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The ECB-SSM's new draft supervisory "Guide" on models used to assess counterparty credit risk and set regulatory capital levels

How does this further ECB-SSM "Guide" impact model governance for direct ECB-supervised and other Banking Union Supervised Institutions (BUSIs)?

On 15 December 2017, the European Central Bank (**ECB**), acting in its supervisory role within the Banking Union's Single Supervisory Mechanism (**SSM**), launched a consultation[1] on a draft "Guide on assessment methodology - assessment methodology for the IMM and A-CVA". This Guide is shortened by the ECB and herein as **EGAM**[2]. EGAM is the latest and perhaps most revealing attempt by the ECB-SSM to advance a very technical part of the EU Single Rulebook for the BUSIs it supervises. It also builds on existing efforts to streamline that Single Rulebook in how it is applied by the ECB-SSM in the Eurozone and its Banking Union.

Although EGAM pertains to some highly detailed rules in terms of model governance, the independence of model validation, the permitted use of third-parties in relation to models and very detailed descriptions of how compliance will be supervised, the real story here concerns the governance that the ECB-SSM expects BUSIs to employ in connection with the use of models. This Client Alert provides an overview of EGAM's content, how its supervisory objectives fit within the EU's Single Rulebook, as applied within the Banking Union and some preparatory steps that BUSIs might want to consider as "no regret actions".

Even if EGAM is only under consultation, and will be subject to some revision before final guidance is published at the end of 2018 and the 2019 supervisory cycle starts:

1. areas of focus for governance are unlikely to change;
2. principles of governance contained in EGAM are likely to apply to far broader set of models than those for measuring counterparty credit risk; and
3. EGAM's principles may ultimately apply to a wider range of BUSIs than just those that are currently subject to direct ECB-SSM supervision,

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[1] The EGAM consultation closes on 31 March 2018 with a further round due to follow in the latter half of 2018. EGAM is the ECB-SSM's second supervisory guide on counterparty credit risk and once final will apply to a range of workstreams within BUSIs.
[2] See: https://www.bankingsupervision.europa.eu/banking/letterstobanks/shared/pdf/2017/ssm.egam_guide_draft.en.pdf

EGAM's content is very technical. However, its supervisory tone is quite clear and communicates very comprehensive principles on what the ECB-SSM expects in terms of model governance the independence of model validation, the permitted use of third-parties in relation to models and very detailed descriptions of how compliance will be supervised. Despite EGAM being drafted as "non-binding guidance" a lot of the content and the "supervisory expectations" do however read like rules and contain detailed qualitative as opposed to just quantitative measures.

Whilst most BUSIs will be familiar with EGAM's concepts, including how to embed them within their relevant operations, the prescriptive detail of what the ECB-SSM expects of BUSIs may merit some to review how their policies, processes, procedures and personnel rank in comparison. Given that certain model and/or governance changes require supervisory pre-approval, in addition to firms undertaking extensive enterprise-wide change management and governance workstreams, some of the remedial or preparatory action might prompt early action. Some of this might also be started whilst EGAM is being finalised during 2018 ahead of the 2019 SSM supervisory cycle.

So how does EGAM fit in to the bigger Banking Union picture?

As EU credit institutions BUSIs require supervisory approvals for new risk models as well as for material extensions and/or changes to credit, operational and market risk models. Those requirements stem from the CRR/CRD IV Framework. The ECB-SSM has streamlined the CRR/CRD Framework, as applied in the Banking Union, by completing a national options and discriminations elimination (**NODE**)[3] exercise. NODE aims to level the playing field amongst BUSIs and thus helps deliver on the objective of making the Single Rulebook more "single" and supported by a single supervisory culture. EGAM contributes to that harmonisation.

Building upon work of the European Banking Authority, EGAM specifically focuses on what the ECB-SSM will use as "assessment methodology"[4] when checking or approving the use of internal models for those BUSIs for which it is the lead prudential supervisor. The internal models that EGAM focuses on are "IMM" and "A-CVA". These are also used to calculate the counterparty credit risk exposures in relation to over-the-counter derivatives and securities financing activities and the amount of relevant regulatory capital that BUSIs must hold.

