ICLAAP

Understanding supervisory expectations and how banks can improve ICLAAP performance

SSM beyond COVID-19 series

August 2021

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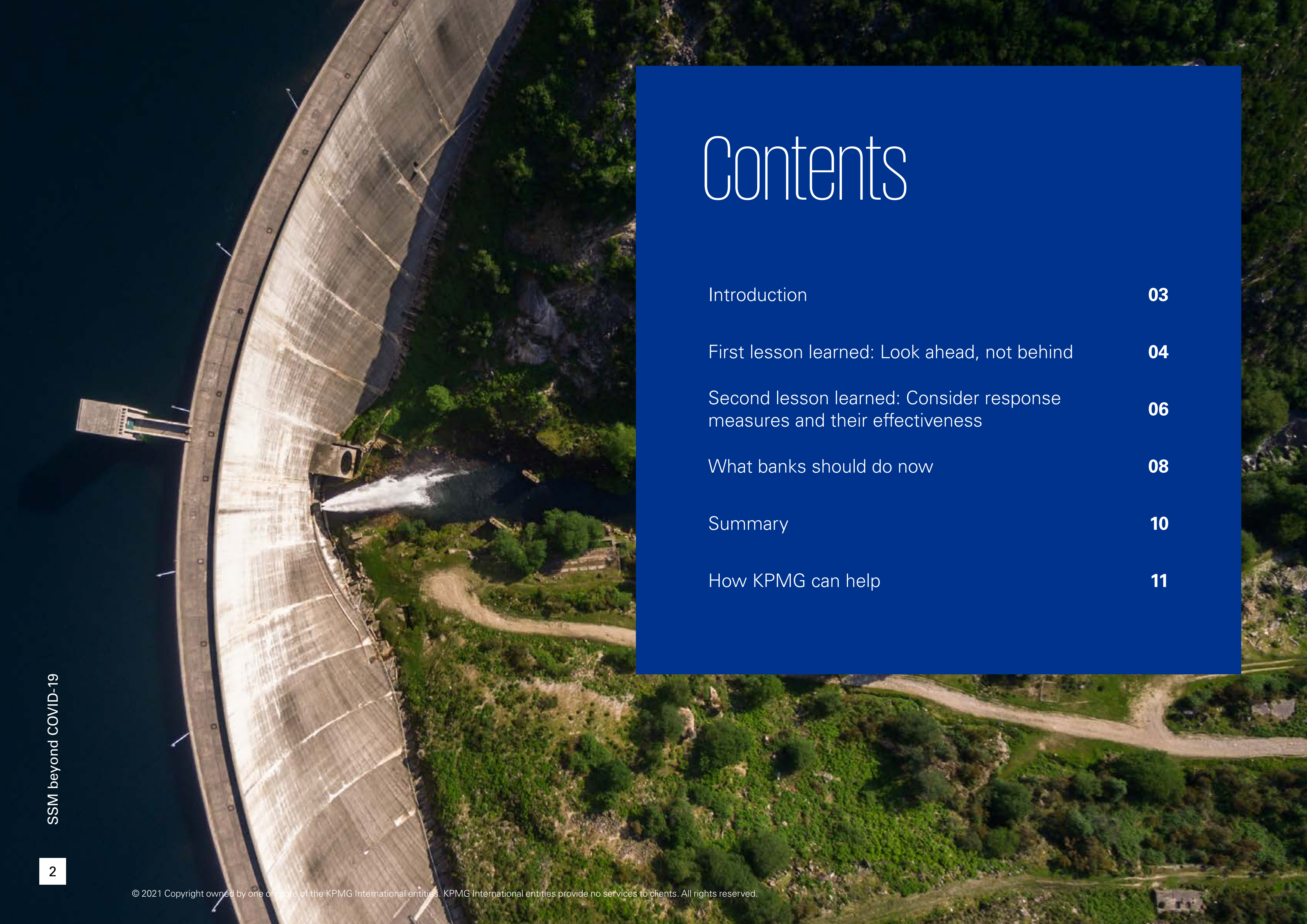

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Introduction

COVID-19 has dominated the global agenda since the first quarter of 2020, with unprecedented effects on individuals and institutions. Banks are no exception. The last year has seen significant volatility in capital and liquidity, often exceeding the EBA's fictional stress test scenarios. A potential drop in asset quality, together with European banks' notoriously weak profitability, has made the capital outlook uncertain. Liquidity was squeezed during Spring 2020, though markets calmed down in response to monetary actions by central banks. Banks and supervisors have reacted to these changes by flexing their attitudes to balance sheet management.

