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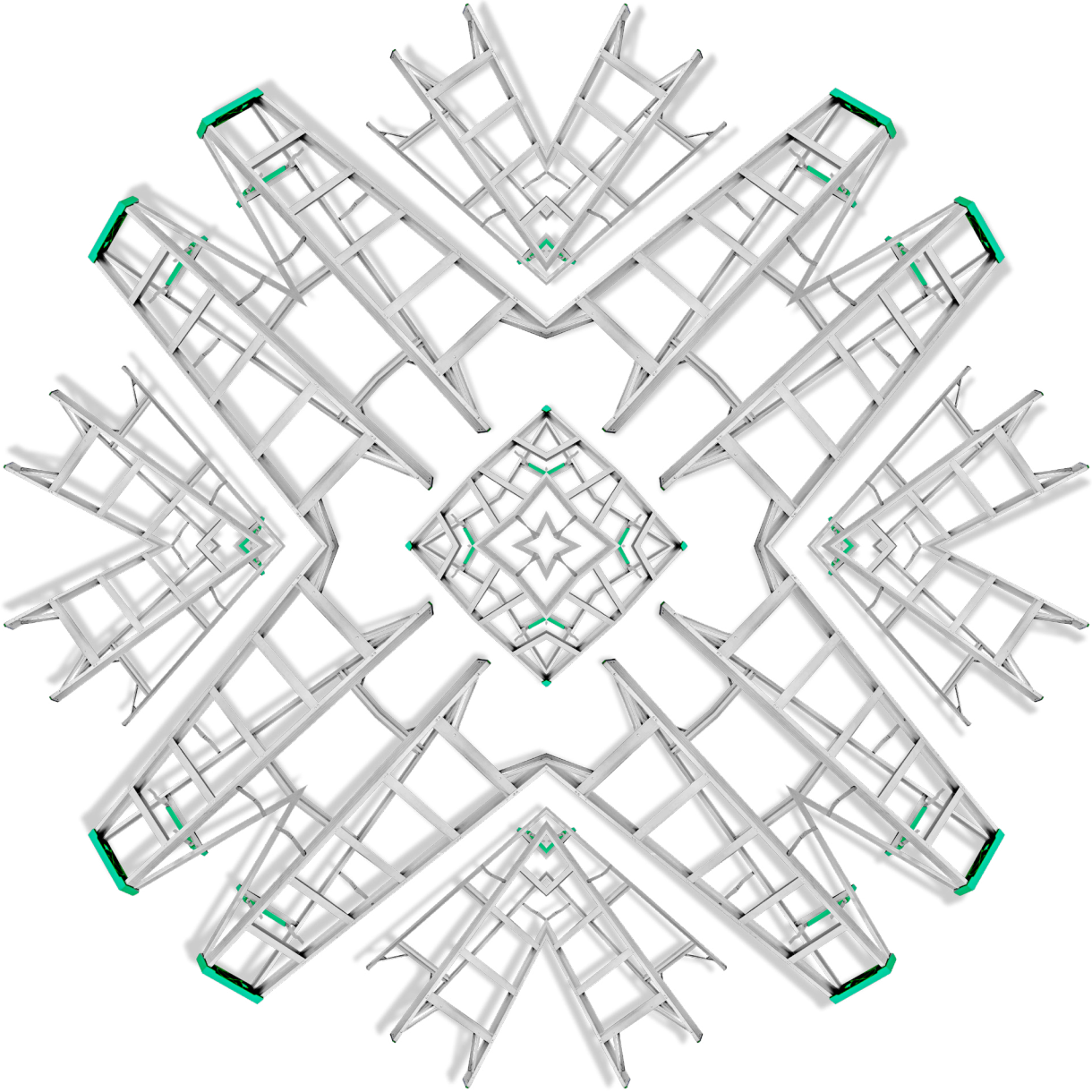


