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Banking Summer Academy

July 7, 2017

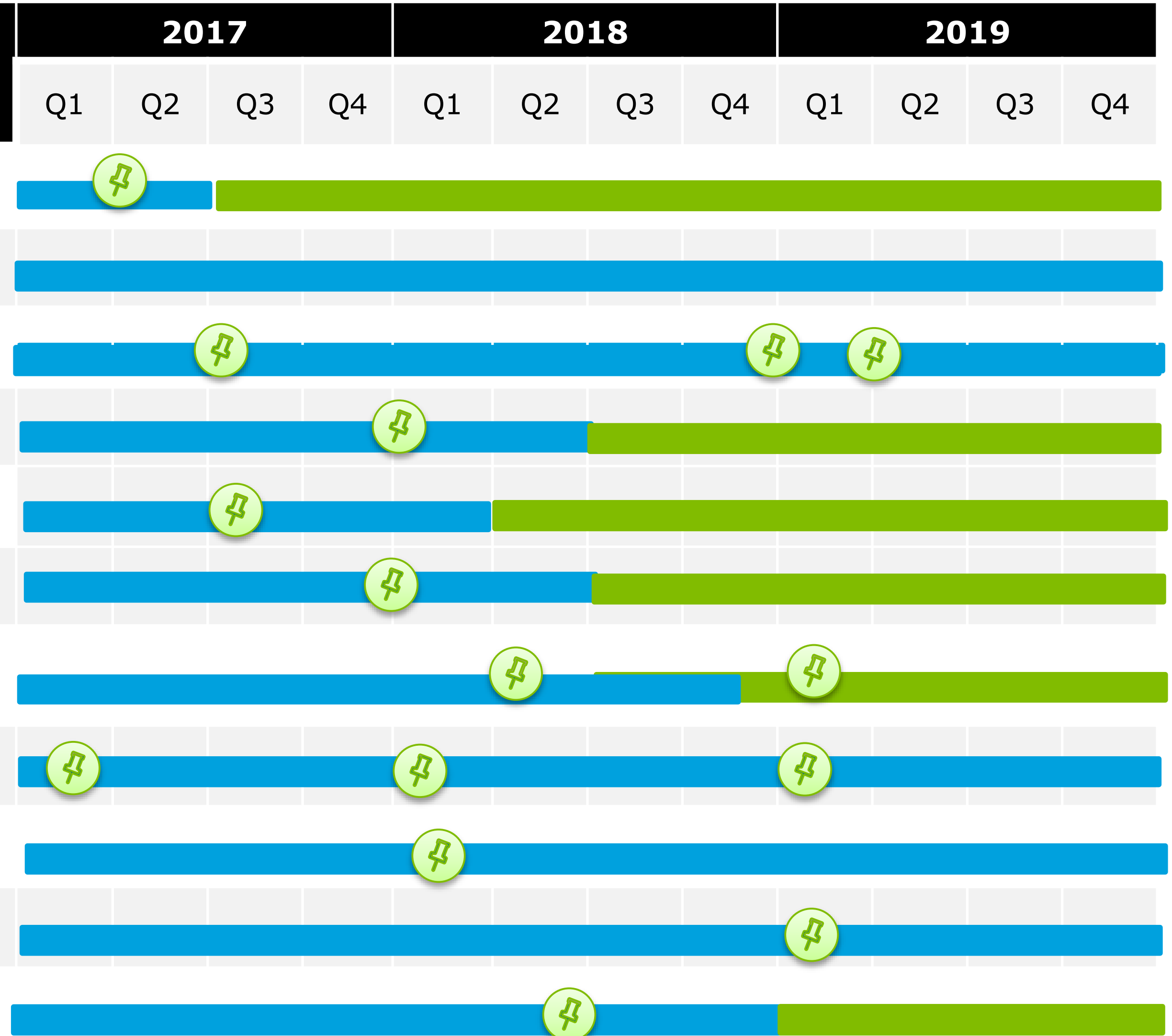
Dimitrios Goranitis

Deloitte Banking Risk Lab

The EU banking regulatory transformation agenda

2017-2019 requires a significant commitment from the banking sector to transform, innovate and comply