But the story has just begun. As Europe moves through the cycle of downturn and recovery, capital and liquidity positions are expected to have major implications for individual banks, systemic resilience, and the health of the whole economy. In fact, recent months have raised doubts about how well-prepared banks' capital and liquidity management frameworks are to cope with crises and transformations such as pandemics, climate change, digitalisation or other threats to operational resilience.

The Internal Capital Adequacy Assessment Process (ICAAP) and Internal Liquidity Adequacy Assessment Process (ILAAP) – or together, simply ICLAAP (as both are based on similar supervisory principles, see Table 1) – are key tools for managing banks' capital and liquidity. Banks should not see ICLAAPs as a supervisory test, or a compliance headache. Instead, we believe banks should view them as a valuable planning mechanism, as a basis for sound decision-making, and as a vital tool for building trust and understanding with investors, supervisors, and other stakeholders.

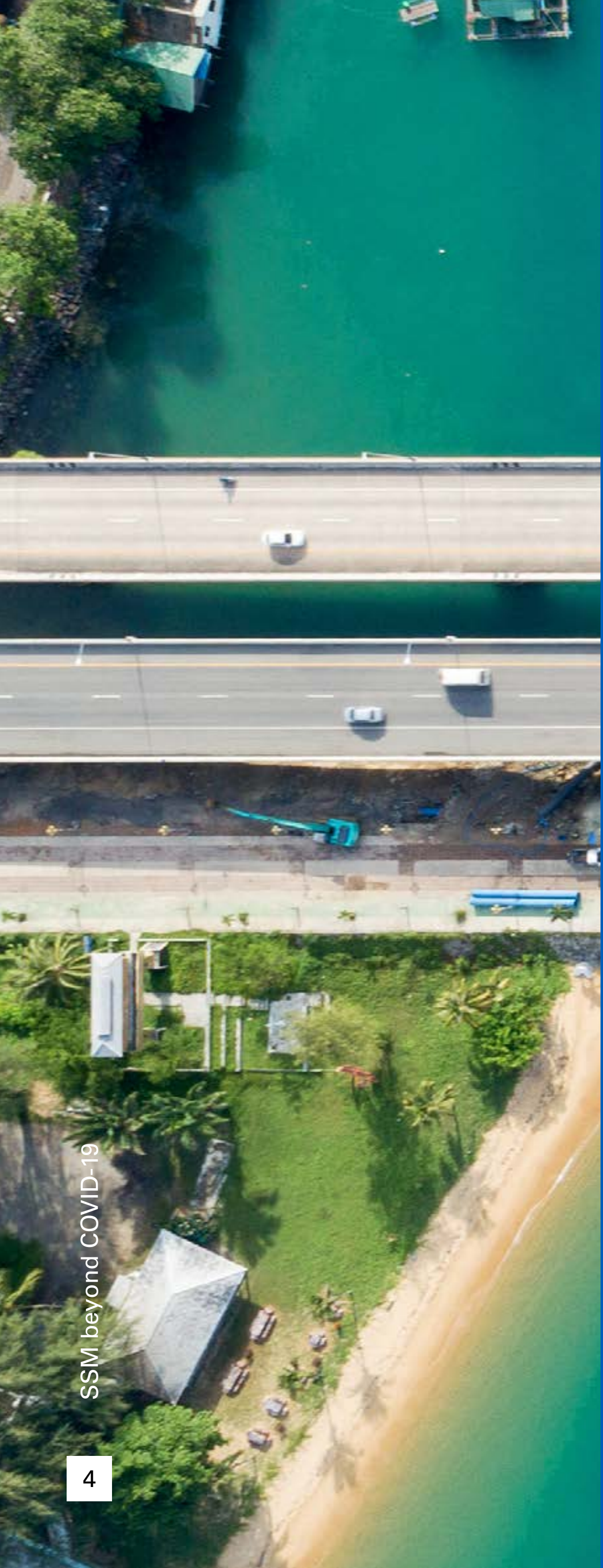
This report aims to help banks critically reflect on the observed value of their ICLAAP over the recent months - their "ICLAAP performance". It identifies two important lessons learned from the COVID-19 pandemic, and closes with some key fields of action to improve banks' ICLAAP performance in the post-COVID-19 world.

