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SSM SREP
WHERE ARE WE AFTER THE FIRST TWO EXERCISES?

DRAWING LESSONS FROM THE 2016 SSM SREP
Stocktaking and Outlook

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About **Avantage Reply**

Established in 2004, Avantage Reply (a member firm of Reply) is a pan-European specialised management consultancy delivering change initiatives in the areas of Compliance, Finance, Risk and Treasury.

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1. Abstract

In December 2014, the European Banking Authority (EBA) issued its Guidelines on common methodologies and procedures for the Supervisory Review and Evaluation Process (SREP). They sought to create a standardised and high-quality banking supervision framework across the European Union (EU). The Guidelines were a fundamental prerequisite to increase consistency in prudential supervisory practices. Until then, there had been significant variation in the implementation of the SREP due to a number of factors, including the differences in supervisory resources, banking practices and cultural diversity between countries, and, last but not least, the way that the Basel framework accommodated varying approaches to supervision. The Guidelines, also known as the 'Common SREP', came into effect in January 2016.

Within the Eurozone and in the context of the Banking Union, the European Central Bank's (ECB) Single Supervisory Mechanism (SSM) has developed and introduced the so-called 'SSM SREP' based on the aforementioned Guidelines. The SSM SREP levels the playing field when it comes to supervision of credit institutions within the Banking Union.

Whilst it was initially deployed across all 'Significant Institutions[1]', a proportionate version of the SSM SREP is now being implemented across 'Less Significant Institutions' as well.

Beyond the EBA Guidelines, the SSM SREP also draws on best practices of banking supervisors from participating Member States and marks a new era for banking supervision. Supervisory powers include a wide range of measures, from imposing additional capital and liquidity requirements (including restrictions on dividend payments) to mandating changes in risk management practices, financial and business plans, or Board composition, to name but a few.

This White Paper shares insights on how Eurozone credit institutions have been dealing with the first two SREP exercises. It also shares our understanding of the ECB's current and future expectations. Last but not least, the Paper explores the impact of the changes in supervisory practices and how these have affected and will continue to affect credit institutions in the Eurozone.

1 Within the Banking Union, credit institutions are categorised as 'significant' or 'less significant'. The ECB directly supervises Significant Institutions, whereas the National Competent Authorities (e.g., ACPR, BaFin, Bank of Italy, CSSF, DNB and NBB) are in charge of supervising less significant banks. A credit institution will be considered 'significant' if it meets one of four conditions, including conditions relating to the absolute size of the institution (e.g., the total value of its assets exceeds EUR 30 billion), the size of the institution compared to the economy or financial system of the Member State where it is established, and the significance of its cross-border activities.

2. SREP: Background and Methodology Overview

2.1. BACKGROUND

In her speech on 18 January 2017 at the WHU New Year's Conference in Koblenz, Ms. Danièle Nouy, Chair of the Supervisory Board of the ECB, commented on the first two years of European banking supervision. Ms. Nouy's speech heralded an increased focus on the supervisory review and evaluation process by the ECB. She reminded the audience that it is only two years since the ECB's SSM took the supervisory approaches of 19 different Member States and merged them into one. A case in point is obviously the main tool of banking supervision, i.e., the SREP.

> **In the SREP, we analyse the risk profile of each bank from four angles. We look at the business model of the bank, its governance and risk management, potential risks to its capital position, and potential risks to its liquidity position.**
>
> **Based on our analysis, we determine how much capital the bank should hold above the regulatory minimum. The higher the risk, the more capital the bank should hold as a buffer against potential losses. We can also apply other measures if needed – increased reporting obligations, for instance[2].**

The level of harmonisation achieved by the ECB's SSM since November 2014 is no mean achievement. The ECB developed the SSM SREP based on the 'Common SREP' encapsulated in the EBA's Guidelines issued in December 2014. Until then, the SREP, and the wider pillar 2 components of the Basel framework, varied to a fairly large degree throughout the EU (see **Figure 1**: Diverging ICAAP and ILAAP Practices in the EU). In 2016, after only two years of operations, the ECB managed to ensure that the SSM SREP be based on:

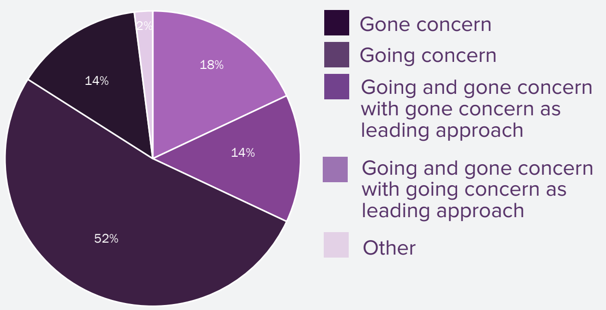
- a common methodology; and
- a common decision-making process allowing for peer comparisons.

As at January 2017, Ms. Nouy can rightly note that the SSM SREP has achieved significant harmonisation, resulting in stronger correlation between a credit institution's risk profile and capital/liquidity requirements. It is of course not the end of the journey. The SSM SREP methodology will continue to evolve, in part in response to changes in the risks faced by credit institutions. In the next few pages, we review where we stand today and the priorities of the ECB for 2017.

***Figure 1:** Diverging ICAAP and ILAAP Practices in the EU[3]*

ICAAP Practices (as of end 2014)

Whilst the majority (52%) of the Member States' credit institutions had a going concern approach for their ICAAP (as would be expected), a large number of institutions had a hybrid approach or a gone concern approach.



ILAAP Practices (as of end 2014)

With the exception of a few Member States, the majority of the EU credit institutions had no formal ILAAP report. However, most of them had internal liquidity reports and frameworks, including some that included a well-documented liquidity risk management section within the ICAAP report itself.

2 "European banking supervision – a necessary innovation", speech by Danièle Nouy, Chair of the Supervisory Board of the ECB, at the WHU New Year's Conference, Koblenz, 18 January 2017
3 SSM SREP Working Session with the ECB on 29 January and 6 May 2015

2.2. METHODOLOGY

2.2.1. Overview of the EBA Common SREP Framework as implemented by the SSM

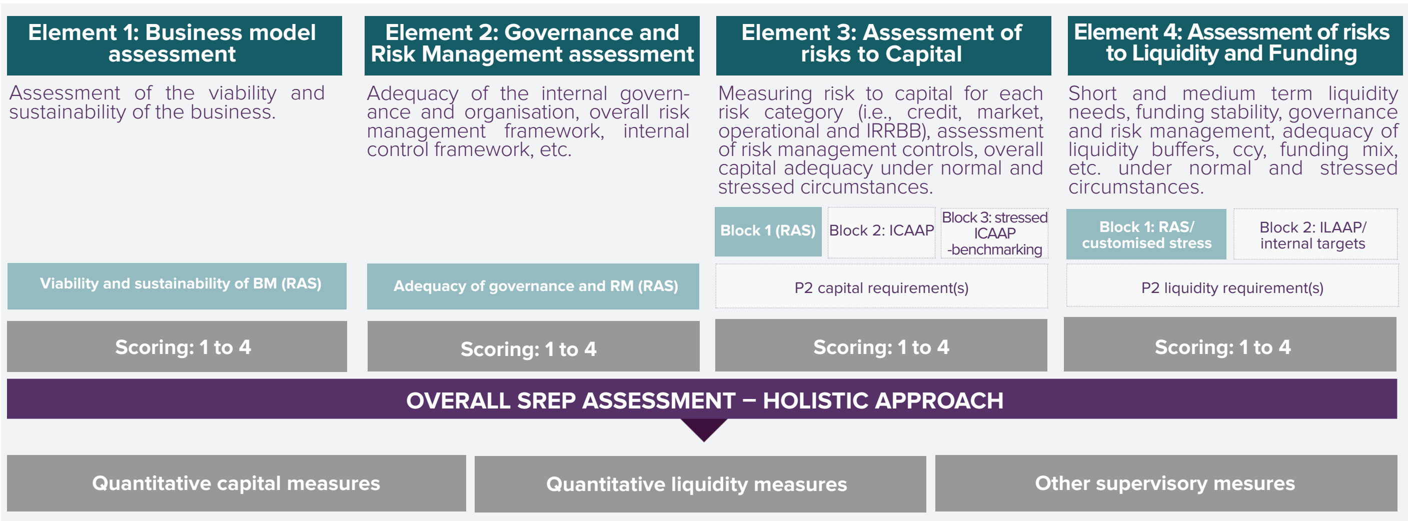
The EBA Guidelines introduced a Common SREP Framework, covering ten components:

1. Categorisation of the credit institution;
2. Monitoring of key indicators;
3. Business model analysis (BMA);
4. Assessment of internal governance and the credit institution's controls;
5. Assessment of risks to capital;
6. Assessment of risks to liquidity;
7. Assessment of capital adequacy;
8. Assessment of liquidity resources' adequacy;
9. Overall SREP assessment; and
10. Supervisory measures (and early intervention measures, where necessary).

In turn, the ECB developed and implemented a building-block approach based on the EBA's Common SREP Framework. **Figure 2** provides an overview of the ECB's building-block approach articulated around four 'Elements', i.e.:

- Element 1: Business model assessment;
- Element 2: Adequacy of governance and risk management;
- Element 3: Assessment of risk to capital; and
- Element 4: Assessment of risks to liquidity and funding.

Figure 2: *Overview of the SSM SREP Framework*[4]



The SSM SREP is a process built on the above four Elements, assessed based on a 'common logic' and a 'constrained judgement' approach meant to ensure the right balance between consistency across SSM banks ('anchor point') and the necessary supervisory judgment.

The assessment of each SREP Element results in an overall SREP assessment, which supports the SREP decision. The decision may include supervisory measures such as quantitative capital measures (e.g., CET 1 ratio add-on), quantitative liquidity measures (e.g., higher LCR threshold) as well as other supervisory measures, which may entail quantitative measures (e.g., reducing the risk profile of certain portfolios by mandating a reduction in (average) PD) and/or qualitative measures (e.g., enhancement of risk management practices).

4 Adapted from SSM SREP Presentation, European Central Bank, January 2016

2.2.2. The SSM SREP Assessment Framework

As depicted in **Figure 3**, the SSM SREP's risk assessment is based on the combined assessment of the institution's 'risk level' and 'risk control':

- The 'risk level' (RL) assessment is primarily based on a range of quantitative parameters, including idiosyncratic aspects, relative to peer firms, and taking into account environmental factors.
- The 'risk control' (RC) assessment is based on a range of qualitative factors pertaining to governance and controls, amongst others.

