EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Feedback on the input provided by the European Parliament as part of its resolution on the Banking Union – Annual Report 2015

The Annual Report on supervisory activities of the European Central Bank (ECB) is presented to the European Parliament (EP) each year in a dedicated session of the Economic and Monetary Affairs Committee (ECON). In the EP's resolution on the Banking Union – Annual Report 2015[1] (hereafter "the resolution"), the EP welcomed the efficient and open way in which the ECB has so far fulfilled its accountability obligations towards Parliament, and called on the ECB to continue to fully engage in this regard and to further contribute to improving Parliament's capacity to assess SSM policies and activities. In response to this call and consistent with the practice related to the ECB's Annual Report, ECB Banking Supervision decided to provide direct feedback to the comments and suggestions provided by the EP as part of its resolution. The ECB's feedback to the EP is being published simultaneously with the ECB's 2016 Annual Report on supervisory activities. This decision underlines ECB Banking Supervision's strong commitment to accountability, which goes beyond fulfilling the requirements of the SSM Regulation[2].

1. The supervisory review and evaluation process and supervisory requirements

1.1 The supervisory review and evaluation process

Paragraph 25 of the resolution considers that the supervisory review and evaluation process (SREP) could benefit from further refinement. The preparatory work and large-scale field testing performed in 2014 meant that the key building blocks of the SSM SREP methodology could be used in 2015. SSM experts were closely involved in the work on supervisory methodology that was carried out by the European Banking Authority (EBA); this allowed for the SSM SREP methodology to be aligned with the EBA guidelines on SREP when the latter entered into force in 2016. While the SSM SREP methodology could be stabilised early, ECB Banking Supervision made it clear that it would continue to develop and refine its methodology, drawing on the experience gained and in line with the development of banking risks and activities. A second cycle of the common SSM SREP methodology was implemented in the last quarter of 2016 with the adoption of SREP decisions for the significant institutions under direct ECB supervision. During this second year of implementation, the SREP methodology has been improved on a number of fronts. In particular, advantage has been taken of the clarifications provided by the EBA in its Opinion of 16 December 2015 on the implementation of the provisions set out in Directive 2013/36 on the maximum distributable amount[3]. The

---

[1] European Parliament resolution of 10 March 2016 on the Banking union – Annual Report 2015

[2] Council Regulation (EU) No 1024/2013

[3] Opinion of the European Banking Authority on the interaction of Pillar 1, Pillar 2 and combined buffer requirements and restrictions on distributions

main change to the methodology was the introduction of a non-legally binding Pillar 2 guidance (P2G), which complements the legally binding Pillar 2 requirements (P2R). In 2017 the ECB plans to introduce a limited number of further methodological improvements to the SREP, including changes arising from the CRD/CRR review.

Since 2015, significant efforts have been made to explain to banks and external stakeholders the ECB's approach to the SREP. Such efforts have included organising three workshops for bank CEOs; the ECB publishing a booklet on the SREP in 2015 and updating it in 2016[4] to reflect changes to the methodology; and ensuring better and mutual understanding of supervisory findings and requirements by means of improved dialogue between supervisors and banks during the development of SREP decisions.

1.2 Maximum distributable amount

The resolution refers to the maximum distributable amount (MDA) in paragraph 26. The EBA's Opinion on the topic clarified the interaction between Pillar 2 and capital buffers by spelling out that Pillar 2 should be seen as a binding requirement (that is, the add-on has to be met at all times) and that buffers are placed on top of Pillar 1 and Pillar 2 requirements. The aim of the EBA's Opinion was to harmonise the application of the single rulebook across the entire European Union, until Article 141 CRD[5] has been amended. An initial proposal has been made by the Commission as part of the review of the CRD/CRR; the ECB is currently preparing an opinion on the proposal.

The introduction of Pillar 2 guidance, as explained above, implies a less stringent MDA threshold. It is therefore also in line with the EP's resolution, which considered that a margin of flexibility could be used in this regard.

