



ECB onsite inspections

Helping you to prepare

Deloitte Malta
Risk Advisory - Banking

Risk Advisory 

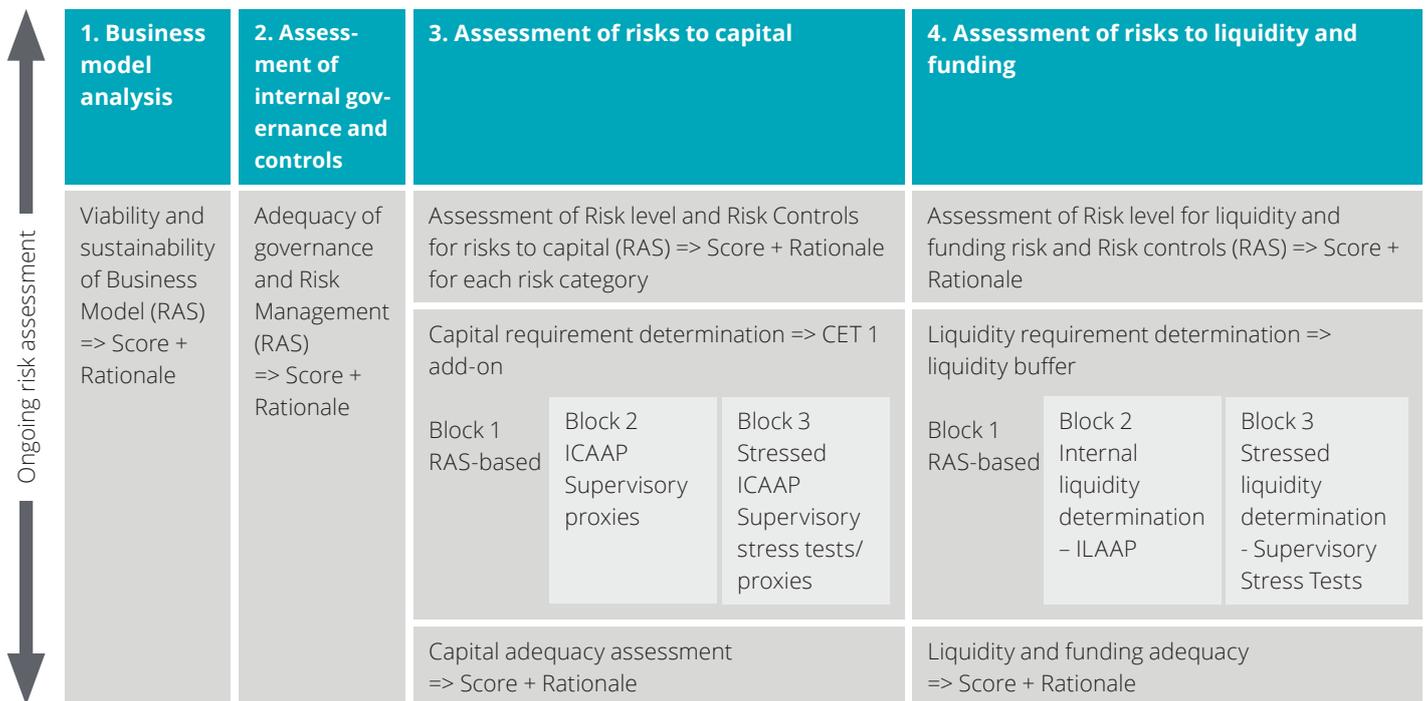
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Timeline for SREP and other regulatory and supervisory requirements



■ Timeline ● Regulatory milestone ● Entry into force ■ Ongoing

SREP Decoded



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

Supervisory measures

- Quantitative capital measures
- Quantitative liquidity measures
- Other Supervisory measures

ECB Priorities for the second half of 2016

Outlining its SREP priorities for the year, the ECB put banks' business models and profitability at the top of the list. This is expected to feature prominently in their onsite inspections which will commence in the second half of 2016.

