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SSM Supervisory Priorities 2019

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Frankfurt, 7 March 2019
The Supervisory Priorities are risk-based and serve as a key input for proportionate supervisory planning.
Top 3 key risks identified for 2019 are geopolitical uncertainties, NPLs and cybercrime & IT disruptions

- Geopolitical uncertainties have increased:
  - Political uncertainty around Brexit continues and creates a number of challenges, including business and contract continuity risks
  - Concerns have risen about trade protectionism and adverse developments in certain emerging markets

- Aggregate NPL levels remain elevated in the euro area:
  - Despite the progress made by SSM banks in reducing legacy NPLs, aggregate levels of NPLs remain elevated
  - Ongoing search for yield along in the context of subdued profitability might result in an excessive risk taking and sow the seeds of future NPLs

- Risks from cybercrime & IT disruptions are becoming more pronounced:
  - Cyber incidents can lead to financial and reputational losses and may even have the potential to cause systemic impact
  - Progressing digitalisation requires banks to continue efforts to modernise their IT infrastructure

Source: ECB and NCAs
Note that risks are not independent and might trigger or reinforce each other
*In 2020 the EU-wide stress test exercise will be conducted.
Follow-up on NPL guidance

Importance and past activities

- **Asset quality has improved** in the past years: the aggregate gross NPL ratio* stood at 4.2% in Q3 2018, down from 5.2% a year earlier**.

- However, **NPL stocks** remain large at a number of institutions, compared to international standards.
  
  - Elevated NPL levels affect bank capital, profitability, funding and consequently inhibit the supply of credit
  
  - **Working out NPLs** is therefore **important for** both bank viability and macroeconomic performance

- **NPL reduction** has been a continuous priority since the inception of the SSM

- In March 2017 the SSM published **NPL guidance** to banks and in 2018 issued an **addendum**, laying out the ECB’s **supervisory expectations** for **provisioning NPLs**

Activities for 2019 & beyond

- The SSM will **follow up** with banks on the **NPL guidance**, engaging further with each affected bank to define **bank-specific supervisory expectations** within a harmonised framework

- **Supervisory expectations** will be:
  
  - Based on a benchmarking of comparable banks and
  
  - Guided by the bank’s individual NPL ratio and its main financial features

- The **objective** of this work is:
  
  - Ensuring a consistent framework to **continue** progress in **reducing legacy risks** in the euro area
  
  - Achieving the **same coverage of the stock and flow of NPLs** over the medium term

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* Gross NPL ratio computed as gross carrying amount of NPLs divided by total loans and advances.

** The aggregate volume of NPLs on SIs’ balance sheets stood at €628 billion in Q3 2018, down from €1 trillion in early 2015. Between Q3 2017 and Q3 2018, it decreased by €131 billion, and the gross NPL ratio dropped by 1 percentage point, to 4.2%. 

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**Supervisory Priorities 2019**

ECB-PUBLIC
2a Credit underwriting criteria

Importance and past activities

- Throughout 2018 euro area banks have reported a continuous easing of credit standards* for loans to enterprises and to households for house purchases.
- In search for yield, there is a tendency of lenders turning to more risky credit segments; in addition there is a significant portion of covenant-light loans.
- Easing credit standards and risk-taking coupled with a deteriorating economic outlook raise supervisory attention.

Activities for 2019 & beyond

- ECB Banking Supervision will assess the quality of banks’ underwriting criteria, with a focus on new lending:
  - Credit standards will be scrutinised with a view to mitigating potential risks; this work may result in tailored bank-specific follow-up actions.
  - Examined asset classes may include: RRE, CRE, SME, corporates and consumer lending.
  - Project is a SSM-wide concerted effort (ECB and NCAs).
- Where possible, data requests will be limited to data needs that go beyond already available data obtainable from e.g. ITS/ FINREP.
  - Effort for banks should therefore be manageable & contained.
  - Template may include key risk indicators, such as LTV, LSTI, DSCR, etc.
  - Template launch will likely be in early Q2, after consultation with banking industry.

*Source: The euro area bank lending survey
In 2018, a series of on-site inspections (OSI campaigns) have been launched with a focus on exposures to CRE & RRE

- In many cases OSI campaigns make use of a dedicated, harmonised methodology and hence allow for a benchmarking of results

In 2019, OSI campaigns will continue, with an expanded scope, also comprising leverage finance:

- Potentially hidden NPLs and underestimation of losses
- Mainly quantitative approach
- Statistical sampling
- Projection of findings
- Classification & provisioning
- Drivers for misstatements

- Risk of loosening lending / underwriting standards
- Preparedness for market cycle
- Qualitative & quantitative approach
- New origination and riskier parts of the portfolio
- Risk management
- Classification and provisioning for high-risk part

- Compliance with ECB-guidance
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- New origination and riskier parts of the portfolio
- Risk management
- Classification and provisioning for high-risk parts
TRIM - Credit risk, market risk and counterparty credit risk models