Area	Statutory deadline
AMLD IV	June 2017
ECB TRIM	2016-2020
EMIR	End in 2020
IFRS 9	1st January 2018
MAR	3rd July 2016
MiFID II	1st January 2018
PSD 2	1st January 2018
Basel III/IV	On-going
ECB NPL	1st January 2018
BRRD	Annual submission
GDPR	25th May 2018

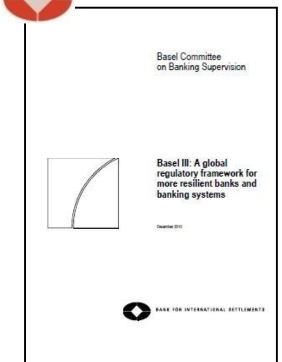


Key focus   Ongoing work   Implementation dates

What is the new regulatory environment?

CRD and CRR together form the CRD IV package which is the implementing act of Basel III in Europe

Basel III



Single Rulebook

Capital Requirements Directive (CRD)	Capital Requirements Regulation (CRR)
Bank Recovery and Resolution Directive (BRRD)	Deposit Guarantee Scheme Directive (DGSD)

CRD transposed into local law

Refer to Appendix 1 for transposition details

What is Basel III?

- Basel III is a global banking standard developed by the Basel Committee on Banking Supervision that seeks to strengthen the regulation, supervision and risk management of the banking sector;
- Basel III will be fully in force from 1 January 2019;
- The third version of the standard was introduced following the global financial crisis, in order to address certain shortcomings as below:

Shortcomings of Basel II
Low level and quality of banks' capital bases; insufficient loss absorbency
Excessive leverage
Insufficient liquidity buffers
Does not deal with pro-cyclicality

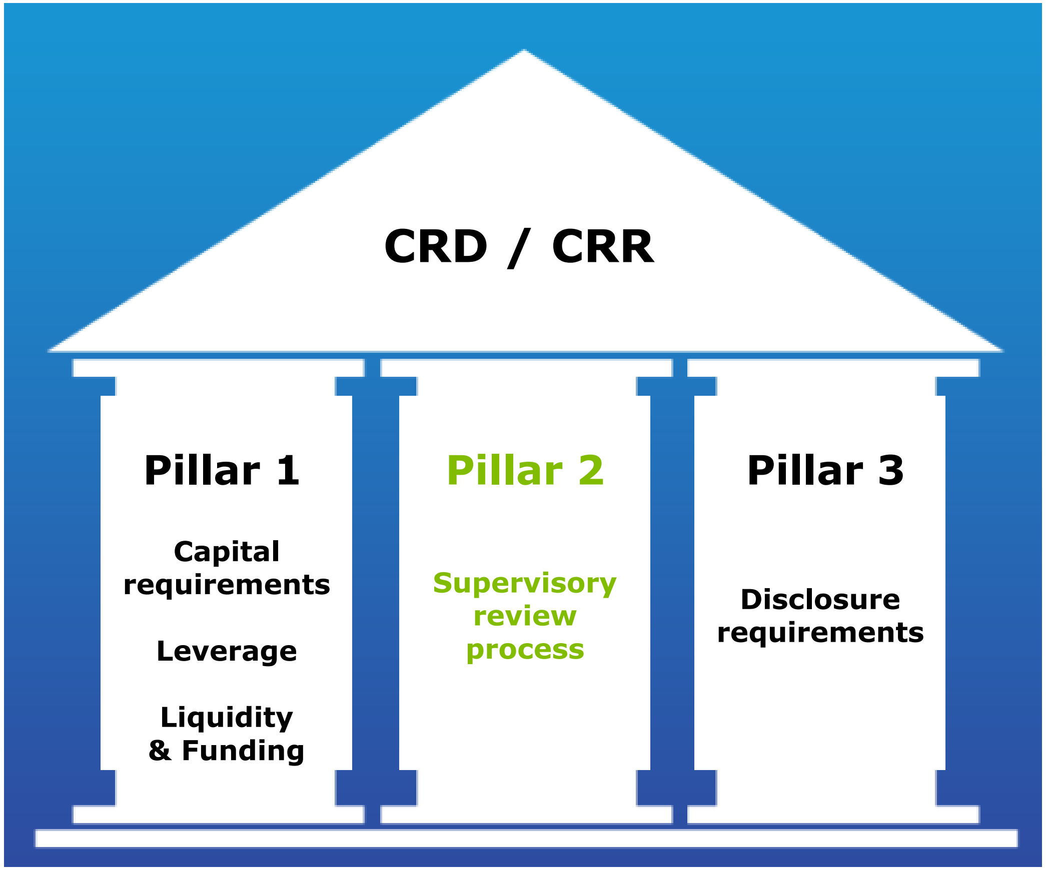
Basel III improvements	
Strengthening the quality and quantity of the capital base	Dealing with procyclicality
Enhancing risk coverage	Addressing Systemic Risk and Interconnectedness
Introduction of an overall Leverage Ratio (LR)	Introduction of Global Liquidity Risk Standards

