EUROPEAN CENTRAL BANK
BANKING SUPERVISION

SSM Supervisory Priorities for 2023-2025

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SSM Supervisory Priorities and strategic planning

Background

- ECB Banking Supervision, in collaboration with the national competent authorities (NCAs) performs every year a **thorough assessment of the main risks and vulnerabilities** faced by significant institutions and defines its **supervisory priorities for the next 3 years**.
- This process also considers the **progress made on the past supervisory priorities** and draws on the outcome of the **Supervisory Review and Evaluation Process** (SREP).

Objectives

- **Supporting the strategic planning** of ECB Banking Supervision
- Delivering **medium-term strategic objectives**
- **Fostering prioritisation and risk-based supervision**
- **Informing our risk tolerance**
- **Providing transparency** and **accountability**

Risk identification and priorities setting process at the SSM

SSM Supervisory Priorities

Set by ECB Banking Supervision, in collaboration with the national competent authorities (NCAs)

Defined annually for three years ahead, but **can be reviewed any time** if warranted by changing risk picture

Based on a thorough assessment of **the main risks and vulnerabilities** faced by significant institutions and **targeting key vulnerabilities**

Mechanism for **coordinating and prioritising supervisory actions** across the SSM and ensuring **risk-based supervision**

Communicated to the public - transparency and accountability of the supervision

Supervisory priorities for 2023-2025

Priority 1: Strengthening resilience to immediate macro-financial and geopolitical shocks

Shortcomings in credit risk management, including exposures to vulnerable sectors	Credit risk
Lack of **diversification in funding sources** and **deficiencies in funding plans**	Funding risk

Priority 2: Addressing digitalisation challenges and strengthening management bodies' steering capabilities

Deficiencies in **digital transformation strategies**	Business model
Deficiencies **in operational resilience frameworks**, namely IT outsourcing and IT security/cyber risk	Operational risk
Deficiencies in **management bodies' functioning** and steering capabilities Deficiencies in **risk data aggregation and reporting**	Governance

Priority 3: Stepping up efforts in addressing climate change

Material exposures to **physical and transition risk drivers**	Climate-related and environmental risk

+ 2023 EU-wide stress test exercise

Priority 1: Strengthening resilience to the immediate consequences of macro-financial and geopolitical shocks

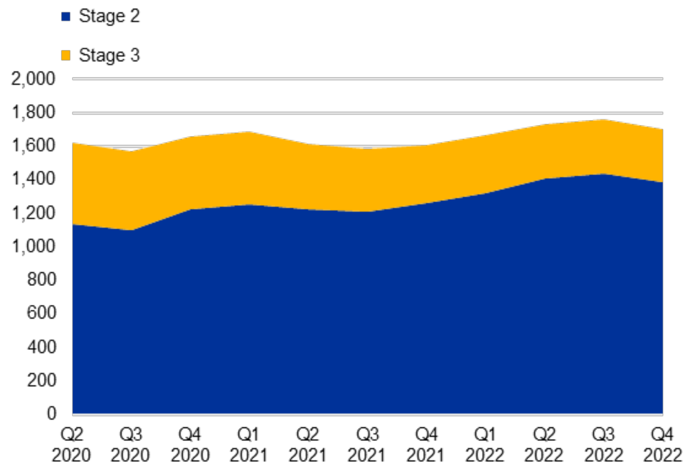
Prioritised vulnerability: Shortcomings in credit risk management, including exposures to vulnerable sectors

Banks should address deficiencies in their credit risk management frameworks to enable them to swiftly identify and mitigate any build-up of risks and strengthen accordingly their resilience to potential asset quality deteriorations.

Key planned activities:

- Targeted reviews on loan origination and monitoring, and IFRS9
- Follow-ups on residual issues identified in the “Dear CEO letter” (e.g. on UTP and forbearance)
- On-site inspection (OSI) campaigns on IFRS9 and commercial real estate
- Targeted OSIs on energy and/or commodity traders
- Internal model investigations and follow-up by JSTs

Volumes of banks’ stage 2 and stage 3 loans
(Q2 2020 – Q4 2022; EUR billions)



Source: ECB Supervisory Banking Statistics.
Note: Changing sample of institutions, comprising 111 SIs as of 2022Q4.