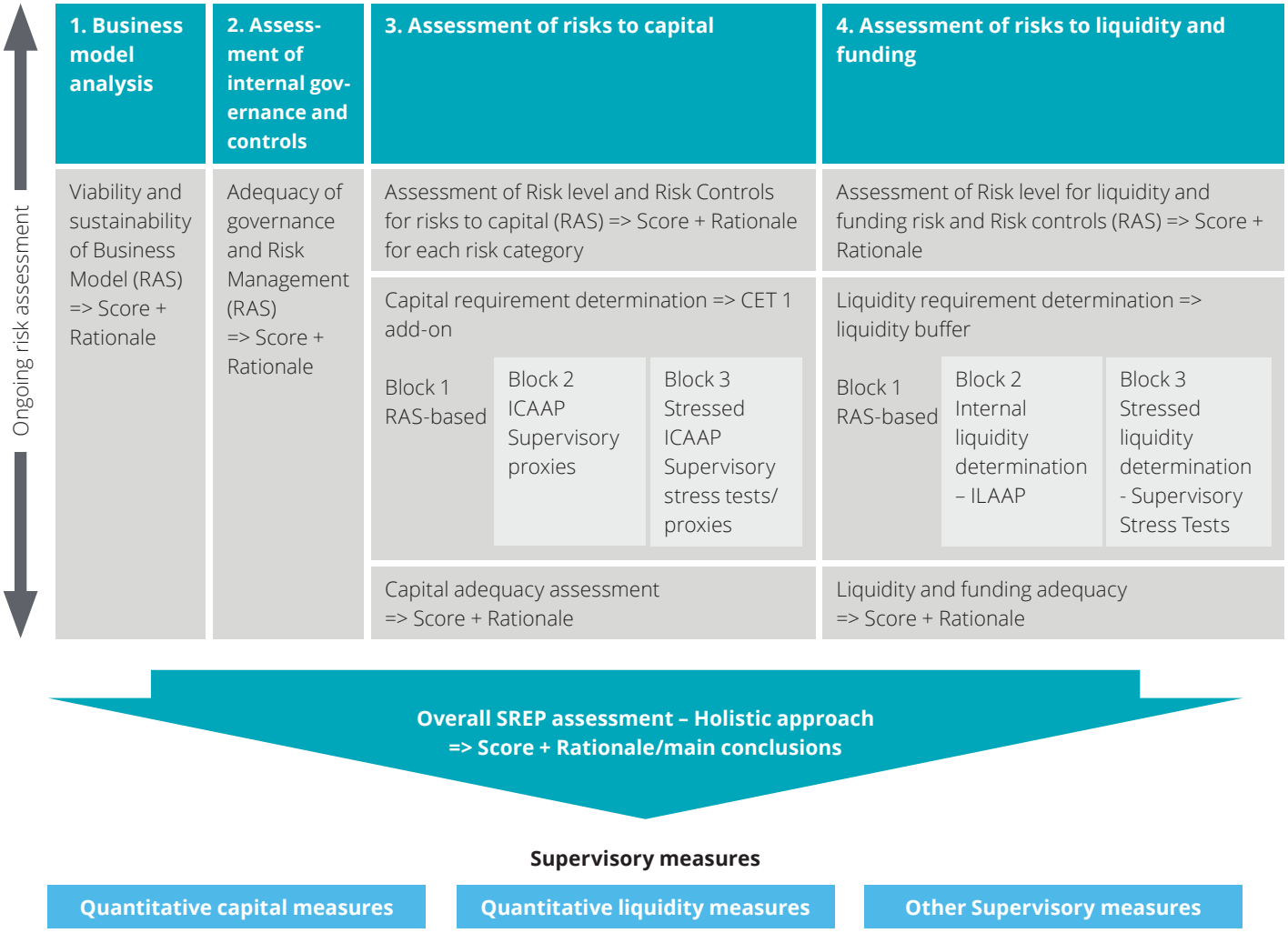
SREP Transformation

The Deloitte approach

Deloitte Malta
Risk Advisory - Banking

Risk Advisory

SREP Decoded



SREP Priorities for 2018

"Among the key risks identified, business model and profitability risk is 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.