As noted in Section 2.2.1 above, the four SREP Elements are based on a 'common logic' and a 'constrained judgement' approach, with each of the RL and the RC being assessed in a four-step process:

- **Phase 1** – Data gathering: Phase 1 leverages data/information available to the SSM (e.g., CoRep filings, STE returns).

- **Phase 2** – Automated anchoring score: Phase 2 includes an assessment based on a number of pre-defined thresholds that apply to all credit institutions in a systematic and comparable way. With respect to RL, the SSM will evaluate in a systematic manner the credit institution's actual quantitative indicators against those of other firms. With respect to RC, the SMM will evaluate the robustness of a bank's controls based on qualitative governance and controls-related questions.

- **Phase 3** – Supervisory judgement: Phase 3 reviews idiosyncratic and industry-wide indicators and information, which allows in addition of a judgmental layer addressing the potential shortcomings of the mechanical approach set out under Phase 1 and Phase 2 above.

  Within Phase 3, the SSM has embedded the concept of 'constrained judgment', which allows the ECB's banking supervisors to adjust the outcome of Phase 2 during Phase 3 subject to certain boundaries as depicted in **Figure 3**. In that context, a Phase 2 rating can only be improved by one notch or worsened by up to two notches.

- **Phase 4** – Combination of RL and RC: Phase 4 includes the combination of RL and RC for each risk, where applicable. For example, it is relevant to Element 3 (risks to capital) but does not apply to Element 2 (the concept of RL is not relevant to Element 2, *Internal Governance and Risk Management*).

The adoption of 'common logic' and 'constrained judgement' provides a robust framework to ensure adequate balance between:

- Harmonisation, i.e., a "common process, ensuring consistency across SSM banks and defining an anchor point; and
- The necessary supervisory judgment, to take into account the specificities and complexity of each institution[5]".

5 SSM SREP Methodology Booklet, European Central Bank, 2016 Edition, page 16

__Figure 3:__ 'Common Logic' and 'Common Framework' in the SSM SREP Framework[6]

Risk level vs. risk control				
SREP Elements	1. BMA	2. Internal governance & Risk Management	3. Risks to capital risk	4. Risks to liquidity & funding
RL	✓	N/A	✓	✓
RC	N/A	✓	✓	✓

Follows a three-phase approach:

Phase 1
Data gathering

Mainly from
- Quarterly ITS
- STE reports

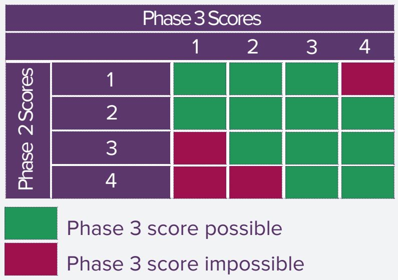
Phase 2
Automated anchoring system

- Scoring system
- Formal compliance checking of risk control

Phase 3
Risk assessment

- Adjustments based on additional factors and considering bank's specificities and complexity

Supervisory judgement is subject to the so-called 'constrained judgement' approach,



Upon completion of Phase 3, Risk Levels and Risk Controls are aggregated under Phase 4,

In line with the EBA Guidelines, the SSM SREP includes a fourth phase where the risk levels and risk controls are combined using an aggregation matrix such as:

		RC			
		1	2	3	4
RL	1	1	1	2	2/3
	2	1/2	2	2/3	3/4
	3	2/3	3	3/4	4
	4	3/4	4	4	4

6 Adapted from SSM SREP Methodology Booklet, European Central Bank, 2016 Edition

2.2.3. Overview of the four SREP Elements

a. Element 1 – Business Model Analysis

As noted in **Figure 2** on **page 5**, the first Element of the SSM SREP is the ***Business Model Analysis*** (BMA). In line with the EBA Common SREP Guidelines (par. 55 to 57), the SSM assesses the credit institution's business and strategic risks in order to form a view on the institution's 'viability' (i.e., does the current business model support the generation of acceptable returns over a one-year horizon?) and 'sustainability' (i.e., does the institution's strategy support the generation of acceptable returns over a three-year horizon?).

The SSM assigns a rating (a risk level score) based on the three-phase approach outlined in Section 2.2.2 above (data gathering, automated score, supervisory judgement). Beyond that score, the SSM uses the BMA to identify the institution's key vulnerabilities from a solvency or liquidity perspective (e.g., funding structure concerns, excessive concentration).

b. Element 2 – Internal Governance and Risk Management

The second Element of the SSM SREP is Internal Governance and Risk Management. In line with the EBA Common SREP Guidelines (par. 81 and 82), the SSM assesses the adequacy of the institution's overall governance arrangements and risk management in the context of the SSM Risk Assessment System.

In assessing the second Element based on the three-phase approach outlined above, the SSM assesses (a) the overall internal governance framework, (b) the corporate and risk culture, (c) the effectiveness of the institution's executive committee and board of directors, (d) remuneration policies and practices, (e) the institution's risk management framework, (f) the institution's control framework and the effectiveness of the internal audit function, (g) the robustness of information systems and business continuity, and (h) recovery planning arrangements.

Practically, this leads the SSM to review three building blocks of a sound internal governance and risk management framework, i.e.:

- Overall governance, including the organisational structure (e.g., business units, reporting lines, management body and committees) and the effectiveness of the risk management (e.g., independence, status, actual functioning), compliance and internal audit functions;
- Risk management framework, including risk appetite (e.g., alignment between risk appetite and incentives/limits), risk culture and the internal capital and liquidity adequacy processes (including embeddedness); and
- Risk infrastructure, data aggregation and reporting.

c. Element 3 – Risks to Capital

The third Element of the SSM SREP is ***Risks to Capital***, which is assessed from three different perspectives, also known as 'three blocks' as depicted in **Figure 4** below:

Figure 4: *Element 3, Risks to Capital – The three Blocks*[7]

Block 1 Supervisory perspective	Block 2 Bank's perspective	Block 3 Forward-looking perspective
Four risk categories: credit risk, market risk, operational risk, IRRBB • Information gathering • Anchoring scores on risk categories • Comprehensive analysis	• Information gathering: e.g., ICAAP reports • Anchoring assessment: with proxies in line with the EBA Guidelines • Comprehensive analysis	• Information gathering: bank internal stress tests • Anchoring assessment: supervisory stress tests • Comprehensive analysis

7 Adapted from SSM SREP Methodology Booklet, European Central Bank, 2016 Edition

Block 1, Supervisory Perspective, is based on the three-phase assessment of risk level and risk control for each risk type (e.g., credit risk, market risk), resulting in a combined risk score in line with the approach outlined in Section 2.2.2.

Block 2, Bank's Perspective, includes a qualitative and quantitative evaluation of the reliability of the institution's ICAAP. The ECB published useful guidance (26 pages in total) regarding its expectations on 8 January 2016[8], including for example the inclusion of a reconciliation between pillar 1 and ICAAP figures and capital adequacy statements duly supported by the ICAAP and signed by the management body.

Finally, Block 3, Forward-looking Perspective, is based on the institution's internal stress tests and supervisory stress tests. In 2016, for example, Block 3 drew upon two large-scale stress test exercises, i.e., (a) the EU-wide EBA stress test conducted in Q2/2016 covering 37 Significant Institutions and (b) the SSM SREP stress test conducted in Q2 and Q3/2016 covering 56 other Significant Institutions.

d. Element 4 – Risks to Liquidity

The fourth Element of the SSM SREP is Risks to Liquidity. It is also assessed from three different perspectives ('three blocks') as depicted in **Figure 5** below:

Figure 5: *Element 4, Risks to Liquidity – The three Blocks*[9]

Block 1 Supervisory perspective	Block 2 Bank's perspective	Block 3 Forward-looking perspective
Short-term liquidity, funding sustainability • Information gathering • Anchoring scores on short-term liquidity and funding sustainability risks • Comprehensive analysis	• Information gathering: e.g., ILAAP reports • Anchoring assessment: challenge the institution's internal estimates • Comprehensive analysis: e.g., of ILAAP reliability	• Information gathering: bank internal stress tests • Anchoring assessment: supervisory stress tests • Assessment of supervisory stress test results and of bank's internal stress tests

Block 1, Supervisory Perspective, is based on the three-phase assessment of risk level and risk control for each risk type (e.g., short-term liquidity), resulting in a combined risk score in line with the approach outlined in Section 2.2.2.

Block 2, Bank's Perspective, includes a qualitative evaluation of the reliability of the institution's ILAAP.

There too, the ECB set out its expectations on 8 January 2016, including for example the inclusion of liquidity adequacy statements duly supported by the ILAAP and signed by the management body.

In 2016, the ECB had not yet completed the implementation of Block 3, Forward-looking Perspective.

8 Refer to ECB, Supervisory expectations on ICAAP and ILAAP and harmonised information collection on ICAAP and ILAAP, available at: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/160108letter_nouy.en.pdf for additional details
9 Adapted from SSM SREP Methodology Booklet, European Central Bank, 2016 Edition

2.2.4. Overall Assessment

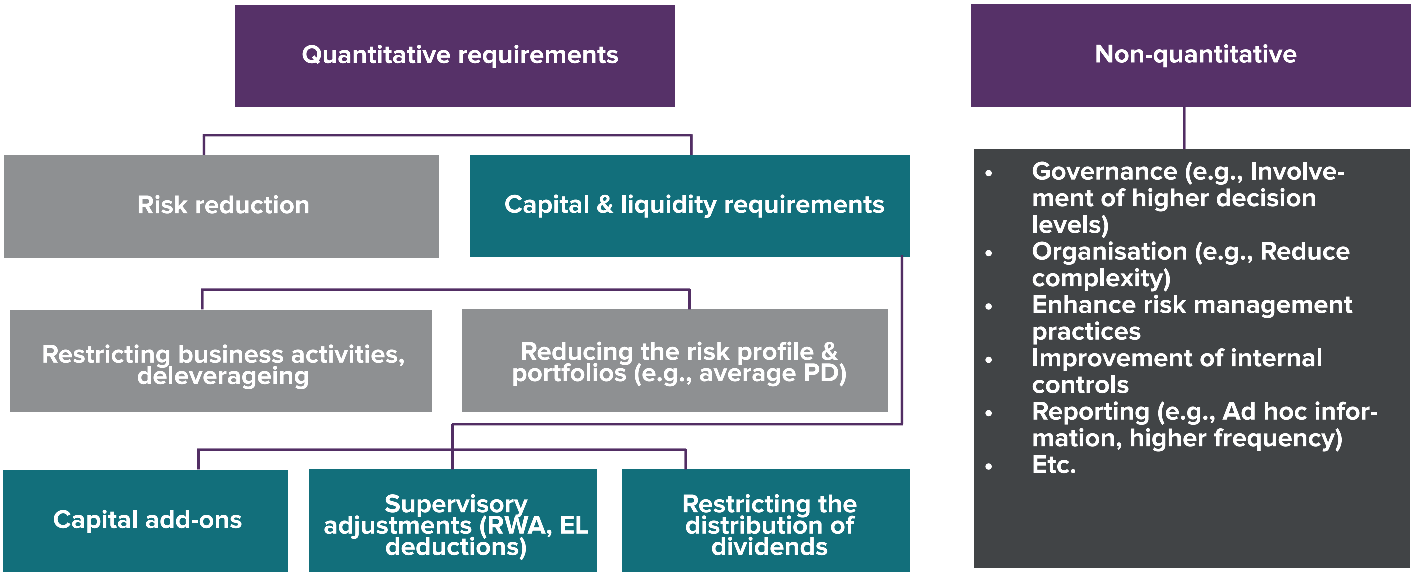
In line with the EBA Guidelines (table 13, pp. 170 and 171), the overall SREP score "reflects the supervisor's overall assessment of the viability of the institution: higher scores reflect an increased risk to the viability of the institution stemming from one or several features of its risk profile, including its business model, its internal governance framework, and individual risks to its solvency or liquidity position[10]."

