2023 EUROPEAN SUPERVISORY EXAMINATION PROGRAMME (ESEP) FOR PRUDENTIAL SUPERVISORS

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EUROPEAN BANKING AUTHORITY

Contents

Abbreviations

AML/CFT	Anti-money laundering and countering the financing of terrorism
BCBS	Basel Committee on Banking Supervision
BCP	Business Continuity Plan
CA	Competent Authority
CRD	Capital Requirements Directive
EBA	European Banking Authority
EREP	European Resolution Examination Programme
ESEP	European Supervisory Examination Programme
ESG	Environmental, Social and Governance
ESMA	European Securities and Markets Authority
EU	European Union
GDP	Gross Domestic Product
G-SIB	Global Systematically Important Bank
ICT	Information and communication technology
IFRS	International Financial Reporting Standards
ML/TF	Money laundering/terrorist financing
NPL	Non-performing loans
SEP	Supervisory Examination Programme
SREP	Supervisory Review and Evaluation Process
USSP	Union Strategic Supervisory Priorities

Executive Summary

The EBA launches annually the European Supervisory Examination Programme (ESEP) for prudential supervisors to drive supervisory convergence in the context of the supervisory review and evaluation process (SREP) across the European Union.

All CAs are expected to pay close attention to the key topics put forward by the 2023 ESEP when developing their 2023 supervisory priorities and supervisory examination programme (SEP) for the institutions that they supervise and implement these key topics in their supervisory activity throughout the year, taking into account the principle of proportionality. Colleges of supervisors are also expected to implement these key items in their work and discuss the relevant supervisory assessments, which should lead to more consistency in SREP reviews and their outcomes also in the context of cross-border groups.

The economic rebound that followed the easing of the sanitary restrictions by various countries have been followed by a new episode of economic uncertainty caused by the Russian invasion of Ukraine and the respective geopolitical situation. Thus the 2023 ESEP is primarily driven by these considerations. The long-term effects of the pandemic on the banking sector amplified by implications of the Russian invasion of Ukraine together with other emerging elements of risks have considerable impact on institutions' asset quality and challenge their business plans and strategies.

Based on these considerations, the four key topics identified for 2023 are 1) Macroeconomic and geopolitical risks, 2) Operational and financial resilience, 3) Transition risks and 4) Money-laundering and terrorist financing (ML/TF) risks in SREP and internal controls/governance.

The 2023 ESEP ensures a balanced approach between newly emerging risks as well as "ongoing" topics that had already been included in preceding ESEP(s), but which require continued supervisory attention (e.g. operational resilience, digital transformation, ML/TF risks).

The EBA has been mandated through the ESAs` review legislation to also establish Union strategic supervisory priorities (USSPs) to facilitate policy implementation by establishing forward-looking considerations in priority areas. The USSPs set for the 2020-2022 period are *business models' sustainability* and *adequate governance structures*. While the USSPs for the 2023-2025 period are yet to be set, CAs indicated that apart from these two broad areas that remain apposite, the importance of the following areas are growing: i) sustainable and digital transformation and their impact on strategy, transformation and profitability, ii) cyber security, ICT risks and data quality, as well as iii) exposures towards COVID-19 vulnerable sectors, and iv) prevention of unmitigated risks in the area of leveraged finance. Most of these priority areas are covered in the proposed 2023 ESEP and the question, should these aspects be incorporated into the next set of USSPs for 2023-2025, represents a valid starting point for the next USSPs cycle.

About the ESEP

According to its founding regulation, the European Banking Authority (EBA) shall contribute to enhancing supervisory convergence across the internal market, including in the context of the supervisory review, and it shall play an active role in building a common supervisory culture and consistent supervisory practices throughout the Union[1].

In the context of enhancing supervisory convergence in the SREP, the Capital Requirements Directive (CRD)[2], in Article 107, requires the EBA, i) to develop common procedures and methodologies for the supervisory review; as well as to ii) report annually on the degree of convergence of supervisory practices to the European Parliament and the Council.

