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An executive guide: SSM supervisory priorities 2019

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Executive summary

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. While the priorities of these three authorities differ by nature, some of them overlap, showing strong supervisory themes for 2019.

For the purpose of this guide, we will focus on the ECB SSM Supervisory categories to look deeper into what these priorities 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.

The priorities are based on the top three risks for SSM banks identified for 2019 where are geopolitical uncertainties,NPLs and cybercrime and IT disruptions.

These priorities are most relevant to Significant Institutions (SIs) under direct supervision of the Single Supervisory Mechanism (SSM), or Less Significant Institutions (LSIs) where the priorities may overlap with those of their National Competent Authorities (NCAs). Within these banks, it most often falls on regulatory offices, the single point of contact for supervisory affairs or the third line of defence to closely observe the evolving supervisory expectations when the first and second lines of defence are under-resourced or over-burdened.

Banks can use these priorities to determine a heat map specific to their organisation, further preparing them for supervisory scrutiny around these topics. Banks should consider analysing 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.

ECB Banking Supervision: SSM supervisory priorities 2019

Credit Risk

— Follow-up on NPL guidance

— Credit underwriting criteria and exposure quality

Risk management

— Targeted review of internal models

— ICAAP and ILAAP

— IT and cyber risk

— Liquidity stress test

Multiple risk dimensions

— Brexit preparations

— Trading risk and asset valuation

What are the implications for banks?

In our view, we expect the following prioritisations to be relevant for SSM banks in 2019;

— To review lending standards so as to keep the balance between risk, its management and return.

— To monitor credit vulnerabilities along with a wider perimeter, e.g. along with due weightage for climate change, for instance, exposure to mortgages on properties in flood regions.

— To adhere to the recently published guidelines on capital and liquidity management (ICAAP and ILAAP) by having robust policies and procedures around determination of Pillar 2 own funds requirement as well as liquidity risk management.

— To take adequate measure to mitigate IT and cyber risks e.g. increasing awareness across the organisation through periodic training sessions.

— To establish sound internal governance frameworks, demonstrating senior management oversight including the role of committees across various functions.

— To build robust contingency plans amid increasing geopolitical uncertainties, taking into consideration multiple scenarios to mitigate the aftermath of Brexit and changing regulatory landscape.

Credit Risk

Follow up on NPL guidance

Non-Performing Loans (NPLs) were identified as a priority area by the ECB for a third year running. Elevated NPL levels affect bank capital, profitability, funding and consequently inhibit the supply of credit, making it essential to work out NPL stocks for both bank viability and macroeconomic performance.

The SSM published an NPL guidance to banks in 2017, followed by an addendum issued in 2018, laying out the ECB's supervisory expectations for the provisioning of NPLs.

Going forward, the SSM will follow up with banks on the NPL guidance, engaging further with each affected bank to define supervisory expectations within a harmonised framework. The expectations of the SSM will be guided by benchmarking against comparable banks, individual NPL ratios and the main financial features of a bank.

In the past, credit risk has been the primary topic for ECB on-site missions. However, there has been an increasing number of on-sites dedicated primarily to the NPL guidance, focusing on collateral management, strategy for reducing NPLs and governance. So while the credit quality and credit risk of banks with high levels of NPLs continues to be a strong focus area, banks without high levels of NPLs should expect to see on-sites that may predominately focus on the adherence to the guidance.

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Credit underwriting criteria and exposure quality

In 2019 ECB Banking Supervision will assess the quality of banks' underwriting criteria with a focus on new lending. This will include evaluating the quality of banks' lending practices and lending standards. In addition, the ECB has highlighted its intention for specific on-site inspections related to asset class exposures such as commercial real estate, residential real estate and leverage finance.

While the ECB has highlighted several asset classes of interest (or alternatively, of potential concern), we don't necessarily foresee the ECB putting in place blanket restrictions on certain forms of lending. This approach would mirror their current stance on leveraged transactions, where, instead of a prevention of lending, much higher demands on controls and risk management are expected.

We anticipate that investigations covering credit lending and investigations covering internal models will remain separate, but within the latter there may be more focus on the usage of internal models for business purposes (e.g. the Use Test). Model inaccuracy and improper use are likely to have direct impacts on lending decisions and portfolio quality. With this in mind, banks should be prepared for stronger supervisory focus on the idea of model risk.

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Risk management

Targeted review of internal models

The ECB targeted review of internal models (TRIM) will continue in 2019 with the overarching aim of reducing unwarranted variability of risk-weighted assets and confirming the adequacy of banks' Pillar I internal models. In the course of 2019, ECB Banking Supervision intends to continue its TRIM on-site investigations, focusing mainly on the models used to assess the credit risk for Low Default Portfolios (LDP), i.e. for exposures to medium and large sized corporates and institutions, as well as specialised lending. The ECB will conduct horizontal analyses on the finalised investigations and plans to publish an updated version of the ECB guide to internal models (risk-type specific chapters).

Even though the TRIM Guide in its entirety is not final, many banks are already running their own gap analyses against the current version. The next iteration of the Guide should be used by all SIs with internal models to assess themselves against, at a granular line by line level. Any SSM bank that is currently using the Standardised Approach and is considering moving to the Internal Ratings Based (IRB)/Internal Model Method (IMM) approaches should carefully consider the TRIM expectations, since awareness and understanding of them will likely be challenged by the competent authority.