Whilst the SSM has not shared this aspect of the methodology in great detail, we understand the SSM SREP determines the overall SREP 'score' with due regard for the multi-faceted nature of this assessment. Whilst the overall assessment is based on the assessment of all four Elements, it is not a simple sum. Rather, the SSM considers a range of facets, including the risks the institution is or may be exposed to, whether the business model, internal governance and risk management may exacerbate or mitigate these risks, the adequacy of capital and liquidity resources, and the potential interconnection between various risk factors.

2.2.5. SREP Decision

The overall SREP is the basis for assessing capital and liquidity adequacy and for taking any necessary supervisory measures to address concerns as illustrated in **Figure 6** below:

Figure 6: *SREP Decisions*



2016 marked an important change with respect to capital measures in particular. In line with the EBA 's communication on 1 July 2016[11], the ECB introduced SREP decisions composed of a pillar 2 Requirement (P2R) and pillar 2 Guidance (P2G). This distinction impacted the CET 1 'stacking order' and therefore the Maximum Distributable Amount (MDA) restriction trigger point.

10 SSM SREP Methodology Booklet, European Central Bank, 2016 Edition
11 EBA, EBA clarifies use of 2016 EU-wide stress test results in the SREP process, available at: https://www.eba.europa.eu/-/eba-clarifies-use-of-2016-eu-wide-stress-test-results-in-the-srep-process

3. Regulatory Expectations and Areas of Focus

3.1 ECB'S PRIORITIES FOR 2017[12]

On 15 December 2016, the ECB published its supervisory priorities for 2017. The 2017 supervisory priorities build on the ECB's assessment of the key risks faced by SSM banks:

- **Business models and profitability drivers,** which remain important due to ultra-low interest rates and weak economic growth across the Eurozone;
- **Credit risk,** targeting high levels of non-performing loans ('NPLs') and the upcoming implementation of financial reporting standard IFRS 9, *Financial Instruments*, with respect to loan loss provisioning; and
- **Risk management,** which builds on the 2016 supervisory priorities relating to risk governance, capital and liquidity adequacy. The 2017 focus will specifically include (i) risk data aggregation and reporting (BCBS 239), (ii) the adequacy of internal models approved for use to determine own funds requirements under pillar 1[13], (iii) the ICAAP and the ILAAP, and (iv) outsourcing.

Figure 7: *Overview of SSM Priorities in 2016 and 2017*

	2016 Priorities - ECB actions	2017 Priorities - ECB actions
Business models and profitability drivers	Challenge banks' business models **Thematic review analysing profitability drivers** Investigate banks' IRRBB approaches	**Thematic review of banks' business models and profitability drivers** **JSTs will** perform in-depth examinations throughout 2017, notably on the possible repercussions of the UK referendum
Credit risk focus on NPLs and concentrations	**Thematic review to evaluate IFRS 9 impact on provisioning** Review of institutions' situation with high levels of NPLs and exposure concentrations (real estate)	Based on the guidance on NPLs to banks, the ECB will continue to review banks' NPLs and the adequacy of loan loss provisions **Thematic review of the potential impact of IFRS 9 will be intensified**

2016	2016 Priorities - ECB actions
Capital adequacy	**Harmonisation of supervisory approach of banks' ICAAPs, including stress-testing** Examination of banks' preparedness for TLAC/MREL Review of banks' internal models
Liquidity	**Harmonisation of supervisory approach of banks' ILAAPs** Framework review for managing liquidity and funding risk
Risk governance and data quality	**Thematic review of compliance with BCBS 239 principles** In-depth analysis on risk governance for selected SIs

2017	2017 Priorities - ECB actions
Risk management	**ICAAP/ILAAP** ICAAP & ILAAP processes are of fundamental importance for institutions in managing capital and liquidity adequacy European banking supervision is committed to promoting the continuous improvement of banks' ICAAPs & ILAAPs
	Target Review of Internal Models (TRIM) European banking supervision will roll out its multi-year targeted review On-site inspections will be launched in connection with this review
	Thematic review of compliance with BCBS 239 European banking supervision will finalise its ongoing thematic review of banks' compliance with BCBS 239, and JSTs will follow up with institutions, as appropriate
	Thematic review of banks' outsourced activities European banking supervision will initiate a thematic review to take stock of banks' outsourced activities and scrutinise how they are managing the associated risks (including IT risks)

The three supervisory priorities above will be the focus of the ECB in 2017. However, the ECB made clear that this is not an exhaustive list. For example, activities related to cybercrime risks, fit and proper assessments continue to be of paramount importance.

12 ECB Banking Supervision: SSM supervisory priorities 2017
13 In this context , the ECB has launched the Targeted Review of Internal Models (TRIM)

3.2 BUSINESS MODELS

Banks' business models and profitability drivers remain a supervisory priority for a second consecutive year. In practice, this priority will manifest itself **in heightened supervisory scrutiny throughout 2017, including in-depth examinations by Joint Supervisory Teams (JSTs)** as part of their on-going thematic review of banks' business models and profitability drivers. Those will feed into the SREP, of which the BMA is an essential component.

Business Models

The banking sector is still in the midst of an era of fundamental change, which has pushed institutions to rethink and adapt their business models. Some of the drivers are:

- **Economic uncertainty:** The economic landscape in the Eurozone remains challenging amid ultra-low interest rates, low economic growth and high levels of NPLs;
- **Political instability:** In Europe, the possible impacts of the outcome of the Brexit referendum on EU membership for supervised banks remain unclear at this stage;
- **Competitive landscape:** As the digital revolution completely reshapes the provision of financial services and spurts the emergence of new entrants ('FinTech'), the established order in the banking sector is challenged; and
- **Regulatory environment:** In the face of an unrelenting wave of regulatory requirements, and as the post-crisis regulatory agenda nears completion with the finalisation of Basel III, banks need to continually assess the overall impact on their business models and whether certain activities remain viable.

The ECB's Standpoint on Business Models

Business models were already among the SSM priorities in 2016. The rationale is, of course, that European banks face profitability issues, which do not bode well for the long term. One of these issues is the prolonged period of low interest rates, as 'legacy yields' roll off the balance sheet on the asset side (e.g., higher yielding fixed rate loans mature) and funding costs reach a trough (unless banks start charging negative rates on deposits). Other reasons have been discussed above.

In a recent speech in Frankfurt[14], Ms. Nouy noted that the ECB intends to "further analyse banks' business models and explore the drivers of their profitability. To that end, [the JSTs] will thoroughly examine their respective banks. And [they] will also assess how developments such as FinTech and Brexit might impact the business models of banks in the euro area."

As discussed on **page 7,** the SSM SREP involves a three-phase process to assess a bank's business model[15].

Figure 8: *The SSM business model review's phases*

Phase 1: Collect information and understand the materiality of business areas	• Contribution of business lines to income, profits and risks. • What are the business lines that drive important risk factors? • Reporting. • Any relevant internal or external information.
Phase 2: Preliminary business model risk rating based on a range of profitability indicators	• An automatic score mainly based on the RoA and the cost income ratio. • Comparison of the results to predefined thresholds, and global scores.
Phase 3: Comprehensive analysis of the viability and the sustainability of the bank's business	• Used to adjust the scores of phase 2 above by taking into account bank's specificities. • More than 60 indicators based on normative reports and of supervision allow comparisons between banks. • Provides an opportunity for expert judgement (subject to the 'constrained judgement' principle).

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14 ECB, New Year's resolutions for a stable banking sector, available at: https://www.bankingsupervision.europa.eu/press/speeches/date/2017/html/se170125.en.html
15 Adapted from SSM SREP Methodology Booklet, European Central Bank, 2016 Edition

3.3 RISK APPETITE FRAMEWORK (RAF)

The second items on the SSM SREP are governance and risk management assessment. In a January 2017 speech, Ms. Nouy reminded bankers that "sound risk management is crucial for any bank at any time; nonetheless, it has now become even more important. Banks have been handed a cocktail that is low in profits and high in liquidity – a combination that might tempt them to embark on a dangerous search for yield. It is up to risk managers to take a long-term view and rein in excessive risk-taking."

Against that backdrop, the SSM has focused and continues to focus on sound governance and risk management practices within a clearly articulated risk appetite framework. An in-depth assessment of the effectiveness of banks' executive committees and boards of directors and banks' RAFs was conducted in 2015 across all Significant Institutions through a thematic review. In June 2016, the ECB published the *SSM Supervisory Statement on Governance and Risk Appetite*[16]. Among other things, the ECB's report sets out supervisory expectations regarding a bank's RAF.

In short, the SSM expects banks to develop and implement a comprehensive RAF, strengthening risk awareness and promoting a sound risk culture. The RAF should "define the level of risk tolerance that the institution is willing to take in relation to both financial and non-financial risks. Risk metrics and limits should be deployed consistently within entities and business lines, and should be monitored and reported to the board regularly".[17] Importantly, the ECB report stresses the importance of ensuring the alignment between the RAF and the bank's business plan, strategy development, capital and liquidity planning, and remuneration schemes of financial institutions. **Figure 9** below expands on the ECB's findings and supervisory expectations with respect to the RAF.

