EUROPEAN CENTRAL BANK

BANKING SUPERVISION

LSI supervision within the SSM

November 2017

Contents

1 Organisation of banking supervision in the SSM

The Single Supervisory Mechanism (SSM), which comprises the ECB and the national competent authorities (NCAs) of participating Member States, is currently responsible for the prudential supervision of all credit institutions in the euro area. Its purpose is to ensure that the EU policy on the prudential supervision of credit institutions is implemented in a coherent and effective manner and that credit institutions are subject to supervision of the highest quality. The SSM's three main objectives are to:

- ensure the safety and soundness of the European banking system;
- increase financial integration and stability;
- ensure consistent supervision.

In accordance with the SSM Regulation[1] and the SSM Framework Regulation[2], which provide the legal basis for the operational arrangements related to the prudential tasks of the SSM, the ECB and NCAs together carry out clearly defined supervisory tasks to protect the stability of the European financial system.

The SSM combines the strengths of the ECB and the NCAs, building on their macroeconomic and financial stability expertise and on the NCAs' long-established knowledge in the supervision of credit institutions within their jurisdictions. The ECB and the NCAs perform their tasks in strong cooperation, taking into account their economic, organisational and cultural specificities and leveraging on a dedicated and highly qualified staff.

As illustrated in **Figure 1**, the ECB directly supervises all institutions that are classified as significant (around 120 significant institutions) with the assistance of NCAs in joint supervisory teams ('JSTs'). The NCAs continue to directly supervise the less significant institutions or 'LSIs',[3] subject to the oversight of the ECB.[4] However, for certain common procedures, the ECB has full responsibility with respect to all SSM credit institutions. These common procedures, carried out in cooperation with NCAs, concern the granting and withdrawal of bank licences and the acquisition of qualifying holdings.

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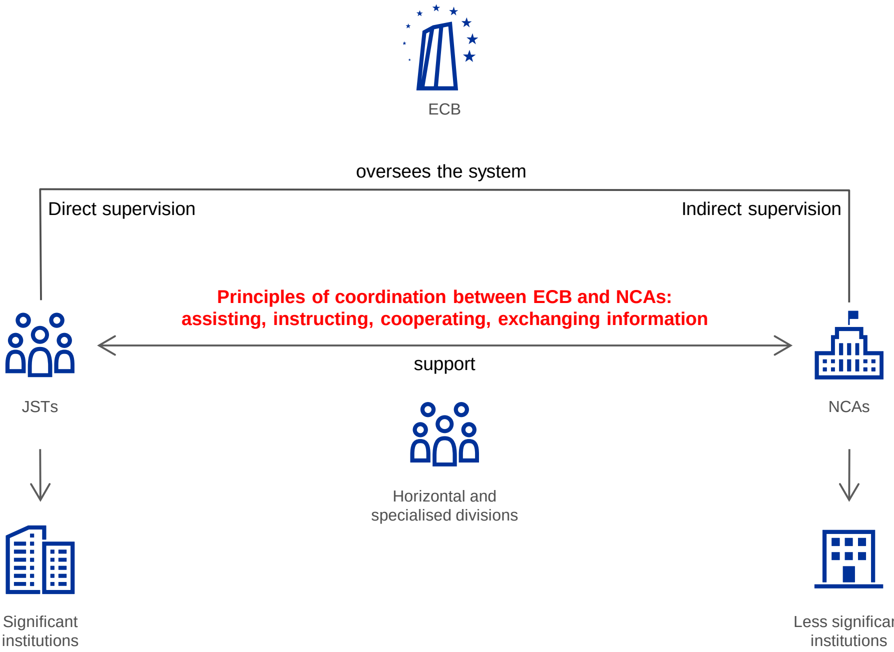
1 Regulation 1024/2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013).

2 Regulation 468/2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the ECB and national competent authorities and with national designated authorities (OJ L 141, 14.5.2014).

3 Article 6 (4) of the SSM Regulation and Article 39 of the SSM Framework Regulation establish the criteria and rules for classifying a credit institution as significant or less significant. This classification determines whether a credit institution is supervised directly by the ECB or the NCA.

4 See the ruling of the European Court of Justice of 16 May 2017 (T-122/15), concerning policies relating to the prudential supervision of credit institutions and their classification as less significant institutions.

Figure 1
Organisational structure of the SSM



Sources: DG MSIII.

The effective and consistent functioning of the SSM depends on the consistency of the regulatory framework and supervisory practices across participating Member States. The ECB needs to ensure that a level playing field applies to all banks in the euro area, including the LSIs, while considering the different features of the national banking systems and the respective supervisory approaches.

As part of its oversight role in LSI supervision, which is the domain of the Directorate General Microprudential Supervision III (DG-MS III), the ECB has a number of tools, including the possibility of issuing legal instruments such as guidelines, regulations or general instructions to NCAs, and joining or leading on-site inspections of LSIs. In exceptional cases, where necessary, to ensure a consistent application of high supervisory standards, the ECB may take over the direct supervision of LSIs[5], upon the request of the NCA or on its own initiative.

1.1 Overview of LSI supervision staff resources in the SSM

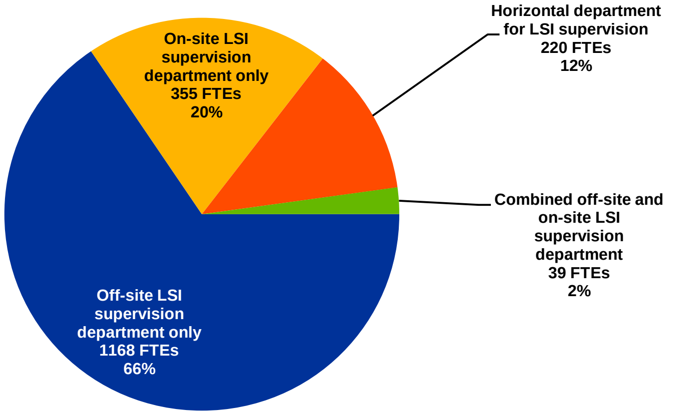
As a result of the changes in the national legal frameworks and following the establishment of the banking union, most NCAs have implemented some restructuring in their internal organisation in the first few years of the SSM. These changes are now gradually coming to a halt. At the end of 2016, in the 19 participating countries, almost 1,800 FTEs (including managers) were devoted to the direct supervision of LSIs.