Importance and past activities

- The overarching goals of the targeted review of internal models (TRIM) are:
  - Reducing any unwarranted variability of risk-weighted assets (RWAs)
  - Confirming the adequacy of banks’ approved Pillar I internal models
  - Promoting the level playing field for internal modelling

- Methodological harmonisation (e.g. ECB guide to internal models) has laid the foundation for the execution of the project

- The SSM has been conducting TRIM on-site missions since 2017, covering market, counterparty credit and credit risk

Activities for 2019 & beyond

- In 2019, TRIM on-site investigations at banks’ premises are planned to be finalised, however some follow-up activities may still take place in 2020

- The focus of the remaining on-site missions in 2019 will be on low-default (e.g. large corporates, financial institutions) portfolios

- The ECB guide to internal models is envisaged to be further refined based on the comments on risk-type-specific chapters received in the public consultation launched in September 2018
### TRIM - Credit risk: Main findings on PD and LGD risk parameters

- Outcomes of credit risk investigations related to Retail and Corporate SME published on ECB banking supervision website in June 2018
- Update of the letter, covering also data quality aspects and market risk, to be published shortly

#### Heatmap of findings

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Topic</th>
<th>Distribution of findings by severity (average number of findings per investigation)</th>
<th>% investigations with findings</th>
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</thead>
<tbody>
<tr>
<td>PD</td>
<td>Risk differentiation</td>
<td><img src="chart1.png" alt="Bar Chart" /></td>
<td>63%</td>
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<tr>
<td>PD</td>
<td>Long-run average default rate</td>
<td><img src="chart2.png" alt="Bar Chart" /></td>
<td>67%</td>
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<td>PD</td>
<td>Margin of conservatism</td>
<td><img src="chart3.png" alt="Bar Chart" /></td>
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<tr>
<td>PD</td>
<td>Framework for review of estimates</td>
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<td>77%</td>
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<tr>
<td>PD</td>
<td>Total PD</td>
<td><img src="chart5.png" alt="Bar Chart" /></td>
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</tr>
<tr>
<td>LGD</td>
<td>Calculation of realised LGD</td>
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<td>70%</td>
</tr>
<tr>
<td>LGD</td>
<td>Risk differentiation</td>
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<tr>
<td>LGD</td>
<td>Long-run average LGD</td>
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<td>Downturn adjustment</td>
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<td>Margin of conservatism</td>
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<td>LGD</td>
<td>Total LGD</td>
<td><img src="chart13.png" alt="Bar Chart" /></td>
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</tr>
</tbody>
</table>

#### Areas of main findings

- **PD parameter**
  - Risk differentiation – lack of consideration of relevant risk drivers, lack of an appropriate definition of the grades
  - Estimation of long-run average DR – calculation of default rates, definition of the period representative of the long-run average

- **LGD parameter**
  - Calculation of realised LGD – use of an inappropriate discount rate, treatment of multiple defaults, specific calculation aspects
  - Estimation of long-run average LGD – treatment of incomplete work-outs and defaulted assets, downturn adjustment
Improvement of banks’ ICAAP and ILAAP approaches & further integration into SREP

Importance and past activities

- ICAAPs and ILAAPs are of fundamental importance for institutions in managing capital and liquidity adequacy.
- After publishing initial ICAAP and ILAAP guidance to institutions in 2016, the SREP assessments and further analyses revealed that the quality of banks’ ICAAPs and ILAAPs requires further harmonisation and improvement.
- Therefore, in 2017 the SSM launched its initiative to foster the continuous improvement of banks’ ICAAPs and ILAAPs.
- After several waves of interaction with banks, in 2018 a public consultation on the ICAAP and ILAAP guides was conducted and the final guides were published.

Activities for 2019 & beyond

- The final SSM guides on ICAAP and ILAAP are to be used in JSTs’ assessments of banks ICAAPs and ILAAPs from the 2019 SREP onwards.
- ICAAP and ILAAP feed into the SREP assessment and into the Pillar 2 capital/liquidity determination process in accordance with the EBA Guidelines on common procedures and methodologies for the SREP.
- High supervisory intensity is expected to continue for the ICAAP & ILAAP also going forward.
- Work will also continue on improving the transparency around the risk-by-risk composition of the Pillar 2 capital requirements.
Assess IT & cyber risk

Importance and past activities

- Cybercrime and IT disruptions are an increasing challenge for banks: the growing number of cyber threats can lead to financial losses and even have a systemic impact.
- ECB banking supervision has already in the past launched respective activities:
  - 2015: thematic review on cyber security
  - 2017: thematic review on outsourcing (incl. IT)
  - 2017: launch of the SSM cyber incident reporting
  - 2018: thematic review on IT risk as part of the SREP
- In addition, a stock take on IT risk supervision by other supervisors outside the euro area was conducted to identify best practices.
- Recently the SSM on-site inspection methodology regarding cyber and IT risks has been updated.