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

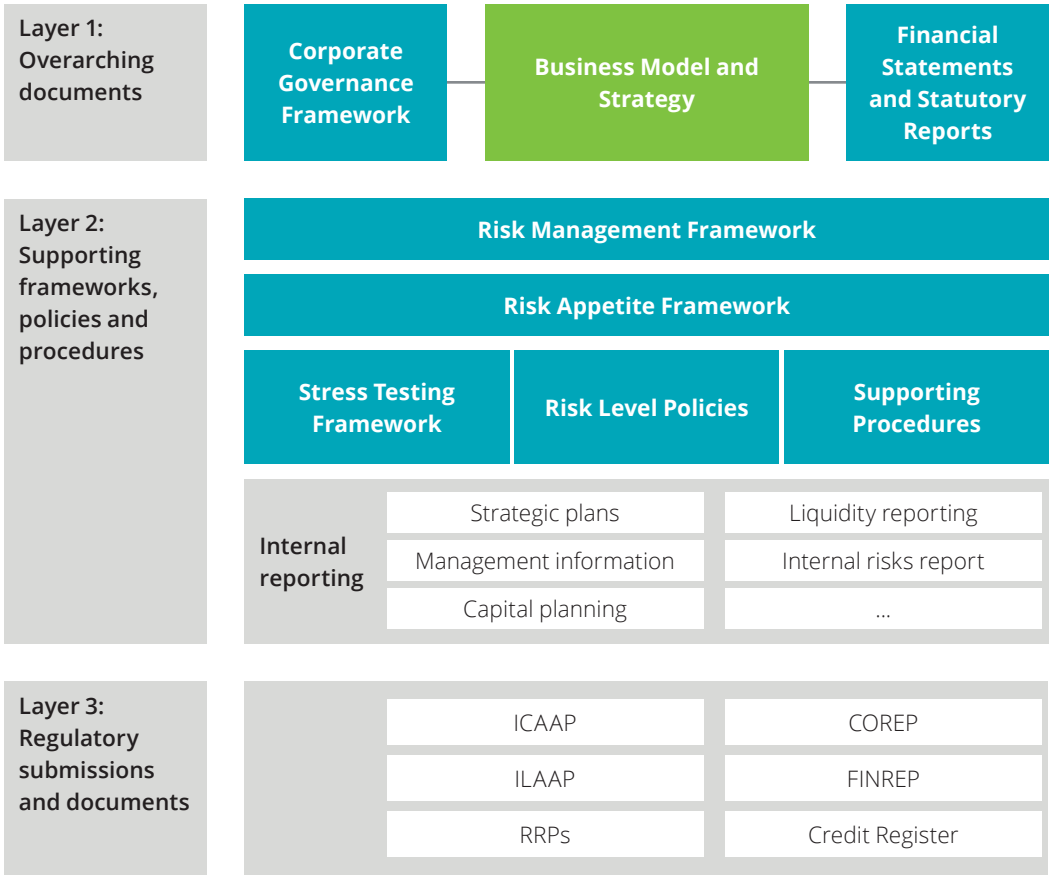
The guidelines hinge on four main components:

- 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

Outlining its SREP priorities for the year, the ECB put banks' business models and profitability at the top of the list

Scrutiny around the Bank's business model

"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

Viability and sustainability are the main supervisory challenges

- Business model analysis is core to the new paradigm of forward-looking, judgement-based supervision

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.
- 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.

However:

- Supervisors' time horizon is different.
- Supervisors' perspectives on risk appetite are different to those of banks.
- Supervisors will look at the bank in its own right and in terms of the risks to the system.

While supervisors will never "approve" a business model, there is a fine line between "approval" and "assessment", particularly when a supervisor identifies concerns about a bank's business model.

The assessment will be detailed, specific and tangible

- What is the main operational model of your bank? Are you a lender? What is your role as a bank? Justify the size of your investment book vs the size of your loan book.
- How aligned are RAF, ICAAP and ILAAP with your commercial strategy? Are you incorporating ICAAP and ILAAP in your pricing strategy?
- How aligned are your deposit and lending rates to ECB rates, LIBOR, EURIBOR. Is the spread sustainable?
- How do you support your commercial assumptions on growth or profitability? What is the source of your market intelligence?
- Do you have sufficient and skilled resources to implement your strategy?
- How aligned is your Risk Appetite Framework, with your ICAAP/ILAAP, your Recovery Plan? How is that supported from an internal governance point of view?
- How effective is your cyber risk strategy? How effective is your AML strategy?
- Can your systems support the strategy? Can your systems support regulatory reporting? Are your systems flexible enough to adjust to increasing data management requirements? What is your IT strategy?

