



ICAAP AND ILAAP in the SREP framework

Deloitte Malta
Banking



Introduction to SREP guidelines

Key elements

On July 7 2014, the EBA published a consultation paper on guidelines for common procedures and methodologies for the Supervisory Review and Evaluation Process (SREP) under Article 107 (3) of Directive 2013/36/EU (CRD IV).

The guidelines are addressed to NCAs and cover all aspects of SREP.

Final guidelines

The consultation closed on 20 October 2014 and responses were subsequently published on the EBA website. The final guidelines which were published in December 2014, and have been applicable since 1 January 2016, include guidance on:

- a. Categorisation of institutions
- b. Monitoring of key indicators
- c. Business model analysis
- d. Assessment of internal governance and institution-wide controls
- e. Assessment of risks to capital
 - Assessment of inherent risks and controls
 - Determination of own funds requirements and stress testing
 - Capital adequacy assessment
- f. Assessment of risks to liquidity and funding
 - Assessment of inherent risks and controls
 - Determination of liquidity requirements and stress testing
 - Liquidity adequacy assessment
- g. Overall SREP assessment
- h. Supervisory measures
 - Quantitative capital measures
 - Quantitative liquidity measures
 - Other supervisory measures
- i. Early intervention measures

Overarching observations

A comprehensive, structured framework

- The guidelines have a broad sweep and significantly expand the scope of a traditional SREP exercise by proposing a structured approach to the SREP.
- Supervisors are expected to assess and score individual elements of the SREP on a scale of 1 to 4. The score is based on risk assessment and the firm's ability to manage and mitigate such risks.
- An overall score is provided to each firm (1-4 and 'F' representing likelihood of failure).
- Supervisors are also expected to conduct a comprehensive analysis of the business model and internal control framework.

Articulation of firm-specific capital requirements

- The guidelines introduce a 'Pillar 1 Plus' approach for the NCAs.
- They introduce the concepts of Total SREP Capital Requirements (TSCR) and Overall Capital Requirement (OCR) which will be fundamental to the assessment of capital adequacy.
- The guidelines set expectations relating to composition of capital for Pillar 2 risks.
- EBA expects firms to operate above both P1 and P2 capital requirements under stressed conditions. This effectively crystallises the nature of P2 requirements as being binding constraints rather than being 'guidance'.