Table 1: Seven SSM supervisory principles of ICAAP and ILAAP.

The ICAAP and ILAAP SSM guidance introduced seven key principles for ICLAAPs, including the requirement for organisations to assess their continuity from both normative and economic perspectives.

1	Management bodies are responsible for ICAAP and ILAAP
2	The ICAAP and ILAAP are integral to risk management frameworks
3	The ICAAP and ILAAP aim to ensure the institutions' short and medium-term viability, using: **a. The normative perspective** – based on fulfilling supervisory requirements over a 3+ year horizon, using a baseline scenario and adverse scenarios **b. The economic perspective** – based on the net present value of assets and liabilities
4	The ICAAP and ILAAP should identify and consider all material risks
5	Capital and liquidity need to be clearly defined, and of high quality
6	Assumptions and methodologies need to be proportionate, consistent and thoroughly validated
7	Regular stress tests should ensure viability under adverse market conditions

Source: ECB ICAAP Guide, ECB ILAAP Guide (both November 2018).



First lesson learned: Look ahead, not behind

The ECB, as the main supervisor of EU banks, has always considered the ICAAP and ILAAP as vital elements of risk management and major drivers of the SREP. Harmonizing ICLAAP practices among EU banks has been a priority for the ECB for many years, and the **ECB's report on banks' ICAAP practices** of August 2020 acknowledged progress at many banks. However, in the same report the ECB also stressed a number of deficiencies and identified data quality, the economic perspective and stress testing as particularly important to fostering the continuity of banks during the pandemic crisis (see Table 2).

Table 2: Observed ICLAAP deficiencies

ICAAPs	ILAAPs
— ICAAP data quality including requirements from BCBS 239 — Economic ICAAP perspective (e.g. implementation of the concept, internal capital definition, risk quantification and use for decision making) — Stress testing (e.g. frequency of changes to stress-testing scenarios and level of severity, ad hoc stress-testing capabilities, and follow-up management actions)	— Concentrated sources of funding — Imbalance of short and long-term funding — Use of scenarios — Analysis in the Liquidity Adequacy Statement — Stress testing frameworks and validation — Level of documentation — Risk identification and inventory — High asset encumbrance ratios

Source: ECB report on banks' ICAAP practices (August 2020), KPMG Insights (ILAAP).

In our view, the COVID-19 pandemic has revealed a particular **lack of an appropriate forward-looking perspective,** with excessive reliance on historic events often leading to low ICLAAP performance. During the height of the pandemic, with strained resources, some banks had to make ad hoc changes to backward-looking metrics, derived from financial crisis scenarios, to develop a forward-looking view of the days and weeks ahead. For liquidity, examples of ad hoc enrichment included redesigning liquidity scenarios with more focus on central bank actions, pandemic indicators and the real economy; enhancing early warning indicators; and increasing the frequency of liquidity stress tests to ensure an appropriate forward-looking perspective.