"Among the key risks identified, business model and profitability risk are ranked the highest, followed by internal governance", ECB stated in a document published on its website.

The concerns over capital adequacy which have preoccupied the ECB since the global financial crisis last decade featured at the bottom of the list in Q4 of this year, however the ECB are expected to carry out onsite inspections for banks across the board.

SSM on-site inspections are:

- In-depth investigations of business model risks, internal control systems and governance with a pre-defined scope and time frame at the premises of a credit institution;
- Conducted in an independent manner with respect to the on-going supervision and in close liaison with the JSTs;
- Different from the supervisory visit conducted by JSTs as part of all the supervisory functions;
- Carried out for all banks in accordance with the SSM Supervisory Manual and at the premises of the credit institution.

Across Europe, Deloitte is involved with onsite inspections, we can leverage on this to ensure a top quality service for your bank.

Furthermore, the EBA has issued guidelines for common procedures and methodologies for the Supervisory Review and Evaluation Process (SREP) which will underpin the process for supervisory reviews.

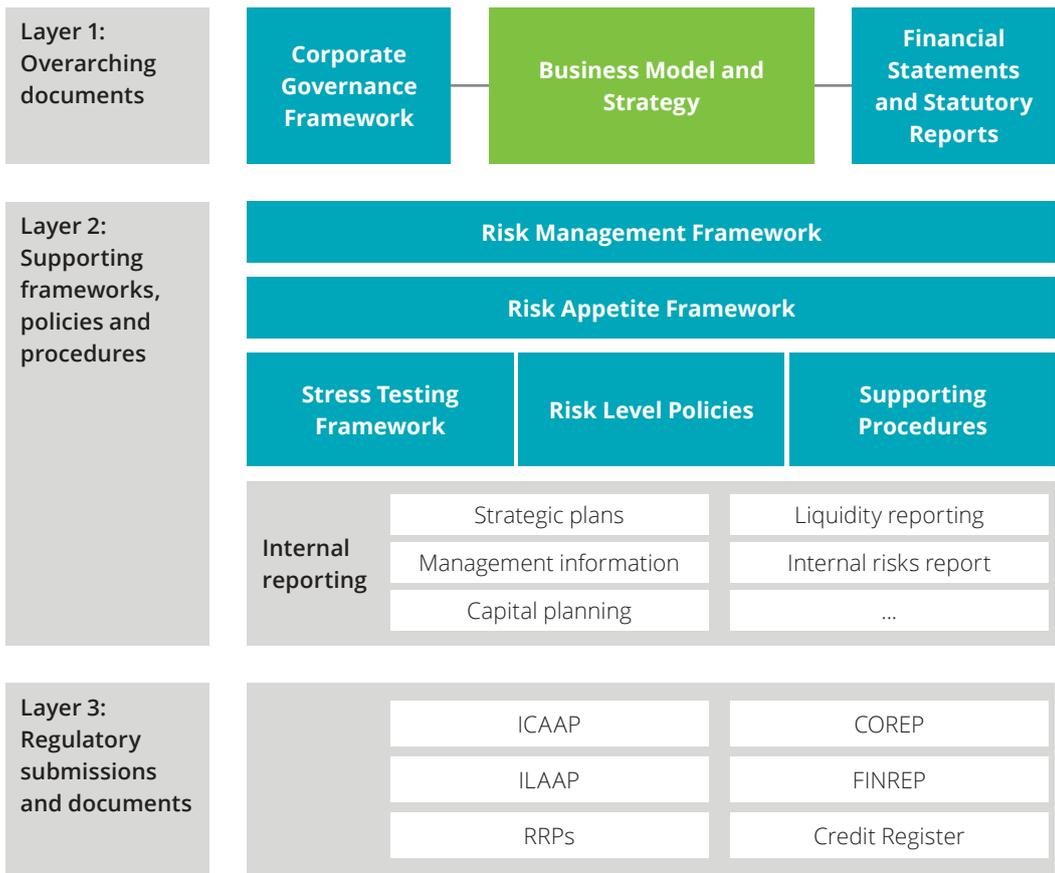
The guidelines hinge on four main components:

- Business Model Analysis and Profitability Risk
- Assessment of Internal Governance
- Assessment of Risks to Capital and Adequacy of Capital
- Assessment of Risks to Liquidity and Adequacy of Liquidity.