The annual ESEP forms part of the EBA convergence toolkit, which allows the EBA to promote convergence by selecting key topics for prudential supervisory scrutiny and implementation for the upcoming year that i) rely on the outcome of the EBA's risks and vulnerabilities assessment, ii) refer to recent and/or relevant policy areas to be implemented, and iii) take into account the practical experiences and observations of CAs. The EBA aims at enhancing the level of convergence in supervisory practices with the ESEP as it is expected to shape CAs practices concerning the supervision of the selected key topics.

The EBA will follow-up on how the key topics, put forward in this document, are i) reflected in CAs' supervisory priorities for 2023 as well as ii) implemented in CAs' supervisory activities throughout the year. Supervisors are encouraged to explore interaction between the key topics in their SEP.

The EBA defines convergence *as a process for achieving comparable supervisory practices in Member States which is based on compliance with the EU rules, and which leads to consistent supervisory outcomes*. Thus, the EBA`s monitoring of the implementation of the 2023 ESEP will also follow the *"Compliance - Comparability – Consistency"* perspectives. The EBA will use the most appropriate convergence tools at its disposal to conduct the assessment, in particular questionnaire, and desk-based review and interviews with CAs, as applicable. The EBA, through its participation in supervisory colleges, will also monitor the level of implementation in the work of colleges. The observations collected will feed into the overall conclusions on the degree of convergence of supervisory practices.

The topics in the 2023 ESEP are listed according to their importance and relevance for the 2023 prudential supervisory work, which supports CAs in focusing their attention. At the same time, if the quickly changing economic and market conditions would warrant the (re)prioritisation of tasks or the reallocation of supervisory resources to other, prominent risks and vulnerabilities in 2023,

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[1] Article 1(fa) and Article 20 and 29 of Regulation (EU) No 1093/2010 establishing a European Supervisory Authority (European Banking Authority), amending Decision No 716/2009/EC and repealing Commission Decision 2009/78/EC.

[2] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

the convergence follow-up will acknowledge that, just as the annual convergence report. The convergence cycle also creates a feedback loop, i.e. the conclusions from the previous cycles feed into the selection process for the upcoming year.

The EBA sets examination programme for resolution authorities

The EBA follows a consistent approach in driving convergence in prudential supervision as well as in resolution. Therefore, the EBA sets, in parallel to the annual ESEP, the European Resolution Examination Programme (EREP) which aims at enhancing convergence across the resolution cycle.

Key topics identified for the 2023 ESEP

Priority 1 — **Macroeconomic and geopolitical risks**

- Impact of the Russian aggression against Ukraine and the legacy of the COVID-19 pandemic
- Interest rate rises, inflation risk, and related asset price corrections

Priority 2 — **Operational and financial resilience**

- Operational resilience (ICT risks and risk data aggregation, ability to face crisis)
- Financial resilience (Appropriate staging and adequate provisioning, stress testing capabilities)

Priority 3 — **Transition risks**

- Digital transformation
- ESG factors and risks

Priority 4 — **ML/TF risks in SREP and internal controls and governance**

- ML/TF risks in SREP
- Internal controls and governance in the context of sanctions

1. Macroeconomic and geopolitical risks

Focus areas:

- **Impact of the Russian aggression against Ukraine and the legacy of the COVID-19 pandemic**
- **Interest rate rises, inflation risk, and related asset price corrections**

Recent economic developments, including a slower economic growth, elevated inflation as well as rising interest rates may negatively impact institutions, market participants, as well as the creditworthiness of borrowers, and ultimately credit quality. This might not least be affected by the Russian aggression against Ukraine, but also other geopolitical and macroeconomic developments, including any further impacts[3] from the pandemic, which is not yet over.

The close monitoring of the impacts on asset quality will continue to be a key part of the supervisory activities in 2023, in particular focusing on asset concentrations to **pandemic-strained sectors and/or energy-intensive sectors** and highly indebted households and companies, that are particularly vulnerable to rising energy costs and increasing borrowing costs. Steady rise in interest rates coupled with elevated and persistent inflation, may cause a portion of the borrowers not being able to pay back their debt. In addition**, commercial and residential real estate** financing could also be impacted via the potential asset price reductions that lead to a lower value of the collateral, as well as **sovereigns** which might be challenged by these changing conditions, in particular in the context of the refinancing of their debts**.**

Institutions need to adapt their credit risk management practices, ensuring timely identification and mitigation of potential deterioration in asset quality and CAs need to assess whether this

[3] Notably from supply chain's disruptions.

also includes the adequate classification of affected sectors and clients, and the timely identification of potential forbearance measures and similar (cf. Priority 2, ‘Operational and financial resilience’).

