Credit Risk: Aligning banks' risk management perspectives with accounting and regulatory requirements

Rodrigue Abi El Hesn

“Vigilance Meets Vision”: Credit Risk

SSM Supervisory Priorities

Looking at this year’s agenda, I drew **strong comparisons** with what risk managers in Europe have been, and will continue to be, busy working on.

ECB Banking Supervision: Single Supervisory Mechanism supervisory priorities	
Previous Cycle: 2023-2025	**New Cycle: 2025-2027**
Priority 1: Resilience to immediate macro-financial and geopolitical shocks	**Priority 1: Ability to withstand immediate macro-financial threats and severe geopolitical shocks**
Shortcomings in **credit risk management** Lack of diversification of **funding sources** and deficiencies in funding plans	Deficiencies in **credit risk management** frameworks Deficiencies in **operational resilience frameworks** (IT outsourcing and security/cyber risks) Special Focus: Incorporating the management of **geopolitical risks** in supervisory priorities
Priority 2: Addressing digitalization challenges and strengthening management bodies’ steering capabilities	**Priority 2: Remediation of persistent material shortcomings in an effective and timely manner**
Deficiencies in **digital transformation** strategies Deficiencies in **operational resilience** frameworks Deficiencies in **risk data aggregation and reporting**	Deficiencies in business strategies and risk management as regards **climate-related and environmental risks** Deficiencies in **risk data aggregation and reporting**
Priority 3: Stepping up efforts in addressing climate change	**Priority 3: Digitalization strategies and emerging challenges from use of new technologies**
Material exposures to **physical and transition risk drivers**	Deficiencies in **digital transformation strategies**

Source: European Central Bank

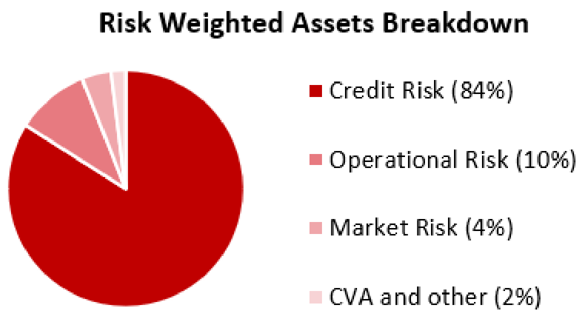
“Vigilance Meets Vision”: Credit Risk

Top Priority: Credit Risk Management

ECB Banking Supervision: SSM supervisory priorities	
Previous Cycle: 2023-2025	**New Cycle: 2025-2027**
Priority 1: Resilience to immediate macro-financial and geopolitical shocks	**Priority 1: Ability to withstand immediate macro-financial threats and severe geopolitical shocks**
Shortcomings in **credit risk management**	Deficiencies in **credit risk management** frameworks

It comes as no surprise that enhancing banks’ **credit risk management frameworks continues to rank high** in the list of European regulators’ priorities.

According to the European Banking Authority’s latest figures (June 2024), credit risk remains by far the **largest consumer of bank’s regulatory and prudential capital**:



Source: European Banking Authority

and credit risk management is evolving at a remarkable pace…

“Vigilance Meets Vision”: Credit Risk

Regulatory Changes

In the EU, much like the rest of the world, **2025 has been a big year** for credit risk management practitioners.

CRR III
Basel IV

European Commission

REGULATION (EU) No 575/2013 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL

of 26 June 2013

on prudential requirements for credit institutions and amending Regulation (EU) No 648/2012

+55 technical standards on CRR until August 2025 (another +80 over next five years)

eba European Banking Authority

Final Report

Guidelines on ADC exposures to residential property under Article 126a of Regulation (EU) 575/2013

Revised ECB guide to internal models

EUROPEAN CENTRAL BANK
BANKING SUPERVISION

ECB guide to internal models

July 2025

New EBA draft guidelines on CCF estimation and Definition of Default

eba European Banking Authority

Consultation paper

Draft guidelines

on Credit Conversion Factor estimation under Article 182(5) of Regulation (EU) No 575/2013

Consultation paper

Draft guidelines

amending Guidelines on the application of the definition of default under Article 178 of Regulation (EU) No 575/2013

"Vigilance Meets Vision": Credit Risk

Key Risks during 2025

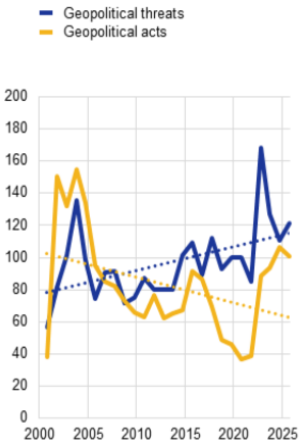
Factors influencing risk management **extend far beyond** regulatory frameworks.