[5] See Article 6(5)(b) of the SSM Regulation.

Despite the restructuring, there are still some differences in the internal organisation of NCAs, which reflect some specificities in the LSI sectors and in the supervisory approaches followed by NCAs. For example, some NCAs supervising a smaller number of LSIs tend to have joint on-site and off-site supervision departments to allow for a more flexible allocation of staff and better exploit synergies that support the supervision of relatively small, often less diversified LSI sectors. Other NCAs have a long tradition of an independent on-site supervisory function. Furthermore, to accommodate both the large size and structural features of their LSI sectors, some countries like Italy and Germany tend to organise their banking supervision also through the NCA's local branches or regional offices.

Chart 1

Split of staff resources (FTEs) per department – end of 2016



Sources: NCAs' 2016 Annual Reports

Off-site supervision continues to absorb the largest share of staff resources for LSI supervision among NCAs. In 2016, off-site supervision accounted for 66% of total FTEs, compared to 20% of FTEs dedicated solely to on-site supervision. Around 2% of total FTEs were allocated to combined on-site and off-site supervision, and 12% were involved in horizontal tasks.

2 Description of the LSI sector and recent developments

In line with ongoing trends in the European banking industry, consolidation of the LSI sector in the euro area has continued to advance. Consequently, the number of LSIs declined in 2016. According to the ECB's regularly updated list of LSIs, there were 3,267 LSIs at solo level at the end of 2016, which represents a 5.1% decline on the previous year. The 2016 results were driven by 145 mergers, 37 licence withdrawals, eight branches[6] terminating their operations and three cases of lapsing[7] of licences, which were hardly offset by the 16 new LSIs licences granted in 2016 and four cases of financial entities newly classified as LSIs.[8] At the same time, nine LSIs became part of significant groups, while three subsidiaries of significant institutions were reclassified as LSIs.

The bulk of the LSI sector continues to be concentrated in Germany, Austria and Italy, reflecting the presence of large decentralised systems of savings and/or cooperative banks, often covered in Germany and Austria under a joint institutional protection scheme (IPS). In Italy, the consolidation of the cooperative banking sector into three major groups is currently under way.[9] Going beyond the traditional banks, focused on profit generation, these banks typically also seek to provide financing to the local community or the cooperative's members. In some other Member States, savings and cooperative banks also play an important role, but their organisation and corporate structure is somewhat different. In France, for example, cooperative banks are consolidated with significant groups and are excluded from the population of LSIs.[10] At the end of 2016, over 84% of all LSIs were domiciled in Germany, Austria and Italy, with shares of 53%, 16% and 15% respectively. In terms of the share of total LSI banking assets, Germany, Austria and Italy accounted, respectively, for around 56%, 6% and 11% of the total LSI assets.

In 2016, the average size of an LSI was €1.5 billion compared to the average size of significant institutions of €173.2 billion. The Dutch LSIs (€5.5 billion) have the largest average size, followed by France (€4.2 billion), Ireland (€4.0 billion) and Belgium (€3.9 billion), while the smallest ones are located in Cyprus and Malta (both with €0.4 billion).

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6 Non-SSM EU banks.

7 Cases of lapsing as a consequence of mergers are included in the figures for mergers.

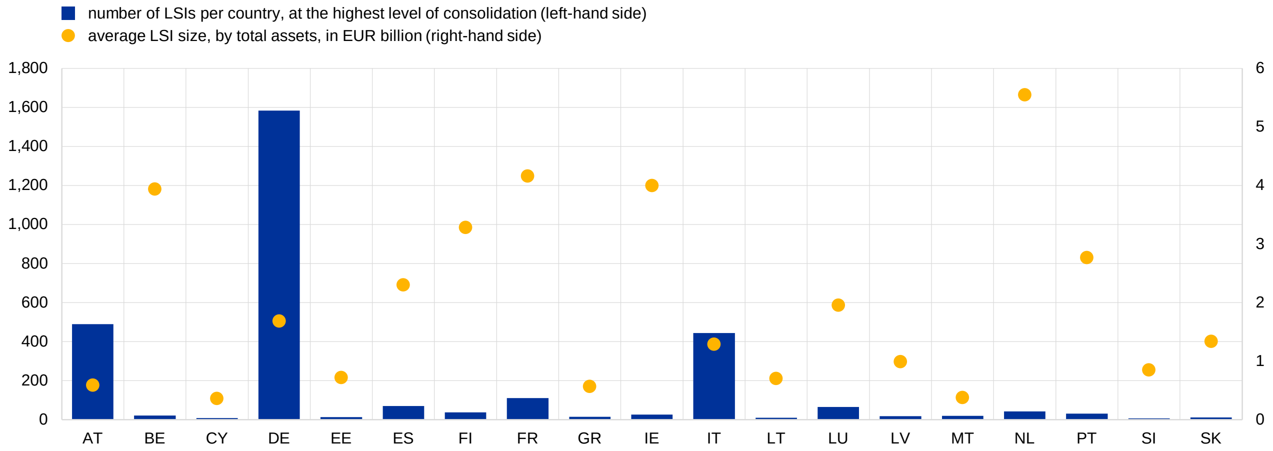
8 E.g. new financial holding companies and new branches.

9 In Italy, the Banche di Credito Cooperativo (BCC) Reform Act will lead to consolidation through the establishment of three banking groups which will encompass all but one cooperative bank. The reform will affect a large part of the Italian LSI sector: based on June 2016 data, the 355 Italian BCCs had total assets of €236 billion, accounting for 77% of Italian LSIs and 42% of total LSI assets.