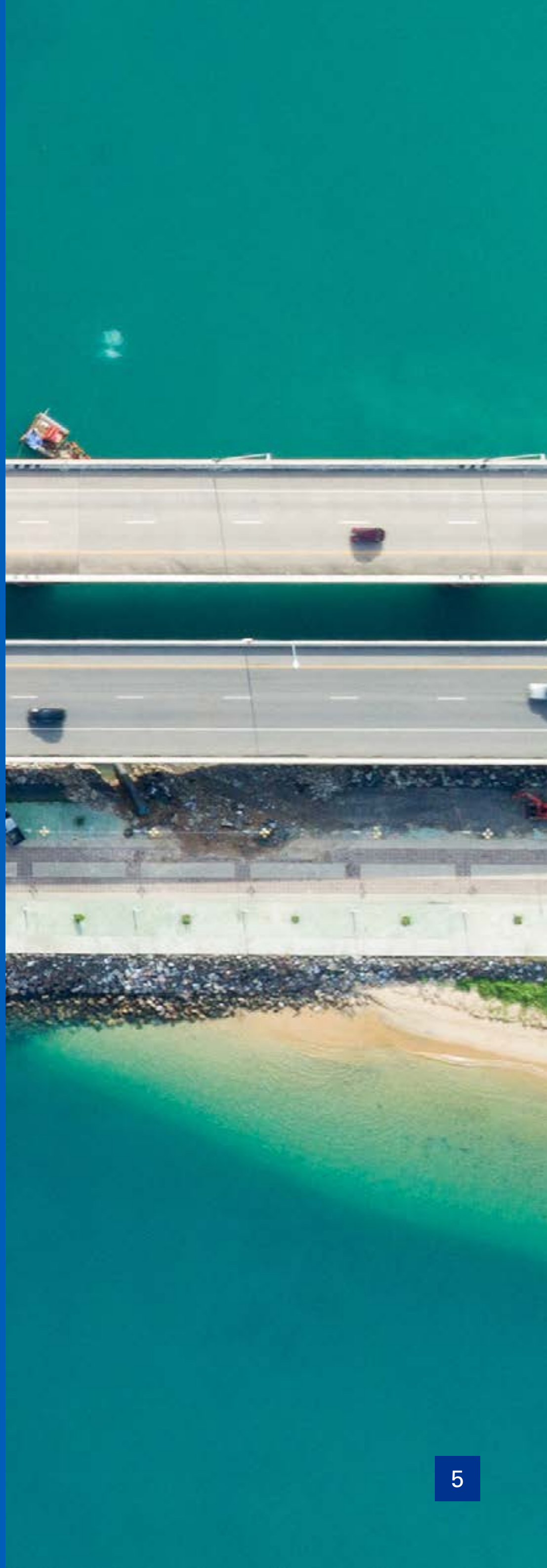
More generally, recent months have shown the importance of the following action areas to **establishing a strong and robust forward-looking perspective:**

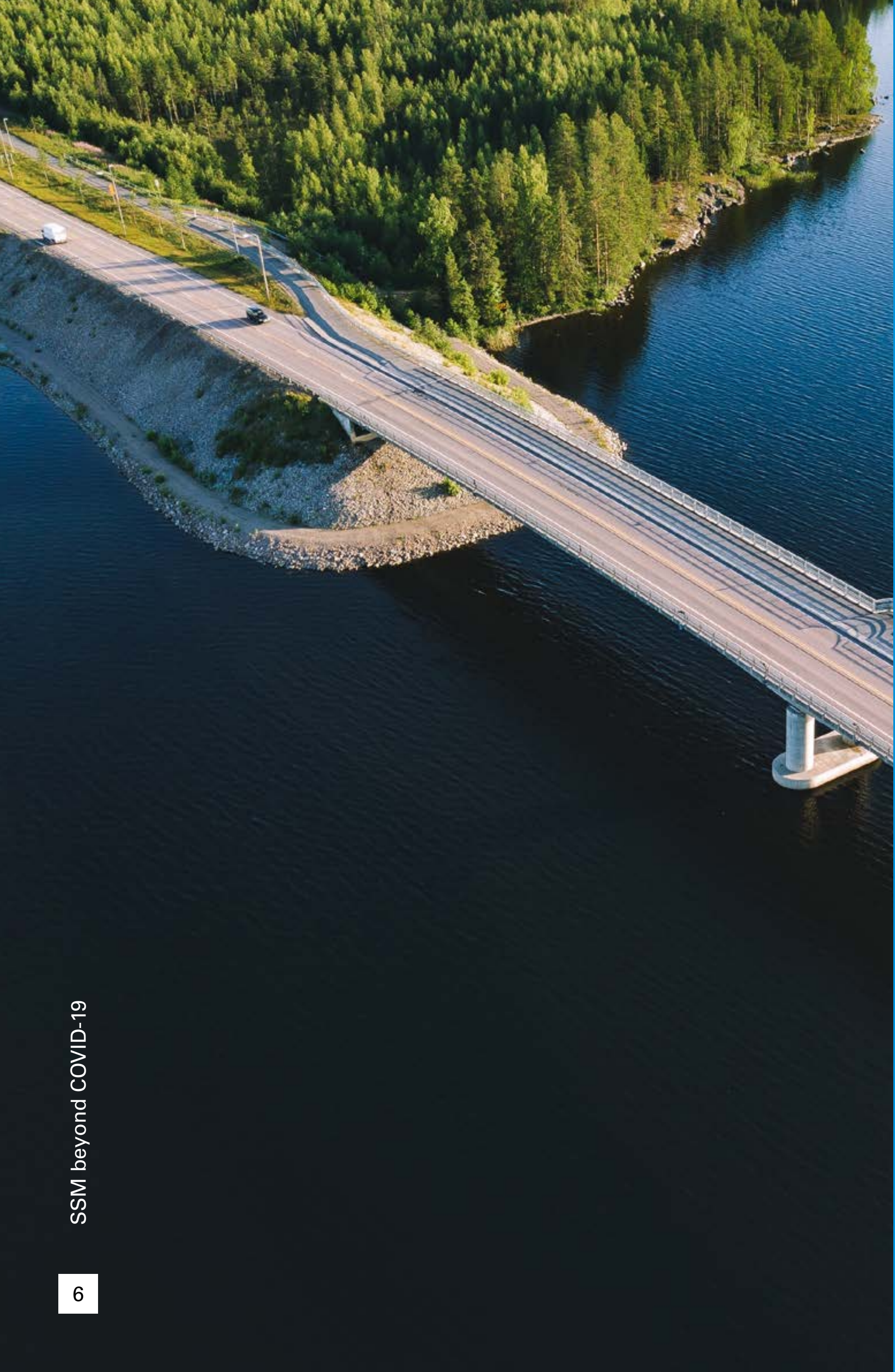
— **Risk identification and assessment should be continuously updated for new risk drivers.** Relevant risk factors should be stressed, with different approaches during and between crises. This could include accurately identifying at-risk sectors and borrowers over a multi-year horizon; analysing relevant risk drivers in addition to standardized risk types; and getting a better grasp on emerging risk events such as a pandemic, climate risk, lower for longer interest rates, or digitalisation. COVID-19 has proved that the simple extrapolation of impacts observed in previous downturns misses the point. New risk factors require a strong forward-thinking perspective, reflected in relevant scenarios.