Macro-financial and credit environment

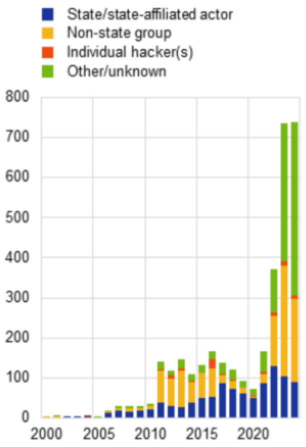
Geopolitical risks, cyberattacks, trade tensions and policy uncertainty

High spending needs and low growth

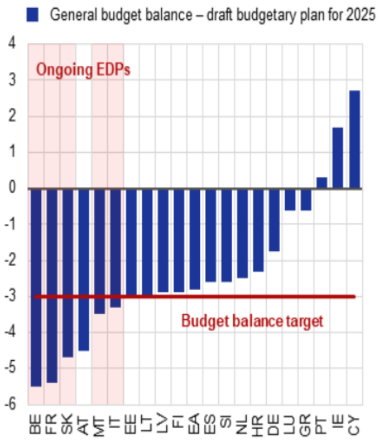
Headwinds for recovering real estate markets



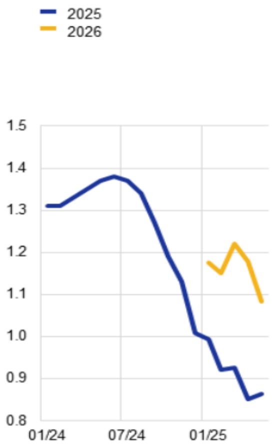
Geopolitical threats and acts on the rise



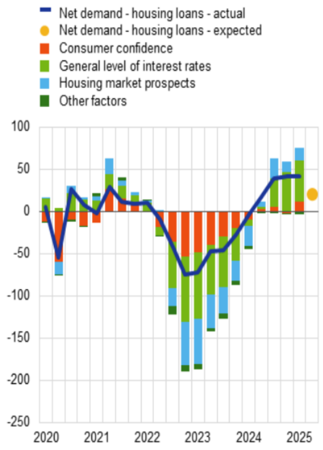
Record cyberattacks and climbing



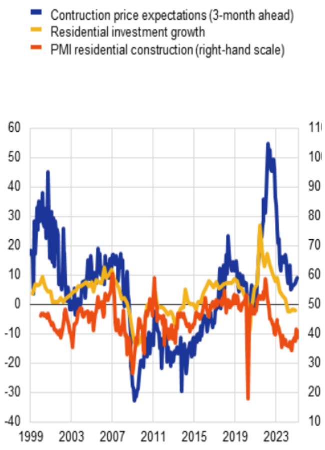
EU Members States facing growing deficits



Private sector GDP forecasts revised downwards



Demand for mortgages slowly picking up…



… but investment and construction activity remain weak

Source: European Central Bank

“Vigilance Meets Vision”: Credit Risk

Key Risks during 2025

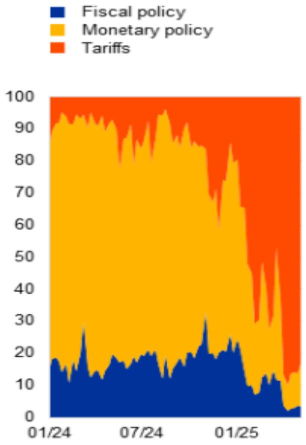
Factors influencing risk management **extend far beyond** regulatory frameworks.

