ECB/EBA: what's new regarding the SREP and supervisory stress tests?

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Abstract

During 2017, the European Banking Authority ('EBA') and the European Central Bank ('ECB') released several publications concerning the SREP process and supervisory stress tests. The purpose remains the same: fostering harmonisation in supervisory practices throughout the Banking Union.

On 20 February 2017, the ECB clarified its **expectations regarding ICAAP and ILAAP** through the publication of a (consultative) **multi-year project** to develop SSM Guides for these processes. The proposals aim to clarify and address a number of identified areas of improvement within eurozone banks. Indeed, the results from SREP exercises have demonstrated that additional harmonisation is necessary across institutions.

The EBA also published several guidelines to update on planned revisions for the SREP process and supervisory stress tests, including notably:

- **A roadmap to update the EU SREP framework in 2017-2018 and beyond,** which includes several revisions to the SREP process, IRRBB and stress tests;
- **2018 EU-wide stress test methodology for discussion,** which presents the common methodology of the exercise.

This Briefing Note focuses on the implications of these latest regulatory developments, highlighting areas that banks should carefully evaluate to address the requirements in a timely fashion, considering all compliance and associated operational issues.

Multi-year plan for development of SSM Guides on ICAAP/ILAAP

By launching its multi-year plan[1], the ECB aims to share its vision for a uniform definition of the ICAAP and the ILAAP for the eurozone banking sector as well as its expectations for harmonised approaches for Significant Institutions. The consultation period of the new guidance ended on May 31, 2017.

The ECB introduced seven principles to describe supervisory expectations of ICAAP and ILAAP processes:

1) An increasing role for senior management and a strengthened governance framework

Senior management should have **full ownership** and ensure **appropriate implementation** of ICAAP and ILAAP frameworks within their institution. In particular, an appropriate governance framework should be established and ICAAP/ILAAP outcomes should be included in strategic decision-making.

Both processes should be subject to internal reviews at regular intervals. These reviews should be conducted on both qualitative and quantitative aspects by independent risk teams including the independent model validation function, as well as coverage by the internal audit function.

Finally, management must produce an annual Capital Adequacy Statement ('CAS') and Liquidity Adequacy Statement ('LAS') to express clear and concise views on the adequacy of capital and the institution's liquidity resources.

2) Full integration of ICAAP/ILAAP in strategic decision-making and risk management processes

The processes have to be aligned and consistent with other internal processes including:

- **Strategic processes** such as the application of the risk appetite framework and the corporate plan/ budget;
- **Risk management processes** through an alignment with risk identification and quantification methodologies; and
- **Other key processes** such as the recovery plan.

The ICAAP and ILAAP should enable institutions to look at both the current and prospective (i.e. at least three years ahead) capital and liquidity resources and needs. In particular,

[1] *ECB's: Multi-year plan on SSM Guides on ICAAP and ILAAP*

the processes should be interconnected with capital and funding planning.

As ongoing processes, institutions should integrate ICAAP and ILAAP related outcomes into their internal reporting. These outputs should also contribute to the calibration of risk appetite and risk-adjusted performance metrics and also capital allocation processes.

3) ICAAP/ILAAP: ensuring banks' viability in times of crisis

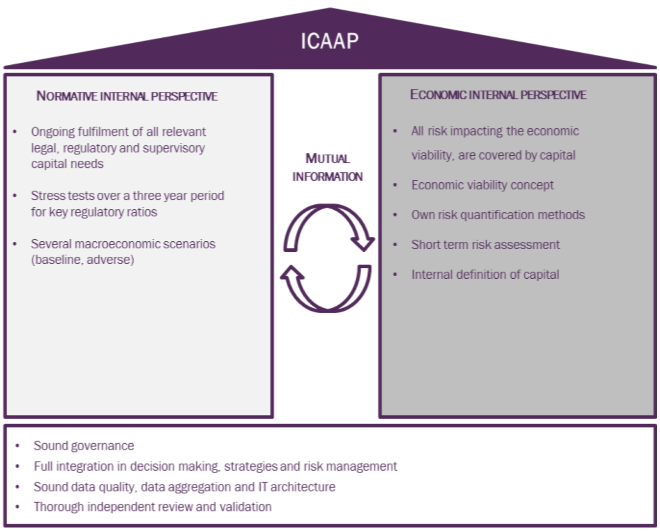
This principle may be **the most important from ECB's point of view**.

Capital and liquidity requirements stemming from ICAAP and ILAAP should sustain the institution's short and medium-term viability. It implies the assessment of solvability and funding needs through forward-looking approaches over various time horizons.

