Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

2017

Thematic Inspection of Regulatory Reporting by International Banks

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Background

The Central Bank of Ireland ('Central Bank') recently completed a Thematic Inspection of Regulatory Reporting in a number of International Banks[1] which are regulated by it, to assess the extent to which it can rely on the accuracy and integrity of Regulatory Returns submitted. The banks were selected based on a combination of risk assessment ratings, previously identified issues in this area and consideration of the importance of the Regulatory Returns to the Central Bank in the performance of its regulatory role.

Regulatory Reporting is a central pillar to the effective supervision of banks and Regulatory Returns are utilised to inform the Central Bank's assessment of a bank's risk profile. The information received, is used by supervisors to monitor a bank's adherence to regulatory requirements and to assess its financial position. Article 74 of the Capital Requirements Directive 2013/36/EU requires that institutions shall have "sound administration and accounting procedures".

Purpose and Key Findings

The purpose of this publication is to inform all banks operating in Ireland about the both the findings and good practices identified during this thematic inspection. Each bank should therefore consider the findings outlined in this communication and evaluate its regulatory reporting framework to establish whether any of the findings identified as a result of this work are in existence within the institution and where necessary, any issues identified should be remediated by the bank.

The on-site inspections conducted by Authorised Officers of the Central Bank ("Authorised Officers") focused on data contained within the Regulatory Returns for a selected sample of Less Significant Institutions ('LSI's'). The inspection specifically focused on the banks' processes for the generation of: (i) Risk Weighted Assets (RWAs) and own funds for Common Reporting (COREP); (ii) off-balance sheet items, Financial Reporting (FINREP); (iii) Large Exposure Returns (LEX); and (iv) Liquidity Coverage Ratio (LCR). We focused on these areas as a result of issues identified further to the Central Bank's off-site supervisory analysis and the importance we place on these returns being accurate to enable us to effectively execute our supervisory role with regard to capital adequacy, large exposures and liquidity requirements. We also wanted to establish compliance by banks with the LCR requirements given that these requirements are comparatively new and very important with respect to the monitoring of bank liquidity.

The following areas were examined as part of the thematic inspection:

(i) the structure of the Regulatory Reporting Function, including the controls, procedures and governance arrangements around the production of the Regulatory Returns;
(ii) benchmarking of the internal processes and systems in place for the generation of Regulatory Returns in order to assess the quality of data feeding into Regulatory Reporting; and
(iii) the appropriateness of the data quality verification, reconciliation and validation processes utilised prior to submission of the Regulatory Returns.

As a result of this work, key themes identified by the Authorised Officers include, but are not limited to:

(i) a lack of comprehensive procedural documentation;
(ii) inadequate resources in the Regulatory Reporting Function, from an Information Technology (IT) and human resources perspective;
(iii) inadequate reconciliation and data quality assurance processes;

[1] The International Banks that were in-scope for this inspection are categorised as Less Significant Institutions as they are banks that do not meet the criteria to be a Significant Institution as evaluated by the Single Supervisory Mechanism.

(iv) weaknesses in the three lines of defence; including the failure to identify or remediate systems and control weaknesses;
(v) errors in the calculation of Credit RWAs;
(vi) shortcomings in the calculation of the Operational Risk capital charge;
(vii) issues relating to the accuracy and completeness of the LCR (DA); and
(viii) shortcomings in relation to calculation of the Large Exposures return (LEX).

The Inspection Team noted a lack of appropriate development of IT systems and insufficient human resources within the Regulatory Reporting Functions of a number of the banks inspected. As a result, in the majority of banks inspected, the end-to-end Regulatory Reporting processes are predominantly manual in nature and require a significant level of manual intervention. These manual interventions are not appropriately documented and rely on the knowledge and experience of a limited number of key staff. This under-resourcing of the Regulatory Reporting function in terms of IT systems, staff numbers, skills and experience emerged as a key theme of the inspection.

The reporting processes followed within a number of the banks inspected are significantly prone to errors with many instances of duplication, misclassification or incorrect assignment of fields noted by the Inspection Team. These issues are compounded by weak Regulatory Reporting control environments in many of the institutions inspected, with gaps in procedural documentation and inadequate review processes evidenced.

