ECB Annual Report
on supervisory activities
2017
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Foreword by Mario Draghi, President of the ECB

The financial crisis started ten years ago, bringing pervasive economic, social and financial instability. Dramatic falls in output, employment and lending to the economy, together with the fragmentation of the financial system along national lines, plagued the euro area for several years. The stability of the banking system was threatened and many doubted the survival of the euro.

The crisis exposed several institutional weaknesses in the euro area, in particular the lack of an integrated banking market – the pillars of which are a single supervisor, a single resolution authority with a single resolution fund and a single deposit insurance scheme. As part of their reaction to the turbulence of 2012, policymakers created a single supervisor, which they hosted at the ECB. In the space of two short years, with the participation of the national competent authorities, European banking supervision was built.

Today, the euro area economy has been expanding for almost five years and growth is broad-based across countries and sectors. The ECB’s monetary policy has been the main driver of the recovery, and its actions have been complemented in important ways by banking supervision at the euro area level.

First, integrated banking supervision has contributed to making banks stronger, which has helped overcome financial fragmentation, improve the transmission of monetary policy and restore credit provision to households and firms. Lending rates across the euro area have converged to record lows.

Second, by requiring banks to hold adequate capital and ensuring that they strike a sustainable balance between risk and return, European banking supervision has been the first line of defence against financial stability risks originating in the banking sector. This has enabled monetary policy to pursue its price stability mandate, even when the policy stance needed to remain accommodative for a long time, because risks to financial stability were and are being contained by effective supervision.

In 2018 banks continue to face some key challenges. These include cleaning up their balance sheets, reducing legacy exposures largely originating from the financial crisis, such as certain non-marketable financial products, and from the ensuing Great Recession, such as non-performing loans. They also include the need to adapt their business models to new technological challenges, as well as to address issues of overcapacity and high costs. These must remain the priority action areas for banks that strive to be strong and to serve the euro area economy.
Introductory interview with Danièle Nouy, Chair of the Supervisory Board

Almost ten years have passed since the failure of Lehman Brothers and the start of the financial crisis. Has the financial system become safer since then?

The global financial crisis undoubtedly triggered many changes. At global level, we have just finalised a comprehensive regulatory reform – Basel III. Rules for banks have become tougher and gaps in the regulatory framework have been closed. At European level, we have started to build a banking union. Currently, the banking union rests on two pillars: European banking supervision and European bank resolution. Together, they help to enhance supervision of banks across Europe and to deal with crises more effectively. All in all, it is fair to say that the existing architecture of the financial system was largely shaped by the crisis. And this architecture is much more stable than the previous one. So yes, the financial system has become a safer place.

What about the banks themselves? Did they learn their lesson?

Well, I hope so. After all, one of the root causes of the crisis was a culture which prioritised short-term gains over long-term sustainability, and which often neglected the impact of banks’ actions on the economy and on taxpayers. This culture needs to change; and this change has to come from the banks, although regulators must ensure that incentives are, and stay, consistent.
What incentives do you have in mind?

The fact that banks can now fail in an orderly fashion should, above all, shift their focus towards sustainability. Public bailouts should be a thing of the past. In Europe, the Single Resolution Mechanism plays a key role here. It passed its first test in 2017, when three large banks failed and were resolved or wound down. The message is clear: banks now have to face up to the consequences of their behaviour; if they act unwisely, they might fail.

So the threat of failure prompts banks to start tackling all the challenges they face?

Yes, of course. Banks have come a long way since the crisis, but there are still challenges that need to be addressed. And now is the time; the conditions are ideal for four reasons. First, the euro area economy is doing well. Second, new technologies might be a challenge to banks, but they also offer new opportunities for banks to earn money and remain profitable. Third, there is regulatory certainty as Basel III has been finalised. And fourth, there is supervisory certainty now that European banking supervision is fully in place. Banks know how we work and what they can expect from us.

Profitability is a major challenge for banks in the euro area, right?

Indeed, profitability is the number one challenge for banks in the euro area. A number of them still don’t earn their cost of capital, and in the long run that’s an unsustainable position. While it’s a problem for the banks themselves, it’s also an issue that worries us supervisors. Unprofitable banks cannot support economic growth and build up capital buffers. At the same time, they might embark on a search for yield, which would increase risks. So we supervisors are concerned about the lack of profitability in the euro area banking sector.

What steps should banks take to increase their profitability?

That’s a more difficult question as each bank is different, and each bank needs its own strategy. The starting point for each and every bank is to have a strategy and to implement it. Here, the concept of “strategic steering” comes into play. In a nutshell, it refers to the management’s ability to set a course towards the bank’s long-term objectives. This requires sound processes and good governance, including risk management. If these conditions are met, the management has, at all times, a good overview and understanding of the entire organisation and can quickly change course if necessary. On the whole, the better banks are at “strategic steering”, the more successful they are. On a more practical level, banks should think about diversifying their sources of income, for instance through new technologies. For large banks in the euro area, more than half of operating income consists of net interest income. Given the record-low interest rates, this is something to work on. Banks
could, for instance, try to increase their fee and commission income. Many banks have indicated that they indeed plan to do so. But, as I said, each bank is different, and each needs to find its own way. More generally, the European banking sector needs to further consolidate.

**What about costs? Wouldn’t cost-cutting be another path to higher profits?**

There is room to cut costs, that’s true. Look at the large branch networks: are they still needed in times of digital banking? Cutting costs might be part of a bank’s strategy to become more profitable. There’s a caveat, though: banks mustn’t make cuts in the wrong places. Reducing staff in areas such as risk management? Not a good idea. Saving on IT systems? Not a good idea either. In more general terms, banks must not save on things that are crucial for future success and stability.

**Do non-performing loans affect profitability?**

Yes, very much so. Non-performing loans, or NPLs, are a drag on profits, and they divert resources that could be used more efficiently. Given that NPLs in the euro area amount to almost €800 billion, they pose a major problem that needs to be resolved. The good news is that banks are making progress: since early 2015, NPLs have fallen by about €200 billion. This is encouraging, but it’s not enough.

**What major steps has European banking supervision taken to help resolve the problem of non-performing loans?**

NPLs are one of our top supervisory priorities. In early 2017, we published guidance to banks on how to deal with non-performing loans. Using that guidance as a reference point, we have scrutinised the banks’ own plans to address NPLs. In 2018 we will continue to monitor how these plans are being implemented.

But banks not only need to get rid of existing NPLs. They also need to deal with potential new ones. To that end, we published a draft addendum to our guidance at the end of 2017. It lays out how we expect banks to provision for new NPLs – these expectations are non-binding, of course. This is the starting point for the supervisory dialogue and will feed into our bank-by-bank approach. The draft addendum was subject to a public consultation, and a final version was published in March 2018.

**So banks still need to clean up their balance sheets.**

Yes, the good times won’t last forever, so banks should make the most of them while they can. When a downturn comes, it will become much more difficult to reduce NPLs. More generally, clean balance sheets are key to profitability in the short and medium term. In this context, the European Banking Authority’s stress test in 2018
will be a moment of truth for banks. It will help to assess how resilient the banks will be when the going gets tough.

Besides low profitability and non-performing loans, what else does European banking supervision have to monitor?

Many things. We are, for instance, taking a close look at the internal models that banks use to determine the risk weights of their assets. This is highly relevant for calculating capital requirements and thus for the resilience of banks. In order to ensure that the models yield adequate results, we are conducting a targeted review of internal models – or TRIM, as we call it. The review has three objectives: first, to ensure that the models used by banks are in line with regulatory standards; second, to harmonise the way in which supervisors treat internal models; and third, to ensure that the risk weights calculated with internal models are driven by actual risk and not by modelling choices. TRIM will help to raise trust in internal models, in capital adequacy and, hence, in the resilience of banks.

Is the targeted review of internal models also related to Basel III and the much-discussed output floor?

There is indeed a connection. As a general rule, Basel III seeks to preserve risk-based capital requirements. This makes perfect sense as risk-based capital requirements are efficient and prompt banks to carefully define, measure and manage their risks. In this context, internal models are key. If they don’t work properly, banks might end up undercapitalised and vulnerable. And as I just mentioned, TRIM seeks to ensure that internal models work properly. It does so bottom-up, if you will, by assessing the models themselves. At the same time, Basel III introduces some top-down safeguards, such as the output floor you mentioned. It ensures that the risk weights calculated with internal models do not fall below a certain level. So, just like TRIM, the output floor helps to make risk-based capital requirements credible. This is very much in the interest of banks.

Turning from Basel to the UK: how is European banking supervision preparing for Brexit?

Well, Brexit will most certainly change Europe’s banking landscape. And it affects banks on both sides of the Channel. Their main concern is to retain access to each other’s market. To do that, they might have to implement far-reaching organisational changes, and such changes need to be prepared well in advance, of course.

But supervisors too need to prepare for the post-Brexit world. We have developed a number of policy stances on relevant issues, and we have made clear what we expect from banks that relocate to the euro area. We keep in close contact with the banks concerned through various channels. This helps us to better understand their plans and to clearly communicate our expectations.
But the changes triggered by Brexit go beyond the relocation of some banks that operate from the UK. As supervisors, we have to think about cross-border banking groups more generally: how can we ensure that they are well supervised, that they are resolvable? This will not only affect banks that operate from the UK, but also banks that operate from any other third country. And it may also affect European banks that operate outside the EU.

Looking beyond Brexit, how do you see financial integration developing in Europe?

Brexit is a sad story; that much is certain. But it is equally certain that financial integration in Europe will continue. Work on Europe’s banking union is well advanced, and the idea seems to appeal to countries outside the euro area as well – eastern European and Scandinavian countries in particular. I find this encouraging.

However, the banking union still needs to be finalised, and its third, missing pillar is a European deposit insurance scheme, or EDIS. Now that banking supervision and bank resolution have been transferred to the European level, the same should happen to deposit protection. Only then will control and liability be aligned. In my view, it is time to take further steps towards EDIS.

As the banking union makes progress, banks should start to reap the benefits of a large and integrated market; they should reach more across borders, and form a truly European banking sector, which reliably and efficiently finances the European economy.
1 Supervisory contribution to financial stability

1.1 Credit institutions: main risks and general performance

1.1.1 Main risks in the banking sector

The economic environment within which euro area banks operate continued to improve over the past year, and some banks were able to generate significant profits, although some others still need to recover. Overall, banks made sound progress in strengthening their balance sheets and tackling non-performing loans (NPLs). At the same time, work on completing the regulatory agenda also advanced, helping to lessen regulatory uncertainty.

Chart 1
SSM risk map 2018 for euro area banks

However, some risks persist, and the overall SSM risk map (see Chart 1) has not changed considerably since the beginning of 2017. The three most prominent risk drivers, both in terms of potential impact and probability, are (i) the low interest rate environment and its adverse effects on banks’ profitability; (ii) persistently high levels of NPLs in parts of the euro area; and (iii) geopolitical uncertainties. The first two risk drivers have decreased somewhat since 2016. Geopolitical uncertainties, on the other hand, have markedly increased, mainly owing to ongoing negotiations on the final Brexit deal and more general global political uncertainty (at the same time,
Political uncertainty in the EU abated somewhat after the French presidential elections.

The prolonged period of low interest rates continues to present a challenge to banks’ profitability. While these low rates reduce funding costs and support the economy, they also compress net interest margins and hence weigh on banks’ profitability. Banks may thus need to adapt their business models and cost structures. At the same time, supervisors have to ensure that banks do not take excessive risks to increase their profits.

High levels of NPLs constitute another major concern for a significant number of banks in the euro area. Compared to 2016, banks have made some progress in tackling NPLs. This is reflected in a drop in the aggregate NPL ratio from 6.5% in the second quarter of 2016 to 5.5% in the second quarter of 2017. Nevertheless, numerous euro area banks still have too many NPLs on their balance sheets. It is therefore crucial that banks step up their efforts to build and implement ambitious and credible NPL strategies. At the same time, further reforms are needed in order to remove structural impediments to NPL workout.1

Finalising and fine-tuning the regulatory framework is conducive to banking sector stability in the medium term. However, the transition to the new regulatory landscape may involve short-term costs and risks for banks, including the failure to adapt in time. These risks have somewhat decreased since 2016 as more details have emerged about the final shape of various regulatory initiatives, following agreements reached in international and European fora.

Debt sustainability is still a concern in some Member States, which remain vulnerable to a potential repricing in bond markets (also owing to the current very low levels of risk premia). Sovereign risk is particularly relevant in the current context of historically high geopolitical uncertainty (to which Brexit contributes). Potential sudden changes in risk appetite on the financial markets could affect banks via the repricing of their mark-to-market holdings and funding costs.

1.1.2 SSM supervisory priorities

The SSM supervisory priorities set out focus areas for supervision in a given year. They build on an assessment of the key risks faced by supervised banks, taking into account the latest developments in the economic, regulatory and supervisory environment. The priorities, which are reviewed on an annual basis, are an essential tool for coordinating supervisory actions across banks in an appropriately harmonised, proportionate and efficient way, thereby contributing to a level playing field and a stronger supervisory impact (see Figure 1).

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1 This includes improving the efficiency of secondary markets for distressed assets and collateral enforcement mechanisms, and harmonising the legal frameworks for insolvency and restructuring.
Figure 1
Supervisory priorities for 2018 and beyond

<table>
<thead>
<tr>
<th>Priorities 2018</th>
<th>Supervisory activities for 2018 &amp; beyond</th>
<th>Continued from 2017</th>
<th>Likely to be continued in 2019</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business models</td>
<td>Interest rate risk implications for banks' business models/profitability</td>
<td>✔️</td>
<td>✔️</td>
</tr>
<tr>
<td>Credit risk</td>
<td>Consistent approach to NPLs¹ forborne exposures (e.g. deep dives/OSIs)</td>
<td>✔️</td>
<td>✔️</td>
</tr>
<tr>
<td></td>
<td>Exposure concentrations &amp; collateral management and valuation (e.g. real estate, Level 3 assets)</td>
<td>✔️</td>
<td>✔️</td>
</tr>
<tr>
<td>Risk management</td>
<td>TRIM²: Credit risk, market risk and counterparty credit risk models</td>
<td>✔️</td>
<td>✔️</td>
</tr>
<tr>
<td></td>
<td>Improvement of banks' ICAAP³ and ILAAP⁴ approaches</td>
<td>✔️</td>
<td>✔️</td>
</tr>
<tr>
<td></td>
<td>Evaluate banks' preparedness for IFRS 9 and other regulatory changes</td>
<td>✔️</td>
<td>✔️</td>
</tr>
<tr>
<td>Multiple risk dimensions</td>
<td>Brexit preparations</td>
<td>✔️</td>
<td>✔️</td>
</tr>
<tr>
<td></td>
<td>EU-wide (biennial) and SSM-wide stress test exercise</td>
<td></td>
<td>✔️</td>
</tr>
</tbody>
</table>

1) Non-performing loans.
2) Targeted review of internal models.
3) Internal capital adequacy assessment process.
4) Internal liquidity adequacy assessment process.
5) Light blue ticks indicate follow-up activities.

1.1.3 The outcome of the sensitivity analysis of interest rate risk in the banking book

The ECB is constantly monitoring the sensitivity of banks' interest rate margins to interest rate changes. In the context of the low interest rate environment, which affects the profitability of the banking sector, the ECB decided to carry out a more in-depth assessment in 2017 of the strategies developed by banks to maintain the level of their interest margins under several scenarios.

Consequently, in the first half of 2017, ECB Banking Supervision ran a “Sensitivity analysis of interest rate risk in the banking book (IRRBB) – Stress test 2017”.² A sample of 111 significant institutions (SIs) was assessed based on two

² The exercise did not cover other types of risk, such as market risk.
complementary metrics: (i) changes in the banks’ net interest income (NII) triggered by interest rate movements; and (ii) changes in the banks’ economic value of equity (EVE)\(^3\) (i.e. the present value of their banking book) triggered by interest rate movements. The aim of the exercise was to achieve a supervisory assessment of risk management practices and to fully leverage the comparison of results across banks. To that end, the banks were asked to simulate the impact of six hypothetical interest rate shocks coupled with a stylised evolution of their balance sheets.\(^4\)

**Chart 2**
**Average projected NII by interest rate shock**

![Chart 2](image_url)

Source: ECB.

Notes: Figures based on net interest income projections aggregated across all major currencies tested in the exercise for all 111 banks. The parallel shifts are currently used for the IRRBB reporting process (+/- 200 bps for EUR positions); the steepener and flattener are drawn from the recent BCBS Standards on IRRBB; the end-2010 shock envisages a return of interest rates to levels last seen in 2010; the end-2016 shock keeps rates constant at end-2016 levels.

The results show that, on average, banks are well equipped to cope with changes in interest rates. A sudden parallel shift of the term structure of interest rates by +2% would have an aggregate positive impact on NII (+10.5% over a three-year horizon, **Chart 2**) and a mild negative impact on the EVE (-2.7% of CET1, **Chart 3**), the latter being the most severe outcome for EVE across all the interest rate shocks considered.

However, the results of the exercise should not be misinterpreted as an absence of risks, especially as they take into account banks’ expectations regarding customer behaviour. For example, banks can model non-maturity deposits as long-term fixed-rate liabilities. In a period of rising interest rates, a repricing of these deposits faster than expected by the bank would result in a NII lower than expected. Banks mostly calibrated their deposit models on a period of decreasing interest rates. As such, the models may only partly reflect the reaction of customers to an increase in interest

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\(^3\) EVE reflects the impact of interest rate shifts on the value of a bank’s banking book.

\(^4\) For details, please see the information published on the ECB’s banking supervision website.
rates. Moreover, modelled durations of core deposits were found to be surprisingly long in some cases.

**Chart 3**

Average change in EVE by interest rate shock

(Chart showing changes in EVE as a percentage of CET1)

Source: ECB.

Notes: Figures based on aggregate EVE projections across all major currencies and aggregate CET1 capital for the full sample of 111 banks. There is no EVE change under the constant rates envisaged under the end-2016 shock.

The results also show that banks make significant use of interest rate derivatives in their banking books. In general, banks use derivatives to hedge mismatches in the repricing profiles of assets and liabilities. However, some banks also use interest rate derivatives to achieve a target interest rate profile. The aggregate impact across banks of these trades on EVE sensitivity is limited (+1.7% of CET1 under the parallel up shock). However, this limited impact is largely the result of offsetting exposures between those banks where derivatives reduce the duration of the assets and those where derivatives increase that duration (55% and 45% of the sample, respectively).

The results of the 2017 exercise fed into the Supervisory Review and Evaluation Process (SREP). Going forward, the exercise will provide valuable input for supervisory discussions on interest rate risk in the banking book. The exercise could act as a starting point for follow-up analyses by Joint Supervisory Teams (JSTs).

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**Box 1**

Banking sector consolidation – barriers to cross-border mergers and acquisitions

A healthy banking system goes together with a healthy market for bank mergers and acquisitions (M&A). The European banking union, including European banking supervision, will make it easier for banks to merge across borders.

Cross-border mergers within the euro area may bring three main benefits. First, it will deepen financial integration within the euro area, paving the road towards the common goal of a truly European banking sector. Second, savers will have more options when investing their money, and companies as well as households will be able to tap more sources of funding. Third, risk-sharing will be improved, helping the EU economy to become more stable and more efficient. Moreover, bank
mergers can play a role in reducing excess capacity and making banks themselves more efficient. For these benefits to materialise, however, merger operations need to be prudentially sound.

The state of the M&A market

After an initial rise following the launch of the euro, mergers and acquisitions in the euro area have been declining. In 2016 they reached their lowest level since 2000, both in terms of the number of deals and their value. And those mergers tend to be domestic rather than cross-border.

Bank mergers are complex, expensive and risky, and their success depends on certain enabling conditions. Banks need to be confident if they are to take that step, and it seems that banks still lack confidence at present.

In particular, there is often uncertainty about the economic value mergers bring. Looking at potential partners, there may be doubts about the quality of their assets and their ability to generate profits. In some parts of the euro area, levels of non-performing loans are still high, and their true value is hard to assess.

On top of this, there seems to be uncertainty about some key long-term drivers of bank performance. How will digitalisation and the associated changes in market structure affect the optimal structure and size of a bank, for instance? Is it still worthwhile to acquire branch networks when digital banking might make them less and less useful? And finally, some remaining uncertainty about regulation may also play a role. It seems that many banks would like to see the single rulebook fully implemented before they consider taking the big leap of merging with another bank.

Uncertainties are compounded by the cross-border dimension. First of all, cross-border mergers require banks not only to go beyond national borders, but also to overcome cultural and linguistic barriers. The lack of harmonisation in the legal and regulatory basis governing supervisory M&A reviews in the countries participating in the SSM may increase the costs of, and prove to be an obstacle to, cross-border M&A. The national laws that govern mergers tend to differ across countries.

More generally, the ring-fencing of capital and liquidity within jurisdictions plays a role. Options to waive cross-border intragroup requirements are currently being considered as part of the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD IV) review and could, where introduced, play a supportive role for cross-border M&A. In addition, the CRD IV and CRR still contain a number of options and discretions which are exercised differently at national level. They make it difficult to ensure a consistent overall level of regulatory capital across Member States and to fully compare the capital positions of banks.

Of course, other regulatory factors can also play a role in banks’ decisions to consolidate. The additional capital requirements that may arise from an increase in the size and complexity of a bank, via other systemically important institution (O-SII) buffers or even global systemically important bank (G-SIB) buffers, may be a disincentive, for example.

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Adding to the picture is the fact that part of the legislative framework (e.g. insolvency laws), tax systems, and regulations (e.g. consumer protection) which supports the functioning of financial systems remains diverse in the EU and in the euro area.

While European banking supervision can point out these obstacles, its role in shaping the environment is limited. Consolidation itself needs to be left to market forces, and changes to the regulatory landscape to the lawmakers.

What European banking supervision has done, though, is help reduce uncertainty about the quality of banks’ assets, the asset quality review of 2014 being a first step towards that goal. In addition, it has made it a priority to address banks’ NPL portfolios. Supervisors can also ensure that supervisory processes related to mergers are effective. On the regulatory side, it is important to ensure faithful and consistent implementation of agreed reforms, including Basel III, as well as to take further steps towards completing the banking union, most importantly the European deposit insurance scheme. All these elements will contribute to reducing uncertainty.

1.1.4 General performance of significant banks in 2017

While 2016 was a particularly difficult year for euro area banks, the situation improved somewhat in 2017. In the first three quarters of 2016, the pre-impairment operating profits of SIs plunged by 10% compared with the first three quarters of 2015. The first nine months of 2017 then saw a recovery in pre-impairment operating profits (+2%). Coupled with a strong decline in impairments (-14.9% compared with 2016, -35.2% compared with 2015) this led to a relative improvement in the annualised return on equity for SIs, which averaged at 7.0% compared with 5.4% in 2016 and 5.7% in 2015.

However, the overall improvement masks considerable differences across banks. Around a dozen banks are still making losses, while a group of about two dozen banks have achieved an average return on equity of around 8% or above over the past three years. Nevertheless, the fact that many publicly listed banks still trade at price-to-book ratios below one indicates a need for further improvements in order to meet investors’ expectations.

