KPMG SSM Insights

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It’s a pleasure to present the last edition of KPMG’s ECB Update for the year.

As we look back at 2018, it’s hard to ignore the impact of political volatility – something that shows no signs of receding as we prepare for the full impact of Brexit in early 2019. This is joined by a growing uncertainty over the direction of the global economy.

These factors are reflected in the risks identified by the ECB as facing SSM banks in 2019; geopolitical uncertainties, non-performing loans, cybercrime and IT disruption.

A strong European banking sector is more important than ever, and the ECB’s, EBA’s and SRB’s recently released work programmes for 2019 show that supervisors will continue to focus on enhancing stability, with a particular focus on credit risk, risk management and multiple risk dimensions.

The themes of uncertainty, risk and technology also underpin the articles in this edition, which address:

- The likely shape and timing of the ECB’s dedicated Liquidity Stress Test in 2019 (LiST 19) – and the importance for banks of putting the right human and data resources in place;

- The need for banks to look beyond the TRIM guidelines as they assess model risks that could arise from new, complex models powered by AI and re-design the model risk management framework;

- The growing importance of change management in Internal Audit, as Heads of IA adapt to fast-changing supervisory, commercial and technological pressures;

- How the complexities of reforming Europe’s risk-free benchmark rates is putting pressure on banks to prepare for a challenging period of transition; and

- The need for senior bankers entering SSM supervision as a result of Brexit to learn the rules, customs and language of the SSM - and prepare for fit and proper tests.

- Lastly, a new report published by the ECB Office looks ahead with a detailed review of the SSM's supervisory priorities in the New Year. This should help banks to draw a heat map of likely areas of scrutiny for 2019.

We wish our readers a pleasant seasonal break - and a busy New Year!

Update on SREP Dialogue 2018

As the year draws to a close, the SREP cycle for 2018 nears its conclusion: most banks had their Supervisory Dialogue around October or November, and since then, some preliminary SREP decisions and letters have been sent to banks, including details on P2G and P2R. In contrast to previous years, final SREP decisions will only be communicated to banks in the first quarter of 2019 due to the delay in the schedule of the stress test in 2018, which again was due to the inclusion of IFRS 9 effects. From our first observations of some draft SREP decisions, amongst other topics, the ECB has focussed on NPLs, including recommendations for provisioning NPLs over the next years. It seems that the ECB is following up on their announcement in July 2018,where they communicated that they would plan to set bank-specific supervisory expectations for the provisioning of NPLs with the aim of achieving the same coverage of NPL stock and flow of the medium term. It will be important to note when the final decisions are sent out in January 2019, whether any contents of the draft letter will change.

Liquidity stress test - The countdown begins

The ECB, concerned about European banks' liquidity risks, will conduct a major dedicated stress test of liquidity in 2019. Failing to prepare for what will be an onerous process could be a costly error. Banks should initiate their planning immediately, with a particular emphasis on having appropriate data and sufficient human resources in place to meet the ECB's demands.

One of the most important changes in banking supervision since the crisis of 2008 has been the shift from a singular focus on regulatory capital - and Tier 1 ratios in particular - to a more balanced view of solvency and liquidity.

Globally, the incorporation of the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR) into Basel III has been the most obvious response to the liquidity crises that many well capitalised banks experienced during the market dislocations of 2008. In Europe, liquidity has also become an integral aspect of banking supervision and this focus is increasingly gaining momentum. There have been numerous initiatives from European supervisory authorities, such as the recently published guide on the Internal Liquidity Adequacy Assessment Process (PDF 510 KB) (ILAAP) by the ECB. ILAAP plays a vital role in the risk control assessments of risks to liquidity and Pillar II liquidity determination process.