10 The same will hold true in Italy for two cooperative groups after the BCC reform (see previous footnote).

Chart 2

Number of LSIs per country and average size – end of 2016

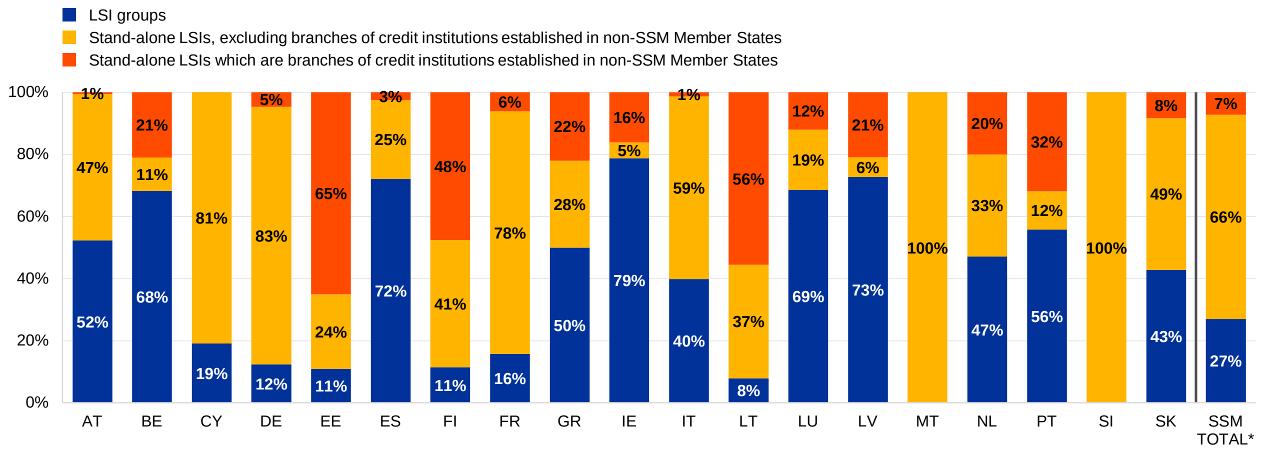


Sources: NCAs' 2016 Annual Reports

Within the SSM, in 2016 the total assets of branches of non-SSM EU Member States stood at 7.2% of total LSI assets, compared to 6% the year before. These branches account for a large proportion[11] of LSIs' banking assets in Estonia (65%), Lithuania (56%) and Finland (48%). The increased importance of branches implies particular challenges for the host country as prudential supervision of the branches' operations, along with liquidity support, resolution and deposit insurance, falls under the responsibility of the home authorities.

Chart 3

Breakdown of LSIs by type of institution, as a share of domestic LSI total assets– end of 2016[12]



Sources: NCAs' 2016 annual reports.

11 Banking assets of branches of LSIs of SSM countries and third country branches are not included.

12 Stand-alone credit institutions include: 1. a credit institution which does not have within the SSM or outside the SSM other credit institutions or financial institutions as either its supervised parent or as a subsidiary; 2. a credit institution that has only ancillary services undertakings as subsidiaries.

The business models of the LSI sector vary considerably across Member States; this reflects the LSIs' presence in a variety of dynamic market segments, ranging from retail, real estate, securities, and private banking to asset and wealth management. Nevertheless, the predominant business model is retail banking. Individually, the product portfolio offered by LSIs generally displays a higher degree of specialisation and their activities tend to be more geographically concentrated than those of SIs.

While the number of LSIs has fallen, the LSI sector has continued to maintain its "market share", at approximately 16% of total SSM banking assets. The weight of the LSI sector in the countries where they operate varies widely across the SSM. While LSIs represent around 36% and 45% of total banking assets in Germany and Latvia respectively, their importance is substantially lower in other Member States, notably in Greece (2%). Relative to the size of the domestic economy where they operate, the biggest LSI sector can be found in Luxembourg, where LSIs primarily focus on private banking and custodian banking, and accumulate assets that represent around 232% of GDP. The next two largest LSI sectors with respect to GDP are located in Austria (80%) and Germany (81%), whereas the smallest can be found in Greece where the LSI sector accounts for only 5% of GDP.

3 Challenges facing LSIs and implications for supervision

Notwithstanding the overall resilience of the LSI sector and the range of features/business models, LSIs face a number of important challenges in the current environment, such as intense competition, a prolonged period of ultra-low interest rates, poor asset quality and weak credit demand. By squeezing LSIs' profits, all these factors make it difficult for a number of LSIs to generate capital internally. The rise of relatively small, flexible and specialised institutions (including fintech credit institutions) as well as the increase of mutual and exchange-traded funds and online banks with leaner cost structures have resulted in greater competition. While some banks have been able to use their broader customer base to sustain profits, other LSIs struggle to compete and defend their business model. For instance, closing branches may upset traditionally-minded customers and reducing HR costs is often curtailed by legal limitations. Despite the overall moderate improvement at the SSM level, in some countries the stock of NPLs in LSIs remains at high – (and sometimes increasing) – levels. NPL coverage ratios also need to improve. Liquidity conditions have improved overall across the SSM but they can be subject to abrupt changes in the case of negative shocks and still remain a cause for concern in certain countries.

Further consolidation could be seen as an attractive way for banks to adapt their business models and improve profitability. Indeed, by cutting fixed operational costs and by increasing market power in deposit and loan markets, consolidation has supported the LSI sector in maintaining profitability in the "low-for-long" environment. Looking ahead, a number of factors are expected to support this trend, inter alia (i) pressure on cost savings and revenue enhancements, (ii) IT-improvements, (iii) globalisation, coupled with increased pressure on financial performance and market competition and (iv) regulation. Differences in the European legal frameworks as well as other national and cultural differences are among the hindrances to cross-border consolidation. However, as most LSIs are locally focused, the scope for cross-border mergers in the LSI sector seems limited, at least for the time being. The most significant LSI sector consolidation is currently foreseen in Italy. Reforms in the Italian credit cooperative sector aim to promote consolidation as a means to enhance its capacity to manage risks and improve operational efficiency and governance frameworks. The integration of all Italian cooperatives[13] into three cooperative groups[14] will impact the overall number of LSIs in 2018 and 2019. Consolidation of LSIs in other jurisdictions is also likely to continue in the coming years, although specific future scenarios are impossible to assess with confidence. In terms of the consolidation in the German banking sector, progress has focused on the savings and cooperative sector.

