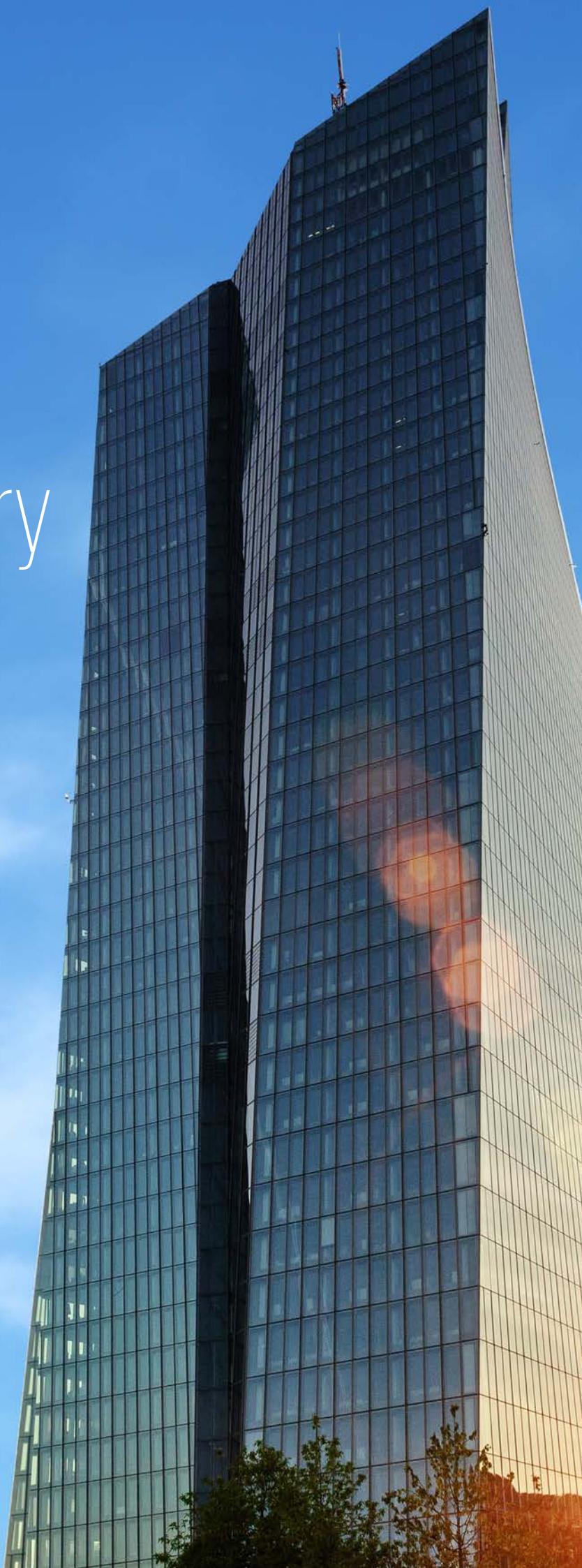




Refining the framework: SSM supervisory priorities 2019

November 2018

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Executive summary



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 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.

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.

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. These remain largely unchanged from 2018, with the exception of business models, which has fallen from the priority areas but will continue to be supervised as part of the Joint Supervisory teams' (JSTs) day-to-day supervision going forward.

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

The EBA had a similar supervisory focus, with five strategic areas (i) Basel III implementation; (ii) financial innovation; (iii) banking data; (iv) relocation of the EBA to Paris; and (v) increasing of the loss-absorbing capacity of the EU banking system. Across each of these strategic priorities, the EBA has also overlaid horizontal priorities that will apply to all policy work. These include further embedding of the proportionality principle, strengthening the Single Rulebook, enhancing consumer protection and wider preparation for Brexit.

To continue improving resolution planning and overall financial stability, the SRB structured its work programme along five strategic areas (i) strengthening resolvability of SRB entities and less significant institutions (LSIs); (ii) fostering a robust resolution framework; (iii) preparing and carrying out effective crisis management; (iv) fully operationalising the Single Resolution Fund (SRF); and (v) establishing a lean and efficient organisation by establishing a solid ICT framework within the SRB.

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.



The three major authorities of the Banking Union set the tone for the supervisory landscape that European banks face"



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. The EBA also named NPLs as a key mandate in their work programme, showing the continued investment from supervisory authorities to address the remaining NPL overhang in Europe. There is strong overlap between the ECB and EBA prioritisation of NPLs, further complemented by the July 2017 [European Council action plan](#). Much has already been achieved, such as the [ECB Guidance on NPLs](#) for SSM banks and a wave of new initiatives to support demand and supply of NPLs in 2018.

The results of these initiatives are material and visible. The total stock of NPLs in the euro area has fallen over the last two years and the results of the [2018 EBA stress tests](#) for the banks which are heavily exposed to NPLs were better than anticipated¹. However, the 2019 priorities show that there is more to be done.

What are the implications for banks?

The ECB is still looking at enhancing their supervision over both new flow and stock NPLs. Part of this is the coming into force of the [ECB provisioning calendar](#) which is a supervisory expectation on how banks should manage the provisioning on new flow, and the [July 2018 ECB press release](#) announcing further supervisory guidance on how to manage NPL stock (aligning in the long terms the NPL stock provisioning to the new flow).