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Your internal structure under SREP

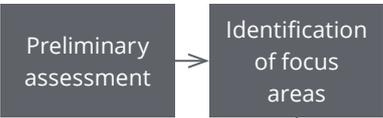
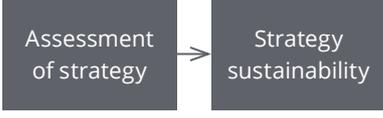
“The Executive team needs to own the business model analysis. It will be a key component in supervisory decision-making, and is an aspect banks can influence.”



- Business model needs to encompass the whole organisation
- Business strategy needs to be aligned across the bank
- Banks need to take a holistic approach to ensure that all components are aligned and interlinked.
- Align with business strategy, risk strategy and appetite and key reports (regulatory, external and internal)
- Need to define business model through the identification of key resources, operational procedures, market conditions and stakeholder expectations

How the ECB will inspect your business model

The regulator's assessment will take the following approach

Your requirements, and how we have phased our approach to addressing them	Questions the Regulators will ask	What the Regulators will expect
<p>Phase 1 Preliminary Assessment</p> 	<ul style="list-style-type: none"> • What are the bank's material business lines, product lines and geographical markets? • Who are the bank's peers? 	<ul style="list-style-type: none"> • Ranking of business lines, product lines and geographical markets; • Knowledge of peers and a peer group analysis
<p>Phase 2 Assessment of business environment</p> 	<ul style="list-style-type: none"> • How does the business environment and competitive landscape impact the bank? • How will trends in the environment impact strategy? 	<ul style="list-style-type: none"> • Assessment of potential market growth and market share; • Impact from regulatory developments.
<p>Phase 3 Assessment of business model and its viability</p> 	<ul style="list-style-type: none"> • Has a qualitative and quantitative analysis been carried out? • How is the bank performing? • What are its key success drivers and dependencies? • Is the business model viable? 	<ul style="list-style-type: none"> • A formal Risk Appetite Framework • Performance assessment, against risk appetite; • A summary of risks; • Benchmarking analysis
<p>Phase 4 Assessment of strategy and its sustainability</p> 	<ul style="list-style-type: none"> • How does the bank plan on achieving its objectives? • Are there planned changes to the business model? • Is the bank's strategy sustainable? 	<ul style="list-style-type: none"> • Plausibility assessment of assumptions; • Assessment of the interaction of business model, strategy, RAF, ICAAP and ILAAP.
<p>Phase 5 Identification of key vulnerabilities</p> 	<ul style="list-style-type: none"> • What are the impediments to the business model and strategy and how are they being addressed? • Does business model and strategy link to the RAF, ICAAP and ILAAP? 	<ul style="list-style-type: none"> • List of ranked key vulnerabilities; • Assessment of controls and identification of any areas for improvement.



How Deloitte can help

The final report should take a holistic approach, enabling the regulator to assess the viability and sustainability of the bank.

Vision, mission, and operating model

We can help define a business model along eight building blocks covering the bank's customers, offer, infrastructure and finances.

01. Business lines and value proposition

Define key business/product lines create value for customers. Rank business areas by materiality.

02. Customer segments

Define the Bank's customer base by service, type, geography, etc.

03. Channels

Define how the Bank reaches its customers to deliver its value proposition (branch, online, platform, road show, etc.).

04. Key activities

Define the activities and critical success factors for effective execution of the business model (IT, Operations).

05. Key resources

Define the resources key to the viability and sustainability of the business model (CIO, CEO, Business Development, IT Director, RM).

