# KPMG's European Central Bank Quarterly Update

Welcome to our final ECB Update of 2017. With one year drawing to a close and another about to begin, this seems an ideal time for KPMG's ECB Office to take stock of the current state of European banking supervision.

Europe's policymakers seem to feel the same way. The past few months have seen a renewed sense of purpose around strengthening and harmonising the Banking Union. As the Single Supervisory Mechanism passes its third birthday, it is clear that the impetus to move the Banking Union forward remains strong.

— We start this issue with a review of the 'State of the Banking Union', including a call for renewed support of the Single Resolution Mechanism.

— With the SRM in mind, we also compare and contrast the progress that has been made on Recovery and Resolution planning.

— We take a look at the wide-ranging Action Plan on Europe's overhang of Non-Performing Loans, which are increasingly seen as a potential weakness within the Banking Union.

— We profile the likely impact of 'Basel IV' – the Basel Committee's recently approved changes to the Basel III regime – including how it may affect some institutions more than others.

— We highlight the key results from our 2017 SREP Survey, which contrasts growing transparency over Pillar 2 Requirements with a lack of clarity around Pillar 2 Guidance.

— Finally, we look at the increasing challenges facing European banks' Internal Audit functions, not least as a result of growing supervisory requirements.

Banks will be all too aware that many of these topics may lead – directly or indirectly – to higher capital requirements. The importance of identifying and planning for these requirements early, and of communicating them effectively to stakeholders, is an underlying theme. So too is the continual and rapid advance of digitisation and other technologies.

As always, our goal is to alert clients and other readers to the impact of forthcoming changes in the supervisory landscape. One thing we can be sure of is that, after a short a seasonal break, the regulatory picture will continue to evolve rapidly in 2018.

## State of the Banking Union

**The success of the Single Supervisory Mechanism (SSM) has given the EU's planned Banking Union (BU) a strong start. The SSM has earned a robust reputation, and continues to evolve. In contrast, the Single Resolution Mechanism (SRM) has struggled to achieve harmonisation. Hopefully, 2018 will see Member States refocusing on the huge potential benefits of BU and giving the SRM their full support.**

The Banking Union (BU) is one of Europe's most important projects. It has the potential to generate a number of profound benefits across the Union, including:

— A strong, trusted banking system;

— The prevention of future bail-outs;

— A harmonised, integrated banking industry that supports the Single Market; and

— The ability for banks to realise pan-European synergies and efficiencies in times of disruption.

The BU is given additional importance by European non-financial companies' high level of reliance on bank financing in comparison to markets such as the USA, where capital markets financing is more commonplace. In the long term, the BU also represents a vital stepping stone towards the goal of achieving an EU Capital Markets Union.

The last few months of 2017 have seen a renewed effort by European policymakers to advance and strengthen this vital project. So this seems like a good moment to ask: How healthy is the BU?

The answer depends on which of the three pillars of the BU we look at.

On the plus side, the **Single Supervisory Mechanism** (SSM) has exceeded the expectations of many since its inception three years ago. It is now well-established, and enjoys national and international credibility as a tough but fair supervisory regime.

Of course, the SSM remains a `work in progress'. For example, the EBA would like to see greater convergence in areas like options and discretions. Europe's persistent overhang of non-performing loans (NPL) has also compelled the European Commission to launch an NPL Action Plan. But overall, the first pillar of the BU is working well and - as illustrated by the SREP's evolution (see our article) - continues to adapt and improve with experience.

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In contrast, the evolution of the BU's second pillar, the Single Resolution Mechanism (SRM) is in an earlier state of maturity given its later start. The principles and framework of the SRM have been established in European law, via the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism Regulation (SRMR) which were also amended recently. But the SRM itself remains very much in `start up mode'.

This is partly about resourcing; the SRB has fewer than 200 full-time employees, while the ECB boasts more than 1,000 supervisory staff. But the SRM's slow progress also reflects a lack of support from Member States. As a result, progress on the resolvability of banks, their resolution plans and the definition of bail-in liabilities has been comparatively limited. This lack of harmonisation means that more banks are currently being resolved via national mechanisms than under the terms of the BRRD.

And what about the third BU pillar, the **European Deposit Insurance Scheme** (EDIS)? To date, this has barely advanced beyond a proposal. The Commission's plans allow for a phased implementation over several years, but for now the EDIS remains the subject of political debate rather than concrete planning. Further progress on this pillar of BU seems unlikely while the second pillar has yet to establish full credibility. In addition, certain member states are re-iterating that further risk reduction in the European banking system is a prerequisite for any pan-European risk sharing by means of a joint deposit insurance scheme.