The EBA will continue to contribute to the European Council's action plan for tackling NPLs in Europe. In the New Year, the outputs from the EBA on this topic will include;

- EBA Guideline on banks' loan origination, internal governance and monitoring (2Q 2019).
- EBA Guideline on management of non-performing and forborne exposures (1Q 2019).
- Draft TS on management information systems (4Q 2019).

The implications of these initiatives are not only limited to banks under SSM supervision, as they will need to be implemented by all EU banks. In 2018 we advised banks to run gap analyses to ensure a thorough understanding of where they are lacking in meeting supervisory requirements. Looking ahead, the scope of implementation will no longer be limited to NPL strategy only but will need to apply to all aspects of the bank organisation:

- The governance, process and procedures of a bank will be impacted by the EBA Guidelines on loan origination, internal governance and monitoring, and EBA Guideline on management of non performing and forborne exposures
- Data and IT will be impacted by the EBA Draft ITS on NPL and Draft TS on management information systems, the ECB provisioning calendar and the EC provisioning calendar once approved. As a result, banks will need to learn how to reconcile the individual needs of these regulatory initiatives, together with their accounting requirements.
- Valuation practices and management of forborne exposures will be a key area of concern for all banks, particularly in light of the results of the gap analyses performed by banks, discussions with their JSTs and the scope of on-site mission.

How can banks prepare for this as a focus area?

2019 is set to be a 'hot year' for the topic of NPLs due to the many anticipated guidelines and initiatives to be published and enforced. In particular, we suggest that banks:

- Perform an impact assessment and a gap analysis of the bank's current internal policies, procedures and systems that could potentially be impacted by the introduction of the ECB Addendum, supervisory guidance on how to manage NPL stock and EU statutory backstops.
- Identify potential short-term and long-term mitigation measures aimed at minimising the impact of the introduction of the ECB Addendum and EU statutory backstop on the banks accounting loan loss provisioning and "cost of risk".
- Develop action plans to be prepared for discussion with the supervisory team and the next Supervisory Review and Evaluation Process (SREP) cycle on how to manage the backstops (on new flow and on stock).
- For the banks impacted by the introduction of the EBA Guideline on the management of NPE and FBE, to start analysing potential gaps in their NPE and FBE management against the requirements set in the Guideline, over the entire 'life cycle' of NPE on which the Guideline is based.
- Evaluate the effectiveness of strategies and operational arrangements to manage NPLs, including the range of options (outsourcing of workout function, joint ventures, structured credits and clean sales), people and skills, data and IT systems enhancement, and collateral valuations.

¹ EBA 2018 EU-wide stress test results <https://www.eba.europa.eu/-/eba-publishes-2018-eu-wide-stress-test-results>

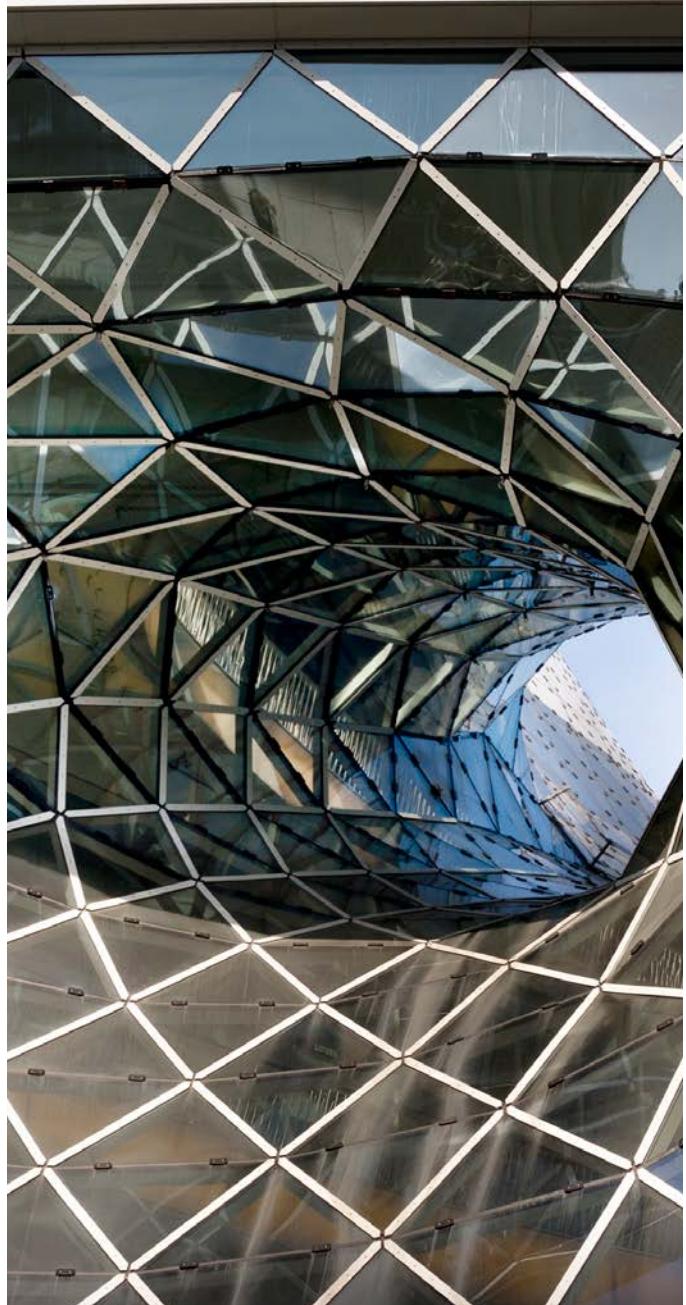
Additional reading

Outsourcing NPLs: an emerging trend
(September 2018)

