ECB-PUBLIC

EUROPEAN CENTRAL BANK

BANKING SUPERVISION

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SSM Supervisory Priorities 2019

4th SSM & EBF Boardroom Dialogue

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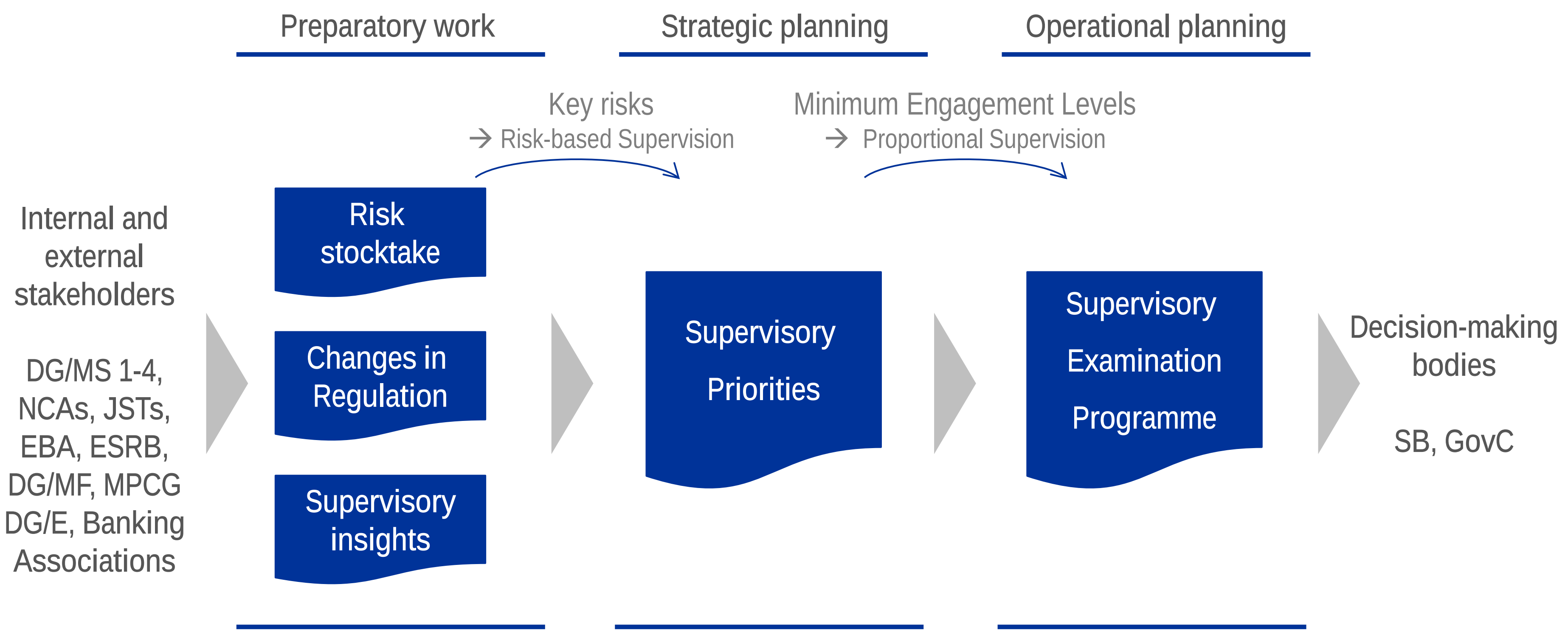
The Supervisory Priorities are risk-based and serve as a key input for proportionate supervisory planning



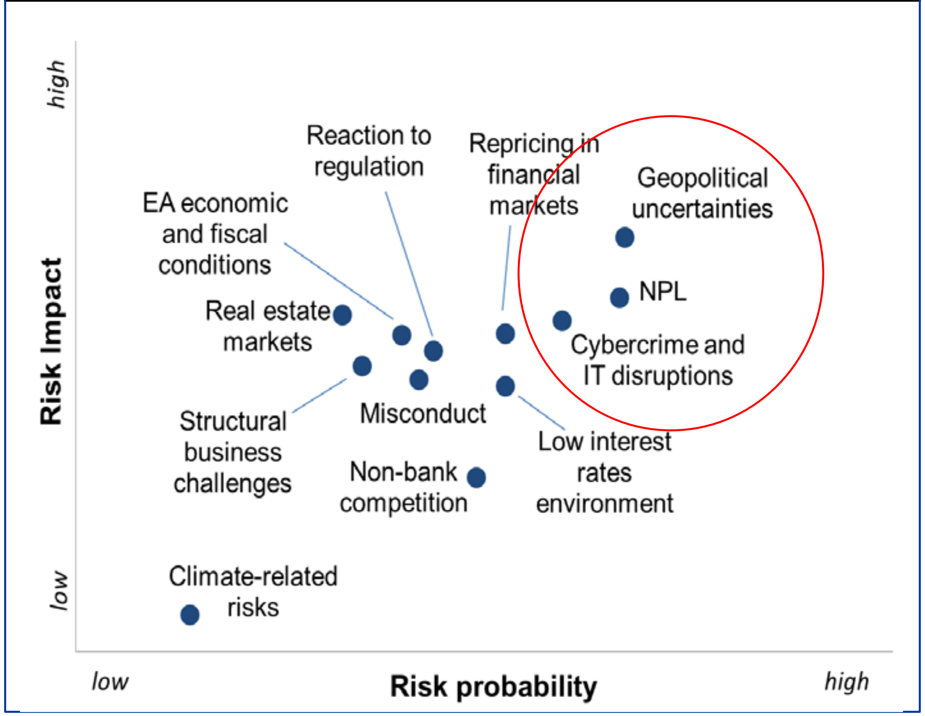
Top 3 key risks identified for 2019 are geopolitical uncertainties, NPLs and cybercrime & IT disruptions