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ICAAP and ILAAP

Internal capital and liquidity adequacy assessment processes (ICAAPs and ILAAPs) were identified as priorities by the ECB in 2019 for their role as key risk management instruments for credit institutions. This came as no surprise given the ICAAP and ILAAP multi-year plans communicated by the SSM in February 2017. A draft version of the ILAAP and ICAAP guide was released in March 2017, followed by a public consultation, before the final guides were published in November 2018.

The final guides aim to facilitate a consistent approach to the assessment of both processes and are envisaged to be used in JSTs' assessments of banks ICAAPs and ILAAPs from the 2019 SREP onwards. The harmonising effect of the new guides mean that banks will have to make changes to their existing ICAAP and ILAAP in order to be compliant with the new approach. Additionally, some banks will have to make significant technical changes across entities within the group.

Given the ECB expectation that banks are compliant with the new ICAAP and ILAAP guides by January 2019, banks should consider identifying the gaps according to the final guides and make adjustments to their action plan, differentiating between quick wins and longer term initiatives.

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IT and cyber risk

The overall message conveyed by the SSM Supervisory Priorities 2019 is that IT risks need to be part of general risk management procedures, crisis management, and business continuity planning. Even if the ECB has investigated these issues in past activities through thematic reviews on cybersecurity and outsourcing, the focus on IT risks will continue in 2019 and beyond via targeted IT on-site inspections as well as the continuation of the SSM cyber reporting process.

Banks should be aware that the SSM on-site inspection methodology regarding cyber and IT risks was recently updated and for the largest institutions such inspections will be carried out every three or four years. If the ECB focuses more on cyber risks and its technical aspects, banks will need to show concrete measures are in place in order to meet supervisory scrutiny such as up-to-date IT risk self-assessments, a comprehensive cybersecurity incident response plan which describes how to react in case of a cybersecurity incident, documented information security policies and procedures approved by the Management Body in line with the business strategy and the risk appetite, as well as regular information security awareness trainings and information campaigns.

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Liquidity Stress Test

Over the past years, ECB banking supervision has invested considerable efforts into strengthening SSM banks' structural liquidity positions and banks have been advised to review the resilience of their liquidity positions, especially under adverse situations.

Against this background, the 2019 supervisory stress test will be carried out with a focused scope, similar to the ECB sensitivity analysis of IRRBB – stress test in 2017. It will seek to assess banks' resilience against liquidity shocks, for instance, to assess banks' ability to handle any impediments to collateral flows. This will be the first time that the ECB conducts liquidity stress tests, however banks should already have a robust framework for managing liquidity if they are in compliance with Basel III requirements or other policies impacting EU banks.

We expect the schedule to be similar to the IRRBB – stress test 2017 which is to say that the exercise is expected to launch around February 2019 and end around June 2019. The results of individual banks' stress tests will then inform the SREP assessments, and are very likely to also impact the probability of future on-site investigations on banks' liquidity risk management programmes, senior management engagement in defining liquidity risk management policies and procedures, and collateral management.

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Multiple risk dimensions

Brexit preparations

As the March 2019 deadline for the United Kingdom's departure from the European Union approaches, the focus of the SSM's work has shifted from preparatory work to the practical implementation of agreed policy stances. The supervisor will closely monitor the progress of banks' Brexit plans in line with the political negotiations and agreed terms of withdrawal. In the case of continued uncertainty, banks are expected to prepare for all contingencies.

The ECB is yet to publish an official policy or guidelines on Brexit, and like many institutions, their initiatives to date have felt reactive rather than proactive due to the uncertain political environment. One of the main issues is the prevention of the setting up of booking models, i.e. empty shell entities where a bank carries out business in the euro area while it continues to use group-wide infrastructure, expertise and arrangements in a third country. In addition, the ECB is preparing to take over the direct supervision of a number of new significant institutions owing to the Brexit-induced relocation of activities.

Banks should expect keen supervisory discussions on this topic, especially if they plan to amend their business models in order to access the European market.

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Trading risk and asset valuations

A key priority for the SSM is to assess the robustness of banks' valuation practices for financial instruments marked at fair value, particularly those classified at level 2 (L) or at level 3 (L3). This is supervised through the SREP and JSTs examination of market risk aspects on a recurring basis.

The ECB plans to continue a number of specific on-site inspections with a focus on trading and market risk, which would require JSTs to conduct deep dives at a selected number of banks in advance so as to tailor the scope of such on-sites. This may include the examination of L2 and L3 asset exposures, as deemed appropriate by the respective JST.

The ECB has currently not opined publically on their supervisory expectations for this topic, but banks with a high volume of trading activities or derivative portfolios should expect supervisory interest in related topics at their institution, such as their methodology for levelling under IFRS 13, valuation adjustments and the recognition of Day one profit and loss, as well as financial instrument valuations.

However what is clear especially from the updated AQR methodology is that the ECB is expanding its review of financial instruments to include L2 instruments as well as classically L3, and banks should prepare for this.

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