To briefly recap, IMM refers to the Internal Model Method. BUSIs must demonstrate that they have rigorous and robust arrangements in place prior to requesting supervisory approval to use the IMM when calculating regulatory capital requirements in relation to counterparty credit risk exposures in derivatives and securities financing transactions. A-CVA refers to the Advanced Credit Valuation Adjustment[5] approach. CVA is often viewed as representing the "price of counterparty credit risk" as it is dependent on counterparty credit spreads as well

[3] EGAM refers to NODE as ECB-Guide on Options & Discretions or "EGOD".
[4] This term is explained in EGAM's draft operative provisions as "… "assessment methodology" refers to the methodology and measures for obtaining a sufficient level of information as a basis for supervisory decisions – especially for approvals of internal models, their material extensions and material changes – regardless of whether this information is received during onsite or off-site internal model investigations, supervisory meetings on model issues, documentation requests or any other inquiry into the model for another purpose in the scope of ECB's supervisory activities."
[5] CVA itself is defined in Art. 381 CRR as "…an adjustment to the mid-market valuation of the portfolio of transactions with a counterparty [which] reflects the current market value of the credit risk of the counterparty to the institution, but does not reflect the current market value of the credit risk of the institution to the counterparty."

as the market risk factors that drive derivatives' values and thus exposure. A-CVA is one permitted method used to calculate the adjustments to the fair value (or price) of derivative instruments to account for counterparty credit risk. To the extent a BUSI is permitted to use the IMM for relevant transactions it must use the A-CVA as opposed to the standardised CVA risk capital charge approach[6].

The draft version of EGAM follows on from steps that culminated in the publication of a final guide referred to as "EGMA"[7], which was published 25 September 2017 and which is now in force (**EGMA-1**). EGMA-1 provides "guidance" and supervisory expectations on how model extensions and changes should be assessed and treated by BUSIs as being either material or non-material. The assessment of materiality determines whether a supervisory notification or approval is required. Both of the "guides" should be read in conjunction one another, especially as EGAM builds upon and cross-refers to content of in EGMA-1.

EGAM and EGMA-1 also complement other ECB-SSM's actions including the:

- on-going work on the Targeted Review of Internal Models (**TRIM**)[8];
- 2018 supervisory cycle;
- 2018 supervisory priorities plus the changes to the Supervisory Review and Evaluation Procedure (**SREP**) methodology[9];
- concurrent roll-out of the ECB-SSM's application of SREP to ca. 5,500 legal entities that are categorised as "less significant institutions" (**LSI**s)[10]; and
- on-going work to finalise its "Supervisory Guide to on-site inspections and internal model investigations"[11] (the **OSIIM Guide**).

At present EGAM and EGMA-1's current scope of application applies to those BUSIs that are, for Banking Union purposes, categorised as "Significant Credit Institutions" (**SCIs**)[12]. Firms that are SCIs are subject to direct supervision by the ECB-SSM. As with other ECB-SSM regulatory action as well as the rolling-out of supervisory tools, there is a possibility that this "guide" could be expanded and be applied to LSIs.

How does EGAM fit in with the Single Rulebook, as applied in the Banking Union?

The actual operative provisions of EGAM are set out in Section 4 of the consultation document. Running to 11 Chapters and close to 70 pages, the operative provisions are detailed, perhaps more detailed than EGMA-1. They also cross-reference to a range of other EU legislative instruments, as amended for use in the Banking Union.

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[6] See Art. 383 CRR.
[7] See our coverage in: http://www.bakermckenzie.com/-/media/files/insight/publications/al_germany_ecbssmtightemssupervisory_oct17.pdf?la=en
[8] which runs to 2019 and possibly beyond.
[9] See our coverage in: http://www.bakermckenzie.com/en/insight/publications/2017/12/ecb-ssm-new-srep-methodology
[10] For Banking Union supervisory purposes SCIs are subject to direct ECB-SSM supervision and LSIs are subject to indirect ECB-SSM supervision but direct supervision by the relevant national competent authorities (**NCA**s).
[11] See our coverage in: http://www.bakermckenzie.com/-/media/files/insight/publications/2017/08/al_germany_consultationlaunched_20170810.pdf
[12] ca. 119 firms representing 85% plus of balance sheet AUM in the Eurozone's banking sector.