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13 All except one BCC, which will become a joint stock company.

14 See footnote 9 and 10.

Albeit not specific to LSIs, the difficulties of many banks to maintain their current operating models combined with the need to either change business models or make them more effective present several challenges for bank supervisors. First, in their assessments supervisors have to strike the right balance between allowing necessary innovations in many LSIs and ensuring the safety and soundness of the banking sector. Second, confronted with a dynamic, rapidly changing environment, supervisors need to be more forward-looking than ever, which requires the necessary tools and expertise (e.g. to conduct stress-tests, analysis of cyber risks, etc.). Finally, NCAs face particular challenges given the large number of often very small banks within these systems, their strong interlinkages, the absence of consolidated supervision, and, in some cases, the use of prudential reliefs for IPS.

Changes in the banking regulatory framework may also affect the LSI sector. For smaller LSIs in particular, compliance with continuing regulatory changes may be especially challenging and burdensome. Specifically, the phasing out of options and national discretions (ONDs)[15] and the introduction of IFRS 9 may have a material impact on capital requirements. The impact of the minimum requirement for own funds and eligible liabilities (MREL)[16] is difficult to assess at this time.

Ongoing developments in the LSI sector are reflected in the NCAs' supervisory agendas, where the main priorities are revised annually in each supervisory cycle. These priorities mirror the risks and challenges faced by LSIs and are broadly aligned with the SSM priorities. The SSM priorities for 2017 approved in 2016 focus mostly on (i) the assessment of business model and profitability drivers, (ii) credit risk with a focus on NPLs concentration and (iii) risk controls and internal governance (including data quality), and are complemented by other national LSI supervisory priorities that take into account the specific features (e.g. size, level of complexity, scope) of the respective LSI sector. Notwithstanding limited staff resources in some NCAs, the priorities are and have been effectively followed by concrete supervisory activities carried out by the NCAs, sometimes supported by technical cooperation within the SSM.

[15] Definition of ONDs: options are provisions in EU law that give competent authorities or Member States a choice on how to comply with a provision selecting from a range of alternatives. National discretions are provisions in EU banking law that give competent authorities or Member States a choice as to whether or not to apply a given provision.

[16] The MREL may be limited for the smallest LSIs, as it could be set at the level of the own funds requirement in cases where a liquidation strategy is foreseen by the National Resolution Authority.

4 Main supervisory activities conducted on LSIs by NCAs

The supervisory priorities of the NCAs for LSI supervision are reflected in concrete supervisory activities. These primarily comprise off-site and on-site activities, thematic reviews and the application of supervisory powers.

4.1 Off-site activities

Through their off-site supervisory activities,[17] NCAs monitor on a continuous basis the financial conditions of individual financial institutions, as well as the overall financial sector, and the different types of risks which these are exposed to. More precisely, banking supervisors assess whether financial institutions are sound, comply with banking regulations and have in place robust practices for the identification, monitoring, management and control of banking risks. To pursue this objective, NCAs use various tools such as conducting the SREP, analysing prudential data and performing LSI reviews or assessments in various forms. Off-site supervisory activities are also important as they help to identify the need and scope of supervisory action as well as on-site inspections. Off-site activities are manifold. The bulk of the off-site activities conducted in 2016 is illustrated in **Chart 4**.

The SREP activities (i.e. risk assessment system (RAS) assignments, ICAAP assessments and ILAAP assessments) account for approximately one third of all off-site supervisory activities. Fit and proper assessments serve to evaluate the suitability of members of the management body and, in some jurisdictions, staff responsible for key functions in credit institutions, based on the criteria and minimum requirements set in EU law and the EBA guidelines. The distribution of fit and proper assessments only partially correlates with the overall size of the LSI sectors as some of the NCAs with relatively smaller LSI sector conducted comparatively large number of fit and proper assessments. Factors influencing the number of assessments include the size of the LSIs' management body, the term of appointment and a national legal requirement for a reassessment in case of renewal of the term of the mandate. Supported by the EBA guidelines and the LSI joint supervisory standard (JSS)[18] on recovery planning, the assessment of LSIs' recovery plans is ongoing reflecting the gradual implementation of the BRRD requirements.

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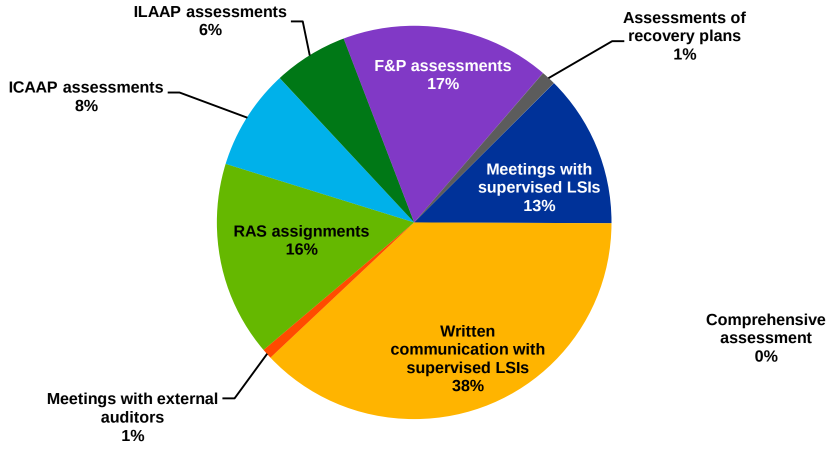
17 The list of off-site activities does not include the determination of additional capital requirements, which leads to a capital decision under Article 104 CRD IV. These are covered under the application of supervisory powers.

18 The aim of the JSSs is to ensure high standards of supervision in the sense of a best practice approach as well as a consistent procedure within the SSM. The ECB is gradually developing JSSs in cooperation with the NCAs. They are in line with the common SSM methodology, applied in a proportionate manner for LSI supervision (see Chapter 5).