Financial markets

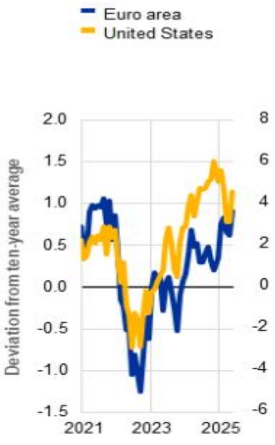
Increased volatility in markets

Risky asset valuations

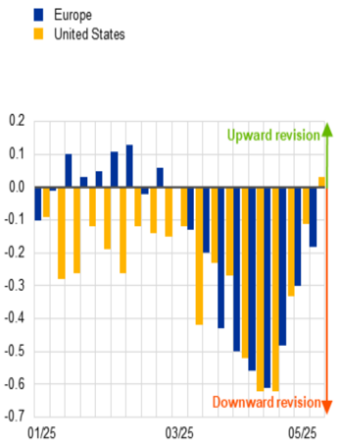
US equities moved 30% (absolute value) in April and May



Bloomberg Articles: Tariffs, the talk of the town



Equity valuations have remained stubbornly high…



… despite sharp downward revisions to earnings forecasts

“We do look at overall financial conditions, and we ask ourselves whether our policies are affecting financial conditions in a way that is what we’re trying to achieve. But you’re right, by many measures, for example, equity prices are fairly highly valued.”

Jerome Powell, Federal Reserve Chairman 23 September 2025

Source: European Central Bank

“Vigilance Meets Vision”: Credit Risk

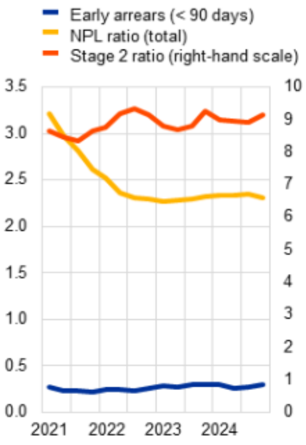
Key Risks during 2025

Factors influencing risk management **extend far beyond** regulatory frameworks.

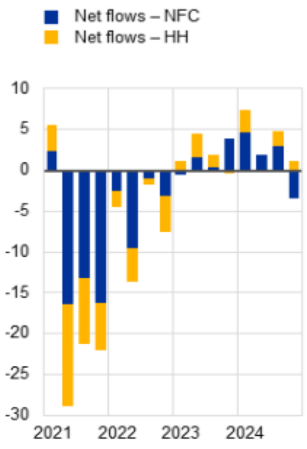
Euro area banking sector

Asset quality strong but under pressure

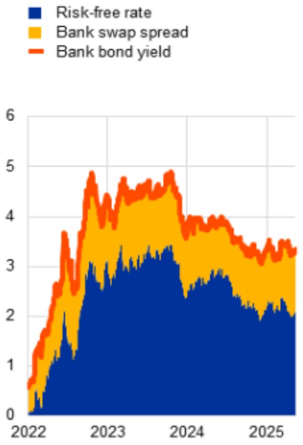
Funding costs down and deposit structure changing in the new interest rate environment



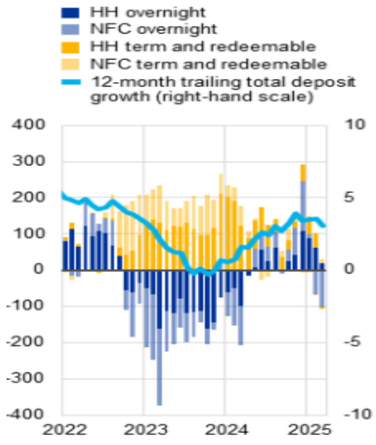
Asset quality remains robust overall…



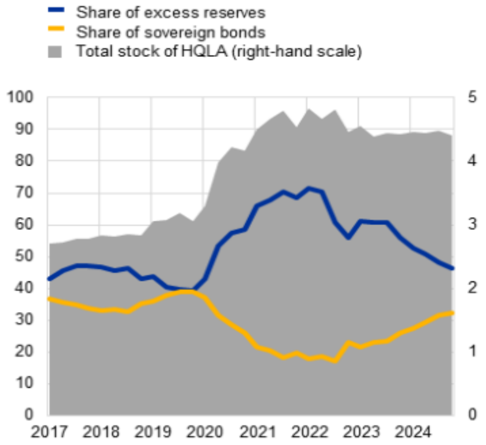
… despite recent rise in corporates and households NPLs