06. Key partners

Define the Bank's network of partners that impact business model execution (business partners, vendors, key relationships)

07. Revenue streams and cost structure

Operating income key categories and drivers, profit margin drivers, key cost categories and trends, top 10 clients and concentration, etc.

08. Asset base and funding mix

Define the Bank's investment and funding strategy (diversity, cost, dependency, etc.).

Peer group analysis

- Identify criteria for peer selection across the Eurozone

- Selection of peers and ranking by relevance
- Analysis of identified peer group
- Sample analytical questions:
 - What are the average returns of the peer group per service offering?
 - What is the balance sheet structure of the peer group and what is the impact on profitability?
 - What is the proportion of short vs long-term funding? What is the respective cost of funding?
 - How does asset quality vary across the sample in terms of level of NPE and forborne exposures?
 - How does provisioning vary across the peer group sample? Both specific and collective provisioning methodologies.
 - In what areas do peers appear to have a competitive advantage?

Assessment of business environment

- Identify market forces
- Identify industry forces
- Define key technological, regulatory, social and economic trends
- Identify macroeconomic forces

Financial performance

- Perform an in-depth analysis of P&L and everywhere where applicable, balance sheet and cash flow statements;
- Assess correlation of performance to the Bank's risk appetite;
- Develop Profitability Metrics Dashboard split by Profit Centre to enable a focused analysis and peer group benchmarking;

Business plan and strategy

Areas of focus in qualitative assessment

- What are your strategic goals? How do they drive the business model?
- Can your systems support strategy? How effective are your cyber risk and AML strategies?

- Is the current organisational structure optimal for execution of strategy? Is strategy challenged by the Board?
- Does your reward system encourage people to take excessive risk which questions business sustainability?
- Are resources adequate to support strategy?

Areas of focus in quantitative assessment

Analyse projections

- Analyse forecasted P&L, cash flow and balance sheet.
- Determine funding requirements.
- Analyse CAPEX requirements.

Assess assumptions

- Assess reasonableness and plausibility of assumptions in the light of management objectives, analysis of business environment and key success drivers.
- Stress assumptions such as macro-economic metrics, and volume and margin growth

Addressing objectives

- **Capital allocation process:** Formalisation of capital allocation processes at all levels of the Bank i.e. business line, asset class, product and attribution of portfolio risks e.g. CVA/VaR and Pillar II risks.
- **Capital demand management:** Development of established capital demand planning and monitoring capabilities, including Management Information (MI) that enables decision makers to better understand their current and future demands for capital resources (e.g. RWA/EL etc).
- **Business performance:** Assessment of return on capital measures that are invaluable as part of the capital allocation process and establishing capital-linked pricing.
- **Risk Mitigation/Transfer and Deleveraging:** Techniques or execution strategies designed to have a positive impact

on capital demand performance e.g. hedging, netting, use of collateral or significant risk transfer transactions. Asset disposal or wind-down strategies designed to lower capital drain e.g. release Expected Loss (EL).

Calculation approach and scope:

Opportunities available to calculating regulatory capital requirements i.e. standardised versus internally modelled approaches and options available to amend internal models currently used e.g. data coverage, granularity or assumptions.

Regulatory transformation plan

- The design of a bank’s business model must consider the requirements and impact of new regulation.
- We can assist in developing an action plan for compliance, and set out an

implementation roadmap using a Gantt Chart.

- Our report will demonstrate how one intends to comply with regulatory developments as well as one’s commitment to implementing the plan.

Risk management

- Perform an analysis of the key risks arising from the Bank’s business model and environment.
- For each material risk identified assess (1) risk exposure, and (2) quality and effectiveness of risk management and controls.
- Consider whether the identified risks are covered in the ICAAP and ILAAP.
- Assess how peers are identifying and managing business model risks. What is

their risk appetite?

- We will take a holistic approach to risk identification and help you identify areas that may be questioned by the Regulator.