In a number of banks reviewed, the Authorised Officers of the Central Bank identified issues in relation to the oversight by the Internal Audit Function (IAF). The scope, depth and frequency of the Internal Audits conducted within the banks, relating to the end to end Regulatory Reporting process fall significantly below what is expected and there are issues with the appropriateness of the rating scales used.

The Inspection Team also noted issues with the accuracy and completeness of both the LCR (DA) and LEX Returns due to data quality issues and limitations in the frameworks which govern the processes to complete these returns. In a number of institutions there were instances of significant misreporting identified since the introduction of the LCR (DA), including misclassifications of components of LCR and the use of incorrect inflow and outflow rates.

During the course of the Inspection, Authorised Officers also identified specific instances where positive initiatives had been adopted, including:

(i) the implementation of an in-house tool to ensure that the end-to-end regulatory reporting process was pre-dominantly automated;
(ii) comprehensive procedural documentation which was reflective of regulatory requirements and subject to appropriate senior management oversight;
(iii) a well-resourced regulatory reporting function with staff displaying a comprehensive knowledge of regulatory requirements; and
(iv) pro-active management of issues following identification by the Inspection Team.

Next Steps

While the seriousness of the issues identified varied across institutions, only one of the institutions inspected demonstrated an appropriate control environment in relation to the production of regulatory returns. The themes identified indicate a potential lack of consideration and prioritisation given to Regulatory Reporting obligations in the remaining LSIs inspected. A more detailed overview of the findings is set out in appendix 1.

The Central Bank has written to all of the International Banks informing them about the outcome of this thematic inspection. Remediation Plans have been issued to the in-scope banks with specific timeframes set for the closure the issues identified. We expect that all banks operating in Ireland to have robust regulatory reporting processes and controls that are proportionate to their business. In this regard all banks should evaluate their regulatory reporting framework in the context of the findings outlined in this publication and remediate any issues identified.

Appendix I (including Schedule of Findings)

Quality and Comprehensiveness of Documented Procedures

Regulatory requirements as outlined in Article 74 (SI 158/2014 Chapter 2, 61 (1)) of the CRD requires institutions to have adequate internal control mechanisms and for such mechanisms to be comprehensive. Therefore, banks should ensure they have established comprehensive documented procedures for the preparation of the Regulatory Returns which, at a minimum, should address the points outlined in Finding 1 below. Additionally, the procedural documentation should be approved at an appropriate management forum and reviewed at least annually.

Finding 1

A number of banks were found to have inadequate or incomplete procedures for the generation of the Regulatory Returns. Procedures reviewed by Authorised Officers were not sufficiently comprehensive to adequately describe and facilitate understanding of the process and the key controls exercised.

The procedural documentation reviewed as part of the inspection process failed to evidence, as appropriate:

(i) details of the manual adjustment processes;
(ii) consideration of regulatory requirements;
(iii) data inputs and process descriptions;
(iv) calculation methodologies for complex fields;
(v) reconciliation processes for all Regulatory Returns against the data contained in audited financial statements and management accounts;
(vi) a check list to ensure that the Regulatory Returns are in accordance with regulatory requirements;
(vii) a process aimed at ensuring that the end to end procedures for the generation of the Regulatory Returns are reviewed for appropriateness on a periodic basis;
(viii) adequate Senior Management oversight; and
(ix) a process aimed at ensuring that the COREP, where necessary, is restated to capture any deviations between the audited and unaudited end of period financial figures.

Additionally, there was no evidence of independent review to ensure that the adopted Regulatory Reporting related processes and practices were in line with the documented procedures.

Resourcing of the Regulatory Reporting Function

As per Article 74 (SI 158/2014 Chapter 2, 61 (1)) of the CRD institutions are required to have adequate internal control mechanisms, including sound administration and accounting procedures that are consistent with and promote sound and effective risk management. In view of the importance of the accuracy of the Regulatory Returns, banks are required to minimise the level of manual intervention required to complete the end to end Regulatory Reporting process and to prioritise the establishment of a central depository of data. Accordingly, the deployment of a central depository should not compromise the data consistency and integrity of the automated feeds for the Regulatory Reporting process. Banks should evidence that appropriate assurance has been obtained in relation to the integrity of the data and that such data integrity is maintained on an on-going basis.

