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# Bank shocks, governance and digital transition among ECB's key supervisory priorities to 2026

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By Abhishek Kumar

Strengthening the European banking sector's resilience to macro shocks and improving internal governance are among key supervisory priorities for the eurozone's central bank, it outlined today. The European Central Bank has three broad supervisory priorities for the three years through to 2026, said the chair of its supervisory board, Andrea Enria, and it has identified seven key vulnerabilities in banks that need to be fixed.

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The European Central Bank has three broad supervisory priorities for the three years through to 2026, said the chair of its supervisory board, Andrea Enria.

These are: strengthening resilience to macro-financial and geopolitical shocks; remedying shortcomings in governance and effective management of climate and environmental risk; and enhancing digital transformation and securing operational resilience of banks.

Banks and supervised entities must strengthen their credit risk and asset-liability management frameworks to protect their assets from potential threats emanating from geopolitical risks and inflationary pressures, the ECB said outlining its medium-term banking supervision priorities for the next three years.

Under the three priorities, the ECB has identified seven key vulnerabilities in banks that need to be fixed. These include shortcomings in credit risk and counterparty risk management frameworks; shortcomings in asset and liability management frameworks; management bodies' functioning and steering capabilities; deficiencies in risk data aggregation and reporting; material exposures to physical and transition risk drivers of climate change; deficiencies in digital transformation strategies; and deficiencies in operational resilience frameworks.

Higher interest rates, despite representing an important revenue stream for banks, also raise funding costs for banks and introduce higher volatility in funding sources, the regulator cautioned.

“While rising interest rates have had a positive impact on profitability so far, banks must be prepared to cope with more volatile funding sources, higher funding costs, a potential fall in asset quality and a further re-pricing in financial markets in the short and medium term, just when a substantial amount of central bank funding is to be replaced,” the regulator cautioned.

Ensuring that supervised entities develop business strategies to strengthen their resilience to shocks remains a key priority; the regular said advising banks to focus on remedying structural deficiencies in credit risk management frameworks including counterparty credit risk and fix deviations from regulatory requirements and supervisory expectations.

On the need for robust internal governance controls, the ECB said bank failures earlier this year, notably in the US and Switzerland, underscore the need for robust internal governance and risk controls in banks. It intends to apply escalation mechanisms to ensure timely remediation of identified shortcomings, it said.

Governance issues, especially concerning risk data aggregation and reporting capabilities remain areas of particular concern, the regulator added, urging banks to align their practices with sound management of climate-related and environmental risks by the end of 2024.

“Supervisory investigations have shown that while some banks have already made good progress with their digital transformation, others have not allocated the necessary resources to achieve their goals,” the ECB said.

Banks need to protect their IT systems from growing cyber threats, which also means checking the increasing dependence on third party service providers to ensure continuity of their critical services even in the event of severe operational disruptions, the ECB said. “Banks will be asked in the months ahead to demonstrate their ability to respond to and recover from such adverse events.” the regulator added.

“While the risk landscape has evolved further since last year, the supervisory priorities and corresponding activities set out in 2022 remain valid overall and still address the main vulnerabilities in the banking sector."

On from climate change and transition risks, the regulator said a self-assessment of banks in 2022 had revealed that 80 percent of supervised banks were unclear about when they would be able to meet regulatory expectations. The supervisory board has recently approved a report on measuring transition risk and will soon be publishing it, Andrea Enria said.

“Several banks did not meet our March 2023 interim deadline to perform an adequate materiality assessment of the impact of climate-related and environmental risks across their portfolios,” Enria said.

The regulator was then forced to issue binding supervisory decisions requiring banks to remediate shortcomings in their risk controls to meet obligations, Enria said.

The regulator also proposes to periodically impose penalty payments if banks fail to comply, Enria added.

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