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ECB-SSM tightens the supervisory approval process for material changes and extensions to certain models (EGMA-1)

How might EGMA-1 change processes and timelines of model governance for direct ECB-supervised and other Banking Union Supervised Institutions (BUSIs)?

On 25 September 2017, the European Central Bank **(ECB)**, acting in its supervisory role within the Banking Union's Single Supervisory Mechanism **(SSM)**, published the final version of the EGMA-1[1]. The finalisation of EGMA-1 details how the ECB-SSM will evaluate the internal models that BUSIs use in connection with their trading books and security financing activities. This will affect BUSIs, specifically those, that for Banking Union purposes are categorised as "Significant Credit Institutions" **(SCIs)**[2] operating in the Eurozone and directly supervised by the SSM. EGMA-1 will also have an impact on certain subsidiaries of third-country banks. In particular, those contemplating creating or expanding a subsidiary in the Eurozone in response to BREXIT will need to adhere to the ECB's approach.

EGMA-1's technical content applies to the approval process for changes and extensions to models used in relation counterparty credit risk **(CCR)** calculations and specifically those that use either the internal model method **(IMM)** and/or the advanced method for credit valuation adjustment risk **(A-CVA)**. The SSM is responsible for approving the material changes and extension to these models prior to SCIs being allowed to apply them. The supervisory aim behind this approval or notification process is to have another layer of checks and balances to ensure models are fit for purpose and reduce the risks of models behaving badly.

With a number of factors set to put processing timelines in the Banking Union and notably the SSM's resources under stress, including the continued SSM work on the Targeted Review of Internal Models **(TRIM)**[3], SCIs may wish to forward-plan how to deal with EGMA-1's impact. These changes may also require senior management (and not just the Chief Risk Officer) to be able to demonstrate an understanding not only of the relevant models, their use and materiality of changes/extensions but also the SCI's processes, controls and model governance policies.

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[1] See: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.egma_guide_201709.en.pdf?a3d3971cf738d43e00dd8d8f8c79e9ea
[2] Ca. 130 representing 85% plus of balance sheet AUM in the Eurozone's banking sector.
[3] Which runs until 2019 and possibly beyond.

Consequently. SCIs may need to look at how to better define and justify the change/extension as well as the design, operation and governance and control procedures in place that are relevant not only for the use of and alteration to the model, but the decision making and review/validation process. As a result, relevant teams and stakeholders within SCIs might want to review the need for and degree of potential improvements (both technical and level of accessibility/usability) to their own internal processes, model governance and risk arrangements, the types of underlying assumptions in the relevant models and the mathematical basis, how decisions are tracked, shaped and documented along with recordkeeping and IT arrangements.

Taking action now may alleviate the supervisory engagement process both with the SSM and national authorities going forward. Such action may need to be undertaken at multiple levels, especially if models are used in business that is Banking Union supervised, but equally outside, including on a global level or in relation to business activity that might be supervised by different pan-European or national authorities.

Why this matters

EGMA-1 is a SSM supervisory tool that is framed as a "Guide" yet reads like rules. It clarifies that the EU's existing prudential capital framework, which applies to BUSIs, requires supervisory approval for those extensions and changes to credit, operational and market risk internal models that are deemed "material". EU Regulatory Technical Standards have been published in respect of credit, operational and market risk types. The ECB-SSM, as well as national authorities, apply a process of granting approval for material changes/extensions to models and a system of notification (ex ante or ex post) for immaterial changes/extensions to models.

At present the EU regulatory and legislative framework has not yet produced a similar form of Regulatory Technical Standards in relation to CCR calculations that use either the IMM and/or A-CVA model. EGMA-1 aims to fill the gap in the Single Rulebook. The IMM and A-CVA models are used by all BUSIs and therefore SCIs to calculate their CCR and thus their Pillar 1 regulatory capital requirements. The relevant IMM and A-CVA models focus[4] on over-the-counter traded derivatives as well as securities financing transactions[5]. Whilst EGMA-1 currently applies to SCIs in the Banking Union, it is conceivable that it could be rolled-out from application to SCIs to all other BUSIs in the Banking Union i.e., to the ca. 5,500+ entities where the national authorities of the SSM are in the lead and responsible for direct supervision and the ECB-SSM for indirect supervision.