The Deloitte approach

Elements	Gap Analysis	Remediation
01. Feasibility 02. Sustainability 03. Alignment	Challenge management with mock supervisory interviews on key management. Provide EMEA-wide lessons learned and identify gaps.	

Assess compliance of internal governance and control

"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

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

The Deloitte approach

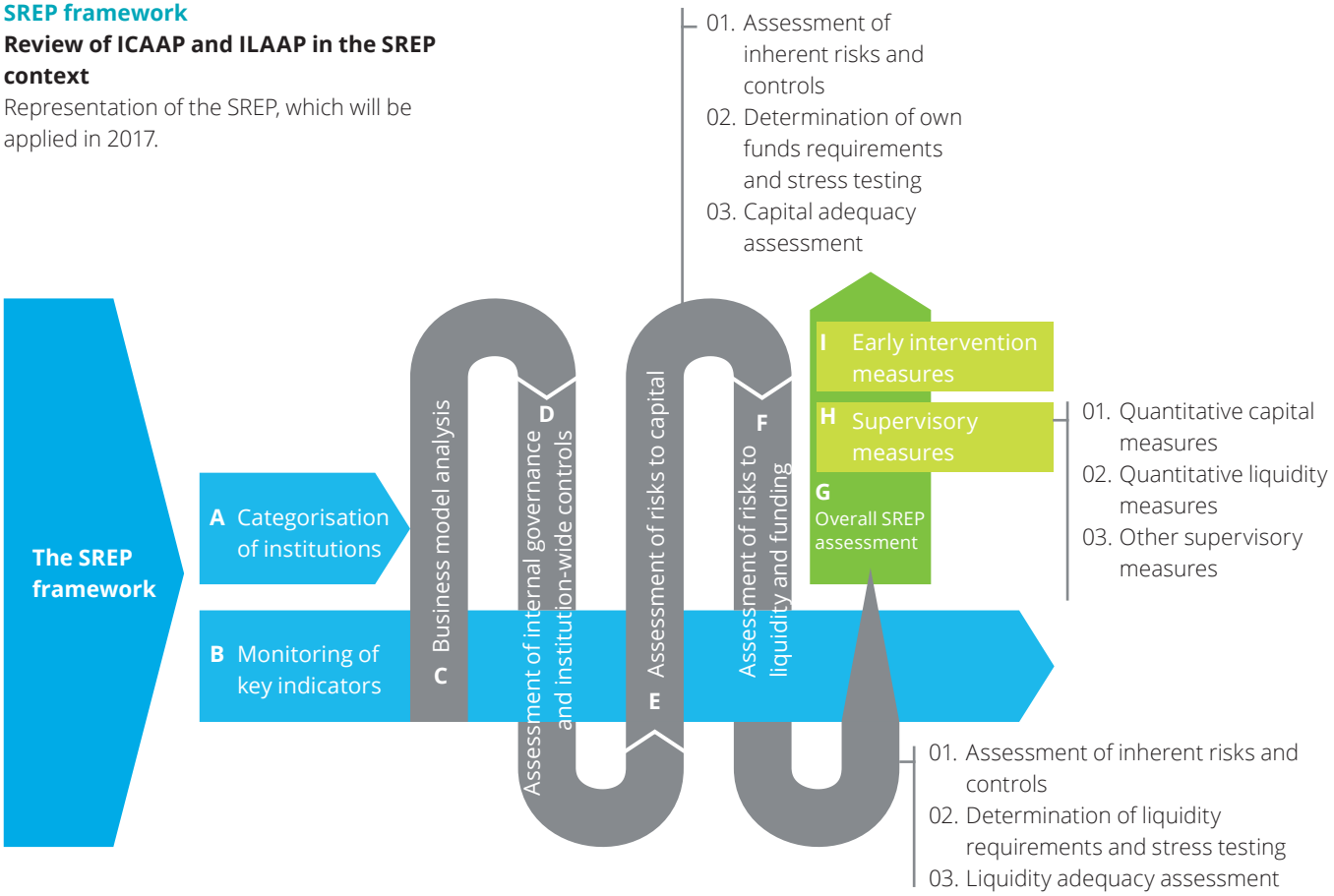
Elements	Gap Analysis	Remediation
01. Overall governance framework 02. Corporate and risk culture 03. Organisation and functioning of management body 04. Remuneration policies and practices 05. Internal control framework 06. Risk management framework 07. Information systems and BCP 08. Recovery planning arrangement	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. Assess the degree to which the institution adheres to the requirements and standards of good internal governance and risk controls arrangements.	