Asset quality deterioration has not materialised so far, but levels of stage 2 loans remain higher than in 2021 reflecting the build-up of risks. At the same time, supervised banks’ provisioning does not seem to reflect recessionary risks.

Priority 1: Strengthening resilience to the immediate consequences of macro-financial and geopolitical shocks – cont.

Prioritised vulnerability: Lack of diversification in funding sources and deficiencies in funding plans

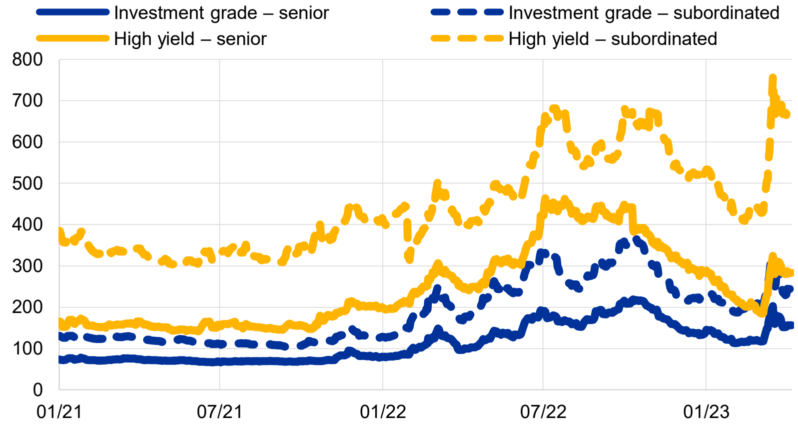
Banks should have sound planning and diversified funding sources to withstand potential funding shocks, also if funding conditions should become less favourable in the future.

Key planned activities:

- Targeted review of TLTRO exit strategies
- Horizontal analysis of banks' liquidity and funding plans
- Targeted OSIs, and JSTs' follow-ups with banks on remedial action plans

Evolution of euro area financial institutions' funding spreads

(01/02/2021 – 10/04/2023; option-adjusted spreads in bps)



Source: Markit iBoxx via the ECB's Statistical Data Warehouse.

Increase in banks' funding costs is visible in the widening spreads of banks' debt instruments.

Priority 2: Addressing digitalisation challenges and strengthening management bodies' steering capabilities

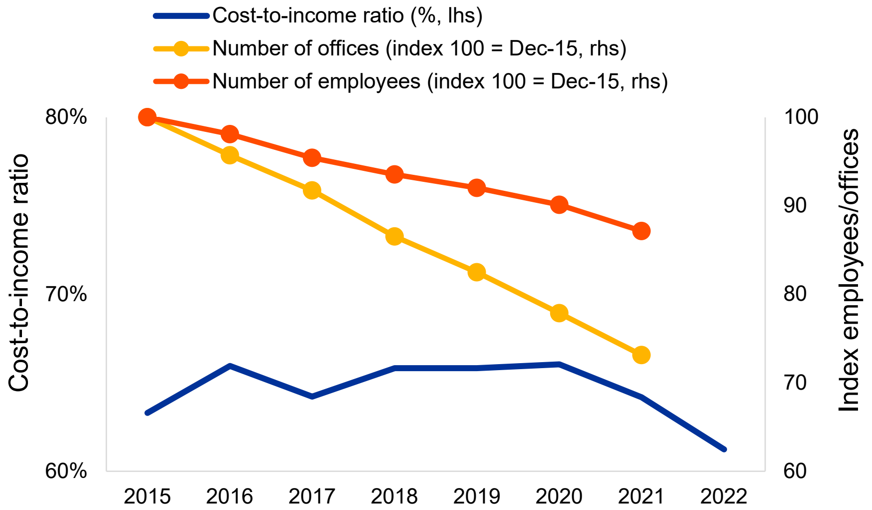
Prioritised vulnerability: Deficiencies in digital transformation strategies

Banks should have sound strategies and adequate arrangements in place to address the challenges posed by innovative technologies.