The framework development	• Heterogeneity in the maturity of the RAFs of SIs • Relatively recent for several SIs (mainly for smaller SIs). Approximately **30%** of the RAFs of the SIs had been developed **within the last 18 months and 12% were still under development**
The scope	• Not always comprehensive • Some **material risk areas missing** (e.g., non-financial risks or profitability and business risk)
The risk metrics	• Not always adjusted properly to the institution's business model and risk profile • Lack of appropriate metrics for board level (even If the number should remain limited) • Inappropriate balance between **static metrics and forward-looking metrics** (including results of stress tests)
The limits	• **The calibration and monitoring** of limits has been identified **as one area for improvement** • The limits do not include enough **material concentration areas** (per single name, sector and/or country) • **The escalation process** in the event of a limit breach **is not defined or displays weaknesses**
Integration of the framework	• The RAF needs to be **integrated and embedded** more closely into the other **structural processes of the institution,** such as strategy, budget process, capital and liquidity planning, recovery plan and remuneration framework
Governance and deployment	• The governance needs to be better formalised • The involvement of key stakeholders such as the board and the internal audit function should be further strengthened • The establishment of the RAF at the level of entities and business lines could still be improved

16 ECB, SSM supervisory statement on governance and risk appetite, available at: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm_supervisory_statement_on_governance_and_risk_appetite_201606.en.pdf
17 SSM Supervisory Statement on Governance and Risk Appetite, European Central Bank, Banking Supervision, June 2016, page 3
18 Based on SSM Supervisory Statement on Governance and Risk Appetite, European Central Bank, Banking Supervision, June 2016

3.4 ICAAP/ILAAP

Internal capital and liquidity adequacy assessment processes (ICAAPs and ILAAPs) are key strategic processes embedded in business decision making. As noted on **page 5,** when discussing Elements 3 and 4 of the SSM SREP, these two processes provide a substantial input into the determination of the capital and liquidity requirements when deemed reliable by the ECB.

The ICAAP and the ILAAP were an SSM priority in 2016 and will remain at the forefront of the SSM's priorities in 2017. In that context, two publications by the ECB and the EBA, respectively, provide useful insights into banking supervisors' expectations:

- On 8 January 2016, the ECB published a letter on its supervisory expectations for ICAAP and ILAAP and harmonised information collection in ICAAP and ILAAP[19]; and
- On 3 November 2016, the EBA published its final guidelines on ICAAP and ILAAP information collected for SREP purposes[20].

3.4.1 ECB's Supervisory Expectations for ICAAP, ILAAP and Information Collection

The SSM **baseline** expectations with respect to the ICAAP articulated in the ECB's January 2016 letter relate to nine areas of focus as summarised in **Figure 10** below:

Figure 10: *SSM Baseline ICAAP Expectations (January 2016)*

Areas of focus	Baseline Expectations (not a comprehensive list)
Governance	• All key elements of the ICAAP (e.g., governance structure, risks covered in the ICAAP, key risk measurement assumptions) should be approved by the Management Body. • An ICAAP document should be prepared at least annually and approved by the Management Body. • In addition, ICAAP-related outcomes should be embedded in the bank's Management Information (MI) framework with quarterly (or monthly) reporting.
General design of the ICAAP	• The ICAAP should include an assessment and quantification of all risks that may materially impact the bank's capital or earnings. • The ICAAP should include a conclusion on the bank's capital adequacy from a holistic perspective over a medium-term horizon (at least three years).
ICAAP Perspective	• The ICAAP should not only comply with mandated regulatory and accounting requirements (e.g., definition of available financial resources) but also hinge upon sound economic analysis (e.g., consider migration risk, credit spread risk in the banking book for positions that are not fair valued).

Risks to be considered	• The bank should have a process to identify all material risks it is or might be exposed to.
	• At a minimum, the ICAAP should consider the following risk types (if not applicable, a justifications should be provided):
	  • Credit risk (incl. FX lending risk, country risk, credit concentration risk, migration risk),
	  • Market risk (incl. credit spread risk, structural FX risk),
	  • Operational risk (incl. conduct risk, legal risk, model risk),
	  • Interest rate risk in the banking book (incl. optionalities such as prepayment options),
	  • Participation risk,
	  • Sovereign risk,
	  • Pension risk,
	  • Funding cost risk,
	  • Risk concentrations,
	  • Business and strategic risk, and
	  • Other risks that may result from material participations (e.g., in an insurance undertaking).

19 Refer to ECB, Supervisory expectations on ICAAP and ILAAP and harmonised information collection on ICAAP and ILAAP, available at: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/160108letter_nouy.en.pdf
20 Refer to EBA, Final Report, Guidelines on ICAAP and ILAAP information collected for SREP purposes, available at: https://www.eba.europa.eu/documents/10180/1645611/Final+report+on+Guidelines+on+ICAAP+ILAAP+%28EBA-GL-2016-10%29.pdf/6fa080b6-059d-4b41-95c7-9c5edb8cba81

Areas of focus *(cont'd)*	Baseline Expectations (not a comprehensive list) *(cont'd)*
Definition of internal capital	• Internal capital (also referred to as available financial resources) should be of sound quality. Where the internal capital definition is linked to regulatory own funds, the SSM expects that a large part of internal capital components will be CET 1.
Assumptions and key parameters	• The parameters and assumptions should be consistent with their risk appetite, market expectations, business model, and risk profile.
Inter-risk diversification effects	• The SSM does not take inter-risk diversification into account in the SREP.
Severity level of stress tests	• Internal stress test scenarios should be tailored with the bank's key vulnerabilities, resulting from its business model and operating environment in the context of stressed macroeconomic and financial conditions. • The bank should conduct reverse stress testing.
Stress testing scenario definition	• At least once a year, the bank should perform an in-depth review of its vulnerabilities and define a set of stress testing scenarios to inform the capital planning process, in addition to using a baseline scenario in its ICAAPs. • In addition, the scenarios should be reconfirmed and used periodically (e.g., quarterly) to monitor potential effects on the relevant capital adequacy indicators over the course of the year.

The ECB's January 2016 letter also provides an overview of the SSM's expectations regarding the ILAAP (albeit more succinctly), including with respect to:

- **The general definition of the ILAAP:** The ILAAP should contain all of the qualitative and quantitative information necessary to underpin the bank's risk appetite, including the description of the systems, processes and methodology to measure and manage liquidity and funding risks. The bank should prepare at least annually an ILAAP document approved and signed by its Management Body. Similarily to the ICAAP, the SSM places a great deal of emphasis on the embeddedness of the ILAAP processes within the bank.
- **ILAAP reporting:** The bank's internal liquidity adequacy statement should be consistent with the bank's risk appetite and be approved and signed by its Management Body.

Last but not least, the SSM clarified its expectations in terms of collection of information on the ICAAP and the ILAAP. The SSM introduced periodic reporting on significant institutions' ICAAPs and ILAAPs in line with the EBA's Guidelines on ICAAP and ILAAP information collected for SREP purposes (see below).

3.4.2 EBA Guidelines on ICAAP and ILAAP Information collected for SREP Purposes

The EBA Guidelines, which came into force on 1 January 2017, provide a backbone for a consistent supervisory approach to the assessment of banks' ICAAPs and ILAAPs under the SREP. They set out what information supervisory authorities should collect with respect to the ICAAP and ILAAP. The ECB already encapsulated most of the (then draft) EBA Guidelines within the SSM SREP through the publication of the January 2016 letter referenced above.

Figure 11 provides an overview of the ICAAP and ILAAP information covered by the Guidelines classified according to four broad categories.

Figure 11: *Overview of the EBA Guidelines on ICAAP and ILAAP Information collected for SREP Purposes*

General information about ICAAP & ILAAP

Business model and strategy
- Business model and main earning drivers (income/costs)
- Link between business, strategy and ICAAP/ILAAP

Risk governance and management framework
- Overall governance arrangements, reporting lines and frequency of reporting

Risk appetite framework
- Integration and use of the risk appetite framework in the overall risk management framework, including links to business and risk strategy, ICAAP and ILAAP

Stress testing framework and programme
- Institution's stress testing programme
- Consistency between solvency and liquidity stress tests (in particular ICAAP/ILAAP stress testing)

Risk data aggregation and IT systems
- Description of data flow, data structure, data checks and IT systems used for ICAAP and ILAAP purposes

Synthesis of ICAAP – specific information

Information on the overall ICAAP framework
- Scope, objectives and assumptions
- List of risk categories and sub-categories

Information on risk measurement, assessment and aggregation
- Overall governance arrangements, reporting lines and frequency of reporting

Information on internal capital and capital allocation
- Internal capital definition and capital elements
- Capital allocation to risks covered/capital adequacy

Information on capital planning
- Description of the general set-up
- Forward-looking view on the development of risks and capital

Information on stress testing in ICAAP
- Assumptions and scenarios
- Outcome and impact on key metrics

Supporting documentation
- Evidence of discussion and significant decisions related to ICAAP, capital allocation, etc.

ICAAP and ILAAP conclusions and Quality Assurance

Summary of main conclusions on ICAAP and ILAAP

Material changes (made or planned) to the risk management framework based on ICAAP or ILAAP results

Material changes (made or planned) to business models, strategies or risk appetite frameworks based on ICAAP or ILAAP results, including management actions

Material changes (made or planned) to the ICAAP and ILAAP frameworks, including improvements to be introduced following the observation of internal validations, internal audit reports and the outcomes of the dialogue with the ECB

Explanation of how the bank ensures that the ICAAP and ILAAP frameworks and models used provide reliable results (e.g. validation concepts, validation reports)

Synthesis of ILAAP – specific information

ILAAP-specific information[21] (incl. both (i) methodology and policy documentation and (ii) operational documentation)