1.3 Bank risks beyond credit risk and the shadow banking sector

Regarding the considerations in paragraph 31 of the EP resolution, the SSM SREP methodology foresees an assessment of all material risks, beyond credit risk. As stated in its booklet mentioned above, the SREP provides a holistic approach towards an institution's risk profile based on the assessment – not just the simple sum – of four elements. These four elements are (i) the business model, (ii) governance and risk management, (iii) risks to capital and (iv) risks to liquidity and funding. The assessment of risks to capital captures credit risk, but also other risk categories such as market risk, operational risk and interest rate risk in the banking book. Furthermore, this comprehensive approach of the SREP ensures that any material non-financial risk is taken into account, mainly through the assessments of banks' governance and risk management and business models. Risks with non-financial components – identified as priorities by ECB Banking Supervision – are the subject of thematic reviews, such as on governance and risk appetite or on outsourcing activities, with the results feeding into the SREP. In this context, a number of additional supervisory activities are being carried out on an ongoing basis, for example regarding risks arising from cybercrime.

---

4 SSM SREP Methodology Booklet

5 Directive 2013/36/EU of the European Parliament and of the Council

We recognise the complexity in the valuation of level 3 assets, including derivatives, and have adopted a supervisory approach that promotes thorough supervision and understanding of these products. Level 3 assets are explicitly captured in the SREP methodology, within the scope of market risk assessment. The joint supervisory teams (JSTs) are equipped with a set of indicators allowing them to assess the complexity of market activities. The steady increase in the number of on-site inspections focusing on level 3 assets confirms how relevant a topic it is for supervisors.

With regard to the links between the regulated banking sector and the shadow banking sector, a number of regulatory measures have already been taken or are being put in place with the aim of reducing the exposure to risks arising from spillovers between different financial sectors. More specifically, these measures consist of the EBA's Guidelines on limits on exposures to shadow banking entities[6] (published in December 2015) and the final Basel Committee standards on Capital requirements for banks' equity investments in funds (dated December 2013). In addition, the ECB actively contributes to the work of the Basel Committee on what is known as "step-in risk[7]", which is potentially embedded in banks' relationships with shadow banking entities. Once these standards have been finalised, their timely implementation in the European Union will be crucial to ensuring that supervisors have the powers needed for dealing with step-in risks. The global standards currently being developed by the Basel Committee in this area are aimed at mitigating potential spillover effects from the shadow banking system to banks. This work is in response to the G20 initiative to strengthen the oversight and regulation of the shadow banking system and to mitigate the associated potential systemic risks.

Furthermore, new regulatory initiatives will contribute to controlling shadow banking activity – in particular by ensuring that transactions across the two financial sectors are sufficiently collateralised. This includes new rules on margining and haircut requirements for over-the-counter (OTC) derivatives under the European Market Infrastructure Regulation (EMIR)[8] and the minimum haircut framework for securities financing transactions developed by the Financial Stability Board. It should also be noted that the proposed regulation for money market funds in the European Union explicitly prohibits banks from acting as sponsors of money market funds.

1.4 Off-balance-sheet items

Regarding the point made in paragraph 32, ECB Banking Supervision agrees that the off-balance-sheet positions of global systemically important banks (G-SIBs) and other institutions deserve closer supervisory scrutiny. We note that several regulatory initiatives in this field that are aimed at reducing risks related to off-balance-sheet exposures have in fact been finalised or are well under way. For example, the Basel III leverage ratio will capture off-balance-sheet as well as on-balance-sheet items. It will hence ensure that off-balance-sheet items will require a certain minimum level of capital, and will thereby limit the amount of leverage banks can generate off balance sheet. For this reason, the ECB welcomes the decision by the

[6] EBA Guidelines on limits on exposures to shadow banking entities which carry out banking activities outside a regulated framework under Article 395(2) of Regulation (EU) No 575/2013

[7] Step-in risk is defined as the risk that a bank may provide financial support to a related entity – beyond, or in the absence of, any contractual obligation to do so – should the entity experience financial stress.