Bank bond yields and spreads lower



Shift in deposit supply to overnight accounts



Liquidity buffers remain ample

Source: European Central Bank

"Vigilance Meets Vision": Credit Risk

Implications on banks

The evolving regulatory framework and disruptions in the operating environment have **significant implications** on banks':

Capital Adequacy

Normative capital allocation and capital planning

ICAAP and economic capital allocation

Business strategies

Underpinning the above elements are:

- Proactive **internal control** functions
- Accurate and reliable **IT and data** infrastructures
- Effective **risk identification and assessment** processes
- Timely **monitoring, reporting and escalation** frameworks
- Robust **governance and oversight** structures, including Management and Board of Directors
- Anchored **risk culture**, guided through alignment between business strategy and risk appetite

"Vigilance Meets Vision": Credit Risk

CRR III / Basel IV

CRR III has introduced **significant changes** to the way banks compute their capital requirements.

Standardised Approach

	Ratings available						Ratings not available (SCRA)		
Credit Quality Step (CQS)	1	2	3	4	5	6			
Central governments	0%	20%	50%	100%	100%	150%	100%		
Unrated PSE	20%	50%	100%	100%	100%	150%	100%		
Corporates, rated PSE	20%	50%	75%	100%	150%	150%	100%		
							Grade A	Grade B	Grade C
MDB (if no RW of 0%)	20%	30%	50%	100%	100%	150%	30%/40%	75%	150%
Institutions >3 Month	20%	30%	50%	100%	100%	150%	30%/40%	75%	150%
Inst. OM <3 Month	20%	20%	20%	50%	50%	150%	20%	50%	150%
Inst. mov. of goods OM <6 M	20%	20%	20%	50%	50%	150%	20%	50%	150%
Corp. Inst. short term rating	20%	50%	100%	150%	150%	150%			
Regional governments	RW analogue to central governments / otherwise RW for institutions								
Intl. Organisations	0% RW if specified under Art. 118								
							All other		
Object finance	20%	50%	75%	100%	150%	150%	100%		
							Preferred	Other	Pre-op.
Project finance	20%	50%	75%	100%	150%	150%	80%	100%	130%
Commodity finance	20%	50%	75%	100%	150%	150%	100%		
Covered bonds	10%	20%	20%	50%	50%	100%	One CQS below institutions		

	Transactor	Other		SCRA*<20%	SCRA>20%		
Retail	45%	75%	Defaulted	150%	100%	Subordinated	150%

Currency mismatch	50% add-on risk weight (max. 150%)

	Legislated programs	Short term resale/VC**	Other		Cash	In collection	Other
Equity	100%	400%	250%	Other items	0%	20%	100%

Immovable property financing

*SCRA = Specific C

Internal Rating-Based Approach

- **A** Central governments and central banks
- **A1** Regional governments and local authorities and public sector entities (RGLA-PSE)
  - Regional governments and local authorities
  - Public sector entities
- **B** Institutions
- **C** Corporates
  - General corporates
  - Specialised Lending (Project finance / Object finance / Commodity finance / Income producing real estate)
  - Corporates purchased receivables
- **D** Retail
  - Secured by real estate
  - Qualifying revolving
  - Retail purchased receivables
  - Other
- **E** Equity
- **E1** Units or shares in CIU
- **F** Securitisation positions
- **G** Other non credit-obligation assets

Banks and other financial companies	CRSA or F-IRB	A-IRB Removed
Banks and other financial companies	CRSA or F-IRB	A-IRB Removed
Corporates belonging to groups with total consolidated annual revenues > €500m	CRSA or F-IRB	A-IRB Removed
Other corporates	CRSA, F-IRB or A-IRB	No change
Specialised lending	CRSA, Slotting, F-IRB or A-IRB	No change
Retail exposures	CRSA or A-IRB	No change
Equity exposures	CRSA or A-IRB	All IRB approaches removed

Probability of Default (PD)	Loss Given Default (LGD)	Credit Conversion Factor (CCF)
The existing input floors are slightly increased from 0.03% under CRR II to **0.05% under CRR III**.	New requirements "calibrated in a prudent manner": ➢ The LGD input floor for unsecured **corporates** exposures is set at 25%; ➢ The LGD input floor for unsecured **general retail** exposures at 30%.	The IRB-specific input floor is set to **50%** of the applicable standardized approach CCF.