The improvement in pre-impairment operating profits was driven by an increase in net fee and commission income of 3.2%, and in net trading income, which increased by 62% compared with the first three quarters of 2016. Net interest income, by contrast, continued to decline and was 1.9% below the value recorded in the first three quarters of 2016, after already dropping by 0.9% from the first three quarters of 2015.
Chart 4
Higher return on equity in 2017 thanks to greater operating profits and lower impairments

(All items are displayed as percentages of equity)

Source: ECB Supervisory Banking Statistics.
Note: Data for all years are shown as second quarter cumulated figures, annualised.

The decrease in net interest income from the third quarter of 2015 to the third quarter of 2016 seemed to be driven by a decline in margins, as loan volumes increased by 4.7%. By contrast, loan volumes decreased by 2.1% between the third quarter of 2016 and the third quarter of 2017, in particular loans to financial institutions (loans to credit institutions -11.8%, loans to other financial corporations -7.3%). It is worth noting that, despite this negative trend, roughly half of SIs have managed to improve their net interest income.

The positive results of banks in the first three quarters of 2017 were helped by lower operating expenses, which are at their lowest since 2015. They dropped by 2.3% with respect to the first nine months of 2016 (-1.6% compared with the first nine months of 2015), most likely thanks to the restructuring measures recently taken by several euro area banks.

1.2 Work on non-performing loans (NPLs)

1.2.1 The situation across Europe

Non-performing loans (NPLs) on SIs’ balance sheets stood at almost €760 billion in the third quarter of 2017, down from €1 trillion in early 2015. However, there are parts of the banking sector where NPL levels remain far too high. Clearly, NPLs are a sizeable problem for the European banking sector. This is because NPLs weigh on the balance sheets of banks, drag down profits, divert resources from more productive uses, and keep banks from lending to the economy. It is therefore necessary for banks to address NPLs. Work on NPLs was one of ECB Banking Supervision’s most important supervisory priorities in 2017. The ongoing project is...
coordinated by a high-level group on NPLs, which reports directly to the ECB’s Supervisory Board. The group’s main objective is to develop an efficient and consistent supervisory approach with regard to banks with high levels of NPLs.

The ECB publishes its Supervisory Banking Statistics on a quarterly basis, including data on asset quality for SIs. Table 1 shows the decrease in NPL levels between 2016 and 2017.

<table>
<thead>
<tr>
<th>Table 1</th>
<th>Non-performing loans and advances – amounts and ratios by reference period</th>
</tr>
</thead>
<tbody>
<tr>
<td>Item</td>
<td>Q3 2016</td>
</tr>
<tr>
<td>Loans and advances ¹</td>
<td>14,170.1</td>
</tr>
<tr>
<td>Non-performing loans and advances</td>
<td>920.1</td>
</tr>
<tr>
<td>Non-performing loan ratio</td>
<td>6.5%</td>
</tr>
<tr>
<td>Non-performing loan coverage ratio</td>
<td>45.8%</td>
</tr>
</tbody>
</table>

Source: ECB.
Notes: SIs at the highest level of consolidation for which common reporting on capital adequacy (COREP) and financial reporting (FINREP) are available. Specifically, there were 124 SIs in the second quarter of 2016, 122 in the third quarter of 2016, 121 in the fourth quarter of 2016, 118 in the first quarter of 2017 and 114 in the second quarter of 2017. The number of entities per reference period reflects changes resulting from amendments to the list of SIs following assessments by ECB Banking Supervision, which generally occur on an annual basis, and mergers and acquisitions.

¹ Loans and advances in the asset quality tables are displayed at gross carrying amount. In line with FINREP: (i) held for trading exposures are excluded, (ii) cash balances at central banks and other demand deposits are included. In accordance with the EBA definition, non-performing loans are loans and advances other than held for trading that satisfy either or both of the following criteria: (a) material loans which are more than 90 days past due; (b) the debtor is assessed as unlikely to pay its credit obligations in full without realisation of collateral, regardless of the existence of any past-due amount or of the number of days past due. The coverage ratio is the ratio between accumulated impairments on loans and advances and the stock of NPLs.

Looking across the euro area, the NPL ratio continues to differ significantly from country to country, as shown in Figure 2. In the second quarter of 2017, Greek and Cypriot SIs had the highest NPL ratios (with country-weighted averages standing at 46.6% and 34.0% respectively). With 18.1%, Portuguese SIs had the third highest NPL ratio. Looking at the trend, the NPL ratio decreased significantly year-on-year for SIs in Cyprus (-6.3 pp), Ireland (-5.6 pp), Italy (-4.4 pp) and Slovenia (-3.2 pp). In the third quarter of 2017, the stock of NPLs for Italian SIs was €196 billion, followed by French SIs (€138 billion), Spanish SIs (€112 billion), and Greek SIs (€106 billion).
1.2.2 The need for a comprehensive strategy for resolving NPLs

ECB Banking Supervision highlighted at an early stage that a joint effort from all stakeholders was needed to resolve NPLs. This was also one of the main findings of the ECB’s NPL stocktake report on national practices, the latest version of which was published in June 2017 (see Section 1.2.3.1). This report referred to the need for a comprehensive European strategy in three key areas: (i) supervisory actions, (ii) legal and judicial reforms, and (iii) the need to develop secondary markets for distressed assets.
A comprehensive strategy to address NPLs requires action from all stakeholders, including EU and national public authorities.

Regarding supervisory actions, ECB Banking Supervision has implemented a comprehensive supervisory framework for NPLs, which includes:

- publishing guidance to all SIs, outlining supervisory expectations with regard to managing and reducing NPLs;
- developing quantitative supervisory expectations to foster timely provisioning practices in the future;
- conducting regular on-site inspections with a focus on NPLs;
- collecting additional relevant data from banks with high levels of NPLs.

Following the 11 July 2017 ECOFIN conclusions on an action plan to tackle non-performing loans in Europe, ECB Banking Supervision is also supporting the European Banking Authority (EBA) in issuing general guidelines on NPL management which are consistent for all banks in the EU. Moreover, ECB Banking Supervision is interacting with the EBA on promoting the enhancement of underwriting standards for new loans.

More generally, ECB Banking Supervision has been actively contributing to numerous other NPL initiatives in the three areas mentioned above, including those which are part of the EU action plan (as agreed by the EU Council in July 2017), closely collaborating with the stakeholders in charge of the initiatives.
1.2.3 Key elements of the supervisory approach to NPLs

1.2.3.1 Stocktake of national practices

In June 2017 the ECB published its latest stocktake of national supervisory practices and legal frameworks related to NPLs. This report presents analyses of practices across all 19 euro area countries as at December 2016. In addition to identifying best supervisory practices, its purpose was to identify (i) current regulatory and supervisory practices, and (ii) obstacles related to the workout of NPLs. This updated and extended stocktake builds upon a previous stocktake of national supervisory practices and legal frameworks related to NPLs. That stocktake covered eight euro area countries (Cyprus, Greece, Ireland, Italy, Portugal, Slovenia, Spain and Germany) and was published in September 2016. It focused on identifying best practices in jurisdictions with relatively high levels of NPLs, or a “sectoral” NPL issue, and existing frameworks for managing NPLs.

The 2017 stocktake shows that, across the euro area, some progress has been made in addressing the NPL issue from a supervisory perspective. The stocktake, combined with experience from jurisdictions with high NPL levels, reveals one key lesson: there is a need for all stakeholders to be proactive and prepared before NPL levels get too high. Many countries with low levels of NPLs have not amended their relevant legal frameworks since the beginning of the crisis. All in all, they should be better prepared to timely and effectively manage the legal aspects that might arise from a potential future increase in NPL levels. This means, for instance, speeding up out-of-court mechanisms (e.g. in enforcing collateral or processing corporate and household insolvency claims).

Regarding the supervisory regime and practices for addressing NPLs, the stocktake illustrates that tools such as specifically focused on-site inspections of arrears and NPL management play a decisive role in detecting emerging issues at an early stage. In this respect, the ECB’s Guidance to banks on NPLs, which is applicable to all SIs, is an important element of supervisory assessment going forward (see Section 1.1.2).

With respect to less significant institutions (LSIs), euro area countries generally still lacked specific guidance on NPLs when the stocktake of national practices was published. However, a number of NCAs have indicated that they are considering whether to apply the ECB’s guidance on NPLs to LSIs as well. Furthermore, in its conclusions of July 2017 the EU Council asked the EBA to issue, by summer 2018, general guidelines on NPL management, consistent with the aforementioned guidance, with an expanded scope applying to all banks in the entire EU.

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7 See ECB, Stocktake of national supervisory practices and legal frameworks related to NPLs, June 2017.
8 See ECB, Stocktake of national supervisory practices and legal frameworks related to NPLs, September 2016.
With regard to the legal frameworks, the stocktake shows that these have (with some exceptions) improved only incrementally in countries with high stocks of NPLs since the first stocktake. In any case, it is too early to assess the effectiveness of these changes. With regard to judicial systems (including the recruitment of insolvency experts), changes are not keeping pace with legislative developments.

As to information frameworks for NPLs, the stocktake shows that most euro area countries have central credit registers in place, which are usually managed by national central banks. Such registers are generally considered to be a valuable supervisory tool for on-site and off-site analyses as well as for the sharing of information between banks.

### 1.2.3.2 NPL guidance and related follow-up

ECB Banking Supervision published qualitative guidance to banks on how to deal with non-performing loans\(^9\) (hereafter referred to as the “NPL guidance”) in March 2017. The publication was preceded by a public consultation, which ran from 12 September 2016 to 15 November 2016. A public hearing was held on 7 November 2016. More than 700 individual comments were received and assessed during the consultation. The development of the NPL guidance was an important step towards a significant reduction of NPLs in the euro area.

#### Aim and content of the NPL guidance

The key policy message of the NPL guidance is that the banks concerned should address high levels of NPLs as a matter of priority and in a comprehensive manner, by focusing on their internal governance and setting out their own operational plans and quantitative targets. All three elements will be scrutinised by the relevant JSTs. The “wait and see” approach we have often seen in the past cannot continue. Banks’ own targets need to be adequately embedded in incentive schemes for managers and must be closely monitored by their management bodies.

The NPL guidance is a practical document which sets out supervisory expectations on all the relevant areas that a bank should address when dealing with NPLs. It is based on the EBA’s common definition of non-performing exposures\(^10\). However, it also covers aspects of foreclosed assets and performing exposures with a high risk of turning non-performing, including “watch-list” exposures and performing forborne exposures.

The NPL guidance was developed on the basis of the existing best practices of several euro area countries. Its structure follows the life cycle of NPL management, outlining related supervisory expectations on NPL strategies, NPL governance and

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\(^9\) ECB, Guidance to banks on non-performing loans, March 2017.

operations, forbearance treatments, NPL recognition, NPL provisioning and write-off and collateral valuations.

**Follow-up work on NPL and foreclosed asset strategies**

Following the publication of the NPL guidance, SIs with high NPL ratios were asked to submit their strategies and operational plans for reducing NPLs to ECB Banking Supervision. To ensure comparable information and a level playing field, a specific template was devised for banks to fill in. Using that template, banks had to demonstrate, at portfolio-level, how and over what period of time they planned to reduce their NPLs and foreclosed assets.

From March to June 2017, the banks submitted their strategies, and ECB Banking Supervision assessed them against its supervisory expectations. The assessment was carried out by JSTs on a bank-by-bank basis with the support of a horizontal NPL team. Throughout the process the JSTs met with their banks to discuss the strategies.

While NPL strategies, operational plans and quantitative targets are the responsibility of each individual bank, ECB Banking Supervision expects them to be ambitious and credible in order to ensure that the reduction of NPLs and foreclosed assets is both timely and sufficient.

**Assessment of the NPL strategies**

In line with the NPL guidance, a bank’s governance framework should ensure that the NPL strategy can be smoothly executed. Against this backdrop, the JSTs assess the strategies bank-by-bank, focusing on three core building blocks: (i) level of ambition, (ii) the credibility of the strategy and (iii) governance aspects.

The level of ambition is measured by the gross and net reduction of non-performing exposures and foreclosed assets that a bank expects to achieve over a three-year horizon. For each bank, an appropriate “level of ambition” is defined. This takes into account a number of elements, such as the bank’s financial situation, its risk profile, the characteristics of its non-performing portfolio, and the macroeconomic environment. ECB Banking Supervision carried out both country-level and peer benchmarking analyses of the ambition levels projected by the banks with high NPL ratios.

In assessing whether the banks’ strategies are credible, ECB Banking Supervision uses a wide range of analyses to determine whether their projected ambition levels match what they can achieve. The relevant indicators include: capital capacity, provisioning coverage and trends, the materiality of “asset-based” strategies, vintage analysis, assumptions about inflows and outflows to and from the non-performing portfolio, cash recoveries and resources to support them, timelines and diversification of strategic options.
What is an ambitious and credible NPL strategy?

- Oversight and ownership by management bodies.
- Clear and unambiguous reduction targets, identified in a bottom-up manner by the bank on sufficiently granular segments.
- A detailed capital, RWA and provisioning impact assessment of the individual elements of the reduction strategy with detailed rationale to support the execution of the strategy and targets.
- Diversification across a variety of strategic options with a strong focus on vintages greater than two years past due.
- Strong strategic governance, including well-defined staff incentives at senior and operational level, to effectively drive through NPL reduction targets at all stages of the NPL resolution chain.
- Robust internal operational capacities and frameworks to deliver effective NPL reduction, including the ability to engage with borrowers early to reduce the level of exposures which turn non-performing.
- If applicable to a bank, a strong focus on the timely sale of foreclosed assets or on increased provisioning if sales are not carried out in the short term.
- A detailed operational plan setting out the key deliverables, milestones, actions and timelines which are required in order to execute the strategy successfully.
- A strong focus on sound forbearance, i.e. identifying sustainable borrowers and providing them with viable restructuring options to return their loans to performing.
- A well-developed forbearance toolkit, monitored for effectiveness on a granular level.
- A granular monitoring framework for the implementation of the strategy, which allows under-/over-performance drivers to be identified.

The assessment of governance focuses on a wide range of areas, which include: (i) banks’ self-assessment processes; (ii) the level of oversight and monitoring of the strategic plan by the management body; (iii) the incentive schemes in place to promote the execution of the strategy; (iv) the ways in which the strategy is embedded into day-to-day operations; (v) the level of resources (both internal and external) allocated by the bank to work out the loans; and (vi) the strategies underlying operational plans.
1.2.3.3 Quantitative supervisory expectations on timely provisioning

In line with its mandate, the ECB needs to apply a forward-looking approach to proactively address risks. Since the publication of the NPL guidance, and also learning from past experience, ECB Banking Supervision has continued working on further measures to address NPLs. On 4 October 2017, it published a draft addendum to the NPL guidance for consultation. This addendum seeks to foster more timely provisioning practices for new NPLs in order to avoid NPLs piling up in the future. During the public consultation, which ended on 8 December 2017, ECB Banking Supervision received 458 individual comments from 36 counterparties. This represents valuable feedback, which was carefully assessed when finalising the document.

The supervisory expectations will improve supervisory convergence and ensure a level playing field. Naturally, the expectations are subject to a case-by-case assessment. In this context, the general supervisory expectation outlined in the addendum is that for unsecured loans, 100%-coverage should be reached two years after a loan has been classified as non-performing. For secured loans, the corresponding time frame is seven years. To avoid cliff edge effects, a suitably gradual path towards those supervisory expectations is important, starting from the moment of NPE classification.

The level of prudential provisions is assessed in the context of the normal supervisory dialogue. As a starting point, the supervisor determines whether a bank’s accounting allowances adequately cover its expected credit risk losses. The accounting allowances are then compared against the supervisory expectations set out in the addendum.

More precisely, during the supervisory dialogue the ECB will discuss with banks any divergences from prudential provisioning expectations. The ECB will then consider the deviations on a bank-by-bank basis and decide, after a thorough analysis that might include deep dives, on-site examinations or both, whether a bank-specific supervisory measure is needed. There is no automaticity in this process. These supervisory expectations, unlike Pillar 1 rules, are not binding requirements which trigger automatic actions.

1.2.3.4 On-site inspections of NPLs

In the course of 2017, 57 credit risk inspections were completed, of which six were led by the ECB and 51 by NCAs. The management and valuation of NPLs was a key topic in these inspections, addressed in 54 out of the 57 on-site inspection reports. In this context, the main aspects of the work were the assessment of NPL strategies, policies and procedures (54 reports) and a quantitative impact assessment (37 reports).
NPL strategies, policies and procedures

Using the NPL guidance as a benchmark, the most significant shortcomings in NPL strategies, policies and procedures have been identified as follows.

**NPL strategy and governance:** in this area, a trend towards more active NPL management has been observed. This is mostly a result of banks’ attempts to meet the supervisory expectations set out in the NPL guidance. However, most of the on-site inspection reports highlight that the information provided to banks’ management bodies is still not granular enough. This affects, for instance, early warning risks and risks that were incurred in different entities of the banking group or that arise from the application of certain restructuring models.

**NPL forbearance:** most banks have been found lacking in efficient forbearance policies, be it at the point of entry to or the point of exit from forbearance status. At entry, the criterion of viable versus distressed restructuring is not precisely defined and certain forbearance measures referred to in the NPL guidance are not recognised as such (e.g. granting of additional facilities, request for additional securities/collateral). At the same time, classic forbearance measures (interest rate reduction, term extension) often do not trigger an NPL status in reporting on clients facing financial difficulties. The rules for identifying financial difficulties remain very heterogeneous and too restrictive, mostly owing to insufficient data. Forbearance exit criteria, especially with regard to forbearance during the probation period, are insufficiently monitored.

**NPL recognition/classification:** most of the findings concerned (i) insufficient unlikely-to-pay criteria, concerning, notably, specific sectors (shipping, commercial real estate, oil and gas) or financing techniques (leveraged finance) and (ii) undue reliance solely on the backstop criteria explicitly mentioned in the CRR.

**NPL provisioning and collateral valuation:** although provisioning processes are increasingly being supported by IT tools and more precise policies, the main areas for further improvement are unrealistic collateral valuations (sometimes indexed upwards instead of revalued), overly optimistic collateral haircuts and recovery times. Besides, certain banks still have inappropriate practices with regard to the treatment of accrued but not yet paid interest.

**NPL data integrity:** the many findings in this area include a lack of risk data aggregation processes, for data relevant to the detection of financial difficulties (e.g. data from income statements, EBITDA, DSCR). Furthermore, key parameters (e.g. collateral haircuts, discount times, cure rates) are often significantly misestimated and the criteria for write-offs (e.g. expressed as time in default) are in many cases not clearly defined.
Quantitative assessment

In addition to assessing policies and procedures as usual, the on-site inspection teams reviewed extensive samples of credit files. In this context, statistical techniques were sometimes used to evaluate parts of the loan book in order to verify whether the level of provisions was sufficiently compliant with prudential requirements (Article 24 of the CRR, and Article 74 of CRD IV transposed into national legislation) and international accounting standards (notably IAS 39 and IAS 8). While the majority of these reviews resulted in either no significant change or by and large bearable adjustments, some of the on-site inspections did identify cases of very significant quantitative shortcomings that triggered individual supervisory actions.

ECB quarterly data collection for high-NPL banks

In September 2016 the ECB’s Supervisory Board approved the launch of a quarterly collection of data on NPLs for SIs with material NPL exposures (“high-NPL banks”).\(^\text{11}\) The objective is to supplement the information collected by the supervisors under the harmonised reporting framework (EBA ITS on Supervisory Reporting) with additional and more granular data. Such data are necessary to efficiently monitor the NPL-related risks of high-NPL banks.

The ECB reporting templates used throughout the 2017 reporting cycle\(^\text{12}\) complement the existing FINREP templates for non-performing and forbear exposures. They include, among other things, a breakdown of the stock of NPLs by vintage as well as information on collateral (also comprising foreclosed assets), NPL inflows and outflows and restructuring/forbearance data.

The data from the quarterly collection are benchmarked and inputted by the Joint Supervisory Teams into the assessment of banks’ strategies, procedures and organisation with regard to NPL management. The example below shows non-performing exposures in respect of which court proceedings had been started as a percentage of the reporting sample of high-NPL banks as at end-June 2017.

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\(^\text{11}\) As outlined in the NPL guidance, ECB Banking Supervision defines high-NPL banks as “banks with an NPL level that is considerably higher than the EU average level”.

\(^\text{12}\) Quarterly reporting from 31 December 2016 to 31 December 2017.
Banks participating in this data collection have been informed of the relevant requirements in their respective SREP letters.\textsuperscript{13}

Leveraging on the experience gained during the 2017 reporting cycle, the ECB has amended and streamlined the set of templates used for the quarterly data collection and has provided the reporting institutions with a revised version of the requirements, which will be applicable from 31 March 2018.

The ECB and the EBA are currently discussing the possibility of including those NPL templates into the harmonised reporting framework.

1.2.4 Outlook and next steps

It is an ongoing key supervisory priority for ECB Banking Supervision to continue its efforts to resolve the NPL issue across SIs. The JSTs will continue their close interaction with high-NPL banks, in particular focusing on their strategies to resolve NPLs. These strategies are expected to be closely monitored and updated at least annually.

\textsuperscript{13} The legal basis for the quarterly NPL data collection for high-NPL banks is Article 10 of the SSM Regulation and Article 141 of the SSM Framework Regulation. Indeed, the ECB may require credit institutions established in the participating Member States to provide all information that is necessary in order to carry out its prudential supervision tasks, including information to be provided at recurring intervals and in specified formats for supervisory purposes. The ECB used those powers within the limits of the maximum harmonisation principle aimed for by the EBA/ITS. This approach allows the ECB the flexibility it needs to obtain data from banks in order to perform its supervisory tasks and to adjust/update the data requirements on a regular basis, as long as those data are not collected under the EBA/ITS.
The final addendum to the NPL guidance was published on 15 March 2018. However, since the addendum focuses on new NPLs, any related follow-up activities with the SIs will only start gradually over time.

Finally, given that many stakeholders are required to act on the issue of NPLs, ECB Banking Supervision will continue to collaborate closely with other European and national stakeholders to address the remaining issues in the NPL-related framework, as outlined in its stocktake report published in June 2017.

1.3 Work on thematic reviews

1.3.1 Business models and profitability drivers

In 2016 European banking supervision launched a thematic review in order to assess the business models and profitability drivers of the majority of SIs in depth. This thematic review will be concluded in 2018.

Assessing banks’ business models and profitability drivers is a key priority for European banking supervision. Profitable banks can generate capital organically and thus build up adequate buffers, while maintaining a reasonable risk appetite and lending to the real economy. Banks that struggle to reach sustainable profitability, on the other hand, may stray into riskier activities.

In the current environment, euro area banks’ profitability is under pressure from low interest rates and continued high impairment flows in some countries and sectors. Moreover, it is also challenged by structural factors, such as overcapacity in some markets, competition from non-banks, increasing customer demand for digital services, and the need to adapt to new regulatory requirements.

The thematic review addresses banks’ profitability drivers both at firm level and across business models. In doing so, it pursues several objectives. Besides assessing banks’ ability to mitigate weaknesses in their business models, it assesses how weak profitability impacts banks’ behaviour. It will also enrich horizontal analysis, in particular by pooling the insights gained by the JSTs and harmonising their follow-up across banks. During the first year of the thematic review, the necessary analytical tools were created and comprehensive guidance to support the JSTs in their analysis was devised.

