EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Supervisory expectations on booking models

August 2018

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Executive summary

- **The purpose** of this presentation is to introduce the views of ECB Banking Supervision on “empty shells” and booking models, and to provide additional clarifications to banks.
- The ECB will carefully assess the impact booking models can have on the development of a **sound risk management** and **control framework** of an SSM entity and its operational resilience in a crisis.
- These concerns have been communicated to banks by the ECB through interviews and through **FAQs**.
- The **expectations** cover a broad set of topics and focus on the risk framework from a first / second line perspective, and will be used by the ECB for the assessment of Brexit cases and for carrying out ongoing supervision of existing banking groups that undertake capital markets operations.
- In October 2017, the **EBA** published a set of **key principles on internal governance, outsourcing, risk transfer and “empty shells”** in its opinion on issues related to Brexit, which provides initial guidance for supervisors. **ECB Banking Supervision** is already in line with those EBA key principles and has developed a **set of supervisory expectations** which is based on them.
- The supervisory expectations on booking models and empty shells will be applied in a proportionate manner to the individual cases, taken into account the materiality and complexity of the bank’s capital market activities.

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Booking models and empty shells - key issues

SSM supervisory assessment of booking models aimed at centralising risk outside an SSM entity (e.g. via back-to-back / remote bookings) is related to the development of an effective risk management and control framework in the entity and its operational resilience in a crisis

Scope	• SSM entities materially engaging in capital markets activities as part of their core business activities, irrespective of whether with trading or without trading intent (e.g. for Banking Book related treasury activities) • Transactions of SSM entities originated / managed in third countries (e.g. other group entities and / or branches) • All types of internal risk transfers (back-to-back and remote) and hedging strategies (e.g. micro / macro or portfolio hedging)
Overall Issues	*Risk management and control framework* • SSM entities service EU27 clients and EU27 products offshore. Significant risks are originated outside of the EU27 and not managed appropriately within the EU27 • As a consequence of back-to-back booking and remote booking, risk transfer and management may not be transparent (e.g. for third-country hedging hubs) • Risk management capabilities are located outside the SSM. Limited knowledge and skills to identify, manage, control and monitor material risks on a stand-alone basis *Operational resilience of banks’ trading and hedging capabilities in a crisis* • Limited stand-alone measurement, monitoring and risk management (execution) capabilities, including access to key FMI and to external counterparties (dealers) • Loss of ability to hedge and trade with internal and external counterparts in crisis and to unwind positions / replace hedges with non-group counterparties in a crisis

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EBA Opinion - main principles

The Opinion of the European Banking Authority on issues related to the departure of the UK from the European Union (October 2017) provides key principles on internal governance, outsourcing, risk transfers and "empty shell" companies, and on resolution and deposit guarantee schemes

Internal governance & staffing	Institutions should **have sound and effective governance** and suitable members of the management body.
Outsourcing	Institutions **should not** outsource activities to such an extent that they operate as "empty shell" companies, and all institutions should have the **substance to identify and manage the risks they generate**.
Risk management and outsourcing	Risk management is an important function of credit institutions and investment firms which goes hand in hand with the extension of business. Local risk management needs to be **commensurate to the business extended**. With respect to outsourcing, institutions should be able to **monitor and manage** the outsourcing arrangements, and ensure that authorities have **full access to all information** they need to fulfil their supervisory function.
Outsourcing to third countries	After Brexit, it is assumed that the UK will be a third country and thus activities outsourced to institutions in the UK prior to Brexit should be assessed with regard to the **ability of the institution to adapt to this possible scenario**.
Back-to-back operations	Institutions engaging in back-to-back or intragroup operations to transfer risk to another entity should have adequate resources to identify and fully manage their counterparty credit risk, and **any material risks that they have transferred** in the event of the failure of their counterparty. Authorities should pay special attention to large exposures or concentration risk to some counterparties, as resulting from systematic use of back-to-backs.
Crisis management and resolution	Institutions should demonstrate their ability to continuously **access financial market infrastructures** (located in the UK), and assess any impact from losing continued access to such infrastructures. Institutions risk management and governance should be scalable in times of crisis and the local capabilities should ensure that risks could be managed or, if needed, positions could be unwound in an orderly way.