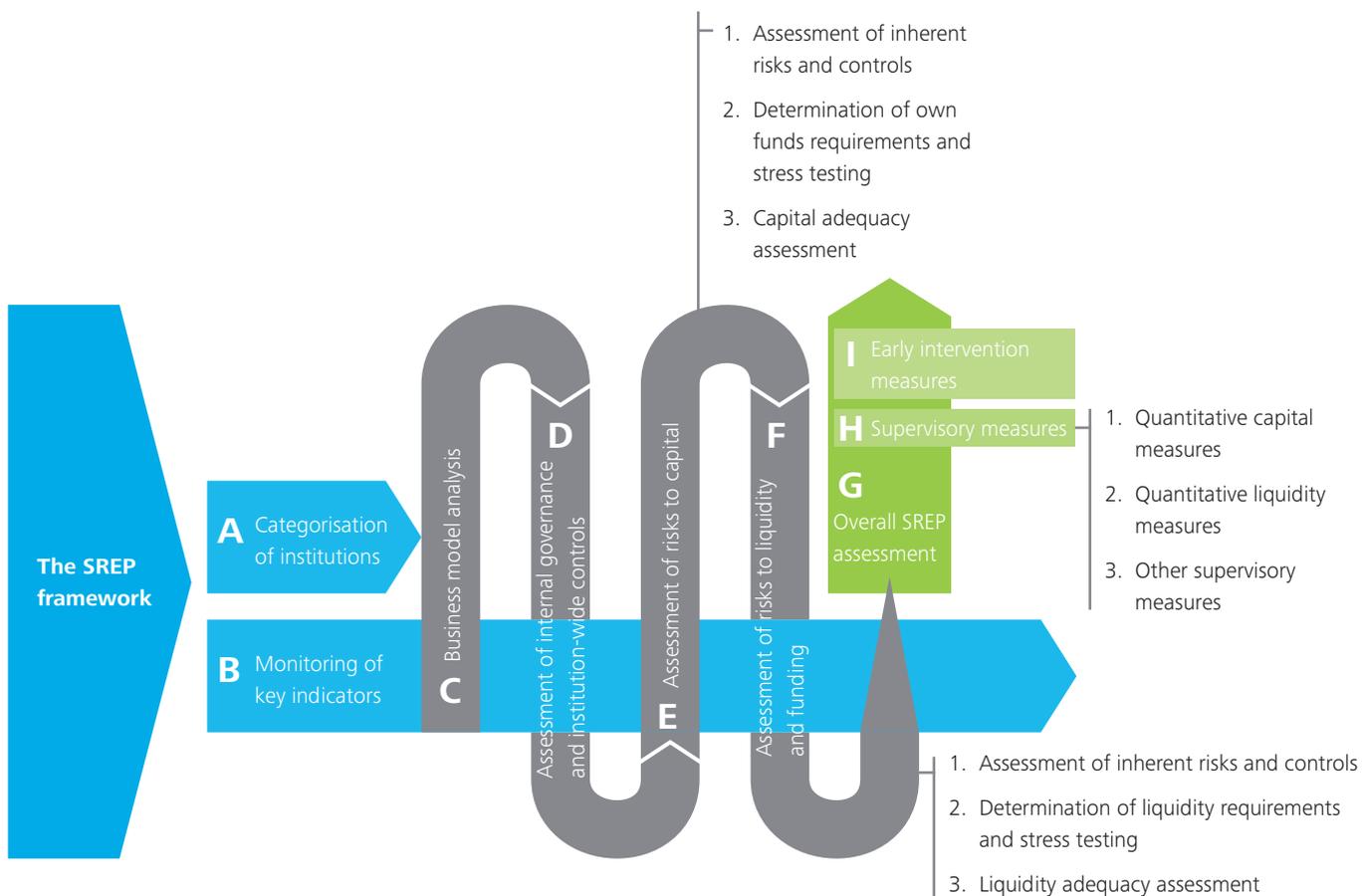
Integration

- Firms are expected to articulate the linkages between their ICAAP, liquidity assessments and recovery and resolution plans. In addition, firms should evidence linkages between their overarching business model, business strategy and plans and top-down and bottom-up assessments of risk.
- The scope of the SREP has been expanded to cover the assessment of institutions' viability.
- Through the overall SREP score, supervisors can determine firms' viability and consequent likelihood of failure which can inform the requirements arising from EBA's Recovery and Resolution Directive (2014/59/EU).

SREP framework

Review of ICAAP and ILAAP in the SREP context

Representation of the SREP, which will be applied in 2016



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:

1. The evaluation of the viability of the business model on a year time horizon;
2. The evaluation of the sustainability of the strategy in the next three years;
3. 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:

1. To guarantee that the governance model and the implemented controls are adequate to the risk profile, business model, size and complexity of the bank;
2. 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.