EBA Guidelines on non-performing and forbearance exposures (April 2018)

The latest on NPLs: how do the newly published regulatory requirements fit together? (March 2018)

Accessible from kpmg.com/ecb



- Continue to focus on measures to reduce the flow of NPLs, including pricing (price-to-risk approaches), underwriting processes, new product development, introduction of new or updated foreclosure mechanisms.
- Ensure that banks meet the enhanced supervisory reporting and public disclosure requirements (ECB and EBA).
- And, finally, to identify interdependencies among the current implementation projects: new Definition of Default, ECB Guidance, ECB Addendum, EBA Guidelines on management NPE and FBE, and IFRS 9.

How might it impact on-site investigations?

In the past years credit risk has been the primary topic for ECB on-site missions, with the ECB also running a gap analysis against the NPL guidance on areas such as governance and strategy. However, there has been an increasing number of on-sites dedicated primarily to the NPL guidance, focusing on collateral management, strategy for reducing NPLs, governance and whether banks have the appropriate resources in the relevant functions. So while the credit quality and credit risk of banks with high levels of NPLs continues to be a strong focus area for the ECB, banks without high levels of NPLs should expect to see on-sites that may predominately focus on the adherence to the guidance, for example in terms of governance.

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How KPMG can help

Follow-up on NPL guidance



KPMG member firms offer a wide range of strategies, services and tools aimed at supporting and advising banking clients in all NPE related tasks, leveraging the integrated approach of multidisciplinary teams across Europe. These teams are able to support clients with portfolio analysis, NPE Strategy and Servicing, data quality, forbearance solutions, governance and operational change, collateral valuation, portfolio pricing and impairment analysis.

Our Gap Analysis Tool offers an assessment of banks against all areas of the EBA Guidelines (or ECB Guidance on NPLs), allowing for cost effective identification of critical shortfalls and possible targeted remediating actions.

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.

This ECB priority has some alignment to the EBA's Activity 7 (Credit Risk) and Activity 15 (Loan management and Valuation). One of the EBA outputs from Activity 15, "Guidelines on loan origination, internal governance and monitoring" will also have relevance for the topic of NPLs.

These initiatives regarding credit risk will provide food for thought for banks that have previously sought to comply with the [ECB Guidance on Leveraged Transaction](#), which was finalised in May 2017, and the EBA [Guidelines on credit risk management and ECL accounting](#), published in May 2017.

What are the implications for banks?

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.

Given the focus on credit lending standards, banks that are starting to use more sophisticated techniques for credit risk decisioning (e.g. random forest, machine learning) will potentially be challenged on management understanding of the general approach, and will need to show that they are not reliant on "black box" solutions.

The ECB has a wide scope of portfolios which it can assess, so banks should not assume that only low default portfolios (such as large corporates) will be the only ones where underwriting criteria are assessed. Depending on the scope of investigation, some banks may struggle to show how standards are applied consistently across portfolios, or in a way that aggregates risk appropriately for Group level reporting/risk appetite.

How can banks prepare for this as a focus area?

There are several steps that banks can take to prepare themselves on the topic of credit underwriting criteria and exposure quality:

- Carry out a stock take of documentation relating to credit risk management processes and underwriting, i.e. quality assurance and annual review of Risk Appetite Framework, Risk Appetite Statement, lending strategies and reporting. Having appropriate documentation is perhaps the most basic hurdle to overcome, but it is critical to facilitate on-site investigations. Documentation covering the IT infrastructure involved in credit decisions is particularly important, including implementation testing results for credit models and rules.
- Perform a dry-run review of a sample of credit decision cases (or alternatively, check to see whether the bank's Internal Audit function has done this recently and to what coverage).
- Review what KPIs are sent to the management body regarding portfolio quality and risk appetite for different asset classes. For example, residential real estate exposures could be considered with regards to interest rate impacts, LTV profiles and customer ability to repay.
- Understand whether the bank's internal stress tests and ICAAP can be used to show the resilience and "quality" of the portfolios that the ECB will be investigating.

How might it impact on-site investigations?

In general, lending processes and controls is an evergreen topic that JSTs have been examining for some time. However the breadth and depth of on-sites in 2019 may increase further. In late 2018 we saw a new type of credit risk on-site, focused on retail mortgages, notably including credit file reviews. We would expect for this trend to continue in 2019.

