EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Feedback on the input provided by the European Parliament as part of its "Resolution on Banking Union – Annual Report 2020"

ECB Banking Supervision welcomes the feedback provided by the European Parliament in its "Resolution on Banking Union – Annual Report 2020"[1] ("the Resolution") of 7 October 2021. In order to continue the dialogue between the European Parliament and the ECB and to underline its strong commitment to accountability, ECB Banking Supervision hereby replies to the comments and suggestions provided by the European Parliament in the Resolution.

1. Response to the COVID-19 crisis and credit risk management

1.1 Potential cliff-edge effects

The Resolution (paragraph 25) calls on ECB Banking Supervision to provide clear guidance on the approach and expected timeline for rebuilding banks' capital buffers, which could be used in order to absorb losses during the acute phase of the crisis. In this regard, ECB Banking Supervision is carefully monitoring the impact of the coronavirus (COVID-19) pandemic on banks' capital trajectories, including potential cliff-edge effects stemming from the end of moratoria. It has communicated clearly that it will allow banks to operate below the level of their Pillar 2 Guidance (P2G) and the combined buffer requirement until at least end-2022 without automatically triggering supervisory actions. Moreover, ECB Banking Supervision will continue to communicate early and frequently on the actions it is taking to protect banks' loss absorption capacity and their role in maintaining lending to the real economy during the recovery in order to facilitate capital planning.

1.2 Credit risk as a key priority

The Resolution (paragraph 29) emphasises that credit risk should remain one of the key priorities for ECB Banking Supervision and supports ECB Banking Supervision's intensified oversight of highly leveraged markets. It also asks supervisors (paragraph 30) to adequately assess the side effects that massive disposals of non-performing loans can trigger for the prudential balance sheets of banks which use internal models.

ECB Banking Supervision shares the European Parliament's views on this issue and wishes to highlight that credit risk management and the reduction of non-performing loans will continue to be one of its key priorities. The assessment of compliance with the expectations laid down in ECB Banking Supervision's letter to banks on 4 December 2020[2] (the "Dear CEO" letter) highlighted concerns with regard to the identification, classification and management of distressed debtors. ECB Banking Supervision is

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

[2] See Letter to the CEO of the significant institution: Identification and measurement of credit risk in the context of the coronavirus pandemic, ECB, 4 December 2020.

following up on these findings both through the analysis of individual banks' remediation plans and further horizontal actions. Moreover, ECB Banking Supervision is stepping up its efforts to monitor the increasing risk posed by banks' exposure to highly indebted borrowers and to foster banks' adherence to its guidance on leveraged finance.

Moreover, in line with the Resolution, ECB Banking Supervision is working together with the national competent authorities (NCAs) within the Single Supervisory Mechanism (SSM) to promote the harmonised implementation of Article 500 of the Capital Requirements Regulation[3], which allows for some adjustments for massive disposals of non-performing loan portfolios.

1.3 Dividend recommendation

The Resolution (paragraph 13) calls on ECB Banking Supervision to provide an estimation of the volume and capital impact of the recommendation on bank dividends, share buybacks and variable remuneration in the first and second quarters of 2021. Moreover, it calls on the Commission to consider implementing a legally binding dividend and share buy-back limitation tool as part of the supervisory crisis toolkit.

ECB Banking Supervision can share the estimation of the volume and capital impact of the recommendation on bank dividends, share buybacks and variable remuneration in the first and second quarters of 2021: banks under ECB Banking Supervision's remit decided to pay out dividends totalling around €10 billion in the first months of 2021, around 12 basis points of significant institutions' (SIs) capital ratios as of the first quarter of 2021. This represents less than a third of the amount banks typically pay out in a normal financial year.[4]

ECB Banking Supervision wishes to reiterate the concerns it already voiced in its 18 May 2021 reply to MEP letter QZ 024[5] regarding the possibility of being granted powers to issue legally binding dividend bans. Introducing new powers for authorities to impose binding restrictions on distributions might signal that such restrictions could occur more frequently in the future. Considering the importance of distributions in enabling financial institutions to raise capital externally, such a step might negatively affect the long-term sustainability of institutions and markets. Moreover, these effects could be particularly pronounced if the European Union (EU) were to take this step unilaterally, without other major jurisdictions establishing similar powers for their authorities.