- **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**

Key risks for SSM banks for 2019



Source: ECB and NCAs
Note that risks are not independent and might trigger or reinforce each other

SSM Supervisory Priorities 2019 - Overview

Priorities 2019		Activities for 2019 & beyond		2019	2020	2021
Credit risk		Follow-up on NPL guidance	1	Activity planned	Activity planned	Activity possible
	EXPANDED	Credit underwriting criteria & exposure quality (e.g. real estate, leverage finance)	2	Activity planned	Activity planned	Activity planned
Risk management		TRIM - Credit risk, market risk and counterparty credit risk models	3	Activity planned	Activity possible	Not yet planned
		Improvement of banks' ICAAP and ILAAP approaches & further integration into SREP	4	Activity planned	Activity possible	Not yet planned
	NEW	Assess IT & cyber risk	5	Activity planned	Activity planned	Activity possible
	NEW	Liquidity stress test	6	Activity planned *		
Multiple risk dimensions		Brexit preparations	7	Activity planned	Activity planned	Activity possible
	NEW	Trading risk & asset valuations	8	Activity planned	Activity planned	Activity possible

Activity planned   Activity possible   Not yet planned

Timelines are indicative

*In 2020 the EU-wide stress test exercise will be conducted.

1 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

* 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%.

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

2b OSI campaigns on exposure quality (e.g. real estate, leverage finance)

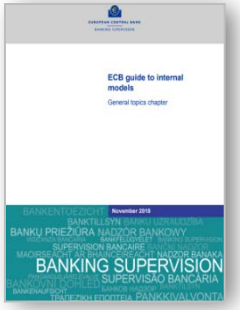
- In 2018, a **series of on-site inspections (OSI campaigns)** have been launched with a focus on exposures to CRE & RRE
  - In many cases OSI campaigns make use of a dedicated, harmonised methodology and hence allow for a benchmarking of results
- **In 2019, OSI campaigns will continue**, with an expanded scope, also comprising leverage finance:

Theme of campaign	Residential Real Estate	Commercial Real Estate	Leverage Finance
Background information	- Potentially hidden NPLs and underestimation of losses	- Risk of loosening lending / underwriting standards - Preparedness for market cycle	- Compliance with ECB-guidance - Risk of loosening lending / underwriting standards
	- Mainly quantitative approach - Statistical sampling - Projection of findings - Classification & provisioning - Drivers for misstatements	- Qualitative & quantitative approach - New origination and riskier parts of the portfolio - Risk management - Classification and provisioning for high-risk part	- Qualitative & quantitative approach - New origination and riskier parts of the portfolio - Risk management - Classification and provisioning for high-risk parts