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Supervisory expectations

ECB Banking Supervision has developed its supervisory expectations regarding the assessment of booking models on risk management and governance against EU regulations and taking into consideration EBA opinions. These expectations span five areas and are elaborated in more detail in the following slides

Area	ECB expectations	EBA principles
Internal governance, staffing & organisation	• A **robust governance and risk management framework is** in place, including related documentation. The SSM entity should be adequately staffed with sufficient knowledge, experience, capabilities and technology to manage both the existing and relocating business and associated risks. • The entity's **management body has a** clear understanding of all risks and **effective control over the entity's balance sheet**	**Internal governance & staffing / outsourcing**
Business origination and FMI access	• **No heavy reliance on third country risk hubs:** SMM entities are expected to manage their market and counterparty risk independently and have independent trading capability (incl. market access on the basis of contractual arrangements in the name of the SSM entity) as well as diversified counterparties within the EU27. When accessing FMIs via a third country entity or branch, SSM entities should consider which alternative FMIs are available in the event that their access to these FMIs via the third country entity or branch is lost or no longer guaranteed. Cost synergies are not used as the sole determining factor for utilising third-country risk hubs	**Crisis management & resolution**
Booking and hedging strategy	• **Sufficient independence**: local decision making capacities are safeguarded; SSM entities retain control over the balance sheet • entities clearly identify their hedging strategies, procedures, controls and governance in a booking model policy	**Back-to-back operations / outsourcing & risk management**
Intragroup arrangements	• **Avoidance of undue complexity** (e.g. legal entity structures or hedging methods) • The ability to independently monitor and manage risks arising from intragroup exposures	**Back-to-back operations**
IT infrastructure & reporting	• The ability to produce daily **complete and accurate reports** • IT-infrastructure should be commensurate with the transfer of assets/ business • In a crisis, operational continuity and access to necessary operational assets should be ensured via adequate contractual provisions (e.g. SLA) and business continuity plans	**Internal governance & staffing / outsourcing / back-to-back operations**

Internal governance, staffing & organisation (1/2)
Supervisory expectations

Aim: to promote a sound and effective risk management and governance framework through an appropriately skilled staff and governance body in the SSM entity	
1	• ECB Banking Supervision will assess the SSM entity’s internal governance, staffing and organisation based on existing directives, guidelines and policies, taking into account booking-model-specific considerations. (“SSM entity” is defined as a group of legal entities subject to supervision under the Single Supervisory Mechanism). • The term “onshore” refers to those elements of the SSM entity (branches, businesses, capabilities, etc.), which are physically located within the EU. • It is unlikely that an EU-headquartered bank will be an “empty shell” when viewed in its entirety. That said, some functions or business lines of such a bank may exhibit empty shell characteristics.
2	• From a governance and risk management perspective, banks are expected to have an adequate management body in its supervisory function (in terms of knowledge, skills and experience, independence of mind, time commitment and formal independence) that is able to effectively provide oversight over the SSM entity’s activities and booking practices. Collectively, the members of the supervisory function should have sufficient geographical presence within the EU27, as well as experience (knowledge of local market and regulatory frameworks), available time (in particular with regard to dual-hatting and travel time) and the independence required to effectively perform the role. • In the case of a two-tier management system, this applies to the management body exercising its supervisory function. In the case of a one-tier system, this applies to the management body exercising its oversight function.
3	• Banks are expected to have an adequate (i.e. regarding capacity and suitability) onshore-based management body exercising its executive function which has a clear understanding of the SSM entity’s booking model and associated control environment, and has effective decision-making powers regarding issues related to the entity’s booking model, as well as-full control of its balance sheet and of transactions booked to the entity.