1.4 International Financial Reporting Standard (IFRS 9) application

The Resolution (paragraph 15) notes with concern the heterogeneous application of IFRS 9 for loss provisioning by institutions as reported during the COVID-19 pandemic. The Resolution calls on ECB Banking Supervision to take measures to ensure the consistent application of reporting standards across institutions in the banking union.

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3 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and amending Regulation (EU) No 648/2012 (OJ L 176, 27.6.2013, p.1).

4 See "Dividends: ECB recommendations prove effective", ECB Banking Supervision Newsletter, 18 November 2021.

5 See Letter of the Chair of the Supervisory Board to Members of the European Parliament Mr Giegold and Mr Urtasun, 18 May 2021.

ECB Banking Supervision shares the concerns mentioned in the Resolution and believes that the high degree of heterogeneity in approaches to applying IFRS 9 impedes the comparability of prudential ratios among SIs and the effectiveness of prudential supervision. While auditing financial accounts is not one of ECB Banking Supervision's tasks, it has the power to require institutions to apply a specific provisioning policy or treatment of assets for prudential purposes (Article 16(2)d of the SSM Regulation[6]). ECB Banking Supervision provided practical guidance to SIs in two letters to banks (the "Dear CEO" letters)[7] sent and published in 2020, and is currently following up with the banks on those expectations. ECB Banking Supervision's latest IFRS 9 benchmarking exercises showed that some of the good practices highlighted in the two letters are being applied across an increasing number of European banks. Although this convergence of practices is a step towards a more consistent application of reporting standards, some issues still require scrutiny – for example, the wide variation in stage 3 classifications across banks. ECB Banking Supervision will continue to carefully monitor banks' provisioning frameworks.

1.5 Forbearance measures in the context of the COVID-19 pandemic

The Resolution (paragraph 33) stresses that the prudential framework should be amended when necessary to encourage banks to apply forbearance measures where they consider that the prospect of recovery remains high. Furthermore, it calls for the removal of all regulatory obstacles to the application of forbearance measures.

As a matter of principle, ECB Banking Supervision would like to underline that the purpose of the prudential framework is to ensure the soundness of institutions' capital and liquidity positions, their overall safety and to protect financial stability. The existing requirements on loan forbearance create appropriate incentives for banks to support distressed customers while at the same time providing a timely and accurate representation of credit risk and asset quality on their balance sheets. It is in banks' own interest to provide customers with forbearance solutions that are considered to help the customer remain viable, in order to maximise value recovery. However, postponing the recognition of any losses resulting from such processes risks amplifying the deterioration of the borrower's credit quality and undermining the comparability of and trust in banks' balance sheets.

After granting a forbearance measure, a bank must consider if that measure was effective in terms of helping the client to become viable. In this regard, it is important to note that the prudential framework already takes into account instances where the prospects of recovery are high. Not all forbearance measures lead to a credit obligation being qualified as defaulted. If a bank makes an assessment that the prospect of recovery remains high (i.e. meaning that the bank most likely will not suffer any loss), the bank is not required to classify that obligation as defaulted. Conversely, if a bank assesses that the forbearance measure is likely to leave a permanently diminished financial obligation, then this qualifies

[6] Council Regulation (EU) No 1024/2013 of 15 October 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, p. 63).

[7] See Letter to the CEO of the significant institution: Identification and measurement of credit risk in the context of the coronavirus pandemic, ECB, 4 December 2020; and Letter to the CEO of the significant institution: Operational capacity to deal with distressed debtors in the context of the coronavirus pandemic, ECB, 28 July 2020.

as a default and causes a loss. Such losses include any reduction in net present values (NPV) of cash flows caused by material forgiveness or postponement.

To foster discipline in differentiating effective from ineffective forbearance and to avoid losses remaining hidden in banks' balance sheets, stringent criteria are needed to identify forbearance measures so that banks can grant effective concessions and thereafter duly consider whether to show losses in their books. These criteria are further clarified notably in the European Banking Authority's (EBA) Guidelines, which suggest that a decrease in NPV of up to 1% might not necessarily be an indication of default. ECB Banking Supervision does not consider this to contradict the above-mentioned principle that banks should recognise losses from a reduction in NPV. Rather, it is an indication that a small NPV fluctuation could be justified by uncertainties in the input variables for the NPV calculation, and raises little concern about a potential default.

