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FINANCIAL INSTITUTIONS & SSM SUPERVISION: WHAT CAN WE EXPECT FOLLOWING THE COVID-19 CRISIS?

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He has notably assisted banks in developing and implementing RAF, ICAAP, ILAAP, RRP, Solvency and liquidity stress testing frameworks but also ALM and Liquidity management and measurement frameworks in line with evolving supervisory requirements and industry best practices. Besides, he has a strong knowledge of regulatory and supervisory packages and has designed and implemented number of remediation plans. Finally, he has worked for both European and French SFIs and LSIs and has a good vision of market practices.

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ABSTRACT

Since 2008, financial institutions have experienced an unprecedented series of crises that have led to an increasing number of prudential measures and a new integrated banking supervision framework. Initiated in 2012, the Banking Union has been established to allow a more consistent application of EU banking rules through new decision-making procedures and tools to help create a more transparent, unified and safer market for banks.

One pillar of the Banking Union is the Single Supervisory Mechanism (SSM) referring to the banking supervision system in Europe in which the European Central Bank (ECB) has been granted a role of central supervisor within the euro area. Since 2014, the ECB has developed and implemented a set of supervisory actions and tools including the annual SREP process, the TRIM program, on-site inspections, deep dives and other specific measures established in line with the annual SSM risk map and supervisory priorities.

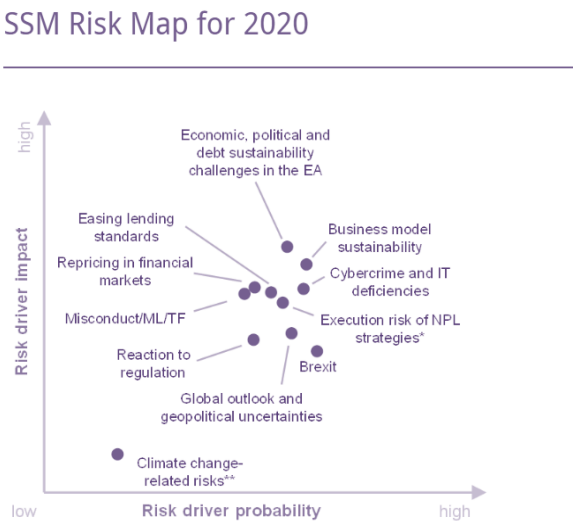
As a result of this strengthening of the supervisory framework, financial institutions have improved the quality and quantity of their capital cushions and liquidity reserves. Internally, they have strengthened their governance, internal control and risk management frameworks. Additionally, they have considerably increased their forecasting abilities and planning capacities through robust stress testing framework.

Despite all these developments and abilities to prepare for future stressed events, the banking sector is once again facing another unique historical challenge. In fact, the COVID-19 crisis currently experienced is in fact a real-time stress test on an unprecedented scale, straining financial institutions on many fronts. Moreover, this crisis challenges the operating capabilities of the crisis management processes such as the business continuity plan and other contingency plans.

This opinion paper aims to present and analyse the key facts regarding the impact of the COVID-19 crisis on how financial institutions might need to address the new challenges post the COVID-19 crisis and how it could interfere on ECB supervision agenda and SSM priorities

OVERVIEW

At the end of 2019, the ECB published their SSM supervision priorities for 2020 based on the risk identification and assessment exercise conducted every year. This exercise provides a list of the key risk drivers expected to affect the euro area banking system over a 2-3-year horizon. This is summarized in the following diagram..



The three most important risk drivers identified are:

- Economic, political and debt sustainability challenges in the euro area;
- Business model ; and
- Cybercrime and IT deficiencies

Based on these outcomes, the SSM 2020 priorities have been defined and split into three categories:

- **Continuing balance sheet repair** through follow-up on Non-Performing Loans (NPL) guidance and Internal Ratings-Based (IRB) models and a specific focus on trading risk and asset valuations;
- **Strengthening future resilience** through a number of topics including credit risk underwriting and asset quality, internal steering processes (BMA, ICAAP, ILAAP), governance, stress tests and IT and Cyber risk;
- **Other priorities** focusing on the follow-up on Brexit work.

The COVID-19 crisis will engender many changes both for banking supervision and for financial institutions that have been hit hard by the crisis. More specifically, financial institutions will have to continue to fund the real economy in a significantly weakened macroeconomic environment. This is in addition to already facing existing challenges such as low interest rates. The ECB has reacted quickly, relaxing specific supervisory measures and providing capital relief for the next 6 months. Undoubtedly the SSM priorities will continue to be adapted or completely redesigned in the coming months and years.

In this opinion paper, we will discuss the potential impacts of the COVID-19 crisis and the associated future challenges for both the ECB and financial institutions banks. Our analysis is broken down into two complementary parts **aimed at confronting these two different perspectives, namely the banking supervision view and the internal banking view,** which will, in our opinion, have to converge to manage the post-crisis adequately and efficiently. More specifically, we will try to answer the following questions:

- What will be the appropriate trade-off between continuing operations and maintaining the high level of compliance to supervisory constraints?
- To what extent will the ECB adapt its supervision policy in the short and medium term?
- In what proportion will the priorities of the SSM be adapted or completely rethought?

FINANCIAL INSTITUTIONS' VIEW: CHALLENGES AND PERSPECTIVES

In this section, our analysis focus on how financial institutions will pursue their fundamental missions as key actors to restore the economy after the crisis but also to maintain a high level of supervisory compliance while strengthening their financial and risk management capabilities.

Unlike previous financial crisis, the banking sector is not at the genesis of the current one and has an unique opportunity to give a positive image by acting as one of the main actors of the post crisis era by providing all the key financing solutions which will help to address the many challenges that the euro zone will be facing by the end of year 2020. However, they will have to continue their classic activities in a very complex environment while continuing to respond to more flexible supervision constraints in the short term. Gradually these will normalize through time with probably increasing expectations around steering and risk management capabilities and frameworks.

Business model sustainability

For a couple of years, euro area banks' profitability has remained under pressure from the economic environment, low interest rates, legacy issues and competition from banks and non-banks. In addition, digitalisation poses significant challenges for banks, while at the same time providing opportunities for efficiency gains and new business. The coronavirus crisis is engendering a major blow to the real economy as a strong financial support is expected from financial institutions to limit the potential damages. In fact, banks will need to provide financial solutions and guarantees to viable households, small businesses and corporates hardest hit by the current economic fallout. While the outlook of prolonged low interest rates and intense competition weigh further on banks' ability to generate income will remain, additional expenses related to the crisis will be also be an area of focus as classical cost-saving efforts won't be enough to offset factors such as need for IT investments and improvements in risk management and stress testing frameworks. Besides, as banks are focusing for some years now on digitalization in order to improve cost-efficiency and to offer new products and services, they will probably need to rethink their business models and strategies, notably on the way they operate and interact with clients through short-term investments.

Credit risk lending and management

The macroeconomic impacts of this health crisis will be disastrous for a large part of the industry. The various external aids or supports (states, banks) will not in fact be able to prevent companies from experiencing major cash flow difficulties, debt restructuring not to mention the probable increase in the number of defaults. With customers experiencing difficult financial conditions, the credit quality of bank's portfolios will be affected and will probably deteriorate over time as pledged collateral will also decline in value. Retail and institutional customers will proactively work with financial institutions to renegotiate loan terms and conditions to resort to delayed payments on their loan balances.