Key planned activities:

- Publication of supervisory expectations
- Targeted reviews on digital transformation strategies and the use of innovative technologies
- Targeted OSIs on digital transformation strategies

Measures of SIs' cost reduction efforts
(2015 – 2022; index)



Sources: ECB Supervisory reporting and Banking Structural Financial Indicators.
Notes: Cost-to-income time series considers a changing sample of institutions, which comprises 111 SIs as of end-2022. ECB SSI database includes euro area (changing composition) institutions, and number of branches refers to domestic branches.

Structurally high and sticky cost-to-income ratios reveal the need to continue streamlining banks' cost structure.

Priority 2: Addressing digitalisation challenges and strengthening management bodies' steering capabilities – cont.

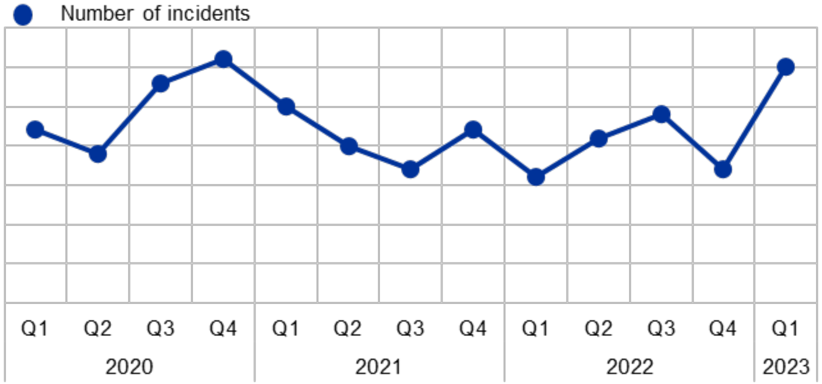
Prioritised vulnerability: Deficiencies in operational resilience frameworks, namely IT outsourcing and IT security/cyber risks

Banks should have robust outsourcing risk arrangements, and IT security and cyber resilience frameworks to be shielded against disruptions of the critical activities and of services they provide to the economy.

Key planned activities:

- Data collection and horizontal analysis of outsourcing registers
- Targeted reviews of outsourcing arrangements, cybersecurity measures and IT risk controls
- Targeted OSIs of outsourcing and cyber security management

Cyber incidents reported to the ECB
(2020 Q1 – 2022 Q3; units)



Source: ECB cyber incident reporting framework.

After remaining at a similar level throughout 2022 compared to 2021, the number of reported cyber incidents has increased substantially in Q1 2023.

Priority 2: Addressing digitalisation challenges and strengthening management bodies' steering capabilities – cont.

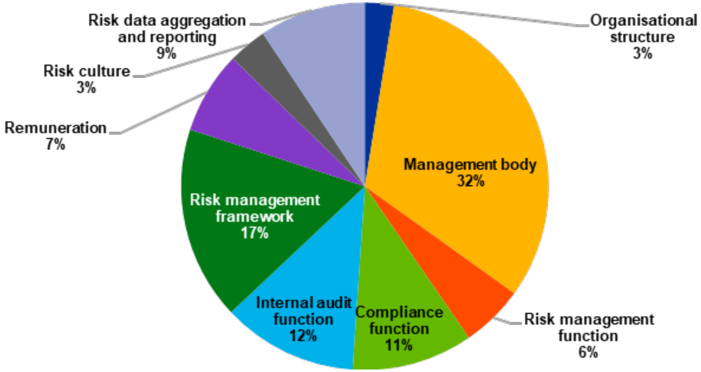
Prioritised vulnerability: Deficiencies in management bodies' functioning and steering capabilities

Banks should strengthen the composition and oversight capabilities of their boards. Better strategic steering capabilities will help addressing the challenges stemming from the constantly evolving environment in which banks operate.

Key planned activities:

- Targeted reviews and OSIs on the effectiveness of banks' management bodies
- Update and publication of supervisory expectations on governance and risk management

Breakdown of SREP 2022 qualitative measures relating to internal governance and risk management



Source: ECB (SREP database). Notes: 2022 SREP values based on 101 decisions. This chart does not include weaknesses which may have already been addressed by supervisory actions outside of the 2022 SREP cycle. One qualitative measure could be allocated to several subcategories.