[8] Regulation (EU) No 648/2012 of the European Parliament and of the Council

Commission to propose the introduction of a 3% leverage ratio as a mandatory requirement in the context of the current review of the Capital Requirements Directive and Regulation (CRD IV/CRR[9]). However, close alignment to the Basel III standard for the calculation of the leverage ratio is considered crucial in order to ensure that these new rules indeed effectively limit on- and off-balance-sheet leverage.

1.5 Early planning of supervisory actions

Regarding the need for early planning of supervisory actions, as mentioned in paragraph 7 of the resolution, ECB Banking Supervision has invested significant effort in planning its main supervisory activities and communicating them to the supervised entities.

Similar to what was done for SSM supervisory priorities for 2016, on 15 December 2016 the ECB published the priorities for 2017 on the ECB Banking Supervision's website. For each of the priorities, the document enumerates the main supervisory initiatives to be carried out, including several cases where full implementation will take over a year.

As was the case last year, the JSTs shared with banks in late 2016/early 2017 the supervisory examination programme (SEP) containing the main supervisory activities planned for 2017 as well as the foreseen timeline (key meetings, thematic reviews, on-site inspections).

In addition, in 2016, contact with the supervised entities has been stepped up, namely through (i) numerous meetings and workshops to communicate to the banks the supervisory initiatives, timelines and organisational topics in advance of, and even during, their implementation (e.g. stress test, targeted review of internal models (TRIM), non-performing loans (NPLs), etc.) and (ii) several public consultations (e.g. on the Guidance for banks on NPLs, Guidance on leveraged transactions, Guide to fit and proper assessments).

2. Single rulebook and reporting requirements for banks

2.1 Options and national discretions

Regarding the comments made on options and national discretions (ONDs) in paragraph 27, the ECB agrees that further steps need to be taken to harmonise unwarranted options and discretions in the regulatory framework – including options and discretions for Member States – and supports work at a legislative level in this direction. From a supervisory perspective, the ECB finalised its OND project, which covered more than 130 ONDs of the CRD IV package. Moreover, the ECB has been cooperating closely with the national competent authorities (NCAs) so that the OND policy is extended, as appropriate, to less significant institutions (LSIs)

The resolution mentions specifically the supervisory discretions on conglomerate and non-conglomerate institutions which have holdings in insurance undertakings. The ECB has examined them as part of its dedicated work on designing a policy for supervisory options and discretions. The regulatory framework provides for a specific prudential treatment of insurance holdings for banks belonging to a conglomerate. It

[9] Regulation (EU) No 575/2013 of the European Parliament and of the Council

grants to the supervisor the discretion to allow those banks not to deduct these holdings from their own funds, as is the rule for non-conglomerate banks. The Supervisory Board of the ECB has decided to maintain prior decisions exercising this discretion, provided that disclosure requirements are enhanced. Such enhancement is now also included in the EBA's Guidelines specifying disclosure requirements in current regulation. Future cases will be decided by assessing the regulatory criteria and taking the specific facts of each case into account.

In the longer term, the Supervisory Board of the ECB is supporting work on the modification of the regulatory framework, in order to ensure a prudent treatment for banks belonging to a conglomerate. Specifically, the Board supports a legislative amendment towards the deduction of the Solvency II requirements of the insurance component from the capital of the bank.

2.2 The regulatory treatment of sovereign exposures

The resolution discusses the regulatory treatment of sovereign exposures in paragraph 33. ECB Banking Supervision agrees that the regulatory framework as it stands needs to be reviewed and refined. The recent financial crisis showed that sovereign debt is not risk-free. The ECB considers that this review should be based on the following three broad principles: first, sovereign risk should be addressed under Pillar 1 and any regulatory change should come about through price effects rather than quantitative restrictions. Second, any revision to this aspect of the regulatory framework should be done very carefully in order not to impair the sovereign bond markets' key role in the functioning of financial markets and to minimise any potential negative impact on the real economy. Third, it would be important to allow for an appropriate transition period. Last, the review should be coordinated at global level to ensure an international level playing field.