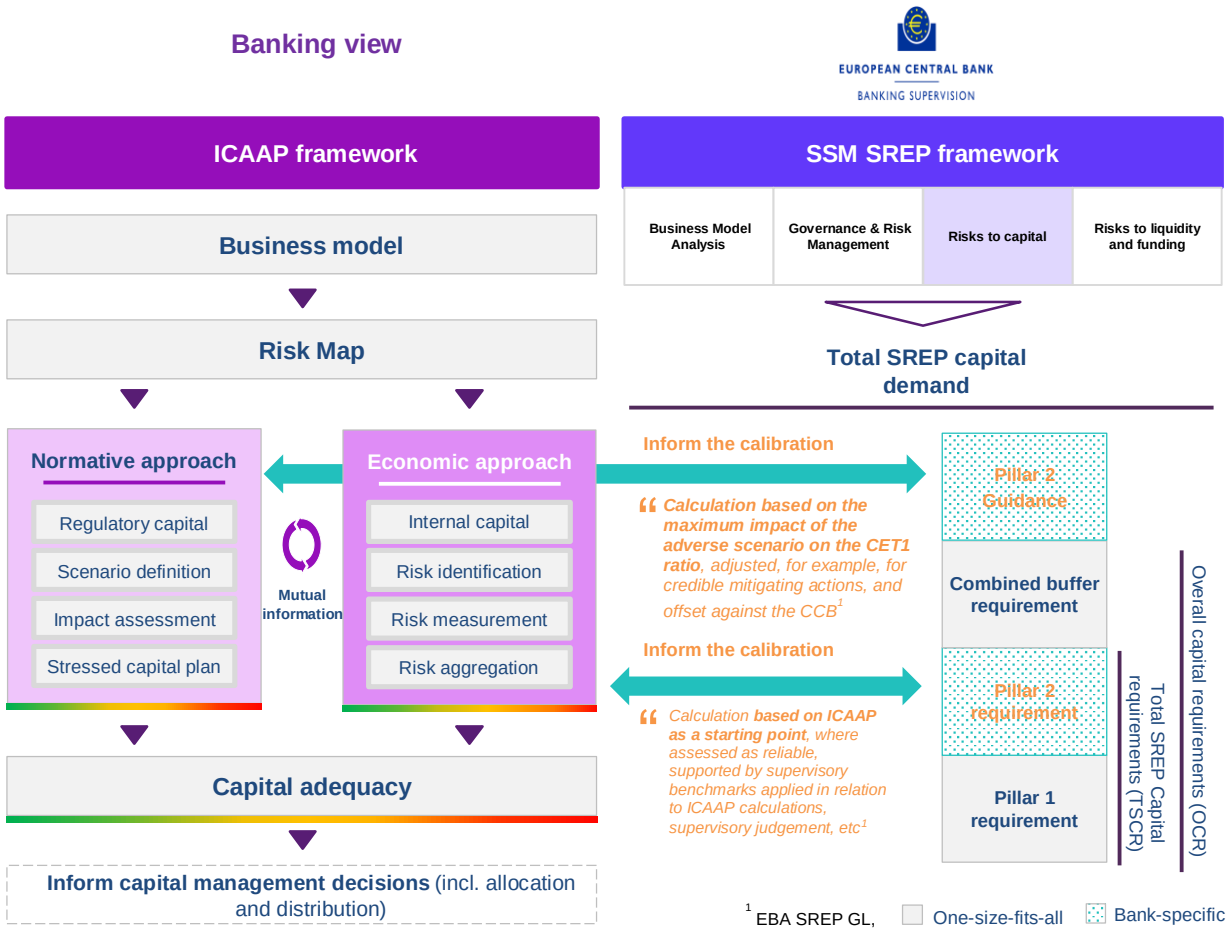
For all these reasons, Risk-Weighted Assets (RWAs) will probably increase as the deteriorated credit quality of portfolios should last and higher charges are expected from a higher counterparty credit risk. As the first crisis since the implementation of IFRS9 standards, banks will also experiment a negative impact in its loss allowances through its expected credit losses (ECLs) which are directly linked to a less favourable economic outlook. Also, borrowers may want to refinance at longer maturities to lock in lower interest rates which could also lead to additional loss allowances under CECL.

Capital management and key stakes associated to an integrated ICAAP

In these times of crisis, financial institutions' capital management framework and ICAAP are challenged. In fact, the soundness and the integration of this process is even more necessary and relevant for strategic steering purposes. In fact, a few pieces of the ICAAP framework have been tested in practice in this stressed environment. A reliable ICAAP is an opportunity to strengthen internal steering process for capital management but also address supervisory expectations as mentioned below.

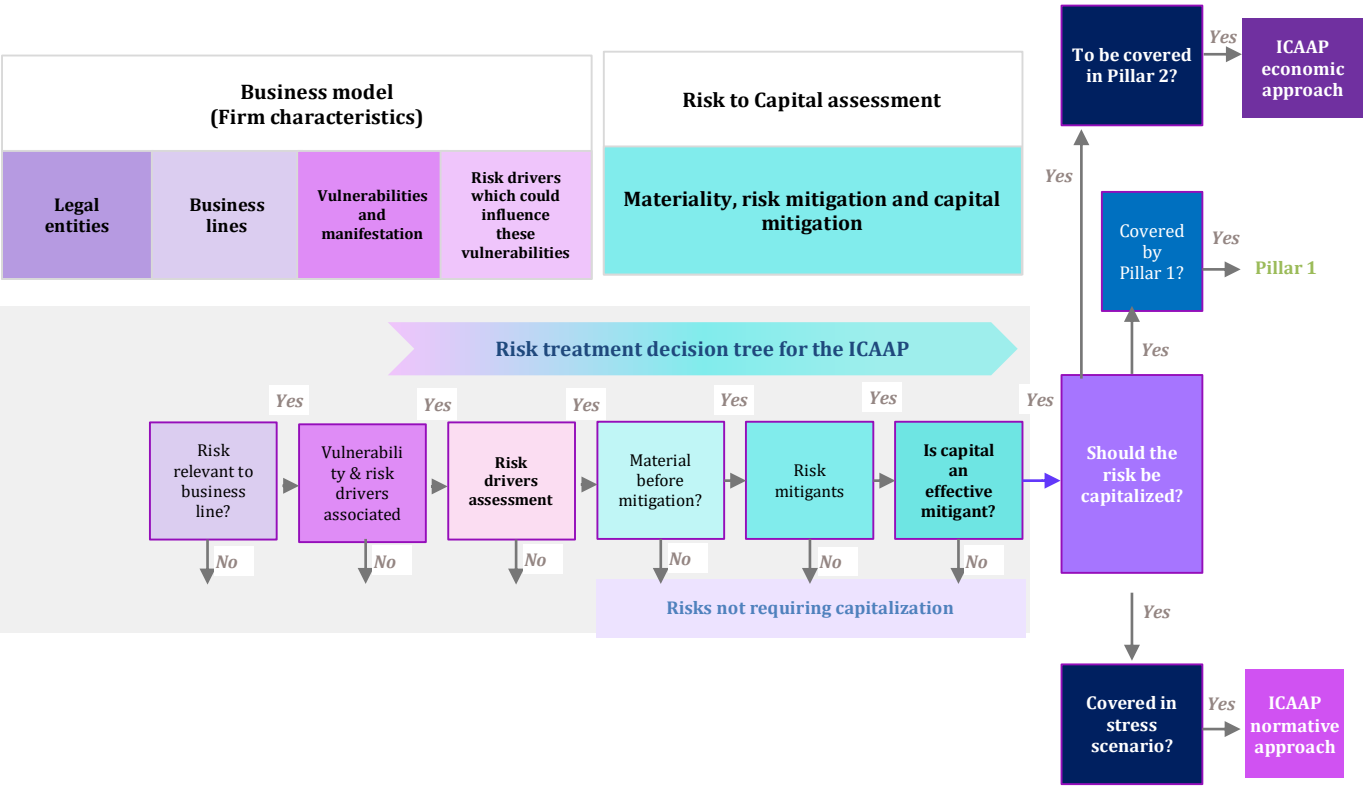
Figure 2: ICAAP's Banking view vs Supervisory view

The ICAAP feeds into all SSM SREP assessments and into the Pillar 2 capital determination process, i.e. the calibration of bank-specific capital charges imposed by the ECB (namely the Pillar 2 capital requirements (P2R) and Guidance (P2G)).



At first, the outcomes of the material risk identification process are to be put into perspective by the simple fact that this health crisis is multi-risk and highlights that several credit, market, balance sheet, operational and non-financial risks have increased to become material or to reach an extreme level of materiality. The analysis of the results of this process is even more important as it conditions several internal management processes.

Figure 3: Overview of the Risk-to-Capital assessment process for the ICAAP



Secondly, risk quantification and stress tests methodologies, whether it is the economic approach or the normative approach, are deeply questioned. Indeed, the economic modelling approach and in fact the level of potential capitalization of operational, credit and business risks (to only name these ones) are likely to be thoroughly reviewed.

Figure 4: Key methodologies assumptions for the economic approach in the ICAAP

Quantitative assessment – Pillar 1 and 2 risks			Key methodologies assumptions
✓ Credit default risk ✓ Traded credit risk ✓ Operational risk ✓ Concentration risk ✓ Securitisation risk ✓ Traded market risk	✓ IRRBB ✓ CSRRBB ✓ Business risk ✓ Underwriting risk ✓ Property risk	✓ Model risk ✓ Reputation risk ✓ Funding risk ✓ Insurance risk ✓ Pension risk	✓ Confident level – Rating-based or internal view - 99.9x %. ✓ **Horizon period** – Short term (up to 1 Year) ✓ **Methodology**: VaR / Specific Stress tests/Add-hoc model ✓ Common indicators and consistent calibrations between the RAF and the ICAAP ✓ Integrated scenarios and assumptions

In addition, the nature, the number and the degree of severity of the stress tests of the normative approach are also to be rethought in the light of the severity and the speed of this crisis. Furthermore, the importance of reverse stress have only strengthened.