Management team

- Detailed CVs for each member of the management team
- Define the management team in such a manner to answer the following questions adequately:
 - Is the management team experienced, knowledgeable, and connected enough to accomplish what they propose?
 - Do members of the management body have successful track records?
 - Why is the team suitable to successfully execute the business model in a viable and sustainable manner?

The Deloitte approach

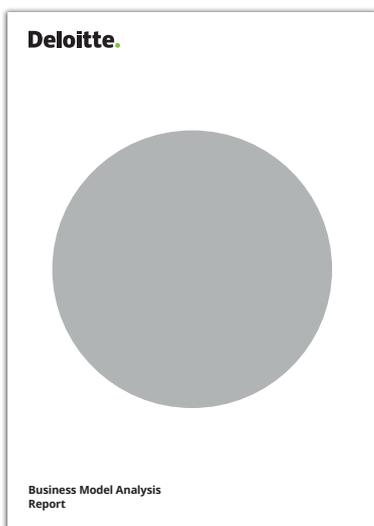
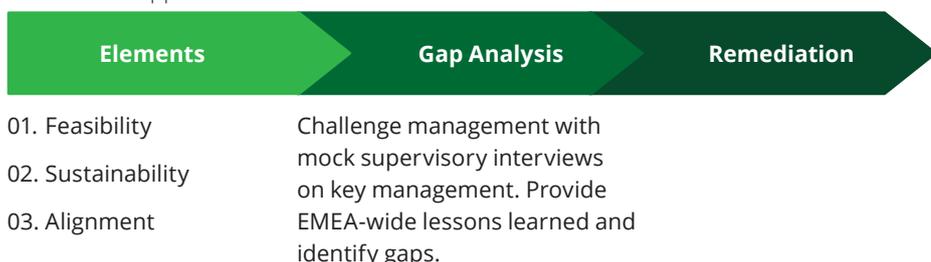


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How the ECB will challenge internal governance and controls

Principles of internal governance

In recent years, internal governance issues have been given prominence by various international bodies with a view to exposing weak or superficial internal governance practices.

The review and evaluation conducted by the competent authority shall include:

- Governance arrangements;
- Corporate culture and values; and
- The ability of directors to perform their duties.

When conducting the review and evaluation the competent authority shall go through:

- Agendas and supporting documents for meetings of the board and its committees; and
- The results of the internal or external evaluation of the performance of the board of directors.

Key areas of assessment

Overall governance framework

The assessment of the organisational 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 and complexity of the business.

Organisation 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 and 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

How Deloitte can help

Elements	Gap Analysis	Remediation
01. Overall governance framework	Ensure that internal governance and institution-wide controls are adequate for the risk profile, business model, size and complexity of institution, in line with EBA guidance on the matter.	
02. Corporate and risk culture		
03. Organisation and functioning of management body		
04. Remuneration policies and practices	Assess the degree to which the institution adheres to the requirements and standards of good internal governance and risk controls arrangements.	
05. Internal control framework		
06. Risk management framework		
07. Information systems and BCP		
08. Recovery planning arrangement		

“Trust in the reliability of the banking system is crucial for its proper functioning and a prerequisite if it is to contribute to the economy as a whole.”Consequently, effective internal governance arrangements are fundamental if institutions, individually, and the banking system, are to operate well.”