Today Europe's banks may be far better capitalised than they were ten years ago, but liquidity remains on top of the ECB's agenda. October 2018 saw notable public statements on the topic from Danièle Nouy, Chair of the Supervisory Board and Sabine Lautenshläger, Member of the ECB's Executive Board. These pointed to concerns about possible weaknesses among Single Supervisory Mechanism (SSM) banks, and set out the ECB's intention to conduct a dedicated liquidity stress test ("LiST 19") in 2019. This was confirmed at the end of October with the ECB's publication of the SSM Supervisory Priorities for 2019 (PDF 48KB) which included liquidity stress test as one of its priorities for the year. Through this exercise the ECB endeavours to assess banks' resilience against liquidity shocks. The results of LiST 19 will inform the Supervisory Review and Evaluation Process (SREP) assessments.

This could be a timely decision, given the growing volatility of capital markets. For now, the methodology and timing of LiST 19 remain to be confirmed. However, previous dedicated stress tests such as the ECB sensitivity analysis of Interest Rate Risk in the Banking Book (IRRBB) stress test exercise of 2017 suggests that banks should expect to be tested against a number of scenarios. Some parameters will be set by supervisors, but others will be derived from internal models - a process that is also likely to be assessed.

Banks' experience of measuring themselves against the LCR and NSFR requirements, and of conducting ILAAP, should mean that most have well established procedures for reporting liquidity metrics. We would expect supervisors' requests to cover liquidity metrics in multiple scenarios, including:

- Maturity ladders and cash flow profiles;
- Time to wall' and survival horizons;
- Currency or counterparty concentrations; and
- The composition of liquidity reserves.

In addition to quantitative testing, banks should expect a qualitative examination of their liquidity risk management. This is likely to cover aspects including governance and oversight, risk reporting and reconciliations between different liquidity requirements.

When it comes to timing, we would expect guidelines and templates on LiST 19 to be published during the first quarter of 2019, and for testing to take place during the spring and early summer. The process is likely to be complete by the second quarter of 2019, with the results feeding into the annual SREP process later in the year.

Even if the precise impact of LiST 19 is still unclear, banks hoping to demonstrate a good grasp of liquidity risk management should start preparing now. Past experience of similar stress tests tells us that it's essential to allocate adequate resources, responsibilities and management time to the greatest areas of priority as early as possible.

In particular, banks should ensure that they have adequate human resources available to meet the requirements of LiST 19. As a rough guide, we might expect a large Significant Institution to require between 400 and 700 person days. Banks can also start preparing for likely data requests, as well as taking any quick and easy steps they can to enhance liquidity risk management frameworks.

Most banks should have little to fear from LiST 19. But a failure to start early, to allocate enough resources, to work across the whole group or to win support from senior managers could lead to some institutions being found wanting. Preparation will be key to success.

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Are the next generation of model risks just around the corner?

With the 2018 publication of the TRIM Guide to General Topics the ECB increased its attention on models and how they affect management's decision making and overall understanding of risk. Many view European supervision as being a latecomer to the topic of model risk, particularly compared to the US. As new models and techniques are developed, will the current European guidelines be sufficient to safeguard banks and their customers?

As the complexity of banking grows, models are becoming increasingly prominent in decision-making. Models are used to gauge the risks banks take on, how much capital they should hold, and how this might vary under different scenarios. In areas like credit scoring, models are even taking their own decisions.

Of course, blindly trusting the outputs of these models is a risk in itself. Hence the term "model risk". The US Fed SR 11-7 paper, published in 2011, defined model risk as the potential of adverse consequences from decisions based on incorrect or misused model outputs.

In 2017 the European Central Bank (ECB) followed suit when it published the TRIM Guide for Internal Models and noted model risk management as a control for flaws in the development, validation and use of models. Our conversations with banks suggest European banks are taking quite a fragmented approach to this area. Some have developed model risk monitoring and reporting, but others view it as a secondary concern. Banks within the scope of US SR 11-7 are further along in implementing effective controls for model risk, as well as typically encompassing a wider scope of models.