We should perhaps not be too surprised by the unbalanced state of the BU's health. The SSM represents one of the EU's most remarkable achievements, but it is a less politically sensitive proposition than the SRM or EDIS, which both involve the mutualisation of risk between Member States.

Nonetheless, we should remember the significant benefits that the BU could deliver for European citizens. Like a stool, the BU needs each of its three legs to be strong if it is to work as it should. If the upsides of the BU are to be realised, Member States need to build on the success of the SSM and increase the credibility of the SRM over the next years by making a high standard of resolution preparedness a prerequisite for EDIS.

## Striking a balance between resilience and resolution

**Recovery and resolution planning have become key issues for banks, their supervisors and resolution authorities, as highlighted in our recent publications Recovery planning and Resolution: an evolving journey in Europe.**

Supervisors are focusing increasingly on the credibility of banks' recovery plans, because these plans should provide a crucial line of defense if banks suffer losses or face liquidity difficulties. Most banks are reasonably well advanced in establishing the core elements of recovery planning - identifying critical functions, using a sufficiently wide range of scenarios, developing a comprehensive suite of recovery options, and ensuring that recovery planning is well governed.

But banks have made less progress in testing their recovery plans and integrating their recovery planning with other aspects of risk management. The supervisory focus is extending to how banks update and test their recovery plans, including through the use of scenario planning and simulation exercises; how well banks integrate their recovery planning with their risk management more generally; and how supervisors can reflect the quality of a bank's recovery planning in Pillar 2 capital requirements.

The ECB expects banks to include breaches of its Pillar 2 capital Guidance (P2G) as an early warning signal in recovery plans, while the EBA recommends that banks should align their recovery planning with the ‘serious but plausible’ scenarios used for ICAAP/ILAAP stress tests. Recovery planning is also part of the assessment of a bank's governance within the EBA's SREP Guidelines, so the ECB could reflect deficiencies in recovery planning in Pillar 2 capital requirements in 2018.

Meanwhile, resolution authorities - including the Single Resolution Board (SRB) and the Bank of England - are building up their resolution planning, including a focus on the critical operational and finance-related services on which the continuity of a bank's critical functions depends; specifying the minimum amount of own funds and eligible liabilities (MREL) that each major bank should hold, and how these should be pre-positioned across a banking group; and requiring banks to enhance their preparedness (data and processes) for a third party valuer to undertake different types of valuation at short notice (the EBA and the Bank of England have already published papers on valuation, and the SRB is expected to finalise its guidance on valuation soon).

Although many of the largest banks (in particular G-SIBs) have made good progress in issuing MREL-eligible liabilities, many other banks subject to a resolution strategy have made less progress and may be over-estimating the appetite of investors to buy bail-inable debt. Many banks remain unable to demonstrate convincingly and in detail that the provision of critical services is sufficiently resolution-proof. And most banks are not yet in a position to facilitate third party valuations to determine rapidly whether the bank should be put into resolution and, if so, the choice of resolution tools.

Finally, both banks and the authorities need to integrate recovery and resolution planning. This reflects the close links between recovery and resolution planning in preserving the continuity of critical functions, and the balance to be struck between resilience and orderly resolution.

## The implications of new EU Regulations on Bank’s NPLs

**The large legacy overhang of Non-Performing Loans (NPLs) still remaining in the European Union (EU), with nearly €900 billion in the Eurozone alone, is increasingly seen as a threat to the success of the Banking Union. Regulators have recently increased their intervention to help speed up the banks’ NPL risk deleveraging process.**

Over the past 18 months, numerous NPL task forces have been debating the topic to define the possible 'optimum' pan-European solutions.[1] In July 2017, the EU Council announced an Action Plan to tackle the issue.

The ambitious plan introduced several initiatives to be implemented in a remarkably short timeframe (mostly in 2017-2018). The topics covered are broad, ranging from strengthening banks’ management of NPL stock, to increasing incentives for banks to adequately provision and deleverage risks, as well as preventing new flows of NPLs in the future. Important progress is already being made, in line with the plan.