Information on liquidity and funding risk management framework

Information on funding strategy

Information on strategy regarding liquidity buffers and collateral management

Information on the cost-benefit allocation mechanism

Information on intraday liquidity risk management

Information on liquidity stress testing

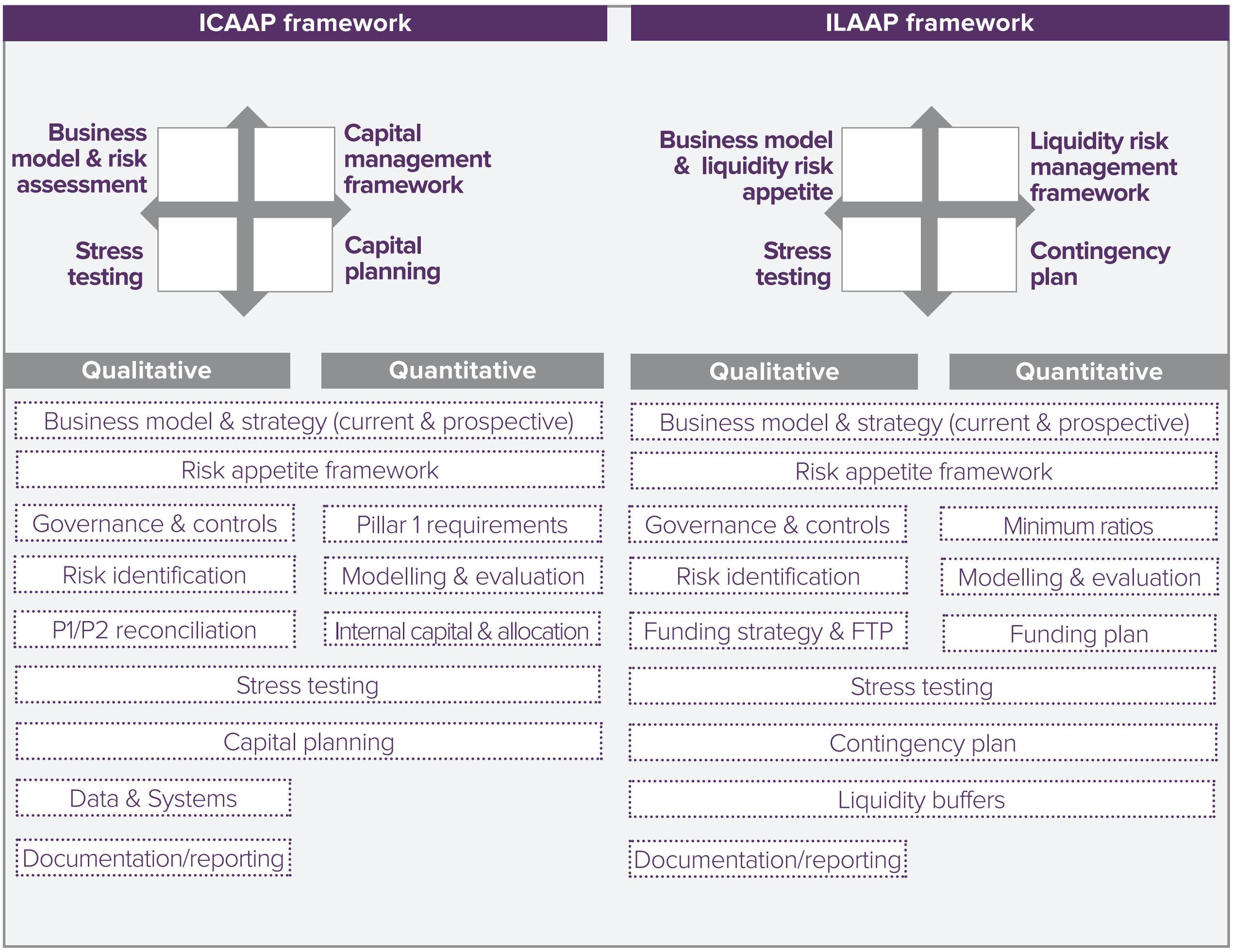
Information on liquidity contingency plan

21 The SSM will also expect to receive all relevant supporting information including minutes of relevant committees and management body meetings evidencing the sound setup and implementation of ILAAP

The ICAAP and ILAAP play a key role in the SSM SREP methodology. They feed into many SREP assessments on business models, internal governance and overall risk management, the risk control assessments for the risks to capital, and into the pillar 2 capital and liquidity determination process.

Figure 12 provides an illustrative description of an ICAAP and ILAAP framework.

Figure 12: *Illustrative Structure of an ICAAP and ILAAP Submission*



3.5 STRESS TESTS: SUPERVISORY VS. BANK PERSPECTIVE

As noted above, the ICAAP figured prominently in the SSM 2016 priorities; when listing the ICAAP priorities, the ECB also emphasised banks' internal stress-testing capacities and the conduct of supervisory stress tests.

In line with the EBA Guidelines, the ECB relies on stress tests, among others, to determine the adequacy of a bank's own funds (quantity and composition) to cover volatility over the economic cycle, and whether measures are required to address potential inadequacies. These include:

- The outcome of plausible but severe stress tests run by the bank as part of its ICAAP; these should be relevant to the bank's business model and risk profile; and
- The outcomes of supervisory stress tests, namely those run by the EBA and the SSM itself as discussed on **page 20.**

The SSM SREP 2016 experience yielded some mixed results in this regard, and will certainly lead the ECB to focus additional attention on stress testing in 2017. **Figure 13** below provides an overview of the ECB's feedback based on a cross-section of SIs.

Figure 13: *SSM SREP: Feedback on Stress Testing Practices*

ICAAP Documentation

Whilst the quality and comprehensiveness of the ICAAP documentation provided by SIs vary a great deal (with institutions filing one document (the ICAAP Submission) and others filing several hundreds documents, information on stress testing was generally included in the ICAAP submission.

Banks should define a set of stress testing scenarios that are expected to result in a material impact on the bank's internal and regulatory capital ratios, based on an in-depth assessment of their vulnerabilities.

- Banks use scenarios that are not consistent with their individual weaknesses.
- The linkage between macro assumptions and micro parameters lacks clarity.
- Perhaps the most important shortcoming of all relates to the lack of use of stress testing results for decision-making purposes.

The stress testing framework and the data aggregation process should be subject to regular internal reviews (including by internal audit) and validation processes.

- There are deficiencies in independent review of the stress testing methodologies.
- There is a lack of coverage of the stress testing framework by internal audi

Figure 14: *Capital assessment: Banking perspective vs. Supervisory perspective*

Banking perspective

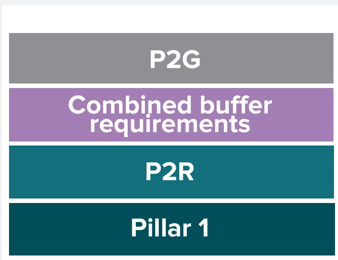
The ICAAP provides a self-assessment of a bank's capital adequacy: The bank may use the assessment methodologies it deems the most appropriate in line with applicable Guidelines.

- **Pillar 1 approach** refers to the quantification of own funds' requirements based on regulatory methods. The scope is necessarily limited to Basel-type risks, (e.g., credit, operational and market) and a one-year time horizon.
- **Pillar 2 approach** refers to the quantification of capital requirements based on the methodologies adopted by the bank to quantify non-Basel-type risks and Basel-type risks in a matter deemed more accurate than under pillar 1.
- **Stress test approach** refers to the quantification of own funds' requirements based on various macroeconomic scenarios (e.g., adverse scenarios).

SREP decisions of 2016 consist of **a pillar 2 Requirement (P2R) and a pillar 2 Guidance (P2G):**

- **Banks are expected to meet the P2G,** which will be set above the level of binding capital (minimum and additional) requirements and on top of the combined buffers.
- **If a bank will not meet its P2G, this will not result in automatic action by the supervisor**, but will be used in determining fine-tuned measures based on the individual situation of the bank.

As part of the SREP, supervisors are entitled to impose so-called pillar 2 capital requirements to supplement the minimum (pillar 1) regulatory capital requirements. **This add-on is intended to cover risks underestimated or not covered under pillar 1.**



Supervisory perspective

3.6 INTEGRATED FRAMEWORK FOR STRATEGIC PROCESSES

Among the key expectations of the SSM are the integration of and consistency between key strategic processes in banks. A well-established Risk Appetite Framework (RAF), articulated through a Risk Appetite Statement (RAS), is a cornerstone of this consistency; it includes a top-down view of the risks taken by the bank, allowing Senior Management to consider them in strategic decisions.

In order to ensure a sound governance framework, together with consistency amongst the processes and well-defined responsibilities for businesses, finance, ALM and risk functions, the indicators used in the RAS should be embedded into the key strategic and business decision processes, which are often conducted by a variety of teams under different calendar cycles:

- Setting the risk tolerance;
- Budgeting and Stressed budgeting;
- ICAAP and ILAAP (including capital and liquidity planning); and
- Recovery and resolution planning.

Ideally, remuneration schemes should also be considered. The indicators and threshold levels should be incorporated in all of these processes.

Hereafter is an overview presenting the processes in which the various thresholds are relevant.

Figure 15: *Relevant processes*

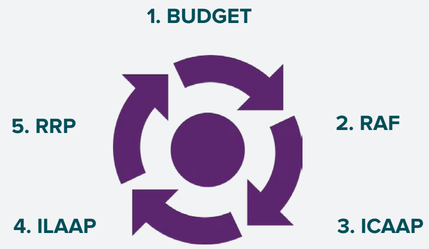


Figure 16: *Processes and Indicators*

	BUDGET		RISK APPETITE (INCL RISK POLICY)	CAPITAL	LIQUIDITY	CAPITAL & LIQUIDITY
	BUDGET	STRESSED BUDGET	RAF	ICAAP	ILAAP	RECOVERY & RESOLUTION
TARGET	✓		✓	✓	✓	
WARNING			✓	✓	✓	
LIMITS		✓	✓	✓	✓	
RECOVERY & RESOLUTION						✓

4. SREP Outcomes: Learning from the Experience of Eurozone Banks in 2016

4.1 SREP OUTCOMES[22]

In 2016, the SSM carried out its second (consecutive) SREP exercise for 123 SIs in 19 countries. The SSM SREP approach in 2016 was enhanced compared to the previous exercise, including in terms of greater harmonisation in the execution of the SREP across the Banking Union.

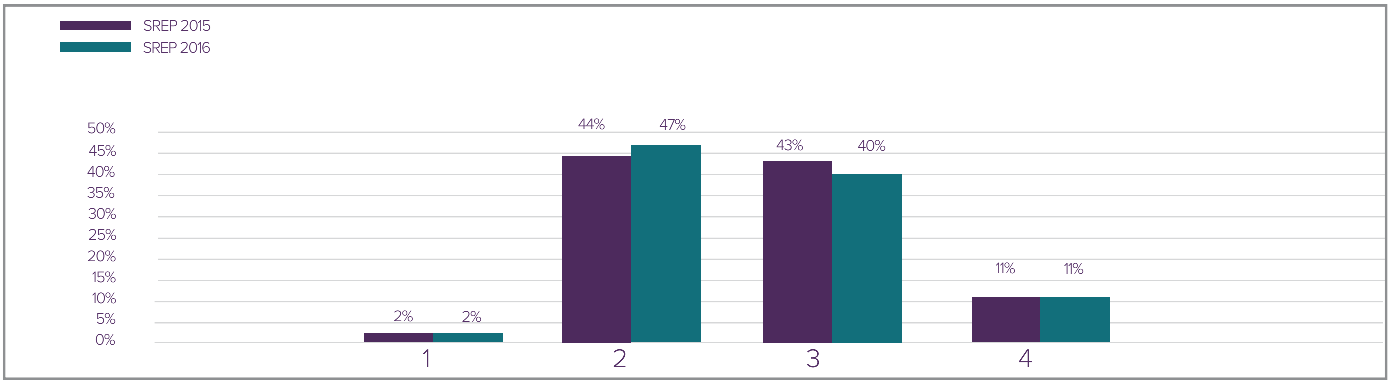
As depicted in **Figure 17**, the 2016 SREP confirmed that the distribution of risks within the Banking Union remains broadly unchanged, with 2% of the SIs rated “1” (no discernable risk to the viability of the institution), 47% rated “2” (low risk), 40% rated “3” (medium risk) and a particularly noteworthy 11% rated “4” (high risk).