Figure 5: Overview of the reverse stress tests process

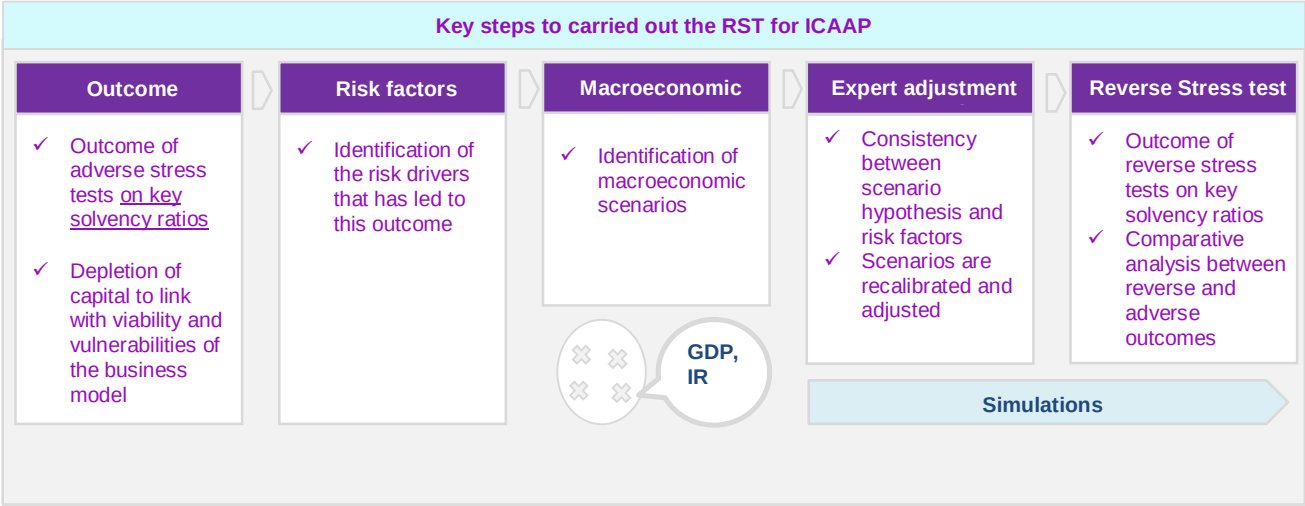
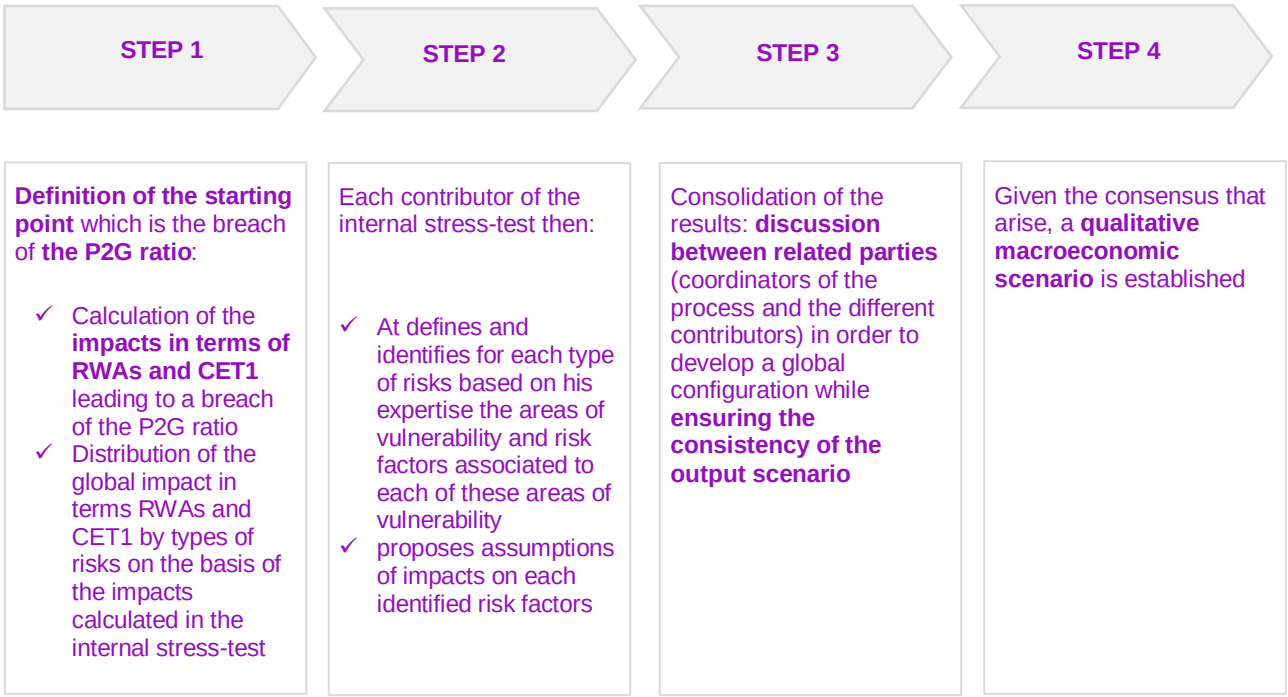
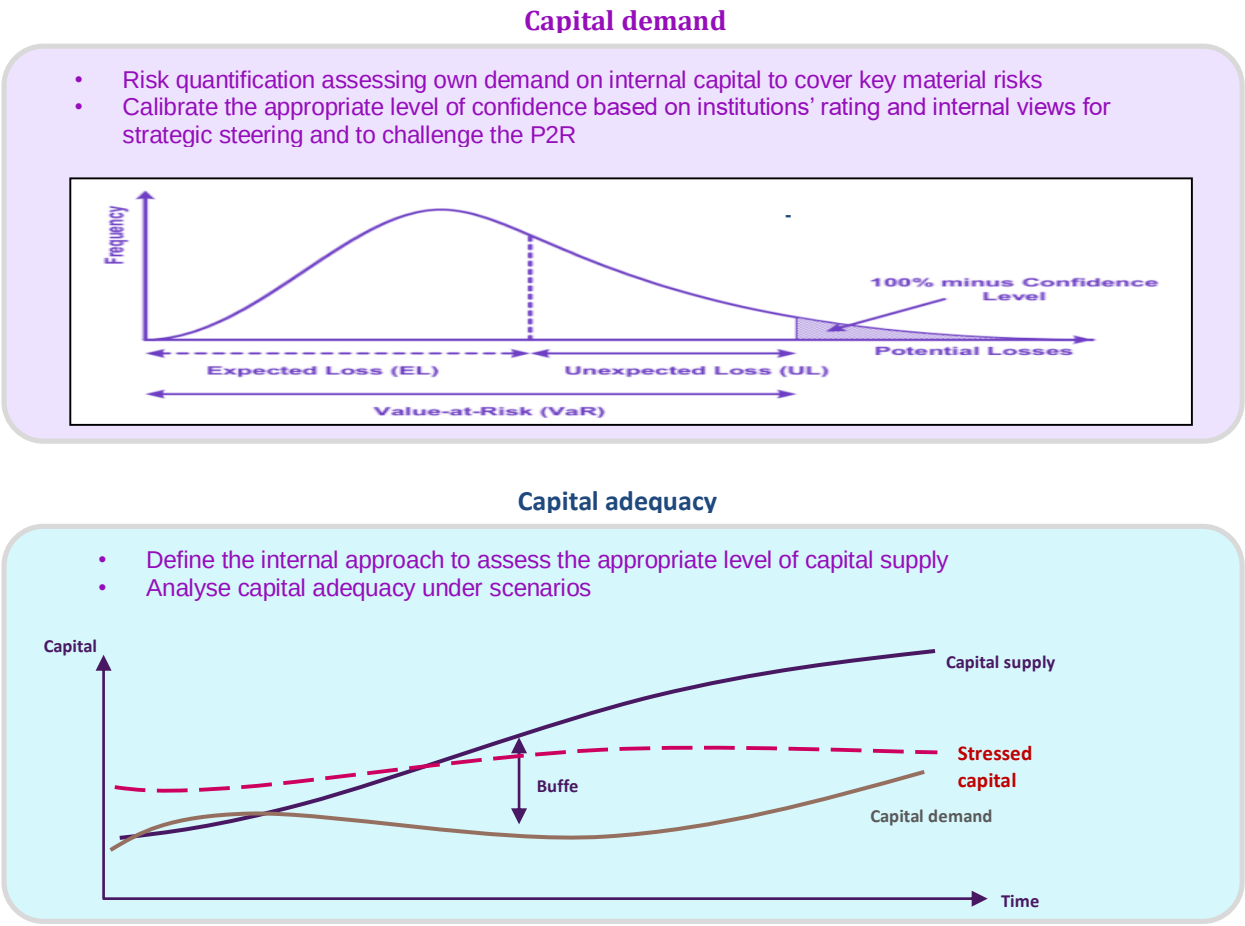


Figure 6: Reverse stress tests méthodology



Finally, many challenges related to capital management remain, whether in terms of planning and the operationalization of management actions used during this crisis or to be implemented after this crisis but also in relation to capital allocation policies and associated profitability measures. To conclude, the ICAAP continues to demonstrate relevance for banks to assess and maintain an adequate level of capital in line with the key material risks to which they are exposed.