Chart 4

Breakdown of off-site activities conducted in 2016



Sources: NCAs' 2016 Annual Reports
RAS: Risk Assessment Score
F&P: Fit and proper

In 2016, the majority of NCAs' interactions with LSIs took place in written form (e.g. email, letters, administrative circulars, etc.). However, particularly in some jurisdictions, face-to-face meetings with the LSIs and meetings with external auditors also play an important role.

4.2 On-site activities

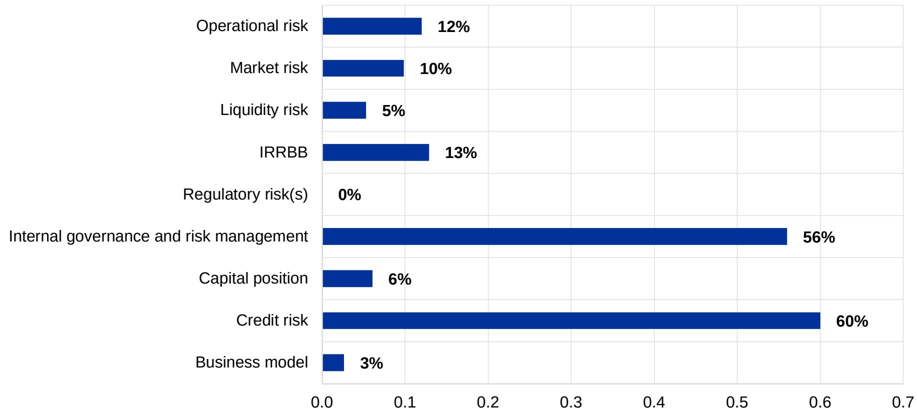
On-site inspections aim to enhance the supervisor's knowledge of credit institutions through in-depth investigations at the premises of the credit institution. They are conducted on the basis of predefined scopes, timelines and resources, using investigation techniques to assess the risks borne by the credit institution, test its internal controls and procedures and verify whether and how these are implemented in practice. The responsibility to perform on-site inspections at LSIs lies with the NCAs. However, as part of its oversight tasks, the ECB can also decide to lead an on-site inspection of an LSI or to participate in on-site inspections led by the NCA.

There are two different types of inspections: full-scope and targeted. The targeted inspections examine certain risk areas only. Among the targeted inspections, credit risk remained the risk area most examined by NCAs in 2016, followed by internal governance. The review of banks' internal governance and risk management continues to gain importance reflecting the supervisory priorities of the NCAs and the SSM. This trend confirms the increasing focus on internal governance in the supervisory landscape in recent years.

Chart 5

Breakdown of risks covered by on-site inspections in 2016

(In percentages)



Sources: NCAs' 2016 annual reports.

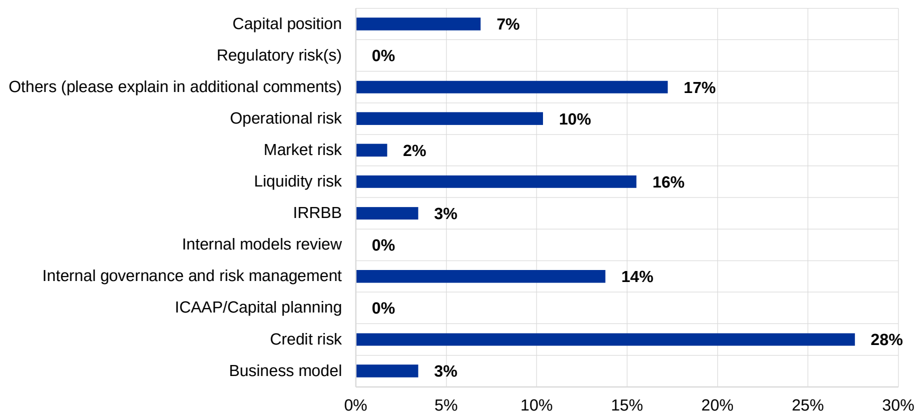
4.3 Thematic reviews

Thematic reviews are an important supervisory tool for LSI supervision. They enhance the assessment of current and emerging risks and allow for a common supervisory response and synergies in the supervision and comparison of peers. Thematic reviews support the identification of sectoral risks that may not be evident in a single LSI. Reflecting the NCAs' priorities, and in line with those of the SSM, most thematic reviews conducted in 2016 focused on credit risk, liquidity risk, and internal governance and risk management.

Chart 6

Focus areas covered by thematic reviews in 2016

(In percentages)



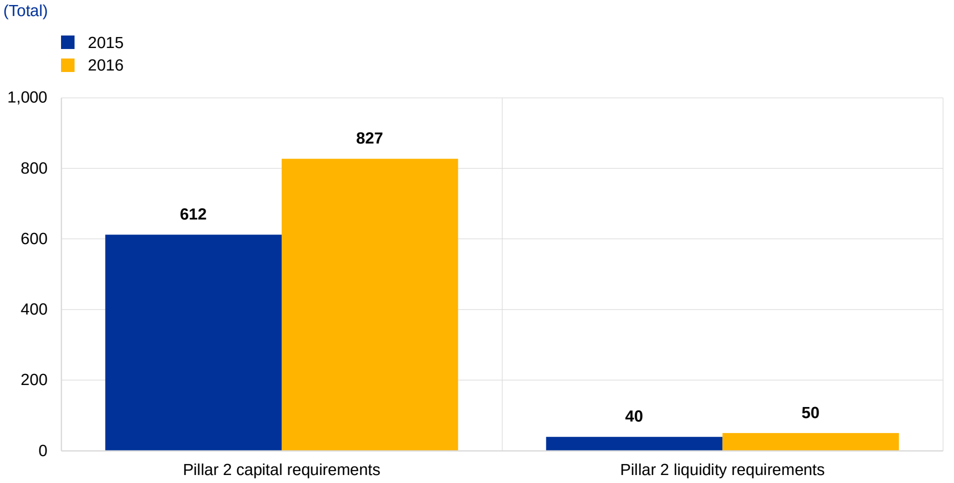
Sources: NCAs' annual reports, ECB calculations.

