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# ECB supervisory priorities for 2023-2025: a useful blueprint for assessing European banks

Sam Theodore | December 2022

**The Single Supervisory Mechanism's (SSM) priorities for 2023-2025, published by ECB Banking Supervision earlier this week, are a very helpful framework for analysts and investors to assess the European banking sector.**

Unlike supervisory frameworks in the past, in Europe or elsewhere, the ECB's priorities are not focused mostly on the prudential aspect of supervision – essentially on capital and liquidity – although this remains very important. They have also moved into areas of growing significance such as digitalisation strategies, cyber risks, and climate-change risk.

At the risk of broad-brushing, I continue to see the overall market assessment of European banks as relatively linear. On the downside, the risk of bottom-line losses leading to dividend non-payments, capital depletion, and ultimately resolution/liquidation. On the upside, the capacity to push returns upwards to make relative value more attractive for investors.

But the value of banks is more complex than merely dodging financial losses and boosting profits. But, as *The Wide Angle* has consistently said, investors and analysts rarely ask banks questions about important areas not addressed by immediate financial metrics. The problem is: advances in digitalisation, in customer satisfaction, or in addressing climate and environmental challenges are rarely winning arguments in an investment, credit or rating committee if the current financials do not support them.

Which is why a major supervisory body looking beyond prudential and financial metrics is a welcome step.

**Challenges for European supervisors**

Having said that, I highlight four potential challenges for the ECB/SSM and other European bank supervisors, which are likely to become more relevant in 2023.

First, stay the course: Since the global financial crisis, it has become a given that, unlike in the previous free-for-all years, bank supervisors are firmly in the driving seat. This very much remains the case but some large banks, feeling increasingly confident that their strong balance sheets and improved profitability can shelter them from future troubles, are trying to push back on some prudential requirements – such as regulatory buffers – in the quest to boost returns.

It is imperative that supervisors firmly stay the course. For many reasons. Not least because an important element in the market's renewed confidence in the European banking sector – especially on the credit side – is the belief that supervisors will remain robust in their approach, detect early, and push back on attempts at regulatory arbitrage.

Second, "Do no harm": Excessive supervision can also be harmful. Especially so if, unintentionally or not, it stifles innovation or competitive gains for banks which are otherwise in good financial and business health.

For example, not applying proportionality in supervising less significant institutions (LSIs) can burden some of them with regulatory overload. Of course, the ECB and national competent authorities (NCAs) are aware of this risk. The ECB referred to it in a recent document on LSIs, which mentions that on aggregate they represent 18% of the euro area's banking assets.

Third, more focus on risk interconnectedness, including in stress tests: This is an area of growing importance but where bank supervision has been historically less present. Connecting the dots or identifying grey areas is not always easy within the existing SREP framework, and the traditional box-ticking classification of risks can miss shifting sands.

For example, a geopolitical earthquake like Russia's war on Ukraine, aside from triggering macro-financial stresses with consequences for banks' loan and investment portfolios, can also flag changing dynamics in the timing of addressing climate and environmental risks (e.g. replacing Russian oil and gas with fossil-fuel energy from other sources becoming an immediate priority). Equally, tectonic shifts in the global trading system currently underway can challenge the global wholesale franchise of some large European banks – a risk that needs to be addressed early on.

Supervisors could, in future stress tests, include non-financial parameters through scenario analyses. In this way, risk interconnectedness could be addressed more convincingly. Not all plausible scenarios for the future need necessarily be supported by numbers.

Fourth, strengthen technology/digital expertise: Becoming a bank supervisor may not be the most natural career path for an IT/digital expert, but this is a field that will need to be nurtured. Banks' comprehensive march to digitalisation and the heightened importance of cyber risk have created a need for related expertise – not only for the banks but for their supervisors too. Especially if the former can outpace the latter with technology and digital expertise.

## The ECB/SSM supervisory priorities for 2023-2025

The ECB identified three broad supervisory priorities for the next three years, addressing vulnerabilities in banks:

1 *Strengthening resilience to immediate macro-financial and geopolitical shocks*

Against the backdrop of deteriorating trends for the euro area, two vulnerabilities identified for banks are (i) shortcomings in credit risk management (including exposure to vulnerable sectors (real estate or sectors impacted by the war in Ukraine like energy suppliers or energy-intensive sectors); and (ii) lack of diversification in funding sources and deficiencies in funding plans.

The 2022 SREP exercise revealed that shortcomings persist in banks' risk controls, notably related to loan origination and monitoring and provisioning against distressed exposures. Regarding funding, exiting TLTRO III funding will require careful management of rollover risk for some banks.

2 *Addressing digitalisation and strengthening management bodies' steering capabilities*

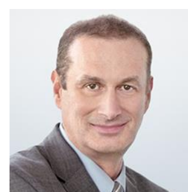
The ECB warns that intensifying competition with digital champions in the banking sector and digital natives from outside the sector (fintechs, bigtechs) may put some banks' business models at risk if they fail to adapt to the changing landscape.

Equally highlighted are deficiencies in operational resilience regarding IT outsourcing and cyber risks. The increased reliance on third-party IT service providers, while necessary, creates new danger areas to banks. Equally of concern are cyberattacks in response to Western sanctions against Russia.

3 *Stepping up efforts to address climate change*

Banks should incorporate climate and environmental (C&E) risks – both physical and transition-related – in their business strategy, governance, and risk management frameworks. While banks are making progress in incorporating these risks in their business operations, risk management and disclosure practices, the ECB notes that income generation relies heavily on higher-emitting sectors and the alignment with supervisory expectations is below expectations.

**Analyst**



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