Transforming a standard into legislation

- The Basel framework was implemented in Europe via CRD and CRR;
- CRD and CRR have also evolved in line with developments in the Basel standard.

How is the new regulatory environment structured?

The pillar framework introduced by the Basel Accords is mirrored in European banking legislation



Basel Pillar 2: Supervisory review process

The supervisory review process ensures capital requirements and risk management process are commensurate to the bank's risk profile

Basel Pillar 2


Basel Committee on Banking Supervision

Pillar 2 (Supervisory Review Process)

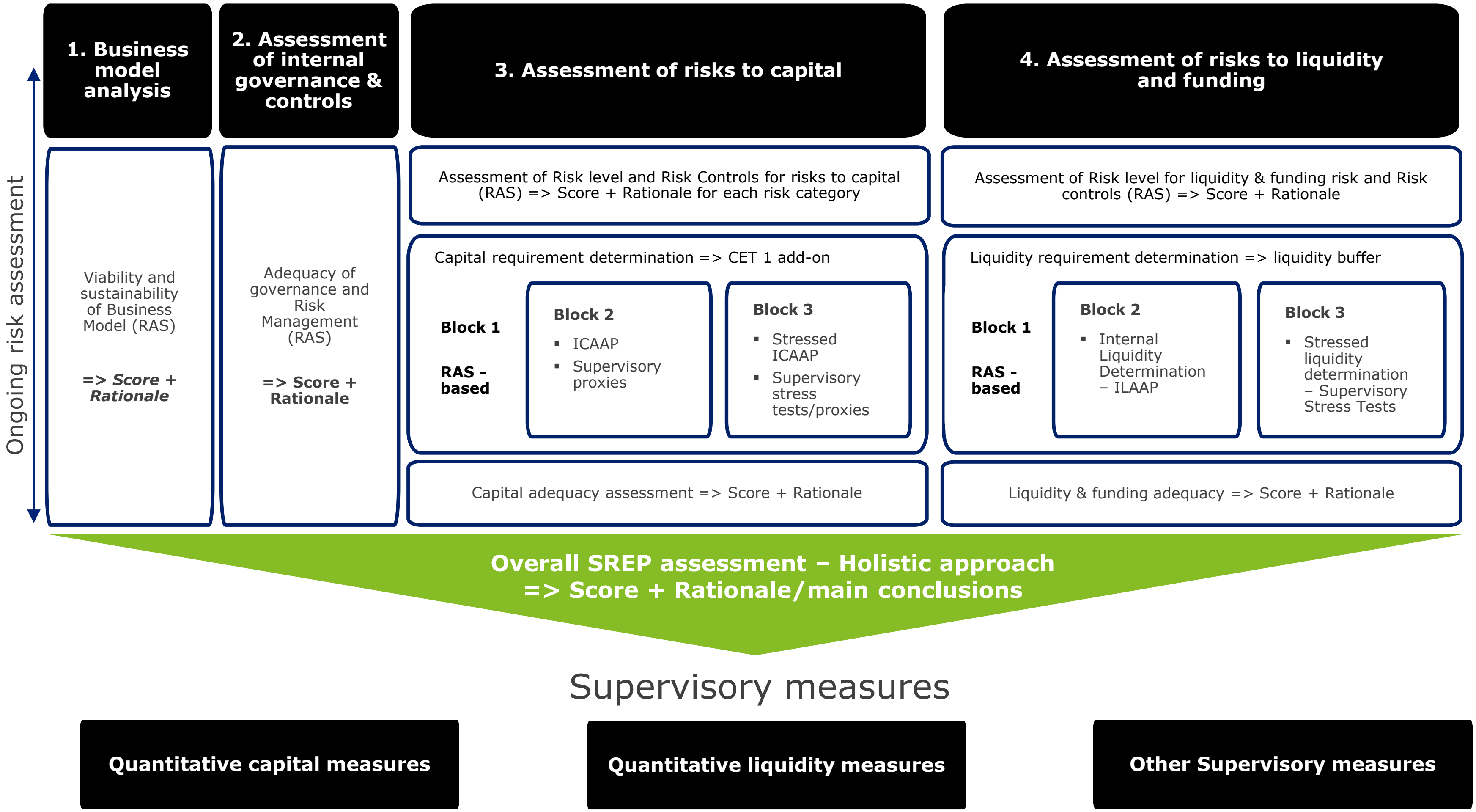
How important is the Second Pillar?

- The Basel Pillar II framework is intended not only to ensure that banks have **adequate capital to support all the risks in their business**, but also to encourage banks to develop and use **better risk management techniques** in monitoring and managing their risks.
- The supervisory review process recognises the responsibility of bank management in developing an internal capital assessment process and setting capital targets that are commensurate with the bank's risk profile and control environment.
- The outcome of the supervisory review process may be additional capital add-ons for **risks that are not captured or not fully captured under Pillar 1**.
- The Basel Committee has identified **4 key principles of supervisory review**, as shown below:

Principle 1: Controls and processes	Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.
Principle 2: SREP	Supervisors should review and evaluate banks' internal capital and liquidity adequacy assessments and strategies as well as their ability to monitor and ensure their compliance with regulatory capital ratios . Supervisors should take appropriate supervisory action if they are not satisfied with the result of the process.
Principle 3: Power of the Regulator	Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.
Principle 4: Prevention rather than cure	Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

