Geopolitical risks and banking sector vulnerabilities: implications for the SSM

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Supporting Banking Union scrutiny
Geopolitical risks and banking sector vulnerabilities: implications for the SSM

Abstract

Geopolitical risk will increasingly confront EU banks and their supervisors in the coming years. This paper assesses four specific manifestations of this type of risk and the related banking vulnerabilities and proposes new or modified priorities for European Central Bank banking supervision.

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# LIST OF ABBREVIATIONS

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<tr>
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<tr>
<td>CCP</td>
<td>Central counterparty</td>
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<tr>
<td>EBA</td>
<td>European Banking Authority</td>
</tr>
<tr>
<td>ESMA</td>
<td>European Securities and Markets Authority</td>
</tr>
<tr>
<td>ESRB</td>
<td>European Systemic Risk Board</td>
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<tr>
<td>GEOVOL</td>
<td>Geopolitical volatility</td>
</tr>
<tr>
<td>IM</td>
<td>Initial margin</td>
</tr>
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<td>NPL</td>
<td>Non-performing loan</td>
</tr>
<tr>
<td>OTC</td>
<td>Over the counter</td>
</tr>
<tr>
<td>SME</td>
<td>Small and medium sized enterprise</td>
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<tr>
<td>SREP</td>
<td>Supervisory Review and Evaluation Process</td>
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<tr>
<td>SSM</td>
<td>Single Supervisory Mechanism</td>
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<td>VM</td>
<td>Variation margin</td>
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EXECUTIVE SUMMARY

The European Union economy is vulnerable and will likely be increasingly exposed to geopolitical risk arising from the less peaceful course of international relations. Geopolitical risk is regularly presented by supervisors as a key element in the risk environment confronting financial institutions, even though its specific implications are rarely spelled out.

This type of risk is routinely incorporated in capital market portfolio allocations and should also be more central in bank risk management and supervision. This paper assesses four specific aspects of elevated geopolitical risk: the increased incidence and more disruptive nature of cyberattacks; loan defaults driven by the energy shock; the changed outlook for energy-intensive and trade-dependent companies; and the deepening interlinkages between banks and derivative markets where energy contracts are traded.

For each of these four aspects of geopolitical risk, new or more severe types of banking sector vulnerability have emerged. The European Central Bank’s supervisory priorities should be adapted in this light, flanked by a more proactive approach to supervision, and by public communications.
1. INTRODUCTION: BANK SUPERVISION IN A CONTEXT OF HEIGHTENED GEOPOLITICAL RISK

In September 2022, the European Systemic Risk Board issued an unprecedented general warning (ESRB, 2022). This warning, adopted by its General Board in which all European Union central banks and other EU-level supervisors are represented, identified three severe systemic risks: a looming recession that might strain the debt-servicing capacity of companies and households; overvaluation in asset prices; and lingering asset-quality problems in banks. These risks could be further aggravated if real-estate markets decline, and if sovereign debt in individual EU states becomes distressed. A key unknown factor in the ESRB’s outlook for systemic risk was the further escalation of geopolitical tensions. The European Central Bank as the supervisor of the euro area’s largest banks is therefore confronted with a complex economic environment and also by greater uncertainty over the EU’s external security, trade and financial relations.

Recent trade tensions, the COVID-19 crisis and Russia’s war in Ukraine have amply underlined that Europe is strategically vulnerable. This has already led to a profound shock to energy prices and supply security, which, by extension, will impact credit quality in Europe’s companies and households.

Geopolitical risks are widely understood to relate to wars, terrorist acts and tensions between states that affect the normal and peaceful course of international relations, and the way states go about controlling and competing for territory (Caldara and Iacoviello, 2022). Manifestations of such risks seem to be infrequent, though potentially cataclysmic, resulting in loss of life and capital in times of war. Yet, ongoing threats are also material. Trade tensions between the United States and China may lead to a technological decoupling that will impact foreign direct investment stakes of European companies in China and force a re-configuration of supply chains. Sanctions and counter-sanctions may also affect third states and unsanctioned European financial institutions. Geopolitics also has profound implications for the more traditional risks from macroeconomic outcomes, with which bank supervision is usually concerned.