In the first quarter of 2017, the ECB collected data on banks’ forecasted profit and loss results as well as the assumptions underlying them. In aggregate, over the next two years, banks expect a gradual improvement in profitability on the back of solid loan growth and lower impairments, while net interest margins will remain under pressure.

During the second and third quarter of 2017, the focus of the thematic review shifted to bank-specific analyses, which were performed by the JSTs. The teams interacted directly with the banks in order to screen all aspects of their business models and

Profitability has been under pressure from various sources

The first year of the thematic review was a preparatory phase: tools were developed and guidance for the JSTs devised

In the second year of the thematic review, the JSTs analysed their banks’ business models and profitability drivers
The aspects examined ranged from the banks’ core capacity to generate revenues to their ability to understand and steer their activities and implement their chosen strategies.

The findings of the JSTs are being combined with analytical results from the ECB’s DG Microprudential Supervision IV, leveraging on internal and external data sources. This includes a thorough analysis of the most profitable banks to understand the drivers of their performance and ascertain whether these are sustainable. Banks’ strategies to address low profitability vary significantly: they include growth strategies to bolster net interest income, expanding fee and commission-related business, cost-cutting and digitalisation.

Deficiencies in the institutions’ internal set-up to steer profitability, as well as issues related to the business plans, such as excessive risk-taking, were brought to the banks’ attention as part of the supervisory dialogue. The identification of deficiencies will also result in risk mitigation plans being drawn up for the affected banks, to be communicated in early 2018.

Ultimately, the results of the thematic review will feed into the 2018 Supervisory Review and Evaluation Process (SREP) and could trigger on-site inspections as well as deep dives into areas where blind spots have been identified. The analyses will also provide the opportunity to benchmark practices across comparable institutions.

1.3.2 Impact of IFRS 9 on provisioning

The new accounting standard for financial instruments (IFRS 9), which entered into force in January 2018, aims to address the lessons learned from the financial crisis, namely, that provisions based on incurred loss models often resulted in “too little, too late”. Against this backdrop, IFRS 9 was designed to ensure more adequate and timely provisioning by introducing an expected credit loss model that incorporates forward-looking information.

The new features introduced by IFRS 9 constitute a major change in the accounting regime for financial instruments, augmenting the role of judgement in the implementation and subsequent application of the standard. Given that accounting numbers form the basis for calculating prudential capital requirements, the SSM made it one of its supervisory priorities for 2016 and 2017 to (i) assess how well SIs and LSIs are prepared for the introduction of IFRS 9, (ii) gauge the potential impact on provisioning, and (iii) promote consistent application of the new standard. This assessment was mainly based on what are considered best practices at international level, as set out in the guidance issued by the Basel Committee on Banking Supervision (BCBS) and the European Banking Authority (EBA). In carrying out this supervisory exercise the ECB collaborated closely with the NCAs, the EBA and the BCBS. This collaboration will continue throughout the follow-up activities planned for 2018.

Regarding the impact on prudential figures, it is important to note that the EU co-legislators have adopted transitional measures. These measures aim to smooth the
The fully loaded average negative impact of IFRS 9 on the CET1 ratio is estimated to be 40 basis points.

A thematic review on risk data aggregation and risk reporting was one of the SSM’s supervisory priorities for 2016 and 2017.

1.3.3 Risk data aggregation and risk reporting

Sound risk management in banks rests on firm-wide data quality and effective risk data aggregation and reporting practices. However, a key lesson from the financial crisis was that some banks were unable to fully identify risk exposures. This was

potential negative impact of IFRS 9 on the regulatory capital of banks. The measures have been implemented through Regulation (EU) 2017/2395\textsuperscript{14}, which was published in the Official Journal on 27 December 2017.

A report with the results of the thematic review has been published on the ECB’s banking supervision website. It provides a summary of the main qualitative and quantitative results for SIs and LSIs. With regard to the qualitative results, the overall conclusion is that, for some institutions, there is still room for improvement if a high-quality implementation of IFRS 9 is to be achieved. Overall, the supervisors have noted that the largest SIs are more advanced in their preparation for the new standard than the smaller SIs. For SIs, the most challenging aspect of IFRS 9 is measuring impairment, as this requires the institutions to significantly change their internal processes and systems. For LSIs, the most challenging aspects are expected credit loss (ECL) modelling and data availability. The thematic review has shown that the vast majority of institutions are working intensively on the implementation of IFRS 9.

From a quantitative viewpoint, the report shows that the fully loaded average negative impact of IFRS 9 on the regulatory Common Equity Tier 1 (CET1) ratio is estimated to be 40 basis points (bps). This result is based on information provided by SIs which are at an advanced stage in their implementation of IFRS 9 and can thus provide the most reliable data. Likewise, the fully loaded average negative impact on the regulatory CET1 ratio of LSIs is expected to be 59 bps. Taking transitional arrangements into account, the average negative impact of IFRS 9 on CET1 at the transition date is expected to be around 10 bps for SIs and 25 bps for LSIs.\textsuperscript{15}

The first phase of the review for the SIs was conducted for those institutions that were ready to be assessed in the first quarter of 2017. Any findings and any need for remedial actions were communicated to the relevant institutions; the JSTs will follow up on outstanding issues throughout 2018. Those institutions that were not fully prepared for the assessment received a warning letter in the first quarter of 2017, and were assessed by the JSTs by 30 November 2017. A horizontal evaluation of the preparedness of a sample of LSIs was performed. The ECB and the NCAs plan to follow up on LSIs’ implementation of IFRS 9 in 2018.


\textsuperscript{15} This impact was calculated by considering that, on day one, 95% of the impact arising from ECL would be added back to CET1 capital. The impact arising from classification and measurement is not subject to any transitional measures.
because they lacked adequate risk information and relied on weak risk data aggregation practices. The affected banks’ ability to take timely decisions was seriously damaged, with wide-ranging consequences for the banks themselves and the entire financial sector.

Against this backdrop, a thematic review on risk data aggregation and risk reporting was one of the SSM’s supervisory priorities for 2016 and 2017.

The thematic review started in 2016, covering a sample of 25 SIs. It was performed by the relevant JSTs, supported by a centralised working group comprising ECB and NCA staff. The NCAs provided operational guidance and ensured that it was applied consistently across the sample. The review was carried out in line with the principle of proportionality, taking into account the size, business models and complexity of the banks under review.

The outcome shows that the implementation status of the BCBS 239 principles for the SIs in scope remains unsatisfactory to a considerable degree. The results of the review were communicated to the banks that were part of the sample, in the context of individual supervisory dialogues. Requests for remedial action were included in the final follow-up letters sent by the ECB in the second quarter of 2017. These requests were particularly directed at banks which showed significant weaknesses that might have a major impact on their risk profiles.

In this context, the banks were also requested to submit clear, accurate, and detailed action plans. The centralised working group, supported by the JSTs, assessed these action plans in order to ensure horizontal consistency.

The methodology developed by the centralised working group will enrich the supervisory assessment methodology on risk data aggregation and risk reporting. More generally, for all SIs, the main outcomes of the review will be incorporated into the assessment of data aggregation and reporting capabilities as part of the SREP.

The review was guided by the principles for effective risk data aggregation and risk reporting issued by the BCBS. And as the ECB monitors how institutions’ risk data aggregation and risk reporting capabilities are improving, it regularly informs and updates the BCBS’s Risk Data Network on relevant insights.

### 1.3.4 Outsourcing

Over the past decade, technological developments have not only changed customers’ expectations regarding banking services. They have also changed the way banks operate and deliver their services. The advent of cloud computing in particular has had a significant impact on how banks structure their business, namely, what they still do “in house” and what they outsource to external service providers.

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These developments provide banks with new business opportunities and easy access to services and expertise outside of the regular banking realm. However, these opportunities also entail the challenge of managing the associated risks. And, quite naturally, this is something European banking supervision pays close attention to. One of the concerns is that outsourcing could render euro area banks mere shell companies or create obstacles to the effective supervision of banks, for instance in view of Brexit and the potential relocation of banks from the United Kingdom to the euro area.

The ECB is notified of certain outsourcing arrangements where a relevant procedure is provided by the national framework. More generally, determining whether outsourcing arrangements are adequate is part of assessing an institution’s risk profile, including its risk management arrangements for SREP purposes. Against this background, outsourcing was identified as one of the SSM’s supervisory priorities for 2017 and a targeted thematic review of banks’ outsourcing management and practices was launched. The objective of the review is to obtain insights into the policies, strategies and governance arrangements that banks use when dealing with risks from outsourcing, and how they assess and monitor outsourced risks.

As part of the thematic review, a horizontal team, working together with the relevant JSTs, collected information on how a representative sample of significant banks manage the risks associated with outsourced activities. The thematic review found that, under the current set-up, banks’ approaches to outsourcing differ a lot both in terms of governance and monitoring. Banks’ uncertainties with regard to the identification of outsourcing and material outsourcing were also flagged. Furthermore, the team identified best practices and found that further guidance for banks on how to manage outsourced activities is not only necessary from a supervisory point of view, but would also be welcomed by the banks themselves.

The thematic review also included a mapping and assessment of the outsourcing landscape across the euro area, including procedural aspects (e.g. notifications and approvals). A comparison of the national regulatory frameworks confirmed that the landscape is very diverse. While SSM countries have transposed the CEBS Guidelines on Outsourcing in one form or another, they differ greatly in how formal and detailed the resulting provisions are. To complete the picture and account for the international character of many SIs, the ECB also exchanged views on supervisory approaches with several supervisors outside the euro area. It sought to better understand those supervisors’ expectations regarding the management of outsourced activities and, on that basis, to level the international playing field.

The review shows a clear need to further flesh out supervisory expectations regarding banks’ outsourcing arrangements. This would provide more clarity to the

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17 The EBA has identified this and recently published its Recommendation on outsourcing to Cloud Service Providers.
18 See SSM SREP Methodology Booklet.
19 Committee of European Banking Supervisors.
On-site supervision

The third cycle of on-site inspections was part of the 2017 supervisory examination programme (SEP). A total of 157 inspections were approved for 2017 (compared with 185 in 2016). The drop in planned on-site inspections (OSIs) compared with 2016 resulted from the prioritisation of TRIM investigations and from a shift to more complex and time-consuming on-site inspections, in particular credit risk inspections.21

As at 31 December 2017, all but one of the planned OSIs (156 out of 157) had been launched. Of these, 64 inspections were completed in 2017 and the final reports shared with the inspected institutions. The overall number of OSIs finalised in 2017 also includes 98 inspections carried out as part of the 2016 on-site SEP programme, which were started in 2016 and finalised in 2017, as well as 18 OSIs outside the SSM countries.

Chart 6
2017 on-site inspections: breakdown by risk type

Notes: In the course of 2017, inspections from both the 2016 and 2017 on-site SEP programmes were finalised. This explains why more capital inspections were finalised in 2017 than were included in the 2017 SEP.

On-site inspections are planned and staffed in close cooperation with the NCAs, which continue to provide most of the heads of mission and team members. As at 31 December 2017, 90% of the inspections had been led by the NCAs, with a focus mainly on groups that are headquartered in the NCAs’ respective countries. The remaining 10% of the inspections were led by the ECB’s Centralised On-site Inspections Division (COI).

21 The share of credit risk inspections increased by eight percentage points from 2016 to 2017, and the requests are increasingly focused on credit file reviews, which are quite time consuming. The duration of on-site fieldwork for credit risk inspections is on average about one-third longer than the overall average.
In 2017 European banking supervision launched a fully-fledged system-wide approach with the objective of increasing the number of cross-border and mixed-team inspections in the coming years. To this end, a more precise definition of mixed/cross-border teams was introduced and an action plan devised by the ECB’s Supervisory Board. Teams are considered to be “cross-border” when the head of mission and at least one team member do not come from the relevant home/host NCA. A team is considered to be “mixed” when the head of mission comes from the relevant home/host NCA, while at least two team members do not come from the relevant home/host NCA.

Applying this new definition, 29 of the 157 OSIs planned for 2017 (18.5%) were staffed by mixed/cross-border teams, representing a slight drop when compared with 2016. The implementation of the new action plan is expected to reverse this trend: in 2018, about 25% of planned OSIs will be carried out by mixed/cross-border teams.

### Table 2

**Staffing of inspections: NCA vs ECB**

<table>
<thead>
<tr>
<th>Cross-border and mixed teams</th>
<th>Number of OSIs in 2016</th>
<th>Number of OSIs in 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>ECB COI + NCA</td>
<td>18</td>
<td>16</td>
</tr>
<tr>
<td>Cross-border</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>Mixed teams</td>
<td>8</td>
<td>7</td>
</tr>
<tr>
<td>Total</td>
<td>32</td>
<td>29</td>
</tr>
</tbody>
</table>

After more than two years of experience, the ECB’s Supervisory Board decided to amend the end-to-end process for on-site inspections. These modifications aimed to improve the overall quality, speed and accountability of the inspections. Banks now have the possibility to comment on the findings in writing in an annex to the inspection report. This revised process allows for full transparency and ensures that the relevant JST can take the bank’s comments into consideration when preparing the follow-up to the inspection.

In July 2017 the ECB issued a guide on on-site inspections and internal model investigations for public consultation. The objective of the guide is to explain how ECB Banking Supervision conducts OSIs and to provide a useful reference for inspected banks. The draft guide is currently being revised and will be issued following the ECB’s Supervisory Board’s approval and the Governing Council non-objection procedure.

For 2018, several inspections that cover virtually identical topics will be aligned in scope and timing. This will allow for an intensified discussion between the heads of mission and the ECB’s monitoring teams. The aim is to further improve the efficiency of the inspections and the consistency of the approach.

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22 From the appointment of the head of mission until the submission of the follow-up letter to the bank.
Key findings from on-site inspections

The following analysis covers eight risk categories and 137 inspections in respect of which the on-site inspection report was released between 1 January and 31 October 2017.

Credit risk

More than half of the credit risk inspections focused exclusively on the qualitative aspects of the credit risk management process. The remaining 45% targeted the quality of the assets by performing credit file reviews, and revealed financial impacts in excess of €10 billion. In more detail, the most critical findings were:

- **Inappropriate classification of debtors**: shortcomings in the definition and/or identification of default or non-performing exposures, weak processes for monitoring high-risk borrowers (early warning system, forbearance identification, internal ratings). As a result, there is a need for additional provisions.

- **Miscalculation of provisions**: collateral haircuts, time to recovery, cure rates, cash flow estimates, and collective provisioning parameters.

- **Weak credit-granting processes**: inadequate debtor analysis, unidentified exceptions to the bank’s delegation/limit system.

- **Governance issues**: deficiencies in the internal control “three lines of defence” model, e.g. weak second line of defence: weak risk management function, lack of involvement of the board or top managers, insufficient power of internal audit functions, over-centralisation of the decision-making process.

- **Regulatory ratios**: miscalculation of risk-weighted assets, breaches of large exposure regulations.

Governance risk

The most frequent topics covered by internal governance and risk management OSIs were the organisational structure, roles and responsibilities of the management body and the internal audit function. Severe findings were often made in the following areas:

- **Organisational structure**: deficiencies in internal control frameworks, inappropriate/unclear reporting lines, lack of coordination within the group.

- **Roles and responsibilities of the management body**: conflict of interest, insufficient definition/updating of strategic approaches, deficiencies in delegation of powers.

- **Internal audit function**: insufficient audit and follow-up activities.
• **Compliance function**: deficiencies in compliance risk assessment, insufficient resources, outdated policies and procedures.

• **Risk management function**: shortcomings with regard to risk measurement, monitoring/controls and reporting, lack of escalation procedures.

• **Governance processes**: deficiencies in setting-up strategies and new product approval processes.

Operational risk

The topics most frequently covered in operational risk inspections were banks’ organisational frameworks, policies and procedures, measurement and management of risks, the scope of their risk management, and risk identification. The majority of critical findings related to the following areas:

• **Organisational framework, policies and procedures**: deficiencies in decision-making processes for operational risks, inadequate segregation of duties, weaknesses in reporting systems.

• **Measurement and management of risks**: inadequate monitoring of operational risk exposures, deficiencies in operational risk data collection processes, lack of risk prevention measures to manage operational risk events.

• **Scope of risk management and risk identification**: incomplete coverage of significant operational risks, deficiencies in operational risk management at group level, inadequate assessment of operational risk in new project/product approval processes.

• **Risk profile, risk strategy and risk appetite**: inadequate assessment of operational risk profiles, lack of operational risk strategies.

IT risk

Inspections of IT risk usually cover: (i) organisational framework, strategy, policies, procedures and system architecture; (ii) organisation and outsourcing; (iii) risk management; (iv) security management; (v) data quality management; and (vi) IT operations management.

About one-third of the findings relate to IT security. The remaining findings relate to IT organisation and outsourcing, risk management, data quality management, IT continuity management and software management.

Examples of the most critical IT risk findings are:

• part of the IT infrastructure is out of vendor support;

• lack of segregation of duties between developers and IT operation;
• no comprehensive up-to-date security policy;
• no proper network segmentation;
• limited log collection by Security Incident Event Management tools;
• insufficient recertification process of access rights;
• no comprehensive business continuity testing.

Capital risk

Inspections related to regulatory capital (Pillar 1) mostly covered the following areas: governance, internal policies and controls, the reconciliation process, data quality assurance and capital requirements for credit risk. In addition, ICAAP inspections focused on organisational structure, risk identification and aggregation, capital planning and stress-testing.

The most critical findings identified in Pillar 1 inspections include:

• shortcomings in the detection and remediation of data quality issues, resulting in errors in the calculation of own funds and risk-weighted assets;
• insufficient policies, procedures and controls for the assessment of requirements on credit risk mitigation techniques.

The most critical issues identified in ICAAP inspections include:

• quantification weaknesses, in particular in credit risk modelling (e.g. regarding assumptions used, unjustified simplifications, parameterisation, etc.);
• underdeveloped stress-testing framework (issues with scenario definition, lack of reverse stress-testing);
• ICAAP process not embedded in the management framework of the bank.

Interest rate risk in the banking book

All inspections of interest rate risk in the banking book (IRRBB) reviewed the measurement, management and monitoring of risk. Nearly all inspections also reviewed the risk inventory, risk appetite and risk strategy as well as the scope of risk management and risk identification. High impact findings are mostly related to the measurement, management and monitoring of IRRBB risk. The most common issues identified include:

• inability of the risk models to handle negative interest rates;
• lack of a consolidated view at the holding level on behavioural models developed by the different legal entities;
• lack of solid grounds for the main assumptions of prepayment models;
• insufficient data collection;
• inadequate definition of the limit framework.

Liquidity risk

All inspections of liquidity risk covered governance, measurement, the monitoring and management of risk, stress scenarios, risk mitigation techniques and reporting and disclosure requirements. The majority of findings deal with risk measurement and governance, with a significant proportion of high criticality findings, in particular:

• Inadequacy of risk modelling: weaknesses in the estimation of the run-off profile of financial products, lack of substantiation of scenarios used for stress-testing purposes, insufficient data quality.
• Governance-related issues: inadequate steering of the holding company, insufficient activity of the validation function, ineffectiveness of the early warning system.

Business models and profitability

In addition to profit generation and allocation, OSIs also frequently covered the plausibility of an institution’s strategic assumptions, operational execution capabilities and financial projections. Critical findings were most commonly made in the following areas:

• Plausibility of an institution’s strategic assumptions: lack of board approval for banks’ strategies; limited involvement of the board in the development of strategies; deficiencies in the plausibility of strategic assumptions.
• Operational execution capabilities: limited operational capabilities and resources to implement the business strategy; discrepancies in institutions’ financial reporting.
• Profit allocation, generation and awareness: deficiencies in the pricing tools in terms of including all costs and risks; incomplete minimum floor pricing processes; insufficient analysis and monitoring of profitability indicators and budget.
• Financial projections analysis (scenarios, sensitivity): overly optimistic financial forecasts; incomplete documentation of financial forecasting tools.
Market risk

Inspections of market risk mostly covered the following topics: governance; organisational frameworks, policies and procedures; risk inventory, risk appetite and risk strategy; organisational structure; risk mitigation and internal audit; classification of level 1, level 2 and level 3 assets. The most critical severe findings related to risk measurement. The most common issues identified include:

- **Fair value hierarchy and valuation**: inappropriate classification (level 1, level 2 or level 3), in particular between levels 2 and 3; day one profit treatment; inadequate valuation adjustments.

- **Organisational issues**: insufficient actions taken by the board; inadequate activity of the internal audit function; ineffectiveness of the IT infrastructure.

1.5 Targeted review of internal models (TRIM)

The **targeted review of internal models (TRIM)** is a large-scale, multi-year project, which started in 2017 following conceptual work conducted in 2016. It aims to assess the current adequacy and appropriateness of approved Pillar I internal models used by the SIs in the euro area, and thereby enhance their credibility. TRIM focuses on the correct and consistent implementation of the regulatory requirements regarding internal models. It thus complements the measures set out in the recent agreement on Basel III. The TRIM project is conducted in close cooperation with the NCAs.

In the beginning of 2017, the first TRIM on-site investigations of internal models started, and the TRIM project thus entered its execution phase. This phase will continue throughout 2018 and 2019. It has, so far, progressed according to plan, thanks to the collaboration of the inspected institutions and the high level of commitment of the assessment teams. Overall, 92 TRIM on-site investigations were successfully launched in the course of 2017. The reviews covered internal models for credit risk (with a focus on retail and small and medium-sized enterprise portfolios), market risk and counterparty credit risk. In order to avoid disrupting institutions’ normal model maintenance, material model changes and initial model approvals have also been assessed on-site, on top of the TRIM investigations and sometimes jointly with them.

The first results of TRIM have already become available. General aspects of internal models, such as model governance and model validation, were reviewed right from the beginning of the project. The cases of non-compliance with the existing regulatory framework that were identified in those reviews have been already addressed through supervisory decisions. This will help to ensure a sound, appropriate environment for the use of internal models and foster a level playing field for the supervised entities.

In order to ensure a level playing field, the TRIM assessment teams are requested to apply common inspection techniques and tools consistently. At the same time, the outcome of the investigations is systematically checked for consistency and
undergoes horizontal analyses and peer reviews. In the decisions which follow the TRIM investigations, the ECB does not anticipate any future regulation on internal models, but applies the current regulatory requirements. Additional recommendations and decisions might follow once the horizontal analyses and peer reviews have been completed.

The central project teams also prepared a dedicated guide in order to make explicit the ECB’s understanding of the most relevant aspects of the existing regulation on internal models that are subject to TRIM. The first version of the guide was shared with the institutions within the scope of TRIM in order to collect feedback on it ahead of the start of the execution phase. Subsequently, the guide was made available on the ECB’s banking supervision website.

TRIM benefited considerably from the feedback received on the guide. The feedback further demonstrated the industry’s strong commitment to the objectives of the project. Alongside this feedback, the experience gained from the on-site investigations conducted so far and the ongoing regulatory developments form a sound basis for updating the guide.

European banking supervision will benefit from this ECB guide and the methodologies and tools developed as part of the TRIM project. All in all, this will contribute considerably to a consistent and comparable use of internal models across the euro area and thus help to ensure a level playing field.