Tackling model risk is not easy. For a start, the definition of a model has never been clear cut. While there are no hard rules, many banks would be more likely to view a trading algorithm as a model than, for example, a simple spreadsheet. The rapid advance of artificial intelligence (AI) and machine learning (ML) threatens to complicate the picture. For now, AI or ML are more likely to be used as `challengers' than as a primary tool. This area of models is perhaps where we find the most interesting aspects of evolving model risk management practice.

For some people, AI and ML can conjure images of robots running amok. Of course, reality is more mundane. Banks are applying AI to tasks such as extracting text from policy documents, tailoring the responses of customer service bots and scanning large volumes of transactions to spot indications of fraud.

The ability of AI to detect useful signals from large volumes of unstructured data has many benefits for banks. It allows analysts and managers to focus on more strategic questions. It can also uncouple the human biases that drive a lot of existing models and processes, and generate new insights from existing data.

However the use of AI can be a double-edged sword. A hypothetical bank that applies ML to millions of transactional records might make some surprising or even nonsensical findings. Let's say it discovers a history of very few defaults among self-employed customers with five or more credit cards. The machine appears to have found a desirable population in terms of risk, but without a human to evaluate and sense-check, there is always the risk of a “black swan” to break the rule (in this example, once banks tighten their lending criteria these customers become a much riskier proposition since they can’t move their debt to a new card).

A lack of transparency is another difficulty, and could be the biggest obstacle to large scale take up and acceptance of ML and AI processes. When people cannot understand the mechanisms and logic a model uses, there will always be an understandable degree of scepticism - particularly on the part of banking supervisors. Improper decisions by `black box' models carry huge reputational risk. That means that the expertise of model validators needs to match the sophistication of the model itself.

So what can banks do to stay on top of emerging model risks? The supervisory expectations of the ECB on model risk can be found in the TRIM guide. However we feel that these expectations are still maturing, and the general exhortation for banks to “have a model risk management framework” may frustrate those looking for specific advice on AI or algorithm-related model risks. With that in mind, we suggest that banks should:

- Apply a regular validation process to all models. If the model is of considerable complexity, where expertise is currently lacking, banks should consider upskilling initiatives or different working modalities (for example AGILE) to bring to bear relevant

SME knowledge. When doing this, however, care should be taken to maintain the adequate independence of the validation unit.

- Consider the perimeter of their model risk framework. Once outside this scope, a robust controls process should be in place as a substitute for model validation. At times, there may need to be a mix of controls and validation. One example comes from the many hundreds of equity research models that some banks hold, which may be too numerous to individually validate.

- Embed a solid risk culture through a program of communication and education. It is often left to risk functions to write bank's model risk management frameworks, but it requires far more effort and accountability for a document to become an active process. The pace of change around AI and ML processes means that users must be aware of the limitations and potential impacts of model misuse.

Lastly, banks shouldn't be deterred from exploring the potential benefits of AI and ML, even if just as a challenger or a pilot of limited scope. Despite the issues outlined above, we do not believe these techniques should be avoided. As models become more and more complex, the levels of controls and understanding from model owners needs to adapt accordingly. One only has to look at some of the products developed in the run up to the Great Financial Crisis to suspect that the next generation of model risks won't come from out of control AI, but from our own hubris that we understand these complex models.

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Change management continues in Internal Audit

Faced with an increasingly competitive environment, the banking sector is currently being forced to adapt their business models and product mix in order to meet evolving customer demand. Therefore, Internal Audit (IA) functions of European banks are similarly impacted by such business changes – they must continue to work hard to maintain their audit quality, recruit and retain skilled staff, monitor risks and respond to on-site inspections. As a result, change management is becoming an increasingly core skill for Heads of IA.

The IA functions of European banks find themselves in an increasingly prominent - and pressurised - situation. IA teams face challenges from supervisory scrutiny, the rapid evolution of technology and the difficulty in adapting to the changing product offerings by banks driven by shifting commercial demands.

