EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Feedback on the input provided by the European Parliament as part of its "Resolution on Banking Union – Annual Report 2021"

ECB Banking Supervision welcomes the feedback provided by the European Parliament in its "Resolution on Banking Union – Annual Report 2021"[1] ("the Resolution") of 5 July 2022. To continue the dialogue between the European Parliament and the ECB and underline our strong commitment to accountability, ECB Banking Supervision hereby replies to the comments and suggestions provided by the European Parliament in the Resolution.

1. General state of the European banking system

The Resolution commends the banking sector's resilience in the face of the coronavirus (COVID-19) crisis as supported by the temporary measures and additional capital relief provided by the ECB (paragraph 5). It also welcomes the 2022-2024 supervisory priorities of ECB Banking Supervision, acknowledging the substantive efforts made to tackle these challenges by the banking sector in recent years and the results obtained (paragraph 9). In this context, the Resolution praises the reduction of aggregate non-performing loan (NPL) ratios and stresses that EU and national supervisors must monitor risks closely as emergency public support measures are phased out. In addition, the Resolution calls on the ECB to closely monitor the impact of the war in Ukraine on the EU banking sector (paragraph 4). Moreover, the Resolution highlights the need to carefully monitor any risks posed by Russia's aggression against Ukraine, to consider different scenarios and to prepare for different possible options (paragraph 14).

Banks remained resilient in the face of the COVID-19 pandemic and kept strong capital and liquidity positions. The Single Supervisory Mechanism's (SSM) supervisory priorities for 2022-2024, published in December 2021, were developed specifically to address, inter alia, vulnerabilities stemming from the impact of the pandemic and also emerging risks, such as climate and environmental risks, cyber and outsourcing risk and counterparty credit risk. In this context, targeted supervisory activities have been initiated or continued in order to address shortcomings in banks' credit risk management frameworks (i.e. relating to loan origination and monitoring, provisioning and internal models), risks stemming from banks' exposures to sectors more vulnerable to the impact of the pandemic, but also risks associated with abrupt adjustments in interest rates and credit spreads. As part of these work programmes, ECB Banking Supervision is carrying out targeted reviews and on-site inspections to benchmark and challenge banks' management of credit exposures, including collateral valuation practices.

[1] The text of the Resolution as adopted is available on the European Parliament's website.

However, banks still need to be prepared to face challenges in the near term. Since the outbreak of the war in Ukraine, the macroeconomic outlook has deteriorated further, while financial markets have proven particularly sensitive to abrupt adjustments in asset prices and interest rates.

Against this background, banks may come under pressure on several fronts. While the overall credit risk of bank balance sheets has thus far remained contained, some signs of increasing credit risk can be observed. The economic slowdown, high inflation and rising interest rates may in future lead to some asset quality deterioration, notably in energy-intensive corporate sectors, residential and commercial real estate markets, consumer finance and leveraged finance. A more pronounced deterioration in asset quality could, among other things, translate into an increase in non-performing loans (NPLs).

At the same time, looking at financial markets, clearing margin pressure on utility companies and commodity traders may translate into higher counterparty credit risk exposure for banks acting as clearing members. The strain placed by liquidity and counterparty credit risk on pension funds, asset managers, private equity firms and other non-bank financial institutions may result in higher credit and counterparty credit risk exposure for banks, but may also give rise to damaging asset price correction spirals which will have an impact on banks' balance sheets beyond direct exposures.

These recent developments and risks highlight once again the importance for banks to have sound risk management arrangements in place to cope with heightened interest rate and credit spread risks and counterparty credit risk. In addition, increased cyber threats stemming from the war are strengthening the need for banks to develop and maintain sound cyber hygiene measures and strong operational resilience, as reflected in the supervisory priorities. In parallel, ECB Banking Supervision is continuing its efforts to improve supervision of banks' climate-related and environmental risk management, internal governance and business models.

While the current macroeconomic environment broadly confirms the relevance of the 2022-2024 supervisory priorities, ECB Banking Supervision is continuing to closely monitor the macro-financial environment and stands ready to adjust its focus to the evolving risk landscape when needed. Specifically, this could entail targeted adjustments to our priorities for the next supervisory cycle of 2023-25. These adjustments will be reflected in the revised priorities to be published towards the end of this year.