“Vigilance Meets Vision”: Credit Risk

CRR III / Basel IV *(continued)*

The changes brought forth under CRR III don’t just affect asset classes, risk-weights under the Standardised Approach and risk parameters under the IRB approach. They also introduce many elements that aim to capture **risk sensitivity at a much more granular level**. Ultimately, this was one of Basel IV’s key ambitions.

2007:

CNBC

Bernanke: Subprime Mortgage Woes Won’t Seriously Hurt Economy

PUBLISHED THU, MAY 17 2007•10:34 AM EDT | UPDATED THU, AUG 5 2010•4:39 PM EDT

2025:

This is a simplified example of what checks a **real estate collateral** must go through before it is eligible as a credit risk mitigation tool:

- **Art. 208 (5):** Damage Insurance
- **Art. 208 (4):** Comprehensive documentation on credit files
- **Art. 229:** Independent and compliant valuation
- **Art. 124 (3) (c):** Valuation not correlated to credit quality of obligor
- **Art. 124 (3) (b), (4):** Lien rank
- **Art. 124 (3) (d):** Client with demonstrated ability to repay
- **Art. 208 (2):** Legal certainty for collateral enforceability
- **Art. 124 (3) (a) (i):** Completion status
- **Art. 124 (3) (a) (ii):** Forest or agricultural land if incomplete
- **Art. 124 (3) (a) (iii):** Legal or moral person if incomplete
- **Art.124 (3) (a) (iii) (1):** Number of units
- **Art. 124 (3) (a) (iii) (1):** Occupancy status
- ✓ **Congratulations, you’re eligible!**

“Vigilance Meets Vision”: Credit Risk

CRR III / Basel IV *(continued)*

CRR III has a real impact on **the way banks do business**.

ADC	100%	**+/- 50%**	150%
RRE	20%	**+/- 130%**	150%
CRE	60%	**+/- 90%**	150%
Retail	45%	**+/- 105%**	150%
Banks	30%	**+/- 120%**	150%
SL	20%	**+/- 130%**	150%

Changes touch on (i) loan origination and monitoring processes, (ii) data collection, storage and flow, (iii) pricing (RAROC), and (iv) overall business strategies.
In times of scarce resources, pursuit of capital efficiency, fierce competition with peers, and the rise of fintechs, banking is being revolutionized.
Where does your bank stand today, and where is it heading?

"Vigilance Meets Vision": Credit Risk

IRB Models

Closely related to CRR III / Basel IV are banks' IRB models, which continue to be the subject of **intensified supervisory scrutiny** and growing bodies of regulation.

In its explanatory memorandum, which accompanied the publication of CRR III, the **European Commission** noted the following:

*Internal models have important benefits… However, the financial crisis highlighted **important deficiencies** in the IRB approaches*

*Internal models demonstrated a **significant level of variability** that was not justified… and that ultimately **undermines the reliability and comparability** of their capital ratios*

*The simplifications implied by several of the preferred options (e.g. **removal of internally modelled approaches**,…) are expected to reduce the costs compared to today*

*The decision to introduce the Output Floor is based on analysis revealing that institutions' use of internal models makes them **prone to underestimate risks**, and hence own funds requirements*

*The Standardised Approach must serve as a **credible alternative** to internal model approaches and as an **effective backstop** to them*

"Vigilance Meets Vision": Credit Risk

IRB Models *(continued)*

Alongside the changes brought forth under CRR III to IRB models, the ECB has published a **revised guide to internal models**.