Beyond the recognition of losses, the prudential framework also recognises the potential benefits of forbearance measures for credit obligations: even now, an obligation can indeed return to non-defaulted status when the bank considers that – as a result of the forbearance measure – the prospects of recovery for the remaining (reduced) financial obligation are good and no other trigger of default continues to apply.

2. Risks in the financial system

2.1 Climate-related and environmental risks

The Resolution (paragraph 45) notes the efforts of ECB Banking Supervision to provide guidance and clarity to banks for self-assessment and appropriate reporting of environmental and climate change-related risks. Moreover, the Resolution stresses that further supervisory pressure is required for financial institutions to disclose climate-related and environmental risks appropriately.

ECB Banking Supervision has concluded its first ever large-scale assessment of how European banks are adjusting their practices to manage climate and environmental (C&E) risks.[8] In addition, it has continued to work on increasing the transparency of its supervisory practices by publishing the results of the assessment in a report on its website.[9] The conclusions of the assessment reveal that institutions have taken initial steps towards incorporating C&E risks, but that none of them are close to meeting supervisory expectations regarding management bodies, risk appetite and operational risk management as set out in the November 2020 ECB Guide on C&E risks.[10] The analysis covered 112 directly supervised banks with combined assets of €24 trillion. Half of the assessed banks expect C&E risks to have a material impact on their risk profile in the next three to five years, with credit, operational and business model risk most affected. However, all banks which considered that they are not exposed to C&E risks had significant shortcomings in their assessment of those risks. They are still in the early stages of incorporating climate change into their risk frameworks, and if they continue at this pace,

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8 See "Banks must accelerate efforts to tackle climate risks, ECB supervisory assessment shows", ECB press release, 22 November 2021.

9 See "The state of climate and environmental risk management in the banking sector", ECB, November 2021.

10 See "Guide on climate-related and environmental risks – supervisory expectations relating to risk management and disclosure", ECB, November 2020.

many institutions will not meet the supervisory expectations any time soon. ECB Banking Supervision is therefore urging banks to take swifter action.

In 2022 ECB Banking Supervision will carry out a thematic review of institutions' C&E risk management practices as well as a stress test on climate-related risks. The results of the two exercises will be included in the Supervisory Review and Evaluation Process (SREP), mainly in a qualitative manner. It should be noted that the 2022 SSM climate stress test will not be a capital exercise. Its results will not be factored in to the determination of P2G. At the same time, ECB Banking Supervision is updating its dedicated SREP methodology so that C&E risks will eventually influence banks' Pillar 2 capital requirements. The decision of ECB Banking Supervision to focus the next supervisory stress test on climate-related risks is in line with the growing importance of climate change for the economy and increasing evidence of its financial impact on banks.

2.2 Money laundering and terrorist financing

The Resolution (paragraph 46) recognises the efforts that have been made over the past years to enhance the exchange of information between ECB Banking Supervision and anti-money laundering/countering the financing of terrorism (AML/CFT) supervisors. The Resolution calls for this responsibility to be matched by appropriate funding and resources.

ECB Banking Supervision remains fully committed to reflecting the relevant findings of AML/CFT authorities in prudential supervision and dedicating appropriate resources to this task. However, given the shortcomings in the identification of money laundering and terrorist financing as witnessed over the past years, which also hamper the ability to incorporate such findings, ECB Banking Supervision supports the Commission's legislative proposals to improve the EU's AML/CFT framework, in particular the proposal to set up an EU-level AML/CFT Authority. Effective cooperation at European level between the AML/CFT supervisors and banking supervisors can make the supervisory functions more efficient and enable money laundering and terrorism financing risks to be included in ECB Banking Supervision prudential assessments more consistently. In order to support the process of adopting a new EU AML/CFT legal framework, the ECB stands ready to share its relevant expertise, both as a supervisor and as a central bank.

2.3 Impact of digital euro and digitalisation

The Resolution (paragraph 19) welcomes the ECB's work on the digital euro and invites the ECB to conduct further analysis of the implications of a digital currency for the banking sector. It also cautions that the accelerated pace of digitalisation in the banking sector should be pursued with full regard for consumer protection rights and financial inclusion.

