The risk landscape in 2024

The European economy saw modest growth with reduced inflationary pressures.

In 2024, the European economy struck a delicate balance between modest recovery and persistent internal and external headwinds. Real GDP growth was close to 1% for the European economy, marking a slow but steady rebound from earlier stagnation. Growth was, however, uneven across Member States, with southern European economies (such as Spain and Portugal) showing resilience, while Germany faced greater difficulties due to weakened industrial output and exposure to global trade. France, meanwhile, showed moderate growth supported by domestic demand in a context of political instability.

Employment remained a relative bright spot. Unemployment rates across the EU hovered near historic lows, with employment growth softening slightly to around 0.6%. Labour shortages in certain sectors, particularly healthcare, construction and technology, sustained wage pressures, although not enough to spark wage-driven inflation.

After peaking in 2022–2023, inflation moderated significantly in 2024. In several months, headline inflation in the euro area dipped below the ECB's 2% target, falling to 1.7% in September 2024, driven by lower energy prices and easing supply chain pressures. In response, the European Central Bank (ECB) began easing its monetary stance. Starting in June 2024, the ECB cut rates by 75 basis points over several months, bringing the deposit facility rate to 3% by the year end, with its forward guidance indicating a further decrease to 2% by late 2025. This was a marked shift from the aggressive tightening of the previous two years.

Geopolitical uncertainty emerged as the predominant risk factor

The EU economies faced numerous challenges, some of which became more pronounced. This included increasing geopolitical tensions, not only due to Russia's war of aggression against Ukraine, escalating conflicts in the Middle East, and a slowdown in global trade

attributed to sluggish global recovery, particularly in China, which negatively impacted European export growth. Furthermore, the fragmentation of global supply chains posed a disadvantage to export-reliant EU economies. Additionally, geopolitical tensions between the US and China intensified. Geopolitical tensions further escalated in early 2025, in the wake of US tariffs and retaliation measures by some countries. This casts a shadow over export-reliant economies both within the EU as well as globally, and contributes to uncertainty and volatility in commodity and energy prices, creating further uncertainty for households and corporations alike.

Internal factors also contributed to uncertainty for the EU economy in 2024. Political instability created a political impasse in several countries during this year. The region also faced challenges from declining manufacturing output due to weak automotive sector exports arising from reduced demand and ongoing energy cost issues. Additionally, high levels of public debt and fiscal constraints posed difficulties for EU economies. The limited fiscal space restricted the ability of governments to stimulate growth or invest in infrastructure, the climate transition or digitisation. In technology, Europe lags behind the US and China in tech investments, AI adoption and startup ecosystems, partly due to low research and development intensity and fragmented capital markets that limit long-term productivity growth.

Many of these deficiencies were highlighted in the 'Draghi' and 'Letta' Reports published in 2024. The reports provide a comprehensive roadmap aimed at revitalising Europe's economic competitiveness through substantial investment, innovation and policy reforms.

European banks demonstrated resilience in this highly uncertain environment

European banks still benefited from high interest rates in 2024, which fuelled net interest income, resulting in record profits for the sector. The exceptional profit levels reported by EU/EEA banks enabled them to further strengthen their capitalisation. Despite the increased levels of payouts through dividends and share buybacks, weighted average CET1 ratios remained at around 16%. This exceeded the minimum requirements, with an average management buffer for EU/EEA banks estimated at more than 400 basis points. They also

maintained strong liquidity levels without markedly increasing their funding costs.

The robust profitability, capitalisation and liquidity of EU/EEA banks provide a cushion for the underlying risks of the sector. These include heightened geopolitical risks, slow economic growth and inflation above central bank targets, and can result in lower asset quality, higher operational and cyber risks, as well as market and liquidity risks.