It was against this background that KMPG ECB Office recently hosted its second European Internal Audit roundtable. These events aim to provide Heads of IA with a forum in which to share the challenges facing their functions, and to discuss potential strategies or solutions in response to this changing environment.

On this occasion, the key challenges discussed included the scarcity of talent, the pressure for cost effectiveness, the intensity of supervision by the ECB and national authorities, and new risks emerging from innovation and digitalisation. The debate centred on the following four themes:

- **The need to maintain a strong third line of defence at a time of increasingly agile development.** In an environment of competition with Fintechs, the commercial need for banks to innovate and bring new concepts to market quickly is posing challenges for IA functions. Ideally, IA teams should be involved throughout any initiative's development process, from design right through to implementation - enabling them to raise concerns when required and contribute to efficient pre-approval. Even so, IA teams still need to give robust, independent opinions on deliverables once a project is completed. These two imperatives are becoming increasingly hard to reconcile.

- **The problems of recruitment and retention.** Achieving the desired size and skills of IA teams is a major challenge for Heads of IA. Joint supervisory teams (JSTs) are increasingly focused on the human resources of IA functions, and some are seeking to enforce a suggested ECB target for IA staff to account for 1% of institutional headcount - a target that many banks may find difficult to achieve. More specifically, the need for technology-skilled IA staff is another major challenge, given the difficulty of recruiting and retaining experts in areas such as cyber security, modelling and data analytics in the current market.

- **The increasing intensity of on-site inspections.** JST's on-site inspections of IA functions are becoming increasingly demanding. Some deep dives on internal audit have even seen JSTs requesting details of the skills, education and training of individual IA staff members.

- **The growing use of, and supervisory emphasis on outsourcing.** Banks are under pressure to modernise their core IT infrastructure in order to reduce costs, meaning that more banks than ever are outsourcing elements of their operations to third party providers. This presents a number of IA challenges, and many banks now run Supplier Assurance teams within their IA function. When it comes to meeting contractual provisions on whose responsibility it is to audit external service providers, Heads of IA often feel that the first and second lines of defence should take the lead. However, they also agree that IA teams must be prepared to review their work when required, to dig deeper into material risks and to respond to specific requests from JSTs.

Overall, the message is clear. Despite the challenges of recruitment and resourcing, the ECB expects more rigorous and intense remediation of their findings. In short, IA functions are facing greater challenges than ever when it comes to balancing the competing requirements of maintaining a diligent third line of defence, responding to supervisory remediation demands, as well as retaining enough talent to perform all these activities. Change management and strategic thinking are becoming vital disciplines for Heads of IA.

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The future of euro risk free rates

There are encouraging signs of movement in the reform of interbank offer rates. Even so, timings and replacement rates remain highly uncertain. The next few months should provide greater clarity over the future of Euro risk-free rates. In the meantime, banks need to monitor the situation closely and do all they can to prepare for what is certain to be an extremely demanding transition.

A credible mechanism for calculating inter-bank rates is critical to effective, functioning capital markets. That’s why historic failures and abuses of this process called for a reform of the interbank offer rates and why the EU Benchmark Regulation (BMR) was put in place. However, time pressure and a lack of clarity over replacement rates continue to dominate debate over the transition from EONIA and EURIBOR to a BMR compliant risk-free rate.

In theory, change is coming soon. The EONIA overnight rate and the EURIBOR rates calculated by the European Money Markets Institute (EMMI) for key tenors such as one week, three months and twelve months, will become non-compliant with the BMR on 1 January 2020.

In reality, the scheduled withdrawal of EONIA and EURIBOR rates has not yet stimulated a comprehensive response from market participants. In February 2018 the ECB therefore launched a Working Group on Euro risk free rates. The goal of this industry-led body is to identify replacements for EONIA and EURIBOR.