In the absence of a compiled copy of the CRR/CRD IV Framework, as amended by EU and/or NODE driven changes, affected market participants will be facing a Rulebook that perhaps looks and feels less single than what policymakers are aspiring it to be. It remains to be seen whether the ECB-SSM would, as it has done in respect of other rules and/or supervisory guides, publish a consolidated i.e., "recast" version of how these core fundamental rule, as modified and supplemented are to be applied. With all the tailoring that the ECB-SSM has added to EU banking sector legislation, which itself has already been tweaked by other EU and/or national supervisory authorities, many market participants might find a recast version rather welcome.

Whilst EGAM aims to provide harmonised clarity in relation to the specific scope of what it covers in the Banking Union, it needs to be read with an array of other materials. Moreover, the majority of SCIs are globally active. They may want to consider, as suggested in our coverage on EGMA-1, how these ECB-SSM specific changes impact their global and not just their Banking Union focused business activity. For some firms, this might mean structuring model design, governance and validation processes more formally. It may also mean delineating these more by jurisdiction specific requirements rather than enterprise-wide. For a number of firms this might involve careful timing as documentation changes and reworking organisational arrangements may also have a range of spillover effects.

To further complicate matters, administrative timelines, certainly within the SSM, are likely to be protracted due to available resources being under "business as usual" stress, the 2018 scheduled stress-tests and the impact on SSM-administered SREPs. That being said, there are perhaps some immediate steps that affected firms may wish to take in relation to EGAM's 11 Chapters irrespective of how and when the final version is published and when it begins to apply.

So what can BUSIs do now?

Some of these key takeaways from EGAM's 11 Chapters include the following possible steps or actions for any multi-disciplinary and multijurisdictional project team within a BUSI to:

1. **undertake a self-assessment review.** That review should concentrate on how to improve and/or embed policies, processes and procedures relevant to the use and governance of models and the:

    a. design, the assessment process of and categorisation of whether model changes and/or extensions are material or non-material;

    b. internal/external approval and notification processes;

    c. the efficacy and independence of control functions as well as those specific in relation to processes relating to use and governance of models;

    d. the completeness as well as the independence of the model validation function and the relevant processes as well as the overall interoperability with existing and new governance arrangements - this builds upon what many affected firms may already be doing in respect of EGMA-1 and may involve splitting certain arrangements between those that are Banking Union and non-Banking Union compliant.

e. the decision-making audit capture process. EGAM prominently references the importance of minutes of deliberations and decisions;

f. ensuring the model relevant policies, processes and procedures and their validation are embedded in a firm's operating process and culture. The ECB-SSM will focus its supervisory scrutiny on whether compliance is being embedded across a firm;

2. **ensure relevant details are sufficiently captured in documentation.** Following the suggestions in Step 1 above, firms should ensure, that in accordance with EGAM's draft General Provision 3 (Quality and auditability of documentation), the documentation of models or aspects of them are capable of satisfying the ECB-SSM's expectations of being "…sufficiently detailed and accurate to allow for the examination of these models by third parties." EGAM's provisions clarify that "sufficient detail" must facilitate an understanding of the reasoning and procedures underlying the model development, how models operate, including their limitations and key assumptions as well as an ability to "replicate the model development"[13]. Moreover, the ECB-SSM elaborates that in respect of draft General Provision 3 it will need evidence that (and the ECB-SSM will probably aim to concentrate compliance checks on these easy to verify measures):

    a. "the documentation has been approved at the appropriate management level of the institution" - in practice, and in keeping with existing ECB-SSM supervisory standards, this will also mean that the relevant management levels should be able to evidence a suitable understanding of what has been approved and how the model operates;

    b. "the institution has policies in place outlining specific standards to ensure a high quality of internal documentation and that there is specific accountability for ensuring that the documentation maintained is complete, consistent, accurate, updated, approved and secure" - in practice this will mean, in addition to having the requisite policies, procedures and processes in place as highlighted in Step 1 above, that appropriate control function verification processes as well as restrictions on access rights ought to be reviewed as to whether these are sufficiently robust;

    c. "each item of documentation contains at least the following information: type of document; author; reviewer; authorising agent and owner; dates of development and approval; version number; and a history of changes to the document" - in practice this means establishing an appropriate system of version control, whether by using a document management system or otherwise, and