4.4 Supervisory powers

Article 104 CRD IV provides for the use of supervisory powers, enabling SSM supervisors to take various types of decisions and supervisory measures including those related to: Pillar 2 capital requirements, Pillar 2 liquidity requirements, plans to restore compliance, reporting requirements, reinforcement of governance arrangements, provisioning requirements and limitation to business or divestments. Pillar 2 decisions, which require institutions to hold own funds in excess of the minimum requirement, constitute the bulk of supervisory decisions under Article 104 CRD IV. The number and content of Pillar 2 capital decisions depend on individual NCA supervisory practices following the EBA SREP Guidelines (EBA/GL/2014/13). The way in which NCAs communicate supervisory decisions and measures to LSIs still varies; in some cases, these are shared with the LSIs as formal supervisory decisions through an administrative act or circular, while in other cases they are, for example, communicated as part of the supervisory dialogue.

Chart 7

Total number of Pillar 2 capital and liquidity decisions – 2015/2016



Sources: NCAs’ 2016 annual reports.
Notes: The increase in Pillar 2 decisions partially reflects the coming into force of the EBA’s SREP guidelines for competent authorities in 2016.

5 Promoting the convergence of LSI supervision across the SSM

Since assuming responsibility for the supervision of the euro area banking sector on 4 November 2014, the ECB has focused considerably on aligning the NCA's supervision of LSIs. By capitalising on different mind sets, experiences and skills, the ECB together with all NCAs has made substantial progress in promoting a common supervisory approach, methodologies and toolkit for LSIs. Apart from developing, together with NCAs, day-to-day operational processes, the ECB promotes consistent, high-quality supervision through: (i) a supervisory approach incorporating both an LSI-specific focus − based on an LSI prioritisation methodology – as well as a sectoral focus; and (ii) the JSS, which are developed in line with the SSM Supervisory Manual.[19] In line with the principle of proportionality, the JSS allows for flexibility to take into account the nature, size and complexity of the LSIs. In order to ensure an effective and consistent functioning of the SSM, the oversight function of the ECB includes both backward and forward looking perspectives.

5.1 Institution-specific and sectoral supervision and oversight

For specific institutions, the NCAs and ECB apply a proportionate approach to supervision and supervisory oversight. To this end, they have adopted a methodology that classifies LSIs as low, medium or high priority, based on their intrinsic riskiness and potential impact on the domestic financial system. Low-priority LSIs are considered to represent a very limited threat to financial stability and have manageable intrinsic riskiness, whereas medium-priority LSIs have either (i) high intrinsic riskiness with low or medium impact, (ii) low intrinsic riskiness but medium or high impact or (iii) medium riskiness and medium impact. High-priority LSIs are considered as medium or high risk with high or medium impact (i.e. their failure may endanger the domestic financial system). The ECB and NCAs use this jointly developed methodology to determine the classification of the high-priority LSIs during an annual dialogue. [20]

This prioritisation is reflected in the scope and intensity of the LSI-specific oversight performed by the ECB and the direct supervision conducted by NCAs (bearing in mind that NCAs may use other or additional classifications). The prioritisation is used in allocating supervisory resources and activities within the SSM as well as in determining the amount of supervisory information required by the ECB from NCAs. For example, the ECB receives NCAs' Supervisory Examination

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[19] The SSM Supervisory Manual sets out the processes, procedures and methodologies for the supervision of significant and less significant institutions.

[20] Although the methodology enables the classification of all categories, only high-priority LSIs have been officially determined by the ECB and NCAs so far.

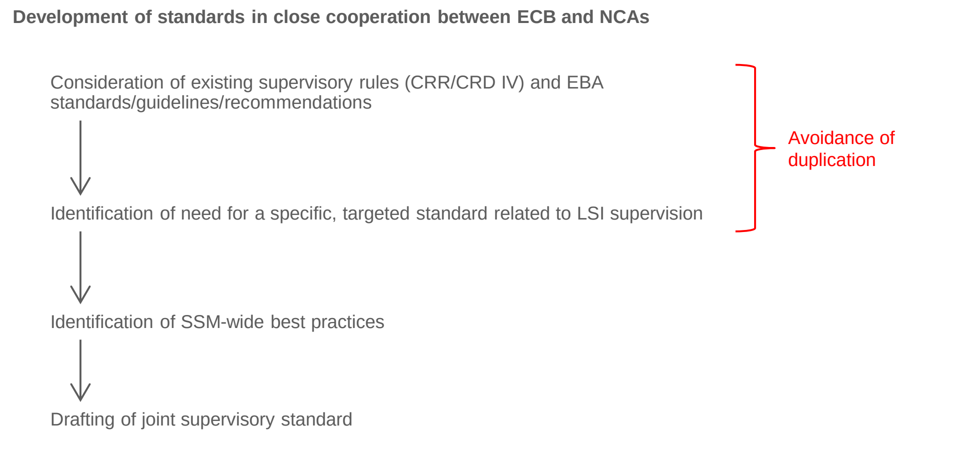
Programmes (SEPs) annually for all LSIs, while individual SEPs are required for high priority LSIs, for all other LSIs at a minimum aggregated SEPs are requested.

The sectoral approach enables the NCAs to exercise a more targeted supervision and the ECB to focus its oversight. It facilitates a systemic perspective, where necessary, of the risks relating to LSIs that, without forming a group, nonetheless share a number of common features (e.g. being subject to the same specific legal requirements, have similar business models or shared central services, mutual support agreements or other forms of interconnection). The aim of sector-related oversight is to (i) identify common risks for banks clustered in a sector, (ii) capture potential contagion effects between individual institutions and (iii) assess the risk reduction imparted by sectoral arrangements.

5.2 Joint supervisory standards and common supervisory approaches

The development of a series of JSS and common supervisory approaches in close cooperation between NCAs and ECB contributes to consistent high supervisory standards (see **Figure 2** and **Table 1**). Although the work has been challenging at times, the ECB and the NCAs cooperate intensively, with the ECB acting as a catalyst to bridge material divergences in NCAs' long established supervisory approaches and institutional traditions. To ensure consistency of outcomes, the commonalities and differences across the euro area LSI sector as well as national specificities (including legal frameworks) need to be taken into account.

