EUROPEAN CENTRAL BANK
BANKING SUPERVISION

ECB-PUBLIC

Feedback on the input provided by the European Parliament as part of its "resolution on Banking Union – Annual Report 2017"

ECB Banking Supervision is grateful for the feedback provided by the European Parliament in its "resolution on Banking Union – Annual Report 2017"[1] (hereafter "the Resolution") of 7 February 2018. In line with the practice established for the European Parliament's annual resolutions on the banking union, this is ECB Banking Supervision's response to the comments and suggestions provided by the European Parliament, underlining ECB Banking Supervision's strong commitment to accountability.

1. Interactions with the Single Resolution Board (SRB), supervisory work ahead of bank resolutions/liquidations and stress tests

The Resolution agrees with the Commission that the procedures leading to decisions as to whether or not a bank is "failing or likely to fail" (FOLTF) need to be improved (see paragraph 2) and notes areas for improvement concerning the exchange of information and coordination between the ECB and the SRB (see paragraphs 5 and 40). The Resolution also calls for using consistent methodologies, scenarios and assumptions when defining stress tests (see paragraph 3).

The experience gained with the crisis cases experienced in 2017 and 2018 has shown that close cooperation and a comprehensive information exchange between all stakeholders contributed significantly to a smooth FOLTF process despite tight timelines, and allowed all authorities to act quickly and address the respective situation within the required time frame. In accordance with the Memorandum of Understanding (MoU) between the ECB and the SRB, cooperation between ECB Banking Supervision and the SRB intensifies when the condition of a significant institution (SI) deteriorates. In particular, among other things, cooperation and information exchange were enhanced with regard to those banks that were determined to be FOLTF in 2017 and 2018. This thorough and extensive exchange of information helped to prepare all stakeholders early on.

The coordination and information exchange between ECB Banking Supervision and the SRB in crisis cases was also ensured via cross-participation in the respective decision-making bodies. Representatives from the SRB participated in meetings of the ECB's Supervisory Board and in meetings of the crisis management teams organised by the ECB. The SRB thus received the same information as the Supervisory Board members and at the same time (including the drafts of the FOLTF assessments). Likewise, ECB Banking Supervision, together with the European Commission, participated as observers

[1] http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+REPORT+A8-2018-0019+0+DOC+XML+V0//EN

in the meetings of the SRB Executive Session, thus receiving information on the assessment carried out by the SRB regarding the other conditions for resolution (i.e. the lack of alternative measures and the public interest). This allowed continuous alignment with and understanding of each other's perspectives. Overall, close cooperation and information-sharing between the ECB and the SRB were essential in order to address the banks' situations, and contributed significantly to an efficient crisis management process in the banking union.

As regards the conditions for declaring a bank FOLTF, the ECB applies the criteria identified in the European legal framework and further specified in Guidelines[2] of the European Banking Authority (EBA), which provide a set of objective elements that should support the determination that an institution is FOLTF, without constraining the ultimate supervisory discretion of the competent authority. Moreover the ECB developed internal operational guidance to joint supervisory teams (JSTs) on determining whether an entity is FOLTF.

The ECB has recently started internal work on the revision of the crisis monitoring and management framework, also taking into account the recommendations of the European Court of Auditors[3], which will further enhance the ECB's internal escalation process.

Regarding the exchange of information and cooperation with the SRB, the ECB and the SRB concluded an MoU at the end of 2015, which establishes rules for cooperation and information exchange.

Relevant information is exchanged both on a regular basis as well as on an ad hoc basis. At the end of 2016, the SRB was granted direct access to relevant supervisory information and data stored in the ECB supervisory IT system in line with the scope of information agreed upon in the MoU. This streamlined and automated the ongoing exchange of information and also ensured that the reporting burden on banks was kept to a minimum.

In line with the provisions of the MoU, the ECB and the SRB reviewed the MoU in 2017. The objective was to review certain parts of the MoU to take account of the experience gained in the first two years of its implementation and to address the practical challenges encountered. The revised MoU was published on 6 June 2018 on ECB website. The main change is related to the information exchange framework and aims to further enhance cooperation and information exchange between the ECB and the SRB.

In addition to an automated and ad hoc exchange of information, close cooperation between ECB and the SRB is also supported by several arrangements that aim at fostering cooperation on all levels. Apart from institutional representation in each other's Board meetings, there was also constructive and increased cooperation between ECB and the SRB at a technical level within the respective substructures. In

2 EBA Guidelines on the interpretation of the different circumstances when an institution shall be considered as FOLTF under Article 32(6) of Directive 2014/59/EU (EBA/GL/2015/07).