ECB Banking Supervision is carefully monitoring the effect of the developing macroeconomic shock on banks and calls on them to proactively monitor the downside risks underlying the macroeconomic and financial outlook. In this regard, we asked banks to update their capital projections taking into account sufficiently adverse macroeconomic developments, including economic recession scenarios. ECB Banking Supervision will collect these updated projections by the end of October and will further assess potential vulnerabilities stemming from the current environment on that basis. In parallel, ECB Banking Supervision is continuously monitoring developments in financial markets, with a particular focus on the ongoing tightening of financial conditions and increased volatilities across asset classes and on the channels, both direct and indirect, through which banks could be affected. This includes not only the potential credit risk impact of gas stoppage scenarios but also market, counterparty and liquidity risks from derivatives transactions and systemic risk in general. Jointly, these follow-up activities aim to ensure that banks take concrete action to identify and mitigate the risks early on and start taking action to engage with borrowers. ECB Banking Supervision has asked more exposed banks to strengthen their risk management arrangements and to proactively monitor the evolution and concentration of derivatives and securities financing transactions portfolios as well as counterparties' creditworthiness, particularly in the case of less-regulated or less-transparent non-bank financial intermediaries or where the use of financial leverage is higher.

Throughout this process, ECB Banking Supervision has maintained open and frequent dialogue with banks to monitor risk profiles, assess banks' reactions and identify vulnerabilities at an early stage, and ECB Banking Supervision stands ready to coordinate action to ensure that banks remain safe and sound in any scenario. A resilient banking sector in Europe can help maintain access to credit and liquidity for both its corporate sector and its citizens, including in difficult circumstances. Considering that European banks have a central role to play in financing Europe's path to a more sustainable, resilient and digital economy, it is important to create the conditions that allow banks to do so efficiently and effectively across Europe.

2. Impact of the digital euro

The Resolution invites the ECB to consider the potential impact of the digital euro on payments, banks' lending capacity and financial stability (paragraph 11).

The primary aim of a digital euro is to provide central bank money for retail payments in the digital era. Issuing a digital euro and providing citizens with public money in electronic form would combine the benefits of central bank money with how people use money and pay today. As such, a digital euro would help preserve the role of public money as the anchor for the monetary system in the digital era, protect monetary sovereignty and support competition and efficiency in payments.

The Eurosystem is committed to designing a digital euro in such a way as to avoid risks to the banking sector. Therefore, its design will be carefully assessed with regard to the potential impact on monetary policy, financial stability and the provision of services by financial intermediaries, as evidenced by a number of recent ECB publications on the topic.[2] A digital euro will not challenge the role of banks as key financial intermediaries as (i) excessive holdings of digital euro will be avoided (for example, by embedding tools such as limits on individual holdings or tiered remuneration or a combination of such

[2] See, for example, Adalid, R. et al., "Central bank digital currency and bank intermediation", *Occasional Paper Series*, No 293, ECB, May 2022.

tools in the design of the digital euro) and (ii) banks will be an integral part of a digital euro payment solution (for example, through their front-end services).[3] It should be noted that the Eurosystem expects a digital euro to be distributed through supervised intermediaries with proven experience in areas like the onboarding of consumers, anti-money laundering checks and consumer-facing services. A digital euro would require a compensation model with adequate economic incentives to foster its adoption. The ECB is committed to continuing its regular reporting to the European Parliament on the progress of the investigation phase of the digital euro project.[4]

ECB Banking Supervision is closely following the progress made in the digital euro project and monitoring the potential impact both on the banking sector overall and on individual banks. It is the task of the co-legislators to ensure that the regulatory framework protects public and private forms of money in the digital age. In this respect, it is important to drive forward the regulation of crypto-assets and to ensure that no regulatory gaps in the crypto-asset ecosystem remain. The ECB therefore welcomes the progress on both the Markets in Crypto-Assets Regulation and the recast Transfer of Funds Regulation.

3. Gender balance in financial institutions

The Resolution regrets the failure to ensure full gender balance in EU financial institutions and bodies, in particular the fact that women continue to be underrepresented in executive positions in the field of banking and financial services (paragraph 13).