In September, the Working Group recommended that a new Euro short term rate (ESTER) calculated and published by the ECB using reported transactions, should replace EONIA.

Does that mean the problem is solved? Sadly not.

- To begin with, ESTER is not scheduled to be published until October 2019, just three months before the existing rates are due to be withdrawn. That is not a timetable that many banks are likely to be able to achieve.

- Furthermore, things are even less clear regarding EURIBOR's replacement. One possibility is that EMMI might develop a new way to calculate EURIBOR from real transactions rather than quotes from market participants. Another is that, once ESTER is published, market makers will begin using derivatives to build a 'term structure' based on this new rate.

This situation means that the European authorities have received two requests to ease the transition process. One asks to extend the BMR deadline by two years, bringing it in line with the UK's withdrawal of support for LIBOR at the end of 2021. The other asks for ESTER (and possibly an ESTER-based term structure) to be designated as critical benchmarks, signalling their status as successors of EONIA and EURIBOR to the market.

The ECB's round table on euro risk-free rates on 9 November made it clear that industry participants are hoping that EMMI's approach will emerge as 'Plan A' for solving the EURIBOR question. That was hardly surprising, given that this represents the least disruptive outcome in terms of changes to existing processes and contracts. A hybrid approach could see this 'Plan A' supported by a fall-back 'Plan B' of a new term structure.

Once again though, there are catches.

- First, an extension to the BMR's timeline could be hard to achieve. The European Commission's policy of not tabling any new legislation before the Parliamentary elections of May 2019 means that a delay would need to occur via one of two pending legislative proposals - perhaps as part of the proposed amendments over low carbon benchmarks.

- Second, the 'Plan A' currently being proposed by the Working Group would require ESMA to authorise EMMI's approach as being compliant with the BMR. Again, that can't be taken for granted.

So where does this leave the banks, which remain deeply uncertain about which rates they will need to be using, and when?

The short answer is that, even if an extension to the implementation of BMR is looking increasingly possible, this certainly cannot be counted on.

The longer answer is that, if an extension were to occur, this should be viewed as a valuable opportunity - not a licence to relax. Prior experience shows that this kind of transition can be exceptionally demanding. Changing IBORs affects every aspect of a bank's value chain including contracts, pricing and valuation, risk modelling, risk management, technology, accounting, financial performance and regulatory reporting.

It follows that banks need to prepare their data, systems, processes and staff for change and engage actively with regulators, clients and other stakeholders - while they still have time.

Getting in shape for Brexit

For a small but important group of senior bankers, Brexit could bring the first taste of SSM supervision. That will pose some significant personal challenges. Priorities should include understanding the rules, customs and language of the SSM;

documenting relevant professional experience; and preparing for licensing interviews and 'fit and proper' tests.

As they look ahead to 2019, many banking professionals will be planning a new fitness regime for the New Year. But, as we all know, getting started in the dark days of January can be difficult. To boost their motivation, some may set themselves a challenge, such as entering a half marathon.

Of course, the decision to get physically fit is a personal choice. 2019 is also likely to present a number of senior bankers with a more professional challenge - Brexit. For many senior bankers, Brexit represents the greatest professional change of their career.

As we approach the end of 2018, the possibility of a 'hard Brexit' is looking more likely than ever. In response, many banks are on the point of activating their contingency plans for a 'no-deal' scenario. For some, this will mean pressing ahead with the use of new legal entities and their associated operating structures.

These initiatives, discussed until now in administrative terms, will soon begin to have a real human impact. A significant number of senior bankers face the prospect of moving to new markets, or of changing their legal status; for example, from being the manager of an office to becoming the director of a subsidiary.

In either case, key individuals falling under the Single Supervisory Mechanism (SSM) for the first time can expect - and should prepare for - increased personal scrutiny.

First, when a new banking licence is sought, senior managers and directors need to submit personal details of their skills, knowledge and experience to the relevant National Competent Authority (NCA). Directors can also expect to be interviewed by NCAs or the ECB as part of the licence application process.