Figure 2
Process for the development of a JSS and common supervisory approaches



Sources: DG-MS III

Table 1

Main examples of JSS and common supervisory approaches

Finalised to date	Work in progress
JSS on conduct of on-site inspections at LSIs	LSI SREP
JSS on the supervision of car financing institutions	JSS on FMIs
JSS on supervisory planning	The operational Brexit guidance
JSS on LSI recovery planning	*Further topics under discussion (governance, outsourcing, use of external auditors by NCAs, IFRS 9)*
Guidance on national options and discretions in CRD IV/CRR for LSIs	
Guide on the prudential recognition of IPS	
Policy stance on licencing of fintech credit institutions	
Common policies and framework on NCA crisis management	
Guidance on Notification requirements regarding LSIs	

Sources: DG-MS III.

Of these projects, the SREP is one of the most crucial for the harmonisation of supervisory processes. The ECB, in cooperation with NCAs, has developed a SREP methodology for LSIs, which is based on that for significant institutions, but embeds features that allow for proportionality and flexibility in the scope of the application. Once fully developed, the common methodology for the LSI SREP shall be adequately implemented by the NCAs, as direct supervisors, to decide capital, liquidity and other supervisory measures. This project is still ongoing: in March 2016, a key milestone was achieved with the release of a first version for specific parts of the RAS: business model analysis, internal governance and risk management, risk to capital and risk to liquidity and funding. Another milestone was achieved in May 2017 with the release of the first preliminary version for the test of the SREP methodology for LSIs in 2017. The complete SREP methodology for LSIs is planned to be implemented by NCAs from 2018 onwards and by 2020, at the latest, following a staggered approach.

A common approach for supervisory planning, which was completed in 2016 but largely developed in 2015, has enhanced the strategic and operational planning processes applied by several NCAs, helping to promote proportionate, consistent, risk-based supervision. With the implementation of the JSS on supervisory planning, NCAs have to define on an annual basis domestic supervisory priorities and adopt SEPs, including minimum engagement levels for a set of standard activities. In addition, the introduction of common descriptions of standard supervisory activities eases the comparison of the supervisory processes by the ECB in order to ensure the consistent application of high supervisory standards.

Another contribution towards ensuring a level playing field is the introduction of simplified obligations on recovery planning for certain LSIs and the development of standardised assessment tools for NCAs. With the JSS on recovery planning, the ECB recommends that NCAs apply simplified obligations only for non-high-priority LSIs, while high-priority LSIs should be subject to the full recovery planning requirements. IPS should provide a single full scope recovery plan for all of the institutions that have individually been waived from the requirement. As the NCAs were given considerable discretion in the implementation of the JSS, the ECB will review how the NCAs have applied the simplified obligations and will build on the NCAs' experience in assessing LSI recovery plans with the standardised assessment tools.

There is also a need to enhance the processes in place for LSI crisis management and related cooperation between the ECB, the NCAs and where appropriate other relevant external parties including the national resolution authorities (NRAs). Two JSS for LSI crisis management have been developed. The first (JSS on NCA supervisory practices for LSI crisis management and cooperation with NRAs) provides the NCAs and ECB with a common understanding, focusing on internal procedures for dealing with LSIs in crisis, cooperation with NRAs, the SRB and other relevant external parties, and communication with the public. The second JSS aims to ensure consistent supervisory actions should an LSI breach the minimum capital requirements, which could ultimately lead to a procedure for the withdrawal of authorisation. This implies a common understanding of the supervisory process to address financial deterioration, in particular regarding the timing for requiring remedial action and, where applicable, the conditions for triggering a withdrawal of authorisation, in full acknowledgement of the need for supervisory discretion and compliance with national law. In the area of risk identification, the work on early warning systems and indicators, aimed at an early detection of financial distress, goes in this direction.

The JSS on on-site inspections has also contributed to the harmonisation of supervisory practices by specifying the definition and objectives of on-site inspections as well as the main principles to be followed in their conduct. It also covers the planning of inspections as part of the SEP as well as the minimum level of engagement in terms of frequency, duration and resources. Moreover, the JSS provides guidance related to the inspection process itself, covering the main steps of an on-site inspection: preparation, investigation, reporting, and follow-up.

Besides the harmonisation of supervisory processes, some projects aim to promote common approaches to the supervision of risks arising from specific business models. In 2016, the ECB and the NCAs developed a JSS related to the supervision of car financing institutions. Financial market infrastructure-LSIs, whose main activity is performing the business of central counterparties or of central securities depositories with a banking licence, also have a specific business model that warrants closer supervisory scrutiny.

To ensure a level playing field across credit institutions, the ECB also decided to harmonise the exercise of options and national discretions (ONDs) for the LSI sector[21]. Legislative action by policy makers is nevertheless needed for ONDs which are exercised through national legislation. While in the majority of

21 For this purpose a guideline and a recommendation were published in April 2017: Guideline (EU) 2017/697 of the European Central Bank of 4 April 2017 on the exercise of options and discretions available in Union law by national competent authorities in relation to less significant institutions (ECB/2017/9). Recommendation of the European Central Bank of 4 April 2017 on common specifications for the exercise of some options and discretions available in Union law by national competent authorities in relation to less significant institutions (ECB/2017/10).

cases, the policy proposals for LSIs are the same as those adopted for significant institutions, for certain ONDs a proportionate approach for LSI supervision that differs from the policy stance developed for significant institutions (e.g. combination of the risk and audit committee) has been applied. Moreover, in some cases, where harmonisation is not needed to ensure the robustness of supervision or to attain a level playing field, NCAs are allowed to take a flexible approach to the application of some ONDs. Additionally, some of these differences should gradually diminish over the coming years as transitional arrangements are phased out. The completion of work on ONDs is a major step towards consistent supervision and greater harmonisation and means that considerable divergences in the national application of options and discretions have been largely overcome.