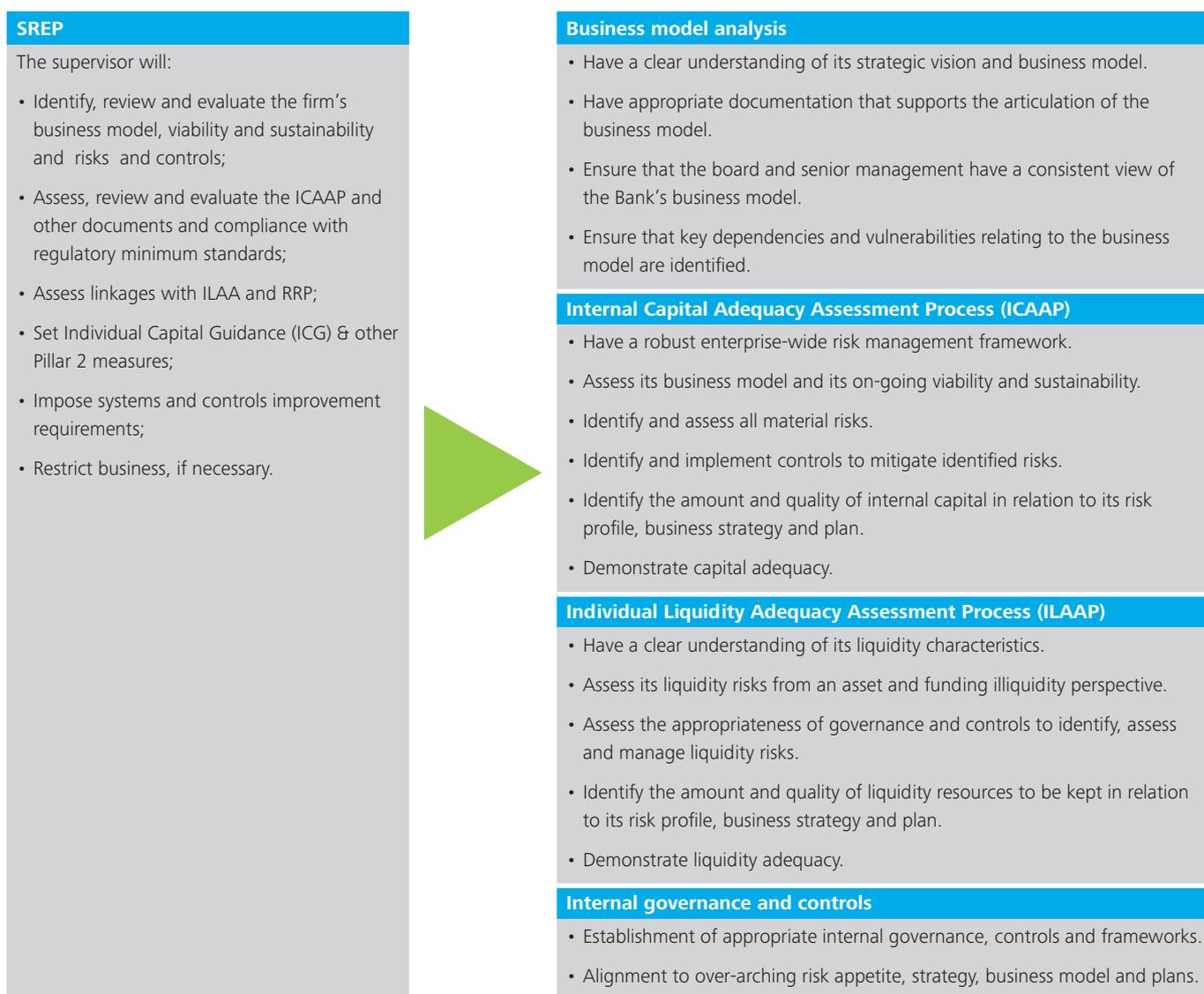
It will use as its main tool the bank's ILAAP and it can result in specific measures to comply with the liquidity requirements previously defined.