Internal governance, staffing & organisation (2/2)
Supervisory expectations

Aim: to promote a sound and effective risk management and governance framework through an appropriately skilled staff and governance body in the SSM entity	
4	• In the case of a gone concern and / or crisis scenario, where the SSM entity does not have (or no longer has) access to (i) a third-country group entity, (ii) a branch of an SSM entity in a third country (which should be considered as similar in nature to a third-country legal entity for the purposes of the supervisory expectations on booking models) or (iii) a market based in third countries, the SSM entity's business continuity plans are expected to provide comfort that the entity will be able to carry out its business independently from another third-country group entity or branch of an SSM entity in a third country, and that it will have sufficient onshore risk management processes to identify, manage and monitor its material onshore risks. • To be considered credible, a continuity plan is expected to demonstrate that a sufficient number of key function holders and staff are employed by the SSM entity, and that they have the appropriate level of knowledge and authority to ensure the staff of the entity can cope with the increased workload and tasks in such a scenario, while maintaining execution and operational risks within tolerance limits. • "Risk management" for the purposes of this document refers to both the first and second lines of defence in the "three lines of defence" model. The first line, namely the business lines, includes execution capabilities which are also responsible for direct action in the market (e.g. pricing and hedging positions). The second line includes the risk management function in a stricter sense and further functions such as independent price verification and controls. • In the event of a crisis, both the first and second lines of defence are needed to effectively manage risks arising from existing business. In particular, banks relocating their business are expected to proportionally adjust both their first and second lines of defence.
5	• The extent of outsourcing arrangements by the SSM entity should not result in the SSM entity having the characteristics of an "empty shell" property, and banks should ensure the adequacy and quality of the governance and control environment, especially - but not limited to - intragroup outsourcing agreements. From a supervisory perspective, outsourcing includes agreements between two legal entities, as well as service level agreements between parent companies and their branches.
6	• Dual hatting and secondments of members of the management body, key function holders and staff employed by the SSM entity are expected to be used only in exceptional circumstances and in duly justified cases.

Business origination and access to FMIs

Supervisory expectations

	Aim: to ensure that an SSM entity has continuous access to FMIs and a diversified set of counterparties, especially in times of crisis, and sufficient local front-office staff to execute on its business plan
7	• To ensure that the SSM entity does not exhibit the characteristics of an "empty shell", supervisors should assess the entity's onshore (i.e. excluding its branches in third countries) ability to originate business and access key financial market infrastructures (FMIs) on a continuous basis in order to identify and manage its risks based on existing directives, taking into account booking-model-specific considerations from within the EU. • Particular attention will be given to SSM entities that access FMIs via third-country group entities or branches in third countries, and the ability of those SSM entities to access markets relevant to their business and risk profile at all times, and consideration will also be given to the details of their continuity plans in the event of a gone concern and / or crisis scenario in which an SSM entity no longer has access to a third-country group entity or a branch in a third country. • As expressed by the EBA[1)] , SSM entities should consider which alternative FMIs are available in the event that their access to existing FMIs is lost or curtailed or the finality of their instruments/settlements is no longer guaranteed.
8	• ECB Banking Supervision will assess the adequacy of sales / business origination capabilities within the SSM entity located onshore to ensure asset growth and revenue plans are achievable and supported by trading capabilities that are appropriate for executing trades and hedging risks. • Capabilities will also be assessed in relation to the SSM entity's ability to execute on business continuity plans.

1) *Opinion of the European Banking Authority on preparations for the withdrawal of the United Kingdom from the European Union (EBA/Op/2018/05, 25 June 2018)*

Booking and hedging strategies (1/2)

