The EU banking regulatory transformation agenda 2017-2019 requires a significant commitment from the banking sector to transform, innovate and comply.

<table>
<thead>
<tr>
<th>Area</th>
<th>Statutory deadline</th>
<th>2017</th>
<th>2018</th>
<th>2019</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Q1</td>
<td>Q2</td>
<td>Q3</td>
</tr>
<tr>
<td>AMLD IV</td>
<td>June 2017</td>
<td></td>
<td></td>
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<tr>
<td>ECB TRIM</td>
<td>2016-2020</td>
<td></td>
<td></td>
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<tr>
<td>EMIR</td>
<td>End in 2020</td>
<td></td>
<td></td>
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</tr>
<tr>
<td>IFRS 9</td>
<td>1st January 2018</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>MAR</td>
<td>3rd July 2016</td>
<td></td>
<td></td>
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<tr>
<td>MiFID II</td>
<td>1st January 2018</td>
<td></td>
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<tr>
<td>PSD 2</td>
<td>1st January 2018</td>
<td></td>
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<tr>
<td>Basel III/IV</td>
<td>On-going</td>
<td></td>
<td></td>
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<tr>
<td>ECB NPL</td>
<td>1st January 2018</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BRRD</td>
<td>Annual submission</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDPR</td>
<td>25th May 2018</td>
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</tbody>
</table>

Key focus | Ongoing work | Implementation dates
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:

<table>
<thead>
<tr>
<th>Shortcomings of Basel II</th>
<th>Basel III improvements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low level and quality of banks’ capital bases; insufficient loss absorbency</td>
<td>Strengthening the quality and quantity of the capital base</td>
</tr>
<tr>
<td>Excessive leverage</td>
<td>Dealing with procyclicality</td>
</tr>
<tr>
<td>Insufficient liquidity buffers</td>
<td>Enhancing risk coverage</td>
</tr>
<tr>
<td>Does not deal with procyclicality</td>
<td>Addressing Systemic Risk and Interconnectedness</td>
</tr>
</tbody>
</table>

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.

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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

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:

<table>
<thead>
<tr>
<th>Principle 1: Controls and processes</th>
<th>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.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Principle 2: SREP</td>
<td>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.</td>
</tr>
<tr>
<td>Principle 3: Power of the Regulator</td>
<td>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.</td>
</tr>
<tr>
<td>Principle 4: Prevention rather than cure</td>
<td>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.</td>
</tr>
</tbody>
</table>
What is EBA’s SREP?

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

1. Business model analysis
   - Viability and sustainability of Business Model (RAS)
   - Adequacy of governance and Risk Management (RAS)

2. Assessment of internal governance & controls
   - RAS - based

3. Assessment of risks to capital
   - Capital requirement determination => CET 1 add-on
     - Block 1: Internal Capital Adequacy Assessment (ICAAP)
     - Block 2: Stressed ICAAP
     - Block 3: Supervisory stress tests/proxies
   - Capital adequacy assessment => Score + Rationale

4. Assessment of risks to liquidity and funding
   - Liquidity requirement determination => liquidity buffer
     - Block 1: Internal Liquidity Determination (ILAAP)
     - Block 2: Supervisory proxies
     - Block 3: Stressed liquidity determination – Supervisory Stress Tests
   - Liquidity & funding adequacy => Score + Rationale

Overall SREP assessment – Holistic approach
=> Score + Rationale/main conclusions

Supervisory measures

Quantitative capital measures
Quantitative liquidity measures
Other Supervisory measures

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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

<table>
<thead>
<tr>
<th>1. Business Models and Profitability Drivers</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Risk Appetite Framework</td>
</tr>
<tr>
<td>• Profitability</td>
</tr>
<tr>
<td>• Sustainability</td>
</tr>
<tr>
<td>• Peer Group Analysis</td>
</tr>
<tr>
<td>• Investment to support regulatory</td>
</tr>
<tr>
<td>transformation</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2. Credit Risk</th>
</tr>
</thead>
<tbody>
<tr>
<td>• IFRS9</td>
</tr>
<tr>
<td>• NPL Management</td>
</tr>
<tr>
<td>• Credit underwriting process</td>
</tr>
<tr>
<td>• Credit Risk Models</td>
</tr>
<tr>
<td>• Concentration</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>3. Risk Management</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Governance</td>
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<tr>
<td>• Data quality BCBS239</td>
</tr>
<tr>
<td>• TRIM</td>
</tr>
<tr>
<td>• Cyber risk</td>
</tr>
</tbody>
</table>
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

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

Management information

Liquidity reporting

Internal risk reports

Capital planning

Layer 3: Regulatory submissions and documents

ICAAP

ILAAP

RRPs

COREP

FINREP

Credit Register

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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.

Overall governance framework

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

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

Corporate and risk culture

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

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

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.

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

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.

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

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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

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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

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

**Models**

- **General**
  - Pillar 1 models

- **Credit Risk**
  - PD, LGD, EAD
  - Treatment of defaulted assets

- **Market Risk**
  - VaR, SVaR, IRC

- **Counterparty Credit Risk**
  - 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).
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**

<table>
<thead>
<tr>
<th>2013 - 2015</th>
<th>Q1 2016</th>
<th>Q2 2016 - Ongoing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial BCBS 239 compliance remediation</td>
<td>Compliance independent evaluation</td>
<td>Continuing compliance effort and remediation work</td>
</tr>
</tbody>
</table>
Contact

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Email: digoranitis@deloittece.com