— **Systems should be robust, yet flexible during turbulent times.** They should be able to amend simulations or model sensitivity calculations at short notice, to increase the frequency of scenarios and simulations, and to change – for example, to generate daily LCR reporting with minimal additional resources. For liquidity, reporting and analytics capabilities and well-defined crisis risk dashboards including early warning and recovery triggers are key in times of stress.

— **Scenario analyses should be flexible,** allowing for ad hoc adjustments of scenario narratives, parameters and granularity in response to the changing macroeconomic environment – for both ICAAP and ILAAP.

— **ICLAAP governance should be enhanced and fully integrated into risk appetite frameworks.** It should include a clear distinction between crisis and non-crisis modes, to help activate additional monitoring and shorten reaction times. For many liquidity crisis management frameworks reworked after the 2008 crisis, 2020 was their first real test. Many banks realized that while these frameworks worked well initially and picked up stress signals in the markets, they were less helpful in managing liquidity through the crisis since comprehensive playbooks with detailed lists of countermeasures and their potential impacts (such as costs, implications for banks' core business and adverse market signalling were missing.





Second lesson learned: Consider response and their effectiveness

In addition to the lack of a forward-looking perspective, recent months have shown that a thorough consideration of relevant response measures – including their potential upsides and downsides – is key to banks' ICLAAP performance. To illustrate this, Table 3 shows selected policy responses taken over recent months with the aim of maintaining financing to the real economy. As this overview shows, the impact of policy response measures differed largely between banks; while some benefited from capital or liquidity relief measures, others were helped by monetary policy or government support.

Furthermore, rapid changes to public policy, and the impact on those policies of external factors such as infection or vaccination rates, meant that banks needed to continuously monitor the potential upsides or downsides of policy responses for their capital and liquidity levels. Internal crisis responses such as lending decisions, limit increases or more intense borrower monitoring were equally dynamic. However they were not always fully considered in banks' capital or liquidity adequacy decisions, lowering banks' ICLAAP performance.