A number of models exist to understand domestic political uncertainty (e.g., Baker et al., 2016) and these have recently been extended to gauge various forms of geopolitical risks. Risk metrics essentially fall into three categories: indicators compiled by commercial agencies reflect the multifaceted nature of political and geopolitical risks, though often use conflicting or subjective criteria; indicators based on media coverage (e.g., Caldara and Iacoviello, 2022), or natural language processing (e.g., the widely-used Blackrock indicator, depicted in Figure 1); and methodologies based on signals extracted from traded securities (for instance in the GEOVOL, or Geopolitical Volatility, index, also depicted in Figure 1).

Figure 1 also underlines that metrics based on different methodologies may not be closely correlated, though there are now plenty of granular data to assess individual sources of risk, including exposures of individual financial institutions. Blackrock, for instance, currently flags high risks from a potential Russia-NATO conflict, from global technology decoupling and from major cyberattacks.¹

Greater and more variable geopolitical risk has been linked to volatility in financial asset valuations. Most market participants therefore track a set of specific risk indicators. Geopolitical risk also depresses corporate capital expenditures, in particular in industries with a high degree of investment irreversibility (Dissanayake et al., 2018). The link to bank stability is less well studied, but is of course intuitive, given banks’ various exposures to the corporate sector and trade finance, and given their external financial assets. Bach Phan et al. (2022) documented a direct link between risk indicators and bank stability, with common prudential buffers muting this effect. In a period of deglobalisation, the financial system may now become more fragile as the gains from diversification and access to high growth markets are reversed (Buch, 2022).

Geopolitical risks have so far been largely a marginal consideration in banks’ risk management and in ECB bank supervision, but may now need to be more in focus. European bank supervisors have of course acknowledged the significance of geopolitical risk for their future strategy and priorities (Enria, 2022). Yet, there does not seem to be a strategy to translate heightened geopolitical risk into the established processes of ECB supervision. Uncertain linkages and poor data on exposures no doubt play a role. Even though, in theory, an individual institution’s exposure to trade tensions or energy market risks could justify imposing additional capital buffers in the form of a Pillar 2 requirement, this would need to be justified based on detailed exposure data, and could potentially be subject to a legal challenge.

Section 2 of this note examines four different aspects of geopolitical risk, and how the ECB has handled them: the increased risk of cyberattacks; loan defaults driven by the energy shock; the changed outlook for energy-intensive and trade dependent companies and what this means for banks’ loan origination; and the deepening interlinkages between banks and derivative markets, where energy-price volatility has led to large margin calls and strains on liquidity. For each of these four types of risk, new or more severe forms of banking sector vulnerability have emerged, and the existing ECB supervisory priorities and tools are set out. The concluding section 3 then looks ahead and ask how ECB tools and processes could be adapted, or whether new ones need to be defined. Table 2 at the end of the paper provides a summary.
2. GEOPOLITICAL RISKS AND BANKING SECTOR VULNERABILITIES

2.1. Cyberattacks

Cyberattacks are closely associated with geopolitical tensions and could be a key plank of so-called hybrid threats by hostile states (Demertzis and Wolff, 2019). ECB (2022) documented a three-fold increase in global cyberattacks between 2015 and 2021. The frequency of attacks increased during US presidential elections and periods of geopolitical tension. Given the ongoing trend of digitalisation and remote working, also in financial institutions, vulnerability to such attacks is likely to increase. Vulnerability may be further raised by the wider scope of attacks, and by the deepening linkages between the real sector and financial institutions.

As regards likely future trends, Blackrock has flagged cyberattacks as one of the top three geopolitical risks, pointing out that "attacks are increasing in scope, scale and sophistication, with the U.S. facing an ‘epidemic’ of ransomware. Repeated attacks could cause significant damage and sustained disruption, which may spill over to financial markets and the economy.” European supervisors have similarly communicated some alarm and have noted that threats are no longer primarily motivated by financial motives but that “a new type of cyber threat seeks to focus on the destruction of critical infrastructure and causing as much disruption as possible” (Tuominen, 2022). As yet, attacks on financial institutions are largely carried out by criminals, while nation states account for only a minor share (ECB, 2022).