Concerns in the area of management body are visible in a high share of SREP 2022 qualitative measures, targeting almost half of the significant institutions

Priority 2: Addressing digitalisation challenges and strengthening management bodies' steering capabilities – cont.

Prioritised vulnerability: Deficiencies in risk data aggregation and reporting (RDAR)

Banks should set up proper risk data aggregation and reporting frameworks to serve as a basis to make well-founded decisions. This also pays off in times of crisis when critical decisions need to be taken rapidly.

Key planned activities:

- Refinement and communication of supervisory expectations on risk data aggregation and reporting principles
- Targeted engagement, horizontal analysis and OSIs for banks with persistent shortcomings
- Extension of the 2022 OSI campaign on risk data aggregation and reporting

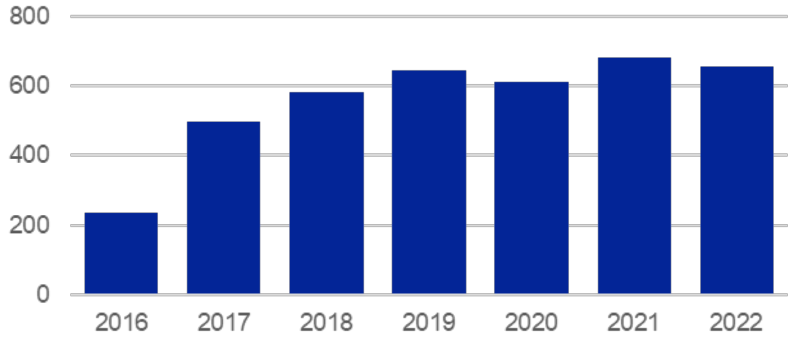
RDAR still a challenge …

Adequate RDAR capabilities still the exception and full adherence to BCBS 239 principles yet to be achieved:

- **Fragmented and non-harmonised IT landscapes** slow down the production of accurate reports, especially non-standardised ones;
- **High costs limit management bodies (MB) incentives** to undertake/ prioritise required investments leading to slow progress of remediation programmes;
- **Limited knowledge and expertise at MB level** undermines the remediation of RDAR issues.

As a result, the number of the respective outstanding supervisory measures has remained broadly unchanged in the last years, indicating sluggishness in banks' response.

Total open supervisory measures* in the area of RDAR



Source: ECB (SREP database).
*Total open supervisory measures computed as the difference between cumulative open measures and cumulative closed measures.

MBs need to increase their awareness and efforts to remediate weaknesses

- In line with Art. 74 of CRD and its national transpositions as well as the EBA guidelines*, **SSM expects that banks improve their data aggregation and reporting arrangements within reasonable time**. A bank's ability to manage risk-related data has a significant impact on its overall risk profile and the sustainability of its business model;

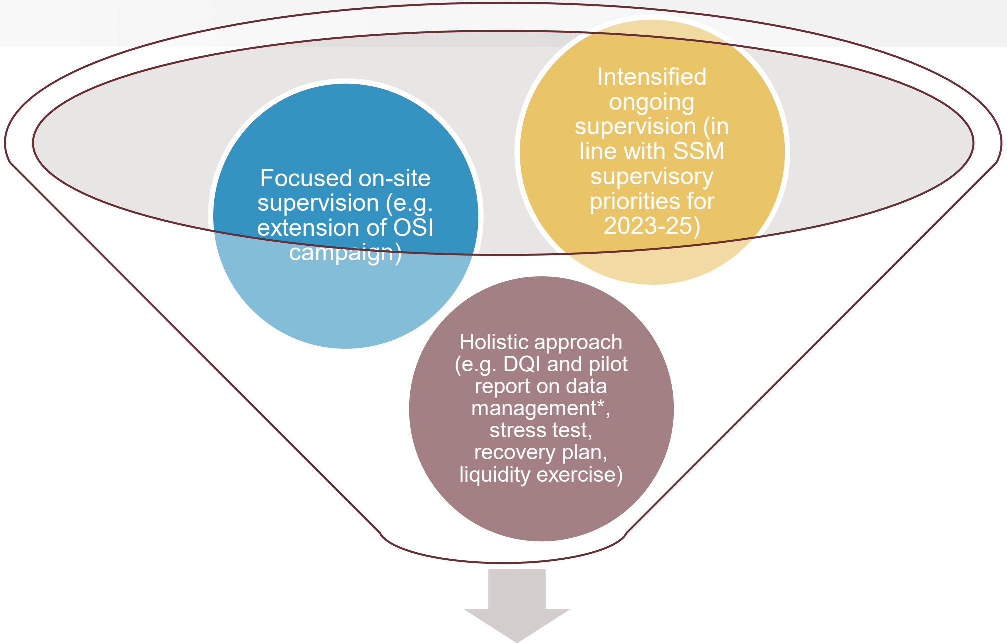
- Thus, the SSM expects that **MBs prioritise the remediation of RDAR issues** and increase their (collective) knowledge as necessary;