With regard to IPSs, the ECB published two guidelines on how to (i) monitor IPSs (including adherence to legal requirements) and (ii) coordinate the activities of the ECB and NCAs in order to ensure that new IPS applications are assessed in a harmonised way.

A JSS on fintech was developed owing to the increasing number of SSM common procedures related to fintech credit institutions, which are generally LSIs; the common procedures include **activities related to the issuance and withdrawal of LSI authorisations, and the assessment of qualifying holding acquisitions (‘common procedures’).** Since July 2016, DG MS III[22] has been in charge of carrying out the common procedures relating to LSIs. In this context and due to the increasing number of SSM common procedures related to fintech, a policy stance has been developed on the assessment of licensing applications from fintech credit institutions. This policy stance aims at promoting a harmonised approach within the euro area in this increasingly important sector. In order to secure a level playing field, supervisors need to ensure that fintech credit institutions are held to the same standards as other types of credit institutions.

The notification processes used by NCAs vis-à-vis the ECB are being further aligned across the SSM, supported by a guidance for NCAs on notification requirements regarding LSIs, which has been developed together by the ECB and NCAs. Under the notification framework, NCAs are required to notify the ECB of any rapid and significant deterioration in the financial situation of an LSI, to allow for early risk identification; NCAs are also required to notify ex ante material supervisory procedures and draft material decisions regarding high-priority LSIs, on a wide range of supervisory issues (e.g. capital, liquidity, SREP, internal governance).[23] Areas where consistency can be strengthened include, for example, the criteria to define the materiality of draft procedures and draft decisions.

Following the United Kingdom’s decision to leave the European Union, Brexit is another important aspect on the supervisory agenda, with relevance both for significant institutions and LSIs operating in the SSM. As a result of Brexit,

22 Transfer of activities from DG MS IV (Horizontal functions of the SSM) to DG MS III (Oversight function of the supervision of the LSIs) for the LSIs common procedures.

23 Where NCAs consider it relevant to notify the ECB of decisions and procedures regarding low or medium-priority LSIs, they may still do so on their own initiative.

UK banks operating in the EU may lose their passporting rights and therefore access to the Single Market. For this reason, some activities may be relocated to the SSM and related changes could impact the SSM environment. The ECB is currently developing specific policy stances and an operational guidance on Brexit relevant items. Moreover, incoming banks that are supposed to become significant institutions in the context of Brexit will be subject to a comprehensive assessment carried out by the ECB.

5.3 Challenges and areas for future convergence

Substantial progress has been made on the harmonisation of standards and practices. Nonetheless, a number of important challenges remain. In particular, different accounting systems hamper higher comparability of input data. Differences in the implementation of the SREP throughout Member States, notably in terms of the capital requirement definition, make it difficult for the ECB to aggregate and compare supervisory measures such as Pillar 2 capital add-ons. Moreover, **a majority of LSIs (around 75%)[24] report financial figures according to national Generally Accepted Accounting Principles (nGAAP) which are not in line with IFRS.** To respond to this challenge, DG MS III supported by external consultants is in the process of developing a methodology and a tool to align selected nGAAP-based data points with IFRS-equivalent data points. Work on the methodology of the converter itself as well as if and how the converted data can be used are still ongoing.

An IFRS 9 project is under development to help the NCAs to support their respective LSIs on the implementation of IFRS 9 “Financial instruments” for annual periods beginning on 1 January 2018. For this purpose, an IFRS 9 LSI Methodological Guidance has been developed. It includes supervisory expectations and scoring criteria and helps NCAs to gauge and document banks preparedness to implement IFRS 9 in a consistent way. It is based on the methodological guidance for significant institutions, but tailored to LSIs’ specificities.

[24] In comparison, about 10% of significant institutions prepare their financial statements according to national Generally Accepted Accounting Principles (nGAAP).

6 Glossary

AQR	Asset Quality Review
BRRD	Bank Recovery and Resolution Directive
CRD IV	Capital Requirements Directive
CRR	Capital Requirements Regulation
EBA	European Banking Authority
ECB	European Central Bank
EU	European Union
FTE	full-time equivalent
GAAP	Generally Accepted Accounting Principles
GDP	gross domestic product
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
ILAAP	Internal Liquidity Adequacy Assessment Process
IPS	institutional protection scheme
JSS	joint supervisory standard
LSI	less significant institution
NCA	national competent authority
OND	options and national discretions
SEP	Supervisory Examination Programme
SREP	Supervisory Review and Evaluation Process
SSM	Single Supervisory Mechanism

7 List of countries and authorities

Countries	Abbreviations	List of supervisory authorities	Abbreviations
Austria	AT	Oesterreichische Nationalbank	OeNB
		Financial Market Authority	FMA
Belgium	BE	Nationale Bank van België/Banque Nationale de Belgique	NBB
Cyprus	CY	Central Bank of Cyprus	CBC
Germany	DE	Deutsche Bundesbank	BBk
		Bundesanstalt für Finanzdienstleistungsaufsicht	BaFin
Estonia	EE	Estonian Financial Supervision Authority	EFSA
Spain	ES	Banco de España	BdE
Finland	FI	Financial Supervisory Authority (Finanssivalvonta)	FIN-FSA
France	FR	Autorité de Contrôle Prudentiel et de Résolution	ACPR
Greece	GR	Bank of Greece	BoG
Ireland	IE	Central Bank of Ireland	CBI
Italy	IT	Banca d'Italia	BI
Lithuania	LT	Lietuvos Bankas	LB
Luxembourg	LU	Banque Centrale du Luxembourg	BCL
		Commission de Surveillance du Secteur Financier	CSSF
Latvia	LV	Financial and Capital Market Commission	FCMC
Malta	MT	Malta Financial Services Authority	MFSA
Netherlands	NL	De Nederlandsche Bank	DNB
Portugal	PT	Banco de Portugal	BP
Slovenia	SI	Banka Slovenije	BoS
Slovakia	SK	Národná Banka Slovenska	NBS

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