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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Additional reading

Leverage Finance (September 2017)

Accessible from kpmg.com/ecb



How KPMG can help

Credit underwriting criteria and exposure quality

KPMG teams have extensive experience helping banks to review and redevelop their credit policies and CRM frameworks in line with supervisory expectations. The KPMG PeerBank Tool can also be used as an aid for analysing trends in the credit quality of banks.



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).

Alongside TRIM, the EBA strategic priority "Leading the Basel III implementation in the EU" will also affect internal models, as one of the objectives will be to "monitor undue variability and potential arbitrage in the risk weighted assets calculation". In terms of the EBA work package, Credit Risk and Market Risk have the greatest overlap with TRIM. Banks will need to consider the topic of TRIM alongside the EBA's guidelines on Definition of Default and Regulatory Technical Standards.

What are the implications for banks?

TRIM is a long-running exercise, so in-scope banks will already already have an awareness of relevant activities and missions. However there are specifics to bear in mind:

- LDPs are likely to be an area where there is a high level of heterogeneity in models and expert judgement, hence a number of modelling areas that banks can be challenged on.
- Horizontal analysis and consistency checks performed as TRIM wrap-up activities may throw up new issues for High Default Portfolios or Market Risk, that have not been examined in TRIM for a while; banks need to be able to respond quickly to such supervisory questions.
- Poor practice that leads the ECB to think that there is non-compliance to the CRR or material misspecification of risk may lead to capital add-on requirements – so the potential implications of TRIM are high and warrant adequate time and resources from banks.

How can banks prepare for this as a focus area?

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. Some banks may see value in benchmarking activities against peers to get a better sense of good practice. 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.

How might it impact on-site investigations?

The ECB is conducting on-site missions on the topic of LDPs. Given that there are still discussions over what good practice looks like for LDPs, it may be that the ECB treats these missions as investigatory in nature, i.e. information collation, rather than immediately trying to set the standard. This may mean that banks may expect another round of LDP missions post 2019, once the ECB has had time to analyse practices horizontally, and come up with their expected standard.

Post-completion and publication of the TRIM Guide, future on-site missions relating to internal models are expected to use the TRIM Guide as the underlying standard of evaluation.

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Additional reading

Model Governance and Model Risk
(March 2018)

Definition of Default: The next hurdle (September 2018)

Accessible from kpmg.com/ecb



How KPMG can help

Targeted review of internal models



KPMG ECB Office provides European banks with roundtables and benchmarking studies related to model governance and governance topics, allowing banks to benchmark against their peers. KPMG member firms have extensive experience in redeveloping and reviewing models, and can aid incoming banks (e.g. Brexit banks) in completing TRIM gap analysis work. KPMG professionals are also able to support banks in meeting the requirements of the new Definition of Default (DoD).

ICAAP and ILAAP

What are the implications for banks?

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 is not a surprise given the [ICAAP and ILAAP multi year plans](#) published in February 2017 and the respective guidances. This was followed by the release of the final ICAAP and ILAAP Guidelines in November 2018. The Guidelines aim to facilitate a consistent approach to the assessment of both processes as part of the supervisory review and evaluation process (SREP). In order to prepare for the SREP in 2019, banks need to finalise their implementation of any changes to their ICAAP and ILAAP frameworks.

The Guidelines introduce a set of seven key principles articulating the ECB's expectations in regards to the roles and responsibilities of the management body of the bank, the integration of ICAAP and ILAAP into the overall management framework, as well as the core elements of the processes. However, the Guidelines are not exhaustive, as the design of ICAAP and ILAAP remain the responsibility of the individual institutions.

The harmonising effect of the new Guidelines 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.

How can banks prepare for this as a focus area?

ILAAP and ICAAP should be used as a management tool by banks, with their outcomes embedded in the decision making process and their risk perspective integrated into all business activities.