Not only borrowers could be impacted by the current uncertain geopolitical and macroeconomic environment and related spill-over effects (including a possible recession), but they also carry considerable risk for institutions’ business model and profitability. Institutions might need to **adjust their strategy and business model** quicker and more often amid rising geopolitical risks and quickly changing political environments. Supervisors should ensure that institutions understand and address the challenges related to rising geopolitical risks and are able to react timely and adjust their strategy and business models, including deleveraging of exposures towards potentially politically high-risk countries.

In addition, interest rates started to rise in 2021, with increases on a broader basis in 2022. Institutions need to consider **all aspects of the rates’ rises** and project and mitigate the risks stemming from them, including the increasing funding costs as interest rate volatility impacts institution’s funding conditions. Supervisors should review institutions` management actions, in particular, if funding plans have been updated, also with a view to the diversification of funding sources. Profitability is impacted by the financing of the fixed rate lending contracts at higher funding rates and when institutions start to roll over expiring long-term central bank’s funding facilities and should therefore be addressed through a proper **interest rate risk management**. Interest rates and credit spreads shocks may exacerbate the likelihood of a **repricing risk** in bonds or in equity markets. It is essential that institutions are prepared to cope with such potential trends. CAs are therefore expected to ensure that institutions have adequate monitoring of such **interest rates and credit spreads shocks** and prepare to withstand them both in their trading and banking books. Volatility in asset prices and potential further asset repricing will impact individual institutions differently, based on the composition of their asset portfolio.

The inflationary pressure poses challenges for banks, among them the increasing operating costs, which is a growing concern for supervisors. While rising interest rates could improve the prospects for interest income in an environment of increased inflation, interest and non-interest expenses too are being driven up. Supervisors therefore should assess institutions` cost management to cope with these challenges.

2. Operational and financial resilience

Focus areas:

- **Operational resilience:**
  - **ICT risks and risk data aggregation**
  - **Ability to face crisis → recovery planning**
- **Financial resilience:**
  - **Appropriate staging and adequate provisioning**
  - **Stress testing capabilities**

Operational resilience

- **ICT security risk**: cyber risk and other external ICT-related threats have become increasingly relevant with the outbreak of the pandemic and the expanded use of on-line channels, thus supervised institutions and Competent Authorities should pay increasing attention to ICT security aspects covering **cyber risks, cyber testing, system vulnerabilities, security management and security awareness**, also with respect to outsourced services**.** CAs should investigate whether the information security measures taken by institutions are adequate to mitigate cyber risks and are in line with the requirements set for institutions in the EU by the *EBA Guidelines on ICT and security risk management (EBA/GL/2019/04)*[4] in relation to the mitigation and management of their ICT security risks.
- **ICT availability and continuity risk:** institutions should test (and update) their business continuity plans (BCPs) periodically and at least annually as per the *EBA Guidelines on ICT and security risk management (EBA/GL/2019/04)*. CAs should ensure that institutions actually test their BCPs and demonstrate their ability to sustain the viability of their businesses until critical operations are re-established. The testing should cover procedures to verify the ability of their staff and contractors, ICT systems, and ICT services to respond adequately to the scenarios defined, the adequacy of the scenarios themselves, as well as to effective crisis communication to internal and external stakeholders.
- **Risk data aggregation**: effective risk management and supervision of institutions build both on timely, complete, and accurate data. If information is flawed, the assessment of risks becomes unreliable. Equally important are the consistency and comparability of supervisory data across market participants to ensure consistent microprudential and macroprudential decisions, as well as institutions' ability to collect and aggregate data. Although efforts have been devoted to improving risk aggregation and reporting practices, the progress observed by the BCBS for G-SIBs is still far from satisfactory. For other systemically important institutions or smaller institutions, the assessment could even be less satisfactory. The EBA's observations in supervisory colleges also confirm that weaknesses persist in data quality and aggregation which could endanger the effectiveness of the control functions.