Revised guide to internal models

Machine Learning	Credit Risk	Market Risk	Counterparty Credit Risk
New section specifies expectations for using **machine learning techniques** in internal models	Refined expectations on **internal validation** and **internal audit** Clarifications on the **responsibilities of Senior Management and the Board of Directors** regarding application packages Refined expectations on **definition of default, PD and LGD**	Split into two chapters to present supervisory expectations for market risk models under both CRR2 and CRR3, reflecting the EC's decisions to **delay the implementation of the FRTB**	More detail on how to model the risks of trades with partners, changes in exposure and updates on maturity in line with **CRR III**

"The revision helps institutions ***streamline their model landscapes****, allowing them to better choose suitable portfolios for internal models and* ***apply simpler approaches to others****.*

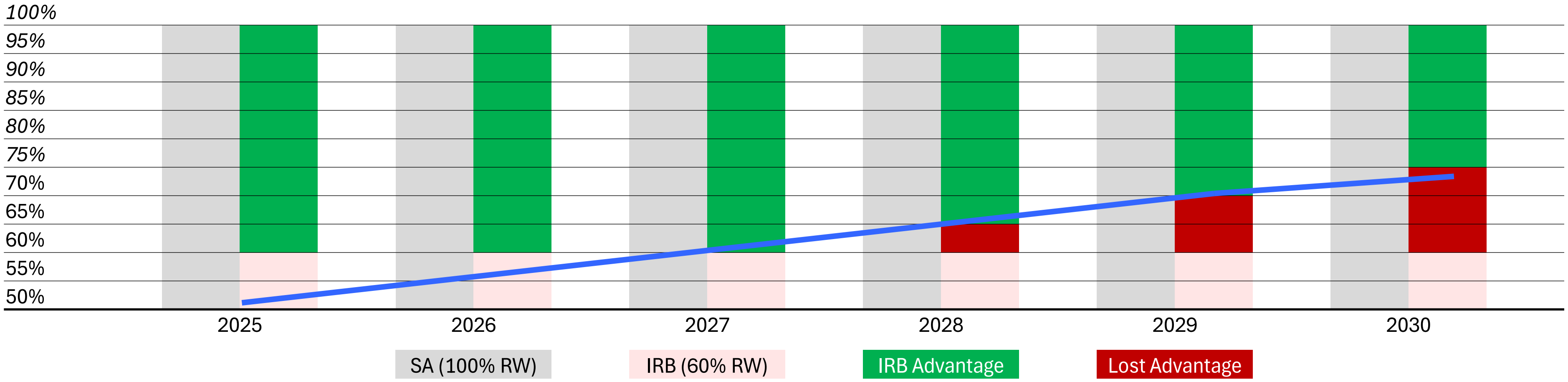
In this vein, the revision of the guide is not in conflict with the ***ongoing initiatives on models' simplification****, but it rather further supports them."*

“Vigilance Meets Vision”: Credit Risk

IRB Models *(continued)*

Banks are assessing the efficiency of IRB approach for various asset classes to which they are exposed, intricately balancing between:

- **Intensified supervisory scrutiny**
- **Gradual phase-in of the Output Floor under CRR III**