EBA Guidelines on Internal Governance (GL 44) requires that: (i) in order to fulfil its internal governance responsibilities, the management body of an institution's parent company should ensure that sufficient resources are available for each subsidiary to meet both group standards and local governance standards; and (ii) in developing its internal control framework, an institution should ensure there is a clear, transparent and documented decision-making process and a clear allocation of responsibilities and authority to ensure compliance with internal rules and decisions and that an institution shall have effective and reliable information and communication systems covering all its significant activities. Therefore, banks must ensure that there is an appropriate level of staffing within the Regulatory Reporting Function and that all staff involved in the preparation of Regulatory Returns have the appropriate level of skills and expertise to perform their duties.

In view of the important role of the Regulatory Reporting process, banks should ensure that the management of regulatory change is appropriately designed and effectively communicated to business lines.

Relevant staff should have a sufficient knowledge (at a minimum) of:

(i) the bank's Regulatory Reporting obligations;
(ii) the methodologies used to calculate the bank's regulatory requirements; and
(iii) the regulatory change management process within the bank.

Finding 2

Authorised Officers identified issues relating to the resourcing of the Regulatory Reporting Function from both a human and Information Technology (IT) perspective. The generation of the Regulatory Returns, for a number of banks, was identified as excessively manual with limited integration of source systems and an overreliance on manual adjustments and Microsoft (MS) Excel. The compilation and accuracy of the Regulatory Returns was further impaired by the lack of a centralised data depository within a number of banks.

The adequacy of human resourcing within the Regulatory Reporting Function fell below expected standards. A number of banks inspected had no formal training plan, no formal succession plan, a failure to ensure staff awareness of the bank's regulatory obligations and further, Authorised Officers evidenced an overreliance on the experience and knowledge of a limited number of key staff.

Instances were identified, in a number of banks, where a lack of regulatory understanding by staff in the Regulatory Reporting Function resulted in non-compliance with regulatory requirements including but not limited to;

(i) the omission of Credit Value Adjustment (CVA) from the Regulatory Returns;
(ii) a failure to calculate the volatility adjustment within COREP;
(iii) lack of documented policies for the assignment of income to the CRR business lines;
(iv) a failure to provide legal opinions for derivative netting contracts;
(v) inaccurate reporting of LEX; and
(vi) inaccurate/ incomplete reporting of LCR (DA).

Reconciliation and Data Quality Assurance

Regulatory requirements, as outlined in Article 74 (SI 158/2014 Chapter 2, 61 (1)) of the CRD and EBA Guidelines on Internal Governance (GL 44), require banks to have adequate internal control mechanisms, including sound administration and accounting procedures.

The Board of Directors is ultimately responsible for ensuring that all Regulatory Reporting is complete, accurate and in compliance with relevant legislation, therefore appropriate oversight should be exercised.

Finding 3

In a number of banks, it was identified that there was a lack of a robust reconciliation and data quality assurance process, aimed at ensuring the integrity of the data employed in the bank's Regulatory Returns.

Data quality issues were identified in all institutions, albeit to varying degrees, relating, but not limited to:

(i) misclassification of exposures to CRR exposure classes;
(ii) data inconsistencies and data integrity (including the completeness and accuracy of data);
(iii) limitations in system processes;
(iv) a failure to implement a robust reconciliation process for both on and off balance sheet items; and
(v) a failure to implement an appropriate management review process.

Authorised Officers noted an absence of a formal data attestation process between business lines and the Regulatory Reporting Function. The lack of a formal data quality attestation in addition to gaps in data validation and verification resulted in inaccurate data being utilised in the generation of the regulatory returns.

Authorised Officers identified specific instances where;

(i) balances had failed to be appropriately reconciled; and
(ii) balancing figures were used to force consistency where banks could not fully reconcile data.