Recovery plans need to take into account newly emerging risks and institutions have to be prepared to adjust their operations quickly – including having back-up solutions in place – in case of a further materialising conflict, pandemic, cyber attack or similar. Outsourced activities must be considered in that context, in particular with regard to the potential effects on the business continuity of institutions and/or their subsidiaries related to the unforeseen interruption in critical services provided by external suppliers (e.g. due to the potential effects of sanctions). Both the COVID-19 pandemic and the Russian aggression against Ukraine

[4] https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Guidelines/2020/GLs%20on%20ICT%20and%20security%20risk%20management/872936/Final%20draft%20Guidelines%20on%20ICT%20and%20security%20risk%20management.pdf

impacted European institutions, one way or the other, and CAs are expected to ensure that respective experiences and lessons learned are considered in the (revision of the) recovery plans, including the consistency of the governance arrangements at the level of institutions/individual subsidiaries as well as the assessment and implementation of the recovery options under different scenarios. Revised plans and processes could benefit from dry-run exercises to reinforce their implementation in crisis situation.

Financial resilience

Institutions not only have to be prepared to withstand emerging risks and shocks from an operational perspective, but also from a financial perspective by setting aside the necessary funds to cover expected losses. In the context of the close monitoring of the implications of the deteriorating macroeconomic environment on asset quality and following the publication of the EBA report on *the IFRS 9 monitoring,* where different practices on the implementation of this standard were identified across European institutions, supervisory attention should be warranted in 2023 on the relevant areas: (i) **staging assessment,** with a particular importance of the application of collective assessment and overlays, (ii) update of the macroeconomic scenarios in models and respective impacts, (iii) expected credit loss measurement, with a particular focus on the usage of overlays, and (iv) classification and measurement, including the aspects related to business model assessment and derecognition. Inadequate accounting practices could lead to undesirable impacts in the regulatory ratios. The supervisory review of the practices applied by institutions in these areas is crucial, notably in the context of the legacy of the COVID-19 pandemic and the Russian invasion of Ukraine.

Notwithstanding the considerable efforts made by European institutions to reduce non-performing exposures (NPEs), it remains essential to verify if institutions **adequately provision such exposures** and have proper models in place for the estimation of such provisions. The EBA's *IFRS 9 benchmarking exercise* will support CAs in challenging institutions' models in this regard. Realistic and updated strategies for the resolution of NPLs should be in place. The *EBA Guidelines on management of non-performing and forborne exposures (EBA/GL/2018/06)*[5] provide CAs with the necessary and effective tools to oversee the management of NPEs by institutions and ensure their timely recognition and provisioning as well as promote supervisory convergence in their treatment across EU institutions. CAs are expected to continue to follow closely the provisions of these Guidelines.

The resilience of institutions should not only be considered in the context of operational resilience but also acknowledging their preparedness to take a forward-looking view in their risk management, that stress testing aims at facilitating. Institutions' **stress testing capabilities** come to the forefront in times of great uncertainties. In the current environment, it is therefore crucial that institutions have sound stress test framework, that CAs should verify. In this context, CAs should rely on the *EBA Guidelines on institutions' stress testing (EBA/GL/2018/04) as well as the second revision of the EBA SREP Guidelines for credit institutions under Directive 2013/36/EU*

[5] https://www.eba.europa.eu/sites/default/documents/files/documents/10180/2425705/371ff4ba-d7db-4fa9-a3c7-231cb9c2a26a/Final%20Guidelines%20on%20management%20of%20non-performing%20and%20forborne%20exposures.pdf.

that will become applicable from 1 January 2023. In particular, it is important to understand whether institutions have a strong governance structure for conducting stress tests and whether the data infrastructure, in particular the data aggregation capabilities, is able to support the execution of this task. Ensuring that the outcomes of the stress testing programmes are channelled into management actions, including the assessment of institution's capital planning, is also key in an uncertain financial environment.

3. Transition risks

Focus areas:

- **Digital transformation**
- **ESG risks in business strategies and in the overall governance framework**

The pandemic fast-forwarded the digital transformation within institutions, along with an increase in digitalisation projects. The transition to a business model including ESG considerations is also an overarching "risk" for institutions, as for nearly all other industries. Considerable amounts will have to be invested by institutions on an ongoing basis and in the long-term to ensure transition to a sustainable and digitalised economy. Consequently, the respective transition costs will have to be taken into account in the institutions' planning processes.