- Moreover, **ensuring adequate project management** is key to control execution risk;

Future supervisory efforts will target these root causes. The SSM will also refine and communicate to banks the supervisory expectations on RDAR.

*Guidelines on internal governance under Directive 2013/36/EU
Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing

Increased supervisory scrutiny and escalation of supervisory pressure



Increased emphasis on structured **escalation** of supervisory interventions, using all options of the supervisory toolkit, including **enforcement measures and sanctions.**

* Current DG-S/SUP initiatives. DQI stands for data quality indicators.

Priority 3: Stepping up efforts in addressing climate change

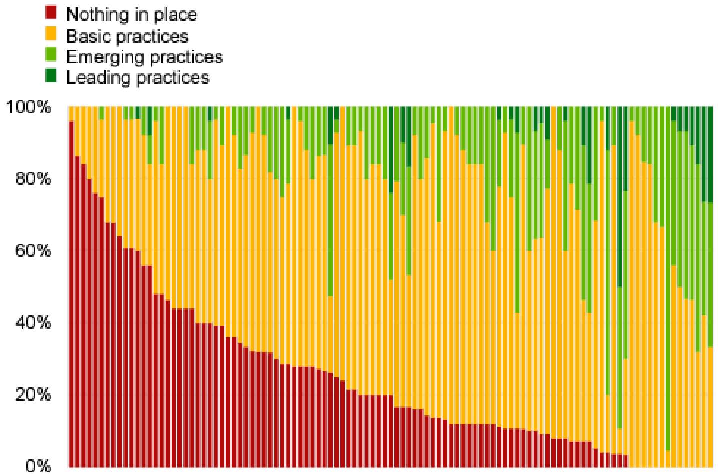
Prioritised vulnerability: Material exposures to physical and transition risk drivers

Banks should take action and adequately address climate-related and environmental risks in their strategies, risk management practices and decision-making processes. They can also play a vital role in financing the transition to a greener economy.

Key planned activities:

- Targeted follow-ups on shortcomings from 2022 climate risk stress test and thematic review
- Review of banks' compliance with new ITS and Pillar 3 requirements
- Deep-dives on reputational and litigation risk
- Preparatory work for reviews of banks' transition planning capabilities
- Targeted OSIs

Bank-by-bank results of the 2022 thematic review
(gaps vis-à-vis supervisory expectations by institution, percentages)



Source: ECB, "Walking the talk - Banks gearing up to manage risks from climate change and environmental degradation".

Notwithstanding the development of some good practices, supervised institutions fail to meet supervisory expectations in the area of C&E risk.

Conclusion

- While banks remained resilient up to now, risks to the sector have increased significantly, calling for extreme caution on the side of banks and supervisors.
- The supervisory priorities set out in 2022 remain broadly valid. Some adjustments, however, are warranted to address emerging risks. Currently we are working on the update for 2024-26.
- Follow-up from previous findings and escalation in case banks do not remediate to shortcomings are key.
- In the current highly uncertain environment, ECB Banking Supervision stands ready to revise its priorities should changes in the banking sector risk landscape require it.