Two complementary approaches need to be implemented in order to assess the viability of the institution:

- **The normative perspective** aims to assess the ability to fulfil supervisory requirements against a baseline scenario and at least two adverse economic scenarios over a minimum three year period.
- **The economic perspective** evaluates on the bank's economic viability. It should incorporate a wide range of possible and material risks over a 1-year period.

Below is an illustration on how the ECB presents both approaches:



Note that the ECB is not precise how these approaches are mutually informative.

4) Identification and evaluation of material risks

Institutions should implement a comprehensive annual process to identify a complete set of risks (the risk taxonomy) and evaluate their materiality. It should combine top-down and bottom-up risk identifications.

Once the materiality of each risk (and risk subcategory) has been assessed, several criteria should be defined to determine which risks need to be capitalised (or not) in the ICAAP.

5) Definition of internal capital and liquidity buffers and stable sources of funding

Institutions need to clearly define internal capital and liquidity needs in terms of quantity and quality.

Regarding internal capital, it should be mainly composed of CET1 and to be easily available to absorb losses as and when it is necessary.

Liquidity buffers should be marketable and of very high quality. Funding sources needs to be well diversified.

6) Risk quantification and methodology assumptions

Institutions are expected to implement appropriate and validated risk quantification methods that are tailored to their risk profiles and business models. All risks should be assessed, even those which are not easy to quantify.

In noting remaining areas needing improvement, the ECB has focused on weaknesses in independent model validation and internal audits.

Finally, the methodologies used in the ICAAP and in the ILAAP should be conservative, aligned with risk appetite metrics and well integrated into risk management processes.

7) Regular stress testing aims to ensure viability under adverse circumstances

Based on in-depth reviews of the institution's key vulnerabilities, internal stress tests should be conducted once a year (at least).

When designing the set of internal stress scenarios, institutions should use a broad set of information on historic and hypothetical stress events, including supervisory stress tests. Moreover, they must be aligned to the institution's risk profile and business model.

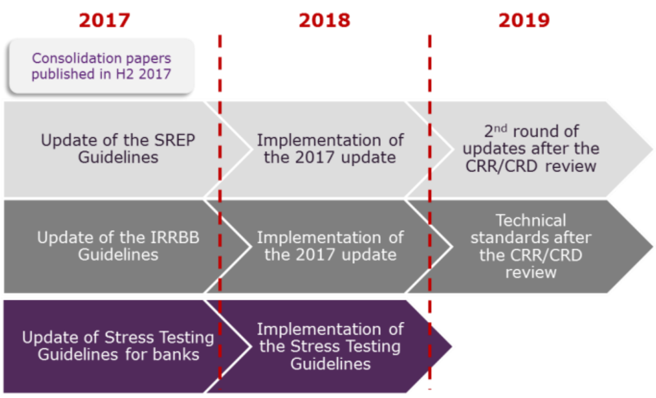
The severity should be very high which requires flexible scenario generation processes and forecasting capabilities.

Institutions are also expected to conduct reverse stress testing which identifies the set of circumstances that would lead to business model non-viability, thereby allowing the firm to control its risk exposures and maintain appropriate risk mitigation measures.

EBA Pillar 2 roadmap

On 11 April 2017, the EBA published the roadmap[2] **designed to update the EU SREP framework** in 2017-2018 and beyond. The objective is to consult on the revisions in the second half of 2017, targeting practical implementation in 2018.

The key milestones of the Pillar 2 roadmap (indicative timeline) are discussed below.



The roadmap describes the multi-stage approach the EBA will take to the update of the EU SREP framework and the revision of the following guidelines.

1) The revision of the SREP guidelines

The main proposed revision covers the link between supervisory stress tests and the setting of Pillar 2 capital guidance ('P2G') and notably how it could be set on the basis of the outcome of supervisory stress tests under an adverse scenario.

Among the additional themes which will also be revised and/or clarified, the following topics are important:

- The clarifications regarding the differences between risks and viability scores;
- The interactions between the four elements of the SREP;
- The communication of total SREP capital requirements ('TSCR') and overall capital requirements ('OCR') to banks; and
- The business model analysis and technical guidance on ICAAP/ILAAP linkages and their assessment.

2) The revision of the interest rate risk in the banking book (IRRBB) guidelines

These guidelines are expected to implement the latest Basel Committee standards on IRRBB, including:

- Clarification of definitions and expanding the scope of the guidelines to include credit spread risk in the banking book;
- Updating the parameters and assumptions of the supervisory standard shock;
- Updating the standardised interest rate shock scenarios; and
- Updating the requirements on internal governance arrangements.

The implementation of these revised guidelines should coincide with the 2018 implementation date for the revised Basel Committee standards. Furthermore, after the update of the IRRBB Guidelines within the first phase, the EBA will start working on technical standards, given the new mandates for the EBA expected to be introduced by the revised CRR2/CRD5.