In practical terms the Banking Union's supervisory process categorises extensions and changes to such internal models as being either:

- "material" and thus requiring prior approval from the competent authority - in the Banking Union this takes the form of an ECB-SSM Decision of the Governing Council; or

[4]Given on-going EU driven regulatory reforms occurring in respect of both over-the-counter derivatives as well as securities financing transactions, some of the models may need changing to reflect the impacts of those reforms.
[5]See also the SFTR: http://eur-lex.europa.eu/legal-content/en/TXT/?uri=CELEX%3A32015R2365

- "non-material" changes/extensions and thus requiring ex ante notification or ex post notification to the competent authority i.e., the ECB-SSM.

The scope of technical (qualitative and quantitative) assessment criteria that determine materiality, and thus approval or notification requirements, are set-out in Chapter 5 of EGMA-1. That chapter is split into three parts: a general part, an IMM part and an A-CVA part. These are integral to one another and should be read as applying in their entirety.

EGMA-1's processes: supervisory approval or notification

In the Eurozone-19's Banking Union, the ECB-SSM is the competent authority for SCIs in relation to their prudential regulatory supervision and approves material extensions or changes. It may notify a SCI that it wishes to investigate an extension or change as to its materiality. In terms of process, whether an extension or change is material or non-material is first self-assessed by the SCI and then submitted to and validated by the ECB-SSM. Some of the details of such extensions or changes, and how the ECB-SSM would view these are set out in the Annexes to EGMA-1.

Models and changes/extensions to the models are typically complex irrespective of the materiality classification. Importantly, EGMA-1 is clear that changes or extensions to a model may not be merged or split in a manner that would lower their materiality. EGMA-1 also clarifies that if a SCI is in doubt as to the materiality of a change or extension it must assign it the higher materiality.

Following the approval/notification of a change or an extension, the SCI must implement it within the relevant timeframe communicated to it. The SCI may not implement the change or extension prior to approval via an ECB-SSM Decision or the notification route. Time, careful planning and evidencing how decisions were taken within a SCI are likely to be of essence in ensuring smooth supervisory engagement on EGMA-1.

So how might EGMA-1 impact timing and processes for relevant teams at SCIs?

In summary, the EGMA-1 evaluation process distinguishes between the consideration and evaluation of an extension or a change in respect of (1) an IMM; or (2) an A-CVA. Each of those have defined assessment criteria that look at qualitative as well as quantitative factors. However, EGMA-1's process harmonises how some of these decisions and the supervisory points of engagement will operate in the Banking Union. All of this may have spillover effects for those SCIs that equally use the same models and processes in relation to their business operations and activities outside the Banking Union and/or outside the EU-27 and the United Kingdom.

This is crucial, as in many ways this means that regulatory capital planning and business modelling for globally active SCIs could be driven by the outcome of those qualitative and quantitative assessments conducted by the ECB-SSM. SCIs will want to assess whether they need to split models, or if not the model, then possibly at least the policies and processes between ECB-SSM EGMA-1 compliant workstreams and those that are driven by the nature of supervisory engagement in other jurisdictions, notably the United States and possibly the United Kingdom following BREXIT and its status as a third-country for EU regulatory purposes.