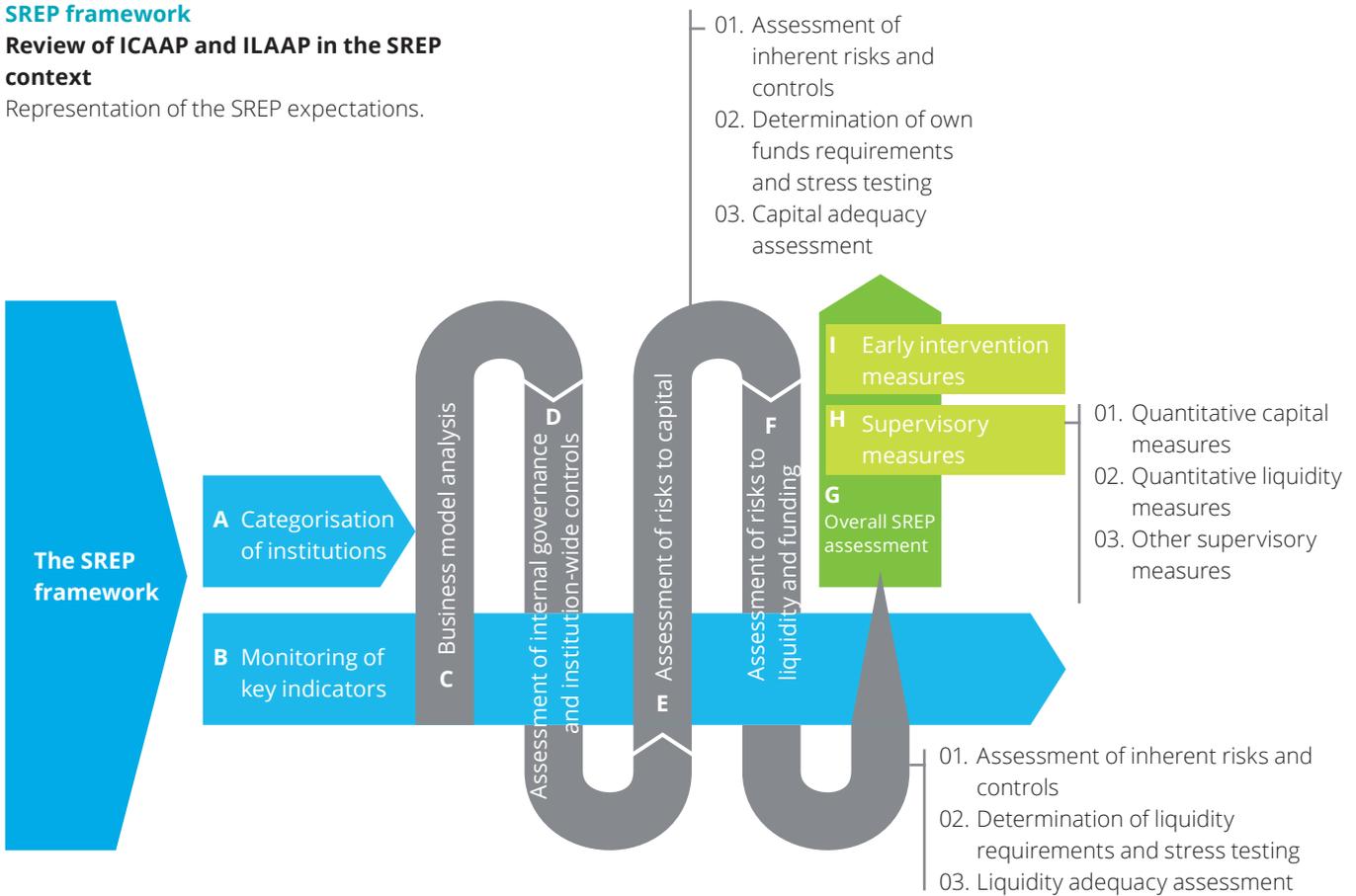
EBA Guidelines on Internal Governance

How the ECB will assess ICAAP and ILAAP

SREP framework

Review of ICAAP and ILAAP in the SREP context

Representation of the SREP expectations.



A Categorisation of institutions

Financial Institutions will be distributed in four categories (Level 1 to 4), according to the systemic risk they represent. The level of frequency and intensity of the monitoring, changes depending on the category (Level 1 being the most intense).

B Monitoring of key indicators

The quarterly monitoring of the main financial and non-financial indicators of all the Financial Institutions, intermediated with the SREP's evaluations, will allow to identify any potential deterioration on the risk profile and lead to an update on the evaluations of all SREP components.