Figure 7: Overview of key components of the Capital management process included in the ICAAP



Liquidity management and key staked associated to an integrated ILAAP

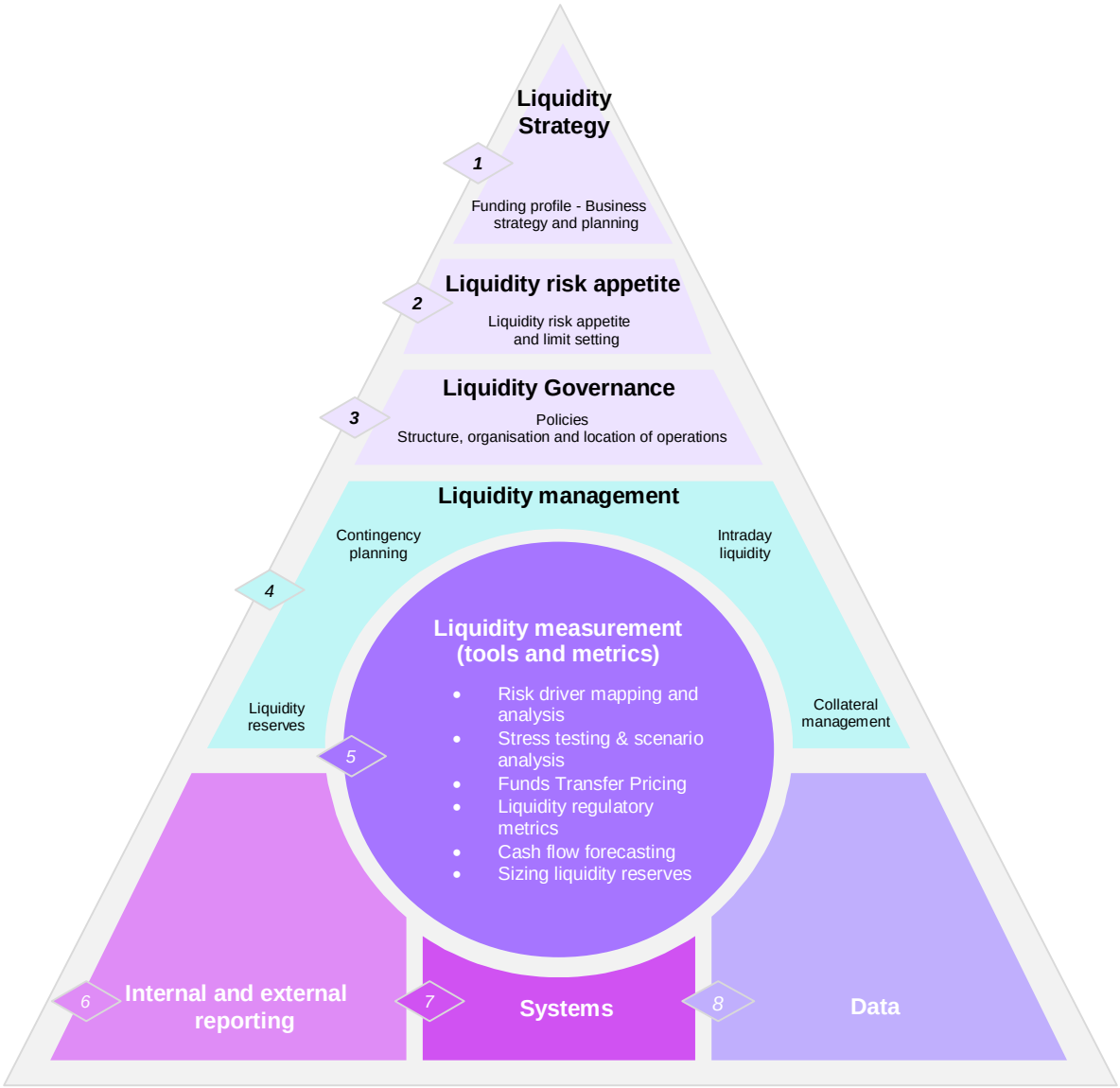
While world central banks have intervened in the interbank market through a few measures to ensure adequate market liquidity financial institutions have experienced various liquidity issues related to funding capabilities and market tightening, but also funding and liquidity risk monitoring and measuring as well as stress testing. As banks' funding and liquidity management and risk monitoring frameworks are particularly exposed in these challenging days, the relevance of the ILAAP remains even more important and useful for strategic steering purposes.

Figure 8: Top-down view of ILAAP's key components

ILAAP	
Qualitative principles	**Quantitative requirements**
Liquidity principles	**Liquidity mismatches and maturity calendars**
Risk appetite & tolerance	
Funding strategy and market access	**Funding plan**
Governance	**Regulatory minimum requirements**
Liquidity management	**Liquidity risk identification and measurement**
Intraday liquidity risk management	**Liquidity models**
Collateral management	**Liquidity buffers and reserves**
Stress testing	
Contingency funding plan	

Due to market volatility, financial institutions have experienced liquidity shortfalls and some difficulties to secured funding (including market access) or conduct asset sales. In fact, they probably had to sell very quickly their most liquid assets by accepting even a partial discount linked to these tense markets or go to finance themselves on the markets at a higher cost than usual. These legitimate difficulties in a crisis and recurrent for 10 years nevertheless question the relevance of a financing strategy dependent on bond or interbank markets and more generally the sustainability of this kind of business models.