Table 3: Selected COVID-19 policy measures

COVID-19 policy measure	Description	Ex-post assessment
Monetary policy	— Keeping interest rates low on main refinancing operations, marginal lending and deposit facilities. — Pandemic emergency purchase programme (PEPP). — Recalibrated targeted longer-term refinancing operations (TLTRO III). — Collateral easing measures until June 2022. — Four additional pandemic emergency longer-term refinancing operations (PELTROs).	— Proved valuable to ease liquidity constraints of some banks. — Provided incentive to some banks to extend lending, due to long-term nature of tenders and collateral easing measures.
Liquidity Coverage Ratio (LCR)	— Short–term, allowing banks to temporarily operate below LCR requirements.	— While most banks ensured LCR adequacy at end of quarters, some banks used significant portions of liquidity buffers intra-quarter.
Supervisory capital relief measures	— Allowing banks to theoretically release up to €120 billion CET1 capital for up to €1.8 trillion new lending[1].	— Substantial move building on 10 years of effort to build up capital, though passed with relatively little market reaction indicating its short–term nature and the fact that Maximum Distributable Amount (MDA) trigger remained unchanged. — According to the ESRB, the risk of adverse feedback loops from insufficient lending availability persists as banks may still decide to deleverage to meet capital requirements imposed by regulators or markets.
Dividend restrictions	— Request to refrain from dividends, bonuses or share buybacks and exercise "extreme moderation" on variable remuneration. — Demonstration of sustainable capital positions in the medium term as precondition for dividend payments or share buybacks.	— Highly debated short-term measure, questioning the competence of supervisory authorities to limit or ban dividends. — Signalling a slow and gradual return to pre-crisis capital levels.
Government support measures for the non-financial sector	— Comprehensive national debt moratoria, public guarantee schemes and other measures of a fiscal nature to protect the real economy (see ESRB for a comprehensive overview of policy responses for scenario validation).	— Supporting banks' capital buffers in the short, medium and long term through lower impairments and provisions. — According to the ESRB, loan losses currently remain limited, though the longer the crisis lasts and the weaker the economic recovery, the greater the spillover risks for the financial sector.

Sources: ECB, ESRB, KPMG International, 2021

[1] Release of P2G (~150 bps), CCB (250bps), use of AT1 and Tier2 instruments (~90 bps), release of CCyB (~30 bps).

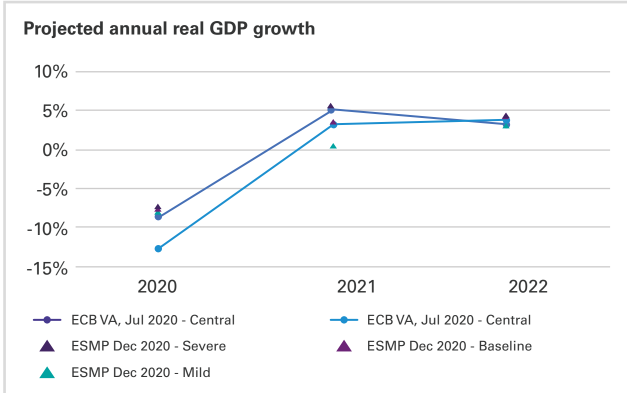
What banks should do now

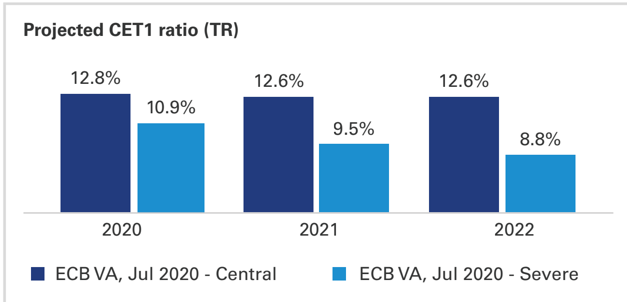
Given the two main lessons learned from COVID-19, a highly uncertain economic outlook, and current threats to banks' capital and liquidity positions, what should banks do now to improve their ICLAAP performance? In our view, three fields of action are important post-COVID-19:

I. Improve ICLAAP scenarios and scenario flexibility.

In the short term, making effective use of scenarios - a highly judgmental matter at the best of times - is particularly important. Establishing the baseline is incredibly challenging, since no forecasters agree on whether a macroeconomic recovery to pre-pandemic levels (or even above) over the coming months or years (see figure 1) can be expected. The current picture is complicated by emergency funding, income support and debt forbearance packages launched by European governments and public bodies, with uncertain durations that are likely to be influenced by the success of vaccination programs. Furthermore, COVID-19 has shown the need for scenarios, their narratives and parameters to be flexible and to quickly adapt to new realities. Ensuring scenarios and parameters can be adjusted "on-the-fly" in response to evolving crisis situations may be achieved by simplifying scenarios, or by maintaining the capabilities for ad hoc deep dives into more complex scenarios covering the risks posed by further pandemics, climate change, ultra-low interest rates, rapid digitalisation and sovereign or debt crises[2].