The TRIM project is designed to enable a continuous dialogue with the industry to be maintained. In addition to a dedicated conference in February 2017, regular updates on the overall status of TRIM and information on upcoming milestones were provided in information letters to the institutions taking part in August and December 2017. Furthermore, the TRIM project members regularly participated in industry events.

In the course of 2017, on top of the 92 on-site investigations launched as part of the TRIM project, 70 investigations on internal models were launched at SIs (of which 37 were performed on site). Altogether, 133 investigations not related to TRIM had been finalised by the end of the year, of which 123 resulted in an ECB decision (not including the ECB’s contributions to joint decisions with other competent authorities as home supervisor).
1.6 Indirect supervision of less significant institutions and supervisory oversight

The SSM Regulation gives the ECB the mandate to ensure the effective and consistent functioning of the SSM and thus entrusts it with an oversight function, while the NCAs retain the primary responsibility for the supervision of less significant institutions (LSIs). On the basis of the overarching objective of this function, i.e. to ensure that high supervisory standards are consistently applied across the entire euro area, ECB Banking Supervision cooperates closely with the NCAs in developing an operational framework for the oversight of LSI supervision. Examples of specific initiatives undertaken in 2017 can be found in this section.

1.6.1 Joint supervisory standards and common methodologies

Joint supervisory standards (JSS) and common methodologies for LSI supervision, jointly defined by the ECB and the NCAs, remain key tools for promoting supervisory practices that ensure consistent and high-quality LSI supervision. Following the development of joint standards and methodologies in previous years, the focus in 2017 was on implementation.23 NCAs continued to apply the previously completed JSS (e.g. JSS on supervisory planning and recovery planning) and started implementing new ones, such as the JSS for the conduct of on-site inspections at LSIs. This JSS aims primarily to foster harmonisation in the planning of inspections and setting minimum levels of supervisory engagement. Further work is currently being undertaken to support the practical implementation of JSS by the NCAs (e.g. through dedicated workshops).

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23 For a description of the initiatives undertaken to promote a common supervisory approach for LSI supervision, see LSI supervision within the SSM.
Besides the harmonisation of supervisory processes, other projects aim to promote common approaches to the supervision of risks arising from specific business models. One example is the JSS on car financing institutions (CFIs), which was finalised in 2016 and which aims to ensure a consistent, high-quality and proportionate approach to the supervision of CFIs (both SIs and LSIs) across the euro area. In 2017 topical workshops with the industry were organised, focusing on business model analysis and CFIs’ specific risk profile.

Following the development of a cooperation framework between the ECB and the NCAs in the area of crisis management, two relevant JSS were developed in 2017 which are to be finalised in 2018: one on NCAs’ supervisory practices for LSI crisis management and cooperation with resolution authorities, the other on NCAs’ supervisory procedures for LSIs that are in breach of minimum capital requirements.

With regard to institutional protection schemes (IPSs), work that had been conducted in 2016 was complemented in 2017 with further monitoring of “hybrid” IPSs, which have both SIs and LSIs as member institutions. The work was jointly conducted by the ECB and the NCAs in Austria and Germany, which are currently the only euro area countries with “hybrid” IPSs in place. The scope of the exercise is aligned with the requirements set for IPSs in Articles 113(7) and 49(3) of the CRR. The fulfilment of these requirements is subject to regular monitoring. In the coming years it will benefit from the gradual implementation of the reporting specifications of the ECB Guide on Options and Discretions, which will increase the availability of IPS-related data.

A thematic review on IFRS 9 covering both LSIs and SIs is being conducted in close collaboration with the NCAs. The objective is to ensure that the new IFRS 9 standard is consistently implemented across banks in the euro area. Among other things, tools were developed to help supervisors assess how well prepared LSIs are for IFRS 9 (see Section 1.3.2).

Moreover, a Guide to assessments of fintech credit institution licence applications was published for consultation in autumn 2017. The final version of the guide is to be published in early 2018. It aims to increase transparency for potential fintech credit institution applicants (i.e. entities with a business model in which the production and delivery of banking products and services are based on technology-enabled innovation). Ongoing work focuses on the implications of financial technologies (e.g. big data, distributed ledger technology) for banking supervision and takes a closer look at the role of “regulatory sandboxes”.

The ECB is also working on the supervision of financial market infrastructures (FMIs) with a CRR banking licence whose main business activities consist of providing central counterparty (CCP) or central securities depository (CSD) services to market participants, including SSM banks. To ensure a consistent, high-quality and

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24 For more details, see Section 2.4.1.
25 See Guide to assessments of fintech credit institution licence applications.
proportionate approach to the supervision of these special institutions, the ECB, in close cooperation with several NCAs, is currently finalising a **JSS on SREP assessments for FMI institutions.**

**Options and national discretions for the LSI sector**

To ensure a level playing field across credit institutions, the ECB, in very close collaboration with the NCAs, has decided to harmonise the exercise of options and national discretions (ONDs) for the LSI sector. After a public consultation that ended in January 2017 a Guideline and a Recommendation to the NCAs were published in April 2017.

While in the majority of cases the policy proposals for LSIs are the same as those adopted for significant institutions, for certain ONDs a proportionate approach to 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.

**1.6.2 SREP methodology for LSIs**

The finalisation of the joint ECB and NCA work on establishing a common methodology for the *Supervisory Review and Evaluation Process (SREP) for LSIs* was an important milestone in 2017. The methodology is based on that applied to SIs and uses the same structural elements in a proportionate manner. It also introduces some simplifications and adaptations, giving the NCAs some flexibility to take into account the specificities of LSIs as well as the heterogeneity of accounting principles. The SREP for LSIs will promote supervisory convergence in the LSI sector while supporting a minimum level of harmonisation and a continuum in the assessment of SIs and LSIs. NCAs will retain full responsibility, as direct supervisors, for carrying out the assessments and deciding on capital, liquidity and qualitative measures.

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26 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).

27 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).
The work on the SREP for LSIs was initiated in 2015 when a common Risk Assessment System (RAS) methodology was defined. It continued in 2016, focusing on capital and liquidity quantification. In 2017, the LSI SREP methodology (including the revised RAS methodology) was trialled by the NCAs. All NCAs actively participated in the trial and provided useful comments, which formed the basis for the necessary adjustments to the methodology.

The **principle of proportionality** is reflected in the methodology by building a minimum supervisory engagement model that depends on the priority assigned to LSIs. As a result, aspects such as information needs, the intensity of the assessment, and supervisory expectations differ, depending on the category of the LSI and the nature of its business. The methodology also offers some flexibility to the NCAs. Flexibility in the SREP plays an important role when it comes to assessing LSIs’ ICAAPs, ILAAPs and stress tests.

The methodology will be implemented by the NCAs as part of the 2018 supervisory cycle. To support a smooth transition from the national SREP to the SSM SREP methodology, NCAs will apply it at least to the high-priority LSIs in the first year. This allows the NCAs to further test the methodology, in particular with respect to smaller institutions, before the final implementation date of 2020. The methodology will be further assessed and will evolve, as needed, to take into account experience gained within the SSM and wider developments (for example in the regulatory framework and further work that may be conducted by the EBA as well as within the SSM).

**1.6.3 Cooperation on individual LSI supervision**

Proportionality is of primary importance for the efficient functioning of supervisory oversight. The practical application of the proportionality principle is based on a prioritisation framework. This framework takes into account both the intrinsic riskiness of the particular LSI and its overall impact on the national financial system.

In 2017 NCAs continued to submit, via the Central Notification Point, (i) ex ante notifications concerning material supervisory procedures and material draft supervisory decisions related to LSIs which are classified as high-priority (around 100 LSIs), and (ii) ad hoc notifications regarding any deterioration in the financial situation of LSIs. The experience gained over the past years has fed into the revised guidance on notification requirements for LSIs, which is applicable as of 2018. This guidance clarifies the criteria for defining the materiality of decisions for notification to the ECB and provides a set of triggers and indicators to promote the timeliness of notifications. The ECB received 67 notifications in 2017, mostly related to capital and governance matters.

Based on notifications from the NCAs, as well as other available information, the experts from the ECB’s specialised country desks have continued to monitor LSIs in their respective countries, particularly those institutions that have faced financial deterioration. ECB experts have also been in continuous dialogue with their NCA counterparts in order to monitor the implementation of recommendations and follow-up actions related to decisions on common procedures. Cooperation regarding
1.7 Macroprudential tasks

In 2017 the ECB continued to engage actively with the national authorities with regard to macroprudential policy in the euro area, in accordance with the tasks conferred on it under Article 5 of the SSM Regulation. The Macroprudential Forum serves as a platform for Governing Council and Supervisory Board members to bring together microprudential and macroprudential perspectives from across the SSM. This ensures that microprudential and macroprudential actions complement each other effectively.

In 2017, the ECB received over 100 macroprudential policy notifications from national authorities. Most notifications concerned (i) quarterly decisions on setting countercyclical capital buffers (CCyB) and (ii) decisions on the identification and capital treatment of global and other systemically important credit institutions.

Following the BCBS methodology, the ECB and national authorities identified seven global systemically important banks (G-SIBs) – one fewer than in the previous year. Those institutions were allocated to buckets entailing phase-in capital buffer rates from 0.75% to 1.5% in 2018 (on completion of the phase-in, in 2019, the final buffer levels for those banks will range from 1.0% to 2.0%).

The ECB also received notifications on the capital buffer rates for 109 other systemically important institutions. These rates were in line with the ECB methodology for assessing other systemically important institutions and determining their buffers.

Furthermore, the ECB received notifications on the implementation of the systemic risk buffers and tighter risk-weight requirements from a number of national authorities, as well as notifications regarding the reciprocation of macroprudential measures taken in other Member States.

The ECB was also involved in the work conducted by the European Systemic Risk Board (ESRB), which is responsible for the macroprudential oversight of the financial system in the EU. The ESRB identifies and prioritises systemic risks and, if necessary, initiates systemic risk-prevention measures.
necessary, issues warnings or recommendations for remedial action. JSTs used information from the ESRB, along with other macroprudential analysis produced by the ECB – both internal and externally published – to ensure that all relevant risks were considered. Likewise, the ESRB and other macroprudential authorities use input provided by the JSTs in order to make sure that information on individual institutions feeds into system-wide risk analysis and to identify possible mitigation measures.

In addition, the ECB advocates the modification of the G-SIB assessment methodology to allow the European banking union to be considered as a single geographical area.
2 The SSM’s contribution to the EU crisis management and resolution framework

2.1 Resolution cases in 2017

The EU’s recovery and resolution framework provides an important anchor for a stable banking sector. ECB Banking Supervision plays a major role within this framework.

In the first half of 2017, ECB Banking Supervision took, for the first time, the decision to declare that three of the banks it directly supervises were “failing or likely to fail” (FOLTF).

The Single Resolution Mechanism Regulation (SRMR) stipulates that once a significant institution (SI) is declared FOLTF, the Single Resolution Board (SRB) must assess whether the other conditions for resolution have been met as well. In particular, the SRB must assess whether: (i) having regard to timing and other relevant circumstances, there is no reasonable prospect that any alternative private sector measures taken in respect of the entity would prevent its failure within a reasonable time frame; and (ii) resolution action is necessary in the public interest.

If the latter condition is not met, the bank would not be resolved but would become subject to the relevant national insolvency procedure.

For one of the three banks, Banco Popular Español, the SRB decided that the conditions for resolution had indeed been met and adopted a resolution scheme. For the other two banks, Veneto Banca and Banca Popolare di Vicenza, the SRB concluded that resolution action was not necessary in the public interest, and the banks were eventually wound down under Italian insolvency proceedings.

2.1.1 The case of Banco Popular Español

On 6 June 2017 ECB Banking Supervision determined that Banco Popular Español was FOLTF in accordance with Article 18(1)(a) and 18(4)(c) of the SRMR as it would, in the near future, be unable to pay its debts or other liabilities as they fell due as a result of an idiosyncratic liquidity crisis. Consequently, the SRB concluded that the conditions for resolution had been met and decided to adopt a resolution scheme, which involved the write-down of capital instruments and the sale of the bank to Banco Santander.

Banco Popular Español had had some structural problems, such as a high level of non-performing loans (NPLs), low coverage compared with its peers, a high level of foreclosed assets and low profitability.
Since 2012, the bank had carried out three capital increases worth €5.5 billion. However, it did not manage to materially wind down its €37 billion (gross) troubled real estate exposure. Moreover, the deterioration of this portfolio further eroded the bank’s capital. The bank’s announcement of additional provisions and year-end losses in February 2017, as well as its announcement on 10 April that owing to its tight capital position, a capital increase or corporate transaction might be needed in order to handle any potential additional impairment of the non-performing assets portfolio, resulted in rating downgrades and caused significant concerns among the bank’s customers. This led to significant cash outflows and a severe deterioration in the bank’s deposit base, and left it unable to tap other sources of liquidity.

Cooperation and information exchange with the SRB

The deteriorating situation of Banco Popular Español was communicated by ECB Banking Supervision to the SRB in early April 2017 and discussed in detail at crisis management meetings organised by the ECB, in which SRB representatives also participated. The exchange of information intensified in the course of May 2017, which helped to prepare all stakeholders early on. The SRB was also invited to participate as an observer in the meetings of the ECB’s Supervisory Board, at which the Supervisory Board members were updated on the evolving situation and took decisions on Banco Popular Español. As an observer at the SRB Extended Executive Session, the ECB also received information on the assessment carried out by the SRB regarding the other conditions for resolution. The ECB also provided supervisory information relevant to the SRB’s task.

Overall, the close cooperation and information-sharing between the ECB and the SRB significantly contributed to an efficient crisis management process.

Procedural steps leading up to the FOLTF assessment

On 6 June 2017 the ECB’s Supervisory Board decided to start the FOLTF process and initiated a formal consultation with the SRB.

After the SRB was consulted, the Supervisory Board adopted the FOLTF assessment for Banco Popular Español. It was then submitted to the ECB’s Governing Council for approval under the non-objection procedure.

The Governing Council did not object to the Supervisory Board’s assessment, which was sent to both the SRB and the European Commission, in accordance with Article 18 of the SRMR, on 6 June. ECB Banking Supervision also notified all the relevant authorities of its decision in line with Article 81 of the Bank Recovery and Resolution Directive (BRRD) and CRD IV.
Actions following the FOLTF assessment

On 7 June 2017 the SRB determined that all the conditions for resolution had been met and decided to adopt a resolution scheme, which the European Commission endorsed pursuant to Article 18.7 of the SRMR on the same day. The resolution decision included the following elements: (i) write-down of shares; (ii) write-down and conversion of Additional T1 instruments into shares; (iii) conversion of outstanding T2 instruments into shares of €1 nominal value; and (iv) transfer of the resulting shares to Banco Santander.

2.1.2 The cases of Banca Popolare di Vicenza and Veneto Banca

On 23 June 2017 ECB Banking Supervision determined that Veneto Banca and Banca Popolare di Vicenza were FOLTF in accordance with Article 18(1)(a) and 18(4)(a) of the SRMR.

The SRB concluded that in both cases the conditions for resolution had not been met. The banks were subsequently put under compulsory administrative liquidation under Italian insolvency law.

Banca Popolare di Vicenza and Veneto Banca, which were located in the north-east of Italy and had a similar business model and market share, had attracted particular supervisory attention since 2014 owing to their (i) low profitability; (ii) high operating costs compared with core income; (iii) high funding cost linked to a fundamentally impaired franchise; and (iv) low asset quality.

Despite consecutive capital increases being performed at the request of ECB Banking Supervision, both banks had depleted a significant amount of their own funds over the three years preceding their failure. This clearly showed that their respective business models were not suited to ensure their profitability and viability.

In 2017 the two banks submitted to the ECB a combined business plan (“Project Tiepolo”) which envisaged the two banks merging by the end of 2017. The plan identified a total capital need of €4.7 billion.

The ECB concluded that the effective and timely implementation of the plan in order to recapitalise the two banks, merge them and create the conditions for a new viable business model in the future was implausible. The ECB also considered that no other effective supervisory measures or early intervention measures were available.

Cooperation and information exchange with the SRB

ECB Banking Supervision informed the SRB early on about the deteriorating situations of Banca Popolare di Vicenza and Veneto Banca, and information exchange had been stepped up since the end of 2016.
The exchange intensified further in the course of the first half of 2017. This thorough and extensive exchange of information helped to prepare all stakeholders early on.

Moreover, to better prepare for the possibility of a FOLTFT assessment, in the last stages of crisis escalation, the situation of the two banks was discussed in detail at crisis management meetings, in which the relevant SRB Board and staff members also participated.

The SRB was also invited to participate as an observer in the meetings of the ECB’s Supervisory Board, at which the Supervisory Board members were updated on the situations of Banca Popolare di Vicenza and Veneto Banca and all decisions concerning the two banks were taken. The SRB thus received the same information as the Supervisory Board members and at the same time. Likewise, as an observer at the SRB Executive Session, the ECB received information on the assessment carried out by the SRB regarding the other conditions for resolution. Overall, close cooperation and information-sharing between the ECB and the SRB was essential in order to address the banks’ situations and contributed significantly to an efficient crisis management process.

Procedural steps leading up to the FOLTFT assessment

On 19 June 2017 the ECB concluded its assessment of the second version of the Tiepolo plan submitted by the two banks and concluded that it was not credible.

The capital situations of the Banca Popolare di Vicenza and Veneto Banca had been continuously deteriorating and capital requirements had been continuously breached, despite measures taken by the two banks to try to address the breaches. Both Banca Popolare di Vicenza and Veneto Banca had been requested on several occasions in the years running up to the decision to address their weaknesses. However, the measures taken by the banks proved to be ineffective.

In light of the above, on Wednesday, 21 June 2017 ECB Banking Supervision considered that there was material evidence that Banca Popolare di Vicenza and Veneto Banca were FOLTFT in accordance with Article 18(1)(a) and 18(4)(a) of the SRMR.

Consequently, the ECB’s Supervisory Board decided to start the FOLTFT process and initiated a formal consultation with the SRB, which lasted until noon on Thursday, 22 June. On 23 June the FOLTFT assessment was submitted to the Governing Council of the ECB for approval under the non-objection procedure.

The Governing Council did not object to the Supervisory Board’s assessment, which was sent to both the SRB and the European Commission in line with Article 18 of the SRMR. The ECB also notified all relevant authorities of its assessment in line with Article 81 of the BRRD and CRD IV.
Actions following the FOLTF assessment

On 23 June 2017 the SRB decided not to take resolution action in the cases of Banca Popolare di Vicenza and Veneto Banca. It concluded that, while the conditions for resolution listed in Article 18(1)(a) and (b) of the SRMR had been met, the condition listed in Article 18(1)(c), which relates to public interest, had not been satisfied.\textsuperscript{32}

Therefore, the two banks were wound down under Italian insolvency proceedings.

On 25 June 2017 the Italian Government adopted a Decree Law\textsuperscript{33}, which entered into force immediately. This Decree regulated (i) the compulsory administrative liquidation of the two banks and (ii) the liquidation aid provided by the government in order to support the transfer of assets and liabilities to Intesa Sanpaolo in compliance with the European framework for State aid, given regional risk to financial stability.

On the same day, the European Commission announced the approval, under EU rules, of the Italian measures to facilitate the liquidation of Banca Popolare di Vicenza and Veneto Banca under national insolvency law.\textsuperscript{34}

The two banks were put under compulsory administrative liquidation by the Italian Ministry of Finance, upon a proposal by the Banca d’Italia, and liquidators were appointed.

Good assets and liabilities were transferred to Intesa Sanpaolo, which substituted the banks in their relationships with their customers. In compliance with the European framework for State aid, burden-sharing was applied to equity and subordinated debt. Non-performing loans are planned to be transferred to Società di Gestione degli Attivi, a vehicle owned by the Italian Ministry of Finance used for the liquidation of Banco di Napoli. The plan is to gradually dispose of these non-performing loans with the aim of maximising the recovery on those assets.

As a result of the liquidation procedure, the banking licences of both banks were withdrawn on 19 July 2017. Subsequently, two subsidiaries, which were not transferred to Intesa Sanpaolo (Banca Intermobiliare di Investimenti e Gestioni and Farbanca), were both assessed as less significant institutions. Consequently, direct supervision over these two subsidiaries was handed over to the Banca d’Italia in September 2017.

\textsuperscript{32} See Notice summarising the effects of the decision taken in respect of Banca Popolare di Vicenza S.p.A and Notice summarising the effects of the decision taken in respect of Veneto Banca S.p.A, published on the SRB website.


\textsuperscript{34} European Commission press release: “State aid: Commission approves aid for market exit of Banca Popolare di Vicenza and Veneto Banca under Italian insolvency law, involving sale of some parts to Intesa Sanpaolo”. 
Key lessons learned

Banco Popular Español, Veneto Banca and Banca Popolare di Vicenza were the first banks to be declared FOLTTF by ECB Banking Supervision. These cases therefore provided useful lessons for both ongoing supervision and the functioning of the crisis management framework.

One lesson learned from all those cases was that close cooperation and comprehensive information exchange between all stakeholders\(^{35}\) contributed significantly to a smooth process under tight timelines and allowed all authorities to act quickly and address the situation within the required time frames.

Coordination and information exchange between ECB Banking Supervision and the SRB in both crisis cases was also ensured via cross participation in the respective decision-making bodies. Representatives from the SRB participated in meetings of the ECB’s Supervisory Board and in meetings of the crisis management teams organised by the ECB. Likewise, ECB Banking Supervision, together with the European Commission, participated as observers in the meetings of the SRB Executive Session. This allowed continuous alignment and understanding of each other’s perspectives.

Since December 2015 a Memorandum of Understanding (MoU) has served as a basis for cooperation between ECB Banking Supervision and the SRB. This MoU establishes the general terms for cooperation, including the exchange of information, between the two authorities in order to ensure efficient cooperation in the performance of their respective tasks. In line with the provisions therein, a review of the MoU is currently taking place in order to take account of the experience gained in the first two years of its implementation. It is scheduled to be completed in the first part of 2018 (see also Section 2.2).

Another important lesson learned relates to the importance of timing when declaring a bank FOLTTF. Timely action in the event of a crisis is crucial in order to avoid the situation of the bank deteriorating further, thus minimising the overall cost of failure. At the same time, a FOLTTF assessment must not be made unreasonably early. Otherwise, value might be unnecessarily destroyed while there is still a possibility for recovery. In this respect, the supervisory discretion embedded in the current framework is important and should be preserved.

Furthermore, the experience gained has shown how important it is to effectively use early intervention measures, which has proven to be challenging under the current legal framework. Two main areas have been identified where amendments to the legal framework are needed. Relevant amendments have been recommended in the ECB Opinion on revisions to the Union crisis management framework (CON/2017/47).

\(^{35}\) In particular, ECB Banking Supervision and the SRB, as well as the national resolution authorities, competent authorities and central banks.
First, there is a significant overlap between the supervisory measures under CRD IV and the SSM Regulation and the early intervention measures provided for in the BRRD. The overlap occurs both in terms of content and in the conditions for the application of the measures. Such an overlap creates significant challenges for the practical implementation of the early intervention framework, particularly in view of the lack of clarity regarding the conditions for early intervention.