Figure 9: Top-down view Funding and Liquidity management framework



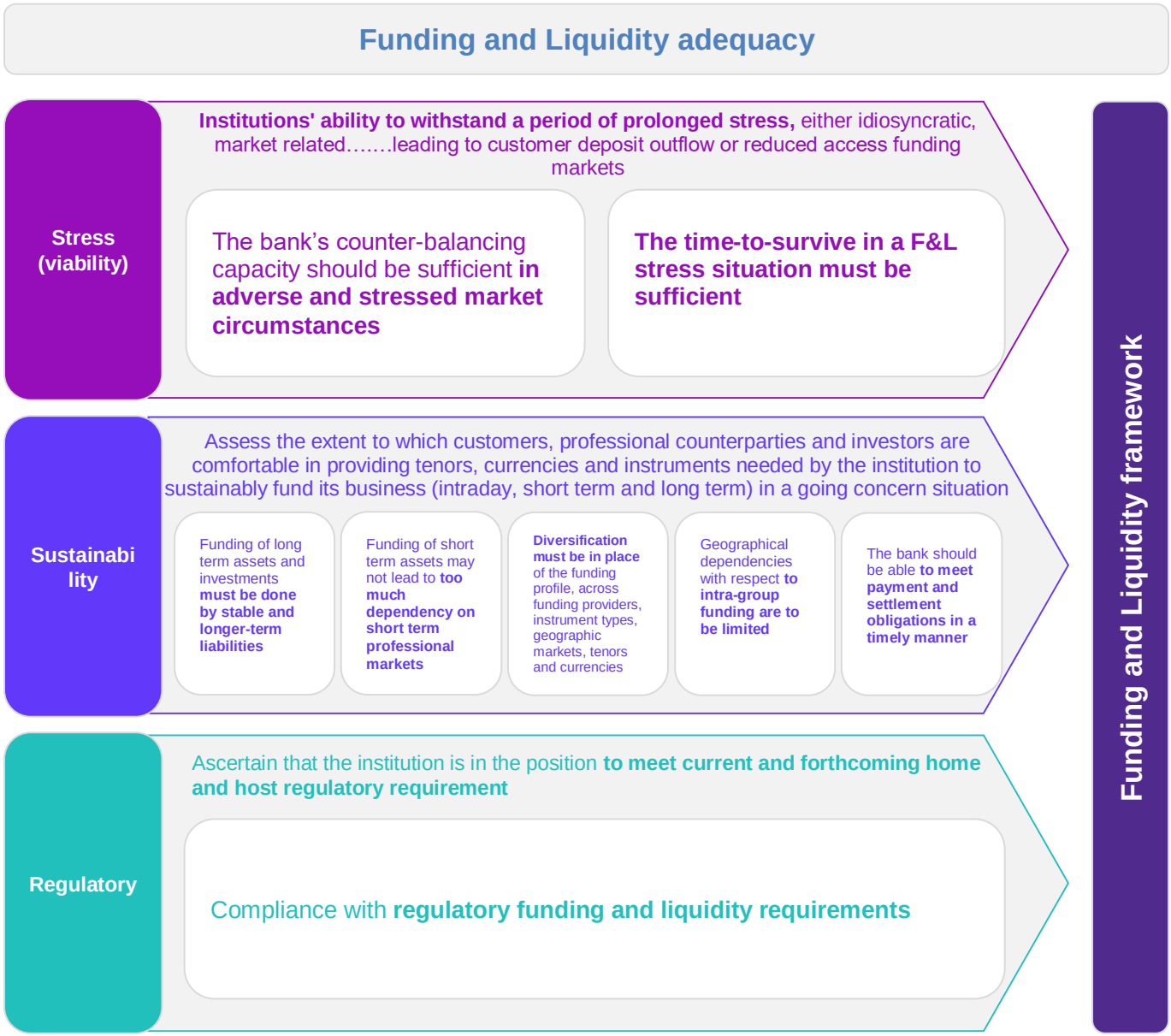
1	• Liquidity and funding risk is a key consideration when establishing setting bank's strategy, formulating business plans and managing performance • Active management of balance sheet, funding profile and liquidity needs • Resource allocation embedded into performance management and decision-making process in line with bank's strategy
2	• Risk appetite clearly articulated which reflects the organization's risk bearing capacity and risk/return objectives • Risk appetite and tolerance should be defined with appropriate metrics, several tolerance thresholds and appropriate limits • Adapted escalation process and management actions
3	• Senior management ownership and responsibility • Appropriate organization and committees including clear delineation of role and responsibilities • Clear risk management policies and procedures for managing all material risks (including Contingency Funding Plan) • Structure and organization of treasury operations
4	• Short- and medium-term liquidity and funding management • Management and optimization of liquidity reserves and collateral • Intra-day liquidity management • Contingency planning
5	• Risk driver mapping and analysis • Liquidity models to forecast consumer behavior and cash-flows • Internal and regulatory metrics to steer and monitor liquidity positions • Multi-scenarios stress tests to assess liquidity reserves in a stress environment • Contingency funding plans and associated governance
6	• Internal reporting to integrate in bank's liquidity management and strategic decision-making process • Regulatory requirements for liquidity reporting (LCR, NSFR, AER,…)
7	• Implementation of fit for purpose systems to meet liquidity management demands in business as usual and stress scenarios • Selection of vendor solutions or in-house development • Specific data capture and system capabilities (including legal entity and jurisdictional control)
8	• Availability and granularity of data sourced, recorded, stored and reported • Central repository database where the firm can store internal, market and contractual data to facilitate liquidity risk management processes

A certain number of limits have surely been breached materializing the sensitivity of the liquidity balance sheet to one or more risk drivers (ex: off-balance sheet drawdown, massive outflow of wholesale deposits ...). In some cases, the absence of internal and specific indicators on the concentration risk, the off-balance sheet risk or on the volatility of certain types of deposits has been noted demonstrating a certain weakness of the risk management framework. Similarly, the measurement of short-term liquidity risks such as intraday remains perfectible. Depending on the level of crossing of the tolerance threshold, more or less strong corrective measures have been deployed but sometimes showing practical difficulties of implementation.

Figure 10: Top-down view Funding and Liquidity risk appetite

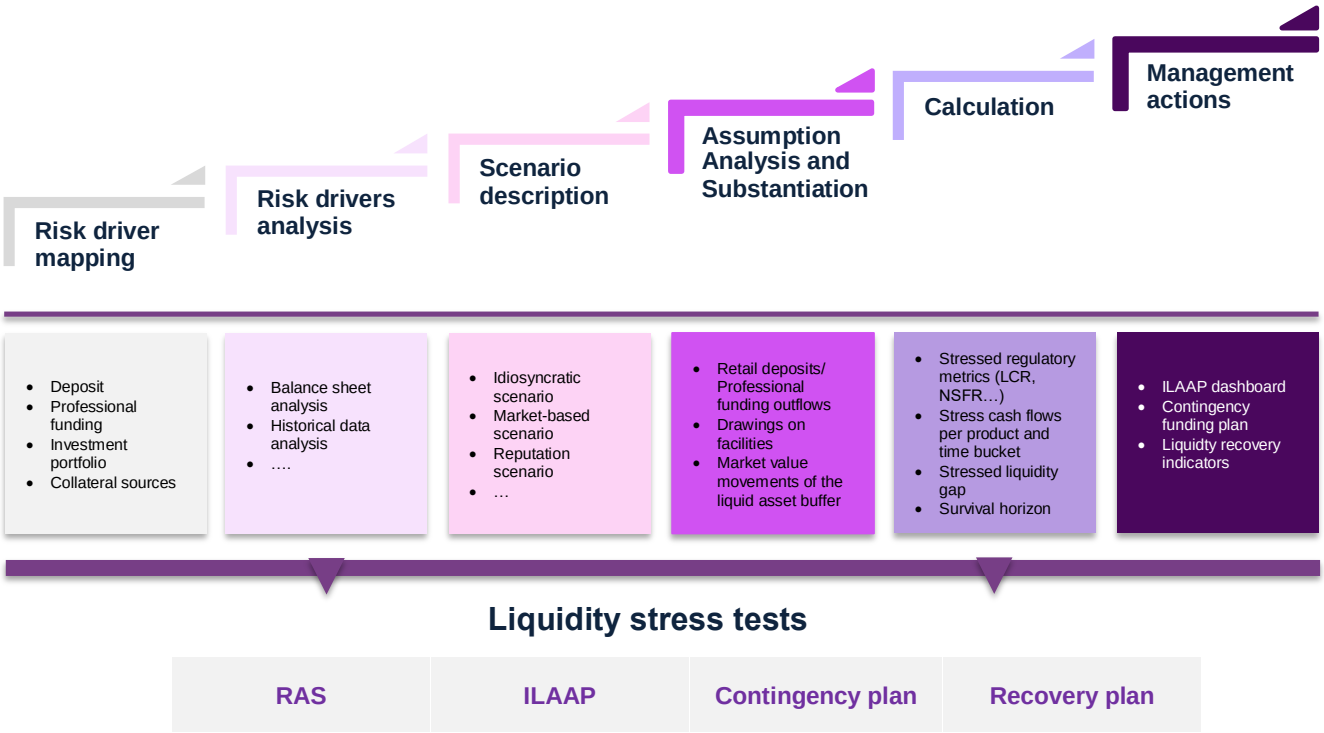
The Funding & Liquidity risk management framework defines the F&L Risk appetite statements through 3 lenses:

1. Stress (viability)
2. Sustainable
3. Regulatory



Existing liquidity stress tests have often demonstrated inadequate or even completely false results. Thus, in a large number of cases, multiple simulations had to be carried out manually with numerous approximations. In this regard, many areas for improvement are necessary on the liquidity stress testing devices with the inclusion of the following 3 dimensions: (i) multi-scenario; (ii) multi propagation speed; and (iii) multi horizon period.

Figure 11: Liquidity stress testing process



In some extreme cases, institutions' have activated their contingency funding plans (CFP) in order to ensure adequate level of liquidity across the enterprise in these difficult times.

Through the operational deployment of this process, the adequacy of the escalation process and the quantitative measures of this emergency plan could be tested and demonstrate the benefits but also the limits of the funding mechanism of each institution. While it is normal to use liquidity buffer in stressed circumstances, being in a situation requiring the activation of the contingency plan demonstrates key weaknesses in the funding mix or the inefficiency of the liquidity stress tests device especially when banks have LCR ratios well above 100%. It also demonstrates areas for improvement of their Funding and Liquidity risk management framework especially the integration of liquidity stress tests outcomes in strategic processes and limit/threshold calibration in line with it.

To conclude, institutions' ILAAP remains perfectible and strengthening its different components such as Liquidity stress tests, risk management framework or contingency funding plans will be necessary to address a number of weaknesses identified during the crisis. As it is the case for the ICAAP, it is also an opportunity to address supervisory constraints and to strengthen funding and liquidity management process and risk management framework.