The ECB views diversity as essential to guarantee effective governance of financial institutions, resulting in better decision-making and risk management. Diversity relates to gender, but also to other aspects, in particular experience, knowledge and skills, age and geographical provenance.

ECB Banking Supervision addresses the lack of gender balance on the boards of supervised banks through the Supervisory Review and Evaluation Process (SREP), and the suitability of board members through fit and proper assessments. ECB Banking Supervision has conducted benchmark exercises and stock-takes to collect information on diversity on banks' boards and on the applicable national legal and regulatory diversity frameworks. As explained in the ECB Opinion on the proposal to amend the Capital Requirements Directive (CRD)[5], further EU harmonisation of the fit and proper process towards ex ante

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3 See Panetta, F., "The digital euro and the evolution of the financial System", introductory statement at the Committee on Economic and Monetary Affairs of the European Parliament, Brussels, 15 June 2022.

4 See the letter of 14 June 2022 from ECB Executive Board member Fabio Panetta to the Chair of the Committee on Monetary and Economic Affairs on progress reporting; and "Progress on the investigation phase of a digital euro", ECB, 29 September 2022.

5 Opinion of the European Central Bank of 27 April 2022 on the Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/36/EU as regards supervisory powers, sanctions, third-country branches, environmental, social and governance risk (CON/2022/16) 2022/C 248/03 (OJ C 248, 30.6.2022, p. 87).

approval of board members by European banking supervision would better ensure the collective suitability of banks' management bodies.

The ECB also supports a timely dialogue with banks on diversity practices to help foster diversity on their boards. As part of the monitoring of banks' governance risk management, ECB Banking Supervision has identified institutions that do not have diversity policies and targets in place for the underrepresented gender and has requested these institutions to adopt such policies.

In addition, in line with the 2022-2024 supervisory priorities, further supervisory activities are ongoing, such as the targeted analysis of the effectiveness and diversity of banks' management bodies and the clarification of supervisory expectations and practices on diversity to supervised entities.

4. Climate-related and environmental risks

The Resolution welcomes the ECB's commitment to carrying out climate stress tests in 2022 as an important element in tackling climate-related risk and calls for such tests to be based on realistic data and assumptions (paragraph 17). It also stresses the need for further improvements in the disclosure of climate-related and environmental (C&E) risks by banks, as well as improvements in the disclosure of transition strategies by entities to facilitate banks' and supervisors' assessment of risk. The report also calls for banks to take a "double materiality" perspective when assessing their climate-related risks and notes the importance of clear legislation to prevent greenwashing.

Moreover, the Resolution (paragraph 17) worries about an increase in NPLs due to stranded investments in fossil fuels and calls for the early identification and proactive management of such at-risk assets, encouraging the SSM to continue and strengthen work in this direction.

The 2022 climate stress test evaluated aspects of both physical and transition risks. Its methodological choices strike a balance between the ECB's objective of accelerating banks' management of climate-related risks and conducting a robust stress test. The stress test results[6] revealed that, despite the relevance of climate-related risks, most banks do not have robust climate risk stress-testing frameworks in place and lack relevant data. Banks also face significant difficulties in providing sound climate risk projections. Overall, banks' losses are lower in an orderly transition scenario than after delayed action. The climate stress test also shows that more than half of banks' income from non-financial corporate customers has its origin in greenhouse gas-intensive industries. This makes banks more vulnerable to transition risks and highlights the need for banks to understand their corporate customers' transition plans.

Another area of concern identified during the stress test is the high reliance on proxies for the calculation of financed emissions and energy performance certificates. Banks therefore need to step up their customer engagement and collaboration with external data providers. This should help banks to collect better climate-relevant counterparty data and put them in a better position to get a complete picture of their exposure towards transition risks.

Finally, the 2022 climate stress test underlines that banks are not well positioned for the green transition. Banks have made some progress in incorporating climate risk stress testing frameworks. However, ECB Banking Supervision has identified plenty of room for improvement. Banks are currently vulnerable because they are not yet able to properly reflect their strategic responses to different transition pathways in their long-term projections.