The digital euro project is being pursued by the central banking arm of the ECB. Following the Governing Council's decision of 14 July 2021, the Eurosystem launched the investigation phase of the digital euro project, which will address key issues regarding the design and distribution of a digital euro. A digital euro must be able to meet the needs of Europeans citizens while at the same time helping to prevent illicit activities. It should also have no undesirable impact on financial stability and monetary policy. The investigation phase will assess the potential impact of a digital euro on the overall economy, financial markets and banking. It will also look at how the digital euro will interact with the European retail payments market and how it will affect the business models of public and private participants in the digital euro ecosystem.

In parallel, ECB Banking Supervision is closely assessing the evolution of the business models of banks, including their digital transformation strategies and the related risks and challenges.

2.4 Low profitability and consolidation

The Resolution (paragraph 38) calls for the possible benefits of banking consolidation in addressing low profitability, overcapacity and fragmentation of the banking sector to be further documented. In this regard, the Resolution acknowledges the ECB Banking Supervision guide on the supervisory approach to consolidation in the banking sector. It also highlights the benefits of protecting the diversity and plurality of financial sectors in building systemic trust and maintaining financial stability.

The ECB has recently published studies on the potential benefits of further consolidation in the banking sector[11] and believes that consolidation would generate benefits, namely greater economies of scale and, particularly for cross-border transactions, enhanced risk-sharing. It would also help to reduce the excess capacity in the European banking sector. In particular, cross-border consolidation, as well as the removal of the impediments to cross-border banking, would support the further integration of the European banking market.

In addition, ECB Banking Supervision pays close attention to concerns arising from the size of such cross-border entities (so-called "too big to fail" issues). It is working to address such issues in close cooperation with other authorities responsible for financial stability and resolution.

However, ECB Banking Supervision remains neutral on specific consolidation initiatives and assesses mergers and acquisitions transactions from a purely prudential perspective. Even if ECB Banking Supervision sees there is scope for banking consolidation in Europe, this must be a market-driven process, and its role is not to favour specific types of consolidation or organisational structures for cross-border banking groups under its direct supervision.

2.5 Post-Brexit regulatory environment

The Resolution (paragraph 50) acknowledges the progress that many significant banks have achieved in implementing their post-Brexit target operating models and supports ECB Banking Supervision efforts to monitor banks' progress in this area. The Resolution considers that existing regulatory loopholes in the EU legal framework should be closed in order to strengthen supervision.

To assess the progress made by significant banks to reach their post-Brexit target operating models, ECB Banking Supervision has carried out horizontal monitoring exercises complemented by bank-specific follow-ups. When ECB Banking Supervision identified shortcomings regarding the adherence

[11] "Euro area bank profitability: where can consolidation help?", *Financial Stability Review*, ECB, November 2019; Supervisory banking statistics, ECB, 2021 (the complete set of supervisory banking statistics with additional quantitative risk indicators is available on the ECB's banking supervision website); and Fernandez-Bollo, E., Andreeva, D., Grodzicki, M., Handal, L. and Portier, R., "Euro area bank profitability and consolidation", *Financial Stability Review*, No 40, Banco de España, 2021.

to its supervisory expectations, supervisory actions were taken. In parallel, ECB Banking Supervision launched a horizontal review to assess the booking models of the newly established EU subsidiaries of international banking groups, with the key objective of banks being operationally self-standing and thus not overly reliant on group entities outside the EU. ECB Banking Supervision will continue to monitor the adequate implementation of the post-Brexit target operating models of SIs and oversee the target operating models of less significant institutions (LSIs) in cooperation with NCAs.

In line with the Resolution, ECB Banking Supervision fully supports further legislative initiatives to mitigate the risks of regulatory fragmentation in the EU. Accordingly, it supports legislative efforts towards the harmonisation of third-country rules and the enhancement of the EU's supervisory framework. For instance, the authorisation and supervision of third-country branches should be further harmonised at EU level, and ECB Banking Supervision supports the provisions of the European Commission's Banking Package 2021 to this effect.