Figure 1: Key result of the ECB vulnerability analysis (ECB VA) from July 2020. In addition, selected Eurosystem Staff Macroeconomic Projections (ESMP) as of December 2020 are shown for comparison.

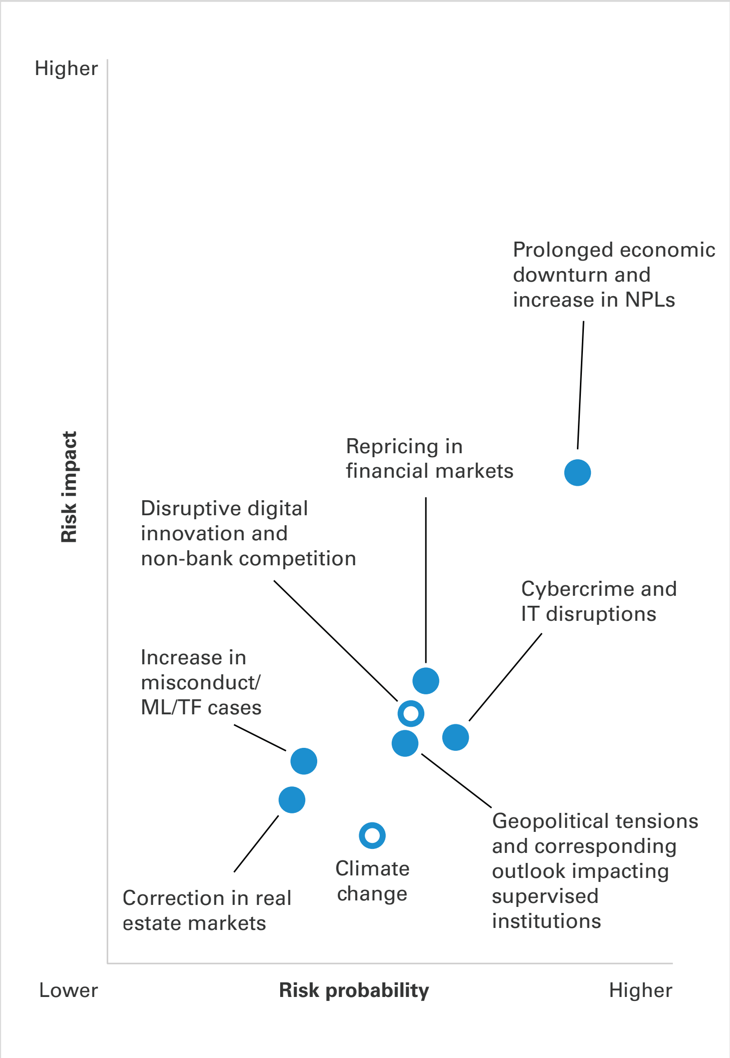




Sources: ECB Banking Supervision, 2020.

[2] See e.g. the **SSM Risk Map for 2021** in figure 2 for key vulnerabilities as currently observed by the ECB and national competent authorities.

Figure 2: SSM Risk Map for 2021



Source: ECB Banking Supervision, 2021. Dots with a white fill denote risk drivers that are expected to increase strongly over the next five years, 2021.

II. Embed normative and economic views.

Establishing and improving the normative and economic view as part of the ICLAAP is a persistent challenge for banks. For many banks, the normative view - based on the ability to fulfil supervisory requirements with future potential balance sheets – limits their risk taking, given the need for conservatism and the requirements of CRR and CRD including the effects of "Basel IV", MREL, IFRS9 and other regulatory and accounting initiatives. However, the economic view - based on banks' current balance sheet and considering factors such as economic capital or the liquidity survival period – also presents a hurdle for some banks, with the volatile market conditions created by COVID-19 or during the financial crisis limiting banks' ability to take risks. The economic and normative perspectives should mutually inform each other, both during a crisis and in a recovery cycle. That will require further attention from banks to ensure consistency between management decisions, scenarios and ICLAAP metrics.