Setting and overseeing digital transformation strategies are key responsibilities of the management body. These digital strategies, which must be aligned with and be an integral part of institutions' overall business strategies, influence the institutions' overall risk strategies and risk profiles. CAs therefore should review the digital strategy setting process and whether the **collective suitability of the management body** sufficiently reflects adequate knowledge of digital transformation opportunities and threats, and whether the **management body in its management function** drives and implements the digital strategy, while the **management body in its supervisory function** monitors and constructively challenges it. This is to ensure that adequate capital and human resources are foreseen to support the strategy implementation and **that the investment spent on digital efforts achieves actual transformations**, i.e. not only impacts on internal workflows[6] and outsourcing arrangements, and facilitate a more customer-centric approach, including new products and services designed to fulfil current and foreseen customers' expectations. Supervisory attention is also warranted to assess whether the digital transformation is driven by sufficient agility and innovation culture, while the institutions are equipped with appropriate risk awareness to identify and manage new emerging risks.

Supervisory attention should also be warranted on the **impact of the implementation of institutions' digitalisation strategies on the business model and risk profile** and on how institutions measure the success of their digital strategy by developing adequate metrics[7] and extracting adequate financial data to build up their cost-benefit analysis. Institutions should perform adequate cost-benefit analysis, along with risk/control assessments, to understand the

[6] Including legacy systems.

[7] e.g. revenue streams, metrics to measure customers' experience and satisfaction, etc.

potential impacts and risks entailed by accelerating their digital strategies.

In the short-term, ESG risks-related considerations are expected to be incorporated in strategies, objectives and governance structures; institutions must manage these risks as drivers of financial risks, so these **aspects already put forward by the 2022 ESEP remain in the supervisory focus for 2023**. While the tools, methodologies and practices are still under development, it is important that CAs continue to monitor institutions' efforts to appropriately **reflect ESG risks in their business strategies, governance and risk management processes**. When it comes to the inclusion of sustainability risks in the business strategy and risk management, Competent Authorities should ensure that institutions are **able to identify ESG risks and properly reflect them in their risk appetite**. Furthermore, starting from 2023, institutions are expected to start including ESG aspects in their disclosures with the scope of information required to be disclosed gradually increasing over the coming years.

The *EBA Report on ESG risks management and supervision* (published in June 2021)[8] emphasises the importance for institutions of proactively considering ESG risks when assessing, designing, or modifying their business model and strategies, notably due to the impact ESG factors may have on the institutions' financial resilience in the short, medium and longer-term horizon. In that context, CAs are expected **to promote institutions' understanding of ESG risks they are exposed to due to their business model** and the key vulnerabilities which may stem from these factors and affect the long(er)-term resilience of institutions.

As part of the overall internal control framework, institutions should have a holistic institution-wide risk management framework which should consider how ESG risks and factors, via various transmission channels, may drive their prudential risks. Thus, **ESG risks and factors should be encompassed in the risk management framework** with appropriate consideration of both financial and non-financial risks. CAs are expected to observe how institutions consider ESG factors and risks, in particular climate-related and broader environmental factors and risks, in their internal governance framework and overall business model. Furthermore, ESG risks resulting from the banks' exposure to economic sectors and jurisdictions particularly vulnerable to violations of international law and human rights, should also receive a special attention of the supervisors.

The *EBA GLs on loan origination and monitoring (EBA/GL/2020/06)* outline specific processes and procedures that institutions should have in place to take into account the risks associated with ESG factors, including processes for assessing and monitoring counterparties' eligibility for sustainable lending. CAs are expected to check that the institutions' **credit strategy is fully aligned and properly reflects their underlying ESG risk appetite** and that responsibilities for implementing and monitoring ESG targets are set.