The ECB is also supportive of the ongoing regulatory work on risk reduction, which is also mentioned in paragraph 33 of the resolution. The ECB has been actively engaged in the relevant policy discussions in the Basel Committee, in cooperation with the relevant European institutions and NCAs. With regard to the convergence of internal ratings-based (IRB) systems for the measurement of credit risk, the objective of this work, which includes the launch by the ECB of TRIM – the Targeted Review of Internal Models – is to ensure an appropriate reduction in unwarranted risk-weight variability while maintaining risk sensitivity without a significant overall increase in capital requirements. The ECB also welcomes the current legislative proposals by the Commission, aimed at implementing several internationally agreed standards such as the Total Loss-Absorbing Capacity (TLAC) standard, which will effectively increase the resilience and resolvability of the EU banking system.

2.3 Reporting requirements and proportionality

The resolution emphasises in paragraph 8 the need to avoid double reporting requirements and to uphold the proportionality principle. The ECB Regulation on reporting of supervisory financial information of 17 March 2015 closed some of the data gaps in supervisory reporting in a permanent and harmonised fashion. In particular, it extends the harmonised regular reporting of financial information so as to cover the consolidated reports of banks under national accounting frameworks and solo reports (e.g. for supervised entities that are not groups). As a consequence, and because of the use of the "sequential approach" used

by the ECB to collect the data, banks report the data "once only" and use a "single channel" for reporting both to the NCAs and the ECB. Hence, the Regulation has been designed so as not to create any double reporting requirements.

The Regulation duly respects the principle of proportionality by distinguishing between different groups of reporters, depending on whether: they are significant or less significant; they are reporting on a consolidated or individual basis; and their total assets are above or below a materiality threshold of €3 billion.

The Regulation does not affect the accounting standards applied by supervised groups and entities in their consolidated or annual accounts, nor does it change the accounting standards applied to supervisory reporting. For further details regarding how ECB Banking Supervision ensures the proportionality of supervisory requirements, please refer to previous letters sent on the topic.[10]

2.4 Fair value measurement in IFRS 9

The resolution also mentions the fair value measurement under IFRS 9 in paragraph 28. Pursuant to the transition requirements of the CRR, unrealised gains and losses related to financial instruments measured at fair value should be reflected in the calculation of CET1 capital subject to the applicable percentages determined by competent authorities within the ranges defined in the CRR for the period from 1 January 2014 to 31 December 2017.

As highlighted by the comprehensive assessment conducted in 2014, the way transitional rules regarding the definition of own funds were previously exercised at the national level resulted in inconsistencies across Member States, with a significant impact on certain banks. More generally, fragmentation in the application of prudential standards has negative implications for banks, markets and supervisors. This has led to the ECB considering whether harmonisation of the exercise of the transitional options and discretions was necessary from a prudential perspective.

The ECB highlights that prudential filters will not apply under IFRS 9, which will come into effect on 1 January 2018. Given that IFRS 9 was legislated through a Commission Regulation, the ECB considers that a phased removal of the prudential filters using the minimum speed within the percentage ranges of the CRR represents a proportional approach; such approach facilitates a smooth transition to the full application of IFRS 9. Consequently, as part of ECB Regulation (EU) 2016/445 on the exercise of options and discretions available in Union law, the ECB determined the applicable percentage of unrealised gains and losses within the meaning of Articles 467(1) and 468(1) of the CRR, including gains and losses on exposures to central governments classified in the "available for sale" category for the years 2016 and 2017. For inclusion of unrealised losses, the set percentages are 60% in 2016 and 80% in 2017. For removal of unrealised gains the percentages represent 40% in 2016 and 20% in 2017.