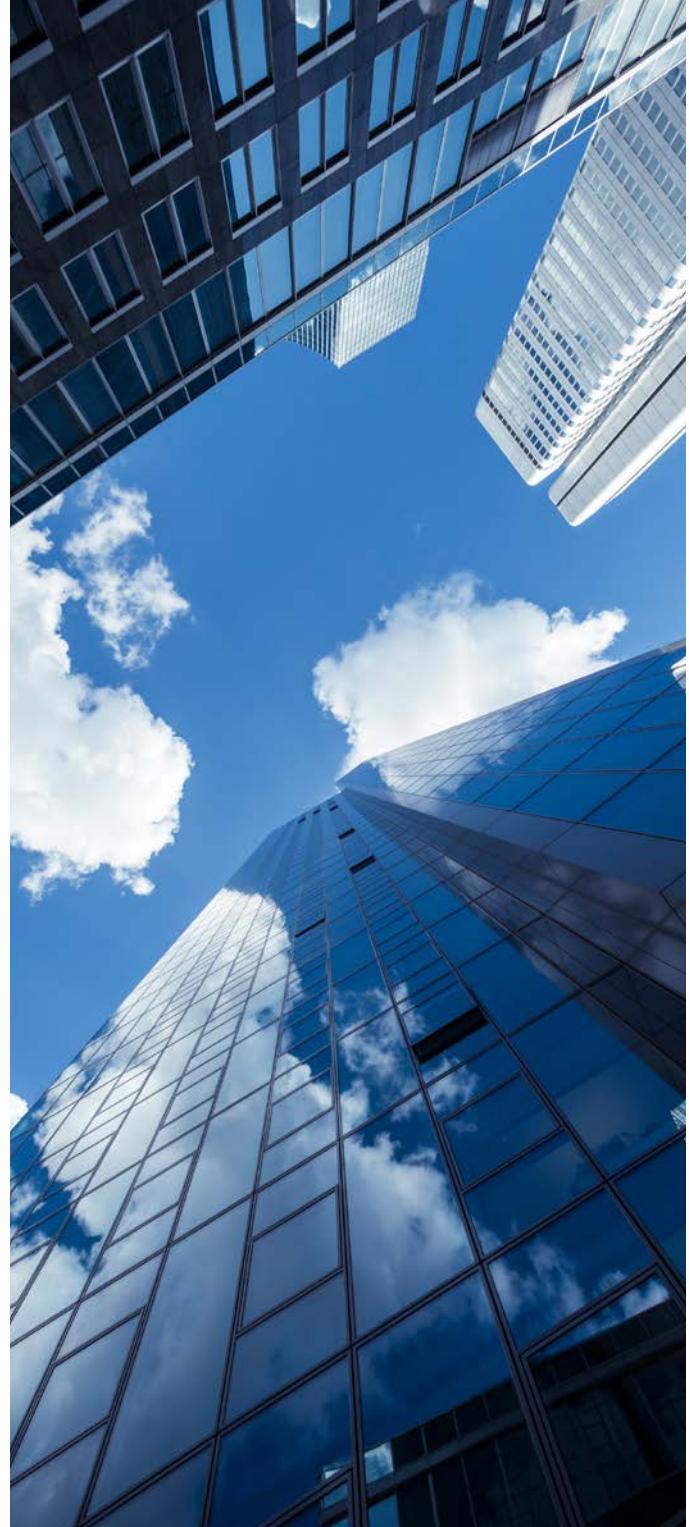
The ECB guide introduces a formally revised set of approaches for the calculation of Institutions risk bearing capacity by implementation of the so-called internal normative and economic perspective, which is expected to require most European banks under the supervision of the ECB to adjust their current approaches to ICAAP and ILAAP.

With the new guidelines a particular role has been given to the management board which needs to regularly approve and sign a capital and liquidity adequacy statement to demonstrate to supervisors an effectiveness and understanding of the main ICAAP and ILAAP elements.

Banks are expected to have a more formalised process in terms of internal review and validation, requiring adequate policies and processes on this. The internal review requirements have been extended to cover all ICAAP and ILAAP elements and because of this, banks are required to make significant extensions to their existing concepts and activities. Validation requirements have also been extended for risk quantification methodologies. For this reason banks need to strengthen the model of independent validation of ICAAP and ILAAP and to integrate these into their governance framework. In addition, the outcome of such an internal review and validation has to be reported to the management body and senior management.

Banks need to comprehensibly document the interaction of the individual ICAAP/ ILAAP components (for example risk appetite, stress tests, liquidity contingency plan) by establishing a consistent overall process and a corresponding overall documentation. They are requested to consider both expected (baseline) and adverse scenarios in both perspectives, based on the bank's own assumptions and taking into account adverse future market developments and external environment. The particular focus will be on KPIs, thresholds and management actions as well as consistency of processes.

The guides create a stronger connection between ICAAP, ILAAP and the recovery planning of the bank, for example by linking in with the capital planning and stress testing. The final guidelines highlight that the appropriateness of stress testing needs to be assessed at least on a quarterly basis and that scenarios are expected to capture the institutions' identified material vulnerabilities and its business model, as well as to the outcomes of other stress tests of the institution's stress testing program.



Given the ECB expectation that banks are compliant with the new ICAAP and ILAAP guidances by January 2019, KPMG professionals recommend that banks identify the gaps according to the final guidelines on ICAAP and ILAAP and make adjustments to their action plan, differentiating between quick wins and longer term initiatives. While methodology changes might take more time to implement, defining proper governance and adjusting policies and procedures to reflect the wider scope of ICAAP and ILAAP might be worthwhile quick wins.

How might it impact on-site investigations?

Going forward, ICAAP and ILAAP remain key areas of focus for banks and the ECB. Early action is required to ensure a favorable outcome of the SREP in the coming year, especially since the guidelines are expected to be considered in the 2019 SREP.

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Additional reading

ICAAP + ILAAP = ICLAAP?

Accessible from kpmg.com/ecb



How KPMG can help

ICAAP & ILAAP

The current version of the guidelines leave several grey areas. There remains a wide scope for interpretation, especially with regard to the interplay between the key date-related economic and normative risk quantification and its prognosis. KPMG experts can help European banks to conduct gap analysis in order to identify key areas of action for ensuring compliance with the ECB's ICAAP and ILAAP expectation using the KPMG network of experts and their deep knowledge with regard to industry best practice.



IT and cyber risk

What are the implications for banks?