ECB bank supervision has for some time recognised that cyberattacks could destabilise individual financial institutions or even the entire financial system. The ECB’s supervisory priorities already include vulnerabilities from IT outsourcing and cyber resilience (Table 1). This has led to a new cyber-incident reporting framework and closer scrutiny of banks’ outsourcing arrangements and operational risk management.

The EU’s proposed Digital Operational Resilience Act (DORA) should, when adopted, significantly strengthen resilience of financial institutions, require more regular incident reporting and allow better information sharing between supervisors. Yet, the Act might only be implemented in 2024, leaving financial institutions exposed in the interim.

2.2. Energy-related non-performing loans

In Q2 2022, euro-area NPLs stood at the lowest level since consistent ECB reporting began in 2015, at 3.5% for enterprises and 2.3% for households (Figure 2). These are of course backward-looking indicators. Accounting measures of credit risk have consistently deteriorated since the onset of the COVID-19 pandemic, and the so-called stage-two loans (which have shown a significant deterioration in credit risk) increased to 11% of total loan volumes in mid-2022. While banks’ capital buffers seem ample and interest rate rises have buoyed net interest income, credit risk and the legacy of the COVID-19 crisis still present a key concern for supervisors.

Europe’s energy crisis will now take an additional toll on household and corporate balance sheets. Energy-intensive companies will be especially vulnerable to higher prices, volatility and insecurity in supplies. Estimates suggest that the total loan exposure of euro-area banks to energy-intensive sectors is about 18% of the total corporate loan portfolio (Enria, 2022). For firms in the top quartile of energy intensity, euro-area banks have already doubled the provisioning ratio (ECB, 2022).

The impact of the energy price shock on retail and household credit is less well understood. Numerous support measures have been announced or adopted to shield households and businesses from the energy price shock. These vary widely across EU member states, and also in terms of scope and the duration support measures or price caps. Nevertheless, it is clear that credit quality in retail portfolios has already deteriorated, with the ECB pointing to strains in consumer credit.

For banks, it is inherently more difficult to spot debt distress among retail borrowers than among corporate borrowers. Household finances are less transparent given that there are numerous types of wealth and sources of income, while private and business funds are often mixed. At the same time, many commitment payments exist outside the banking sector.

Household debt distress may in the first instance be apparent in the unusual drawing down of more expensive lines of consumer credit and credit-card debt, which do not require collateral. A household would in the first instance default on an energy provider, not a bank (banks may nevertheless spot changing payment patterns). The energy provider would typically offer a payment plan, and have the claim handled by an outside loan servicer, or in the last resort sell the claim. This would affect the borrower’s credit score but would not necessarily lead to a bank withdrawing credit lines. Unlike in the corporate sector, debt restructuring would initially be specific to an individual claim, rather than reflect the borrower’s entire set of financial commitments. This is particularly problematic for individual entrepreneurs who mix personal and business funds.

In recent years, ECB bank supervisors have improved markedly their understanding of risks in larger corporate loans. Since 2018, banks report highly detailed data on individual new exposures to the analytical credit datasets (‘AnaCredit’). In addition, there have been onsite inspections that have

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3 See Bruegel dataset on national fiscal responses to the energy crisis: [https://www.bruegel.org/dataset/national-policies-shield-consumers-rising-energy-prices](https://www.bruegel.org/dataset/national-policies-shield-consumers-rising-energy-prices).
generated more data and thematic reviews of risks. The results of a sectoral analysis of bank exposures to energy-intensive sectors is expected before year-end.

Since about 2016, ECB banking supervision has also closely scrutinised banks’ processes for dealing with distressed loans, largely based on the highly detailed NPL Guidance (ECB, 2017). This has been the basic toolkit for ECB supervisors in addressing banks’ shortcomings in distressed loan management. The ECB guidelines emphasise improved data quality and the preparation of loan sales in secondary markets, which could be an effective means of NPL resolution in addition to internal workouts. This has been flanked by various legislative measure that facilitate the work of external loan servicers. Banks indeed seem to have taken ECB advice to heart. Over the past two years alone, more than half of the aggregate reduction in the euro-area NPL ratio could be attributed to loan sales, while the upgrading or curing of non-performing loans to a performing status has accounted for only a minor part (ECB, 2022).