[13] This draft provision may cause some concern unless further explanations as to what it means and what it requires are inserted into EGAM.

recording details both in a centralised fashion but equally on the respective documentation itself;

d. "the institution adequately documents its policies, procedures and methodologies related to the application of the IMM and A-CVA approaches as referred to in this guide" - in practice this follows the suggestions set out in Step 1 above;

3. **confirm compliance with delegation and outsourcing standards.** EGAM's draft General Provision 4 relates to the delegation of tasks, activities or functions relating to the design, implementation and validation of internal models by a SCI to a third party. The ECB-SSM's expectations in this area build upon principles previously communicated by a range of EU and national supervisory policymakers and authorities. In summary, the ECB-SSM states that it will verify (and this could prompt action for BUSIs) whether:

    a. "the senior management and the management body, or the committee designated by it, are actively involved in the supervision of and decision making on any tasks, activities or functions delegated to a third party and of any IT risk management tool solutions obtained from third parties" - in practice most of this could be satisfied by appropriate documentation and embedding the outcomes in the firm's compliance and risk framework;

    b. "there is sufficient in-house knowledge and understanding of the tasks, activities or functions that are outsourced or delegated to third parties and of the structure of any data and methodologies obtained from a third party" - in practice this could be satisfied by ensuring appropriate checks and evidence are collected from the requisite individuals and/or third-parties;

    c. "continuity of the outsourced functions or processes is ensured, including by means of appropriate contingency planning" - again in practice this could be evidenced in relevant documentation as well evidence on the efficacy and testing of those arrangements;

    d. "neither internal audit nor any other kind of control over the outsourced tasks, activities and functions by the institution are limited or inhibited by the outsourcing" - as per the above, this could be documented and verified;

    e. "the ECB has been given the opportunity to access all relevant information including, where applicable, by initiating on-site inspections at the third party's premises." In practice this will be evidenced by an actual visit, but could in the interim also be tested with a mock visit conducted by appropriate external counsel;

4. **limit conflicts of interest arising from self-validation.** EGAM's draft General Provision 4 and in particular subparagraph 3 thereof also introduces the obligation for a relevant firm to verify and limit the ability of third-parties to self-validate the risk methodologies applied by it. In short,

the firm instructing the third-party retains the EGAM compliance obligations. Whilst it can receive relevant information from the third-party to whom it has delegated/outsourced, the firm itself must conduct any validation exercise in respect of its own actions as well as the third-party's performance. The ECB-SSM states that it will review compliance with reference to the relevant agreements and documentation, including those of the third-party;

5. **implement a viable Compliance Restoration Plan.** EGAM's provisions also recognise that from time to time a relevant firm may fall into temporary non-compliance when using the IMM for its calculations. Borrowing on existing supervisory principles, EGAM's draft General Provision 5 introduces a concept of a "Compliance Restoration Plan" in which firms detail how they plan to return to full model compliance. This plan may be reviewed by the ECB-SSM;

6. **embed IMM Implementation Plans.** EGAM's provisions on the sequenced implementation of IMM merit attention. A relevant firm will need to devise and then follow an "Implementation Plan". EGAM's draft provisions set clear supervisory expectations in that the plan must capture all counterparty credit risk exposure of the SCI, or any parent undertaking and its subsidiaries unless a permanent exemption applies and implementation needs to be justified by the applicant SCI in a manner that evidences feasibility;

7. **review robustness of model validation processes.** As with the suggestions in Step 1, EGAM's draft General Provisions 9 and 10 place specific emphasis on how the ECB-SSM will scrutinise the frequency, the depth and robustness of the model validation process (including methodology and objectives) and the independence of those involved from derivative and securities financing activity as well as the staff responsible for model design and development;