3 https://www.eca.europa.eu/Lists/ECADocuments/SR18_02/SR_SSM2_EN.pdf

addition, JSTs and Internal Resolution Teams interact with regard to individual banks. Furthermore, regular staff-level exchanges took place between the horizontal functions of the ECB and the SRB.

Regarding planning-related work, the ECB consulted the SRB on those recovery plans for which it was the consolidating supervisor. The feedback received from the SRB was subsequently taken into account for the ECB's assessment of the recovery plans. At the same time, the SRB consulted the ECB on draft resolution plans and the minimum requirements for own funds and eligible liabilities (MREL).

Regarding the call raised in the Resolution to limit as much as possible the additional burden and complexity for the SRB arising from cross-border less significant institutions (LSIs) that are not supervised by the ECB but do fall under the responsibility of the SRB, the ECB agrees that close cooperation between supervisory and resolution authorities is key for the successful handling of crisis cases. Despite the fact that the FOLTF assessment for less significant cross-border groups falling under the direct responsibility of the SRB is a competence of the national competent authorities (NCAs), the ECB is fully committed to cooperating within the applicable legal framework in order to support the SRB in successfully performing its work. This is underlined by the ECB publication "LSI supervision within the SSM"[4], which points out existing common policies on crisis management for LSIs and the related cooperation between the ECB, NCAs and, where appropriate, other relevant external parties including the national resolution authorities and the SRB.

Stress tests are a tool designed to cast light on the resilience of institutions to certain adverse macroeconomic scenarios that may or may not materialise. The ECB agrees that consistent methodologies, scenarios and assumptions are crucial to achieving this goal. The EBA stress test results should not, however, be singled out as the ultimate supervisory indicator of the health of an institution. In particular, the stress test is not a "pass or fail" exercise; rather it is conceived as an input into the Supervisory Review and Evaluation Process (SREP) decision and is reflected in SREP decisions in the form of Pillar II guidance. Therefore, the stress test exercise needs to be interpreted in combination with other tools available to supervisors, such as asset quality reviews, on-site and internal model investigations, as well as other ongoing supervisory monitoring activities.

2. Monitoring of risks and the impact of new financial reporting standards

2.1 Non-performing loans

The Resolution would welcome better coordination between efforts to address non-performing loans (NPLs) and calls for a swift implementation of the Council Action Plan to tackle NPLs in Europe (see

[4] https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.reportlsisupervision2017.en.pdf

paragraph 8). Furthermore it reiterates concerns regarding the then draft Addendum to the ECB guidance on NPLs (see paragraph 9).

ECB Banking Supervision strongly supports the swift implementation of the Council Action Plan and has, on numerous occasions, called on all stakeholders involved to undertake timely actions in this respect. The efforts of ECB Banking Supervision on NPLs, including the development and publication of the NPL guidance, NPL stocktake and NPL Addendum, were closely coordinated with relevant stakeholders including the European Commission and the EBA. ECB Banking Supervision also participated actively in EU working groups on NPLs including those organised by the Council's Financial Services Committee, the Commission, and the European Systemic Risk Board (ESRB) – thus contributing to the development and implementation of the NPL Action Plan. On the NPL Addendum and the Pillar I NPL backstop proposal, in particular, the coordination with the European Commission was very intensive and included aligning the timing of and approach to communication.

With regard to the NPL Addendum, the ECB launched a public consultation in the interest of supervisory transparency, which is a core principle of our work. During the consultation process, the Legal Service of the EP commented inter alia on the potentially legally binding character of the Addendum. The ECB took note of these analyses and made sure, when drafting the final version of the Addendum, that they were fully taken into account and that no ambiguity remained as to the non-binding nature of the Addendum.

Finally, it should be noted that neither the Addendum nor other supervisory activities are asking banks to sell NPLs. In fact, the addendum works on the net exposure side, meaning that it aims to ensure that sufficient risk coverage is available for aged NPLs to avoid a piling-up of uncovered NPLs in the future.

2.2 Level 3 assets

The Resolution calls on the Single Supervisory Mechanism (SSM) to make Level 3 assets a supervisory priority for 2018 (see paragraph 10).

The attention paid by the ECB to the valuation of fair-valued instruments, which has been under the scrutiny of the European supervisors since the SSM was established, has increased in recent years, notwithstanding the observed reduction in the volume of such instruments held by banks.