3. Transparency

The Resolution (paragraphs 26 and 27) notes ECB Banking Supervision efforts to increase transparency through its recent practice of publishing bank-specific Pillar 2 requirements and expects that the recent changes in the SSM organisation will facilitate more risk-based supervision and internal institutional collaboration.

As noted by the Resolution, ECB Banking Supervision has indeed increased transparency by publishing aggregate data on Pillar 2 requirements. ECB Banking Supervision has also increased transparency by publishing for the first-time certain results from the SSM stress test for banks that were not part of the EBA's sample[12]. In addition, ECB Banking Supervision has applied a new two-step bucketing approach for setting P2G[13], which makes the level of P2G more predictable for banks when they set their capital management and dividend policies, and increases transparency for the market when it assesses a bank's risk profile. This process will ensure a level playing field, reinforce consistency when setting capital guidance and provide more clarity and transparency to banks and the market about the supervisory implications of the stress test.

ECB Banking Supervision also confirms that its new organisational set-up allows for holistic, strategic planning that strengthens risk-focused supervision and ensures that supervisory outcomes are even more consistent. The reorganisation reinforced the role of ECB Banking Supervision as a prudent, efficient and transparent supervisor, and enhanced cooperation with the NCAs within European banking supervision.

In 2021 ECB Banking Supervision developed and implemented a new framework for identifying risks and setting strategic priorities. This new framework aims to strengthen the link between the assessment of the risks and vulnerabilities of supervised institutions on the one hand and the supervisory response enshrined in the supervisory strategy on the other. Based on a thorough assessment of the main risks and vulnerabilities to the significant institutions under its direct supervision, ECB Banking Supervision

[12] See "Stress test shows euro area banking system resilient under challenging macroeconomic scenario", ECB press release, 30 July 2021.

[13] See Pillar 2 Guidance (P2G) on the ECB's website.

has developed a set of strategic objectives and underlying work programmes, spanning the next three years, which aim to address the most material vulnerabilities identified during this year's risks and priorities exercise. The comprehensive nature of the planning cycle makes our action more predictable and gives visibility to banks and other market participants in terms of the focus areas for banking supervision in the coming years. The outcome of this year's exercise was published on the ECB Banking Supervision website on 7 December 2021.[14] A further innovation foreseen in the new risks and priorities' framework to support the risk identification was the launch in 2021 of the new ECB Banking Supervision Market Contact Group (BSMCG). The BSMCG is a forum for exchange between ECB Banking Supervision and market professionals involved in issues related to the euro area banking sector. The BSMCG discusses developments in the banking sector, structural and regulatory trends, and the impact of ECB Banking Supervision's activities.

Other initiatives to increase transparency have been taken. ECB Banking Supervision has published its memoranda of understanding with other supervisory authorities on the exchange of supervisory information and has launched several public consultations on supervisory guidance in the area of consolidation[15], fit and proper assessments[16], options and discretions policies[17] and securitisations[18].

4. Close cooperation with Българска народна банка (Bulgarian National Bank) and Hrvatska narodna banka

The Resolution (paragraph 1) welcomes the entry of Bulgaria and Croatia into the banking union, takes note of the ECB's decisions to establish close cooperation with both national central banks respectively, and highlights that both NCAs are duly represented in the Supervisory Board of the ECB. On 1 October 2020, ECB Banking Supervision became responsible for the direct supervision of the SIs in Bulgaria and Croatia and the common procedures for all credit institutions (e.g. licensing and qualifying holding procedures), as well as the oversight of LSIs in these two countries.

One year of application of the close cooperation framework shows that, whilst the close cooperation legal framework enshrined in the SSM Regulation and the SSM Framework Regulation[19] is complex, as significant credit institutions in countries that have entered into close cooperation are supervised by ECB Banking Supervision via ECB Banking Supervision instructions addressed to the NCAs, the continuous cooperation between ECB Banking Supervision and the Bulgarian National Bank and Hrvatska narodna banka has allowed for smooth processes and the use of practical solutions to ensure strong supervision.

[14] See "Priorities and risks", ECB, December 2021.

[15] See Public consultation on the ECB Guide on the supervisory approach to consolidation in the banking sector.

[16] See Public consultation on draft Fit and Proper Guide and new Fit and Proper Questionnaire.

[17] See Public consultation on draft revisions to options and discretions policies.