Overall, the exercise revealed that the **distribution of risks in the system remains broadly stable**, with some idiosyncratic changes.

A more granular analysis of the results provides useful insights into the main areas of concern of the ECB. As depicted in **Figure 18**, these remain unchanged compared to 2015, i.e.:

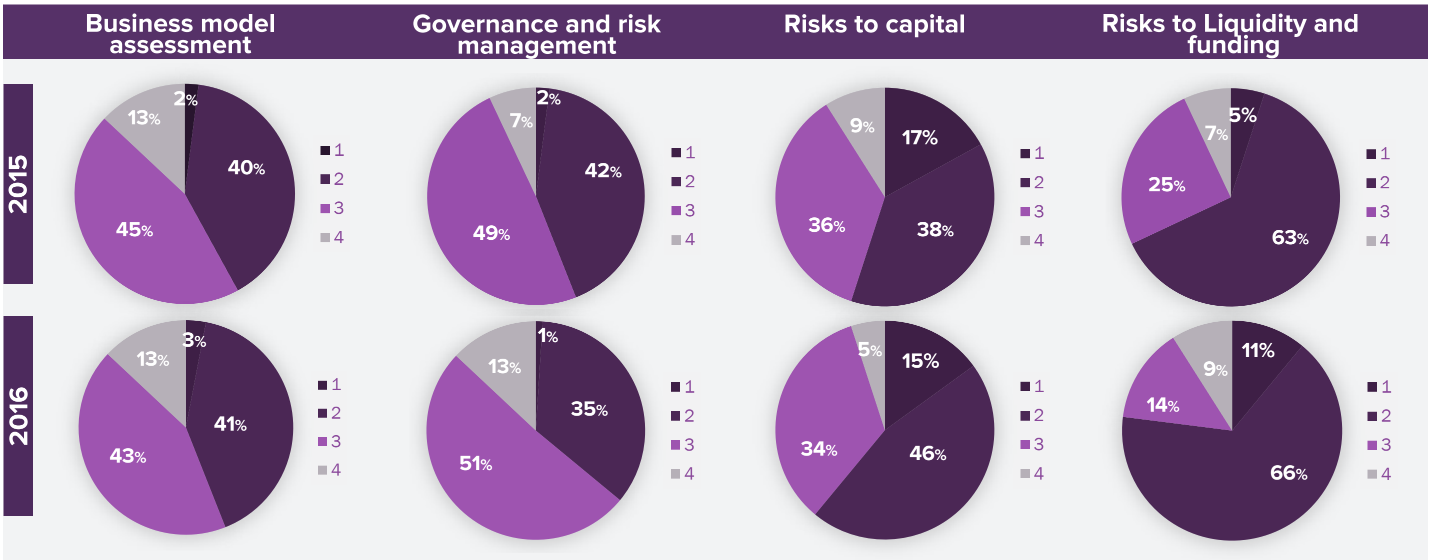
- Element 1, Business Model, is rated medium to high risk in 56% of the SIs (2015 - 58%);
- Element 2, Internal governance and risk management is rated medium to high risk in 64% of the SIs (2015 - 56%); and
- Element 3, Risks to capital (especially credit risk) is rated medium to high risk in 39% of the SIs (2015 - 45%).

Figure 17: *Overall SREP score (2015 vs 2016)*[23]



22 *Adapted from the SSM SREP Methodology Booklet, European Central Bank, 2016 Edition*
23 *Ibid*

Figure 18: *SREP Scores per Element in 2015 and 2016*[24]

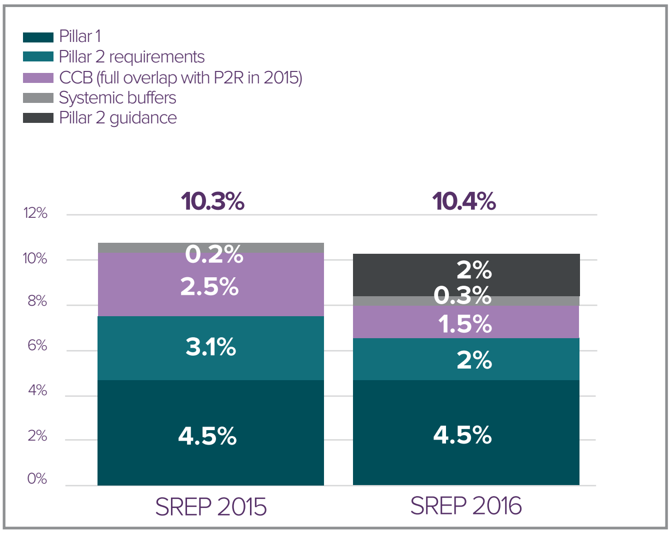


4.2. SUPERVISORY MEASURES

4.2.1 Capital Measures

As depicted in **Figure 19**, the 2016 SREP yielded equivalent results to the 2015 SREP in terms of CET 1 requirements imposed by the SSM, i.e., 10.4% on average across the Eurozone's Significant Institutions (2015 – 10.3%).

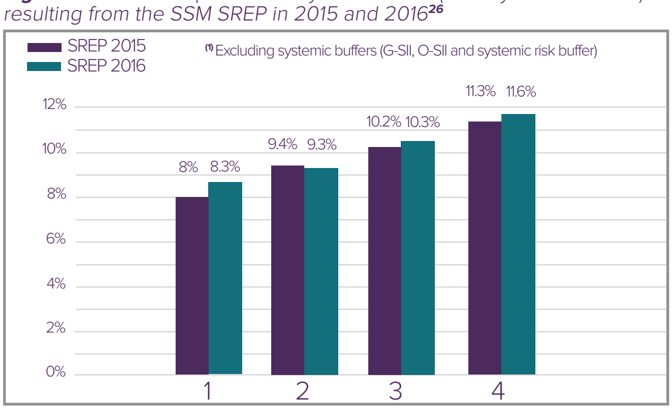
Figure 19: *CET 1 Requirements (incl. systemic buffers) resulting from the SSM SREP in 2015 and 2016*[25]



The maximum distributable amount (MDA) trigger decreased in line with the EBA's guidance on P2R and P2G, resulting in a reduction in the MDA trigger from 10.2% (2015) to 8.3% (2016). Taking the final SREP 2016 decision into account, only five out of 126 SIs had CET 1 below the MDA threshold.

It is also particularly interesting to note the difference in CET 1 requirements between banks with a very low risk profile (8.3% in 2016) and those with a high risk profile (11.6% in 2016), i.e., a bank rated 'high risk' is required to hold on average 40% capital (CET 1) more than a bank rated 'low risk'.

Figure 20: *CET 1 Requirements by SREP Score (excl. systemic buffers) resulting from the SSM SREP in 2015 and 2016*[26]



24 Adapted from SSM SREP Methodology Booklet, European Central Bank, 2016 Edition
25 SSM SREP Methodology Booklet, European Central Bank, 2016 Edition
26 Ibid

4.2.2. Liquidity Measures

In 2016, the SSM also imposed targeted liquidity measures to address weaknesses identified during the SREP exercise, including (a) overreliance on wholesale short-term funding, (b) the lack of integration between the liquidity risk strategy and tolerance framework and the overall risk appetite framework, and (c) shortcomings in terms of collateral management.

Measures imposed by the SSM included (a) imposing a higher LCR than the regulatory minimum and (b) imposing the holding of specific amounts of liquid assets beyond regulatory minima.

4.2.3. Other Supervisory Measures

The SSM imposed qualitative measures to all banks with an overall SREP score of "4" (high risk). Two recurring themes included measures to enhance:

- The quality and independence of the management body; and
- The consistency and robustness of RAF versus risk profile.

4.3 LESSONS LEARNED: INSIGHTS FROM DIFFERENT MEMBER STATES

4.3.1. Overarching Findings

The first two years of European banking supervision (of which the SREP is the main tool) have been about 'harmonisation'. The SSM inherited the supervisory approaches of 19 Member States, evolving regulatory guidance encapsulated in the EBA Guidelines finalised in December 2014, and developed a harmonized supervisory approach for SIs deployed across the Banking Union. As noted in **section 2,** this was no mean task given the disparity in supervisory approaches until then. Together with national supervisors, the ECB has now started to work on a harmonised SREP for LSIs.

"Whether a bank operates in Estonia, Germany or Italy, it is subject to the same supervisory expectations, which are based on global standards[27]."

The preceding sections of this paper set out the primary priorities of the ECB for 2016 and 2017 and the primary challenges faced by European SIs. Key recurring themes include:

- Governance, in particular as related to:
  - the level of engagement of the management body; and
  - the integration of the key strategic processes (e.g. RAF) in the decision-making processes.
- Capital planning, in particular as related to:
  - Taking into account forthcoming pillar 1 changes (e.g., FRTB) in the capital planning process; and
  - The granularity of the capital planning process itself.
- Scenario and stress testing, in particular as related to:
  - The alignment between the scenarios and the bank's specific vulnerabilities; and
  - The use of the stress testing results for decision-making purposes.
- Internal controls, in particular as related to:
  - The review of the ICAAP and stress testing methodologies by an independent validation function; and
  - The inclusion of the ICAAP processes within the scope of internal audit.
- Risk identification and measurement, risk data, aggregation and reporting, including:
  - The identification of all material risks and the robustness of their quantification; and
  - The quality of data and the robustness of data aggregation capabilities.

Beyond these overarching findings that were broadly common across the 19 Member States, specific issues and themes were noted in specific Member States. This paper provides an overview of some of these specific challenges in a sample of Member States, drawing on the experience of Avantage Reply consultants assisting firms in each of these countries.