Second, the ECB must exercise its early intervention powers on the basis of national transpositions of the BRRD. This results in uncertainty and inconsistency regarding the available measures and the conditions for their application in different Member States.

Consequently, the ECB recommends: (i) removing from the BRRD those early intervention measures that are already available in CRD IV and the SSM Regulation; and (ii) amending the SRMR in order to provide a direct legal basis for the ECB’s early intervention powers in order to facilitate their consistent application.

An additional lesson learned relates to the need to ensure access to liquidity in resolution. In some cases, the issue is addressed through the ability of a buyer to provide liquidity. In other cases, it is important to make sure that, after resolution tools have been applied, the bank has access to liquidity until it restores market confidence. In this regard, the role of the Single Resolution Fund (SRF) is important and the ECB is strongly in favour of setting up a common backstop for the SRF. This common backstop should fully cover the SRF’s mandate, namely, it should be available for both liquidity and solvency purposes. Given the importance of sufficient funding for an orderly resolution process, the common backstop should be set up as soon as possible, ideally before the transition period for the full mutualisation of the SRF resources ends.

Moreover, experience has shown that, from a financial stability perspective, resolvability may be reduced if subordinated debt instruments are to be held by retail investors. Therefore, consideration should be given to putting in place clear and easily understandable disclosure requirements and other safeguards to raise investors’ awareness of the risks associated with such instruments. In the same vein, it would be appropriate to consider requiring a minimum denomination of at least €100,000 per unit in respect of each instrument. This would increase the investment threshold and raise investor awareness, thereby limiting direct retail investment. A common framework at EU level on these issues should be pursued in order to avoid Member States taking different approaches, which would lead to fragmentation within the European market for these instruments.

2.1.4 Communication on FOLT cases

Communication plays an essential role in managing a crisis. When a bank fails, it is important not only to find a solution to address the crisis, but also to effectively communicate this solution to the public in order to ensure that no contagion occurs and financial stability is preserved. In this regard, coordination between the various...
stakeholders involved is essential in order to send a clear and comprehensive message to the public.

Unlike resolution actions, in respect of which the scope of publication by the SRB is defined in the SRM Regulation\(^{36}\) and in the BRRD, there is no such indication when it comes to FOLTF assessments. A clarification regarding the publication of FOLTF assessments seems advisable.

**Coordinated communication after a FOLTF assessment**

*Early preparation* of communication and terms of reference as well as alignment between all stakeholders is crucial when dealing with a crisis. In order to ensure that alignment, communication teams at the SRB, the ECB and the European Commission started working together at an early stage, well in advance of the FOLTF decisions. This allowed a comprehensive communication strategy which contributed to the successful handling of the crisis.

Moreover, the *timing of external communication* is very important and should be carefully planned. In the case of Banco Popular Español, the FOLTF decision was made late in the evening on Tuesday and was followed by notifications to all the relevant authorities in line with Article 81(3) of the BRRD. External communication to the public took place the next morning, with the SRB announcing the sale of the bank to Banco Santander S.A.\(^{37}\) and, following that, ECB Banking Supervision announcing the FOLTF decision\(^{38}\). The timing of the communication took into account the need to communicate the solution (resolution, transfer of business in liquidation, etc.) together with the problem (failure of the bank).

The coordinated communication process was intended to provide comprehensive information to the public about the situation of the bank and actions taken by the relevant authorities.

In the cases of Veneto Banca and Banca Popolare di Vicenza, on Friday, 23 June 2017 ECB Banking Supervision published on its official website the information that a FOLTF assessment had been made.\(^{39}\) On the same day, the SRB informed the public of its decision that resolution was not warranted for the two banks and, consequently, that they would be wound down under normal Italian insolvency proceedings.\(^{40}\) Also on the same day, the Italian Ministry of Finance issued a press release stating that a meeting was planned for the weekend in order to adopt all the necessary measures to ensure continuity in the banks’ activities, while protecting all depositors and senior bondholders.\(^{41}\)

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\(^{36}\) Article 29(5) of the SRM Regulation and Article 83(4) of the BBRD.

\(^{37}\) See SRB press release of 7 June 2017

\(^{38}\) ECB press release: “ECB determined Banco Popular Español S.A. was failing or likely to fail”.

\(^{39}\) ECB press release: “ECB deemed Veneto Banca and Banca Popolare di Vicenza failing or likely to fail”.

\(^{40}\) See SRB press release of 23 June 2017.

\(^{41}\) Comunicato Stampa N° 109 del 23/06/2017.
Public access requests

The ECB has received a number of public access requests, submitted under Decision ECB/2004/3 on public access to ECB documents, for disclosure of its FOLTF assessments. The European Commission and the SRB have also received requests for access to the ECB’s FOLTF assessments.

Furthermore, requests for information have been submitted by national parliaments and ministries of finance. Several Members of the European Parliament (MEPs) have submitted written questions, both on the resolution of Banco Popular Español and on the liquidation of Veneto Banca and Banca Popolare di Vicenza.

The ECB has provided answers to these questions and requests for information, in line with the confidentiality rules applicable in the field of banking supervision. The replies to the written questions from MEPs have been published on the ECB’s banking supervision website.

Publication of non-confidential version of FOLTF assessments

A FOLTF assessment is a supervisory assessment of an individual bank by the ECB. It is addressed to the SRB in order for the latter to assess whether the conditions for placing the bank under resolution have been fulfilled. A FOLTF assessment is an intermediate step in the resolution process, and the European Commission and other relevant authorities are notified of it in line with the provisions set out in Article 18(1) of the SRMR and Article 81(3) of the BRRD. FOLTF assessments are part of ECB Banking Supervision’s supervisory tasks. Therefore, they are subject to the professional secrecy obligations and confidentiality rules that apply to all the decisions the ECB makes in its role as supervisor.

Nevertheless, for the purpose of transparency and accountability, and in view of the general interest of the public, the ECB decided to publish non-confidential versions of its FOLTF assessments on its banking supervision website. In order to comply with professional secrecy obligations, confidential information was not disclosed. The publication of non-confidential FOLTF assessments is an exception to the general communications policy of the ECB, which, in line with the law, does not provide for the publication of individual supervisory decisions that are protected by professional secrecy rules.

In the future, a clarification of the legal framework with respect to the publication of FOLTF assessments will be warranted. Whereas the BRRD and SRMR do not currently provide for any publication of FOLTF assessments, they do provide for publication of the order or instrument by which the resolution action is taken. This

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43 Article 27 of the SSM Regulation, read in conjunction with Articles 53 et seq. of CRD IV.
fact, combined with the large number of requests for release of information following such assessments by the competent authority, creates a communication imbalance.

2.1.5 Audit by the European Court of Auditors

The European Court of Auditors (ECA) conducted an audit on “The operational efficiency of the ECB’s crisis management for banks” in 2017. The ECB cooperated closely with the ECA throughout the audit and the final report was published on 16 January 2018. The report provides constructive recommendations on a range of topics related to cooperation, crisis identification and response and recovery planning in order to further improve the SSM’s crisis management efficiency. Of the eight recommendations made, six were accepted by the ECB. Work is already well under way to implement the recommendations which concern, among other things, cooperation with the SRB, additional guidance on recovery plans, and guidance on early intervention assessments. Of the two recommendations the ECB rejected, one was not accepted as the ECB had already developed guidance to operationalise FOLTF assessments, and the other was rejected as the ECB considered that it had cooperated fully with the ECA during the audit, while respecting its mandate to assess the operational efficiency of the ECB’s management.

2.2 Interaction with the Single Resolution Board

In 2017 the ECB and the SRB continued to cooperate closely under the terms of the bilateral Memorandum of Understanding (MoU). The MoU was concluded at the end of 2015 and establishes rules for cooperation and information exchange. Throughout the year, information was exchanged both on a regular basis as well as on an ad hoc basis.

At the end of 2016, the SRB was granted direct access to relevant supervisory information and data stored in the ECB supervisory IT system; the scope of this access was agreed upon in the MoU. This streamlined and automated the ongoing exchange of information and ensured that the reporting burden on banks was kept to a minimum. In addition, the ECB has adapted the supervisory IT system so that the SRB can also use it for resolution purposes as of 2018.

Cooperation between ECB Banking Supervision and the SRB increased, in accordance with the MoU, when the condition of an SI deteriorated. In particular (and not exclusively), enhanced cooperation and information exchange took place with regard to those banks which were determined to be FOLTF in 2017 (namely, Banco Popular Español, Veneto Banca and Banca Popolare di Vicenza).

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44 The operational efficiency of the ECB’s crisis management for banks.

45 This mandate is to assess the operational efficiency of the management of the ECB, as defined in Article 27.2 of the Statute of the ESCB and Article 20(7) of the SSM Regulation.
In line with the provisions of the MoU, ECB Banking Supervision and the SRB began to review the MoU in 2017. The aim is to review certain parts of the MoU to take account of the experience gained in the first two years of its implementation and to address the practical challenges encountered. The review is scheduled to be completed in the first part of 2018 and will further enhance cooperation and information exchange between ECB Banking Supervision and the SRB.

Apart from the exchange of information, close cooperation between ECB Banking Supervision and the SRB is also supported by other arrangements. A representative from the ECB participates in the meetings of the SRB’s Executive and Plenary Sessions. Likewise, the SRB Chair is invited to any relevant meetings held by the ECB’s Supervisory Board. The aim is to foster a high-level exchange between the two boards. Constructive and increased cooperation between ECB Banking Supervision and the SRB takes place at a technical level within their respective committee structures. In addition, Joint Supervisory Teams and Internal Resolution Teams interact with regard to individual banks. Furthermore, regular staff-level exchanges take place between the horizontal functions of ECB Banking Supervision and the SRB. The two institutions also closely liaise with regard to policy areas relevant from a supervisory and resolution perspective.

As in the previous two years, ECB Banking Supervision consulted the SRB on the recovery plans it received from all SIs for which it was the consolidating supervisor. The feedback received from the SRB was subsequently taken into account in the assessment of the recovery plans by ECB Banking Supervision.

Conversely, the SRB consulted ECB Banking Supervision on draft resolution plans for a large number of SIs in 2017. For a subset of the institutions for which a resolution plan was provided, ECB Banking Supervision was also consulted on the minimum requirement for own funds and eligible liabilities (MREL) set by the SRB. ECB Banking Supervision assessed both the draft resolution plans and the MREL from a supervisory perspective and provided feedback to the SRB. The SRB also consulted ECB Banking Supervision regarding the calculation of the ex ante contributions to the Single Resolution Fund. ECB Banking Supervision assessed the potential impact on SIs from a going-concern perspective and provided feedback to the SRB.
2.3 Work on recovery planning

The assessment of the recovery plans of SIs is specified, inter alia, in the BRRD, Delegated Regulation 2016/107546 and EBA Guidelines47, and it forms part of the overall suite of supervisory activities. The purpose of this task is to be able to restore the viability of banks during periods of heightened stress. Pursuant to the EBA Guidelines for common procedures and methodologies for SREP48, the overall outcomes of the assessment of recovery plans feed into the SREP assessments.

2.3.1 The 2016 cycle of recovery plans: assessment and benchmarking

The 2016 recovery plan assessment cycle for SIs – the second since the launch of the SSM – started in September 2016 and lasted until the end of August 2017. A total of 109 plans were submitted by SIs. For banks where the ECB is the consolidating supervisor, plans were submitted in two batches, in September and December 2016, allowing the assessment to be carried out outside of JSTs’ SREP-related workload peaks and avoiding resource constraints. The vast majority of recovery plans were submitted to ECB Banking Supervision in December 2016. The full process of assessing recovery plans and consecutively reaching joint decisions on the assessment with other competent authorities, where required49, can last up to six months.

The 2016 cycle allowed for the first full comparison of plans, as all plans were submitted in accordance with the BRRD. In the previous cycle, a substantial part of the recovery plans had been submitted under existing pre-BRRD national law. This was due to the late transposition of the BRRD in some Member States. Moreover, in Delegated Regulation 2016/1075, adopted on 23 March 2016, all SIs were informed about the expected content and the minimum criteria applied by competent authorities when assessing recovery plans.

The benchmarking of the recovery plans submitted in 2016 revealed substantial improvements in terms of completeness and quality. Notwithstanding these improvements, around 20% of the plans assessed were either subject to a dedicated action plan, meaning that the SIs concerned were asked by ECB Banking

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46 Commission Delegated Regulation (EU) 2016/1075 of 23 March 2016 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the content of recovery plans, resolution plans and group resolution plans, the minimum criteria that the competent authority is to assess as regards recovery plans and group recovery plans, the conditions for group financial support, the requirements for independent valuers, the contractual recognition of write-down and conversion powers, the procedures and contents of notification requirements and of notice of suspension and the operational functioning of the resolution colleges (OJ L 184, 8.7.2016, p. 1).

47 EBA Guidelines on the minimum list of qualitative and quantitative recovery plan indicators (EBA/GL/2015/02) and EBA Guidelines on the range of scenarios to be used in recovery plans (EBA/GL/2014/06).

48 EBA Guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP) (EBA/GL/2014/13).

49 In accordance with Article 8(2) of the BRRD the consolidating supervisor and the competent authorities of subsidiaries shall endeavour to reach a joint decision on, inter alia, the assessment of the group recovery plan.
Supervision to improve their recovery plans, or declared materially deficient pursuant to Article 6(5) of the BRRD. In the latter case, the SI is required to submit a revised recovery plan within two months (extendable to three).

The benchmarking also showed that adequate recovery planning (that is, good preparation for crisis situations) increases the likelihood that recovery options can be implemented in a timely and effective manner.

Two main conclusions emerged from the assessment and benchmarking of the plans. First, recovery plans need to be implementable in practice. Second, SIs seem to overestimate their potential recovery capacity. Both issues were identified as priorities for ECB Banking Supervision’s assessment of recovery plans going forward.

2.3.2 The 2017 cycle of recovery plans: timeline and standardised templates

The 2017 recovery plan assessment cycle for SIs was again composed of two submission batches, in September and December 2017. It is expected to last until summer 2018. 107 SIs submitted recovery plans as part of the 2017 assessment cycle.

For the second year in a row, banks will submit a standardised reporting template alongside their recovery plans. The use of this template has facilitated the presentation of necessary data for the recovery plans and their assessment and significantly increased the quality of the data presented.

2.3.3 Going forward: focus on usability of recovery plans and link to crisis management

As outlined in the 2016 cycle benchmarking results, a key objective pursued in the current assessments and in interactions with SIs is to make recovery plans more operational and usable.

Based on two years of experience, ECB Banking Supervision came to the conclusion that not all plans could be effectively implemented or operationalised in crisis situations. This is due to their sheer size and complexity (some plans are close to 2,000 pages long) and a lack of clear processes and concrete steps showing how to effectively implement them under stress. This is a significant drawback, considering that the purpose of a recovery plan is to provide the bank’s management with a sufficient set of options that can be put into action in a timely and effective manner, particularly in situations of severe stress.

ECB Banking Supervision intends to share, in the course of 2018, the best practices employed by some SIs in order to help banks make their recovery plans more operational.
Moreover, with improved recovery plans in place, ECB Banking Supervision will be able to systematically use the outcome of recovery plan assessments in crisis identification and management, as well as integrate this outcome into the SREP assessment.

2.4 Crisis management for less significant institutions

The management of a crisis situation involving an LSI requires a high level of information exchange and coordination between the relevant NCA, in its capacity as direct supervisor of the LSI, and the ECB, in its oversight function and in its capacity as competent authority for decisions on common procedures.

The NCA is responsible for supervisory decisions, measures and actions related to an LSI in crisis. The need for closer cooperation arises as the LSI approaches the point of non-viability. At such time, there is a need to consider the liquidation or resolution of the LSI, which may include common procedures such as the withdrawal of its authorisation, the assessment of acquisitions or increases in qualifying holdings, and the granting of new authorisations (for example, for a bridge institution).

Against this backdrop, the ECB monitors the situation of LSIs in crisis, supports the crisis management activities of the NCAs and prepares draft decisions on common procedures based on proposals by the NCAs. These decisions are approved by the Supervisory Board and adopted by the Governing Council.

2.4.1 LSI crisis management framework

In 2017 a crisis management cooperation framework for the ECB and the NCAs became operational and was used on several occasions. The purpose of the LSI Management Cooperation Framework is to assist the NCAs and the ECB in their crisis management-related tasks. Moreover, it covers cooperation and information-sharing both between the ECB and the NCAs and with any other stakeholders that may be involved (for example, the responsible resolution authorities). Throughout 2017, cooperation between the NCAs and the ECB in several LSI crisis cases was characterised by a regular, fruitful communication exchange which enabled decisions to be made within relatively short time frames.

As a further step, in 2017 the ECB and the NCAs developed a Joint Supervisory Standard (JSS) on NCAs’ supervisory practices for LSI crisis management and cooperation with resolution authorities, which is to be finalised in 2018. This JSS will ensure that consistent LSI crisis management practices are applied at national level and thus foster common supervisory outcomes within the SSM. The JSS will also cover cooperation and information-sharing between the NCAs and Single Resolution Mechanism authorities (the Single Resolution Board and the national resolution authorities) where relevant for the performance of their respective tasks.
In parallel, in 2017 the ECB and the NCAs developed a JSS on NCAs’ supervisory procedures for LSIs breaching minimum capital requirements, which is also to be finalised in 2018. This JSS will promote a joint understanding of the administrative procedures used to address the financial deterioration of LSIs, in particular regarding the timing for requesting remedial action and the conditions for triggering a withdrawal of authorisation.
3 The SSM as part of the European and global supervisory architecture

3.1 European and international cooperation

As euro area banks have a presence in over 90 non-European jurisdictions (see Figure 4 below), the SSM cooperates extensively with other supervisory authorities outside as well as inside the EU. Consequently, the ECB is committed to facilitating cooperation, whether by contributing to supervisory colleges or developing cooperation tools such as Memoranda of Understanding (MoUs). MoUs have been negotiated with counterparties such as supervisory authorities of non-euro area EU Member States, third country supervisory authorities and national market authorities.

Figure 4
Euro area banks’ branches and subsidiaries outside the EU

Source: Financial Reporting and Register of Institutions and Affiliates Database.

ECB Banking Supervision generally cooperates with other prudential supervisory authorities through MoUs, participation in supervisory colleges or agreements concluded on a case-by-case basis.
3.1.1 MoUs for cooperation with other supervisory authorities

Cooperation with third country authorities

The ECB strives to engage in fruitful cooperation with third country supervisory authorities and facilitate ongoing cross-border supervision. Where feasible, ECB Banking Supervision joined the existing MoUs that had been agreed between euro area NCAs and third country supervisory authorities before the SSM was established. In some cases, ECB Banking Supervision needed to develop tailored cooperation solutions. Over time, the ECB concludes its own MoUs with third country supervisory authorities so as not to rely on existing MoUs between euro area NCAs and third country supervisory authorities.
Cooperation within the European Economic Area

The ECB frequently cooperates with the NCAs of non-euro area EU countries, in compliance with the provisions of CRD IV on cooperation and exchange of information between competent authorities in the EU. In order to lay down additional details and further enhance cooperation, the ECB, in line with Article 3(6) of the SSM Regulation, currently negotiates an MoU with those NCAs. Moreover, the EU/EEA MoU on prudential supervision of significant branches in Nordic countries\(^50\), concluded by the ECB in 2016, has been signed by five additional authorities.

ECB Banking Supervision also entered into two MoUs with national market authorities. These MoUs are based on a template prepared by the ECB in cooperation with ESMA.

In order to ensure consistency at EU level, ECB Banking Supervision closely cooperates with the EBA Network on Equivalence, which conducts equivalence assessments on the confidentiality regimes of third country supervisory authorities. MoUs for supervisory cooperation may only be concluded if the required equivalence of professional secrecy is met.

3.1.2 Colleges of supervisors

Colleges of supervisors are permanent yet flexible coordination structures that bring together the competent authorities involved in supervising cross-border banking groups. Colleges play an important role for euro area banks with a presence in non-euro area countries.

European legislation fully empowers colleges of supervisors as relevant fora in which the home and host supervisors of cross-border institutions exchange relevant information and agree on the risk assessment and the capital and liquidity requirements of EU banks. While the JSTs supervise banks in the euro area, supervisory colleges facilitate consolidated supervision in non-euro area countries.

In 2017 ECB Banking Supervision acted as consolidating supervisor in 30 EU colleges, which were therefore chaired by the respective JST. Each of these colleges comprises the NCAs from the relevant EU Member States, the EBA and the ECB. Authorities from third countries in which the institution has material subsidiaries or branches may join the colleges as observers.

\(^50\) This MoU is designed to facilitate cooperation on significant branches between ECB Banking Supervision and the Nordic authorities (and for the latter among themselves), both inside and outside the euro area. Therefore, the MoU not only covers euro area entities but also a broader range of entities under the supervision of these Nordic authorities. Furthermore, in addition to banking supervision tasks, the MoU also covers consumer protection, payment services and systems as well as anti-money laundering. Hence, the MoU’s scope goes beyond the tasks of ECB Banking Supervision. However, the degree of cooperation between the signatory authorities remains subject to EU law. Consequently, ECB Banking Supervision will participate in the MoU only with regard to its supervisory tasks.
Seven cross-border institutions domiciled in non-euro area EU Member States operate through SIs in the euro area. As required by European legislation, ECB Banking Supervision is an active member in the respective colleges, which are chaired by the relevant NCA. The JST in charge of the subsidiary or branch in the euro area represents the ECB in these colleges and discharges its responsibilities.

In addition, four SIs only have material cross-border operations outside the EU. For these institutions, ECB Banking Supervision acts as consolidating supervisor and operates colleges for the exchange of information.

Finally, for five international institutions headquartered in third countries with significant subsidiaries in the euro area, the relevant JSTs act as active host supervisors in the colleges organised by the third country consolidating supervisor.

3.1.3 State of play on close cooperation

EU Member States whose currency is not the euro may participate in the SSM under a regime of close cooperation. The main conditions for this are set out in Article 7 of the SSM Regulation and the procedural aspects are specified in Decision ECB/2014/5. No formal requests for close cooperation were received in 2017.

3.1.4 EBA Review Panel

ECB Banking Supervision continued to actively participate in the EBA Review Panel, which is responsible for conducting peer reviews to strengthen consistency in supervisory outcomes.

In 2017 the EBA Review Panel performed a peer review of the EBA Guidelines on the criteria to determine the conditions of application of Article 131(3) of CRD IV in relation to the assessment of other systemically important institutions (O-SIIs). The objective of this peer review was to assess (i) the effective application of the provisions set out in the Guidelines and (ii) the processes the relevant authorities implement in order to achieve an appropriate evaluation of the conditions for determining whether institutions should be designated as O-SIIs.