The overall message conveyed by the ECB is that cyber risks need to be part of general risk management procedures, crisis management, and business continuity planning. Banks should be aware of the fact that IT inspections will be carried out every three or four years (for large banks) and self-assessments on IT and cyber security will feed into the SREP and then be challenged by the ECB. It should also be noted that the ECB takes cyber resilience very seriously and uses a comprehensive approach, meaning the supervision of IT risks covers end-points of payment systems and markets infrastructures in the banks directly supervised as well. Therefore, banks are strongly encouraged by the ECB to cooperate with a wide range of stakeholders (both internal and external) to address cyber risks as exemplified in the [TIBER-EU framework](#), the first European framework for controlled cyber hacking to test the resilience of financial market entities, and the public consultation on the [Cyber Resilience Oversight Expectations](#).

When considering the broader European perspective, one of the five strategic areas in the EBA Work Programme for 2019 is also related to Information and Communication Technology (ICT) risks, namely "Understand risks and opportunities arising from financial innovation". This includes several policy areas such as authorisation and regulatory sandbox; prudential risks and the impact of FinTech; broader cyber security issues; and consumer protection.

The naming of IT and cyber risk as priorities for 2019 echo the many recent ICT related guidelines and policies that became effective in 2018, such as the [EBA Guidelines on ICT Risk Assessment under the SREP](#), the [EBA Recommendations on outsourcing to cloud service providers](#) and the ECB IT Questionnaire which was the first comprehensive self-assessment of IT risk levels and control frameworks requested by the ECB.

Additional reading

Raising the bar for ICT risk assessments

Accessible from kpmg.com/ecb



How can banks prepare for this as a focus area?

The ECB acknowledges that banks are under pressure to modernise their core IT infrastructure in order to reduce costs, enhance the quality of customer experience and become more efficient in an environment of competition with Fintechs and the threat of cyber attacks which could adversely impact the financial system either at a domestic or international level. To address such risks, the ECB will continue its focus on IT and cyber risks in 2019 through targeted IT on-site inspections as well as the continuation of the SSM cyber reporting process.

How might it impact on-site investigations?

Banks which have experienced IT on-site inspections reported a strong focus on IT governance rather than purely on technical aspects. However, if in 2019 the ECB focuses more on cyber risks and its related technical aspects, banks should demonstrate that they have at least the following in place:

- Recent ICT risk assessments based on the EBA Guidelines on ICT risk assessment under the SREP (e.g. appropriateness of risk identification, risk measurement, risk control and risk reporting with a strong focus on cyber risk and IT security management).
- In particular for the largest institutions, a harmonised IT Risk Management Framework that can claim compliance with regulatory requirements in multiple jurisdictions (US / UK / EU) to identify, mitigate, report and follow-up IT risks in a timely manner, while guaranteeing the independence of the three Lines of Defence.
- A comprehensive cybersecurity incident response plan, which describes how to react in case of a cyber security incident, incorporating five risk management categories (governance, identification, protection, response and recovery).
- Documented information security policies and procedures approved by the Management Body, and in line with the business strategy and the risk appetite.
- Regular information security awareness trainings and information campaigns or initiatives (social engineering, malwares, data leakage through internet social networks and phishing).

- Documented, approved and enforced data classification policies and procedures, describing how to classify information based on confidentiality, integrity, availability and legal/ regulatory requirements (e.g. data protection).
- Concrete measures to protect IT systems from attacks either from the internet or other external networks that include perimeter defence technologies such as firewalls, IPS/IDS, web application firewalls, web filters, mail filters, antivirus and content scanner devices.
- Protection against malware (e.g. antivirus, advanced malware prevention solutions, sandboxes) installed on the endpoints (e.g. desktops, laptops, mobile phones) as well as on the servers and on the gateways communicating with the external world (e.g. mail gateway and web filter).
- Strong IT reporting capabilities (e.g. number of third parties that have access to internal systems, budget spent on IT innovations, amount of losses due to successful cyber-attacks).