Introduction to Pillar 2 Components

SREP

Conceptual understanding of SREP and ICAAPs

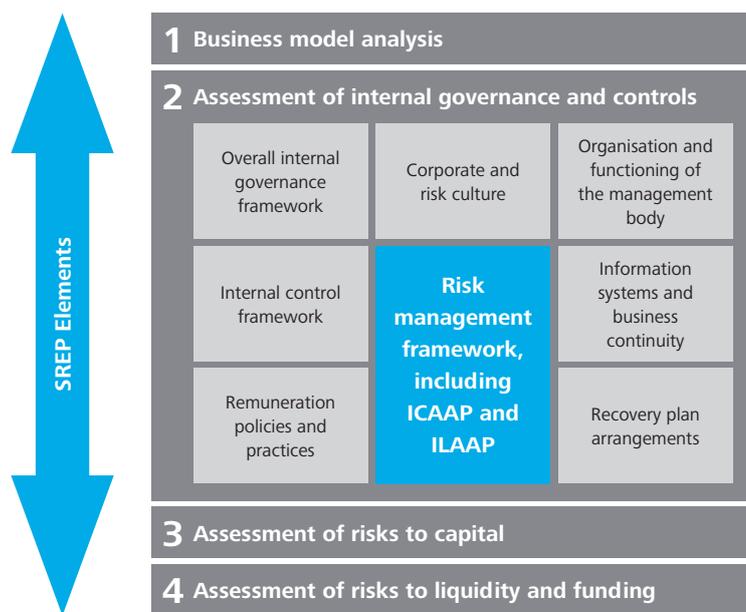
Pillar 2 is not merely a simple capital adequacy assessment. It combines institutions' Internal Capital Adequacy Assessment Process (ICAAP) and supervisors' SREP. The ICAAP (performed by the bank) is an internal risk based assessment of capital requirements and resources, whilst the SREP (performed by the regulator) is a review and challenge of the ICAAP and underlying processes. Under the EBA guidelines, the scope of the SREP has considerably widened to include many other elements: including business model analysis, Individual Liquidity Adequacy Assessment Processes (ILAAPs), internal governance and controls.



Board and senior management should consider that ICAAPs and other related documents are not merely compliance exercises – they represent a holistic assessment of the bank's risks and capital and liquidity requirements on a current and projected basis under normal and stressed conditions and should be integrated with the bank's strategy, risk appetite and operational management.

SREP framework

Where do ICAAP and ILAAP come in?

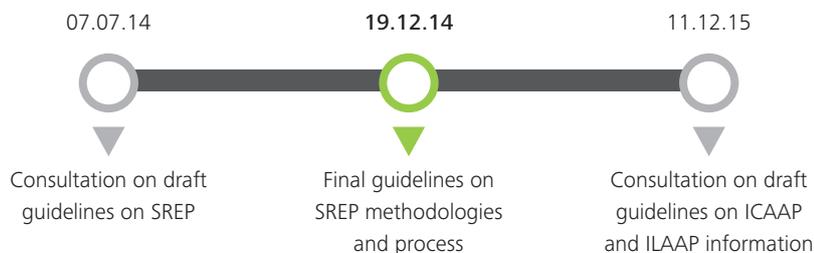


What is SREP?

- 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 & ILAAP come in?

- As part of SREP, competent authorities will assess the ICAAP and ILAAP on the basis of:
 1. **Soundness:** are policies and processes appropriate for maintaining an adequate level of capital and liquidity to cover risks to which the institution is exposed?
 2. **Effectiveness:** to what extent is ICAAP and ILAAP embedded in decision-making?
 3. **Comprehensiveness:** are all business lines, legal entities and risks covered?



SREP framework

SSM expectations on ICAAP and ILAAP

Integration with the business strategy

Institutions are expected to have their ICAAP and ILAAP processes intertwined with the business strategy of the Bank. Banks' risk appetite and stressed scenarios reflect the business model, and the parameters and results emanating from the ICAAP and ILAAP processes should be used for business decision making. ICAAP and ILAAP will therefore be used as management tools not simply regulatory documents.

Governance

Institutions should produce at least once per year, a clear formal statement on their capital adequacy supported by an analysis of ICAAP outcomes, approved and signed off by the management body.

General design

The shorter term perspective must be complemented by a longer term (usually at least a three-year horizon) forward looking process.

ICAAP perspective

Institutions are expected to implement a proportionate ICAAP approach aimed at the survival of the institution.

Risks considered

Institutions are responsible for implementing a regular process for identifying all material risks, as shown opposite.