Going forward, this approach to NPL reduction may become more difficult. Disposals of distressed loans to energy-intensive firms and SMEs will require specialist expertise among loan servicers and restructuring firms. This will be further complicated by the unclear outlook for energy prices and their volatility. Moreover, distressed-debt investors will suffer from a further tightening of financing conditions in this relatively high-risk segment of non-bank financial markets. A particular weakness of NPL sales lies in tackling retail credit defaults, on which national approaches prevail and restructuring of specific instruments rather than of entire household balance sheets may complicate a recovery. The banks’ standardised management of retail customers’ arrears and their offering of high-cost credit facilities may further reflect poorly on the image banks have in public opinion, and could result in adverse regulatory or tax measures in individual states.

2.3. A structural break in the euro-area economy

Large parts of the euro-area corporate sector will also be exposed to the repricing of energy contracts and supply uncertainty. Futures prices currently suggest that gas contract prices will remain above €100/MWh until early 2024, representing a near five-fold increase over early 2021. There will be a significant difference in energy costs between Europe and other jurisdictions, and price volatility and uncertainty of supply will also weigh on enterprise credit quality. ECB (2022) already documents a significantly greater sensitivity of risk premia and of equity indices to energy price volatility in the euro area, compared to the US over the past year.

For banks this implies that energy scenarios should become more central in the assessment of credit risk in new exposures in several sectors. Operational staff and lending officers may not fully take the changed outlook into account, in particular if lending decisions are based on collateral value rather than future cash flows. Local businesses and political stakeholders will clamour for continued access to credit, in many instances using their roles on bank boards. Where certain business models and sectors have become unviable, continued access to credit may delay the needed structural change. Similarly, supply chain resilience and the trade and investment exposures of companies to potential conflict zones should be a factor in bank risk management. China-related risk will clearly need to be part of such considerations.

Supervisors have a key role in assessing banks’ internal governance arrangements, how lending policies are defined, and in reviewing banks’ risk appetite frameworks. The ECB has already identified deficiencies in banks’ credit risk management as one of its priorities (Table 1, Priority 1a). It also examines banks’ internal governance arrangements, controls and board steering capabilities, which
are crucial in allocating new bank lending (Priority 2b). This type of engagement with banks draws on \textit{Loan Origination Guidelines}, which were issued by the European Banking Authority (EBA) in 2020\textsuperscript{4}. These guidelines underline the need for a well-defined risk culture within the bank, as bank boards need to communicate a ‘tone from the top’ to operational units. In relation to mid-sized and large companies, the guidelines point out that a realistic cashflow analysis should be made, and also that the borrower’s business model and strategy should be taken into account.

There is now a risk that existing bank processes fall short in two respects. First, bank boards may not sufficiently reflect the changed energy outlook in loan origination, or might do so only over short-term horizons. Second, existing risk-assessment methodologies may be based on collateral values rather than cashflows. The former might suggest continued credit quality but are in fact based on illiquid collateral markets and may not reflect asset devaluation related to the climate transition. By contrast, assessments of borrowers’ business models and cashflow-based risk models would make credit risk much more resilient to various energy-price scenarios. Such models would expose poor credit quality, given volatility in input prices and diminished earnings.

### 2.4. Spillovers between energy markets and the banking sector

The energy crisis has also exposed complex and deepening interlinkages between the banking sector and the markets on which energy and commodity contracts are traded.

The financial system supports commodity markets through financing, trading and risk-management services (Bank of England, 2022). Banks act as broker-dealers intermediating between physical commodity markets and non-bank financial institutions such as hedge funds. Also, they trade directly between different participants in the energy market in so-called over-the-counter (OTC) transactions for derivatives and spot contracts.

Energy providers have traditionally protected themselves against wholesale-market volatility by trading on futures markets, increasing certainty about supply and prices for end-consumers. These contracts are widely traded on exchanges and their associated central clearing parties (CCPs), but also on OTC markets. A CCP will be a counterparty in every transaction as this eliminates counterparty risk and ensures delivery of contracts. Initial margins and additional variation margins on counterparties, which vary with the underlying energy price and volatility, ensure that each member is protected through adequate collateral for the duration of a derivative contract. Energy traders generally prefer central clearing over uncleared OTC contracts, and this preference does not seem to have changed much since markets became more volatile in 2022 (ECB, 2022).