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**What can EU banks expect and how will this impact them?**

In March 2017, the European Central Bank (ECB) published its NPL guidance for significant institutions, which has put considerable pressure on high NPL banks under Single Supervisory Mechanism (SSM) supervision to produce robust and detailed NPL strategies and demonstrate their ability to deliver operationally on those plans. The European Banking Authority (EBA) is also expected to issue guidelines on NPL management in 2018, to be applicable to all banks in the EU. This will add pressure on less significant institutions to begin actively addressing their NPLs.

Regulators are intending to further encourage NPL reductions by increasing the cost of holding them on the balance sheet. For example, the ECB is completing its supervisory expectations for provisioning on new NPLs (expected to come into effect by mid-2018). While this is a non-binding guidance, non-compliance will have the potential to trigger pillar 2 measures (e.g. close supervisory monitoring or capital add-ons) for significant institutions. An additional provisioning backstop proposal from the European Commission (EC) would affect all banks in EU-27 countries and also have direct implications on Pillar 1 capital requirements. However, it is currently unclear how these two sets of measures will coexist. The ECB's guidance will probably bridge the gap until the EC can implement its measure, expected to be a multi-year process if incorporated in CRR3.

Improving standardisation and comparability of banks' NPL data is also a top priority. For example, the EBA published its NPL templates on 14 December 2017 (for which KPMG was the adviser), which aims to set new market standards for NPL transactions.

The collective effect of these actions is to significantly increase the pressure on banks of all sizes to address their NPL backlog. Even banks with low levels of NPLs need to start assessing the impact of the NPL Action Plan of the EU Council, if they have not done so already.

**What does this all mean for banks?**

The regulatory oversight for NPLs will continue to have a considerable impact on banks. As a result, we expect to see more NPL portfolios for sale in the EU market over the coming years. More elaborate alternatives to the traditional 'direct sales' are also likely be used by banks to deleverage their NPL risks. Further pan-European initiatives by the regulators could also increase the options available to sellers and buyers, including the ECB's idea for creating a NPL transaction platform and the design of the AMC Blueprint in progress by the EC.

In the short term, EU banks need to understand that they are facing a 'new normal', with NPLs becoming much more costly and demanding over the next few years for banks to hold, requiring banks to revisit their NPL strategy and operational plan accordingly.

[1] From which numerous publications came to light (including from the FSC, ESRB, ECB and BIS).

## Basel IV – Banks should act now on capital and strategic planning

**The package of changes to the Basel III framework informally known as 'Basel IV' was formally endorsed on December 7 (High-level summary of Basel III reforms (PDF 276 KB)). There is now intense debate about the likely impact of Basel IV on risk weighted assets and the resulting amount of regulatory capital banks will be required to hold under the new rules.**

Based on KPMG's Peer Bank tool, which includes a Basel IV Calculator, and applying recent EBA Quantitative Impact Studies to bank specific portfolios, we expect the revised standards to hold a number of impacts on European banks if adopted in full. In particular:

- On average, the common equity Tier 1 (CET1) capital ratios of major European banks would fall by around 90bps. However, the range of impact is wide. Some banks may see little change to their capital ratios, while others face a significant decrease. The most affected decile could see a decrease by more than 4%, while the least impacted decile experience a decrease of just 18bps.
- The greatest CET1 impact (averaging 2.5 - 3%) would fall primarily on banks in Sweden and Denmark, followed by those in Norway and the Netherlands (decreases of around 1.5%). This mainly reflects the balance of those banks' asset portfolios, and the extent to which they have used IRB models for their calculations of capital requirements.
- The impact on pillar 1 capital requirements will vary according to different banks' business models. Our analysis suggests that more focused models will be hit harder. For example, asset managers could see a decrease of around 2.8% and sector lenders a decrease of approximately 1.6%. The average decrease for G-SIBs will be around 70bps. The increased risk sensitivity of wholesale portfolios might push the CET1 requirements of a typical wholesale lender down by around 0.9%.

The additional capital requirements of Basel IV will be driven largely by restrictions to the IRB approach, such as moving portfolios from Advanced-IRB to Foundation-IRB. And while the introduction of an IRB output floor will have little overall effect, it could have a significant impact on banks with comparatively high mortgage exposures - such as those in Scandinavia and the Netherlands.

In contrast, revisions to the calculation of Credit Risk (Standardised Approach), Market Risk and Operational Risk will probably only account for around 10% of the capital impact of Basel IV. We believe that bank internal calculations differ from these numbers because they typically also include effects due to the Fundamental Review of the Trading Book (FRTB), amongst others.