Definition of internal capital

This has to be consistent with the ICAAP perspective on capital needs. The SSM pays particular attention to the quality of capital.

Assumptions and key parameters

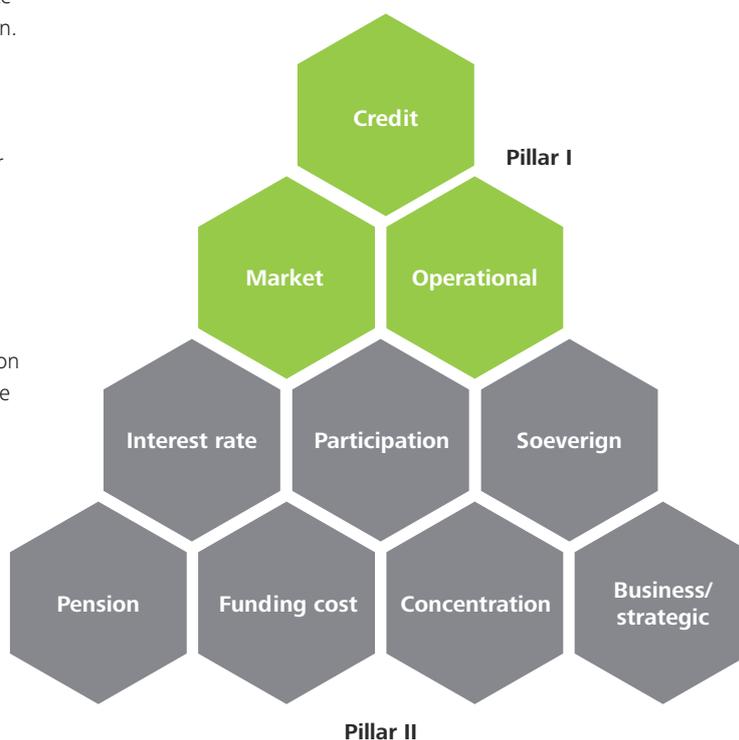
These should be set in line with risk appetite, market expectations, business model and risk profile.

Inter-risk diversification effects

Institutions should be transparent and produce gross figures in addition to net figures.

Severity level of stress tests and stress testing scenario definition

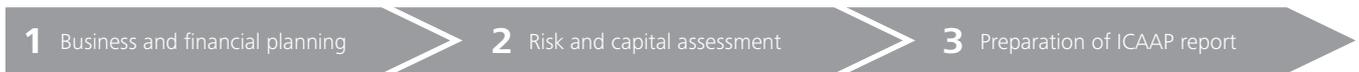
Scenarios have to be tailored to the institution's vulnerabilities resulting from its business model and operating environment. At least once a year, institutions shall perform an in-depth review of their vulnerabilities.



How can
Deloitte assist?

The Deloitte phased approach to ICAAP

Through our granular understanding of regulatory expectations we are able to assist you in the development of your ICAAP process