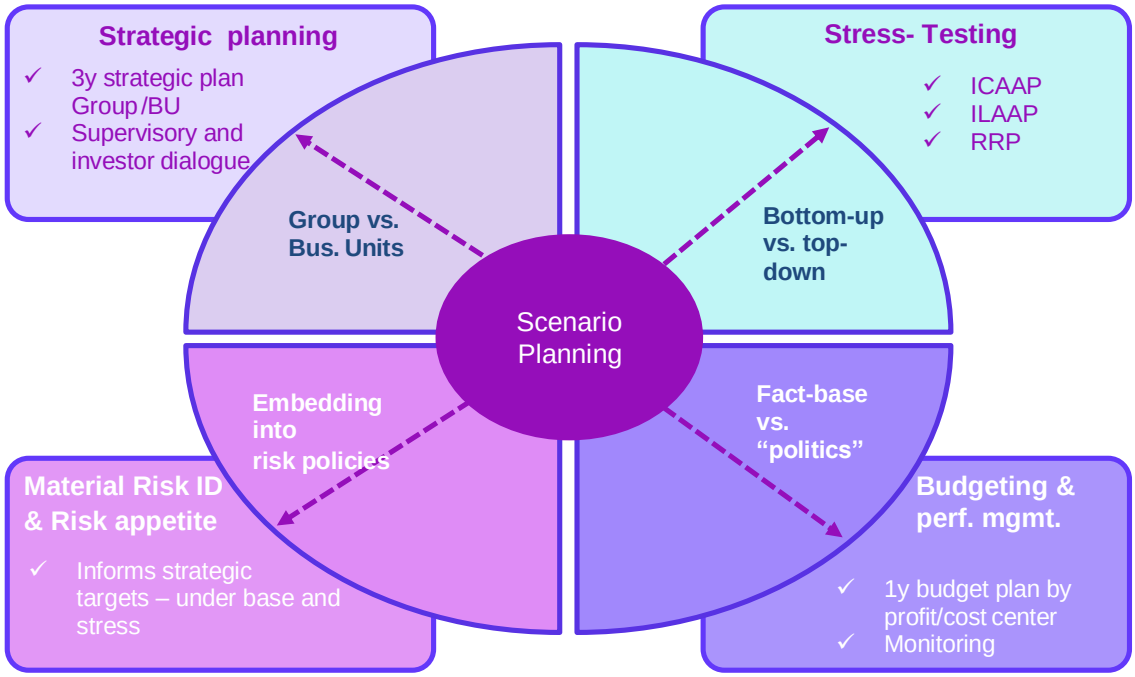
Internal stress tests and forecasting capabilities

This unique crisis in terms of severity and speed has confirmed the fundamental role of stress tests in strategic and risk management processes. Although banks have been working for many years to design and implement global internal stress testing frameworks to address supervisory constraints but also for internal management purposes, many areas of improvement are emerging during this crisis and it will be necessary to ensure a better integration of the stress tests into internal management and decision-making process..

At first, an in-depth review of institution's top-down and bottom-up vulnerabilities will be necessary to ensure a more adequate and transversal design of stress test scenarios to take into account risk, solvency and liquidity perspectives. When designing internal stress scenarios, institutions will need to use a broader set of information on historic and hypothetical stress events but also establish scenarios aligned to institution's risk profile and business model including past events which having already impacted the bank. The severity should vary depending on the scenario and should be high in some cases while remaining plausible. Beyond the classical scheme including a baseline scenario, adverse scenarios and possibly reverse ones, the design of future scenarios must include a stronger dimension on the speed of shocks propagation, especially on liquidity components and certain specific risks. Note the design and the use of reverse stress tests which allow to identify circumstances that would lead to business model non-viability remains all the more important in the overall stress testing process.

These different aspects demonstrate the necessity of a flexible scenario generation process but also strong forecasting capabilities. Numerous investments have already been made in recent years within financial institutions of a view to carrying out overall internal stress tests once a year. The efforts made will surely be continued by relying on an integrated infrastructure on both the risk and finance sides, allowing the number of scenarios and especially the frequency of calculations to be widened in order to make these simulations much more dynamic and more integrated into management.. Finally, the adequacy and operational feasibility of the various corrective measures that have been deployed will be assessed in consistency with the recovery options.

Figure 12: Scenario planning for steering and management purposes



Crisis management processes

In these exceptional circumstances, firms have deployed their business continuity and contingency plans, which are composed of various concrete operational measures such as alternate workplace arrangements including split work sites, working from home, and rotating shifts for all types of employees. Besides, institutions have also heightened measures to ensure the safety and health of their employees through various means and have cancelled large events.

Long-existing business contingency plans have rarely been implemented operationally and will surely demonstrate weaknesses in these difficult times. Post-crisis analyses will allow to identify and implement key areas of improvement in terms of methodologies and simulations, governance and escalation process and operational deployment. In addition, it should be noted that the activation of capital and / or liquidity contingency plans have probably allowed to demonstrate (or not) their effectiveness, particularly regarding the mobilisation of capital and liquidity resources. Additional reflections will surely be necessary to address the weaknesses of the plans which were not effective or whose stress tests and preventive indicators did not allow to anticipate (even a little) their activation during this crisis.

Finally, in the most extreme cases, the activation and operational feasibility of the recovery options will also allow institutions to be restored to adequate solvency and liquidity levels, but also to identify the weaknesses of their business model. In this regard, the enrichment of recovery plans on the stress test dimension and calibration of recovery indicators will probably be necessary at the end of this crisis.

Operational risk management framework

In the context of this crisis, non-financial risks such as conduct risk/culture, third-party risk, and cyber risk are taking an increasing importance due to the scale of the massive use of remote work potentially resulting in information network and/or system failures, and thus a more climate-friendly environment for cyberattacks. Moreover, the large use of several institutions in external IT services (e.g. independent valuation, back-office) increases the various risks associated with outsourcing activities.

The various difficulties encountered during the crisis will lead to numerous changes in operational risk management framework. Firstly, the operational risk mapping will have to be reviewed to consider the different risk situations observed in practice through the census of the different incidents but also their evaluation in terms of frequency and severity. Secondly, a reflexion will surely be necessary to redefine the different operational crisis scenarios as well as their modelling and integration in the steering and management of the bank. Finally, the control plans associated to operational risks mapping will surely have to be strengthened. For example, conduct risk controls will have to be adapted regarding alternate work arrangements and as business process and flows are changing cyber risk management framework will have to be defined.

ECB SUPERVISION POLICY AND STRATEGY: CHALLENGES AND PERSPECTIVES

In this section, we are focusing on how the COVID-19 crisis might impact ECB banking supervision. More specifically, our analysis aims to cover the following themes**:**

- A general reflection on how the ECB supervision policy and strategy might be adapted;
- A more specific analysis on how SSM priorities will probably be adapted or reshaped due to the current circumstances.

Since the implementation of the SSM mechanism, ECB Banking supervision has never experienced such a fast and strong crisis. In this context, the central supervisor of the euro area is experiencing its first practical test to assess the beneficial effect of the existing prudential package and supervisory measures. Therefore, the ECB will play a key role in the coming strong and deepen economic crisis. In this regard, its strategy and policy might have to evolve and adapt by leveraging notably on the Joint Supervisory Team (JST) practical observations of the effects of the crisis within the financial institutions.

Short term situation – Operational and capital relief

From the first weeks of the crisis, the ECB has demonstrated its capacity to adapt by showing flexibility in terms of supervision. In fact, as of 12th March 2020, the ECB announced temporary capital and operational relief in reaction to the crisis through a number of measures to relieve its directly supervised banks. The main objective for the supervisor is to ensure that financial institutions continue to fulfil their role in funding the real economy as the economic effects of the coronavirus (COVID-19) become more and more significant. The different supervisory measures include notably;

- A full use of capital buffers by operating temporarily below the Pillar 2 guidance (P2G) level and potentially consuming the Capital Conservation Buffer (CCB) to withstand potential stress losses;
- A substantial use of liquidity buffers through the HQLA portfolio and by operating below LCR 100% level
- A benefit from relief in the capital composition of the Pillar 2 requirement (P2R) composed of a mix of CET1, Tier 1 and Tier 2 capital instruments
- An operational flexibility in the implementation of bank-specific supervisory measures

In the second half of March 2020, the ECB has shared more details regarding the different relief measures including:

a) Relief measures regarding asset quality deterioration and non-performing loans

The treatment of non-performing loans (NPLs) has been eased to allow banks to fully benefit from guarantees and moratoriums put in place by public authorities to tackle the current distress. It includes notably, flexibility when implementing the ECB Guidance on NPLs. On a temporary basis, supervisors will exercise flexibility regarding the classification of debtors as “unlikely to pay” when banks call on public guarantees granted in the context of coronavirus. Note that certain flexibilities might be considered regarding loans under Covid-19 related public moratoriums. Loans which become non-performing and are under public guarantees will benefit from preferential prudential treatment in terms of supervisory expectations regarding loss provisioning. Supervisors will also show some flexibility when discussing with banks the implementation of NPL reduction strategies, taking into account the extraordinary nature of current market conditions.