[18] See Public consultation on the draft Guide on the notification of securitisation transactions.

[19] Regulation (EU) No 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (SSM Framework Regulation) (ECB/2014/17) (OJ L 141, 14.5.2014, p. 1).

5. Fit and proper assessment

Regarding fit and proper assessments of bank board members and key function holders, the Resolution (paragraph 43) endorses the review of the guide to fit and proper assessments, carried out by the ECB in 2021. The objective of the review of the fit and proper package[20], launched in June 2021, was to increase consistency and create a level playing field, ensuring full transparency by providing further details on fit and proper assessments and policy stances, as well as on the ECB's supervisory expectations.

6. Gender balance in EU financial institutions and bodies

The Resolution (paragraph 23) expresses disappointment over the failure to ensure full gender balance in EU financial institutions and bodies, noting that women continue to be underrepresented in executive positions in the field of banking and financial services. The Resolution calls on governments and all institutions and bodies to prioritise the attainment of full gender balance as soon as possible, including through the provision of gender-balanced shortlists of candidates for all future appointments requiring the European Parliament's consent. The European Parliament also recalls its resolution of 14 March 2019 aiming to secure gender balance in the forthcoming list of candidates for EU economic and monetary affairs nominations and reiterates its commitment not to take into account lists of candidates where the gender balance principle has not been respected.

The ECB fully supports the goal of gender balance in EU financial institutions. The ECB itself has adopted an internal gender strategy for the years 2020-26, which aims to increase overall female representation in its talent pipeline and management pool.

ECB Banking Supervision is also addressing the lack of gender balance on the boards of supervised entities through the assessment of diversity as part of the annual SREP exercise, as well as via the suitability assessment of board members. To this effect, ECB Banking Supervision has conducted benchmarking exercises and "stocktakes" to collect information on diversity in banks' boards as well as assessing the relevant national and international legal and regulatory diversity frameworks. In addition, the ECB has included a specific reference to gender diversity in its revised Guide to fit and proper assessments and included specific questions on this topic in the fit and proper questionnaire. ECB Banking Supervision is also considering further actions such as developing policy and publishing supervisory expectations on gender diversity.

7. CRR3/CRD6 review: Basel 3 implementation and beyond

The Resolution (paragraph 20) underlines the importance of sound global standards for banking regulation and their consistent and timely implementation in the context of the finalised Basel III standards.

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[20] See "Guide to fit and proper assessments", ECB, December 2021.

ECB Banking Supervision fully shares the European Parliament's views, and supports the full, timely and faithful implementation of the final elements of the Basel III reforms in the EU. In this context, ECB Banking Supervision welcomes the publication on 27 October of the European Commission's legislative proposal which allows the EU to move forward with the adoption of the Basel III package agreed in December 2017. ECB Banking Supervision would encourage the co-legislators to finalise the implementation as soon as possible, as these reforms address key shortcomings in the existing framework and are essential to ensure that banks can withstand future crises.

The ECB is preparing its opinions on the legislative package and can at this stage only offer a preliminary staff assessment. The ECB welcomes the Commission's decision to implement one of the central elements of the Basel III reform – the output floor – in line with the Basel Committee's recommendations on the "single stack approach" where banks only have one way of measuring their risk-weighted assets. However, the ECB also notes that the proposals contain a number of implementation choices which may raise prudential and financial stability concerns. If kept at all, these implementation choices should remain transitional only, as it is important that the EU converges to full compliance with Basel III standards over time. The ECB's analysis of the macroeconomic impact of Basel III implementation on the euro area shows that the short-term transitory costs of Basel III implementation are outweighed by the long-term benefits of strengthening the resilience of the financial system[21]. Full compliance with Basel III standards is also crucial to ensure that no risks are left uncovered or insufficiently covered.

Beyond the Basel III implementation, the Commission's proposal also introduces a number of additional positive elements which will enhance the current prudential framework and increase the consistency of the single rulebook. The inclusion of environmental, social and governance (ESG) risks in the framework is particularly welcome. In terms of governance, the frameworks for fit and proper assessments and sanctioning will be further harmonised, as it is rightly recognised that a common EU approach is needed. Finally, the introduction of a harmonised prudential regime for third-country branches will help achieve a better level playing field, and less regulatory arbitrage, while still preserving the openness of the European financial markets.