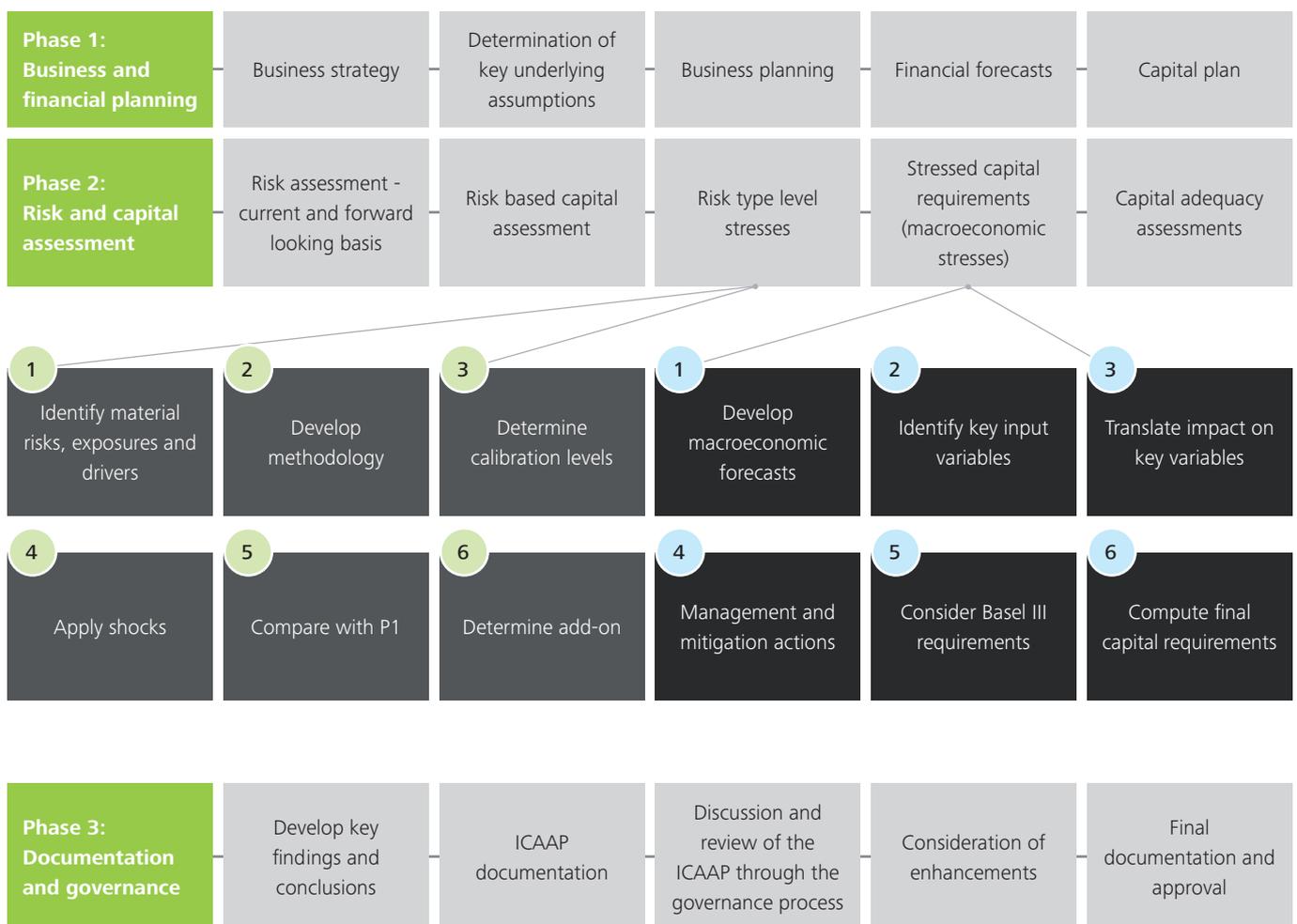


Phase	Description	Key Deliverables
Phase 1	<ul style="list-style-type: none"> • Discussion on business strategy and determination of key underlying assumptions; • Discussion of assumptions, gaps and improvements; • Collection and analysis of information about current methodologies; • Review of the models and development of new models (where applicable) that consider both quantification of risks and aggregation of risks; • Assist in business plan and financial forecasts. 	<ul style="list-style-type: none"> • Financial statements (balance sheet and profit and loss); • Capital plans.
Phase 2	<ul style="list-style-type: none"> • Risk assessment – current and forward looking basis; • Risk based capital assessment; • Review of the calculations and simulations for the quantification and aggregation of risks, including risk-type level stresses and stressed capital requirements (macroeconomic stresses); • Documentation of the results; • Capital adequacy assessment. 	<ul style="list-style-type: none"> • Determination of capital requirements and resources; • Stress test results assessment; • Capital adequacy assessment.
Phase 3	<ul style="list-style-type: none"> • Develop key findings and conclusions; • ICAAP documentation, including improvements on the models and the report; • Discussion and review of the ICAAP through the governance process; • Consideration of enhancements; • Final report and approval. 	<ul style="list-style-type: none"> • Final ICAAP report; • Regulatory discussions.