In addition, excessive volatility of loan loss provisioning should be tackled at this juncture to avoid excessive procyclicality of regulatory capital and published financial statements. Within its prudential remit, the ECB recommends that all banks avoid procyclical assumptions in their models to determine provisions and that those banks that have not done this so far opt for the IFRS 9 transitional rules.

b) Relief measures regarding the operational aspects of supervision

While it remains important to maintain the high quality of ongoing supervisory activities and actions during stressed times, the ECB is, however, very much aware of the need to support banks at this difficult juncture, and to reduce the supervisory burden on financial institutions.

Against this backdrop, the ECB has decided to:

- Postpone, by six months, the existing deadlines for remedial actions imposed in the context of on-site inspections, TRIM investigations and internal model investigations;
- Postpone, by six months, the verification of compliance with qualitative SREP measures:
- Postpone, by six months, the issuance of TRIM decisions, On-Site follow up letters and internal model decisions not yet communicated to institutions, unless the bank explicitly asks for a decision because it is seen as beneficial to the bank.

JSTs will be in contact with the banks to provide clarity on the revised implementation timeline of those requirements and their specific application.

c) Relief measures regarding capital and liquidity requirements

Banks are allowed to operate below the P2G level and to frontload the rules on the composition of P2R originally scheduled to come into force in 2021 with CRD V. The ECB estimates that the capital relief provided by the possibility to operate below the Pillar 2 Guidance (P2G) and the frontloading of the new rules on the Pillar 2 Requirement (P2R) composition amounts to €120 billion of CET1 capital. This relief is available for banks to absorb losses without triggering any supervisory actions or to potentially finance up to €1.8 trillion of loans to households and corporate customers in need of extra liquidity. Besides, banks have made important efforts in recent years to reach good levels of liquidity buffers (evidenced by the LCR well above the 100% minimum). These buffers can now be used substantially. It is key that banks make use of the buffer under stress, even if that means falling substantially below the minimum 100% level, in order to ensure liquidity in the system and avoid contagion effects and chain reactions that might trigger liquidity problems in other institutions. In particular, the ECB will take a flexible approach when approving LCR restoration plans which banks are legally required to submit when breaching the LCR requirement.

d) Additional clarifications on banks' dividend policies

To boost banks' capacity to absorb losses and support lending to households, small businesses and corporates during the coronavirus (COVID-19) pandemic, the ECB request financial institutions to not pay dividends for the financial years 2019 and 2020 until at least 1 October 2020. Banks should also refrain from share buy-backs aimed at remunerating shareholders This recommendation does not retroactively cancel the dividends already paid out by some banks for the financial year 2019. However, banks that have asked their shareholders to vote on a dividend distribution proposal in their upcoming General Shareholders Meeting will be expected to amend such proposals in line with this recommendation. The ECB expects banks' shareholders to join this collective effort. In this vein, capital conserved by refraining from dividend distributions and share buy-backs can also be used to support households, small businesses and corporate borrowers and/or to absorb losses on existing exposures to such borrowers.

Medium-long term supervisory policy

While we will probably stay in the health crisis for several more months, it remains unclear at this stage to what extent the banking supervision will evolve in the medium term. Nevertheless, it is possible to envisage several scenarios regarding the SSM agenda for the coming months and years.

In this configuration, the ECB will probably leverage on the 6-month relief period offered to financial institutions to closely monitor their situation and develop a global opinion of the impact of COVID-19 crisis on their business model and risk profile, their financial and risk absorption capabilities in terms of capital and liquidity and the operational difficulties encountered. With hindsight and practical feedback from all the banks directly supervised, the ECB will gradually draw their own conclusions and will decide what follow-up measures and next steps in terms of supervisory practices.

To start, it is probable that the original supervisory agenda will be rolled out with a number of adjustments including new prioritizations and some calendar shifts. In fact, for some years now, the ECB has assessed and challenged institutions' business models, organisation and governance, models and stress tests, systems and data for all types of risk and activities. Through the Supervisory Review Evaluation Process (SREP), Target Review of Internal Models and dedicated on-site inspections, thematic reviews or deep dives, the ECB has implemented useful and robust supervisory tools which would be strengthened over the years to keep tracking financial institutions' weaknesses.

As the COVID-19 crisis should allow to identify the beneficial effects and limits of the current supervisory framework, it should also demonstrate its key weaknesses which could lead the ECB to adapt reshape its prudential agenda and thereby review its priorities. Then, the ECB might adapt SSM priorities in a less global, more targeted and specialized spirit with higher expectations on a limited number of themes and an extension of time for other priorities.

We can therefore imagine a limited number of priorities and expectations per bank according to their categorization, nature of activity or size. Within this specific framework, the ECB could be more demanding and stricter in terms of time but with more targeted content (e.g. ICAAP, ILAAP and Operational risk). The rest of the priorities and expectations could spread over time to ensure greater flexibility for supervised institutions. This would allow each institution to define dedicated remediation plans that are more flexible and doable over time while allocating sufficient resources on a more limited number of themes.

In the next section, we analyse SSM existing priorities and the areas of priority that we believe will emerge from the crisis as well as other areas of interest for the ECB identified during the crisis.

Existing SSM priorities: challenges and perspectives

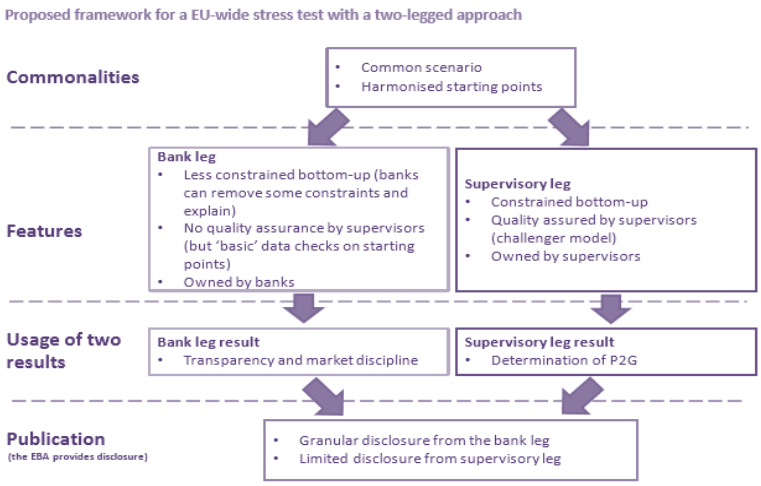
After conducting a preliminary analysis of the possible evolutions and adjustments of the banking supervision policy, it is interesting to discuss and assess the potential impacts of the crisis on current SSM priorities. Indeed, all types of crisis often allow a real time view of the prudential and supervisory frameworks in force and to test their effectiveness by evaluating the resilience of financial institutions in this deteriorated environment.

In this context, current SSM priorities which are setting the annual agenda of the banking supervision might could be reviewed, enriched or postponed. The table below lists the key existing areas of focus which, from our point of view, could reach the top of JST's agenda in the short and medium term.

Themes	*Key areas of focus*	*Description*
Strategic steering & Governance	Business model sustainability	The ECB will undoubtedly monitor closely the overall P&L impact of the COVDI-19 crisis. More specifically, an in-depth impact study will probably be conducted to assess business model sustainability and key impacts in terms of revenues and costs per business model in a similar format as framed for different topics in the SREP 2019 (i.e. GSIB/Universal banks, different type of lenders, custodians/asset managers…). It is possible that discussions or even scenarios relating to the consolidation of the banking sector come back into the debate as it is already obvious that the crisis is demonstrating that some specific mono activity business models are showing signs of weakness in the current stressed macroeconomic scenario.
	Capital and Liquidity Management	Future areas of focus will also be closely monitored regarding banks capabilities to absorb potential short-term significant losses linked to market activities, the deterioration in the credit quality of certain portfolios, customers behaviour or the decrease in loan production or asset collection. The ECB will also probably evaluate how banks have managed the increased mobilization of capital buffers and liquidity reserves coupled to the potential difficulties in terms of refinancing capacities in financial markets and even potentially absorbed the additional cost. In this context, the quality and the soundness of ICAAP and ILAAP processes will be tested as they play a major role in assessing the deviation of capital and liquidity positions but also the tolerance thresholds of each institution in a crisis scenario. In addition, they also allow to understand the different existing contingency plans and potential mitigating actions.
	Governance	While being already in the supervisory spotlight this crisis is also an opportunity for supervisors to assess governance aspects from several perspectives, including board functioning and organisational framework, internal control functions, and data aggregation and quality.