As it is the NCAs’ responsibility to identify O-SIIs, the ECB’s role in the review was to clarify the SSM’s tasks in relation to identified O-SIIs. CRD IV entrusts NCAs with the task of applying additional capital buffer requirements to O-SIIs. The ECB, in line with its macroprudential mandate and responsibilities, can then “top up” these buffers by imposing stricter requirements under Article 5 of the SSM Regulation. In June 2016 the ECB introduced a floor methodology for O-SII buffer requirements with a view to ensuring that relevant systemic or macroprudential risks were addressed in a consistent manner across the euro area. After assessing NCAs’ notifications of their planned O-SII capital buffers, the ECB did not see the need to exercise its top-up power in 2017. This assessment was also based on the fact that all O-SII capital buffer requirements implemented by national authorities for banks identified by them as O-SIIs have been set at or above the ECB floor.
3.1.5 The IMF Financial Sector Assessment Programs

The IMF’s Financial Sector Assessment Programs (FSAPs) are comprehensive, in-depth assessments of a jurisdiction’s financial sector. They encompass (i) the identification of key vulnerabilities and the assessment of the resilience of the financial sector; (ii) the assessment of a country’s financial stability policy framework and its supervisory framework and practices; and (iii) the evaluation of financial safety nets and the financial system’s capacity to manage and resolve a financial crisis.

In January 2017 the President of the EU’s Economic and Financial Committee asked the IMF to carry out an EU/euro area FSAP, with a view to acknowledging the new banking supervision and resolution architecture in the euro area. The FSAP, which was launched in June 2017, therefore focuses, among other things, on banking supervision and crisis management of SIs. To this end, the IMF will carry out (i) a detailed assessment of the relevant51 Basel Core Principles52 (BCPs) for Effective Banking Supervision, resulting in grades; and (ii) an analysis of compliance with selected elements of the FSB Key Attributes of Effective Resolution Regimes for Financial Institutions. In addition, the IMF will (i) analyse the framework for the supervision of LSIs, without grades, and (ii) assess the solvency of the banking sector in the context of the risk assessment. Prior to the first IMF mission as part of this FSAP, the ECB had prepared a BCP self-assessment which had been reviewed by the ECB’s Supervisory Board and approved by the ECB’s Governing Council. Moreover, NCAs had provided input on relevant national legal provisions in response to the IMF’s request to evaluate the impact of national legal frameworks on the effectiveness of European banking supervision. The first mission took place in October/November 2017, during which more than 60 meetings were held with all five business areas of ECB Banking Supervision and relevant shared services.

The exercise is scheduled to be finalised in 2018 and its conclusions are to feed into the 2018 IMF Article IV consultation with the euro area, which is expected to be concluded in July 2018.

In IMF FSAPs for individual euro area countries, the national authorities take the lead in the overall exercise. However, the ECB, in accordance with its mandate, is also heavily involved, its main objectives being to (i) ensure the cross-country comparability and consistency of the banking sector component of FSAPs for euro area countries; (ii) exploit to the extent possible synergies with EU/euro area-wide banking stress tests; and (iii) ensure that the key features of the micro- and macroprudential banking framework of European banking supervision are accurately reflected. In 2017 the IMF concluded FSAPs for Luxembourg and Spain and launched an FSAP for Belgium. FSAPs for France, Italy and Malta are scheduled to start in the second half of 2018. The results of the euro area FSAP are expected to

51 One of the 29 BCPs, BCP 29, Abuse of financial services, will not be covered in this exercise, as the ECB is not competent for anti-money laundering issues. However, the euro area FSAP will include an IMF staff note on financial integrity.
52 The 28 relevant BCPs collectively cover 216 essential criteria and 17 additional criteria.
be public by then and can therefore inform these national exercises, especially regarding compliance with the BCPs for effective banking supervision.

More broadly, forthcoming FSAPs for euro area countries are expected to make full use of the conclusions and recommendations of the euro area FSAP, particularly in respect of the supervision and crisis management of SIs. This approach will be consistent with the current policymaking framework in Europe, and will fully reflect the respective competences at the levels of individual Member States, the euro area and the EU. At the same time, it will help to ensure that IMF surveillance and advice continue to be effective and relevant for all the authorities concerned.

Box 2
Brexit preparations

In the course of 2017, Brexit became one of the most relevant issues for ECB Banking Supervision. To promote a consistent approach to Brexit, ECB Banking Supervision established an SSM-wide project, aimed at ensuring that banks and supervisors are properly prepared.

In practical terms, the SSM’s work on Brexit covers both policy-related tasks and engagement with affected institutions and other stakeholders. The development of policy stances and supervisory expectations are important to address and clarify supervisory issues that have arisen in the context of Brexit. The ECB’s policy stances provide assurance that relevant issues are dealt with in a consistent manner throughout the SSM. They provide the basis for supervisors in the SSM to give clear guidance to credit institutions, for instance on the need to ensure adequate risk management, solid infrastructure and staffing commensurate with the institution’s activities. Among the issues that have been dealt with are the assessment of back-to-back booking models, the treatment of internal models transferred from the United Kingdom to the SSM, as well as internal governance and risk management.

The ECB has organised workshops with banks to inform them about the ECB and NCAs’ supervisory expectations. It has also published FAQs on the ECB’s banking supervision website to provide guidance, especially to banks that intend to relocate their business from the United Kingdom to the euro area. The FAQs cover topics such as authorisations and banking licences as well as the issues mentioned above. The ECB also conveyed its key messages in the summer, autumn and winter editions of the SSM Supervision Newsletter.

To ensure that SIs currently operating in the United Kingdom are properly prepared for Brexit, the ECB has engaged in structured dialogues with these banks. JSTs have begun discussions on Brexit-related scenarios drawn up by the banks and reflected in their respective contingency plans. In parallel, preparations were made to deal with banks that plan to relocate from the United Kingdom to the euro area, in anticipation of the loss of their EU passport. The aim is to ensure a prudent approach towards the licensing of new credit institutions and the transfer of activities to existing credit institutions. The ECB and NCAs also maintain close contact with other authorities that supervise entities of euro area banking groups, including UK and third country supervisors. The objective is to ensure coordination between all relevant authorities in response to developments in the euro area banking sector.
Brexit will stay high on the supervisory agenda for 2018

Brexit will remain one of the main supervisory priorities. As banks’ Brexit-related plans enter into operation, the focus of their activities will shift from preparatory work to the assessment of actual cases and the practical implementation of the policy stances mentioned above. Notwithstanding the political agreement on negotiating a possible transition period, there is still uncertainty about the outcome of this negotiation. The ECB advises banks to be proactive and timely in their Brexit preparations to ensure that all authorisations required for carrying out activities in the EU are in place in a timely manner. However, depending how the political discussions on a transition period develop, banks may discuss with supervisors the possibility of extending the time period for implementing certain aspects of their individual relocation plans.

The ECB – together with NCAs – will continue to assess institutions’ plans for relocating activities to the euro area along with applications for banking licences. The supervisors will look especially at the banks’ compliance with the SSM’s policy stances and supervisory expectations, in particular with a view to avoiding the establishment of empty shell companies in the euro area, i.e. institutions with only minimum capabilities in the euro area which extensively outsource their activities in the EU to third country entities. The ECB will develop additional policy stances where needed and keep the industry and stakeholders informed about supervisory expectations. For institutions that, owing to the expansion of their euro area activities, are likely to become significant in the short or medium term, the ECB is making preparations to ensure the smooth transfer of their direct supervision to the ECB. The ECB will continue to engage with both home and host supervisors in order to monitor the preparedness of euro area banks as well as incoming banks. The ECB also plans to organise further workshops on banks’ relocation plans and will regularly update the Brexit-related FAQs.

3.2 Contributing to the development of the European and international regulatory framework

3.2.1 Contribution to the Basel process

2017 marked the finalisation of Basel III, the cornerstone of the post-crisis regulatory framework. The ECB, which is actively involved in the work of the Basel Committee on Banking Supervision (BCBS), contributed to this standard-setting process by joining in policy discussions, providing expertise in various BCBS groups, cooperating with BCBS members throughout the EU and around the globe, and contributing to relevant impact analyses.

Finalisation of Basel III

The agreed reforms are an important step towards restoring confidence in banks’ risk-weighted capital ratios. The ECB welcomed the finalisation of Basel III, which strengthens the regulatory framework and is an important step towards restoring confidence in banks’ risk-weighted capital ratios. The ECB took an active part in the policy discussions. The finalisation of Basel III sends a strong signal of continued international cooperation in...
banking regulation. The agreed reforms contribute to regulatory certainty and enable banks to make well-informed decisions. The envisaged phase-in period for implementation, beginning in 2022 and ending in 2027, will ensure that the impact on banks is manageable, even for those most affected by the reforms.

Focus on implementation and policy evaluation

The ECB considers it crucial that all parties consistently transpose the agreed reforms. To that end, the ECB has provided technical advice to legislators, in particular through its legal opinion on the European Commission’s proposals for revisions to the CRD IV/CRR framework (see Box 3). The ECB expects to provide similar support in the context of these reforms.

In the coming years, the BCBS will continue to work on identifying Basel III implementation issues encountered by supervisors in practice and, more generally, on promoting strong banking supervision. The BCBS will also initiate a post-implementation evaluation of the reforms put in place since the crisis. The ECB will continue to contribute actively to the BCBS agenda.

3.2.2 Contributions to the work of the EBA

Throughout 2017, ECB Banking Supervision worked closely with the EBA towards the shared objectives of increasing financial stability and promoting consistent supervision across the European banking sector.

ECB Banking Supervision actively contributes to the EBA’s work at all levels. In 2017, ECB Banking Supervision staff was represented in a total of 45 EBA sub-structures, four of which in the role of chair or co-chair. Moreover, ECB Banking Supervision participated in the EBA Board of Supervisors as a non-voting member.

The two examples below illustrate the substantial progress made by the EBA working groups and how the EBA and the ECB complement each other in achieving their shared objectives.

First, in 2017 the EBA published, together with ESMA, its guidelines on the suitability of members of the management body and key function holders to (i) ensure that banks have sound governance structures and (ii) set common rules for the scope of fit and proper assessments carried out by supervisors. Working in close alignment with the EBA, the ECB developed and published its guide to fit and proper assessments, clarifying supervisory criteria and the process for determining the suitability of banks’ board members.

Second, ECB Banking Supervision fully incorporated the principles set out in the EBA’s guidelines on credit risk management practices and accounting for expected credit losses, published in 2017, in its internal methodology for assessing banks’ preparedness for the implementation of IFRS 9.
In the course of 2017, the ECB made notifications to the EBA under the comply-or-explain procedure with respect to eight EBA guidelines, including one joint committee guideline, and one EBA recommendation. In all of these cases, the ECB notified the EBA of its compliance or intention to comply.

**Box 3**
Review of EU banking legislation (CRR/CRD IV, BRRD and SRMR)

### The proposal
In November 2016 the European Commission published a comprehensive package of amendments to the EU legislation on capital requirements (CRR and CRD IV) and crisis management (BRRD and SRMR). The Council of the European Union started reviewing the Commission’s proposal in the first quarter of 2017. The European Parliament's Committee on Economic and Monetary Affairs published relevant draft reports in November 2017. The final adoption of the amendments is expected between the end of 2018 and the first quarter of 2019.

The ECB provided expert advice to co-legislators on the amendments. At EU Council level, ECB experts regularly presented the ECB’s views on the proposed package to the Working Party on Financial Services. And at the request of the European Parliament and the EU Council, the ECB issued three Opinions outlining its policy stances on the package.

### Table A
Overview of the prudential areas covered by the European Commission’s proposal

<table>
<thead>
<tr>
<th>Implementation of Basel standards</th>
<th>Resolution framework</th>
<th>Supervisory framework</th>
</tr>
</thead>
<tbody>
<tr>
<td>net stable funding ratio (NSFR)</td>
<td>harmonisation of the creditor hierarchy*</td>
<td>changes to the Pillar 2 framework</td>
</tr>
<tr>
<td>leverage ratio</td>
<td>inclusion of a new moratorium tool</td>
<td>introduction of an intermediate EU parent undertaking (IPU) requirement</td>
</tr>
<tr>
<td>fundamental review of the trading book (FRTB)</td>
<td>implementation of the FSB’s total loss-absorbing capacity (TLAC) standard</td>
<td>introduction of cross-border capital waivers</td>
</tr>
<tr>
<td>standardised approach for counterparty credit risk (SA-CCR)</td>
<td>other adjustments to the minimum requirement for own funds and eligible liabilities (MREL)</td>
<td>lower frequency of reporting for smaller banks</td>
</tr>
<tr>
<td>interest rate risk in the banking book (IRRBB)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

* This dossier was fast-tracked and finalised in December 2017. The new provisions entered into force in January 2018.

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54 Includes the EBA notification in respect of EBA/GL/2016/01, which was a late notification by the ECB.
The ECB’s policy stances on the proposed reform package

The ECB’s Opinions supported the Commission’s package of amendments, which seek to substantially strengthen the regulatory framework and make the banking sector more resilient. However, the ECB also had specific concerns and suggestions.

Regarding the supervisory framework, the ECB generally supported the proposal to allow supervisors to waive, under certain conditions, individual capital requirements of subsidiaries located in a different Member State than their parent entities, while safeguarding financial stability as the banking union is still moving towards completion. Moreover, the ECB argued that appropriate transitional arrangements should be put in place. The ECB is also in favour of the proposed requirement to establish an intermediate EU parent undertaking for third-country banking groups with two or more institutions in the EU. This would promote more effective and coherent supervision. However, to avoid arbitrage, the ECB suggested that the requirement should also cover significant branches.

Revisions to Pillar 2 were a specific area of concern for the ECB. While seeking to increase harmonisation, the Commission’s proposal restricted supervisory action in essential areas. The ECB highlighted that supervisors should have enough flexibility in respect of each institution to measure their risks, determine the amount of additional own funds they should hold and approve or reject changes in their composition. Moreover, supervisors should be able to flexibly require ad hoc granular data whenever necessary in order to properly assess an institution’s risk profile. These views were shared by the European Parliament’s Committee on Economic and Monetary Affairs in its draft report on amendments to CRD IV. The ECB also called for greater harmonisation of the EU prudential framework, to be achieved by incorporating into EU law certain supervisory powers (e.g. on authorisation procedures, especially fit and proper assessments) and removing unwarranted options and discretions. Such harmonisation would curtail the use of different national provisions, which impede effective supervision. Lastly, the ECB called for a review of the supervision of large cross-border investment firms that carry out bank-like activities, suggesting that such firms be treated as credit institutions. A proposal to that effect was put forward by the Commission in December 2017.57

Regarding the implementation of Basel standards such as the leverage ratio (LR), the net stable funding ratio (NSFR) and the fundamental review of the trading book (FRTB), the ECB stressed that their proper transposition into EU law is necessary to ensure comparability across institutions and a level playing field. The ECB also recommended the inclusion of review clauses for all standards still under discussion in the BCBS at time of the Opinion’s publication (NSFR, LR, FRTB).

On the crisis management framework, the ECB supported the proposed introduction of a harmonised category of non-preferred senior debt in order to facilitate compliance with the upcoming TLAC and MREL requirements. However, the ECB argued the need for additional reforms to further harmonise the hierarchy of creditor claims in bank insolvency proceedings, particularly the introduction of a general depositor preference.

The ECB welcomed the implementation of the TLAC standard through the MREL. However, on the calibration of the MREL, the ECB recommended that the resolution authority should be allowed to

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57 This proposal was part of the Commission’s wider review of the prudential framework for investment firms. Under the Commission’s proposal, systemic investment firms (i.e. with assets above €30 billion) would become subject to the same rules and supervision as banks in the EU.
provide for a safety margin by increasing the MREL recapitalisation amount. This would ensure that entities resulting from resolution would have sufficient resources to cover additional unexpected losses and costs in the post-resolution period. The proposed MREL guidance should then be eliminated, as it would complicate the framework to no clear advantage. The ECB supported the proposal to defer the application of MDA restrictions in cases where institutions breach their combined buffer requirements owing to their inability to replace liabilities that no longer meet the MREL eligibility or maturity criteria. However, the ECB recommended that the deferral should last twelve months rather than six as proposed by the Commission.

The ECB also recommended that its early intervention powers should be directly enshrined in the SRMR in order to facilitate their consistent application. Finally, the ECB recommended removing from the BRRD those early intervention measures that are already available under CRD IV and the SSM Regulation.

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3.2.3 Contribution to the work of the FSB

In 2017 ECB Banking Supervision actively contributed to the work of the Financial Stability Board (FSB), in particular in the areas of supervisory and regulatory cooperation, standards implementation as well as resolution. ECB Banking Supervision also participated in the meetings of the FSB’s regional consultative group of Europe.

The FSB’s focus has recently shifted from policy design to monitoring the implementation, and evaluating the effects, of financial sector reforms. ECB Banking Supervision will continue contributing to the work of the FSB in this latter regard and will highlight the positive effects of financial stability and well-functioning banking sectors on economic growth. ECB Banking Supervision will also contribute to workstreams on other major topics such as resolution and crisis management, governance frameworks, compensation and fintech.
4 Authorisations, enforcement and sanctioning procedures

4.1 Developments in the number of significant institutions and in common procedures

4.1.1 The number of significant institutions

The annual assessment, in line with the SSM Framework Regulation, of whether a bank or banking group fulfils any of the significance criteria,\(^{58}\) was conducted in October 2017. The outcome of this assessment as well as changes in group structures and other developments in five banking groups brought the number of significant institutions to 119, down from 125 at the beginning of the year.

Barclays Bank PLC Frankfurt Branch was newly identified as significant owing to a material increase in size and became subject to direct ECB supervision as of 1 January 2018.

Having not met any of the significance criteria for three consecutive calendar years the banks Raiffeisen-Holding Niederösterreich-Wien reg. GmbH and SEB AG had ceased to be significant and supervisory responsibilities were transferred to the Austrian and German NCAs respectively.

The changes in group structures and other developments\(^{59}\) concerned the acquisitions of Banco BPI S.A. and Banco Popular Español S.A. by other SIs and the withdrawals of the banking licences of Agence Française de Développement (voluntary return of licence), Veneto Banca S.p.A. and Banca Popolare di Vicenza S.p.A.

The list of supervised entities is updated throughout the year. The most recent version of the list can be found on the ECB’s banking supervision website.

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\(^{58}\) These criteria are set out in Article 6(4) of the SSM Regulation.

\(^{59}\) The list of significant and less significant institutions published in December 2017 reflects (i) the significance decisions notified to the supervised institutions before 5 December 2017 and (ii) other changes and developments in group structures effective before 1 October 2017.
Table 3
Significant and less significant banking groups or stand-alone banks in the SSM following the 2017 annual assessment

<table>
<thead>
<tr>
<th></th>
<th>Total assets (in € billions)</th>
<th>Number of entities</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>at consolidated level</td>
<td>at individual level</td>
</tr>
<tr>
<td>Significant institutions</td>
<td>21,171.8</td>
<td>119</td>
</tr>
<tr>
<td>Less significant institutions</td>
<td>4,920.8</td>
<td>2,869</td>
</tr>
<tr>
<td>Total</td>
<td>26,092.6</td>
<td>2,988</td>
</tr>
</tbody>
</table>

Source: ECB.
Notes: Total assets of entities included in the list of supervised entities as published in December 2017 (with reference date for the group structures of 1 October 2017 and for significance decisions of 5 December 2017); reference date of total assets is 31 December 2016 (or the latest available).

In view of Brexit, the ECB is closely following the relocation plans of banks from the United Kingdom. The aim is to ensure the timely identification of these banks’ significance status and a smooth shift of supervisory responsibilities from the UK authorities to the ECB or the NCAs for the activities that are transferred to the euro area.

Comprehensive assessment 2017

As no banks newly fulfilled the significance criteria in 2017, no comprehensive assessment exercise took place. However, the asset quality review methodology was updated in preparation for 2018, in order to take into account the introduction of the IFRS 9 accounting standard and the risk profile of bank business models focused on investment services and activities.

4.1.2 Common procedures and fit and proper assessments

In 2017, a total of 3,026 authorisation procedures were notified to ECB Banking Supervision by NCAs, comprising 24 licence applications, 41 licence withdrawals, 52 lapsing of authorisation, 160 acquisitions of qualifying holdings, 2,301 management and supervisory board appointments and 448 passporting procedures.

In total, 1,673 authorisation procedures were approved by the Supervisory Board and the Governing Council in 2017. In addition, 319 authorisation procedures were

60 The only institution newly identified as significant in 2017 was a branch of (UK-incorporated) Barclays Bank PLC. Euro area branches of credit institutions from non-participating Member States are not subject to the comprehensive assessment on a stand-alone basis.
61 Lapsing of an authorisation means that, where national law provides for it, the authorisation ceases to exist without requiring a formal decision to that effect; it is a legal effect that takes place as soon as a specific, well-defined trigger occurs, e.g. the express renouncement of a licence by the entity or the fact that the institution itself ceases to exist, for instance because of a merger with another company.
62 Including a limited number (17) of requests for additional directorships.
63 These 1,673 authorisation procedures were incorporated in 1,238 ECB legal acts. Some legal acts cover more than one authorisation procedure (e.g. fit and proper assessments of several members of the management bodies of the same significant institution or acquisitions of qualifying holdings in different subsidiaries resulting from a single transaction).
approved by senior management within the delegation framework, which took effect in June 2017\textsuperscript{64}. Another 70 authorisation procedures not requiring a formal ECB decision were completed, comprising mainly passporting procedures and lapsing procedures.

Table 4
Authorisation procedures notified to the ECB\textsuperscript{65}

<table>
<thead>
<tr>
<th>Procedure</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>Licensing</td>
<td>7</td>
<td>37</td>
<td>24</td>
<td>24</td>
</tr>
<tr>
<td>Withdrawal of licence\textsuperscript{1}</td>
<td>5</td>
<td>26</td>
<td>42</td>
<td>41</td>
</tr>
<tr>
<td>Lapsing of licence</td>
<td>0</td>
<td>26</td>
<td>178</td>
<td>52</td>
</tr>
<tr>
<td>Qualifying holdings</td>
<td>9</td>
<td>134</td>
<td>142</td>
<td>160</td>
</tr>
<tr>
<td>Fit and proper</td>
<td>115</td>
<td>2,729</td>
<td>2,544</td>
<td>2,301</td>
</tr>
<tr>
<td>Passporting</td>
<td>34</td>
<td>431</td>
<td>252</td>
<td>448</td>
</tr>
</tbody>
</table>

Source: ECB.
\textsuperscript{1} In the ECB Annual Report on supervisory activities 2014, withdrawals and lapsing procedures were reported together. Due to the increase in lapsing, the procedures are reported separately as of 2015.

Overall the number of common procedures (licensing, withdrawals, lapsing of licences and qualifying holdings) remained rather stable compared with the previous year. For fit and proper decisions, the number of procedures decreased by 10% compared with 2016. This is mainly the result of a legislative change in France, which meant that re-appointments of non-executive board members were no longer assessed as of November 2016. The decrease in lapsing procedures was expected since the high number of lapsing of licences in 2016 was due to an incidental effect (i.e. the merger of a group of affiliated banks into a single entity). The significant increase in the number of passporting procedures may be related to a rise in incoming passporting by UK banks, in particular by virtue of the implementation by banks of preparatory Brexit scenarios and the implementation of the UK Banking Reform Act, requiring banks to separate core retail banking from investment banking (ring-fencing).