Given they are subject to a long transitional period, the capital requirements of Basel IV look manageable for most European banks. If anything, the required changes to banks' business models, their response to the low interest environment and weak profitability, are likely to have a more widespread impact - a fact highlighted by the ECB's 2017 SREP decisions.

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Now that the specifications of Basel IV have become clear, we will see European banks begin an all-too-familiar cycle of internal discussion. This cycle will begin with CROs assessing the impact of the new rules on risk weightings. Next, CROs and CFOs will work together to identify the likely capital and operational costs. After that, CEOs can be given detailed briefings and the debate will move on to consider the wider strategic implications, and to agree a set of actions.

KPMG's Basel IV Calculator, part of our Peer Bank tool, has been designed to support these discussions. It allows banks to model the likely impact of Basel IV line-by-line, to gauge the overall effect on key capital metrics, and to benchmark themselves against national, European and sectoral peer groups.

This kind of impact assessment is a key step in enabling banks to plan their responses to Basel IV, and to communicate their expectations to investors and regulators. That is particularly important given the range of other measures – such as P2Rs, P2G and non-performing loans - currently changing bank's capital.

It is clear that capital planning is becoming more challenging than ever, and that European banks need to get on top of this vital issue. However, Basel IV will also prompt banks to reassess their internal models and risk management processes including their value added. We therefore expect banks to include selected Basel IV measures into their planning for reshaping their business models. KPMG can help banks to consider the impact of Basel IV on businesses, processes and capital requirements, and to explore possible reductions to the cost and complexities of their business.

## SREP: The evolving capital challenge

**As predicted, 2017's SREP was the most transparent and risk sensitive so far. The calculation of Pillar 2 Requirement is becoming clearer, even if the banks see room for further improvement. In contrast, banks still see the determination of Pillar 2 Guidance as a `black box'. At a time when demands on Pillar 1 and Pillar 2 are growing, this opacity poses an increasing challenge for capital planning and investor communication.**

In the October edition of KPMG's ECB Update, we predicted that the 2017 SREP process would be the most transparent and risk sensitive to date (Read SREP 3.0 online here).

Recent developments appear to confirm these expectations. For example:

— KPMG's 2017 SREP survey shows a sample median Pillar 2 Requirement of 225bps for 2018, similar to the 2017 figure, and a sample median Pillar 2 Guidance level of 156bps, down from 200bps in the prior year.

— MDA triggers appear to have increased on average by 90 basis points (bp) compared to SREP 2016, mainly due to the increase of P2R (~20 bp), the phasing-in of capital conservation buffer (~50 bps – less than 62.5 bps due to more front loading in certain EU countries) and the introduction of systemic buffers (~20 bp).

— As part of its Pillar 2 Roadmap, the EBA has also published revised guidelines for the 2019 SREP. The planned changes include the use of supervisory stress testing results for setting P2G; an assessment of institutions' stress testing frameworks; and a new distinction between viability scores and risk scores. However, we believe that these amendments will not fundamentally change the ECB supervisory approach in 2018.

Even so, many banks feel they are still a long way from a clear understanding of how the SREP affects their capital planning activities.

On the upside, there is no question that the transparency and risk sensitivity of the **Pillar 2 Requirement** (P2R) continues to improve – even if some banks feel the link with the ECB's supervisory measures could still be made clearer. More specifically:

— The impact of each SREP element's score (the assessments of Business Models, Governance & Risk Management, Risks to Capital and Risks to Liquidity & Funding) on the final P2R figure has become much clearer.

— That makes it easier for banks to conduct business driver assessments, helping them to understand how decisions over their business models could affect their P2R.

— This is demonstrated empirically by the increasing correlation between SREP scores and P2R. According to the ECB, correlation increased to 76% in 2016 from just 40% in 2014.

On the downside, many banks feel that the calculation of non-binding Pillar 2 Guidance (P2G) is opaque. Our SREP survey did not detect any obvious pattern for P2G based on banks' sizes, business models or home markets. Quantitative stress tests also appear to have a limited impact on P2G – similar to the findings of our 2016 SREP survey. That contrasts with the EBA's consultation on revised SREP guidelines.

In short, the determination of P2G appears to remain a 'black box' process dominated by supervisory discretion. Furthermore, while P2G is not legally binding, the ECB's expectation that banks will operate above this level means it is *de facto* mandatory. In effect, P2G is therefore a confidential capital target that banks cannot disclose to investors or other external stakeholders.