Supervisory expectations

Aim: to promote strong controls around hedging and risk management practices together with reducing concentration on hedging providers	
9	• It is expected that SSM entities are not overly reliant on intragroup back-to-back hedging strategies with third-country entities or branches in third countries, or on remote booking to / from third-country entities or branches in third countries. SSM entities are expected to have a proven ability to hedge their material risks with a diversified set of external (third party) counterparties. • Banks are expected to have in place booking models and hedging strategies that enable the SSM entity to have full control of its onshore exposures. For SSM entities, the expectation is that EU products and transactions with EU clients are booked onshore and that risk management capabilities related to these products are also located onshore. • Remote booking is a type of booking model in which an employee of one legal entity books a transaction directly to another legal entity, e.g. a parent company. In the context of assessing booking models, branches in third countries are to be treated analogously with legal entities. Therefore, the practice whereby an employee of the SSM entity's third-country branch books transactions to the balance sheet of the SSM entity's parent is considered to be remote booking. • In a back-to-back booking model, an entity transfers risks to a third party or to another intragroup entity that then hedges the risk in the market. This can be applied to various types of hedging (e.g. micro, macro or portfolio hedging). When transactions are 100% back-to-backed, mirroring internal trades are booked at the same time as client bookings in order to hedge risks.
10	• The SSM entity's booking and hedging strategies are assessed on the basis of whether the entity is limited or restricted in its ability to access capital/assets via the third-country branches during a resolution scenario. The Resolution Plan is expected to be consistent with the preferred resolution approach determined by the SRB / NRAs for that entity. • Banks are expected to take into account their branches in third countries in the group-wide recovery plans, in a proportionate manner that appropriately reflects the risks stemming from these branches. They are also expected to consider any scenarios to the downside that involve branches, if those scenarios could threaten the financial stability of the group.

Booking and hedging strategies (2/2)
Supervisory expectations

Aim: to promote strong controls around hedging and risk management practices and to reduce concentration on hedging providers	
11	• The SSM entity is expected to have in place both a consistent booking model policy that identifies booking and hedging strategies for each product class / business, as well as the relevant controls.
12	• The SSM entity is expected to have developed a comprehensive control and risk framework to identify and manage all material risks stemming from its trading activities and booking practices, including those with internal counterparties. The framework should enable the SSM entities, excluding their branches in third countries, to retain full and independent control of material and complex exposures. In the case of globally active banks, this can be achieved, for example, through global risk management practices applied and carried out locally.

Intragroup arrangements

Supervisory expectations

Aim: to ensure SSM entities are able to independently monitor and manage risks arising from intragroup exposures and independently price and evaluate intragroup transactions	
13	• SSM entities are expected to be able to identify and monitor onshore the risks arising from intragroup exposures and to have access to and manage those risks (i.e. the solvency, capital profile and liquidity situation of its internal counterparts).
14	• The SSM entity is expected to develop effective independent price verification (IPV) and fund transfer pricing (FTP) capabilities and processes to price and evaluate intragroup arrangements and is expected not to be systematically loss-making.

IT infrastructure and reporting
Supervisory expectations

Aim: to ensure that SSM entities are able to produce complete and accurate reports on their intragroup arrangements and booking practices on a regular and ad hoc basis	
15	• SSM entities are expected to be able to produce regular, complete and accurate Management Information System (MIS) reports in relation to the activities and risks associated with their booking model and hedging strategies that enable the onshore-based management to manage, independently and at the local level, the risks associated with the booking model and hedging strategies that are applied.
16	• The SSM entity's business and implementation plan is expected to provide comfort that the IT infrastructure will be commensurate with the transfer of assets and relocation of business to the SSM within the build-up period. • IT capabilities are expected to provide sufficient comfort that the SSM entity is able to provide ad hoc and more frequent reporting outside the normal reporting cycle in stress situations, as well as in compliance with BCBS239 principles.

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Build-up periods

These supervisory expectations will serve as a basis for discussions between the JSTs and individual banks taking into account banks' specific situation. To address the risks mentioned in supervisory expectations, banks are encouraged to take the following steps:

1. ***An implementation plan to take these expectations into account, including clear milestones and approved by the entity's management board, is submitted by the entity***
2. ***The SSM entity defines and implements a dedicated booking model policy around booking models and the related control environment***
3. ***The SSM entity defines and implements a dedicated policy around marketing practices and the related control environment***
4. ***Recovery and crisis management capabilities are updated to incorporate considerations around Brexit and hedging / market access continuity options in recovery as outlined in the SSM expectations***
5. ***SSM entities are expected to develop their hedging / market access capabilities and the relevant control framework at a pace that is proportional to the growth in their business activities (or proportionally with the size / complexity of existing activities)***

- For **new entities / entities expanding their activities significantly**, it is expected that plans will take into consideration the expectations and develop these capabilities proportionally with the pace at which business activities are transferred / expanded.
- **Existing SSM entities** are expected to incorporate these considerations in their business planning cycle. Banks are encouraged to submit their plans to ECB Banking Supervision for review.