27 ECB, Dealing with diversity – the European banking sector, *https://www.bankingsupervision.europa.eu/press/speeches/date/2016/html/se161128.en.html*

4.3.2. Review of Select Member States

Belgium

In Belgium, the intensity of supervisory supervision under the SREP increased with the introduction of the SSM, though a number of Belgian credit institutions had already experienced intrusive supervision by the national supervisor (National Bank of Belgium or 'NBB') prior to November 2014. The NBB had conducted in-depth reviews of the ICAAP submissions prepared by credit institutions, delving into economic capital modelling (methodology, embeddedness, understanding by the management body), including aspects that are still being raised today by the ECB as pervasive weaknesses in the Banking Union (e.g., the lack of independent review of the ICAAP models and stress tests by an independent function).

As in other Member States, what changed is the emphasis of the SREP exercise on the viability and the sustainability of a bank's business model and the adequacy of the governance and risk management processes. The latter was already an area of attention by the NBB (e.g., involvement of the Board of Directors and its committees), but the intensity of today's Elements 1 and 2 is significantly greater than before November 2014. It does come with challenges, as banks do not always understand the rationale for the supervisors' scrutiny of their business models. More explaining will be required to ensure that the industry and supervisors see eye to eye on this. It is our understanding that the objective of the SSM is not to undermine the responsibility of the institution's management body for running the business. Rather, it is to assess the viability and sustainability of the institution's current business model on the basis of its ability to generate acceptable returns in the future. In Belgium, banks have been subject to thorough thematic reviews on this topic.

Alongside the BMA, the SSM is particularly eager to ensure that banks enhance the embeddedness of their risk management processes and risk governance in day-to-day processes. In Belgium, the recent thematic reviews revealed that major enhancements are still needed for banks to reach supervisory expectations. In particular, the SSM pointed to insufficient challenge exercised by the management bodies and inadequate risk-management processes, particularly the alignment of the risk-appetite framework with the business plan and strategic developments.

France

The entry into play of the SSM has represented a significant disruption compared to supervisory practices under the aegis of the ACPR, the French supervisory authority. It emerges that the link between banks' business models and key strategic processes (e.g., RAF) is partial, especially in terms of strategic decision making. To some extent, the gap finds its origins in the first wave of Basel II implementation in 2007; at that time, the quantitative dimension of pillar 1 – in particular the potential capital savings through internal models implementation for credit risk (IRBF, IRBA), operational risk (AMA) and market risk (VaR models) – somewhat supervisory attention to other topics. In particular,

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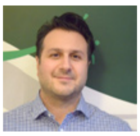

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initiatives to develop and implement economic capital frameworks from a pillar 2 perspective were quickly pushed back, or abandoned altogether.

For French banks, dealing with European supervisors implies learning how to cope with another supervisory culture and philosophy, which is not without challenges in practice:

(a) The introduction of ICAAP and ILAAP submission requirements has represented a change of paradigm, as banks have typically managed their risks on the basis of pillar 1 metrics. In practice, the outcome is a necessity to catch up at a forced march, especially as French banks are compared to peers in other Member States with ICAAP and economic capital traditions.
(b) Other weaknesses identified with respect to other Eurozone SIs relate to governance, profitability models and risk appetite.

Germany

In Germany, there are currently 21 SIs under direct ECB supervision and about 1,660 LSIs which are jointly supervised by the Federal Financial Supervisory Authority (BaFin) and the Bundesbank. Following the introduction of the SREP in 2006 in the Basel framework and, later, in the Capital Requriements Directive, and its implementation in Germany, German banking supervisors began implementing the ICAAP in the German banking system and using it as an important tool for their supervisory activities.

The SSM SREP which applies to the 21 German SIs and will, once adapted, also apply to the LSIs, introduced a number of significant changes compared to the previous approach. Specifically, the introduction of new Elements such as the BMA and the ILAAP raised the bar compared to the previous regime even for the largest German institutions. Another aspect which added to the significance of the change relates to the documentation requirements and the supervisory measures that can ensure, including capital and liquidity add-ons.

The SSM SREP has introduced changes for SIs and will no doubt challenge German LSIs in the years ahead. One aspect where German banks may wish the SSM SREP to perhaps ‘learn from’ the German supervisors’ experience is in going beyond the numbers and avoiding a sometimes too mechanistic approach. This is on the agenda of the SSM and is, in our view, an aspect where the BaFin’s approach was in general particularly robust.

Italy

Following the introduction of the “SSM”, in 2016 the Bank of Italy reformed its SREP process for the first time since 2011. The SREP process in Italy has strong parallels in supervisory priorities for Significant and Less Significant Institutions, with important differences in implementation. 14 significant banking groups are directly supervised by the ECB, and 462 less significant institutions are directly supervised by the Bank of Italy, under a simplified SREP approach.

The main outcomes standing of the first SREP are the needs to:
- Increase collaboration between the CRO and CFO to produce coherent information on forecast profitability figures

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and forward-looking risk measures;
• Improve the data quality framework;
• Achieve greater transparency in the construction of peer metrics; and
• Produce additional information on non-performing loans.

The SREP process for LSIs is based mainly on qualitative scoring, and quantitative information required under the simplified approach from already available reporting. They were subjected to a stress test in 2016. The SREP process plans a calendar of annual activities based on risk profile analysis, at the consolidated and individual bank levels. The process is supplemented by on-site inspections of individual banks performed by the Bank of Italy's staff, which makes an important contribution with respect to the robustness of the data acquired through 'intrusive' reviews of corporate processes.

Luxembourg

The Luxembourg national supervisor (CSSF) introduced an ICAAP requirement as far back as 2007 and amended applicable requirements over the years in line with evolving regulatory requirements adopted by the EBA (and its predecessor, CEBS). Accordingly, Luxembourg banks have implemented the ICAAP (and later the ILAAP) and prepared ICAAP submissions to the CSSF for almost 10 years. Though well acquainted with the ICAAP and ILAAP processes and submission, the sea change for Luxembourg banks under direct supervision (five banking groups) resulted from:

(a) the significant increase in the thoroughness and volume of documentation to be provided (e.g., 15 ICAAP items to be provided in line with the January 2016 SSM Guidelines (reader's manual, ICAAP data template, capital adequacy statement, etc.);
(b) the intrusiveness of banking supervisors, including the in-depth review of the business model and internal governance/risk management (e.g., questioning the level of engagement of senior management and the board of directors in challenging the ICAAP and ILAAP);
(c) the assessment of the operational risk resulting from outsourcing, including outsourcing to group entities; and
(d) the in-depth review of risk quantification and stress testing methodologies.

The Netherlands

In the Netherlands there are currently seven large institutions subject to ECB direct supervision.

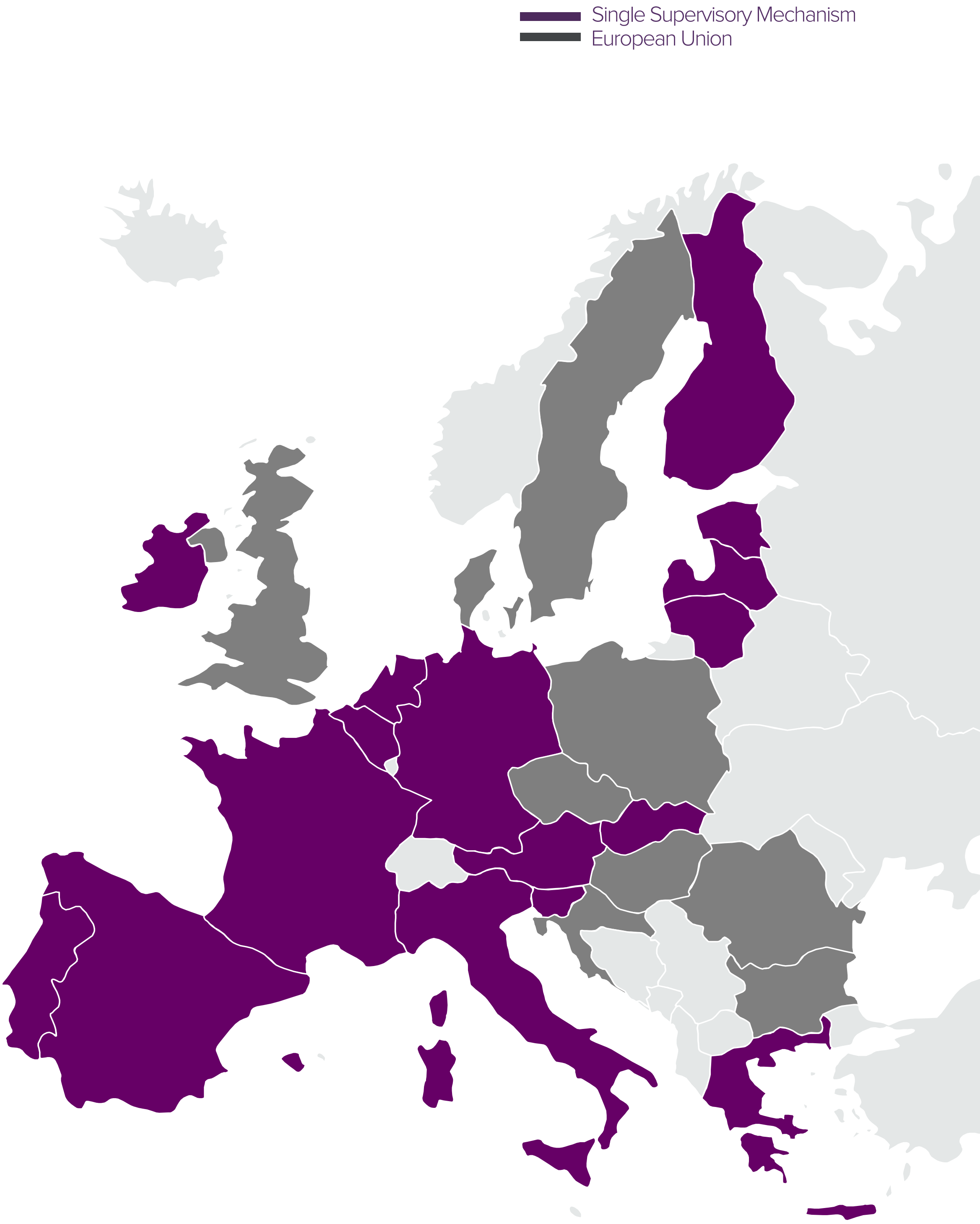
One of the key challenges of the ICAAP remains the capital requirement in respect of Credit Risk and Model Risk, as many banks in the Netherlands have a relatively high portion of 'low default' portfolios, which are at times challenging in terms of quantification under the pillar 1 internal model requirements. The Targeted Review of Internal Models will likely be a high priority this year.