This combination of P2R transparency and P2G opacity will make it hard for banks to carry out internal capital planning, let alone to explain to investors how their capital is being put to use or project funds are being allocated. The picture is further complicated by the different capital buffers, the growing number of measures and supervisory expectations affecting Pillar 1 and Pillar 2. Some notable examples include Basel IV where for example, it is unclear how changes of the Pillar 1 requirements in Operational risks will be reflected by ECB's Pillar 2 requirements, Non-performing loans, Resolution planning, internal governance or leveraged transactions.

Despite the improvements in the SREP process, it is clear that SSM banks face a rapidly evolving capital challenge.

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## Internal Audit: Threading the needle

**Faced with a rapidly evolving risk environment, Internal Audit (IA) functions leaders must continue to develop new capabilities. However, an emerging challenge for banks' IA is to retain their independence while balancing the needs of the business against the ever increasing demands of Supervisors.**

European banks continue to face a challenging operational and regulatory environment, putting their IA functions in a more prominent and pressurised position. To understand these challenges better, KPMG conducted an Internal Audit Benchmark Survey of 22 SSM banks based in 11 EU Member States.

The full results of this study will be released in February, at a roundtable event for the IA leaders of participating banks. However, an initial look at our findings shows that regulation and supervision is seen as the leading challenge for these IA functions. There are several aspects to this, including:

- The need to monitor banks' compliance with an ever-expanding regulatory burden;
- The need for close co-operation with Joint Supervisory Teams (JSTs), including conducting follow-up work based on SREP findings; and
- The need to meet supervisory expectations on internal governance and risk appetite, including IA functions themselves. Internal governance is a key priority for the SSM, and the on-site inspections of the 2017 SREP generated more IA-specific findings than in previous years. Some of the most common recommendations by JSTs focused on the resourcing, independence, coverage and quality of IA activities.

Apart from increasing expectations around regulation and supervision, our survey shows that IA functions face two other major challenges. The first of these is the impact of technology. The rapid advance of digitization, data analytics, artificial intelligence and other technologies poses a number of challenges for IA teams. These include the need to tackle growing cyber risks; the importance of adapting to rapidly changing business processes; and the requirement to develop new IA tools and techniques that harness the latest technology.

Another major challenge is resourcing. Banks are finding it increasingly difficult to attract and retain suitably qualified and experienced IA staff. Indeed, the 2017 SREP judged some IA functions as having insufficient resources to fulfil their remit. One way that a number of banks have tried to tackle this challenge has been through increased introduction of rotations between the first and second line and IA staff. This, when delivered effectively, has extended knowledge transfer, enhanced the skills of staff members and facilitated further integration across the bank.

Looking ahead, IA leaders identify a number of key priorities for the next three years. These include making better use of digital audit techniques; managing cyber and cloud outsourcing risks; enhancing their communication with Supervisors; and improving their combined and coordinated approach to the planning and performance of assurance activities across the bank.

However, it is notable that Heads of IA see culture and status as equally important priorities for the future. Remaining a trusted advisor, valued by banks' leaders and board members, is a key goal for many. But so too is achieving a culture that strikes the right balance between `assurance' and `consulting' activities.

Once again, banking supervision has a significant impact on these so-called `soft' factors. On one hand, the desire to advise banks' leaders about supervisory thinking carries the risk of compromising the independence that is essential to any effective IA function. On the other hand, the need to support JSTs in their work carries the risk of IA functions being perceived as supervisors' agents.

In short, IA functions, already under pressure to develop new capabilities to meet increasing regulatory and technological demands, face a growing challenge in ensuring they strike the right balance between supporting supervision, retaining their independence, and adding value to the business.

# Further insights

## Resolution: an evolving journey in Europe

Resolution poses many challenges for banks. When designing a commercial banking model with operating structures that are capable of facilitating recovery and resolution, it is essential for banks to understand clearly how to navigate the regulatory requirements and what to focus on to meet each of these specific challenges.

Earlier this year, KPMG's ECB Office and EMA FS Regulatory Centre of Excellence published a report on Recovery Planning for banks and financial institutions. This new paper continues that discussion, focusing primarily on the challenges facing larger banks in Europe, and how the various strands of their recovery and resolution planning work should be joined-up. Download the report here.

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