Policy conclusions and suggested measures

The EBA's risk assessment report highlights the critical need for ongoing vigilance and proactive measures to tackle emerging risks in the banking sector. This involves ensuring that EU/EEA banks maintain strong capital and liquidity positions to withstand potential shocks, especially amid elevated macroeconomic uncertainty and increased geopolitical risks.

Monitoring should be fully embedded in banks' risk management. Given the materialisation of geopolitical risks in recent years, it is reasonable to assume that this risk will persist. Monitoring might include scenario analysis of the potential impact on capital, liquidity, funding, business model and operational resilience. Banks should be prepared to address risks related to cyberattacks but also to staff, operations, data and processes, which might result from the materialisation of geopolitical risks.

Enhancing credit risk management frameworks is essential for identifying and mitigating potential risks early. This entails regular stress testing, scenario analysis, and vigilant monitoring of credit exposures, particularly in vulnerable areas such as SMEs, CREs, and those sensitive to geopolitical developments. Recognising potential interactions with NBFIs is equally crucial. Maintaining stringent loan underwriting standards is also crucial for assessing new loans' quality through comprehensive credit evaluations, accurate collateral valuation, and adherence to prudent lending practices.

To monitor asset quality trends and detect early signs of deterioration, banks should implement robust monitoring and reporting systems. These include periodic reviews of loan portfolios, updated collateral valuations, prompt recognition of NPLs, and active management of distressed assets. Engaging with borrowers is also vital to comprehend their financial conditions and offer necessary support, such as restructuring options or financial advice.

Financial institutions are critical to the global economy, so their resilience to climate risks is essential. They must integrate climate risk into their risk management framework to maintain financial stability. This includes incorporating climate risk considerations into their credit risks assessment and underwriting practices and diversifying investment portfolios to mitigate exposure to high-risk geographical areas or sectors. An efficient pricing of physical and transition risks is crucial for supporting Europe's transition to a more sustainable economy.

Furthermore, banks need to focus on sustainable finance while effectively managing greenwashing risks. This involves developing precise internal guidelines and frameworks to encourage sustainable finance practices, transparent reporting, and compliance with established ESG standards. Diversifying funding sources is equally important to minimise reliance on a single source by tapping into various markets, including retail deposits, wholesale funding and capital markets.

Establishing robust liquidity risk management frameworks is imperative. This includes setting internal liquidity limits, regular monitoring, and having contingency plans to address potential shortfalls. Banks should aim to maintain strong LCR and NSFR ratios and a sufficient buffer of high-quality liquid assets that are easily convertible into cash to meet short-term obligations, such as government bonds and other highly liquid securities.

Financial markets show a higher level of nervousness, which can affect banks' access to funding at reasonable prices. This is further amplified by banks higher reliance on market-based funding following the repayments of central bank funding. It remains crucial for banks to seize favourable moments to issue bonds, especially given the possibility of ongoing market volatility. Equally important is for banks to continue managing customer deposits at competitive rates.

Banks should diversify their revenue base and control costs in order to support profitability. With NII likely to decrease and both cost of risk and operational expenses potentially continuing to rise, it is crucial for banks to diversify their revenue sources, including generating income from fees and commissions. Additionally, they must maintain a tight rein on expenses, even as ongoing ICT investments are necessary. Consolidation could prove beneficial in managing some of these challenges.

Banks should bolster their operational resilience against increasing digital and cyber threats. They should further invest in advanced cybersecurity measures and governance, regularly update systems, and conduct frequent security audits to guard against breaches. It is important that banks and supervisors remain vigilant to operational and financial stability risks that could arise from cyber threats. With increased digitalisation and technological innovation, enhancing fraud detection and prevention mechanisms using AI and ML is crucial for identifying and thwarting fraudulent activities. Additionally, with the growing dependency on third-party services, strengthening third-party risk management frameworks, involving thorough due diligence, regular monitoring, and clear contractual agreements, is essential. As wider operational risk losses diverge significantly, it is important to gain a deeper understanding of drivers of such losses across countries and banks, and to identify possible drivers or lessons where losses are low.

Improving data governance is crucial for managing the complexities associated with AI adoption in the banking sector. Implementing robust data governance frameworks ensures the accuracy, reliability, and security of data used in and outputs of AI models, with regular audits and assessments of data quality being integral parts of these frameworks.

Banks should ensure sufficient resources to invest in their medium-term businesses, cautiously plan their distribution policies and capital allocations. Solid capital reserves are an important element of banks' capacity to handle emerging risks and ensuring investments are made for future business sustainability.

Abbreviations and acronyms