[10] Reply to letters QZ146-148 and letter to MEP Giegold on The principle of proportionality: application in the Single Supervisory Mechanism

3. Comprehensive assessment

3.1 Review of comprehensive assessments

Regarding a call for a review of comprehensive assessments of ECB-supervised institutions (paragraph 11), the ECB notes the following. After the finalisation of the 2014 comprehensive assessment the SSM carried out an internal "lessons learned" exercise as part of the quality assurance on supervisory processes, the findings of which were taken into account in subsequent comprehensive assessments conducted in 2015 and 2016. Technical clarifications and improvements to the methodology of the asset quality review (AQR) were implemented where needed. The core AQR approach as such was retained, thereby ensuring that the high standards of the 2014 exercise continued to apply and a level playing field across the participating institutions was maintained. The EBA published an updated and revised methodology for the 2016 EU-wide stress test (in which 37 significant institutions under direct ECB supervision participated), which has been applied as the stress-test component of the 2016 comprehensive assessments.

The comprehensive assessment has proved crucial as a supervisory tool to assess institutions' asset quality, capital level and internal processes related to asset valuation. However, it should be emphasised that it is a complement to, rather than a substitute for, ongoing supervision and has neither been designed nor presented as a tool accounting for each and every possible source of risk an institution may be exposed to. Nevertheless, SSM supervisors do check whether issues emerging at the level of an institution could or should have been detected in a prior comprehensive assessment: such checks have not revealed any material shortcomings in the comprehensive assessment methodology to date. As regards stress test scenarios, it should be noted that conducting ex post reviews of whether the projections of a given scenario have materialised and potentially adjusting the capital impact for a given institution on this basis would materially deviate from the logic and purpose of stress testing. Stress test scenarios are meant to capture possible forward-looking paths, whether realistic (baseline scenario) or severe, albeit plausible (adverse scenario), among an infinite range of possibilities. The purpose of an adverse stress test scenario is to test the resilience of individual banking groups and of the banking system as a whole. As such, the strength of an adverse stress test scenario lies not only in the likelihood of the scenario occurring, but also in its ability to detect weaknesses. In this respect, it is expected that institutions are, at any given point in time, adequately capitalised under a baseline scenario that reflects market expectations at the time of the forecast. The same institutions should show an adequate degree of resilience under a severe, but plausible, adverse scenario.

4. Transparency, accountability and reporting

4.1 Transparency

The resolution calls for more transparency and suggests that the publication of a list of Frequently Asked Questions (FAQs) on the SREP could be a useful tool in paragraphs 37 and 38. The ECB strives to increase transparency with regard to its Pillar 2 assessments and the underlying methodology for the SREP. In response to the suggestion provided in the resolution, the ECB published an introductory FAQ on the SREP

on its website[11] in June 2016. In the same year the ECB enhanced the communication to the banks on the assessments that lead to Pillar 2 decisions. For example, in order to ensure consistency and quality across the euro area, the ECB shared with all significant institutions an indication of the key drivers of the possible decisions (e.g. capital, liquidity and other qualitative specific measures), a review of the stress test outcomes as well as peer comparison of key indicators.

Among the other activities conducted to enhance the transparency regarding the SREP were seminars for the senior management of banks as well as numerous explanatory meetings with journalists, banking federations and other stakeholders. Moreover, as already mentioned earlier, the ECB has published a detailed overview of its SREP methodology, the *SSM SREP methodology Booklet 2016*. This booklet provides not only a detailed description of the SSM SREP methodology as such but also an overview of the aggregated results of the 2016 SREP cycle.

4.2 Audits by the European Court of Auditors

The resolution discusses the audits by the European Court of Auditors (ECA) of ECB Banking Supervision (paragraph 40).

As stated by the Vice-Chair of the ECB Supervisory Board during the joint CONT-ECON meeting on 13 February 2017, the clearly defined limitation of the ECA's mandate with regard to the ECB, which is stipulated by Article 27.2 of the Statute of the ESCB, is aimed at safeguarding the ECB's independence. The SSM Regulation was necessarily, but also deliberately, made consistent with the provisions of primary law.