Additionally, a number of fundamental errors were identified in Regulatory Reporting submissions which should have been identified and remediated during the management review process.

Deficiencies in the Three Lines of Defence

The regulatory requirements and guidelines set out that the Board will ensure compliance with the regulatory requirements set out under the EBA Guidelines on Internal Governance (GL 44), Article 74 (SI 158/2014 Chapter 2, 61 (1)) of the CRD and, align its practices with the BCBS guidelines on corporate governance principles for banks.

Finding 4

In a number of banks reviewed, Authorised Officers identified issues in relation to the oversight provided by the Internal Audit Function (IAF). The scope, depth and frequency of the Internal Audits conducted within the banks, relating to the end to end Regulatory Reporting process falls significantly below what is expected.

In the majority of banks, the audit testing of the Regulatory Reporting processes failed to cover:

(i) the classification of credit exposures to the CRR exposures classes;
(ii) a process for the extraction and assignment of External Credit Assessment Institution (ECAI) grades and mapping to Credit Quality Steps (CQS);
(iii) mapping of income to business lines for Operational Risk charge calculation purposes;
(iv) testing of the Regulatory Reporting system; and
(v) lack of a process aimed at ensuring that the end to end regulatory capital calculation process is subject to periodic review for effectiveness.

In several banks, periodic regulatory prescribed audits were not conducted and consideration of regulatory audits in the audit planning process fell significantly below requirements.

A number of the findings in relation to the IAF should be considered in the context of the operation of the IAF more broadly. For example, the rating system implemented by IAFs in some institutions is based on a two-point rating system. This is considered to be insufficiently granular and can lead to the exclusion of issues of lesser significance from the Internal Audit reports raising concerns regarding the transparency of reporting to the Audit Committee.

Additionally, the validation process for the closure of Internal Audit findings was deemed to be inadequate in a number of institutions.

Inconsistencies in the implementation of the LCR (DA)

In order to ensure compliance with the Commission Delegated Regulation of 10 October 2014 to supplement Regulation 575/2013 with regard to liquidity coverage requirements and Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools (January 2013), banks are required to have an appropriate Liquidity Risk Framework in place which appropriately considers the various elements of the LCR (DA) and to ensure an accurate and comprehensive LCR calculation methodology is in place.

Finding 5

Instances of material misreporting were identified in relation to the LCR (DA) including; (i) the ongoing submission of incorrect LCR returns since the introduction of the LCR (DA); (ii) failure to calculate and report potential outflows; and (iii) misclassification within inflow categories and outflow categories. While these issues were not identified in all banks, the findings are significant and warrant appropriate attention to prevent similar issues arising in other banks.

Further, the thematic inspection identified three common themes in relation to the LCR (DA) process across the banks inspected relating to;

(i) incorrect inflow and outflow rates being used due to misclassifications of elements of LCR;
(ii) weaknesses in the approach used for consideration of the Historical Look-back Approach; and
(iii) inadequate development of the Liquidity Risk Framework in relation to the requirements of LCR.

Categorisation and Reporting of Large Exposures

As per Article 387 to 403 of the CRR, banks are required to ensure that they have a process in place to identify and calculate Large Exposures correctly, and to review transactions with underlying assets where appropriate. Banks are also required to ensure that the production of the LEX return is adequately documented with reference to all relevant regulatory legislation.

Finding 6

In a number of banks, the LEX reporting process was not documented with Authorised Officers identifying misreporting issues due to system limitations and the requirement for excessive manual intervention in the production of the return.

The Inspection identified common themes in relation to the categorisation and reporting of LEX across the banks inspected relating to;

(i) a lack of comprehensive of procedural documentation;
(ii) inaccurate reporting of LEX under Article 394(1)(b);
(iii) a sub-standard reconciliation process; and
(iv) lack of adequate review and approval of the return.

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Banc Ceannais na hÉireann, Sráid Wapping Nua, Cé an Phoirt Thuaidh, Baile Átha Cliath 1.
Central Bank of Ireland, New Wapping Street, North Wall Quay, Dublin 1.