C Business model analysis

- This analysis consists of:
01. The evaluation of the viability of the business model on a year time horizon;
 02. The evaluation of the sustainability of the strategy in the next three years;
 03. The identification of the main vulnerabilities that may impact the bank or lead to a situation of recovery/ resolution.

D Assessment of internal governance and institution-wide controls

- This evaluation's main focus is:
01. To guarantee that the governance model and the implemented controls are adequate to the risk profile, business model, size and complexity of the bank;
 02. To evaluate the degree of compliance of the bank with the requirements and standards of a good governance and internal control practices.

E Assessment of risks to capital

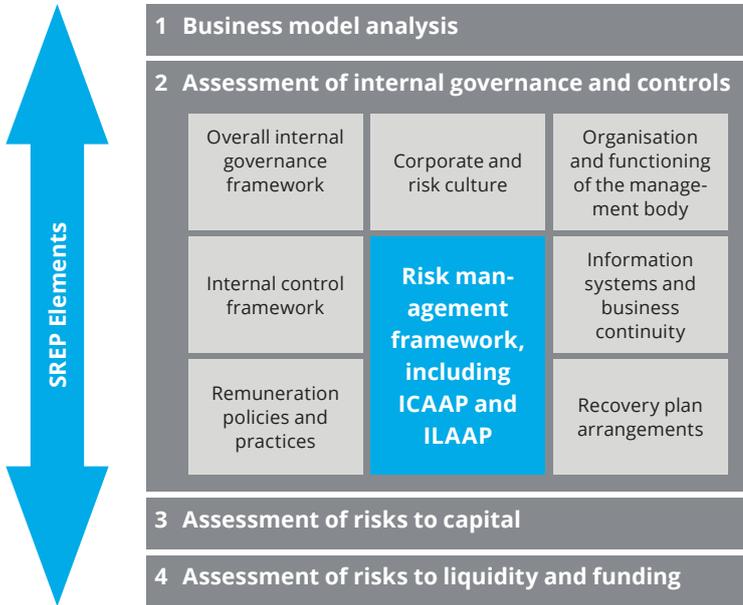
- There will be evaluations to the material risks identified for the bank, which will result in a grade that is based on the inherent risk and on the management and control of existing risks.
- This evaluation will use the bank's ICAAP as its main tool. The output will then be used to determine the adequate capital levels.

F Assessment of risks to liquidity and funding

- This evaluation is focused on the liquidity and funding risks, as well as on its management and on the existing internal controls.
- It will use as its main tool the bank's ILAAP and it can result in specific measures to comply with the liquidity requirements previously defined.



Where do ICAAP and ILAAP come in?



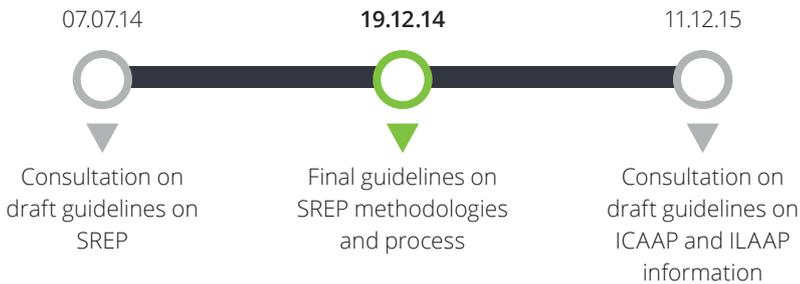
What is SREP?

- SREP constitutes for regulators a common framework and methodology for assessing the institutions' risks and viability.
- The four elements of the SREP framework are assessed and scored on a scale of 1 to 4.

Where does ICAAP and ILAAP come in?

- As part of SREP, competent authorities will assess the ICAAP and ILAAP on the basis of:

- 01. Soundness:** are policies and processes appropriate for maintaining an adequate level of capital and liquidity to cover risks to which the institution is exposed?
- 02. Effectiveness:** to what extent is ICAAP and ILAAP embedded in decision-making?
- 03. Comprehensiveness:** are all business lines, legal entities and risks covered?