The ILAAP has been an established process in the Netherlands for many years – indeed, the ECB used the DNB manual as an input into the SSM methodology. However,

With more than 25 years of experience in the Luxembourg financial sector as external auditor, consultant and banker, **Jean-Marc Thomas** specialises in risk management, credit and compliance. Before joining Avantage Reply as a Partner in Luxembourg, Jean-Marc was a member of the Executive Committee of Rothschild Europe, responsible for Risk Management, Internal Control, Compliance, Collateral Management and Credit. Jean-Marc was recognised as one of the subject matter experts of the Rothschild Group in these areas.

Arnold Veldhoen has extensive international experience in project and risk management in Financial Markets. Arnold has successfully delivered project components of a Counterparty Credit Risk Internal Model accreditation for a European SI, ICAAP submissions to the DNB and ECB for Dutch SI, an ECB SSM AQR for a Dutch SI, and assisted the Dutch Bankers Association supporting the European Banking Federation as supervisory Policy advisor. He is currently finalising the ECB SSM ILAAP and ICAAP for a German SI.

the need for good quality and high frequency liquidity data aggregation is being intensified under the BCBS 239 regime, including pressures for demonstrable second line Liquidity Risk data ownership and monitoring as opposed to first line Treasury.



5. What are the Next Steps?

Work on the harmonisation of supervisory practices will continue alongside the harmonisation of regulatory requirements. As repeatedly emphasised by the ECB, the European rules for banks contain a wide range of options and discretions, which run counter to the objective of harmonisation and a level-playing field. The SSM will continue to work toward the harmonisation of the regulatory landscape. In addition, new regulatory developments (e.g., the completion of the so-called 'Basel III agenda') will likely be implemented in the Banking Union, a 'looming' development that banks are expected to 'anticipate' in their ICAAP.

As discussed on **page 11,** the priorities of the SSM for 2017 have been clearly communicated. In the next few paragraphs, this paper provides additional insights as to how banks may wish to upgrade their capabilities in response to these supervisory expectations.

In her introductory statement at the second ordinary hearing at the European Parliament's Economic and Monetary Affairs Committee in November 2016[28], Ms. Nouy briefly touched on the SREP. She noted that the exercise revealed that the level of risks in the system remains broadly stable but Euro area banks are still facing a number of challenges, in particular profitability and non-performing loans. As noted in **Figure 20**, key performance indicators (RoE, RoA and CIR) for SIs tend to prove her point; there is no doubt that this will remain a key area of focus for the SSM in 2017 and beyond (as confirmed by the SSM Priorities for 2017).

Figure 20: *Key Performance Indicators for SIs*[29]

Indicator	Q2/2015	Q3/2015	Q4/2015	Q1/2016	Q2/2016
Return on equity (RoE)	6.16%	5.70%	4.41%	5.13%	5.36%
Return on assets (RoA)	0.37%	0.34%	0.28%	0.32%	0.33%
Cost-to-income ratio (CIR)	60.52%	61.44%	63.25%	67.89%	64.22%

What struck institutions the most during the first two SREP exercises is the ECB's intrusive approach to assessing banks' business models. As noted above, this will continue. The BMA provides the SSM with a much deeper understanding of the bank under supervision, including key profitability drivers and vulnerabilities.

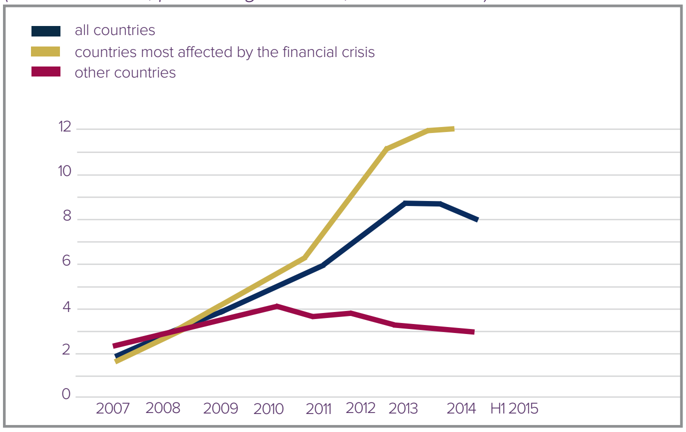
A related expectation that will remain at the forefront of the SSM priorities is the integration and responsiveness of strategic planning processes. Banks should continue to upgrade their capabilities and the integration of their strategic planning, risk appetite and budgeting processes; with an increased focus on the responsiveness of such processes (i.e., the ability to adapt to market conditions), moving away from a static annual planning process.

Credit Risk and Focus on NPLs and Concentration

Given the evolution of non-performing loans (NPLs) in the Eurozone (see **Figure 21**), it is no surprise that credit risk will remain a key supervisory priority in 2017. Banks should duly consider the ECB's Guidance on NPLs[30] jointly with the introduction of IFRS 9, *Financial Instruments*.

28 ECB, Second ordinary hearing in 2016 of the Chair of the ECB's Supervisory Board at the European Parliament's Economic and Monetary Affairs Committee, available at: https://www.bankingsupervision.europa.eu/press/speeches/date/2016/html/se161109.en.html
29 ECB, Supervisory Banking Statistics - second quarter 2016, available at: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/supervisorybankingstatistics_second_quarter_2016_201611.en.pdf
30 ECB, Draft guidance to banks on non-performing loans, available at: https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/npl/npl_guidance.en.pdf

Figure 21: *Impaired Loan Ratio for a Sample of 55 SIs (2017 to H1 2015; percentatge of loans, median values)*[31]



With respect to credit risk concentration (e.g., shipping, real estate, single name), the SSM will likely increase the intrusiveness of supervision, including through the conduct of additional on-site inspections. This is an area where banks may wish to upgrade their capabilities in terms of data quality, data aggregation and stress testing (in particular the 'so what' question).

Risk Management

Whilst there are several issues captured under the broad heading 'risk management' in the 2017 SSM Priorities (internal models, outsourcing, etc.), the area of focus that is likely to cause the most issues for SIs relates to the increased focus on risk data, aggregation and reporting in line with the principles set out by the Basel Committee (BCBS 239). Rising to the challenge involves work on infrastructure (e.g., systems), data quality, not only in the Risk and Finance functions but very much upstream, ensuring that the information used for decision-making purposes is reliable and timely.

31 SNL Financial, illustrated in ECB, Draft guidance to banks on non-performing loans, p. 4, https://www.bankingsupervision.europa.eu/legalframework/publiccons/pdf/npl/npl_guidance.en.pdf

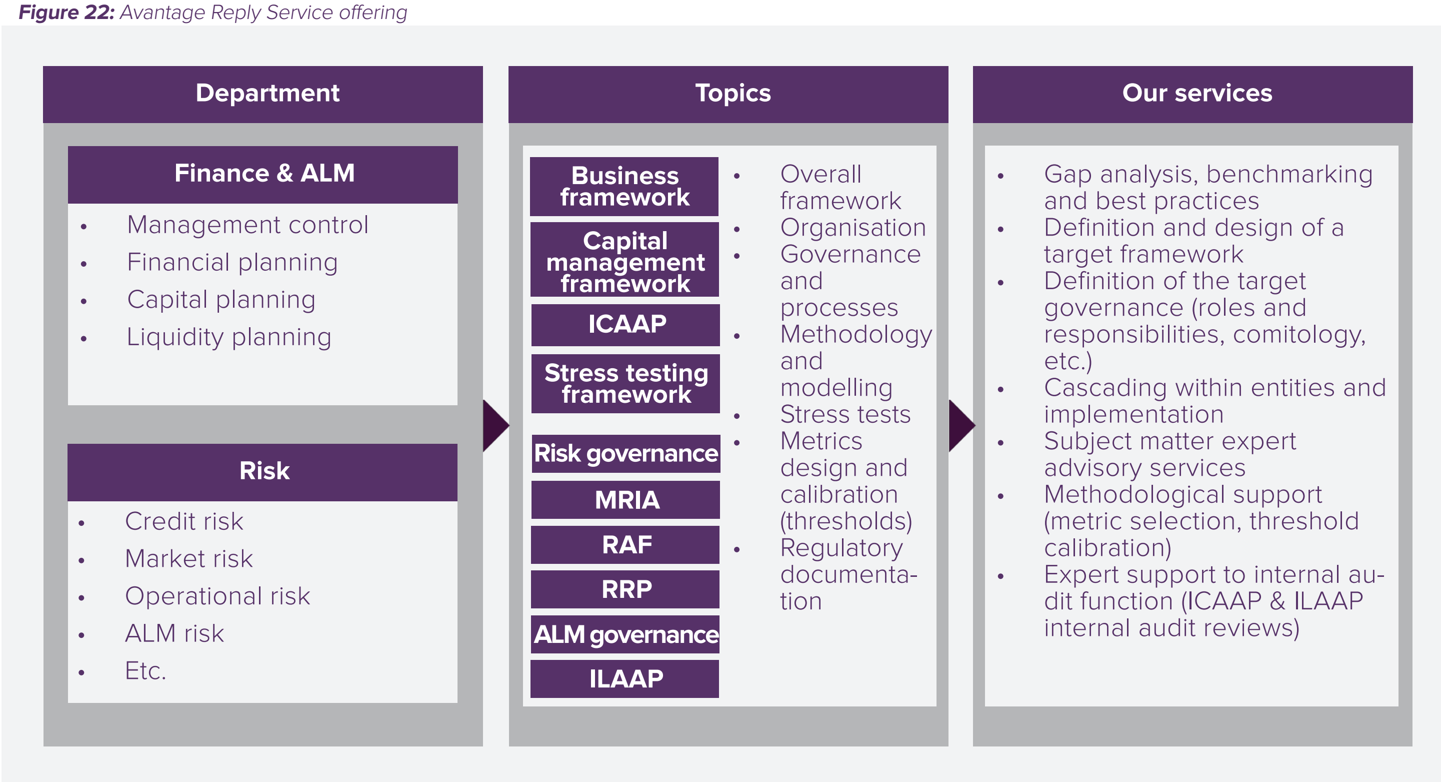
6. How Avantage Reply can Help

Having assisted clients with end-to-end solutions, Avantage Reply have experience in developments including risk appetite frameworks, ICAAP and ILAAP frameworks that meet ECB and EBA requirements.

We assist our clients in designing and implementing banks' key strategic processes to ensure their integration into business strategy and decision processes at both the group and entity levels.

We offer a proven approach that addresses the key challenges required by the SREP requirements, helping clients accelerate the transformation needed in terms of governance, organisational aspects, methodology; systems and data. These are essential to successful compliance with SSM expectations, as illustrated below.

Figure 22: *Avantage Reply Service offering*



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