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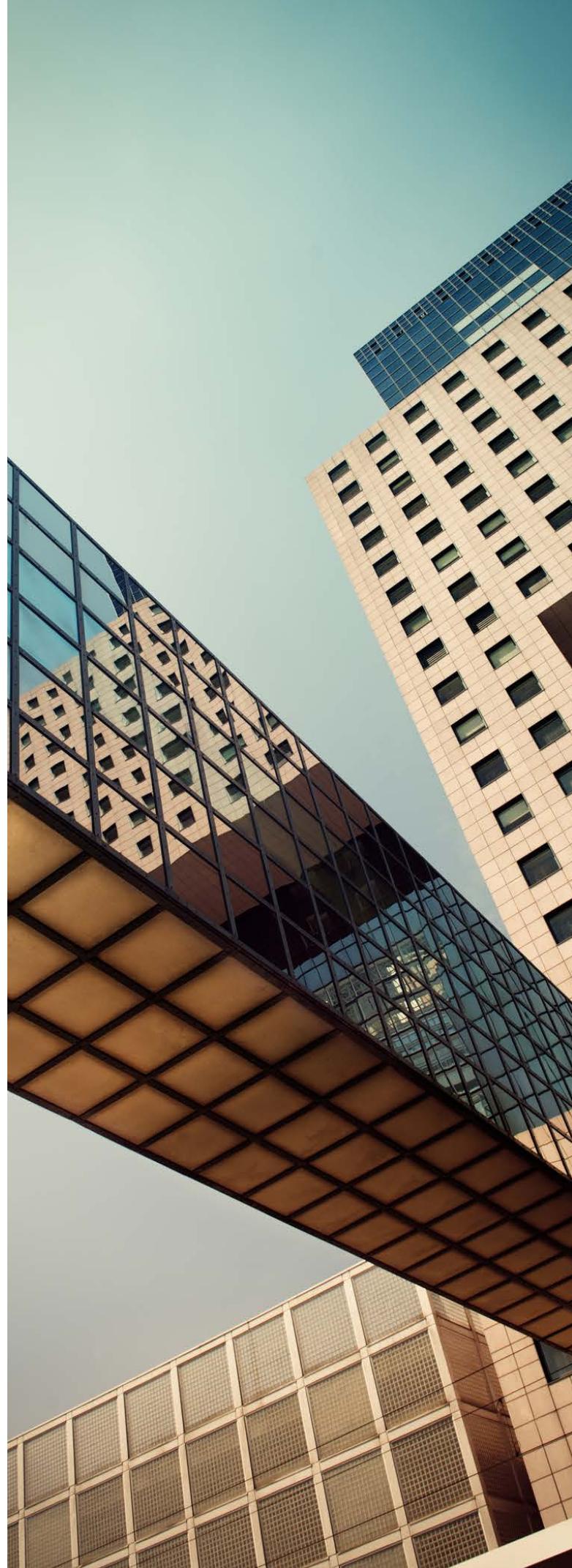
How KPMG can help

IT and cyber risk

KPMG member firms have acted as auditor and advisor to many large European banks enabling KPMG professionals to offer an overview on how European banks are approaching supervisory IT audits.

Our proven experience in delivering quality regulatory projects with the ECB and assisting SIs with ECB IT on-site inspections before, during, and after the audit process, gives us a depth of insight into IT and cyber risk issues across European banks.

To help banks better understand how they measure up against their peers, KPMG recently conducted a major Europe-wide benchmarking study of banks' ICT risks and their related supervisory expectations. All participating banks also received an in-depth, customised report with an analysis of their strengths and pain points, helping them to prepare for potential on-site inspections and the ECB IT Questionnaire in 2019.



Liquidity stress test

During the 2007 financial crisis many banks – despite adequate capital levels – experienced difficulties as they could not manage their liquidity prudently. Consequently, liquidity risk gained increased significance due to the systemic impact of liquidity risk events, for instance liquidity shortages. In response, regulators put forth stress testing as a mechanism for identifying, measuring and circumventing liquidity risk exposures.

Similar to the ECB sensitivity analysis of IRRBB – Stress Test 2017, the supervisory stress test in 2019 will be conducted with a focused scope. It will seek to assess banks' resilience against liquidity shocks, for instance, to assess banks' ability to handle any impediments to collateral flows. The results of individual banks' stress tests will inform the Supervisory Review Evaluation Process (SREP) assessments.

The EBA has a responsibility related to liquidity risk stemming from the 2019 work programme related to "leading the Basel III implementation in the EU" which will have a direct or indirect impact on liquidity risk.

What are the implications for banks?

LiST19, the annual stress test for 2019, will focus on liquidity risk management. The implications on banks will vary, but in general, banks may be impacted in the following ways.

- It is expected that banks will be required to report on the below areas to the supervisors:
 - Liquidity metrics in multiple scenarios including cash flow profiles over a defined time horizon, "time-to-wall" (e.g. the survival horizon in the specific scenario), composition of the liquidity reserve and currency or counterparty concentration.
 - Quantitative impact analysis of material internal models, such as for deposits, credit lines or collateral.
 - Qualitative description of the overall liquidity framework (including governance, measurement framework and controlling).
 - Implicit or explicit reconciliation of results including a qualitative description of deviations against internal liquidity risk models and regulatory metrics or ratios (ALMM, LCR, NSFR).

- Banks may have to also demonstrate that senior management, specifically the Board, have adequate oversight over exposures, liquidity risks, as well as models and metrics to control the liquidity position. Further, banks will potentially be required to have a robust written liquidity risk management documentation process, which should include classification of the liquidity of portfolio investment and determination of a highly liquid investment.
- Non-compliance with liquidity risk management schemes or controls may result in banks being required to maintain additional liquidity buffers corresponding to their risk profile.

How can banks prepare for this as a focus area?

Although this will be the first time that the ECB will be conducting liquidity stress tests, 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. In preparation for LiST19, banks can focus on the following activities:

- Historization of selected data as of year end 2018.
- Examine regulatory reporting and potential pitfalls as of year end 2018.
- Provisioning of budget for 2019.
- Definition of internal responsibilities.
- Implementation of quick wins to upgrade liquidity risk management.

How might it impact on-site investigations?

We expect the ECB schedule for LiST19 to be similar to IRRBB – Stress Test 2017 i.e. the stress test exercise is expected to launch around February 2019 and to end around June 2019 followed by the integration to the SREP. The results of LiST will inform the SREP/ILAAP assessment of banks 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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How KPMG can help

Liquidity stress test



KPMG service offering covers the phases of the liquidity stress test i.e. preparation and execution of the stress test, support in communication internally and with the supervisor, and support with the help of technology based solutions.