3) The finalisation of the stress testing guidelines for banks

All aspects related to the supervisory assessment of institutions' own stress testing, supervisory stress testing and the use of quantitative outcomes of stress testing will be incorporated into the revised SREP Guidelines

The EBA will also finalise its draft Stress Testing Guidelines (the public consultation that took place in 2016) in the same timeline as the revision of the SREP Guidelines. It will mainly focus on setting key requirements for institutions as a second public consultation will be launched by the EBA by the end of the year 2017.

[2] *EBA Pillar 2 roadmap*

Supervisory stress tests

2017 ECB interest rate stress test[3]: sensitivity analysis of IRRBB

While no EU-wide stress tests took place in 2017, ECB Banking Supervision conducted a dedicated exercise focusing on the sensitivity analysis of IRRBB for the banks under its direct supervision in 2017.

In particular, the exercise focused on the changes in the economic value of the banking book assets and liabilities and on the development of net interest income generated by six different interest rate shocks (set in April 2016 by the BCBS). Each shock materialises various changes in the level and shape of the interest rate curve.

The results will mainly feed into the SREP assessment notably **to calibrate the P2G.**

2018 EBA's EU-wide stress test methodology for discussion

EBA published the 2018 EU-wide stress test draft methodology[4] and templates for discussion with the industry, along with the list of institutions participating in the exercise (70% of the banking sector in the EU).

The methodology covers all relevant risk areas **and will also incorporate IFRS 9 accounting standards for the first time**. For banks starting to report under IFRS 9 in 2018, the 2018 EU-wide stress test takes into account the impact of the implementation of IFRS 9 on January 01, 2018 — both in terms of starting point and projections.

The final methodology will be published as the exercise is launched **at the beginning of 2018** and the results will be published in mid-year 2018.

Next steps: what are the key challenges?

The different topics outlined above provide a clear understanding of the ECB's supervisory approach and expectations. The harmonising effect of these guidelines will impact national markets in different ways; notably in countries where national supervisors have taken different views from the ECB.

The bar is raised to a new level in particular regarding internal stress tests, ICAAP, ILAAP and IRRBB. Below summarises the key challenges banks are facing following the implementation of these guidelines.

Management responsibility and integration

ICAAP and ILAAP are expected to be more integrated into the bank's governance and risk management.

It should ensure when possible that risk appetite metrics, ICAAP and ILAAP outcomes **are interlinked with the business strategy** but also integrated into management decision bodies and decision-making processes through dedicated KPIs and KRIs.

To some extent, KPIs and KRIs on profitability, solvability and liquidity management will have to be revisited and completed. In fact, ICAAP and ILAAP will ultimately **become core processes of profit-oriented bank management.**

ICAAP + ILAAP = ICLAAP

ICAAP and ILAAP are conducted separately, but are getting **closer.**

Indeed, these processes are represented equally from a supervisory point of view through the seven principles of ECB's mutli-year plan. While requirements have been substantially extended for the ICAAP, expectations regarding the ILAAP have also been substantially increased.

Forecasting abilities: focus on going concern in a multi-year view

Through the introduction of the normative approach, there is a clear positioning on measuring the relevant balance sheet items **according to the going concern principle**. These are expected to feed into institutions' overall stress testing programmes.

It also implies regular updates and simulations of three year business plans, capital plans and liquidity plans under normal and stressed scenarios which remains a practical challenge.

Risk quantification and independent validation

Whether it is for ICAAP, ILAAP, internal stress tests or IRRBB, institutions will have to **implement new models for both Pillar 1 and Pillar 2 risks.** In particular, institutions will have to assess risks with different perspectives, with different level of severities and various horizon period.

Moreover, all these quantification methods will have to be independently validated under a process equivalent to the respective standards of the pillar-1 models.

[3] *ECB sensitivity analysis of IRRBB – stress test 2017*

[4] *EBA issues 2018 EU-wide stress test methodology for discussion*

Finally, all these models will have to be included in institutions' model risk management framework.

Stress tests

For the current and for future supervisory requirements, stress test will remain a key challenge and a key area of focus for institutions.

Bearing in mind that all stress tests results will contribute to future SREP decisions and that the stress testing guidelines are going to be finalised, institutions should not underestimate the challenge.

Due to the interdependencies and feedback effects, target stress testing frameworks will require an increasing number of scenarios, strengthened forecasting abilities to model balance sheet and income statement components results and industrialised IT infrastructures.

About Avantage Reply

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

Within our core competencies, we have extensive experience in implementing changes driven by:

- Industry-wide legislative and regulatory initiatives (e.g. CRD, BRRD, MiFID);
- Mergers, Acquisitions & Divestments (e.g. business combination, separation and flotation); and
- Business improvement and optimisation agendas (e.g. risk appetite and capital allocation).

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