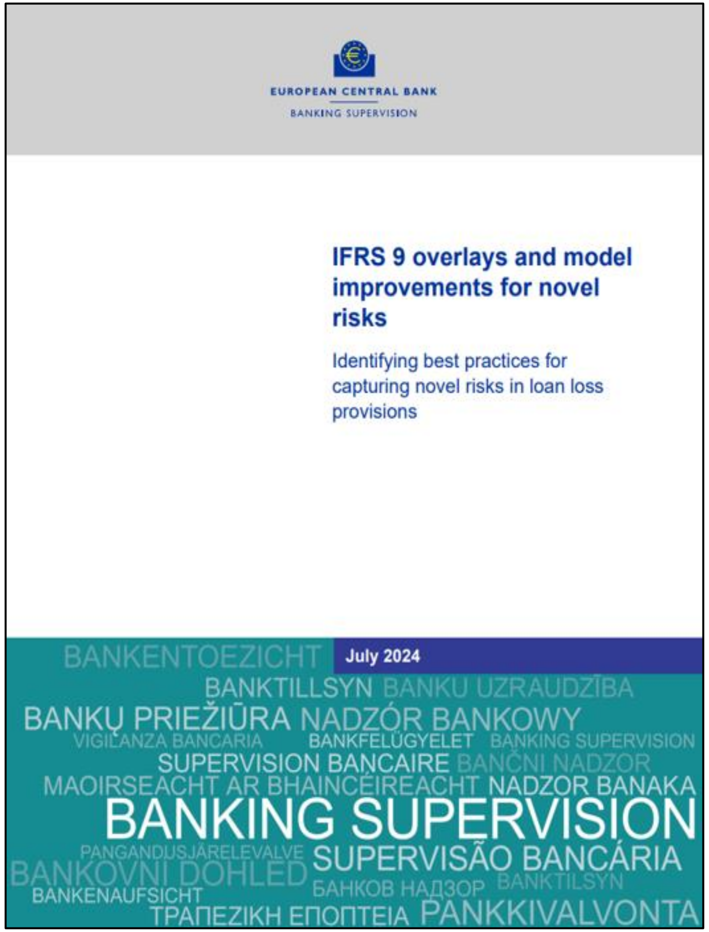


- **Running costs for developing, operating and maintaining models**
  - **Technology and Infrastructure**: Software licenses, hardware, cloud services and data storage solutions
  - **Personnel**: Budgets for data scientists, quantitative analysts, IT specialists and others who develop, maintain and validate the models
  - **Data Acquisition and Management**: Acquire, collect, clean and manage vast amounts of historical data to develop and test models
  - **Regulatory Compliance and Reporting**: Expenses related to reporting to regulatory bodies and ensuring adherence to evolving guidelines
  - **Continuous Improvement**: Costs for ongoing research, updates to models based on new regulations or market conditions and performance monitoring

“Vigilance Meets Vision”: Credit Risk

IFRS9

A **growing focus on IFRS9 models**, and their validation processes, is also being observed in the EU.



Documentation

Comprehensive documentation with clear articulation of supporting analysis and justification on each key decisions and applied assumptions

Forward Looking element

Macroeconomic assumptions developed with focus on **emerging risk/novel risk**

Less reliance of overlays without thorough analysis

Enhancement of scenarios analysis with consideration of sectoral differences and potential non-linear effects of shocks

Model Testing

Extension of scope of model testing, no more restricted to certain parameters, such as 12-month PD and including other critical components such as LGD and EAD

Enhancement of **follow-up and remediation activity** to tackle model deficiencies revealed by back-testing