EU/EEA banks' lending growth rate slowed down as a result of risk aversion and stringent lending standards. There was only modest growth in lending to non-financial corporations (NFCs) and households throughout the year, with the latter being supported by renewed demand for mortgage lending during the final two quarters of 2024. The slow economic growth and sectoral idiosyncrasies resulted in a deterioration in asset quality. Yet, despite the heightened risks, mainly stemming from geopolitical uncertainty, the effect on banks' asset quality was moderate, partly because the robust labour market supported household spending. At the same time, corporate insolvencies increased but at a slower pace compared to previous years. The deterioration in asset quality was more notable for exposures related to the commercial real estate sector, due to cyclical and structural changes in this market. Although these markets stabilised towards the second half of 2024, sustaining their valuations, they still face potential downside risks.

Downside risks for EU/EEA banks remain highly susceptible to geopolitical developments. Banks not only have direct exposures to jurisdictions with heightened geopolitical tensions, but also have exposures to sectors directly affected by changes in the geopolitical landscape (e.g. tariffs on EU exports or supply chain disruptions). Geopolitical risks can extend beyond credit risk to market, liquidity and operational risks, including cyber risks. Geopolitical developments may exacerbate these risks by creating a risk-averse environment, which may lead to reduced growth potential, diminished investment, increased market volatility, and ultimately further impact banks' asset quality and capital. The heightened geopolitical tensions have also induced the need for increased defence spending for several EU countries, which could impact their levels of sovereign debt and raise sovereign debt sustainability concerns. EU/EEA banks hold substantial amounts of sovereign debt in their asset portfolios, whose valuation can affect banks' capital positions. Additionally, banks may be required to help finance increasing defence spending needs,

which may exacerbate the sovereign-bank nexus.

In 2024, EU/EEA banks reported a substantial rise in their risk-weighted assets due to operational risk. This comes at a time when they are confronted with heightened ICT and cyber risks, in parallel with geopolitical developments and as banking services become increasingly digital. Banks have to invest in strong security measures to prevent data breaches and cyber-attacks. At the same time, the rapid pace of technological change means banks must continually innovate to stay competitive. Failure to do so could result in a loss of market share to more innovative peers or FinTech/BigTech companies, which are agile and quick to adopt new technologies. As such, the sector is also integrating AI to detect illicit activities and to enhance further customer-related services.

The interconnectedness between banks and non-bank financial intermediaries also posed a major risk to the EU banking sector and could create an adverse loop for financial stability. The increasing complexity of these linkages may create vulnerabilities during periods of financial instability.

Climate change poses significant financial risks for banks because of the increased frequency and severity of natural disasters. This became evident in 2024, as several catastrophic climate events took place across Europe. Although the impact was idiosyncratic and affected banks with substantial exposure to the industries or regions most affected by these events, EU/EEA banks need to promptly account in their risk assessments for the risk of higher default rates and increased loan losses due to climate risk.

Despite the robust position of EU banks, looming risks warrant increased vigilance. In January, the EBA launched another EU-wide stress test campaign for 2025. This exercise is a crucial component of the supervisory toolkit used by Competent Authorities to assess the resilience of EU banks to severe shocks, identify residual areas of uncertainties, and inform the supervisory decision-making process (SREP) to determine appropriate mitigation actions. Ultimately, the stress test informs the Pillar 2 Guidance (including P2G leverage ratio). It goes beyond examining depletions and CET1 ratios, and provides a comprehensive view of how banks may fare under adverse conditions.

The 2025 stress test scenario places a significant emphasis on worsening geopolitical tensions and their potential impacts. It highlights the risks associated with the escalation of conflicts and disruptions to global trade and supply chains, which could lead to a sharp economic contraction. This adverse scenario, while hypothetical, is designed to be severe, plausible, and reflective of the current economic and geopolitical uncertainties that might threaten the EU banking sector. It is essential to remember that the stress test is not a prediction but rather a tool to ensure that EU/EEA banks are prepared to weather potential challenges, as demonstrated in previous exercises where the CET1 ratio remained comfortably above 10% even under demanding scenarios.