KPMG is able to support clients in the automatic aggregation of partial deliveries from various divisions and entities, delivering checks for LiST template entries, visualisation of relevant LiST result for analysis and internal communication, and in benchmarking the quantitative results, intermediate results and single data points with peer data.



Multiple risk dimensions

Brexit preparations

Banks' preparedness for Brexit remains a high priority for ECB as the March 2019 deadline for the United Kingdom's departure from the European Union approaches. As banks implement their Brexit plans, the supervisor will closely monitor their progress 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 EBA also identified the withdrawal of the UK from the EU as a priority in 2019. This applies not only to their role of the regulatory agency of EU institutions, but also to their own operations as they move their headquarters out of London to Paris. The EBA's expectations on this topic relating to the engagement of competent authorities to ensure that financial institutions are preparing adequately for this situation were outlined in their [opinion on Brexit preparations](#) in May 2018, and further stated that banks' planning should advance more rapidly in a number of areas, commenting that the financial stability of the European market should not be put at risk due to this topic.

What are the implications for banks?

It is tempting for banks to assume that Brexit is a UK issue – but one of the biggest affected group of banks will be non-EU and UK banks who need to have access to the European market. Currently under the Brexit plans, these banks would not have access to the European market if they would remain in London alone. Therefore, there will be a limited number of banks affected by the need for passporting, and for those banks, they should consider different types of planning, including:

- Establishment of a newly licensed entity in the Eurozone
- Expansion into an existing entity in the Eurozone
- Establishment of a branch in the Eurozone

However, Brexit will affect many other issues relevant to banks, including those already active from the Eurozone but with a client angle in the UK. If the outcome of the negotiations between the EU and the UK is a "hard Brexit", the UK would immediately be considered as a third country which has various implications, some of which are:

Legal aspects (such as contracting agreements for financial instruments);

- Bank management aspects (e.g. consolidation of UK exposures);
- Payments to the UK;
- Derivate clearing; and
- Data protection.

All of these may need to be amended based upon how the withdrawal is agreed. Whatever the outcome, the ECB will expect banks to have their Brexit planning clearly laid out and explained for the supervisor.

How can banks prepare for this as a priority area?

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, ie: empty shell entities where a bank carries out business (including capital market transactions) in the euro area while it continues to use group-wide infrastructure, expertise and arrangements (e.g. a centralised risk management function) in a third country. For the ECB, this is unacceptable, as explained in their [supervisory expectations](#).

For banks that become a significant institution and therefore will be under ECB supervision, they will need to consider the fact that they will have a comprehensive assessment, as discussed in the [FAQ](#) published by the ECB and last updated on 2 August 2018.

For banks incorporated in the Euro area which have a UK-angle, it is of utmost importance to assess their exposure given the various legal implications of a hard Brexit and what a third country status of the UK may imply.

How might it impact on-site investigations?

The triggering of Article 50 is more likely to affect banks in their supervisory reporting to the ECB and their discussions with the supervisory, rather than in their on-site investigations. Banks however 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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Additional reading

Brexit: Is banking only the start?
(May 2017)

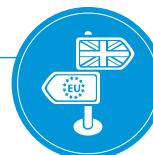
SSM views on Brexit (March 2018)

Accessible from kpmg.com/ecb



How KPMG can help

Brexit



KPMG member firms have the expertise for on boarding banks to SSM supervision and supporting them through the Comprehensive Assessment. We are able to run gap analyses to understand where banks need to improve their business models and structure in order to adhere to the ECB requirements.

Our global teams apply their combined experience and knowledge of regulation to ensure that banks have all of the information they need in order to comply with SSM supervisory expectations. KPMG experts have various tools that can help support on the comprehensive assessment, such as the ICT Risk Assessment tool which can be used to evaluate compliance scores.





Trading risk and asset valuation

How might it impact on-site investigations?

The ECB plans to continue a number of specific on-site inspections with a focus on trading and market risk, which would require deep dive reviews at a selected number of banks in advance so as to tailor the scope of such on-sites. With respect to publications on this topic, the key accounting standards for financial asset and liability valuation as well as related P&L recognition – specifically IFRS 9 and IFRS 13, are the key rules that banks must consider. The ECB has currently not opined publicly 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. Deep dives are expected to understand the portfolios of banks and to which samples should be taken during an on-site.

However what is clear especially from the updated AQR methodology is that the ECB is expanding its review of financial instruments to include Level 2 instruments as well as classically Level 3, and banks should prepare for this.

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Additional reading

Illiquid securities and derivatives

Accessible from kpmg.com/ecb



How KPMG can help

Trading risk and asset valuation

KPMG experts are able to leverage our experience from previous on-site inspections on trading risk and asset valuations to provide the latest insights into requirements for banks to follow.



KPMG iRADAR has extensive experience in levelling, valuation adjustments and in valuation of financial instruments. They can provide banks with an independent view on their portfolios by valuing and levelling under IFRS 13.

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