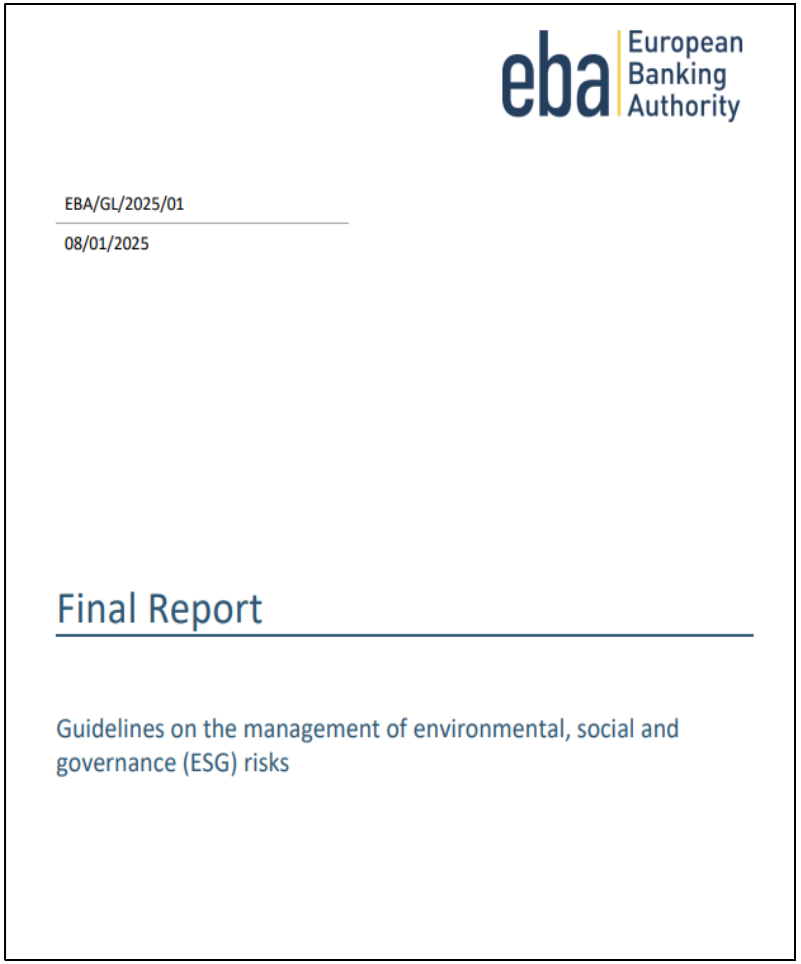
Model Validation

Enhancement of **validation requirements** to IRB standard with comprehensive guidelines

Trend to have internal validation **review scenarios** to have the end-to-end ECL computation covered

“Vigilance Meets Vision”: Credit Risk

Climate and Environment-related Risks



European Banking Authority

EBA/GL/2025/01

08/01/2025

Final Report

Guidelines on the management of environmental, social and governance (ESG) risks

Identified as a key SSM priority for 2025-2027, the topic of **CER and its embedment into banks’ ICAAP and Risk Appetite** is a key focus area.

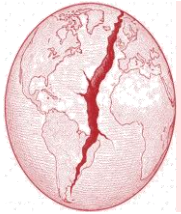
- Reflect the potential impacts of CER drivers on **capital adequacy considering capital needs and supplies**, as well as all expected and unexpected losses
- Assess how CER drivers impact the **sustainability of banks’ business model** under the economic and normative perspective, taking into consideration the long-term perspective and strategic planning
- Reinforce the links between the **risk identification, risk assessment, scenario generation, and capital allocation** surrounding CER
- Ensure clarity on CER assessments in banks’ **Capital Adequacy and Risk Appetite statements**, and how the are reflected in the overall decision-making process
- Strengthen the CER **stress testing framework** by (i) ensuring coverage of relevant time horizons and (ii) centering scenarios on banks’ specific risk profiles (client concentration, exposed business lines and product types, geographical concentration in exposures or collateral, etc.
- Continued efforts to collect **Energy Performance Certificates** for enhanced risk identification and monitoring

“Vigilance Meets Vision”: Credit Risk

Conclusion

- Total assets of EU-headquartered credit institutions stand at around €35 trillion, **twice the size of the EU’s GDP**.
- In the US, 80% of corporate funding comes from capital markets. **In the EU, over 70% comes from banks**.
- ➢ Credit is **BIG** in the EU.

- In 2014, EU banks carried €1 trillion in NPLs. Despite growing loans and many uncertainties, **that number has been brought down by two-thirds**.
- ➢ Recovery from GFC and EU crisis, as well as prolonged periods of low interest rates, were key. **Credit risk management was also a potent actor**.



- In the aftermath of the Russia-Ukraine conflict, EU banks had to **unwind €70 billion in exposures almost overnight**.
- Over 50% of **global sanctions** since 2014 have been financial: freezing assets, cutting off credit flows and blacklisting borrowers.
- EU banks have over €300 billion in exposures to China, and **EU corporates rely on China for over 90% of rare earth imports**.
- EU countries plan to **raise defense spending by €400 billion by 2030**. Much of this will be debt-financed.
- ➢ Geopolitics has erased years of business strategies and weaponized credit. It is also becoming a **key driver of sovereign credit risk**.

- The ECB estimates that, without transition, **climate change could wipe out 10% of EU banks’ loan books** by 2050.
- With the current pathway, **losses for banks could be almost three times higher** than they would be under a Paris-aligned scenario.
- ➢ Credit risk is no longer just about analyzing financials and keeping up with the news. And **weather forecasts** are no longer only for weekend plans.

- Both **slow-moving** (15% drop in RRE prices in two years) and **fast-moving** (20% drop in collateral securing lombard loans in two weeks) events.
- ➢ Data-driven credit risk management, backed by robust models and informed by stress testing, is a **top priority** for data, credit and risk programs.