ICAAP development and integration to SREP

ICAAP process overview

Through our granular understanding of regulatory expectations we are able to assist you in the development of your ICAAP process.



The Deloitte phased approach to ILAAP

We can assist you to face the challenges the integration of the ILAAP process introduced in 2016.



Phase	Description	Key Deliverables
Phase 1	<ul style="list-style-type: none"> Conduct a detailed review of the bank's liquidity risk management framework to identify any inconsistencies/gaps with Basel Principles, regulatory guidelines (including SREP) and a benchmark peer bank European ILAAP; Highlight specific areas within each of the bank's liquidity policy documents which need to be enhanced to address any gaps identified including suggested language and quantitative metrics; Discuss high level ILAAP structure and flow. 	<ul style="list-style-type: none"> Expanded Deloitte high level review report
Phase 2	<ul style="list-style-type: none"> Review key liquidity risk drivers and liquidity stress testing scenarios, identifying any required enhancements; Assist in expansion of quantitative analysis including proposing new liquidity risk metrics (if required); Assist in assessment of adequacy of risk appetite and contingency funding plan; Assist in assessment of supporting rationale for key liquidity metric thresholds and limits; Assist in assessment of the level, quality and process for determination of the liquidity buffer. 	<ul style="list-style-type: none"> Summary document covering recommendations for enhancement of the quantitative liquidity framework and stress scenarios including a roadmap to determine liquidity buffer
Phase 3	<ul style="list-style-type: none"> Finalise ILAAP document format; Draft ILAAP document (including identifying any supporting documentation) and ensure it meets requirements as identified; Independent challenge of final draft and production of ILAAP document for management sign off. 	<ul style="list-style-type: none"> Final ILAAP Report

ILAAP development and integration to SREP

ILAAP process overview



ILAAP development and integration to SREP

We can assist in developing and integrating your ILAAP process along with leading market practice.

- Within the SREP related to the implementation of CRR/CRD IV ('Basel III'), the ILAAP is introduced as a new assessment process complementary but distinct to the ICAAP, with the view of strengthening the robust management of liquidity risk
- ECB considers ICAAP and ILAAP as management tools not regulatory reports, and will evaluate the business plan and operation of the bank based on how well they are integrated in SREP
- Integration does not relate only to risk management but also to commercial strategy. How are for example ICAAP and ILAAP interacting with RWA calculation methodology, credit risk and product pricing?
- The ILAAP will be reviewed and scored by competent authorities in the context of the SREP's risk assessment, in parallel with the review and assessment of the ICAAP and other institution's organisational aspects
- Weak scores in the SREP whether linked to ILAAP, ICAAP or other aspects of an institution are expected to lead to additional capital and liquidity requirements, requests for qualitative adjustment of the business model or other sanctions

Key benefits from ILAAP

- ILAAP greatly increases consistency between the strategy of the bank and operational processes. A liquidity risk appetite is defined on a strategic level and translated into qualitative statements and risk metrics at an operational level;
- ILAAP meets the expectations of the regulator on banks' liquidity risk management;
- ILAAP gives an overview of the liquidity risk on a bank-wide consolidated level. (Possibility to analyse the impact of stress scenarios on its consolidated, group-wide, and individual entities);
- ILAAP produces a clear publication improving transparency of the banks' liquidity risks to regulators;
- ILAAP provides a systematic approach to assess liquidity risks and to decide on additional risk controls required. The bank can execute an internal assessment of how liquidity risk is managed and check if the required minimum level of liquidity risk is maintained;
- ILAAP evaluates the suitability of the current liquidity profile of the bank and the level of actual liquidity expressed in absolute amount, ratios and limit breaches, etc.

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