In the light of these concerns, ECB Banking Supervision will continue its work on integrating physical and transition risks into its SREP and is committed to guiding European banks through the green transition. It will conduct on-site inspections, engage with institutions with material deficiencies in their management of climate-related and environmental risks to ensure they implement sound remedial action plans on time, and monitor compliance with upcoming regulatory requirements. Moreover, following the completion of its thematic review of the integration of climate-related risks into governance arrangements as well as risk appetite and risk management frameworks, ECB Banking Supervision plans to issue a compendium of observed good practices in the last quarter of the year.

In order to supervise climate risks in an adequate manner, it is also necessary to introduce prudential rules on transition planning for banks, as proposed under the sixth Capital Requirements Directive (CRD VI)[7]. ECB Banking Supervision hopes to see this confirmed in the final version of the banking package, as explained in its Opinion on CRD VI[8]. These plans are an important risk management tool. They will ensure that credit institutions thoroughly assess the structural changes that are likely to occur in the sectors they are exposed to and promptly identify the assets at risk of becoming stranded.

Furthermore, a consistent integration of the double materiality perspective across the financial system will be essential to ensure effective supervision. The proposed Corporate Sustainability Reporting Directive[9] will introduce a double materiality disclosure requirement, under which large banks and banks' corporate clients will be asked to disclose their transition plans. In this context, and as mentioned in the ECB Opinion on CRD VI, policymakers should promptly deliver on their commitment to define intermediate targets for the financial sector. Likewise, it is important that EU economic sectors show further progress on defining voluntary roadmaps towards achieving climate neutrality as foreseen by Article 10 of the

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6 See 2022 climate risk stress test, ECB, July 2022.

7 Proposal for a Directive of the European Parliament and of the Council amending Directive 2013/36/EU as regards supervisory powers, sanctions, third-country branches, and environmental, social and governance risks, and amending Directive 2014/59/EU (COM/2021/663 final).

8 See Opinion of the European Central Bank of 27 April 2022, op. cit.

9 Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL amending Directive 2013/34/EU, Directive 2004/109/EC, Directive 2006/43/EC and Regulation (EU) No 537/2014, as regards corporate sustainability reporting (COM/2021/189 final).

European Climate Law[10]. These tools will improve the assessment of the risk of assets becoming stranded for both banks and supervisors.

5. Lending rates for mortgage holders and SMEs

The Resolution (paragraph 19) urges the European Commission and banking supervisors to consider measures to ease the burden on mortgage holders and small and medium-sized enterprises (SMEs) in Member States with higher lending rates, so as to ensure that all citizens and businesses can access funding at fair and competitive rates.

ECB Banking Supervision would like to point out that the primary purpose of the prudential framework is to ensure the safety and soundness of banks. Therefore, it is outside the mandate of banking supervisors to ease the burden on mortgage holders and SMEs in Member States with higher lending rates. Against the current backdrop of increasing real estate and corporate vulnerabilities, any prudential relaxations would unduly increase the risks for the financial system. Regarding mortgages, for instance, there is strong evidence from both the European Systemic Risk Board (ESRB)[11] and the ECB[12] of increasing residential real estate overvaluation and household indebtedness, which are making mortgage loans riskier. Similarly, loans to SMEs are somewhat riskier (as can be seen, for example, in firms' financial ratios and observed default rates)[13] than other types of lending, such as to larger companies, which might be reflected in higher expected losses and hence in higher interest rates.. Supervisors' prudential decisions should remain risk-based and not target lending conditions. Lowering prudential requirements may also be ineffective at easing the burden on mortgage holders and SMEs, as it cannot be ensured that the benefits of lower requirements would be passed on to borrowers. For instance, the actual impact of the SME supporting factor implemented in EU prudential requirements on lending to SMEs remains unclear, as observed by the EBA.[14]

Moreover, bank lending rates are not determined by regulatory and/or supervisory measures per se, but rather reflect the broader interest rate environment and other economic and technical conditions.[15] They are determined by a number of factors, such as the economic situation and outlook, the creditworthiness of borrowers, interest rate fixation periods, loan maturities and market reference rates, a lack of

[10] Regulation (EU) 2021/1119 of the European Parliament and of the Council of 30 June 2021 establishing the framework for achieving climate neutrality and amending Regulations (EC) No 401/2009 and (EU) 2018/1999 ("European Climate Law") (OJ L 243, 9.7.2021, p. 1).