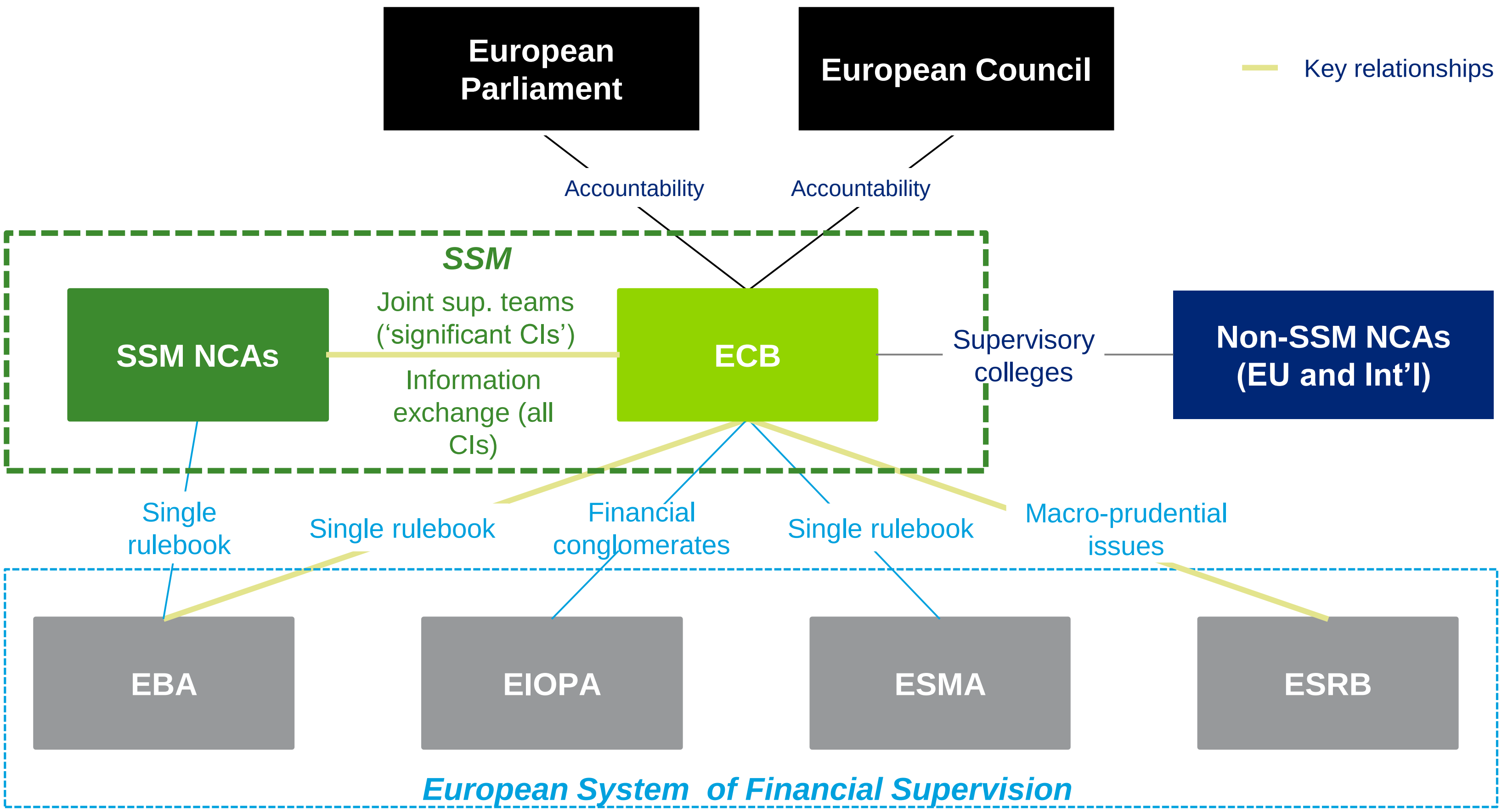
What is EBA's SREP?

One single cohesive financial and non-financial risk framework to supervise lenders in EU



What is the Single Supervisory Mechanism?

How the ECB will work with the existing supervisory network in EU?