Developments in common procedures

The majority of licensing procedures (approximately 80%) related to the establishment of new LSIs. The two main drivers of new bank applications in 2017 were fintech companies, which use digital innovations to provide services to EU clients, and Brexit, which led to an increase in requests for banking licences in the euro area in the second half of 2017. Both trends are expected to continue in 2018. No more than around 20% of the licensing procedures concerned SIs, mainly pertaining to the extension of licences for investment services. One SI procedure

\textsuperscript{64} These procedures refer to the assessment of management and supervisory board members who are subject to the delegation framework approved in the Decision (EU) 2017/935 of the European Central Bank of 16 November 2016 on delegation of the power to adopt fit and proper decisions and the assessment of fit and proper requirements (ECB/2016/42).

\textsuperscript{65} As the cut-off date for 2014 was 15 January 2015, there is a limited overlap between the numbers of 2014 and 2015.
concerned the establishment of a new subsidiary for mobile banking services and another arose from the intended relocation by an existing bank to the euro area.

Withdrawal and lapsing procedures largely arose from credit institutions voluntarily terminating their banking activities or from banks entering into a merger or undertaking a restructuring. Licence renunciations by SIs alone accounted for 33 out of 41 withdrawal procedures. However, for a limited number (5) of withdrawals of authorisations, the decisions were driven by an institution’s failure to meet prudential requirements.

Several qualifying holding procedures were related to acquisitions of majority stakes in supervised institutions by specific acquirers, involving aspects relating to complex corporate structures, possible short-term investment horizons or the use of leveraged funding. In 2017 only limited cross-border banking sector consolidation activities were observed among SIs. In terms of numbers, the majority of qualifying holding procedures notified to the ECB in 2017 related to internal reorganisations of the shareholding structure of supervised institutions. Such reorganisations mainly serve to simplify the group structure and/or generate cost savings, but can also be driven by tax optimisation.

**Developments in fit and proper assessments**

Approximately two-thirds of the fit and proper procedures concerned non-executive members of the management body, the remaining third concerned executive members of the management body. The number of assessments of key function holders is negligible since, on the one hand, not all Member States provide for such assessments in their national laws and, on the other hand, key function holders are appointed on a less frequent basis than board members. In about a fifth of all cases, specific concerns needed to be addressed. In many cases, the ECB imposed conditions, obligations or recommendations to address those specific concerns, for example regarding the experience and time commitment of the candidates.

**Development of policy stances**

In 2017 ECB Banking Supervision continued developing policy stances and ensuring their consistent implementation in cooperation with the NCAs and the EBA. The aim is to achieve common supervisory practices and simplify authorisation procedures.

In May 2017 the Guide to fit and proper assessments was published. This guide increases transparency on the ECB’s policies, practices and processes that are

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66 "Specific acquirers" are characterised by a high level of complexity or a lack of transparency (e.g. private equity funds, sovereign management funds).

67 Key function holders are employees who are not members of the management body but have a significant influence over the direction of the institutions under the overall responsibility of the management body, e.g. credit risk officers, compliance officers, etc. In 2017, 12 euro area countries provided for the assessments of key function holders under their national law.
applied by the ECB when assessing whether members of SIs’ management bodies are suitable. These assessments are important because malfunctioning of the governing bodies is often at the origin of banks’ weaknesses and risks at a later stage. While the guide will help to make such assessments in a more harmonised manner, discrepancies are set to remain on account of the application of national laws. These include the uneven transposition across countries and, in some cases, only a partial transposition of CRD IV itself. The ECB would therefore like to see greater convergence in this area, so that the principles enshrined in CRD IV, complemented by the new ECB policy, are fully effective (see also Box 3).

Policies were developed on the assessment of the various criteria for qualifying holdings.

Work was completed on a first batch of policy stances relating to the scope of licensing requirements and procedural issues regarding the granting of licences, while work on a second batch addressing the assessment of licensing criteria is already well advanced. The policy stance on the assessment of banking applications by fintech firms was also completed. Following the finalisation of the policy stances, two guides were published for consultation. These guides lay out the criteria used in the assessment of licence applications by credit institutions and by fintech credit institutions respectively. Final publication of the guides is planned for early 2018.

4.2 Reporting of breaches, enforcement and sanctioning proceedings

4.2.1 Enforcement and sanctioning

Under the SSM Regulation and the SSM Framework Regulation, the allocation of enforcement and sanctioning powers between the ECB and the NCAs depends on the nature of the alleged breach, the person responsible and the measure to be adopted (see ECB Annual Report on supervisory activities 2014).

With a view to efficiency and consistency, the ECB enhanced its processes for enforcement and sanctioning in 2017 by, among other things, developing and implementing new IT tools.

The ECB initiated ten sanctioning proceedings in 2017. Taking into account the 35 proceedings that were ongoing at end-2016, the ECB handled 45 proceedings in 2017. Of these, 44 were related to sanctions and one to enforcement measures (see Table 5).
Of the 44 sanctioning proceedings handled in 2017, 28 related to suspected breaches of directly applicable EU law (ECB decisions and regulations included). These cases concerned 26 SIs and related to the areas of own funds, reporting, public disclosure, liquidity and large exposures. In 2017 the ECB adopted three sanctions decisions imposing five penalties in an overall amount of €15.3 million. The penalties were imposed on three supervised entities for breaches committed in the areas of liquidity (2), reporting and public disclosure (1), large exposures (1) and own funds (1). Nine proceedings were closed in 2017 owing mainly to the non-materiality of the suspected breaches or the absence of a legal basis for imposing sanctions.

The remaining 16 out of the 44 sanctioning proceedings handled in 2017 related to suspected breaches of national law transposing CRD IV provisions and concern SIs or natural persons. These proceedings involve suspected breaches with regard to governance (including internal control mechanisms), management body functions and remuneration. In 2017 the ECB addressed seven requests to NCAs to open sanctioning proceedings within the remit of their national competences. Following the ECB’s requests, and having assessed the cases in accordance with their national law, the NCAs adopted three sanction decisions, imposing 28 penalties in an overall amount of €5.1 million.

The enforcement proceeding handled in 2017 concerned non-compliance with an ECB supervisory decision. This proceeding was closed in 2017 as the supervised entity returned to compliance.

A complete breakdown by area of infringement of the suspected breaches subject to the enforcement and sanctioning proceedings handled in 2017 by the ECB is displayed in Chart 8.
If the ECB has reason to suspect that a criminal offence may have been committed, it requests the relevant NCA to refer the matter to the appropriate authorities for investigation and possible criminal prosecution, in accordance with national law. Five such requests were submitted to the relevant NCAs in 2017.

4.2.2 Experience with reporting on breaches under Article 23 of the SSM Regulation

It is the ECB’s duty to ensure that effective mechanisms are put in place that enable any person to report breaches of relevant EU law (a process commonly referred to as “whistle-blowing”). Accordingly, the ECB set up a breach reporting mechanism (BRM) which includes a pre-structured web platform, which can be accessed through the ECB’s banking supervision website.

In 2017, 89 breach reports were received by the ECB, close to the number received in 2016. Of these, 61 referred to alleged breaches of relevant EU law, 56 of which were considered to be within the remit of the ECB’s supervisory tasks and five within the remit of the NCAs’ supervisory tasks. The remaining 28 breach reports referred mainly to national issues not related to prudential requirements and thus fell outside the scope of the BRM (e.g. consumer protection).

As in the previous year, among the most common alleged breaches reported were governance issues (85%) and inadequate calculation of own funds and capital requirements (8%). The complete breakdown is shown in Chart 9.
related issues referred mainly to risk management and internal controls, fit and proper requirements and organisational structure\textsuperscript{68}.

\textbf{Chart 9}

\textit{Alleged breaches reported in the BRM mainly concern governance issues}

\begin{figure}
\centering
\includegraphics[width=\textwidth]{chart9.png}
\caption{Alleged breaches reported in the BRM mainly concern governance issues.}
\end{figure}

Source: ECB.

The main investigatory actions taken in 2017 in relation to the breach reports received were:

- internal assessment with existing documentation (47% of the cases);
- requests for an internal investigation/audit or documents/explanations to the supervised entity (42% of the cases);
- on-site inspections (11% of the cases).

\textsuperscript{68} “Risk management and internal controls” comprises the mechanisms or processes that an entity needs to have in place for the adequate identification, management and reporting of the risks it is or might be exposed to. “Organisational structure” refers to the extent to which an institution has well-defined, transparent and consistent lines of responsibility.
5 Organisational set-up: ECB Banking Supervision

5.1 Discharging of accountability requirements

This Annual Report has been produced as one of ECB Banking Supervision’s main accountability channels in accordance with the SSM Regulation. The Regulation provides that the ECB’s supervisory tasks should be subject to appropriate transparency and accountability requirements. Maintaining and fostering the accountability framework that was set out in detail in the Interinstitutional Agreement between the European Parliament and the ECB and the Memorandum of Understanding between the EU Council and the ECB continued to be among the ECB’s priorities in 2017.

With regard to interactions with the European Parliament in 2017, the Chair of the Supervisory Board spoke before Parliament’s Committee on Economic and Monetary Affairs (ECON) to present the 2016 ECB Annual Report on supervisory activities (23 March), and participated in two ordinary public hearings (19 June and 9 November). She also participated in a public hearing on the legislative package on risk reduction in the banking sector (25 April) and three ad hoc exchanges of views with MEPs (23 March, 19 June and 9 November). Among the key issues discussed were measures to reduce non-performing loans, the first resolution and liquidation cases involving significant institutions (SIs), and legislative dossiers in the area of banking supervision, including the completion of banking union. Furthermore, the Vice-Chair of the Supervisory Board participated in a joint meeting of the ECON Committee and Parliament’s Budgetary Control Committee on the Special Report of the European Court of Auditors on the Single Supervisory Mechanism (13 February).

In the course of 2017, the ECB published 41 replies to questions from MEPs on supervisory matters on its website. The letters touched on, among other things, the legal framework for banking supervision as well as the ECB’s policies on a broad range of supervisory topics, such as the resolution and liquidation cases involving SIs, the ECB’s supervisory approach towards both SIs and less significant institutions (LSIs), its policies on non-performing loans and its interactions with national authorities.

Moreover, in line with the Interinstitutional Agreement, the ECB systematically submitted the records of proceedings of its Supervisory Board meetings to the European Parliament.

With regard to interactions with the EU Council in 2017, the Chair and Vice-Chair of the Supervisory Board attended six meetings of the Eurogroup: on 7 April the Chair presented the 2016 ECB Annual Report on supervisory activities, and on 6 November she attended a further regular exchange of views on the execution of the ECB’s supervisory tasks. ECB Banking Supervision participated in other Eurogroup meetings on 26 January, 15 June, 11 July and 4 December. Furthermore,
the Chair of the Supervisory Board participated in a discussion in the informal ECOFIN Council on 7 April. The topics of interest to the finance ministers overlapped to a large extent with those discussed in the European Parliament.

As part of the reporting requirements under the SSM Regulation, representatives of the ECB involved in banking supervision took part in exchanges of views with national parliaments. Furthermore, the ECB published two replies to questions from members of national parliaments on its website.

5.2 Reviews and audits of the work of the SSM

ECB Banking Supervision is subject to extensive reviews by various institutions and bodies of the EU, such as the European Commission and the European Court of Auditors (ECA).

As part of its first audit of the "operational efficiency of the management of the ECB", conducted under Article 20(7) of the SSM Regulation, the ECA published in November 2016 a special report entitled "Single Supervisory Mechanism – Good start but further improvements needed". In response, ECB Banking Supervision followed up on the report’s recommendations in 2017 by, among other things:

- streamlining the procedure for the adoption of supervisory decisions;
- strengthening the presence of the ECB and, more generally, of non-home/host NCA staff in on-site inspections;
- improving the supervisory IT system;
- allocating additional resources to the ECB’s internal audit function.

The ECB also committed extensive resources to the ECA’s second audit of ECB Banking Supervision, which focused on crisis management. The report on this audit was published on 16 January 2018.69

In line with Article 32 of the SSM Regulation, the European Commission published a review of the SSM in the form of a report70 and an accompanying staff working document71 on 11 October 2017. In the process leading up to the report’s publication, the ECB interacted closely with the Commission, responding to approximately 130 questions and hosting two joint workshops at staff level.

The Commission’s report observed that the effectiveness of banking supervision has improved in the euro area, with the integrated supervision of credit institutions bringing clear benefits in terms of level playing field and confidence. The report

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69 See Section 2.1.5 for more information on the ECA audit on crisis management.
highlighted, in particular, the SSM’s “remarkable efforts” in furthering harmonisation and increasing the quality of supervision in core areas such as the SREP, internal model supervision, fit and proper assessments, common procedures and supervisory colleges. The report also welcomed ECB Banking Supervision’s constructive approach towards recommendations arising from reviews (e.g. by the ECA and the IMF), its successful cooperation with other EU and international bodies, as well as the delegation of decision-making powers in relation to supervisory decisions, which should lead to significant improvements in the efficiency of ECB supervisory decision-making. The Commission also made a number of observations and recommendations on the functioning of the SSM, for example on safeguards for the ECB’s shared services, transparency and the proportionality of supervisory fees. The report concluded that no changes to the SSM Regulation were needed at this stage.

5.3 Decision-making

5.3.1 Supervisory Board and Steering Committee

A total of 32 meetings of the Supervisory Board took place in 2017. Of these, 22 were held in Frankfurt am Main, and nine were held via teleconference. One meeting took place in Helsinki at the invitation of the Finnish Financial Supervisory Authority (Finanssivalvonta). In 2017, the Supervisory Board took the majority of its decisions by written procedure.\(^\text{72}\)

A very large number of decisions concerned individual banks (see Figure 6) and were adopted via the non-objection procedure. In this two-step process, individual draft decisions are first submitted to the Supervisory Board for approval. Thereafter, the final draft decisions are sent to the ECB’s Governing Council for adoption by non-objection. Thirty-three of the 119 banking groups directly supervised by the ECB in 2017 asked to receive formal ECB decisions in an EU official language other than English.

\(^{72}\) Under Article 6.7 of the Supervisory Board’s Rules of Procedure, decisions may also take place by written procedure, unless at least three members of the Supervisory Board who have a voting right object. In such cases, the item is put on the agenda of the subsequent Supervisory Board meeting. A written procedure normally requires at least five working days for consideration by the Supervisory Board.

\(^{73}\) The number of significant institutions as at 5 December 2017. The list of supervised entities is updated regularly and published on the ECB’s banking supervision website.
Figure 6
Decisions by the Supervisory Board in 2017

- 32 meetings
- 1,888 written procedures
- 2,308 decisions taken

Most common decisions:
- 1,057 suitability assessments
- 342 SREP-related decisions
- 188 own funds decisions

Decisions were addressed to:
- 119 significant banking groups and the (potential) acquirers of SSM banks
- 33 of which communicate in a language other than English

1) The numbers in this figure relate to individual supervisory decisions addressed to supervised entities or their potential acquirers and instructions to NCAs on SIs or LSIs. One decision may contain several supervisory approvals. In addition, the Supervisory Board took decisions on a number of horizontal issues (e.g., common methodologies) and institutional issues.
2) Including decisions related to the short-term exercises for both the 2017 and the 2018 SREP.

In addition to the bank-specific decisions, the Supervisory Board decided on several horizontal issues, most notably the application of common methodologies and frameworks in specific areas of its supervision. Some of these decisions were drafted by temporary structures mandated by the Supervisory Board, consisting of senior managers from the ECB and the NCAs. These groups carried out preparatory work on the stress test exercises, the SREP methodology, cross-border on-site inspections, high levels of non-performing loans, and the simplification of SSM processes.
Supervisory Board

Front row (from left to right): Stelios Georgakis (alternate for Yiangos Demetriou), Anneli Tuominen, Vita Pilsuma (alternate for Zoja Razmusa), Elisa Ferreira, Andreas Dombret, Danièle Nouy, Sabine Lautenschläger, Claude Simon, Pentti Hakkarainen, Ray Vella (for the Malta Financial Services Authority), Oliver Bonello

Middle row (from left to right): Ilias Plaskovitis, Renata Bagdonienė (alternate for Vytautas Valvonis), Helmut Ettl, Vladimir Dvorchák, Norbert Goffinet, Tom Dechaene, Denis Beau, Matej Krumberger (alternate for Primož Dolenc)

Back row (from left to right): Nora Dambure (alternate for Pēters Putniņš), Madis Müller, Kilvar Kessler, Matthias Güldner (alternate for Felix Hufeld), Ed Sibley, Ignazio Angeloni, Andreas Ittner, Javier Alonso, Jan Sijbrand

Chair
Danièle Nouy

Vice-Chair
Sabine Lautenschläger

ECB representatives
Ignazio Angeloni
Julie Dickson (until 31 July 2017)
Pentti Hakkarainen (since 1 February 2017)

Belgium
Mathias Dewatripont (Nationale Bank van België/Banque Nationale de Belgique) (until 17 May 2017)
Tom Dechaene (Nationale Bank van België/Banque Nationale de Belgique) (since 18 May 2017)

Germany
Felix Hufeld (Bundesanstalt für Finanzdienstleistungsaufsicht)
Andreas Dombret (Deutsche Bundesbank)

Estonia
Kilvar Kessler (Finantsinspektsioon)
Madis Müller (Eesti Pank)

Ireland
Ed Sibley (Central Bank of Ireland)

Greece
Ilias Plaskovitis (Bank of Greece)

Spain
Javier Alonso (Banco de España)

France
Robert Ophèle (Banque de France) (until 2 August 2017)
Denis Beau (Banque de France) (since 3 August 2017)

Italy
Fabio Panetta (Banca d’Italia)

Cyprus
Yiangos Demetriou (Central Bank of Cyprus)

Latvia
Pēters Putniņš (Finanses un kapitāla tirgus komisija)
Zoja Razmusa (Latvijas Banka)

Lithuania
Vytautas Valvonis (Lietuvos bankas)

Luxembourg
Claude Simon (Commission de Surveillance du Secteur Financier)
Norbert Goffinet (Banque centrale du Luxembourg)

Malta
Kanol Gabarretta (Malta Financial Services Authority) (until 18 January 2018)
Alexander Demarco (Bank Ċentrali ta’ Malta/Central Bank of Malta) (until 8 August 2017)
Oliver Bonello (Bank Ċentrali ta’ Malta/Central Bank of Malta) (since 9 August 2017)
The Steering Committee held 18 meetings in 2017. Of these, 17 were held in Frankfurt am Main, and one was held in Helsinki at the invitation of the Finnish Financial Supervisory Authority (Finanssivalvonta). In April, the usual rotation of the five NCA members, who are appointed for a one-year term, took place.

Additionally, the Steering Committee held six meetings in its extended composition, that is, with the participation of senior representatives from all 19 NCAs. Of these meetings, two were held in Frankfurt am Main and four via teleconference. The focus of these meetings was the ECB sensitivity analysis of interest rate risk in the banking book (IRRBB) – stress test 2017.

5.3.2 Streamlining the decision-making process

To further streamline its decision-making process, in 2017 the ECB adopted a legal framework for the delegation of decision-making powers for supervisory decisions. This framework allows certain types of supervisory decisions to be adopted by ECB senior managers instead of the Supervisory Board and Governing Council. This new framework is applied to supervisory decisions of a routine nature that involve limited discretion, taking into consideration the materiality and impact of the decisions that are delegated. It enables the Supervisory Board and the Governing Council to focus on more complex issues. By adopting a delegation framework, the ECB has also addressed concerns raised by the ECA\(^74\), the European Commission\(^75\) and the IMF\(^76\) on the efficiency of the supervisory decision-making process. Additionally, the Supervisory Board has established a Simplification Group that will spearhead a further review of processes in the SSM to ensure that decision-making and other procedures are efficient.

The ECB has also approved an alternative fit and proper process, which allows, under certain conditions, decisions to be made by the ECB on the sole basis of NCAs’ assessments.

\(^74\) ECA Special Report No 29/2016, “Single Supervisory Mechanism - Good start but further improvements needed”.
The delegation framework

The legal framework for the delegation of decision-making powers is based on a number of legal acts, which were published in the Official Journal of the European Union on 1 June 2017.\(^7^7\)

The general framework for delegation\(^7^8\) establishes the possibility of delegating decision-making powers which are related to supervisory tasks. The decision on the general framework, which was adopted by the Governing Council upon a proposal by the Executive Board, lays down the institutional aspects, namely the scope of responsibilities attributed to the ECB heads of work units, the procedural requirements for the adoption of delegated decisions and the reporting requirements for delegated decisions. In addition, delegation decisions are adopted by the Governing Council under the non-objection procedure, setting out the specific criteria that need to be met for each type of delegated supervisory decision. These delegation decisions are complemented by decisions issued by the ECB’s Executive Board, nominating the ECB heads of work units to whom delegated decision-making powers are granted (see Figure 7).

The new delegation framework has been applied to two types of supervisory decisions:

- assessment of fit and proper requirements\(^7^9\);
- amendments to the significance of supervised entities\(^8^0\).

The decisions nominating the ECB heads of work units to whom delegated decision-making powers are granted were approved by the Executive Board\(^8^1\), and delegated decision-making has been in force since 21 June 2017.

\(^7^7\) See OJ L 141, 1 June 2017.
\(^7^8\) General framework for delegating decision-making powers for legal instruments related to supervisory tasks, Decision ECB/2016/40.
\(^7^9\) Decision on the delegation of the power to adopt fit and proper decisions and the assessment of fit and proper requirements, Decision ECB/2016/42.
\(^8^0\) Decision on the delegation of decisions on the significance of supervised entities, Decision ECB/2016/41.
\(^8^1\) Decisions nominating heads of work units to adopt delegated fit and proper decisions Decision ECB/2017/16, and heads of work units to adopt delegated decisions on the significance of supervised entities Decision ECB/2017/17.
Implementation of the delegation framework

For fit and proper decisions, the decision as to whether the delegation process can be activated essentially depends on four criteria:

1. the size and nature of the supervised entity;
2. the anticipated outcome of the decision;
3. a set of specific aspects of the fit and proper assessment (such as reputational issues or administrative actions related to non-compliance with financial services regulations);
4. the timely submission of the proposal by the relevant NCA.

For all fit and proper decisions (whether delegated or not) the assessment itself is conducted on the basis of criteria which stem from the national laws that transpose CRD IV; the fit and proper assessment also takes into account the ECB’s Guide to fit and proper assessments. Between June and December 2017, 51% of the ECB’s fit and proper decisions were adopted by means of delegation (see Chart 10).

For amendments to the significance of supervised entities, the delegation framework makes the regular updating of the list of supervised entities (i.e. those institutions which are directly supervised by the ECB) more efficient. The vast majority of these decisions merely reflect changes within the corporate structure of a banking group; however, keeping an accurate overview of the institutions directly supervised by the ECB is necessary for legal certainty and transparency. The delegated decisions may
therefore amend or repeal an ECB decision that classified a supervised entity or a supervised group as significant, covering most changes within the group structure and the change in classification of a supervised entity or group from significant to less significant (the reverse move from less significant to significant cannot be decided by delegation). Between June and December 2017, 52% of the ECB’s significance decisions were adopted by means of delegation (see Chart 10).

Chart 10
Adoption under the delegated and non-delegated decision-making processes

<table>
<thead>
<tr>
<th></th>
<th>Delegated</th>
<th>Non-delegated</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fit and proper decisions</td>
<td>51%</td>
<td>49%</td>
</tr>
<tr>
<td>Significance decisions</td>
<td>52%</td>
<td>48%</td>
</tr>
</tbody>
</table>

Source: ECB.