In this field the ECB particularly focuses its attention on the broader topic of the valuation of fair-valued instruments, encompassing, but not limited to, the correct classifications of instruments to the accounting categories level 2 and level 3 (i.e. asset levelling). Indeed, the classification of assets as level 2 or level 3, while providing an indication of their complexity, cannot be considered a predictor of the underperformance of these assets and level 2 and 3 assets cannot be deemed “toxic” per se. The majority of revenue is generated from client-driven activity. Proprietary trading activities are quite minor both in terms of risk exposure and revenue contribution.

In this context, dedicated inspections were performed with the objective of evaluating the soundness and effectiveness of the valuation framework, the controls over the pricing models used to produce fair values, and the adequacy of the classification of positions measured at fair value (see Section 1.4 of the 2017 ECB Annual Report on supervisory activities[5]).

The valuation of complex fair-valued instruments will continue to be supervised intensively in 2019, with valuation risk being a key area of attention for the ECB. This is reflected by the number of related initiatives – such as on-site inspections, deep dives and benchmarking exercises – already planned or ongoing.

2.3 Cyber security

The Resolution calls on the supervisory authorities to closely monitor and assess cyber security risks, and calls on the SSM to increase its efforts and to formally make cyber security one of its high-level priorities (see paragraph 24).

Since the creation of the SSM, IT risk in general and cyber risk in particular have been identified as key risks to the euro area banking system. In 2015, the ECB performed a thematic review on cyber security risks, aiming at capturing cyber risk profiles of the SIs and comparing these across institutions. This was complemented by targeted on-site inspections starting in 2015. In order to gain more transparency and knowledge and to be able to address potential systemic cyber attacks in an efficient and effective way, ECB Banking Supervision established a cyber incident reporting framework in July 2017. All SIs in the banking union have to report significant cyber incidents as soon as they detect them. This enables the ECB to identify and monitor trends in cyber incidents affecting SIs, and it will facilitate a quick reaction by the ECB in the event that a major incident affects one or more SIs. In addition to these activities, the JSTs of course carry out IT risk supervision (including cyber risk supervision) on an ongoing basis as part of their supervision of operational risk.

2.4 IFRS9

The Resolution stresses the need to monitor the impact of IFRS 9 on the nature and allocation of loans by banks as well as on the potential procyclical effects derived from the cyclical sensitivity of credit risk parameters (see paragraph 18).

The ECB welcomes the call for monitoring of the impact of IFRS 9. ECB Banking Supervision is assigning great importance to the analysis of all the implications of the introduction of IFRS 9. In this context, the ECB conducted a thematic review in which the impact of IFRS 9 was scrutinised. In the future, the ECB will continue to monitor the impact of IFRS9. The short-term supervisory focus will be on analysis of the

[5] https://www.bankingsupervision.europa.eu/press/publications/annual-report/pdf/ssm.ar2017.en.pdf

impacts of applying IFRS 9 for the first time, including the change in exposures and in provisions and their allocation. In addition, the ECB actively participates in several international work streams where the IFRS 9 implementation and interaction with prudential regulation are being closely followed.

3. Transparency and audits

3.1 Transparency

The Resolution considers that the ECB's own stress test for additional banks under its supervision could benefit from more transparency (see paragraph 3).

The ECB considers that different supervisory activities merit different disclosure strategies, depending on their purpose. One of the key purposes of the EU-wide stress test coordinated by the EBA is to facilitate market discipline through the disclosure of granular data on a bank-by-bank level. By contrast, the stress test conducted by the ECB for those banks that are not included in the EBA sample focuses on informing the SREP assessment in order to ensure consistency in the supervisory assessment across all banks under ECB supervision. In line with the holistic nature of the SSM's SREP methodology, this stress test is only one element among a wide range of activities and inputs that are factored into the overall SREP assessment of each bank.

The outcomes of such individual supervisory activities are typically not disclosed. In line with this practice, the ECB decided not to publish the outcome of this so-called SREP stress test in 2016.

At the same time, the ECB is regularly assessing the appropriate disclosure policy on a case-by-case basis. For the 2017 stress test that comprised a sensitivity analysis of interest rate risk in the banking book (IRRBB), the results were published on an aggregate level.

3.2 Audits by the European Court of Auditors

The Resolution calls for an interinstitutional agreement between the ECB and the European Court of Auditors (ECA) to specify the exchange of information between both institutions in respect of their respective mandates as defined in the Treaties (see paragraph 5). The ECB is currently analysing this proposal, including seeking clarifications and assessing certain legal aspects.

