Financial Risk&Regulation

ICLAAP – Understanding supervisory expectations and how banks can improve ICLAAP performance

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Covid-19 has had an unprecedented impact on financial institutions since the first quarter of 2020, resulting in rapid changes in capital and liquidity that have often outpaced EBA stress test scenarios. The possible decline in the quality of assets and the often poor profitability of European banks have made the outlook for capital levels uncertain, although banks and supervisors have reacted with sufficient flexibility to the situation. In essence, in recent months, doubts have been raised about the ability of banks'capital and liquidity management frameworks to cope with crises such as pandemics, climate change, digitalisation, or other threats to operational resilience.

The Internal Capital Adequacy Assessment Process (ICAAP) and the Internal Liquidity Adequacy Assessment Process (ILAAP) - or together simply the ICLAAP (since they are both based on similar supervisory principles) - are key tools in managing banks' capital and liquidity. That is why we believe that banks should not treat these instruments as an eligibility criteria, but rather as a valuable planning mechanism or source of informed decisions, and should see ICLAAP as an essential tool for building trust with investors, supervisors and other stakeholders. The crisis has provided an opportunity for banks to draw clearly identifiable lessons from their ICLAAP performance and to point out areas for improvement in this context.

Change of supervisory focus

Unlike the crisis of 2007/2009, central banks and supervisors intervened quickly in order to stabilize the capital and liquidity position of the banking sector and other economic actors as quickly as possible. The experience of the crisis is now being processed by the sector and in this context, supervisory focus points are expected to shift towards ICLAAP expectations permitting banking operations as much as possible. The SSM operated by the ECB has a direct impact on euro area banks, but it also affects the operations of Hungarian subsidiaries through foreign parent banks, as risk management and planning processes may need to be modified here in order to comply with group-level compliance. Furthermore, the ECB's visions are also important for Hungarian-owned banks, as the MNB also monitors international practices and incorporates some of them into its own methodology, the changes of which we wrote about in our February 2021 and August 2020 newsletters. Furthermore, a more comprehensive ICLAAP process helps determine optimal capital and liquidity, thereby supporting long-term stable operations and value creation.

Lessons from the crisis

The ECB, as the supervisory body of EU banks, has always considered the ICAAP and ILAAP to be essential elements of risk management and the main drivers of SREP. The harmonization of market practices in the context of ICLAAP has been a priority for the ECB for many years, and progress is confirmed by the ECB's August 2020 report. At the same time, the ECB highlighted a number of shortcomings and stressed the importance of data quality, economic prospects and stress tests to support bank continuity. These are also highlighted by the ECB in its 2021 risk map, which is illustrated in Chart 1.

Internal to banks	Weaknesses in management and coverage of credit risk	Structurally low income levels and profitability	IT deficiencies
	Weak governance, incl. weak strategic steering	Lingering cost inefficiences	
External to banks	High public and private debt levels in the euro area	Overcapacities in banking	Fregmentation in the regulatory and legal framework

Chart 1: Table of vulnerabilities 2021

In our view, the Covid-19 pandemic has highlighted the lack of proper vision planning and the fact that over-reliance on past events can often lead to low ICLAAP performance. At the height of the pandemic, some banks had to make immediate adjustments to the backward indicators from the financial crisis scenarios to get a forward-looking view of the days and weeks ahead in a resource-constrained environment. As regards the liquidity situation, the occasional improvement in the indicators is due to the redesign of liquidity scenarios, with a greater emphasis on central bank decisions and a higher number of liquidity stress tests.

In general, recent months have highlighted the importance of the following activities for building a strong and solid forward-looking perspective:

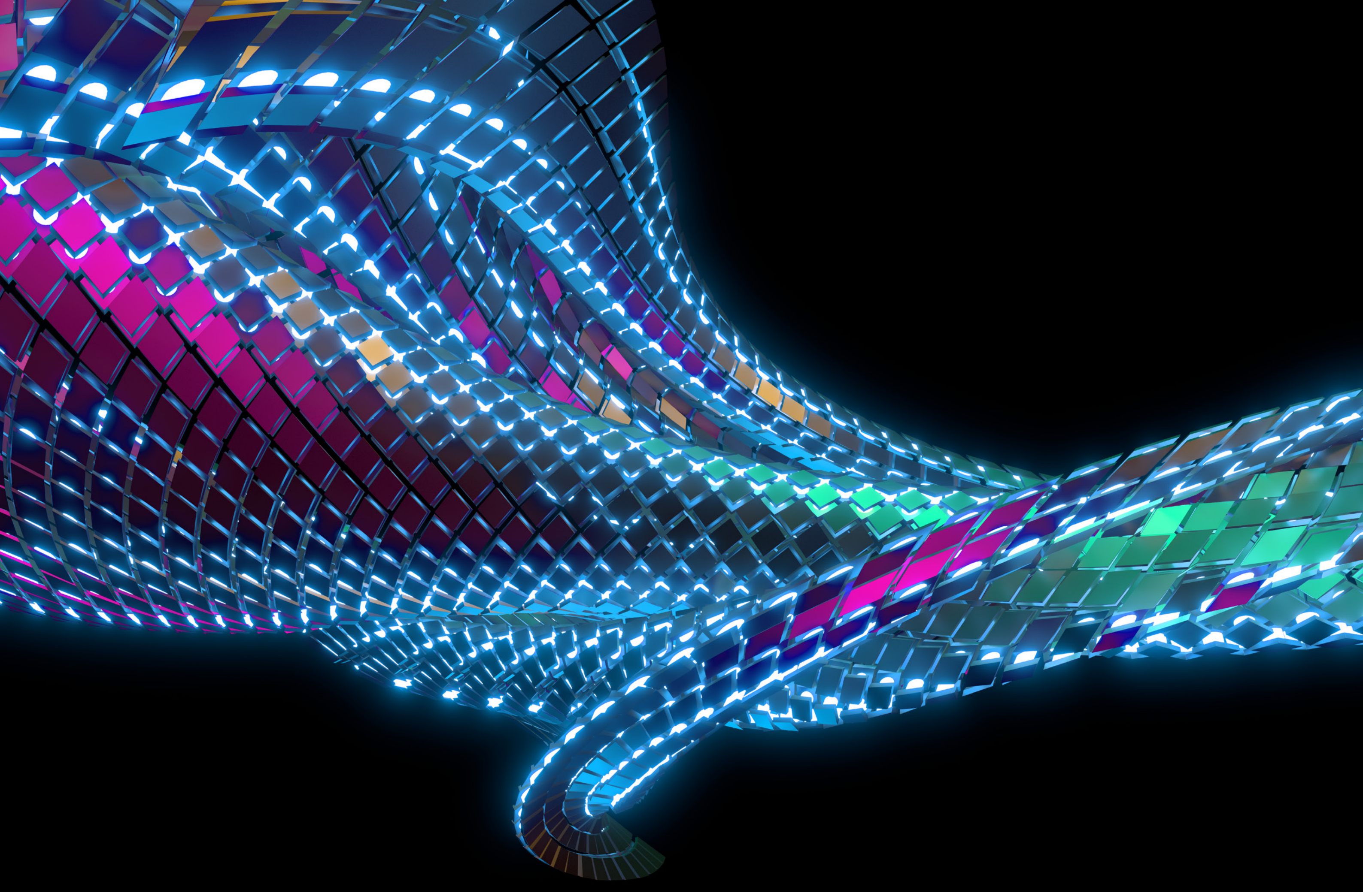
- **The identification and assessment of risks should be constantly updated based on new risk factors.** The Covid crisis has demonstrated that a simple extrapolation of the effects observed during previous downturns is not sufficient to get a bottom line, and new risk factors require strong and relevant planning. It is essential to understand new risk events such as epidemics, climate risks, lower for longer interest rates or digitalization pressures.
- **Banking systems need to be robust and flexible even in a turbulent environment:** they need to be able to redesign simulations and model sensitivity calculations in a short period of time, and change if necessary - for example, to produce a daily LCR report with minimal additional resources.
- **Scenario analysis should also be flexible**, allowing for the fine-tuning of individual narratives and the adjustment of parameters and detail in response to the changing macroeconomic environment - for both ICAAP and ILAAP.
- **The presence of ICLAAP should be enhanced and fully integrated into the risk appetite framework.** It allows us to clearly demarcate periods of crisis and peace, which will help shorten the response time. After the 2008 crisis, 2020 was the first real test for a number of revised liquidity crisis management frameworks. Many banks acknowledged that, although these frameworks initially worked well, they did not prove effective enough during the crisis due to the lack of procedures containing a detailed list of measures and their effects (such as costs, effects on banks' core business and adverse market signals).

