Q&A

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Risks to the financial sector becoming increasingly complex and interrelated

What are the key financial stability risks and the main vulnerabilities in the financial sector at the EU level in the context of lasting very low interest rates, the deterioration of credit risk, the inflationary pressures, and very accommodative fiscal policies?

There are three areas I would highlight in terms of financial stability risks are: the banking system, the corporate debt markets, and sovereign debt.

The European banking sector has come through the pandemic in reasonable health. Capital has increased rather than declined, asset quality has continued to improve rather than deteriorate (in view of NPL ratios), liquidity is abundant, earnings are strong. While yields are rising at the long end in response to higher inflation expectations, we don't expect policy rates to budge any time soon. While this creates an element of continued earnings pressure, it also supports asset risk. As a result, we see credit risk in the banking system as well contained.

In the public debt markets, and also in the fast-growing private debt markets, it's a different story. Although corporates have tended to hoard cash, meaning net debt has not increased much, there has been rapid expansion of lower grade corporate credit, with weak contracts and covenants. These risks are better handled outside the banking system, and paradoxically push default risk out, but still result in greater risk for investors. It's government balance sheets that have seen the biggest change, bearing the brunt of the pandemic response. This creates a political challenge, but it's not yet a major financial one. This is thanks in part to those low interest rates which mean that debt service has continued to improve even while debt has increased.

The key financial stability risk could be a sudden risk aversion resulting in a correction in financial markets, spilling over into real assets like property and ultimately the real economy.

From Moody's analysis and conversations with CEOs/ market participants/ investors, how well do you think the financial sector is prepared to face these vulnerabilities?

Overall, the financial sector has come through the pandemic in much better health than it did following the Global Financial Crisis. We believe the European banking sector is well placed and any deterioration in asset quality and capitalisation should be modest. Given the critical role of banks in funding businesses in Europe, this gives us confidence that the private sector recovery should continue as public health measures ease and normal business activity resumes. At the same time, however, more progress is needed to boost disintermediated finance in Europe, and more broadly to drive the Capital Markets Union agenda.

Globally, there is a continuing shift towards disintermediated finance, which gives businesses access to a wider range of funding sources. However, Europe remains heavily reliant on banking. Boosting disintermediated finance presents significant opportunities for Europe as a whole; given that the EU is a net exporter of capital, it could be a stronger incentive for the private sector to keep funds in Europe, driving private sector investment and tangible increases in living standards. Such private funding flows would complement the planned Next Generation EU initiative, amplifying the benefit for businesses and citizens alike.

Beyond pure financial risks and vulnerabilities, a major focus for the financial sector more specifically, and corporate sector generally, is the transition to net zero. This will be an enormous undertaking for many companies. Do you think the financial sector has the

capabilities to meet these transition commitments and how can the financial sector support the transition to net zero of other sectors as well?

We have a collective responsibility when it comes to supporting the transition to net zero. Companies and governments worldwide are increasingly aligned around the goal of addressing the climate crisis. The financial system has a significant role to play in repricing climate risk and supporting sustainable investments that align with a lower carbon future and enable solutions to climate change.

Few issues are poised to multiply risk – or opportunity – more dramatically in capital markets than climate change. The economic benefit from the transition to a climate resilient, zero-carbon economy could amount to nearly a 25% cumulative gain in GDP over the next two decades alone, compared with a scenario in which the world fails to act. This is equivalent to adding the current Italian or Canadian economy to the global economy each year over this period and creates a €40 trillion investment opportunity for those able to take advantage of it. When it comes to financial institutions, first they need to know where their customers are on the net-zero journey, and then they can assess how they can help customers along the way.

More disclosure will provide better data which will ultimately drive better decisions. Proper accounting and disclosure of greenhouse gas emissions is foundational, with regular reporting to track changes in emissions for every borrower.

Where banks' role will be most important, however, is in financing the transition. Corporations may need finance to retrofit production facilities, decommission high-emitting assets or invest in energy efficiency.

The faster the transition to net zero, the lower the costs will be. Across the G-20, financial firms hold around €20 trillion in loans and investments subject to carbon transition risk. Over the coming years, they will need to ramp up climate risk assessments and set clear goals for reaching net zero in their financed emissions. They will need to invest in green businesses and new technologies. They will have to fund the capital needs of companies in carbon-intensive sectors who are aligning their business strategies with low-carbon business models. A delayed and disorderly carbon transition poses the greatest risk to financial firms.

Cyber security and cyber resilience are themes that are preoccupying the financial services sector as much as any other type of risk. How do you see this category of risks from the perspective of a global risk assessment company? What are the most significant vulnerabilities in this regard and how well set up do you think the financial sector is?

These are real concerns and we have seen that cyber risk is increasing in frequency and severity. We have identified 13 industry sectors as facing medium-high or high risk to cyber, which account for total rated debt exceeding €17 trillion.

The four most at-risk sectors are banks, securities firms, market infrastructure providers, and hospitals – all of which rely heavily on technology for operations, content distribution, or customer engagement. The financial services sector handles extensive customer and proprietary data, are custodians of customers' wealth, and facilitate transactions across critical financial infrastructure. All of this makes them ripe targets for cyberattacks. However, these firm also have fairly strong cyber-preparedness, an essential risk mitigant, and have been leaders in enhancing cyber strategy and investing in cyber defences, processes and talent, as detailed the findings from our recently published survey of 88 rated banks across the globe.

From a cyber risk perspective, we see vulnerabilities directly or indirectly related to banks. Changing behaviours pose new cyber risks - remote and hybrid work arrangements have made cyberattacks easier and more attractive for cybercriminals. Greater demand for and dependence on digital banking technology has increased the risk of successful cyberattacks. Cybersecurity talent gap is growing, vulnerabilities to supply chain attacks highlight the need for deeper assessments of supplier cyber risk, and finally, cyber insurance is poised for change as premiums continue to climb, while the scope of coverage narrows.

From a resilience perspective, banks report having sound cyber governance practices. In addition, regulatory scrutiny will continue to help mitigate cyber risk and mandates around disclosure rules will increase.

A key issue with cyber risk is the fact that financial markets have very little ability to quantify cyber risk. And in the face of future unknowns, resilience is probably more essential than preparedness. Cultivating resilience involves building capabilities within an organization to navigate cyber-attacks. Widening the aperture on cyber security from working to prevent attacks to building greater resilience for when the attack happens will be crucial.