4. Proportionality

The Resolution considers that the proportionality principle could be better taken into account in certain supervisory arrangements by the ECB (see paragraph 20). The Resolution furthermore stresses that supervisory authorities should keep the particular operating principles and the specific mission of cooperative and mutual banks in regard and reflect these in their practices and approaches (see paragraph 22).

Proportionality is a precondition for efficient banking regulation and supervision. Rules that are well aligned to banks' size and complexity foster a level playing field and support a competitive banking landscape. Hence, the principle of proportionality extensively guides the ECB's supervisory activities and measures. A methodology has been developed for tailoring the intensity and frequency of supervisory activities to (i) the significant institutions (SI)' potential impact on the financial system and (ii) their riskiness as assessed in the SREP. The ECB thus follows a risk-based and consolidated supervisory approach, in which the engagement and intensity of supervision vary, with a stronger focus on: institutions with a higher risk profile; the largest and more complex systemic groups; and the more relevant subsidiaries within banking groups. The minimum level of supervisory engagement with each SI depends on the size, risk profile and complexity of the institution in question. This in practice translates into, for example, fewer and shorter on-site missions, less intensive off-site supervision and smaller JSTs. In addition, the outcome of the SREP also forms the basis for taking proportionate supervisory measures, notably Pillar 2 capital add-ons, which are tailored to the individual risk situation of each institution.

The ECB also applies proportionality in its oversight activities for less significant institutions (LSIs) and, in order to do so, it assigns priority rankings to LSIs according to a methodology agreed with the NCAs. This methodology classifies LSIs into high, medium and low priority, based on the impact of the LSI on its domestic financial system and the intrinsic riskiness of the LSI. It is subject to an annual review in cooperation with NCAs to ensure that the list for each category is adequately maintained. Regarding the ECB's oversight tasks, this classification of LSIs is reflected in the intensity of the notifications and reports from NCAs to the ECB on the performance of their supervisory tasks on LSIs (for example, NCAs are only requested to notify the ECB of supervisory decisions that are material and concern high-priority LSIs). Hence, low priority banks are subject to oversight of supervision, but less intensively than medium or high-priority banks.

Another example of the application of the proportionality principle is supervisory reporting, where the ECB applies proportionality by categorising banks and varying the scope and frequency of information requests depending on the nature of an entity.

With respect to the operating principles of cooperative and mutual banks, the ECB's supervisory approach acknowledges that effective governance in credit institutions is feasible under a variety of corporate structures across the different SSM jurisdictions. It does not depend on the size and complexity of a credit institution, but rather on the robustness and soundness of the governance arrangements in place.

5. Coordination between the ECB and the EBA

The Resolution recommends that concrete coordination of the initiatives to be taken by the ECB and the EBA be improved wherever practicable, in order to ensure the consistency of the single rulebook (see paragraph 4).

The SSM is responsible for the prudential supervision of all credit institutions in the banking union. Within the SSM framework, the ECB directly supervises SIs and ensures consistent supervision of all banks across the banking union. The EBA, on the other hand, has been entrusted with a regulatory function, being tasked with supporting the development of the single rulebook and fostering the convergence of supervisory practices across the EU.

The single rulebook is a necessary condition for single supervision and the ECB fully supports the EBA's efforts to provide a single set of harmonised prudential rules across the EU. To this end, the ECB works closely with the EBA towards the shared objective of promoting consistent supervision. It welcomes all practical initiatives that can be taken within the established division of responsibilities to further strengthen the coordination between the ECB and the EBA. Where standards and guidelines are adopted by the EBA, the ECB adjusts its own approach as necessary. At the same time, competent authorities need to be able to address existing risks for the banks under their supervision, including in those areas where the EBA has not yet established harmonised rules and supervisory practices.

Among the most recent examples of the ECB's active engagement with the EBA is the common effort to foster supervisory convergence regarding the timing and process of suitability assessments of the members of banks' management bodies. Moreover, looking forward, the ECB and EBA are jointly establishing a task force to implement a European centralised infrastructure for supervisory data collection.

6. Institutional and human resources issues

6.1 On-site supervision

The Resolution takes the view that involving more ECB staff in on-site inspections could further enhance the independence of banking supervision from national considerations (see paragraph 17).

On-site inspections are an important supervisory tool for conducting in-depth investigations of risks, risk controls and governance at a bank. They are undertaken at the request of the JSTs, but are carried out independently of the ongoing, day-to-day supervision performed by the JSTs. For each on-site mission, the head of mission receives a precise mandate and has a focused objective that is approved in advance by the ECB's Supervisory Board. On-site inspections are planned and staffed in close cooperation with the NCAs, which continue to provide most of the heads of mission and team members.