Focus on stress tests

Stress tests remain more than ever a fundamental tool of supervision although the current format will surely be subject to significant improvements to make them more realistic and accurate for financial institutions.

Themes	*Key Areas of focus*	*Description*
Stress testing	✓ Supervisory stress tests ✓ Internal stress tests	Every two years, the EU-wide stress tests composed of EBA's exercise on a sample of SIs and ECB's additional exercise for the remaining significant banks, assess the resilience of financial institutions to adverse market developments and the possible contagion of additional systemic risk in the EU financial system. Due to the COVID-19 crisis, the 2020's supervisory stress test has been postponed to 2021 in a format still unknown to this stage. In fact, it is highly probable that the next exercise will be different and will include certain changes to take into account the current economic difficulties, the limitations of the current approach but also some of the potential evolutions planned for 2022. The picture below summarises the new approach envisaged by the EBA for the future of supervisory stress tests which would be composed of a first leg by leveraging on internal stress tests and a second leg based on the outcomes of more classical supervisory stress tests exercise. Although the discussions remain and that the final version of the consultation of the EBA paper will not be completed until the end of 2020, it is conceivable to think that the 2021 stress tests exercise will include a global stress test as usual plus possible additional specific stress test exercises. **Figure 1** – Proposed framework for the EU-wide stress test  Source: EBA consultative paper for the future of supervisory stress tests

Focus per risk typology

In the context of this crisis, the loan granting process and credit risk management of (asset quality, NLP) are particularly challenged and should remain a high priority area of supervision. The operational risk management framework also remains a major supervisory issue with a view to better integrating Cyber and IT security risks in particular.

Themes	*Key areas of focus*	*Description*
Credit risk lending and management	✓ Credit underwriting criteria and exposure quality ✓ NPL	The quality of a bank's lending practices which are already under scrutiny will probably be even more closely monitored in this deteriorating economic environment. Bank's loan policies generally reflect the set of all lending terms and conditions specified for the bank's typical business loan, line of credit or loan to a household. Apart from the volume and interest rate, important standards include collateral, covenants, maturity, and loan limits. Amid the COVID-19 related economic shock to the global economy, the ECB is expecting that supervised institutions will continue fulfilling their role to fund households and corporations notably through an increase in loans volume with low interest rate levels and other sustainable solutions to temporarily distressed debtors. In addition, the banks will also have to demonstrate a certain flexibility regarding the quality of the collateral and the conditions of certain covenants. In this respect, the measures taken by the ECB to facilitate the circulation of liquidity on the interbank market and the guarantees granted by the states on bank loans (ex: EUR 350 billion by the French state) should facilitate these various measures and adaptations that banks will have to make to their lending policy. Logically, the quality of some asset classes such as residential real estate and leverage finance will also be closely monitored by the ECB notably regarding institutions' risk appetite governance requirements, investment strategy definition, due diligence requirements and the procedures for risk onboarding and long-term monitoring and management.
IT & Cyber risk	✓ IT systems and Data infrastructure ✓ Operational, Cyber and Outsourcing risks	While the ECB Banking Supervision is already assessing the IT and cyber risks facing banks, the Covid-2019 crisis is particularly challenging institutions' business continuity plan notably their operational risk profile in terms of business continuity arrangements and their effectiveness IT infrastructure and security. In those days, IT systems are also extremely challenged by the team rotation process in place to reduce the risk of contamination, the very strong increase in the use of remote access and the use of fallback sites. Besides, the fact that a significant part of banks' IT systems are provided by third or even fourth parties is also adding operational risks and generating challenges. At the same time, the current environment promotes the increase of cyber incidents which can result in significant costs or reputational losses for banks and can even have systemic consequences, as threats can spread quickly through sectors. The ECB will probably assess and monitor how these risks manifested and to what extent.

COVID-19 related areas of focus

Beyond the classic SSM priorities or the themes that the ECB assesses every year, it seems to us that the following topics are emerging in the context of this crisis. The table below describes some of them which seem particularly important to us.

Additional areas of focus	*Themes*
Business continuity management	A number of business continuity plans have been activated in the context of the COVID-19 current crisis, making it possible to assess in practice their level of feasibility and operational implementation. The ECB is likely to take a close look at post-mortem analysis of these processes, which will notably reveal business, IT and HR difficulties encountered during the crisis.
Recovery plan	In many institutions, the recovery plan is built to reflect a particularly severe stress environment including both solvency and liquidity stress tests through very extreme scenarios, recovery options and recovery indicators. However, this process is generally not designed and perceived to be deployed operationally despite solid governance and escalation processes associated with it. In fact, the severity of this crisis probably pushed some banks to activate their recovery plan (breach of recovery indicators and activation of recovery options) but also to assess its relevance in a situation of extreme crisis. The ECB will surely be attentive to what extent these plans have been activated and will encourage all the more the concept of dry-runs to test the process.
Contingency funding plan	Some institutions' contingency funding plans (CFPs) have been activated and assessed for the same reason mentioned above for the recovery plan. The ECB will be even more interested in big swings in stress testing results and limit/threshold breaches .
Forecasting capabilities	The severity of the current crisis and the speed of the various operational and financial impacts has surely pushed the banks to conduct multiple simulations of these financial, capital and liquidity trajectories. While the ECB is pushing for a better integration of stress tests through ICAAP and ILAAP process into the decision-making process, bank's forecasting abilities will remain a main point of attention for the ECB especially regarding the frequency.

AVANTAGE REPLY

Avantage Reply (a member of the Reply Group) is a pan-European specialised management consultancy delivering change initiatives in Risk, Finance, ALM, Treasury and Compliance within the Financial Services industry.

Founded in 2004, Avantage Reply is providing subject matter expert advisory for key ALM, Finance & Risk hot topics in CFO and CROs agendas. Our service offer is notably covering

- Strategic Risk Management (Risk Appetite, Risk allocation to business, Return indicators)
- Strategic steering (ICAAP, ILAAP, Stress tests) and crisis management processes (Recovery plans, Contingency plans...)
- Finance and Risk organizational structures (target design and implementation) and governance
- ALM/ Liquidity management (steering and governance, structural risk management framework, modelling…)
- Operational and Financial Risk Management frameworks (Market risks, counterparty/credit risk, liquidity/re-financing risk)
- Finance and Risk Modelling and Stress testing
- Model risk management framework
- Finance and Risk measurement systems and reporting
- Regulatory strategy and remediation

With a strike force of almost 250 consultants combining recognized regulatory, business and sectoral expertise within ALM, Finance and Risk functions of the European banking sector, we offer our customers tailor-made solutions adapted to their key issues while accessing the best practices in place. Finally, our European network allows us to have a transversal and European vision of prudential expectations but also of best practices in terms of organization, governance, steering process, modelling and stress testing and information systems of ALM, Risk and Finance functions

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HOW CAN WE HELP?

Avantage Reply supports Deputy CEOS, CROs and CFOs in in their strategic, organizational and methodological transformation. It includes notably:

- Strategic diagnosis, gap analysis and benchmarking
- Definition and design of steering processes and dashboard
- Organizational and governance redesign
- Deployment and operational implementation
- Modeling and Quantitative studies
- Subject matter expert support

[2]Figure 9: Descriptive example of our capabilities regarding RAF/ICAAP/ILAAP/Recovery plan

Produce and draft support	• Holding the pen' on aspects of or entire document • Facilitating and coordinating workshops, steering committees and governance forums, while ensuring firm retains ownership and control
Review and challenge	• Provide critical, structured review of outputs and feed back to key stakeholders • Helps clients anticipate and plan for regulatory challenge and articulate the 'story' of their ICAAP/ILAAP/RRP

Stress testing support and advice	• Advice and challenge on the end to end stress testing process including:
	  • Interpreting and applying prescribed methodology
	  • Scenario generation linked to risks and business drivers
	  • Models and other approaches to projections

Data quality and analytics	• Advice, analysis and challenge on data sourcing, quality and processing, and reconciliation relevant to the quantitative analysis presented in the ICAAP/ILAAP/RRP • Frameworks and tools for reviewing and challenging data outputs presented in the ICAAP/ILAAP/RRP
Contingency planning	• Reviewing the quality and credibility of contingency plans in both the recovery plan and ICAAP/ILAAP • Advice, challenge and support in 'war gaming' contingency plans and actions
Business and risk alignment	• Advice and challenge on integrating ICAAP/ILAAP processes into business planning and risk management including risk appetite, corporate planning, product development, business model changes • Advice and challenge on embedding ICAAP/ILAAP production into processes