Activities for 2019 & beyond

- In 2019, enhanced supervisory intensity for IT risk-related topics is envisaged, with several on-site inspections on IT risk-related topics planned for 2019.
- JSTs will continue the on-going supervisory dialogue with banks on IT risk and how to protect their systems, which will also inform the SREP assessments.
- Regular IT risk questionnaires (bank self-assessment) will allow to identify thematic trends.
- Significant institutions will continue to report any significant cyber incidents to the ECB under the SSM cyber incident reporting process.
- Consider threat-led penetration testing (TIBER-EU).
- Possibility of industry roundtable on IT issues.
Liquidity Stress Test (LiST)

Importance and past activities

- Over the past years, ECB banking supervision has made considerable efforts to strengthen SSM banks’ structural liquidity positions, via the fostering of improved ILAAP processes.
- Liquidity has been abundant in the euro area in recent years, yet idiosyncratic liquidity crisis episodes were observed.
- However, a hypothetical sudden repricing of risks in financial markets could - if severe - trigger an interbank lending freeze and/or deposit outflows and hence may create vulnerabilities in SSM banks’ liquidity positions.
- In the current environment, banks are well advised to review the resilience of their liquidity positions, also under adverse circumstances.

Activities for 2019 & beyond

- The LiST has a focused scope, assessing banks’ resilience against short-term, instantaneous liquidity shocks which may affect their net liquidity position.
- In case of weaknesses, follow-up activities may focus on banks’ liquidity risk management, for example on their ability to handle any impediments to collateral flows.
- Reported data to be challenged through a quality assurance process (e.g. outlier test) and peer benchmarking.
- Results from the exercise will feed into SREP through:
  - Scoring in SREP Element 4, e.g. using observations made, e.g. regarding data availability, timeliness and quality.
  - Informing all three blocks of SREP Element 4, e.g. using peer benchmarking of LiST results and challenging the ILAAP.
  - Taking lessons learned from LiST 2019 to further refine the SREP methodology.
Brexit preparations

Importance and past activities

- With the United Kingdom’s departure from the European Union scheduled for 29 March 2019, the coming months will be crucial for the SSM work on Brexit.
- In 2018, the focus of the SSM’s work has shifted from preparatory work to the practical implementation of agreed policy stances.
- The majority of banks have good made progress in their Brexit plans and have implemented or committed to future set-ups in line with SSM expectations.
- JSTs have supported and monitored the SSM banks operating in the UK and the development of their contingency plans.
- The SSM has established regular contacts with other involved supervisory authorities and further enhanced the communication with the industry.

Activities for 2019 & beyond

- The ECB will closely follow the developments in the political negotiations and assess if any modifications of the SSM Brexit policy stances become necessary.
- In 2019 ECB banking supervision will focus its efforts on the close monitoring of the implementation of banks’ Brexit plans.
- Objective is to ensure that banks comply with the agreed supervisory expectations (including on internal governance, risk management, the use of back-to-back booking models and corporate structure).
- The ECB further prepares to take over the direct supervision of a number of new significant institutions, owing to the Brexit-induced relocation of activities.
Trading risk & asset valuations

Importance and past activities

- The new fundamental review of the trading book (FRTB) rules will require from banks substantial changes to models, data, technology and processes, with major novelties being:
  - Non-modellable risk factors (NMRFs)
  - The P&L attribution at trading desk level

- Since its inception the SSM has been assessing the robustness of banks’ valuation practices for assets marked at fair value, including those for level 2 and level 3 instruments
  - SREP methodology provides for thorough supervision of market risk
  - JSTs examine market risk aspects on a recurring basis, as appropriate and commensurate with banks’ risk profiles

Activities for 2019 & beyond

- The supervisory dialogue with banks to gauge their state of preparation for the envisaged FRTB rules will continue
  - Objective is to ensure that banks prepare their systems appropriately and on time to comply with the new market risk framework

- A number of on-site inspections (OSIs) focused on valuation risk are planned for 2019 & 2020
  - JSTs may upfront conduct deep dives at selected banks in order to tailor the scope of OSIs to relevant risk areas such as the assessment of the Prudent Valuation framework
  - A number of SIs were selected for respective on-site inspections (OSIs) based on their exposure to assets marked-to-market, their RAS market risk score and the number market risk OSIs performed in past years
  - Activities may include the examination of L2/L3 asset exposures, as deemed appropriate by the respective JST
The Supervisory Priorities 2019 are available on the ECB Banking Supervision website

- The SSM Supervisory Priorities 2019 have been published.

- A downloadable 4-page summary version is available on the ECB Banking Supervision website and provides a brief and concise overview of the SSM Supervisory Priorities 2019 and related supervisory activities:


- In addition, the annual risk assessment has also been published and is also available on the website:

Questions & Answers