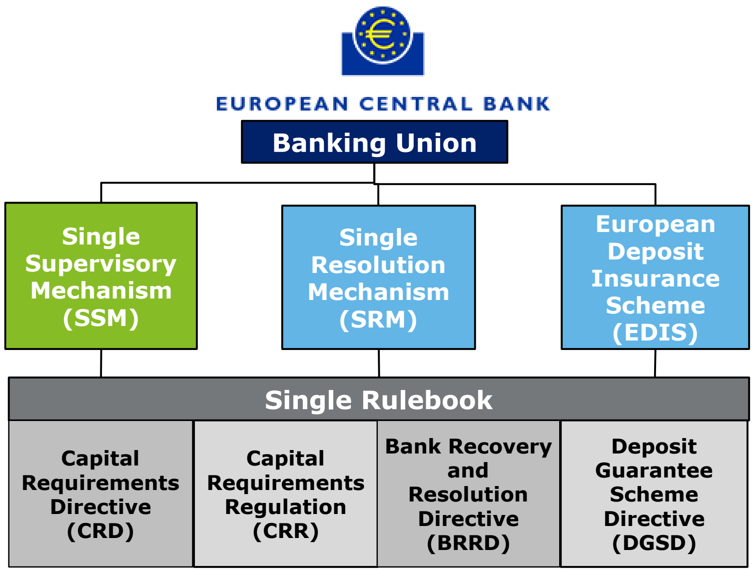


Supervisory Priorities 2017

Have you aligned your priorities to the SSM priorities?

The Banking Union

- ESAs consult on the “twin peak” model – merging EBA/SSM/EIOPA and providing supervisory authority to the top across EU
- ESAs raise red flag on EU’s supervisory convergence
- EBA endorses SSM’s supervisory priorities for 2017



EBA/SSM Priorities 2017

1. **Business Models and Profitability Drivers**
   - Risk Appetite Framework
   - Profitability
   - Sustainability
   - Peer Group Analysis
   - Investment to support regulatory transformation
2. **Credit Risk**
   - IFRS9
   - NPL Management
   - Credit underwriting process
   - Credit Risk Models
   - Concentration
3. **Risk Management**
   - Governance
   - Data quality BCBS239
   - TRIM
   - Cyber risk

SREP Priority 1 : Business Model Analysis

BMA is one of ECB's supervisory priorities for 2017, particularly given the low interest rate environment which is challenging profitability and the fragmentation of the European banking sector that hinders economies of scale

What supervisors are looking for

- **Business model viability** – generate acceptable returns over the following 12 months.
- **Sustainability of strategy** – generate acceptable returns over the following 3 years.
- **Internal alignment** of commercial strategy with risk ecosystem

- **Plausibility of the assumptions** and projected financial performance.
- Assessment of **where and how a bank makes money** and the **risks it takes** in doing so.
- **Riskiness of the bank's strategy**, especially the ambition and complexity of the strategy set against the current business model.
- Bank's **risk appetite**, both for individual and aggregate risks, and its consistency with the stated strategy.
- Bank's **resources** – capital, funding and people – and whether they are sufficient to deliver the strategy.
- Bank's **cost structure** and ability to create economies of scale based on volume
- **Bank's ability and commitment to satisfy future ROE, Capital adequacy and innovation from financial results**

SREP Priority 1 : Business Model Analysis

A deep dive

Layer 1: Overarching documents

- **Corporate Governance Framework**
- **Business Model and Strategy (Financial Forecasting)**
- **Financial Statements and Statutory Reports**

Layer 2: Supporting frameworks, policies and procedures

- **Risk Management Framework**
- **Risk Appetite Framework**
- **Stress Testing Framework etc.)**
- **Risk Level Policies**
- **Supporting Procedures**
- Strategic plans
- Liquidity reporting
- Management information
- Internal risk reports
- Capital planning

Layer 3: Regulatory submissions and documents

- ICAAP
- COREP
- ILAAP
- FINREP
- RRPs
- Credit Register

SREP Priority 2 : Governance and controls

Championed by SSM's Chairwoman Madame Nouy, Governance has expanded to cover the complete risk ecosystem of the bank

SREP Element 2

Overall governance framework

The assessment of the organizational structure of the institution as well as the suitability of the management body.

Corporate and risk culture

The adequacy of the risk and corporate risk culture taking into account the scale & complexity of the business.

Organization and functioning of management body

The assessment of the: 1) oversight of the internal governance framework; and 2) efficacy of the interaction between management and the supervisory functions.