How Deloitte can help



- | | |
|--|---|
| <ul style="list-style-type: none"> 01. Capital 02. Liquidity | <p>Ensure assumptions and internal stress test methodologies are up to standard and aligned with regulatory reporting, management tools, overall strategy and EMEA-wide best practices.</p> |
|--|---|

Our ICAAP and ILAAP gap analysis assessments will cover the following areas of focus:

Structure of ICAAP/ILAAP report

- Are the reports clear formal statements of capital adequacy supported by an analysis of ICAAP outcomes?
- Have they been approved and signed off by the management body?
- Is the shorter term perspective complemented by a longer term (usually at least a three-year horizon) forward looking process?

Proportionality

- Are ICAAP and ILAAP proportionate to the size and nature of the bank's business?

Integration with the business strategy

- Are ICAAP and ILAAP processes integrated with the business strategy of the Bank?
- Do the bank's risk appetite and risks identified reflect the business model, and are the parameters and results emanating from the ICAAP and ILAAP processes integrated into business decision making?
- Are ICAAP and ILAAP therefore used as management tools and not simply as regulatory documents?

Assumptions and key parameters

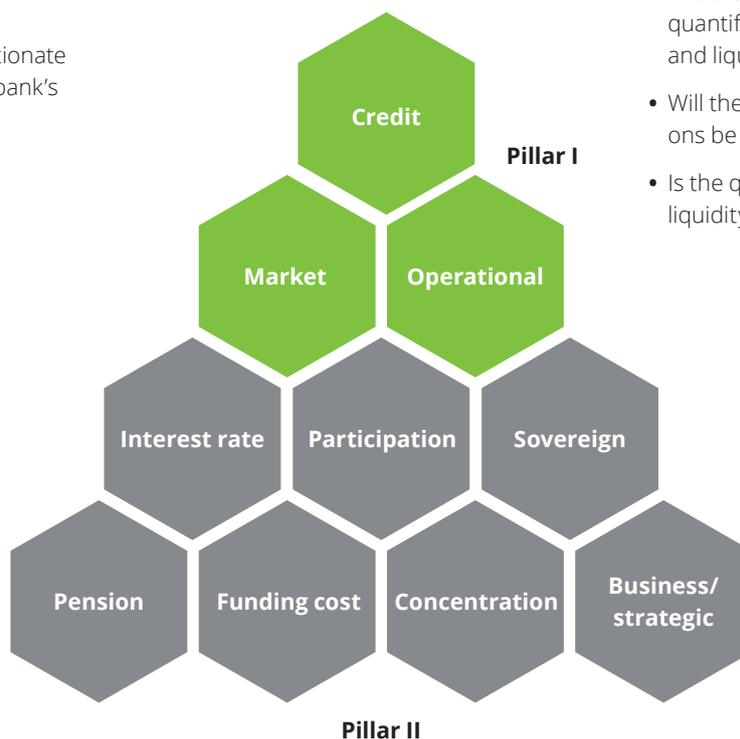
- Are assumptions and key parameters in line with risk appetite, market expectations, business model and risk profile?

Internal stress testing

- Are the scenarios and approach tailored to the institution's vulnerabilities?
- Do they result from its business model and operating environment?

Impact of risks and stress testing on capital and liquidity

- Are the results of the ICAAP and ILAAP quantified in the form of Pillar 2 capital and liquidity add-ons?
- Will the Pillar 2 capital and liquidity add-ons be acceptable to the ECB?
- Is the quality of available capital and liquidity sufficient?



For further information contact:

Mark Micallef

Risk Advisory - Banking Leader
mmicallef@deloitte.com.mt
+356 23432000

Berik Satpayev

Risk Advisory - Senior Manager
bestapayev@deloitte.com.mt
+356 23432000

Peter Galea

Risk Advisory - Assistant Manager
pgalea@deloitte.com.mt
+356 23432000

www.deloitte.com/mt
info@deloitte.com.mt
+356 23432000



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