Banking 2025: Emerging Risks and the Regulatory Agenda

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Lots done, more to do

Prudent risk management practices, robust supervision, and strong capital and liquidity buffers have in recent years led to a collective build-up of financial resilience in the Irish banking system.

Regulators have been quick to publicly espouse the benefits of this resilience as the sector successfully absorbed the external shocks of the COVID pandemic, international banking failures and market turbulence in the wake of rising interest rates.

Nonetheless, the banking sector continues to chart a choppy course through headwinds of macroeconomic uncertainty, higher-for-longer interest rates, global geopolitical unrest and fast-paced technological change.

The emerging narrative from the regulatory authorities is that the extent of the risks and the complexity facing the financial system has significantly increased in recent years, and so too has the vulnerability of the system to external shocks.

The ECB and CBI supervisory agenda in this context is clear: banks need to become better equipped to navigate forward-looking emerging risks and uncertainties to build long-term resilience and sustainable business models.

Provisions in focus

Traditional in-force prudential frameworks, however, lack the flexibility to support such a forward-looking supervisory agenda since they are based largely on historical experience and outcome data series.

This has prompted the ECB to consider the accounting requirements of IFRS9 as a supervisory tool, which requires, inter-alia, comprehensive consideration of forward-looking information in the calibration of loan loss provisions.

Whilst accounting treatments remain outside of the ECB's prudential remit, it is notable that it has recently been granted a mandate to challenge banks' IFRS9 modelling practices when there is a supervisory concern about adequate risk coverage.

On the back of this mandate and based on information collated during their targeted review of IFRS9 in 2022, the ECB recently published their assessment of best practices for capturing novel risks in loan loss provisioning models. The paper is focused on risk coverage across:

- Geopolitical Instability
- Rising Interest Rates
- Climate and Environmental
- Commercial Real Estate

The ECB concludes that when it comes to effective emerging risk quantification, directly supervised banks still have “a long way to go” and many rely on outdated IFRS 9 models that do not fully capture emerging threats.

Banks are “urged” to update their models to better reflect the specific risk factors in focus, in particular ensuring that vulnerabilities in CRE and other risk-sensitive sectors are properly addressed. Banks that fall behind will be subject to “appropriate supervisory measures”.

Risk functions must adapt

Risk functions have often been accused of “fighting the last war” by adopting a reactive and short-term approach to regulatory compliance. This is often understandable, as regulators similarly have a history of arriving only to survey the damage and use legislation to prompt retrospective remedial actions.

However, regulators now recognise that in today’s world, it is impossible for legislation to keep pace with the speed of change on the financial services horizon.

And through the introduction of the Individual Accountability Framework (IAF) by the CBI, there is now an explicit expectation that bank executives and senior management understand the potential risks that their business may face in the future and identify, quantify and manage those risks in a proactive and comprehensive manner.

The ECB publication on novel risks is a reminder to senior management bodies that they should no-longer wait for regulatory expectations to be clarified in legislation. Banks should be demonstrably responsive to this prompt by developing risk management frameworks that are comprehensive, adaptable and resilient to the fast-changing risk horizon.

Grant Thornton Quantitative Risk

Our team of quantitative risk experts can assist in developing robust risk measurement frameworks, enhancing risk management practices, and ensuring compliance with regulatory expectations. Partnering with Grant Thornton ensures that your firm is prepared to meet the evolving demands of the ECB and the CBI effectively.