Banks provide financing to participants in energy derivative markets by funding margin calls through credit lines and guarantees. They may also be directly exposed if they act as members of clearing houses where risks are mutualised. These exposures of euro-area banks are set to deepen further as exchanges become more central amid volatile energy markets, and as more trading and clearing shifts away from the United Kingdom and into the EU. The efficient functioning of these markets, including banks’ funding of margin calls, is crucial for the soundness of energy providers and uninterrupted physical supply (Lehmann, 2022).

Central clearing is mandatory for most financial derivatives, and there are strong incentives for energy derivatives. This limits counterparty risk in the financial system, though it comes at a cost and may create risks of liquidity stress, to which banking supervision will need to be alert.

In summer 2022, energy-price volatility led to considerable strains on liquidity in the energy sector and, by extension, within banks that served energy traders with liquidity lines or guarantees (Figure 3). Data in ECB (2022) shows that initial margins, which are posted at the beginning of each trade, are still roughly twice as high as at the end of 2021. Variation margins led to considerable additional liquidity needs in the sector as price volatility spiked. In mid-2022 euro-area banks had extended roughly €35 billion in credit lines and loans to firms trading energy derivatives. A number of EU governments also made credit lines available to energy traders and utilities, though the ECB has rejected the idea of providing such liquidity outside the banking system. In the absence of such a backup facility, volatility in commodity markets could reverberate as liquidity strains on banks that interact with energy-market participants.

Risks from liquidity strains from central clearing are recognised as a macroprudential risk (ESRB, 2022), though as yet do not seem to have been reflected in the SSM’s work. Only a small subset of significant institutions will have exposures to energy spot and derivative markets, or will fund traders in such markets. For these institutions supervisory teams should be alert to how margin calls and counterparty credit risk are driven by energy-price volatility. ESMA and national supervisors of specific CCPs could offer input. ECB attention to such exposures will be especially needed, given that no central liquidity provision exists under ECB policies, and as government support may be partial or uncertain.

**Figure 3:** Initial and variation margins posted on commodity derivative trades

**Initial margins**

**Daily variation margins posted by euro-area entities (€ bns)**

Source: Bruegel, based on ECB *Financial Stability Review* (Nov. 2022), Special Feature A.
3. IMPLICATIONS FOR ECB BANKING SUPERVISION

Much like climate risk, geopolitical uncertainty is a risk category that at first appears diffuse and poorly measured, and as having uncertain effects on bank credit risk. We have outlined in this note that this is not the case. Several risk measures exist, which are used widely as input in capital-market portfolio allocations, as the impact on various asset classes is now better understood. Russia’s war in Ukraine has exposed Europe’s vulnerability to such risks, which could similarly arise in other conflicts, possibly and importantly with China.

Euro-area banks will also be directly and indirectly exposed to the emerging geopolitical threats, though the effects will differ by type of business model, the extent of their international engagement and quality of IT systems. Risks could manifest themselves in more frequent and more disruptive cyberattacks, higher and more volatile energy prices, trade tensions and a fragmentation of value chains. Models and metrics exist to gauge each of these risks, and these should be an input in bank risk management, in particular at board level. Europe’s strategic vulnerability should have tangible consequences for the assessment of banks’ credit quality, and for defining loan-origination standards.

Geopolitical risk and its implications for the euro-area economy should therefore also inform ECB bank supervision. Individual EU countries and their supervisors have been acutely aware of such risks, though this is less true in the collective decision-making within the ECB’s Supervisory Board. Metrics and models used in capital markets provide ample input and should be regularly communicated. This can also be operationalised within the Supervisory Review and Evaluation Process (SREP), and in the regular interaction with highly-exposed institutions.

Given the new risk environment, the ECB should also update its supervisory priorities, which were last published in December 2021 (Table 1)\(^5\). The current priorities inevitably seek to deal with the legacy of the COVID-19 crisis, with several long-standing structural weaknesses in banks and with tackling additional challenges related to climate risk and the digital transformation, which were included belatedly in the list. A number of items have been directly communicated to banks through the so-called ‘dear CEO’ letters, including in December 2020 on risk-management practices. Supervisory teams have focused selectively on those banks most exposed to certain risks.