Remuneration policies and practices

The alignment of the remuneration guidelines and policy of the institution, with its risk strategy and compliance with CRD IV art. 94 and EBA Guidelines 2017.

Internal control framework

The review of the independence and effectiveness of the compliance and internal audit functions.

Risk management framework

Institution-wide assessment of the: 1) effectiveness of the role of the CRO; 2) risk appetite framework & strategy; and 3) stress testing capabilities.

Information systems and BCP

The suitability of information and communication systems and risk data aggregation capabilities.

Recovery planning arrangement

The assessment of the institution's recovery plans, based on the findings from the internal governance assessment

SREP Priority 3 : Targeted Review of Internal Models

ECB's second wave of Comprehensive Assessments after AQR

Increasing complexity in internal models

- Internal models have grown in complexity
- Incomplete data has resulted in making unjustified assumptions

RWA variability and peer analysis

- Banks could choose from a broad range of modelling approaches, causing variability in RWA's and making peer analysis less transparent
- **Unwarranted variability** of RWA's is a cause for concern

Damaged credibility of internal models

- The global financial crisis of 2008 clearly showed that RWA's were not correctly estimated
- Faith in internal models needs to be restored

Regulatory response

- Ongoing discussions about the best regulatory response for removing complexity and increasing transparency in peer analysis
- America wants a return to the regulatory basics: "less is more"
- Europe wants to regain faith in existing internal models

Identify sources of unwarranted variability

- The **Targeted Review of Internal Models (TRIM)** will target the sources of unwarranted variability
- All SSM Bank in the EU are in scope with selected Pillar I internal models for credit risk and market risk
- Reduce variability through regulations, supervision and market discipline

SREP Priority 3 : Targeted Review of Internal Models

The reduction of unwarranted variability of RWAs is designated as TRIM's main objective

*"Internal models have become **increasingly complex** since they were initially introduced under Basel II. This has made it more and more difficult for banks and supervisors to understand them and to assess whether risks are being mapped correctly and consistently" - ECB*

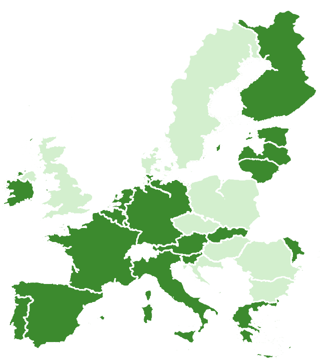
*"A number of benchmarking studies have highlighted **inconsistencies** as well as **high variability** in the capital requirements calculated by different banks' internal models" - ECB*

	ECB Objectives	Methods for TRIM
1.	Ensure compliance	• Assessing reliability of internal model approaches • Ensure adequacy of capital requirement calculation • Review of Data & IT
2.	Harmonise practices	• Reduce non-risk based RWA variability to promote level playing field • Benchmarking and horizontal reviews on specific topics • Identify good practices
3.	Establish supervisory consistency	• Clear communication on expectations and consistent feedback to all SSM Banks • Harmonised supervisory manuals • Develop new supervisory guidance based on lessons learned

SREP Priority 3：Targeted Review of Internal Models

The OSI's for each risk type are different in terms of model scoping and review topic focus

	General	Credit Risk	Market Risk	Counterparty Credit Risk
Models	Pillar 1 models	PD, LGD, EAD Treatment of defaulted assets	VaR, SVaR, IRC	Exposure modelling, CVA
Focus areas	**Unreliable, unavailable, inaccurate, incomplete or outdated data** may lead to errors in risk estimation. Independence, completeness, adequacy and soundness of reporting or underlying methodology in the **validation process** are necessary checks to mitigate model risk."	Inconsistent risk metrics emanate from different **definitions of default** within organisations. Different risk weights on **defaulted assets** between organisations are responsible for a great amount of RWA variability. **Downturn** conditions (including underlying assumptions) and their implications are subjective and should therefore be carefully documented.	Varying use of length, period and weighting of **data periods** for (S)VaR IRC models sensitive to choices between historical vs. market-implied **default probabilities** TRIM focus on aspects that remain after **FRTB**	Use of a variety of **pricing models** for equity and foreign exchange OTC derivatives explain part of the differences. Large **variety in EAD** for similar positions across banks



The TRIM OSI's are held at all SSM Banks with approved Pillar I internal models in the EU.