8. Crisis management

8.1 Cooperation with the Single Resolution Board

The Resolution (paragraph 9) recalls that a strengthened approach to cooperation between the ECB Banking Supervision and the Single Resolution Board (SRB) is important to ensure appropriate and timely action in the current crisis context. It points out (paragraph 56) that the existing overlaps between the requirements for the use of early intervention measures and the standard supervisory powers of the ECB should be removed.

[21] See "Macroeconomic impact of Basel III finalisation on the euro area", *Macroprudential Bulletin*, ECB, July 2021.

ECB Banking Supervision highlights that its interaction with the SRB in past times of crisis has been effective. ECB Banking Supervision continues to share all supervisory information relevant for the SRB's tasks in a timely manner, based on the ECB-SRB Memorandum of Understanding.

ECB Banking Supervision supports the Resolution's call to remove the overlap between the requirements for the use of early intervention measures and standard supervisory measures of the ECB, and to provide a direct legal basis for ECB Banking Supervision to act. A further alignment of the conditions for exercising early intervention powers with those for imposing supervisory measures would make it easier to apply the early intervention framework, while ECB Banking Supervision decisions would still be subject to the proportionality principle.

8.2 European deposit insurance scheme and risk reduction

The Resolution (paragraph 4) supports the establishment of a European deposit insurance scheme (EDIS) as a priority action with a view to completing the banking union, and calls on the Commission to take further steps to relaunch the negotiations on EDIS through a roadmap-based work plan (paragraph 65). The report also calls for further risk reduction in the banking sector as a pre-condition for the introduction of EDIS (paragraphs 32, 39, and 41).

ECB Banking Supervision fully supports the establishment of EDIS as a priority and welcomes the European Parliament's views. As regards the Resolution's call for further risk reduction, ECB Banking Supervision notes that there has been considerable risk reduction in the banking sector over the past years, also as a result of targeted ECB Banking Supervision policies. This is documented in detail in the most recent edition of the joint Monitoring report on risk reduction indicators[22]. So far, this trend has not been reversed by the COVID-19 pandemic. In this context, ECB Banking Supervision does not believe that the introduction of EDIS should be linked to further risk reduction benchmarks. Furthermore, a completed banking union would allow European banks to fulfil their crucial role of supporting the real economy and to provide a sufficient level of financing in view of the challenges of the green and digital transitions. ECB Banking Supervision therefore welcomes the European Parliament's support for completing the banking union with EDIS.

In addition, the Resolution (paragraph 44) takes note of the EU-wide stress test launched in January 2021, which sought to test the capital trajectories of banks in an environment marked by worsening asset quality and the persistence of low interest rates. The Resolution also signals that running stress tests and an asset quality review (AQR) on a rolling sample of LSIs would be an important exercise to build trust. It calls on the EBA to enlarge the scope of subsequent stress test exercises, as the sample of the 2021 exercise is considered too narrow.

The stress testing of LSIs is under the remit of NCAs, which are responsible for the direct supervision of LSIs under European banking supervision. Performing an AQR on a rolling sample of LSIs would be a resource-intensive exercise. By way of comparison, the AQR carried out by ECB Banking Supervision on SIs in 2014 took 12 months, which points to the difficulty in completing such a review efficiently on an annual or regular basis. Nevertheless, if conducting such an exercise would be conducive to

[22] See "Monitoring report on risk reduction indicators", ECB, Single Resolution Board and European Commission, November 2021.

reaching a political agreement on a fully-fledged EDIS as part of the transition from the liquidity phase to the loss-coverage phase of EDIS, a one-off, targeted assessment of asset quality of a risk-based sample of LSIs could be carried out in parallel to the build-up of the new common fund. Given the very large number of banks involved, it would indeed be necessary to have a targeted, risk-based approach, focusing on a limited – but economically material – subset of banks, which would be commensurate both with the risks and the available resources.

Regarding the call on EBA to enlarge the scope of stress test exercises, it is worth noting that the scope has already been widened, as in 2021 ECB Banking Supervision conducted an SSM stress test on 51 medium-sized euro area banks in addition to the 2021 EU-wide stress test in which 38 banks under European banking supervision participated.