and the related economic fallout. Banks' valuations, as measured by price-to-book ratios, dropped to a record low in March 2020, since when they have only partially recovered, reflecting a bleak earnings outlook and increased risks. This is intensifying the pressure on banks to address existing vulnerabilities and adjust their business models to tackle **structural challenges**, such as **overcapacity** and **lingering cost inefficiencies**, and the pandemic might present the opportunity banks need to do so. Increased customer acceptance of digital services, imposed by the pandemic remote working arrangements, combined with the pressure to reduce costs, may help management to tackle otherwise rigid cost structures and improve cost-efficiency in the medium term.

The secular trend towards the **digitalisation** of internal processes can support these efforts. Technology also opens the gates to further **non-bank competition** (such as from big tech firms) in the medium term, while at the same time providing scope to exploit new business opportunities. The effects of the crisis on the competitive landscape remain to be seen, and while it may divert attention away from strategic initiatives in the short term, it also increases the pressure on management to grasp opportunities for synergies. Banks need to continue to adjust existing business models to improve sustainability, as the risks of failing to meet profitability targets have increased in the near term. Therefore, business model sustainability remains a key focus area for supervision.

Advancing digitalisation can support the transformation of banks' business models with a view to increasing profitability in the longer term, but it also exposes vulnerabilities related to existing **IT deficiencies** and susceptibility to **cybercrime and operational disruptions**. Supervised institutions have shown strong operational resilience since the onset of the pandemic, as business continuity plans were implemented swiftly. However, the changing digital environment poses additional challenges. Cyber threats have been on the rise recently, as criminals seek to take advantage of the increased level of remote working.[8] In many banks,

8 See "Are banks Cyber-proof in the digital world?", speech by Pentti Hakkarainen, Member of the Supervisory Board of the ECB, at the European Banking Federation's online conference on "Cyber security and resilience: the basis of it all in digital innovation", Frankfurt am Main, 22 October 2020.

critical processes depend on end-of-life systems requiring large-scale IT expenditure to mitigate the associated risks. This investment might, however, be delayed in the current environment. Furthermore, a thematic review of IT risks conducted by the ECB found that IT risk management and data quality management are key areas in which banks need to tackle deficiencies.[9]

Strong internal governance and strategic steering are crucial for banks to adequately address the challenges stemming from the current crisis. Notwithstanding the progress made in recent years, the COVID-19 pandemic has highlighted a number of pre-existing vulnerabilities in banks' governance frameworks. These include long-standing difficulties with risk data aggregation and accuracy of reporting, hampering the steering of strategic decisions and the proper monitoring of material risks during the pandemic (e.g. credit risk developments and capital projections). Moreover, a number of banks have exhibited insufficient proactivity in control functions to adapt to the crisis environment and to identify, monitor and manage risks, as well as a need for better integration of risk appetite frameworks in risk management practices and decision-making processes and insufficient oversight by the management body of operational and risk management decisions made to deal with the crisis. Weak governance and poor risk controls may also expose banks to **money laundering and terrorist financing risks**. While the competency to supervise such matters remains with the national authorities, the ECB exchanges information with the relevant authorities and factors these risks into its prudential assessments, including the Supervisory Review and Evaluation Process and assessments of the suitability of members of management bodies.

Further areas of focus

Despite the significant progress made so far, **the EU regulatory and legal framework remains fragmented** and there are still national differences in the implementation of some EU rules. Harmonising the EU regulatory framework and completing the banking union are crucial elements in increasing the efficiency and resilience of the EU banking sector. In this regard, harmonisation will foster cross-border activities and facilitate consolidation among banks, which in turn will strengthen the overall sector. Moreover, the third pillar, a European deposit insurance scheme (EDIS), needs to be established. Further efforts are needed along a number of dimensions, including designing the EDIS, addressing the sovereign-bank nexus, improving crisis management frameworks, removing barriers to cross-border flows of capital and liquidity, and enhancing cross-border banking integration. These efforts should be consolidated by removing impediments to further private risk sharing and by increasing the integration of European capital markets under the umbrella of a capital markets union. Moreover, the full, timely and consistent implementation of the finalised Basel III reforms will be vital in order to avoid further fragmentation of the EU regulatory and legal framework.

9 See "The need for improved cyber resilience in euro area banks", *Supervision Newsletter*, ECB, 15 May 2019.

The impact of **climate-related risks** is becoming more apparent to banks and supervisors alike, and the pandemic has led to an increased focus on the need to speed up progress in the management and disclosure of such risks. The economic costs of physical risks are growing steadily, and, at the same time, transitional risks are on the rise, as public policies are increasingly targeting the climate neutrality and environmental sustainability of economic activities. Recent analysis published by the European Systemic Risk Board shows that the macroeconomic costs of delaying action for too long are significant and banks might be adversely affected, particularly in a transition risk scenario of an abrupt tightening of policies aimed at mitigating climate change.[10] Despite the increasing awareness of climate-related risks and the growing involvement of high-level decision-making bodies in monitoring such risks, few banks incorporate climate risk comprehensively in their risk management frameworks. Furthermore, institutions do not yet properly disclose their climate-related risk profile, and considerable efforts are still needed to promote transparency in financial markets with regard to climate-related and environmental risks to which institutions are currently exposed.[11]

3 Conclusion

The assessment of key risks and vulnerabilities in the banking sector serves as a basis for the supervisory priorities that subsequently feed into the underlying strategic planning process. Based on the outcome of the current risk assessment, ECB Banking Supervision has identified the following four priority areas for 2021:

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

Furthermore, supervisory activity will also focus on action taken by banks in response to the ECB Guide on climate-related and environmental risks as well as on prudential threats stemming from money laundering, cyber and digitalisation-related risks and banks' preparedness for Basel III implementation.

In a highly uncertain economic environment, the risk picture can change quite rapidly. Consequently, banks and supervisors need to be able to identify such changes swiftly and refocus their efforts accordingly. As demonstrated in 2020, ECB Banking Supervision stands ready to adapt its supervisory priorities in an agile and flexible manner in line with developing risks.

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10 See "Positively green: Measuring climate change risks to financial stability", European Systemic Risk Board, June 2020.

11 See "ECB publishes final guide on climate-related and environmental risks for banks", press release, ECB, 27 November 2020.

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

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