ECB Banking Supervision is committed to making an effort to reach an agreement with the ECA on future cooperation within the existing legal framework, while fully respecting the confidentiality of supervisory information. The ECB and the ECA are engaged in very constructive dialogue on the issue.

5. Institutional and human resources issues

5.1 Human resources

The resolution mentions the ECB's contracting practices (paragraph 3a). In this regard, the ECB notes the following. The staffing of the core banking supervision functions at the ECB generally foresees permanent positions. To fill these positions the ECB advertises positions with convertible contracts, which after an initial period of three or five years are expected to become contracts of indefinite duration.

To recruit for these positions, the ECB attaches great importance to a comparison of the merits of the candidates against the requirements of a position and to appointing individuals with the highest levels of ability, efficiency and integrity. Accordingly, we clearly specify in the vacancy notices the technical and behavioural competencies against which candidates will be assessed, distinguishing between minimum requirements that all candidates have to meet and additional requirements in terms of knowledge or competence.

[11] What is the SREP?

Short-term contracts are offered in case of short-term employment needs or to cover for absent staff on a short-term basis. In addition, offering short-term contracts to staff from National Central Bank (NCBs) or NCAs, who continue to have an employment contract with the releasing authority, fosters collaboration and leverages the spirit of cooperation and teamwork within and across the SSM.

The ECB Conditions of Employment provide for a standard working week of 40 hours. Members of staff and their managers have joint responsibility for monitoring the working time and may agree upon incidental deviations from standard working hours, with due regard to organisational and personal requirements as appropriate.

The financial crisis and the addition of the banking supervision tasks have resulted in a high increase in demands placed on staff, which has often meant working extra hours. To mitigate these challenges and support ECB staff well-being, the ECB Executive Board has recently endorsed streamlining the ECB regulatory framework on working time. This streamlining is expected to come into force in the third quarter of 2017. This set of measures, currently under consultation with staff representatives, is aimed at ensuring close compliance with the Working Time Directive and making the ECB working time arrangements more flexible. The increase in the number of positions for supervisory-related activities – 160 FTEs in 2016, 141.5 FTEs in 2017 – will also contribute to alleviating the pressure on staff.

The ECB's HR framework provides for manifold opportunities for staff and union representatives to voice their views and submit their feedback on the working conditions and staff benefits. At the same time, the ECB is looking at ways of further enhancing the participation by staff representatives in the context of a Joint Working Programme.

5.2 Joint supervisory teams and the involvement of NCAs

The resolution states that further improvements regarding the JSTs could be pursued and refers to the involvement of NCAs in the decision-making process (paragraph 6). JSTs are the cornerstones of the SSM. They are composed of ECB and NCA staff, the latter making up the majority. JST coordinators, who are ECB staff, are supported by sub-coordinators from NCAs who assist in organising the JST work. Larger JSTs are made up of a core JST consisting of a JST coordinator and the sub-coordinators from NCAs, with the sub-coordinators typically responsible for clearly defined thematic or geographic areas of supervision[12]. In order to further facilitate cooperation between the ECB and NCAs in the JSTs, the ECB introduced dedicated JST workshops in November 2016; these workshops provide an opportunity for JST members and (sub-)coordinators from across the SSM to learn about sound JST practices.

Furthermore NCAs are part of the decision-making process in the SSM. They are represented on the Supervisory Board by one voting member per participating Member State, acting in the interest of the Union as a whole. Since the creation of the SSM, the ECB and NCAs have been collaborating through horizontal networks of experts as well as other working structures, such as task forces or drafting teams, a number of which are chaired by NCA representatives.

[12] For more information on JST composition and organisation, please refer to the ECB's Guide to banking supervision: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssmguidebankingsupervision201411.en.pdf

6. Issues outside the scope of the work of ECB Banking Supervision

In accordance with the separation principle, ECB Banking Supervision is not in a position to comment on suggestions which are of relevance only for the ECB's non-supervisory functions such as those regarding the ECB's role in economic adjustment programmes.