Second, bankers occupying senior management roles should be prepared for the ECB's regime of management scrutiny. Key areas of focus include the function and effectiveness of boards; their discussion and documentation; their oversight of key controls; their independence; and their collective levels of knowledge and diversity.

Third, senior managers entering the ECB's oversight need to ensure they can 'speak the language of the SSM'. A ready understanding of the terminology and technical features used by the ECB and their local supervisor will be essential to a successful transition.

Fourth - and perhaps of greatest personal significance - bankers occupying senior executive positions will need to meet the ECB's 'Fit and Proper' requirements, which include requests for written information and face-to-face interviews. In brief, the ECB's five key fit and proper criteria cover:

- **Knowledge, skills and experience**: Does the candidate have the necessary skills to assume a specific role in the bank?
- **Reputation**: Does the candidate have a criminal record or a history of administrative or tax irregularities? Is the candidate involved in pending legal proceedings?
- **Conflict of interest and independence in mind**: Does the candidate have any conflicting interests that may adversely affect the bank?
- **Time commitment**: Does the candidate devote sufficient time to the proposed function within the bank?
- **Collective suitability of the board?** How does the candidate fit within the overall composition of the board?

Like a New Year exercise programme, the personal requirements of Brexit may seem daunting. The goals are demanding and the advice of peers may be confusing, or even contradictory. The good news is that, as for sport, practice makes perfect. Key individuals can take a range of tangible steps to prepare themselves for life within the SSM, such as completing tailored training, workshops or simulation interviews with JSTs. If they wish to, they can also test their progress using KPMG's comprehensive guide to entering SSM supervision - an interactive resource with key facts, important questions and links to more detailed information. Readers can view a short excerpt from the guide here.

With the right support and preparation, senior bankers can make a good start on the personal challenges of Brexit. A boost in confidence should help key individuals to 'train hard and win easy'.

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Refining the framework: SSM supervisory priorities in 2019 Europe

With the financial services sector marking ten years since the global financial crisis, there has been an acute sense of awareness from the banking authorities around the importance that institutional strength plays in maintaining financial stability. Combined with the current geopolitical climate, an increasing reliance on technology and market competition from FinTechs, there has been a greater supervisory focus on governance, operational resilience and data. All of these macro trends are visible in the priorities of the three major authorities of the Banking Union.

The supervisory landscape in 2019

The European Central Bank (ECB), the European Banking Authority (EBA) and the Single Resolution Board (SRB) set the tone for the supervisory landscape that European banks face. All three institutions have now released their 2019 work programmes, allowing banks to reflect on the priorities that will impact everything from daily supervision to on-site investigations in the coming year.

For the purpose of this report, we will use the ECB SSM Supervisory categories to look deeper into what each priority means for the banks in the context of existing guidelines and upcoming expectations. Although these priorities are not an exhaustive list, they are a strong indicator of future areas for on-site and off-site investigations, deep dives, and a valuable tool for banks to ensure compliance.

ECB Banking Supervision

The ECB 2019 supervisory priorities are based on the risk assessment for 2019 which identified the risk drivers currently affecting the European banking system. Generally, these key risks are similar to the previous year's risk drivers, so it came as no surprise that the ECB priorities for managing these risks are also derived from previous year's priorities. The priorities are banded into three broad categories; credit risk, risk management and multiple risk dimensions.

What are the implications for banks?

While the priorities of these three authorities differ by nature, some of them overlap, showing strong supervisory themes for 2019. Banks can use these priorities to determine a bank specific heat map that differentiates between quick wins and long term projects, further preparing them for supervisory scrutiny around these topics.

We recommend that banks analyse the priorities, consider which ones may be of importance for their particular organisation and business model, take note of the supervisory examination plan (SEP) that the ECB will discuss with banks in early 2019, determine bank specific priorities and develop action plans.

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