[11] See Vulnerabilities in the residential real estate sectors of the EEA countries, ESRB, February 2022.

[12] See "Assessing the strength of the recent residential real estate expansion", *Financial Stability Review*, ECB, November 2021; and "Keeping a close eye on real estate risk", *Supervision Newsletter*, ECB, February 2022.

[13] See EBA Report on SMES and SME supporting factor (EBA/OP/2016/04), EBA, 23 March 2016.

[14] ibid.

[15] The current degree of dispersion across countries in lending rates to households for house purchases is rather low in comparison to historical values. The difference between the 90th and 10th percentile across euro area countries decreased to 0.9 percentage points in August 2022, which is the lowest value for the last ten years, and considerably lower than the 1.6 percentage point dispersion observed in August 2021.

competition in the banking sector and specific (national) features of the banking system. These factors are largely outside the remit of supervisors, but, as regards the lack of competition, further progress towards a genuine banking union would be very helpful.

That said, structural cost efficiency problems at banks, and high levels of NPLs can contribute to higher levels of bank lending rates in certain jurisdictions. This is where supervisors can play a role. Since its inception, ECB Banking Supervision has worked towards reducing high levels of NPLs in individual banks. More generally, it has invited banks to address structural weaknesses in order to make their business models resilient and sustainable in the long term. Further efforts are needed in this area, and this is reflected in the supervisory priorities for 2022-2024.

6. AML

The Resolution (paragraph 23) notes ECB Banking Supervision's efforts over the past two years to enhance the exchange of information between the SSM and anti-money laundering/countering the financing of terrorism (AML/CFT) supervisors. In line with the ECB's position, the report supports the proposal for a new EU Anti-Money Laundering Authority (AMLA) which will directly supervise certain banks and coordinate the enforcement of AML/CFT rules by national authorities. The report also stresses the importance of a strong AML framework in the context of the Russian aggression against Ukraine to ensure the effectiveness of sanctions.

As noted by the European Parliament, the ECB has implemented measures to improve the process for exchanging information with competent national AML/CFT supervisors, which is based on the agreement signed by the ECB and around 50 AML/CFT supervisors. This has given ECB Banking Supervision insight into the existing diversity of approaches among AML/CFT supervisors in the EU. Like Parliament, the ECB therefore warmly welcomes the Commission's legislative proposals to strengthen the EU's framework for the prevention of money laundering and terrorist financing, in particular the proposal to set up AMLA. In order to be instrumental in ensuring regulatory and supervisory convergence in the area of AML/CFT, AMLA needs, from the outset, a sufficiently ambitious level of responsibility for both direct supervision and supervisory oversight. In particular, the scope of entities directly supervised by AMLA should be broad enough and cover all Member States. AMLA will also be instrumental in ensuring good interactions between AML/CFT and prudential supervisors. A good exchange of information on supervised entities would strengthen the effectiveness of both AMLA and ECB Banking Supervision. In addition, cooperation will help to ensure that AMLA's regulations and supervisory expectations fit well with the ECB's prudential expectations of supervised entities. As the co-legislators discuss the legislative proposals, the ECB remains ready to offer advice based on its own experience of setting up EU-level prudential banking supervision.

7. Transparency in banking supervision

The Resolution (paragraph 24) welcomes increased transparency standards in banking supervision, for instance in the outcomes of the SREP, which fosters trust in capital and financial markets and ensures consistent treatment across Member States.

ECB Banking Supervision welcomes the feedback received on its efforts to increase transparency standards. Numerous initiatives are underway or have already been completed this year to improve transparency in both the supervisory process and supervisory outcomes. In addition to the regular publication of the ECB Annual Report on supervisory activities[16], the most relevant publications in 2022 are as follows: in February, the results of the 2021 SREP cycle[17] and the non-confidential version of the "failing or likely to fail" assessment of Sberbank Europe AG[18]; in March, the updated ECB Guide on options and discretions[19], the ECB Guide on the notification of securitisation transactions[20] and the ECB's assessment of banks' C&E risk disclosures[21]; in April, a set of FAQs on the impact of the Russian invasion of Ukraine[22]; since April, additional data on asset quality on the ECB's banking supervision website, providing further information on stage 1, 2 and 3 loans[23]; in July, the results of the first ECB Banking Supervision climate risk stress test[24]; and in August, the Annual Report on Sanctioning Activities in the SSM for the year 2021[25]. On 28 September ECB Banking Supervision launched a public consultation on a new draft Guide to qualifying holding procedures[26], and in the fourth quarter of this year the ECB will publish its supervisory priorities for 2023-25.