III. Establish strong links between business strategy, risk appetite and limits.

In the longer term, banks need to establish strong and robust links between their target business model and risk appetite framework, so as to explain and protect their core business in the context of their limited abilities to rebuild capital or liquidity – especially if those are further eroded by a future crisis. This is not just about navigating the primary and secondary challenges posed by the COVID-19 pandemic. It also reflects the need to address the weak profitability and overcapacity that have been a feature of European banking for more than a decade. Banks should adjust their business and operating models significantly, consolidate the sector, identify new sources of customer value and develop new income streams, as well as significantly reducing their cost base. Sound capital and liquidity planning should give a clear idea of when capital and liquidity will be needed for banks' business and strategic initiatives. This requires the ability to craft and communicate balanced, intelligent strategies that integrate capital and liquidity planning into lending appetites, supervisory expectations, dividend policies, investor relations and many other areas. Success will be crucial to retaining the trust of customers, investors, supervisors and other stakeholders post COVID-19.

> "A good ICAAP fosters a bank's ability to sustainably pursue its business model by allowing it to effectively prepare for, quickly respond to and successfully manage through potential crisis situations, stay economically healthy and take appropriate management decisions based on a strong set of reliable information[3]."

[3] Source: ECB report on banks' ICAAP practices (August 2020).

Summary

Banks face many tensions as they plan their way towards a post-COVID-19 world. In particular, scarce capital resources should be balanced between competing demands. These include loss absorption; new lending requirements – for example to help decarbonize the economy; increasing supervisory expectations; dividend distributions; and the ability to take advantage of strategic opportunities from the digitalisation of financial services.

ICLAAPs have a critical role to play in developing banks' post-COVID-19 recovery, ensuring a sound basis for decision-making, and preparing for scrutiny by investors and supervisors. This is not a matter of identifying absolute truths or 'the right answer'. It is about enabling banks to make strategic decisions in a vastly changed landscape.

We believe ICLAAPs need more forward-looking. They should be continuously aligned with risk appetites, crisis management and strategic planning. The coming months and years will require banks to take hard and sometimes painful decisions, not just because of the fall-out from COVID-19. Things will likely get worse before they get better. ICLAAPs can't change that but improving ICLAAPs can help banks take the best possible decisions in the circumstances they face. On the upside, they can also help banks to tailor their business models to a post-COVID-19 world and to address longstanding weaknesses.

> "The ICAAP and outcomes of its assessment should be taken into account by competent authorities as one of the key inputs for the identification and assessment of risks relevant for the institution[4]."

[4] Source: EBA Draft Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP) and supervisory stress testing under Directive 2013/36/EU (June 2021).

How KPMG can help

KPMG's global network of firms brings together subject matter experts to enhance each aspect of banks' capital and liquidity management frameworks. We can leverage synergies to meet your business needs and help save costs. Our ICLAAP methodologies and tools can help banks improve their ICLAAP performance. With our knowledge of international leading practices and our experience with supervisors and regulators, KPMG can provide the following well-established methodologies:

- Enhance risk identification and quantification methodologies for coping with new risks e.g. from climate change
- Enhance and/or benchmark stress testing program and scenario analyses related to ICLAAP
- Leverage on KPMG's stress test tools (e.g. NIICE, ICE, Visualizations) or KPMG's simulation tools for recovery plan options for assessing effects of recovery options on critical KPIs or the inclusion of Basel IV impacts in the ICAAP
- Integrate ICLAAP into the risk appetite and limit framework, and help increase the impact on decision-making by improving existing reporting formats
- Quick check on risk-weighted asset reduction potential or establish a thorough RWA mitigation program
- Help improve liquidity crisis management, covering crisis governance, steering metrics and instruments as well as crisis playbook
- Quick check of the adequacy of liquidity metrics and early warning indicators
- Strengthen data management and risk IT architecture
- Leverage process efficiency by targeted centralization and automation of key steps; for example, in ICLAAP reporting

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