3 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

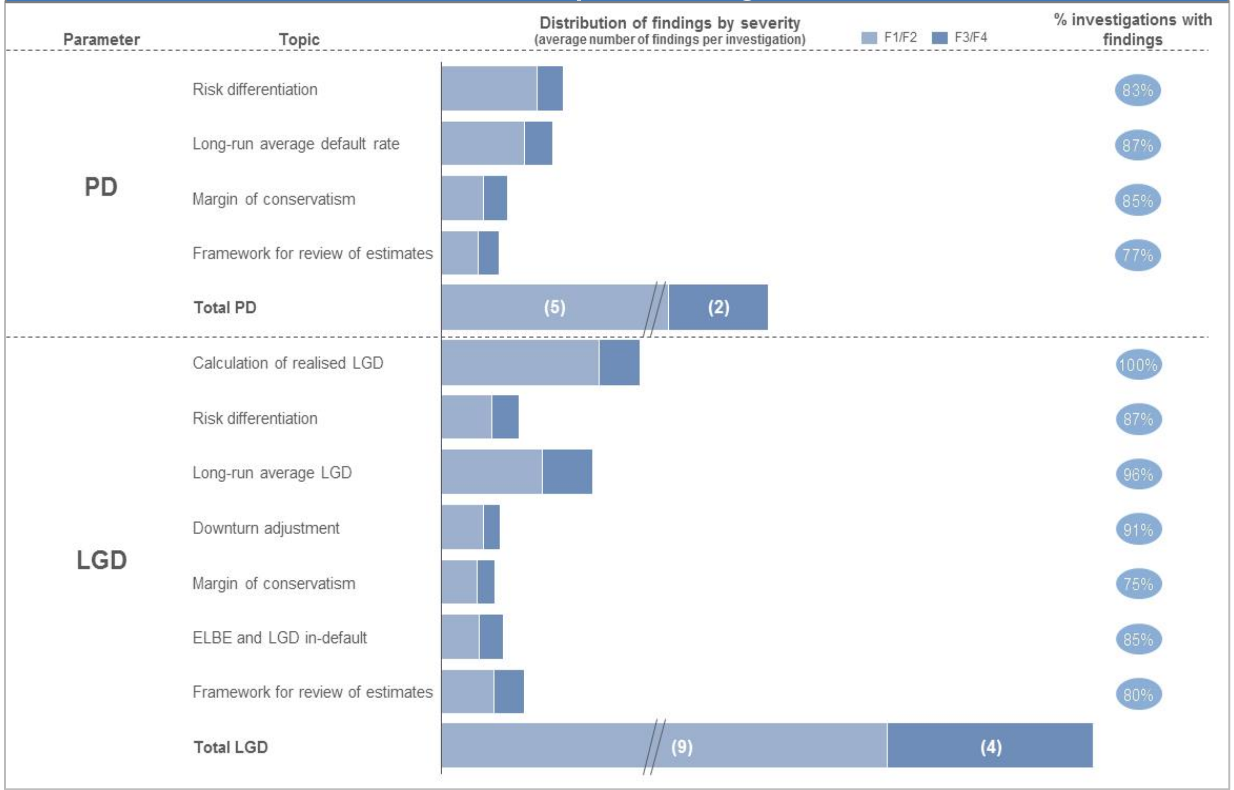
Activities for 2019 & beyond

- 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

3 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



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

4 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

5 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

6 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

7 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

8 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

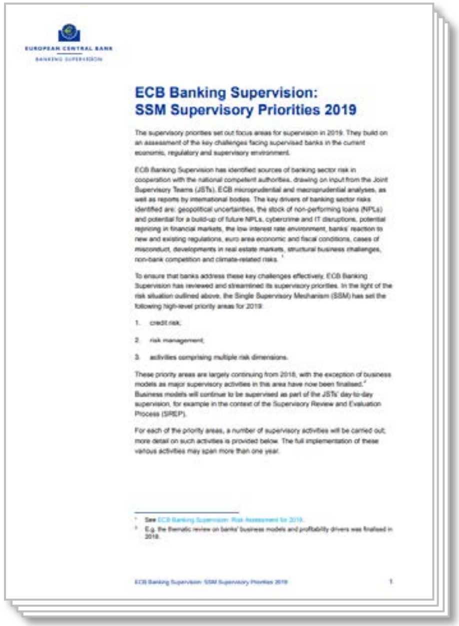
- The SSM Supervisory **Priorities 2019** have been **published**

- 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:

  https://www.bankingsupervision.europa.eu/banking/priorities/html/index.en.html

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

  https://www.bankingsupervision.europa.eu/banking/priorities/risk_assessment/html/index.en.html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ECB Banking Supervision: SSM Supervisory Priorities 2019

The supervisory priorities set out focus areas for supervision in 2019. They build on an assessment of the key challenges facing supervised banks in the current economic, regulatory and supervisory environment.

ECB Banking Supervision has identified sources of banking sector risk in cooperation with the national competent authorities, drawing on input from the Joint Supervisory Teams (JSTs), ECB microprudential and macroprudential analyses, as well as reports by international bodies. The key drivers of banking sector risks identified are: geopolitical uncertainties, the stock of non-performing loans (NPLs) and potential for a build-up of future NPLs, cybercrime and IT disruptions, potential repricing in financial markets, the low interest rate environment, banks' reaction to new and existing regulations, euro area economic and fiscal conditions, cases of misconduct, developments in real estate markets, structural business challenges, non-bank competition and climate-related risks.[1]

To ensure that banks address these key challenges effectively, ECB Banking Supervision has reviewed and streamlined its supervisory priorities. In the light of the risk situation outlined above, the Single Supervisory Mechanism (SSM) has set the following high-level priority areas for 2019:

1. credit risk;
2. risk management;
3. activities comprising multiple risk dimensions.

These priority areas are largely continuing from 2018, with the exception of business models as major supervisory activities in this area have now been finalised.[2] Business models will continue to be supervised as part of the JSTs' day-to-day supervision, for example in the context of the Supervisory Review and Evaluation Process (SREP).

For each of the priority areas, a number of supervisory activities will be carried out; more detail on such activities is provided below. The full implementation of these various activities may span more than one year.

[1] See ECB Banking Supervision: Risk Assessment for 2019.

Questions & Answers