8. **deal with EGAM's specific internal governance, risk control, collateral management and audit expectations.** The specific provisions set out in EGAM's Chapter 4 are supplemental to any existing ECB-SSM powers, supervisory tools or actions carried out pursuant to TRIM or the OSIIM Guide. Chapter 4 of EGAM states that ECB-SSM compliance checks will focus on the following areas (some of which may go beyond the traditional remit of the ECB-SSM as exercised in the first three years of its operation and may merit a greater degree of proportionality being introduced to make these expectations workable):

    a. the "collateral management unit" and its reporting especially in relation to collateral disputes - which suggests as with the "counterparty credit risk unit" (see below) a centralised unit. To the extent this is not lobbied on this may require documentation and organisational changes, especially as some firms may not have such units as fully centralised as the ECB-SSM's would like[14]. Moreover, the expectations in EGAM also state that the ECB-SSM will check evidence that the collateral management unit "…works

[14] As was partly evidenced and reported publically following the 2014 Asset Quality Review.

closely with a legal department" and that staff have "…sufficient access to legal databases and that any contractual change and new contracts are updated in a centralised legal database in a timely manner…" what is considered "timely" is undefined;

b. the internal auditing process, the auditing manuals and a review of findings, conclusions and recommendations of internal audit;

c. the nature and details included in exposure reports relating to both regulatory and internal risk including overdraft reports;

d. evidence that institutional hierarchy and three lines of defence are appropriately evidenced and embedded (which the ECB-SSM already checks) and that these are "…consistently reflected in the minutes of its internal bodies…" (which seems to be supervisory duplication and minutiae of detail);

e. the review of a "counterparty credit risk control unit" - which EGAM suggests in General Provision 16 ought to be centralised and independent from various derivatives and securities financing desks - which may, to the extent this is not lobbied on, require a organisational and documentation changes for a number of firms, especially globally active SCIs some of whom may have centralised counterparty credit risk desks, but may have to designate a specific team as the "centralised unit";

f. verification of identification, mitigation, remedial measures and reporting in respect of limit breaches - which are quite prescriptive in what the ECB-SSM expects BUSIs to verify;

g. assessment of whether model design processes and the outputs of the model's "…general logic exhibits a convincing explanation and whether its outputs lie in line with intuition…" as well as the "…tests to challenge hypotheses, quantify their potential impact (sensitivities) and gauge the model's performance after changes" and whether the "…institution fully understands the model's capabilities and limitations…";

h. verification of "correctness of the pricing of trades" as proposed in draft General Provision 32 for the purposes of effective "expected positive exposure" calculations;

i. assessment of the attributes of legal agreements, in particular regarding master netting and margining agreements as set out in *inter alia* draft General Provisions 37 and specific requirements in relation to securities financing transactions introduced in draft General Provision 47. Whilst the current drafting may require some further changes to make it adaptable to various jurisdictions, the expectations do suggest a greater emphasis on legal and/or regulatory capital opinions for certain transactions; and

j. an emphasis on reviewing the adequacy of design and use of data and IT systems. This is also an overarching ECB-SSM supervisory priority for 2018.

Outlook for 2019

EGAM certainly sets a more intrusive tone and style of supervision in an area that has not been looked at with the same granularity to date. However, as with a number of ECB-SSM rule changes as of late, it remains to be seen to what extent the current supervisory resources in existing Joint Supervisory Teams or centralised functions, such as those involved on TRIM, will be able to police these rules. Moreover and rather unfortunately, neither EGMA-1 nor EGAM do much to accelerate existing timelines or add more certainty to the steps that the ECB-SSM will take to ensure their role as supervisor in granting approvals occurs in a sufficiently timely manner.

That being said on the assumption that the ECB-SSM' supervisory scrutiny will continue to focus on preventing models from behaving badly, SCIs and a range of LSIs may wish to consider what this all means for their planning in relation to model use and governance as well as more general planning, allocation of specialist internal and external resources across various stakeholder levels so that their general compliance framework can meet the supervisory expectations and how the ECB-SSM applies the EU's Single Rulebook.

If you would like to receive more analysis from our wider Eurozone Group or in relation to the topics discussed above or in the text of EGAM, EGMA-1 or the wider impact of CRR/CRD IV, as applied in the Banking Union then please do get in touch with any of our Eurozone Hub key contacts below.

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