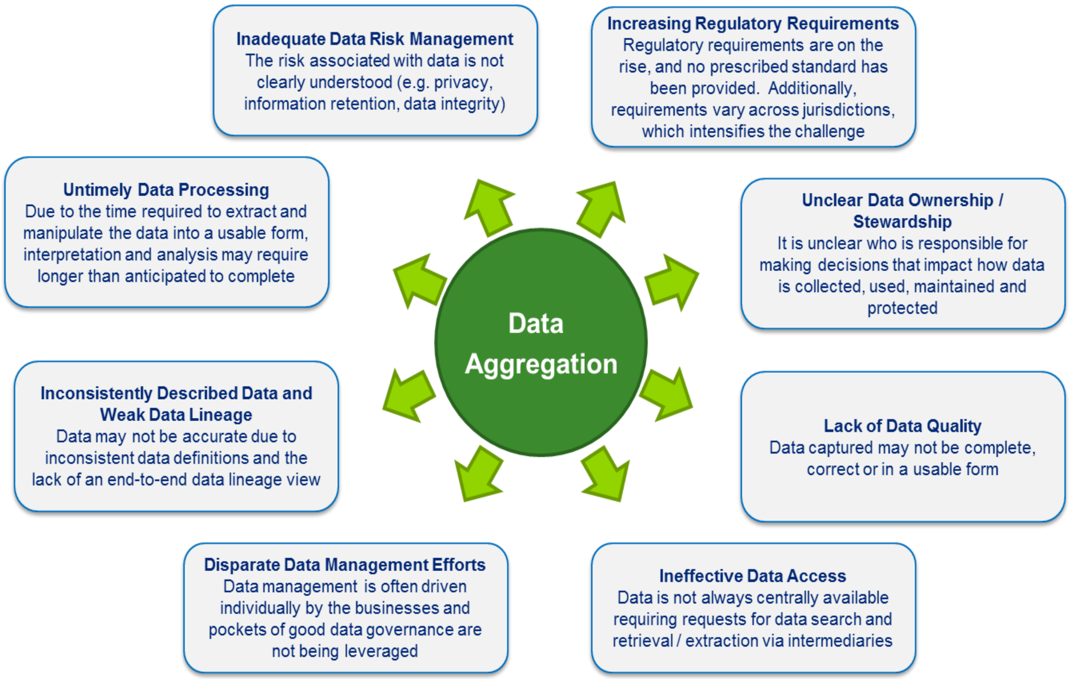
Operational Risk models are out of scope because of the upcoming changes to the Advanced Modelling Approaches (AMA).

SREP Priority 4 : BCBS 239

In 2016 ECB reviewed 25 European Banks. Now EBA considers the application of the guideline across the sector

Latest developments

- Compliance with the 11 principles was targeted for 1st January 2016 for G-SIBs and some D-SIBS
- D-SIBs are due to comply 2 years after recognition
- Results from the latest progress review by the Basel Committee showed very little progress, with areas of pain still the timeliness of reporting and the implementation of a solid IT infrastructure
- In the document, the Basel Committee:
  - Recommends the development of high quality infrastructure and improvements in automation
  - Requires banks to submit a remediation plan in the case of non-compliance by 1 January 2016
  - Emphasises on an independent evaluation of compliance, either by internal or external audit teams.



High level timeline

Contact

Dimitrios Goranitis
Romania – Financial Services Industry Leader
Partner, Deloitte Central Europe
Tel: +40 751 250 884
Email: digoranitis@deloittece.com