8. Banking union and resolution

The Resolution supports efforts to strengthen and complete the banking union and underlines that progress in the different areas of banking union should be made in parallel (paragraph 2). It expresses overall support for a European Deposit Insurance Scheme (EDIS) (paragraph 34) and mentions that risk reduction, together with risk sharing, would contribute to a more stable banking union (paragraph 9). In

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16 See ECB Annual Report on supervisory activities 2021, ECB, March 2022.

17 See Aggregated results of SREP 2021, ECB, 2022.

18 See 'Failing or Likely to Fail' Assessment of Sberbank Europe AG, ECB, February 2022.

19 See ECB Guide on options and discretions available in Union law, ECB, March 2022.

20 See Guide on the notification of securitisation transactions, ECB, March 2022.

21 See Supervisory assessment of institutions' climate-related and environmental risks disclosures, ECB, March 2022.

22 See "FAQs on Russia-Ukraine war and ECB Banking Supervision" on the ECB's banking supervision website.

23 See "Publication of supervisory data" on the ECB's banking supervision website.

24 See 2022 Climate risk stress test, ECB, July 2022.

25 See Annual Report on Sanctioning Activities in the SSM in 2021, ECB, August 2022.

26 See "Public consultations" on the ECB's banking supervision website.

this vein, the Resolution calls on Member States for a time-bound work plan for the completion of the banking union (paragraph 36). The Resolution stresses the importance of the risk proportionality of contributions to deposit guarantee schemes (DGS) and that contributions to a future EDIS must be proportional to risk (paragraph 37). In addition, the Resolution underlines that the completion of the banking union is of the utmost importance in solving home-host concerns. It notes that strengthening cross-border integration and allowing more flexibility in capital flows across banking groups, while respecting the risk profiles of subsidiaries, requires credible and efficient safeguards for host Member States (paragraph 21). The Resolution also supports alternative measures under DGSs to fund deposit book transfers, as well as using DGS funds to bridge the gap between the 8% bail-in prerequisite for access to the resolution fund and the bank's actual loss-absorbing capacity (paragraph 31). It also underlines that State aid rules may need to be revised to preserve a coherent framework.

ECB Banking Supervision supports the European Parliament's view that the introduction of an EDIS and a swift reform of the crisis management and deposit insurance (CMDI) framework would strengthen the resilience of the European banking sector. While the ECB regrets that Eurogroup ministers were unable to agree on a holistic workplan to complete the banking union for the time being, it looks forward to a successful review of the crisis management framework by early 2024. Putting in place a coherent framework which will also allow the management of failures of smaller and medium-sized banks in the banking union and make effective use of DGS funds would mark a significant improvement over the status quo and ultimately enhance the stability of our banking sector. In this context, ECB Banking Supervision strongly supports allowing DGSs to use alternative measures more widely on a least cost basis, also facilitating access to the Single Resolution Fund, for example by using DGS funds to bridge the gap towards the 8% bail-in requirement. Even though progress towards a fully-fledged EDIS is unlikely in the near term, ECB Banking Supervision considers that a successful and promptly implemented CMDI framework would be an essential step towards achieving a complete banking union.

Finally, regarding the revision of State aid rules, the ECB recently made suggestions for enhancing the level playing field between resolution and liquidation as part of the public consultation launched by the European Commission, while advising against incorporating the 8% bail-in requirement in State aid rules.[27] Given the strong interlinkages between State aid rules and the CMDI framework, the review of both regimes should go hand in hand.

As already mentioned, banks have a role to play in financing the various economic transitions that are underway. Progress on the banking union project would allow the banking sector to better support the economy in this uncertain environment and to play its role in financing the digital and green transitions.

[27] See "ECB contribution to the European Commission's targeted consultation on the evaluation of State aid rules for banks in difficulty", ECB, 2022.