ECB bank supervision will need to implement three crucial transitions:

- First, a shift of focus from the credit risk legacy of the COVID-19 pandemic to the fallout from new macroeconomic and geopolitical risks, amid the rapidly tightening financial conditions;
- Second, the ECB will need to reflect the ESRB’s macroprudential recommendations relating to cyber risks and energy-price volatility in its own bank-specific supervision, reflecting both direct and second-round effects;
- Third, the ECB should become more assertive as a proactive, perhaps even intrusive, supervisor, which will alert bank boards to the new risk environment (Viñals and Fiechter, 2010).

The following adjustments could be reflected in a new set of supervisory priorities (summarised in Table 2):

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Cyberattacks are likely to become even more frequent and may well take on a more disruptive nature should they emanate from hostile states. Threat assessments by national and EU agencies should alert ECB supervisors and could be used for a more targeted review of individual institutions. The ECB’s supervisory priority 3c has already led to more clarity about banks’ outsourcing of IT services. Yet, resilience of financial firms will only be enforced broadly once the EU’s new digital resilience act (DORA) is agreed and implemented, which is not expected before 2024. In the light of the greater threat, the ECB should press institutions under its direct supervision to step up preparations along the lines anticipated in DORA much earlier, and to seek a regular information exchange with national and non-EU supervisors.

Credit risk management should remain in focus (Priority 1a). The ECB’s review of corporate loan portfolios could be strengthened through more frequent thematic reviews and scenarios, for instance on the fallout from US-China tensions. Supervisors should also make sure that banks examine more closely retail credit and its vulnerability to the ongoing energy-price shock. Household finances are inherently less transparent, though payments data and credit bureaus could offer early warning signals, especially on debt distress suffered by single entrepreneurs. A deterioration in utility payment obligations and in other non-bank commitments should be speedily recognised in a reclassification of loans. Pro-active and holistic restructuring solutions should then be emphasised over loan sales, in a shift of emphasis relative to the ECB’s 2017 NPL Guidelines. The 2023 bank stress tests will offer an immediate tool to assess vulnerabilities.

Bank boards also need to steer loan business more effectively and should have a better grasp of credit risks on the basis of granular data. This is already a stated priority of the ECB (Priority 2b), but it now takes on additional significance. By setting the ‘tone from the top’, bank boards can communicate the changed outlook to risk-management and lending units. When looking at new exposures, banks will need to recognise that the business models of many energy-intensive firms in Europe may now be broken. Supervisors should therefore reinforce the application of the EBA Loan Origination Guidelines.

Finally, banks’ exposures to energy and derivative markets need to be monitored amid heightened energy-market volatility. This will require closer coordination with ESMA and national capital-market supervisors.

As the euro area enters a recession and bank lending standards are rapidly tightening, further additional supervisory scrutiny will test the ECB’s credibility. EU states and institutions with public-sector backing will be focused on continued access to credit, even where certain sectors now lack a clear and viable business model. The new ECB priorities should be communicated widely in the various public engagements of the Supervisory Board.
Table 1: Current ECB supervisory priorities (December 2021)

<table>
<thead>
<tr>
<th>Priority</th>
<th>Key vulnerabilities</th>
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| Ensuring that banks emerge healthy from the pandemic                      | a. Deficiencies in credit risk management frameworks  
|                                                                          | b. Exposures to vulnerable sectors  
|                                                                          | c. Exposures to leveraged finance  
|                                                                          | d. Sensitivities to shocks in interest rates and credit spreads                      |
| Ensuring that banks address structural weaknesses                         | a. Deficiencies in banks’ digital transformation strategies  
|                                                                          | b. Deficiencies in management bodies steering capabilities                            |
| Ensuring that banks tackle emerging risks                                 | a. Exposure to climate-related and environmental risks  
|                                                                          | b. Exposures to counterparty credit risk  
|                                                                          | c. Deficiencies in IT outsourcing and cyber resilience                                |