Submission requirements and justification of decisions will matter

This may go beyond EGMA-1's Section 8, which lists the (minimum) set of documentation expected of SCIs to be submitted in support of a model extension or change:

Deliverable Item Number Section 8	Documentation required for a:	
	Material extension or change	**Non-Material extension or change (Yes/No?)**
1(a)	Description of the extension or change, its rational and objective	Yes
1(b)	The intended implementation date	Yes In the case of a notification before implementation or the actual date of implementation
1(c)	Scope affected by the model extension or change, with volume characteristics	Yes
1(d)	Relevant technical and process document(s), such as documentation on: (i) calibration of the risk drivers (ii) pricing of the transactions (iii) collateral modelling (iv) netting and margining (v) back-testing (vi) stress testing (vii) wrong-way risk	No
1(e)	Reports on the SCIs independent review or validation	No
1(f)	Confirmation that the extension or change has been approved through the SCI's approval processes by the competent bodies and the date of approval	Yes
1(g)	Where applicable, documentation of the quantitative impact of the change or extension on the risk-weighted exposure amounts or the own funds requirements. This should include: (i) the quantitative impact on the minimum capital requirement for CVA risk if the considered extension or change is to the IMM (ii) where applicable, an explanation of the representative sample or reliable inference methodology (iii) the quantitative impact on all levels for which the institutions applies the model	Yes
2(c)	Not applicable for this assessment	Evidence supporting the SCI's assessment in cases where the institution argues

		that the considered extension or change does not significantly affect the relevant assessment criterion of Section 6(1)(a) and the Annexes to EGMA-1

Outlook for BUSIs and global banks

The contents of EGMA-1 currently apply to those SCIs that operate within the Eurozone's Banking Union. It will also be of immediate relevance, both at the request for a licence application and on-going supervision for those new entrants that relocate and qualify as SCIs.

As with other ECB-SSM supervisory Guides, it is quite possible that in the future the terms of EGMA-1 might be rolled out to the much wider body of BUSIs that are, for Banking Union purposes, categorised as "Less Significant Institutions" (LSIs). Unlike SCIs, LSIs are supervised directly by national competent authorities and indirectly by the ECB-SSM.

Looking further ahead, it is also conceivable that the contents of EGMA-1 will be supplemented by additional provisions (i.e., EGMA-2…etc.) or amended (EGMA-1A…etc.). For a number of non-Banking Union and possibly some non-EU jurisdictions it is also possible that the relevant supervisory authorities, irrespective of a roll-out of EGMA-1, might choose to mirror the processes of EGMA-1. This is especially the case given that the internal models that EGMA-1 deals with, along with the other internal models from EU prudential capital regulation, stem from the global standards that originated in the Basel reforms (Basel III etc.) of the Basel Committee on Banking Supervision.

So what does this mean in practice? Firstly, EGMA-1 is just one workstream that BUSIs will need to deal with against an EU, Eurozone-specific and a global agenda where regulatory reform is on-going. Fortunately in the EU and more so perhaps in the Banking Union, there is a greater sense of what the desired end state of banking sector regulation and supervision ought to look like. Nevertheless, tweaking of existing and new rules will continue to play an important role and EGMA-1 will be no different. For affected stakeholders, this means looking at how EGMA-1 could have knock-on effects to other workstreams in a BUSI's regulatory strategy, its compliance monitoring framework as well as any "live" supervisory touchpoints/priorities.

Secondly, LSIs and globally active new entrants into the Banking Union may want to scenario plan how a roll-out or a mirroring of the EGMA-1 provisions to its operations might impact its own "run the business" as well as "change the business" workstreams along with regulatory capital planning.

Lastly, all BUSIs, especially those that operate in non-EU jurisdictions, will want to assess how EGMA-1 and any ECB-SSM led workstreams on models and regulatory capital planning might impact their non-Banking Union operations. This may merit ring-fencing EGMA-1 relevant workstreams, policies and processes from global items.

Some of the resource and strategic planning might also consider how to leverage RegTech and LegalTech solutions to create more collaborative workstreams for those workstreams affected by EGMA-1. Some of these solutions, especially when dealing with complex model changes, might even assist in greater efficiency along the supervisory touchpoints.

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 EGMA-1, then please do get in touch with any of our Eurozone Hub key contacts below.

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