In 2017, a high level group set up by the SSM explored ways of fostering a stronger SSM-wide approach to on-site missions at SIs. The group found that promoting a common SSM "on-site culture" is likely to be a key element in the further harmonisation of on-site practices. Clearly, cross-border missions (defined as inspections where the head of mission and at least one team member do not come from the relevant NCA) and mixed-team missions (defined as inspections where the head of mission comes from the relevant NCA and at least two team members do not come from the relevant NCA) are an effective means of developing a common banking union on-site culture in addition to the involvement of more ECB staff in the on-site inspections. Therefore, the group recommended that the share of cross-border and mixed-team missions within the SSM should be increased over the coming years. Following the group's proposal, ambitious quantitative targets for raising the number of cross-border missions in 2018 were set. Those targets may be reviewed and possibly raised further over the coming years. This year, 2018, is to be regarded as a pilot phase for the new approach. Accordingly, the ECB has stepped up coordination and staffing efforts related to cross-border and mixed-team on-site missions and has enhanced the support it provides to NCA on-site inspectors willing to participate in such missions.

6.2 Delegation of decision-making

The Resolution calls on the ECB to specify tasks for the delegation of decision-making (see paragraph 30).

The delegation of decision-making powers has led to significant improvements in the efficiency of ECB supervisory decision-making[6]. The decision-making process has become simpler and swifter, and has also enabled the Supervisory Board and the Governing Council to focus on more complex issues, as certain routine supervisory decisions are now adopted by ECB senior managers. In addition, delegation has addressed concerns regarding the efficiency of the ECB's decision-making process raised by the European Court of Auditors[7], the European Commission[8], the European Parliament[9] and the International Monetary Fund[10].

Since its creation in 2017, the delegation framework has been implemented successfully for supervisory decisions on the assessment of fit and proper requirements and on amendments to the significance of

[6] For further information on the delegation framework, see ECB 2017 Annual Report on supervisory activities. For further information on the ECB's decision-making prior to the implementation of delegation, see Report from the Commission to the European Parliament and the Council on the Single Supervisory Mechanism established pursuant to Regulation (EU) No 1024/2013, published on 11 October 2017.

[7] ECA Special Report No 29/2016, "Single Supervisory Mechanism – Good start but further improvements needed".

[8] Report from the Commission to the European Parliament and the Council on the Single Supervisory Mechanism established pursuant to Regulation (EU) No 1024/2013, published on 11 October 2017.

[9] European Parliament resolution of 1 March 2018 on Banking Union – Annual Report 2017 (2017/2072(INI)).

[10] IMF Country Report No 16/196, "Germany: Financial Sector Assessment Program – Detailed Assessment of Observance on the Basel Core Principles for Effective Banking Supervision", 29 June 2016.

supervised entities. In the first quarter of 2018, approximately 60% of fit and proper decisions and 91% of significance decisions were adopted by means of delegation. The extension of the delegation framework beyond fit and proper and significance decisions allows for the efficiency gains in the decision-making process to be extended to other types of supervisory decisions. Thus, in March 2018, the ECB adopted the decisions on the delegation of decision-making powers with regard to decisions on the reduction of own funds, the classification of Common Equity Tier 1 instruments and, where required by national law, to the classification of Additional Tier 1/Tier 2 instruments[11].

The experience gained so far has demonstrated that the two parallel processes of decision-making, namely with delegated and non-delegated decisions, enable a more efficient use of resources, as well as simpler and swifter processes. In addition, transparency and reporting on delegated decision-making have been ensured by regular reporting to the Supervisory Board and the Governing Council.

Building on the very positive experience and the widespread support for further delegation of decision-making powers, the ECB is considering in the course of 2018 whether additional types of routine, uncontroversial supervisory decisions that involve limited discretion could be subject to the simpler and swifter delegated process. That being said, further streamlining continues to take place in the form of simplifying processes, templates and procedures.

[11] Decision (EU) 2018/546 of the European Central Bank of 15 March 2018 on delegation of the power to adopt own funds decisions (ECB/2018/10) (OJ L 90, 6.4.2018, p.105) and Decision (EU) 2018/547 of the European Central Bank of 27 March 2018 nominating heads of work units to adopt delegated own funds decisions (ECB/2018/11) (OJ L 90, 6.4.2018, p.110).