**Table 2:** Overview of risks and ECB responses

<table>
<thead>
<tr>
<th>The challenge</th>
<th>Cyber attacks: higher incidence and “intention to disrupt”</th>
<th>Energy-related NPLs</th>
<th>A structural break in the EU economy</th>
<th>Banking exposures to energy markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Resulting banking sector vulnerability</td>
<td>Higher threat of cyberattacks, which are increasingly aimed at disruption rather than financial gain.</td>
<td>Energy defaults require more complex restructuring solutions Existing mechanisms of loan disposals may not be suitable Cross defaults from utility payments</td>
<td>Outlook for energy markets and supply chain decoupling are not reflected in loan origination</td>
<td>Sudden strains on liquidity related to margin calls Direct exposures for banks that are clearing members Spillovers from a CCP failure</td>
</tr>
<tr>
<td>Wider significance, including for the real sector</td>
<td>Resilience to economic and financial system disruption and to hybrid threats to the Union</td>
<td>Lack of restructurings solution for micro credit and individual entrepreneurs Credibility issues/public opinion backlash where banks enforce or substitute high cost credit</td>
<td>Funding of unsustainable business models Political interference in effort to sustain access to credit undermines ECB independence</td>
<td>Preventing failure of energy providers and traders Securing physical energy supply on spot markets Preparing CCP relocation from the UK</td>
</tr>
<tr>
<td>Existing ECB approaches and tools</td>
<td>Cyber incident reporting, operational risk assessments</td>
<td>ECB NPL Guidelines Work on risk management frameworks, including targeted inspections</td>
<td>EBA Loan Origination Guidelines</td>
<td>unclear</td>
</tr>
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**Geopolitical risk and its manifestations**
- Cyberattacks and hybrid threats
- Trade tensions, supply chain fragmentation, China decoupling
- Prospect of higher costs, volatility, and supply uncertainty in energy markets
## Coverage in 2021 ECB supervisory priorities (Table 1)

<table>
<thead>
<tr>
<th>Suggested new approaches and tools</th>
<th>Priority 3c</th>
<th>Priorities 1a and b</th>
<th>1a and 2b</th>
<th>Priority 3b on counterparty credit risk</th>
</tr>
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<tr>
<td>• Draw on integrated and more up to date threat assessments</td>
<td>• Shift focus from COVID to energy exposures</td>
<td>• Reinforcing the ‘tone from the top’ (board’s steering of the risk culture)</td>
<td>• Targeted review of those banks acting as energy brokers and funding derivative trades</td>
<td></td>
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<tr>
<td>• Advocate and implement a cyber incident coordination framework</td>
<td>• Reflect price caps and national fiscal support</td>
<td>• Make sure that risk models reflect an uncertain and changed energy price outlook and are not based on collateral values.</td>
<td>• Anticipate liquidity strains in derivative markets</td>
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<tr>
<td>• Prepare supervised firms for a speedy implementation of DORA</td>
<td>• Define realistic expectations for loan disposals in NPL strategies, which may require internal workout capacity</td>
<td>• Coordination with ESMA and also the Bank of England which supervises UK-based CCPs</td>
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<td></td>
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<tr>
<td>• Shift focus from COVID to energy exposures</td>
<td>• Integrate household credit risk assessments, proactive restructuring solutions</td>
<td>• Integrate household credit risk assessments, proactive restructuring solutions</td>
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## Overarching challenges for ECB Banking Supervision

- Regularly update geopolitical risk assessments, e.g. from the EU’s External Action Service, and communicate banking risks publicly
- Monitor national fiscal energy support measures in coordination with ECB
- Define risk environment in pillar II SREP
- Strengthen supervision of less significant institutions, where national competent authorities may be more inclined to facilitate access to credit.
REFERENCES

- Lehmann, A. (2022): Volatile energy markets expose the fragility of Europe’s capital market infrastructure, Bruegel blog, October.
- Tuominen, A. (2022): The resilience of the European banking sector, speech at the Florence School of Banking and Finance, June, ECB.
Geopolitical risk will increasingly confront EU banks and their supervisors in the coming years. This paper assesses four specific manifestations of this type of risk and the related banking vulnerabilities and proposes new or modified priorities for European Central Bank banking supervision.

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