In addition to the lack of forward-looking perspective, recent months have shown that careful consideration of relevant responses is key to banks' ICLAAP performance. The impact of policy responses varied significantly between banks; while some benefited from capital or liquidity assistance measures, others were more helped by monetary policy or government support.

Furthermore, the rapid change in the political environment and the impact of external factors such as infection and vaccination rates on political decisions meant that banks had to constantly monitor the potential advantages or disadvantages of policy responses to their capital and liquidity levels. Responses to the internal crisis, such as lending decisions, limit increases or more intensive monitoring of borrowers, were equally dynamic, but were not always fully taken into account in banks' capital or liquidity decisions, as assessed by the ECB, reducing banks' ICLAAP performance.

What banks should do now?

Given the lessons learned from Covid-19, the highly uncertain economic outlook and the threat to banks' capital and liquidity positions, what should banks do to improve their ICLAAP performance?



In our view, after Covid-19, there is a need to focus on three areas of action:

1. **Improve ICLAAP scenarios and scenario flexibility:** Defining a baseline is a major challenge, since there is uncertarinty about the pace of macroeconomic recovery in the coming months or years. The current situation is further complicated by the rethinking of emergency funding, income support and debt relief packages managed by European governments and public bodies, the duration of which is, moreover, uncertain, as it depends to a large extent on the success of vaccination programs. In addition, the crisis has highlighted the need for each scenario and its parameters to be flexible and adapt quickly to environmental events covering the risks posed by further epidemics, climate change, low interest rates, accelerating digitalisation and sovereign or debt crises.

2. **Embed normative and economic approaches:** For many banks, the normative approach - based on the ability to meet supervisory requirements with future potential balance sheets -, limits risk-taking, given conservatism and CRR and CRD requirements, including the "Basel III finalization ", MREL, IFRS9 and other regulatory and accounting initiatives. However, the economic approach - based on banks' current balance sheets and taking into account factors such as economic capital or liquidity survival -, may also be an obstacle due to fluctuating market conditions during Covid-19 or limited risk-taking capacity during the global financial crisis. Economic and normative approaches must complement each other, both in times of crisis and in the recovery cycle. This requires special attention on the part of banks to ensure consistency between management decisions, scenarios and ICLAAP metrics.

3. **Establishing strong link between business strategy, risk appetite and limits:** In the longer term, banks need to establish a strong and solid link between their business model and risk-taking framework to explain and protect their core business with their limited ability to recover capital or liquidity - especially if they are further eroded by a future crisis. This not only navigates the primary and secondary challenges posed by the epidemic, but also reflects the need to address the weak profitability and overcapacity that have characterized a significant part of the European banking sector for more than a decade. Appropriate capital and liquidity planning should provide a clear picture of when capital and liquidity coverage of banking business and strategic initiatives will be required. This requires the ability to develop and communicate balanced, well-thought-out strategies that include the capital and liquidity

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planning required for lend appetite, supervisory expectations, dividend payment policy, investor relations, and many other areas. Success will be crucial in maintaining the confidence of buyers, investors, supervisors and other stakeholders post Covid-19.

The planning process for the post-Covid world seems less smooth for banks: a balanced allocation of particularly scarce resources is needed to stay competitive. New lending requirements are emerging (eg. sustainability criteria), ever-increasing supervisory expectations are making everyday life more difficult, and we cannot go without the strategic opportunities arising from the digitalisation of financial services.

ICLAAP has a critical role to play in developing the post-covid recovery of banks, providing a solid basis for decision-making and preparing for the needs of investors and supervisors. The current situation is about nothing more than the ability to make informed strategic decisions in a changed environment. ICLAAP processes need to be continuously aligned with risk appetite, crisis management and strategic planning. Not only due to deficiencies caused by Covid-19, but also due to further deterioration expected to precede recovery. In our view, this will help banks not only in recovery, but also in adapting their business models to the post-recovery environment and addressing existing weaknesses.

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In accordance with the international regulatory environment and domestic practice, the MNB is further expanding and clarifying the resources that concerns materially financial market participants and their legal requirements meet. KPMG has the expertise to interpret, implement and provide relevant professional advice on supervisory expectations and to develop appropriate practices.

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