[8] EBA/REP/2021/18:https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2021/1015656/EBA%20Report%20on%20ESG%20risks%20management%20and%20supervision.pdf

4. ML/TF risks in SREP and internal controls and governance

Focus areas:
- **ML/TF risks in SREP**
- **Internal controls and governance in the context of sanctions**

Considering the potential detrimental impact of ML/TF risks on institutions' financial soundness, the *revised SREP Guidelines (EBA/GL/2022/03)* provide for an integrated approach to consider ML/TF risks from a prudential perspective in the relevant SREP areas, which expected to be incorporated in supervisory practices in 2023.

In the context of the business model analysis, it is important for Competent Authorities to keep in mind that ML/TF risks are not necessarily linked to an institution's size or financial soundness. A financially successful business model could at the same time give rise to ML/TF risks which could impair the viability and sustainability of the business model. The **prudential implications of ML/TF risks linked to the business model** of the institution should be included in the business model analysis CAs undertake on a regular basis, including the key vulnerabilities to which the business model may expose the institution, e.g. excessive concentrations or volatility of high-risk customers and countries (related to ML/TF risks). CAs should consider any indications that the business model, activities or changes thereof give rise to increased ML/TF risks (e.g. deposit taking or establishment or use of legal entities in high-risk third countries) complementing the analysis through interactions with the AML/CFT supervisor, as appropriate.

In the context of the review of the internal governance arrangements, Competent Authorities should consider, as part of their **assessment of institutions' internal governance framework,** whether it encompasses arrangements and mechanisms put in place by the institution to comply with applicable AML/CFT requirements. Competent Authorities should take into account any supplementary information received from the AML/CFT supervisor on the assessment of these arrangements and mechanisms. Conversely, where the Competent Authority's assessment indicates shortcomings in an institution's internal controls and governance framework that give rise to prudential concerns related to ML/TF risks, Competent Authorities should share the outcome of that assessment with AML/CFT supervisor.

In line with the *EBA Guidelines on internal governance* (EBA/GL/2021/05) and *Joint ESMA and EBA Guidelines on the assessment of the suitability of members of the management body and key function holders* (EBA/GL/2021/06), Competent Authorities should assess from a prudential perspective whether the **responsibilities of the management body with regard to ML/TF risks** are being complied with. Competent Authorities should take into account any supplementary information received from the AML/CFT supervisors following their assessment.

Prudential supervisors and AML/CFT supervisors are expected to cooperate closely and exchange information relevant for their respective tasks as per CRD Article 117(5), in particular if they identify shortcomings in the aspects described above. The practical modalities for this cooperation are further set out in the *EBA Guidelines on cooperation and information exchange in the area of AML/CFT* (EBA/GL/2021/15).

Internal controls and governance in the context of sanctions

Regarding the restrictive measures imposed against Russia and Belarus, the EBA, conscious of the prudential risks and implication of its breaches, issued a statement on 11 March 2022 in which it called institutions to i) ensure compliance with these sanctions and to ii) assess the adequacy and effectiveness of internal controls and governance to ensure compliance with these measures and to adapt or enhance their systems and processes, as appropriate. While other Member State authorities are normally in charge of ensuring implementation of financial sanctions, prudential supervisors should verify whether i) institutions reviewed their internal control and governance frameworks and whether ii) such review facilitates the timely implementation of such unprecedented restrictive measures. Coordination and cooperation with the relevant authorities is key in order not to duplicate the work performed by other authorities.

Further considerations

While there are various areas that will warrant the attention of EU prudential supervisors in 2023, the ESEP puts forward the key items that, in the view of the EBA, will be the main driving forces of the institutions' risk profiles in 2023 in the EU.

It is also equally important to channel the institutions' specific considerations into the SREP assessment and dedicate heightened attention to relevant risks and/or risks controls, although not included separately in this document.

An institutions' specific consideration could potentially be institutions' exposures to shadow banking entities as they are generally not subject to the same standards of prudential regulation as regulated entities and do not have access to central banks' liquidity facilities. Competent Authorities should ensure adequate governance and risk management practices with regard to institutions' exposures towards non-bank financial institutions.

EUROPEAN BANKING AUTHORITY

Tour Europlaza, 20 avenue André Prothin CS 30154
92927 Paris La Défense CEDEX, FRANCE

Tel. +33 1 86 52 70 00

E-mail: info@eba.europa.eu

https://eba.europa.eu