Scrutinise internal capital stress test and internal liquidity stress test

SREP framework

Review of ICAAP and ILAAP in the SREP context

Representation of the SREP, which will be applied in 2017.



B 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).

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.

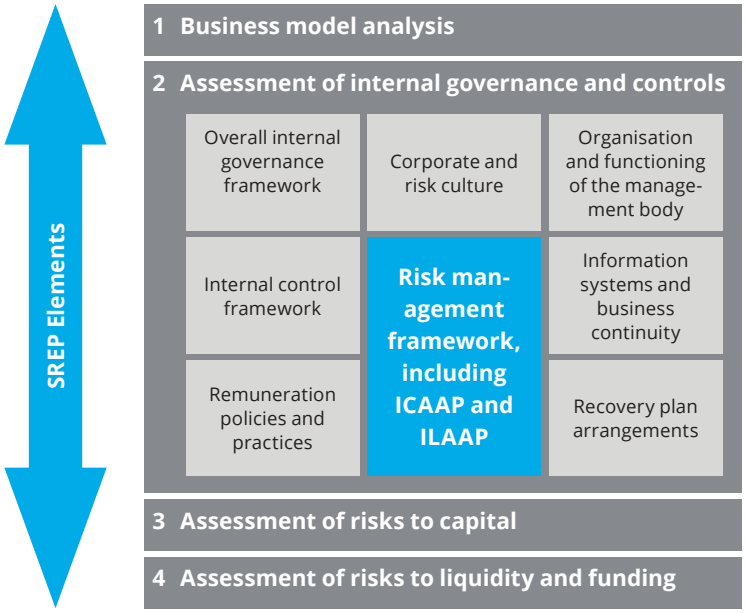
This evaluation will use the bank's ICAAP as its main tool. The output will then be used to determine the adequate capital levels.

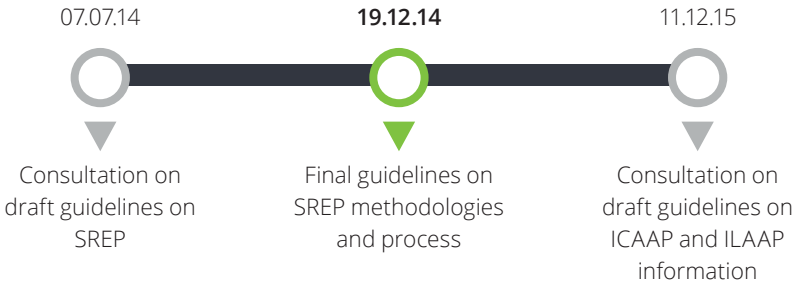
F Assessment of risks to liquidity and funding

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

Elements	Gap Analysis	Remediation
01. Capital 02. Liquidity	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.	

SSM expectations on ICAAP and ILAAP

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.

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.

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.

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A decade of continuously evolving regulations have placed a significant compliance burden on the banking sector. This has not only driven up costs, it has also hampered the ability of banks to respond to customer needs.

But if you view risk as a value creator, then you can see the opportunity to streamline and automate many aspects of the compliance process, creating a cost advantage. Banks that view risk as a driver of performance can use this cost advantage to not only attract new customers through competitive pricing, but they can also leverage the capital unleashed by this cost advantage to invest in their future prosperity.

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