

### CREDIT RISK: A SUPERVISORY PRIORITY

Both the Single Supervisory Mechanism (SSM) and the European Banking Authority decided to include credit risk management as the top supervisory priority area for 2021, in view of the possible further deterioration in loan quality resulting from the COVID-19 crisis and the consequent worsening of the macroeconomic environment.

In November 2020, the SSM designed a coordinated strategy geared towards ensuring that institutions have sound management practices in place to identify, measure and mitigate the impact of credit risk, as well as the operational capacity needed to manage the expected increase in non-performing loans.

In particular, the supervisory focus has been on the early detection of asset impairment and an adequate provisioning policy, paying special attention to the economic sectors most vulnerable to the impact of the pandemic, without forgetting the measures already in place to reduce and remove existing NPLs from banks' balance sheets.

To this end, various analysis tasks have been carried out. Letters were sent to significant institutions (SIs) to obtain precise information on their operational capabilities to manage debtors in difficulty and their credit risk identification and measurement practices. With regard to vulnerable sectors, reviews were focused on the hospitality and food service sectors and commercial real estate.

In the framework of the Supervisory Review and Evaluation Process (SREP), the assessment of credit risk has been given priority over other risks, and the corresponding methodological adjustments have been made to better capture the effects of the pandemic.

Lastly, 2021 was the first year in which the SREP has included a demand for higher capital due to the shortfall in relation to supervisory expectations of additional coverage of older non-performing exposures (for more details, see the European Central Bank's "Communication on supervisory coverage expectations for NPEs" of 22 August 2019).

Despite initial fears of an increase in credit risk in the system with the pandemic crisis, the NPL ratio of SIs under SSM supervision continued to fall in 2021, to an average of 2.32% in June 2021, as compared to 2.94% in June 2020. In the case of Spain, the ratio rose slightly to 3.13%<sup>1</sup> in June 2021 (it was 3.02% in June 2020).

Looking forward, credit risk is also among the strategic objectives and priorities set by the SSM for 2022-2024, in which work will again focus on analysing shortcomings in management frameworks, exposures to sectors vulnerable to the pandemic (including commercial real estate) and, as a new development, exposures to leveraged finance and counterparty credit risk.<sup>2</sup>

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<sup>1</sup> Data obtained from *Supervisory Banking Statistics-Second quarter 2021* for the 11 Spanish SIs.

<sup>2</sup> Access the website from this link (<https://www.bankingsupervision.europa.eu/banking/priorities>).