The delegation framework has been implemented smoothly and led to an adequate balance between the decisions that are delegated and those that are submitted to the Supervisory Board and Governing Council. This “dual track” decision-making process, with delegated and non-delegated decisions, enables a more efficient use of resources, as well as simpler and swifter processes.

There are plans to extend the delegation framework to other types of supervisory decisions in 2018.

5.3.3 Administrative Board of Review

In 2017 four requests for an administrative review of ECB supervisory decisions were filed with the Administrative Board of Review82 (see Table 6).

82 The Administrative Board of Review is composed of five members: Jean-Paul Redouin (Chair), Concetta Brescia Morra (Vice-Chair), Javier Aristegui Yañez, André Camilleri and Edgar Meister; and two alternates: René Smits and Ivan Šramko.
Table 6

Number of requests for review

<table>
<thead>
<tr>
<th></th>
<th>2017</th>
<th>2016</th>
<th>2015</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>ECB decision confirmed</td>
<td>4</td>
<td>1</td>
<td>2</td>
<td>2</td>
</tr>
<tr>
<td>ECB decision amended/reasoning improved</td>
<td>-</td>
<td>2</td>
<td>4</td>
<td>1</td>
</tr>
<tr>
<td>Request inadmissible</td>
<td>-</td>
<td>3</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Request withdrawn</td>
<td>-</td>
<td>1</td>
<td>2</td>
<td>1</td>
</tr>
<tr>
<td>Opinions pending</td>
<td>1</td>
<td>1</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>5</td>
<td>8</td>
<td>8</td>
<td>4</td>
</tr>
</tbody>
</table>

Source: ECB.

1) The Board adopted four opinions, including one on a request for review received in December 2016. One opinion on a request for review submitted in December 2017 is pending.

In most cases in 2017, applicants chose not to proceed with a judicial review following the review by the Administrative Board. The Board therefore continued to be effective in helping to reduce the cost and time of reviewing supervisory decisions for all parties involved. This “procedural economy” was one of the main reasons identified by the EU legislators for establishing the Board\(^83\). The review process, notably the hearing, increases the opportunities for dialogue with the supervised entity.

Topics under review and issues of relevance

The cases reviewed by the Administrative Board of Review touched upon several topics and types of supervisory decisions: corporate governance, compliance with supervisory requirements, withdrawal of a licence and administrative sanctions.

As in previous years, the review of ECB decisions in 2017 mainly concerned issues related to compliance with procedural rules (e.g. including due process requirements, accurate statement of the facts, sufficient grounds in the statement of reasons and compliance with the proportionality principle), and to cooperation between the ECB and NCAs in preparing ECB decisions. In particular, the Administrative Board considered that the more intrusive the measures imposed, the greater the level of reasoning that is called for.

The role of the Administrative Board of Review in the ECB’s decision-making process

In its judgements in Landeskreditbank Baden-Württemberg – Förderbank v ECB and Crédit mutuel Arkéa v ECB\(^84\), the General Court of the European Union highlighted the role of the Administrative Board as part of the ECB’s decision-making process.

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\(^83\) Recital 64 of the SSM Regulation.

In its report on the Single Supervisory Mechanism pursuant to Article 32 of the SSM Regulation\textsuperscript{85}, the European Commission noted that the Administrative Board had been actively used by those concerned and that, in the ECB’s view, its opinions had influenced the ECB’s supervisory practice beyond the individual cases to which they related.

5.4 ECB Banking Supervision staffing

As ECB Banking Supervision has become established and its tasks have evolved, it has become clear that more resources are required for a number of key tasks than initially anticipated.

Following a staggered approach to the headcount increase in 2016 and 2017, the Governing Council approved an additional 113.5 new FTEs (full-time equivalent positions) for core ECB Banking Supervision business areas for 2017, reaching a total of 1,028.5 FTEs. The newly approved headcount took into account three aspects:

1. the new staffing needs triggered by the increase in the number of tasks since 2014 (e.g. the establishment of the new EU crisis management framework);

2. the need to allow NCAs time to meet their commitments regarding the staffing of JSTs;

3. the resource gains identified by the ECB (e.g. synergies in the supervision of host entities belonging to the same non-SSM group).

The approved headcount for 2017 also covered staffing needs for SSM-related tasks in shared services (e.g. administration, human resources, finance, communications, legal services), bringing the total headcount for those services to 422.5 FTEs.

In 2017, 33 recruitment campaigns were successfully carried out to fill the vacant headcount positions. In line with the ECB’s standard recruitment procedure, all candidates had to demonstrate not only the required technical competencies, but also behavioural competencies and leadership skills, as applicable.

In terms of gender diversity, the percentage of female staff increased slightly, reaching 40% of all permanent and fixed-term staff in core ECB Banking Supervision business areas in 2017. The share of female staff in managerial positions did not change compared with the previous year (32%). In non-managerial positions, the share of female staff increased by 2 percentage points from the previous year, reaching 42% in 2017.

Brexit is expected to lead to a permanent increase of significant institutions directly supervised by the ECB, as several banking groups plan to relocate to the euro area. In order to cope with the expected additional workload, the Governing Council

\textsuperscript{85} COM(2017) 591 final.
approved a headcount increase of 70.5 FTEs for the core ECB Banking Supervision business areas for 2018. It also endorsed additional resources for 2019 and 2020, which will be revisited in line with actual developments. The Governing Council has taken a staggered approach to the headcount increase in the period 2018-20. The aim is to calibrate the estimated needs based on how the actual workload increases and what opportunities for internal reprioritisation open up after mid-2018.

Chart 11
Breakdown of approved headcount positions (FTEs) for core ECB Banking Supervision areas for the period 2014-18

As the tasks develop and the organisation of the SSM evolves, it is vital that people management across the institution develops as well. In 2017 the SSM training curriculum and the SSM traineeship programme were further enhanced to foster greater collaboration with the NCAs. Moreover, a JST rotation policy was developed, and organisational changes were agreed on.

Reorganisation of core ECB Banking Supervision areas

In order to rebalance the size of ECB Banking Supervision business areas and align the structure with best practices and good governance, organisational changes were agreed on at the end of 2017: the Authorisation, Enforcement & Sanctions and Supervisory Quality Assurance Divisions were to move from DG Microprudential Supervision IV to the Secretariat to the Supervisory Board. This reorganisation, implemented in February 2018, will foster a clearer division of responsibilities and enhance corporate governance by separating quality assurance and internal control and audits from the horizontal core prudential functions.
SSM training curriculum

It is important for the effectiveness of European banking supervision that staff at both the ECB and NCAs are equipped with the necessary skills and can develop their competencies over time. Creating a common approach to training for SSM supervisors has contributed to a consistent approach to supervision and a common supervisory culture. The approach has also made it possible to take advantage of economies of scale and leverage expertise within the SSM.

Since the launch of the SSM training curriculum in September 2016, 83 system-wide courses have been offered, corresponding to 269 training sessions. About 41% of those sessions were organised by NCAs, in line with the initial overarching objective of setting up a centralised design with system-wide implementation. 2,800 participants attended the system-wide courses between September 2016 and September 2017. Around half of them came from NCAs (48%) and half from the ECB (52%). For 2018, the catalogue of training on offer has been refined to include dedicated courses for staff involved in on-site inspections. In addition, courses will be broadened to encompass a wider range of training tools, such as e-learning and video-based learning.

SSM traineeship programme

The SSM traineeship programme was implemented in 2016 as a unique opportunity for young graduates to gain first-hand experience of banking supervision at the ECB and in one or two NCAs. The programme has helped to cultivate a joint supervisory culture and build up a pool of talent for the entire SSM; upon completion of their traineeships, a number of participants have been employed by the ECB and NCAs.

Based on the feedback received from the first cohort of trainees and from JST coordinators, the programme was slightly adapted to offer the participants more technical training. The second cohort of SSM trainees started in October 2017 and comprises 31 participants.

SSM rotation

European banking supervision has a rotation policy for the ECB staff of JSTs in order to prevent “supervisory capture” and maintain high supervisory standards. Rotation is also seen as an element of career development and an opportunity for staff to expand their supervisory expertise. In 2016 and 2017 more than 20 JST coordinators took up responsibility for new JSTs. Taking into account the overall positive feedback from that experience, the SSM-JST rotation framework for all JST members was put in place in 2017. Rotation is now an annual exercise affecting staff members who have been in the same JST for three to five years. The first fully-fledged round was implemented on 1 January 2018 with 53 staff members moving to a different JST.
Preparation of “Supervisors Connect”

“Supervisors Connect” is an event organised by ECB Banking Supervision for the staff of NCAs, NCBs and the ECB. The first edition will take place at the ECB’s headquarters in Frankfurt am Main from 17 to 19 April 2018.

The event aims to further shape a European supervisory culture by bringing together supervisors from across the euro area every other year. It will be dedicated in particular to those supervisors from NCAs who, although heavily involved in SSM-related work, come to Frankfurt only occasionally. The following categories of staff have been identified as the main target audience: JST coordinators and sub-coordinators; members of the senior management network responsible for LSI supervision; chairs and senior members of horizontal networks; expert-level staff responsible for preparing meetings of the Supervisory Board (i.e. SSM coordinators).

It is expected that out of the 350 participants, 75% will be from NCAs/NCBs and 25% from the ECB.

To shape the programme of the event, in May 2017 the ECB appointed a steering group comprising representatives from five supervisory business areas and the Directorate General Communications.

“Supervisors Connect” will be the “property” of its audience. Hence, many participants will also be speakers and moderators in panel discussions covering relevant topics, such as digitalisation and cyber risk, the impact of Brexit, and profitability challenges for banks.

5.5 Implementation of the Code of Conduct

Under Article 19(3) of the SSM Regulation, the ECB is required to have in place a Code of Conduct that governs ECB staff and management involved in banking supervision and addresses any concerns regarding conflicts of interest. The relevant provisions are contained in the ECB’s Ethics Framework, which is implemented by the Compliance and Governance Office (CGO). The CGO advises all ECB staff on ethical issues.

To further raise staff members’ awareness of professional ethics and integrity matters and with a view to building a strong culture of ethics, workshops and a mandatory e-learning programme were introduced in 2017. The programme was successfully completed by all staff members working in banking supervision during the first quarter of 2017.

In the course of 2017, the CGO received more than 2,000 requests from ECB staff members on a wide range of topics. One-third of these requests were submitted by ECB Banking Supervision staff. Almost half of the requests concerned private financial transactions, followed by requests on conflicts of interest and post-employment restrictions (see Chart 12). These requests indicate increased awareness among ECB staff members regarding ethical questions. The CGO
identified a limited number of instances of non-compliance, one-third of which related to the staff and management of ECB Banking Supervision. None of those instances involved intentional misconduct or other serious non-compliance.

**Chart 12**
Overview of requests from ECB Banking Supervision staff received during 2017

Of those members of staff and management involved in banking supervision who resigned from their posts in 2017, three cases triggered a cooling-off period in line with the Ethics Framework. Two of these cases concerned SSM managers who performed horizontal functions and moved to financial corporations. This resulted in cooling-off periods of three months each. The third case concerned a manager who moved to a financial corporation for the supervision of which he was not responsible/involved. The SSM manager in question effectively observed a cooling-off period of six months.

With a view to achieving an adequate corporate and ethics culture across the SSM, the ECB verified the measures taken by the NCAs to comply with the ECB’s Guideline. This Guideline sets out the common principles of an ethics framework for both the ECB and NCAs, and, with very few exceptions, it has been fully implemented. To facilitate aligned implementation of the Guideline and to achieve, over the medium term, a convergence of ethics standards at an even higher level, the Governing Council has established a dedicated Ethics and Compliance Officers Task Force.

The ECB’s Ethics Committee advises members of the ECB’s decision-making bodies on ethical questions. In 2017, it issued 11 SSM-related opinions, the majority of which related to members engaging in occupational activities in public or international organisations and non-financial corporations following their terms of office. In two cases, the Ethics Committee advised on the cooling-off periods applying to former alternate members of the ECB’s Supervisory Board who moved to credit institutions, and in one case on the cooling-off period applicable to a Supervisory Board member who took up employment with a non-bank financial corporation. The Ethics Committee also assessed a new external activity undertaken in a personal capacity by one of the members of the Supervisory Board.
5.6 Application of the principle of separation between monetary policy and supervisory tasks

The SSM Regulation requires the ECB to carry out its supervisory tasks without prejudice to and separately from its tasks relating to monetary policy.

5.6.1 Application to exchanges of information and decision-making

In the course of 2017, the application of the principle of separation between monetary policy and supervisory tasks mainly related to the exchange of information between different policy areas. In line with Decision ECB/2014/39 on the implementation of separation between the monetary policy and supervision functions of the ECB, this exchange of information was subject to a need-to-know requirement: each policy area had to demonstrate that the information requested was necessary to achieve its policy goals. In most cases, access to confidential information was granted directly by the ECB policy function that owned the information. This was done in line with Decision ECB/2014/39, which allows access to information pertaining to anonymised data or non-policy sensitive information to be granted by the policy functions directly; intervention by the Executive Board to solve possible conflicts of interest was not necessary. Under Decision ECB/2014/39, the involvement of the Executive Board was nonetheless required in a few instances to allow the exchange of non-anonymised information relating to individual banks (e.g. individual FINREP or COREP templates, or other raw data) or policy-sensitive assessments. Access to the data was granted on a need-to-know basis after a business case assessment, and for a limited period of time, to ensure that the need-to-know requirement was fulfilled at all relevant points in time.

Separation at the decision-making level did not raise concerns, and no intervention by the Mediation Panel was required.

5.6.2 Recourse to shared services

The concept of "shared services" is important for the functioning of the SSM. Under this concept, certain ECB departments have been designated to provide support to both the monetary and supervisory functions. Shared services were established in the interest of delivering services efficiently and effectively. The aim was to ensure that efforts were not duplicated in areas where shared support, being technical in nature, did not lead to conflicts of interest between the ECB’s two policy areas. While it is a long-term solution adopted in order to minimise duplication of work, the shared

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86 Decision ECB/2014/39 also contains provisions relating to organisational aspects.
87 FINREP (FINancial REPoring) and COREP (COmmon REPoring) form part of the EBA’s Implementing Technical Standards (ITS). FINREP deals with the collection of financial information from banking institutions; it represents a standardised format of their annual accounts (balance sheet, profit and loss and detailed annexes). COREP deals with the collection, also in a standardised format, of information relative to the Pillar 1 calculation, i.e. details on own funds, deductions and capital requirements (credit, market and operational risk) as well as large exposures.
services concept enabled the ECB to resource the supervisory function more quickly and keep costs down, in particular during the set-up phase. It also helped to make use of the experience existing within the ECB on macroeconomic and financial stability issues and reduce double work in gathering information and performing administrative tasks. This aspect is also reflected in Recital 14 of Decision ECB/2014/39, according to which “[…] effective separation between the monetary policy and supervisory functions should not prevent the reaping, wherever possible and desirable, of all the benefits to be expected as a result of combining these two policy functions in the same institution […].”

In 2017 the ECB assessed the activities of ECB business areas and further clarified the definition of shared services. The aim was to further improve the implementation of the shared services concept, based on experience gathered since 2014, and to address a recommendation of the European Court of Auditors about the potential risks of using shared services.

The business areas designated as “shared services” are those that:

1. perform enabling functions to the benefit of both the central banking and banking supervision functions;

2. perform core functions that are to the benefit of both the supervisory and central banking functions, provided that these functions constitute support services and no conflicts of interest are thereby caused.

By applying this definition, and taking into account the ECB’s organisational set-up, the organisational units that are considered to be shared services are: Internal Audit, Administration, Communications, Finance, Human Resources, Information Systems, Secretariat, Organisational Effectiveness, Operational Risk and Business Continuity Management, Legal Services and Statistics.

The assessment of potential risks deriving from the use of shared services confirmed that the measures that have been taken satisfactorily minimise the potential risks identified.

Regarding the theoretical risk that using shared services could cause conflicts of interest which could impair the ECB’s policymaking, it has been ensured that the vast majority of business areas providing shared services either do not possess relevant information, or do not have the opportunity – as part of their normal business activities – to influence any policy decision-making. In the remaining business areas, a separation principle has been implemented.

The risk of the imbalanced treatment of requests (e.g. related to recruitment, translation, IT) due to inappropriate prioritisation of requests from either the central banking or the banking supervision function is controlled in all shared services business areas by various measures. These measures include regular demand collection and planning exercises, a possibility to resort to external providers in cases where resources are tight or a specific forum to facilitate dialogue between customers and service providers.
Furthermore, an ECB-wide strategic planning approach covering all business areas was introduced in 2016, establishing a formal process to take into account the financial and headcount needs of the various business areas. The outcome has been reflected in the ECB budget, where the expenditure for the supervisory tasks is separately identifiable and on which the Chair and Vice-Chair of the Supervisory Board are consulted prior to its approval.

Box 4
The challenges of multilingual communication in European banking supervision

The ECB has made a commitment to be understood by and accessible to all relevant stakeholders across the euro area and EU. To this end, it makes all necessary and statutory information available in languages other than English. This has been a constant of the ECB’s external communication since 1998. Since the ECB took over European banking supervision in 2014, this commitment has taken on a new dimension, notably in communication between the ECB and the supervised entities.

Under the SSM Regulation, entities under the direct supervision of the ECB are entitled to choose the language of communication with the ECB. Around 40 banks decided to make use of that right and interact with the ECB in languages other than English. Among these languages, German is the language that is selected in most cases, 22 banks having done so. On the ECB’s side, this has led to a significant increase in demand for translation services. In 2017 alone, around 72,500 pages were translated into and out of English for the purposes of supervisory communication.

To manage this increase, the ECB has not only had to increase its workforce in the area of translation services, but also to adapt its business model to ensure that capacity can be flexibly expanded at short notice to absorb the much higher translation demand. A model based on the principle of using shared services for both the supervisory and central banking pillars of the bank has proved much more efficient than a model based on dedicated SSM language services.

Chart A
Demand for the ECB’s language services 2013-17

![Chart A](image)

Source: ECB.

Ensuring high-quality ECB legal acts and court case documents in the field of banking supervision, both in English and in the other relevant SSM languages, is of major importance. All relevant
stakeholders, and in particular EU citizens, can better understand and interpret their rights and obligations when ECB legal documents are clear, consistent and concise in all the relevant official EU languages, and comply with EU legislative drafting and legal translation rules.

The demand for legal editing and legal translation in 2017 in the field of banking supervision reached a total of 23,450 pages on top of non-legal editing and translation, out of which:

- 6,000 pages were SSM legal acts for translation into all official EU languages;
- 5,150 pages were legal documents for editing in English;
- 12,300 pages were legal documents for translation into specific euro area languages.

With regard to individual supervisory decisions and other SSM-related documents, the ECB produced 4,260 pages of legal translation into German, 2,790 pages into French, 2,060 into English and 1,740 into the remaining euro area languages.

5.7 Data reporting framework and information management

5.7.1 Developments in the data reporting framework

In accordance with the SSM Framework Regulation, the ECB is responsible for organising the processes relating to the collection and quality review of data reported by supervised entities. The main objective is to ensure that the SSM uses reliable and accurate supervisory data.

The data flow follows a "sequential approach", in which the ECB maintains close cooperation with NCAs, which are the first recipients of prudential reports from credit institutions and which perform the first quality checks on that data. The ECB also collaborates directly with supervised entities in the case of direct reporting to the ECB.

The sequential approach is currently being enhanced, following two separate time frames: short-term and long-term. Under the short-term approach, NCAs are requested to transmit data to the ECB by the ECB’s deadline, irrespective of whether errors on the validation rules are still pending. This approach aims to ensure that (i) the time lag between the submission of reports by banks and the availability of data to SSM supervisors is shortened, and (ii) the content of NCA/ECB databases are aligned. NCAs have been requested to implement the short-term solution for all data produced as of the second quarter of 2017. Under the long-term approach, the intention is to identify and harmonise best practices in each NCA. The harmonisation

88 Article 140(4) of the SSM Framework Regulation.
89 The “sequential approach” is the framework for the transmission of supervisory data from banks to the NCAs, from the NCAs to the ECB, and from the ECB to the EBA.
of methods for collecting supervisory data from supervised entities and for forwarding this data to the ECB is currently under discussion.

Once received by the ECB, the data reports are forwarded to the SSM Information Management System (IMAS) in order to make the data available to end-users, such as JSTs and the horizontal functions within ECB Banking Supervision. Selected data from a subset of institutions (mainly significant institutions) are also forwarded to the EBA and the SRB upon receipt.

The frequency of data collection ranges from monthly, quarterly and semi-annual to annual; data are available from the reference period of December 2014 (as applicable) onwards.

In the course of 2017 and following the official publication of the underlying legal acts\(^90\), the supervisory dataset has been enriched with data on supervisory benchmarking and funding plans, and changes to the FINREP reporting framework.

The ECB assesses the quality of the supervisory data transmitted under both the Implementing Technical Standards (ITS) published by the EBA and ad hoc Short-Term Exercises (STE). The Data Quality Dashboard per Institution plays a key role in this context. It provides an assessment and summarises, in a user-friendly way, the quality of supervisory data reported by an institution. The Dashboard was improved extensively in the course of 2017, with a view to providing information on key data quality indicators and facilitating the dialogue on data quality issues between supervisors and supervised entities.

In addition to dashboards, the ECB produces regular supervisory datasets, key risk indicators and reports for supervisors. Moreover, aggregated banking data covering significant institutions at the highest level of consolidation are published on the ECB’s banking supervision website each quarter.\(^91\) In 2017, these data were enhanced extensively with additional statistics on the leverage ratio and the liquidity coverage ratio as well as more in-depth breakdowns (e.g. geographical and by bank classification). Every year, the ECB also publishes solvency and leverage indicators at bank level, as disclosed by banks in line with their Pillar 3 requirements.

### 5.7.2 Information management within the SSM – IMAS

In 2017 the Information Management System for the SSM (IMAS) evolved significantly.

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\(^{91}\) See SSM Banking Statistics.
New modules were developed to better support specific SSM processes: for example, SSM internal model investigations and the enforcement and sanction procedures have been incorporated and are now managed within the IMAS system.

In addition, existing modules were enhanced to reflect developments in SSM operations and methodologies, especially in relation to ongoing supervision, on-site inspections, operational planning, the SREP and authorisation procedures.
6 Reporting on budgetary consumption

The SSM Regulation provides that the ECB must be able to dispose of adequate resources to carry out its supervisory tasks effectively. These resources are financed via a supervisory fee borne by the entities subject to the ECB’s supervision.

The expenditure incurred for supervisory tasks is separately identifiable within the ECB’s budget. The budgetary authority of the ECB is vested in its Governing Council. It adopts the ECB’s annual budget following a proposal by the Executive Board in consultation with the Chair and Vice-Chair of the Supervisory Board for matters related to banking supervision. The Governing Council is assisted by the Budget Committee (BUCOM), which consists of members from all the NCBs of the Eurosystem and the ECB. BUCOM assists the Governing Council by providing it with evaluations of the ECB’s reports on budget planning and monitoring. The year-on-year increase in total expenditure incurred for supervisory tasks is primarily explained by the approved increases in the total number of ECB staff working on banking supervision in 2017 and the launch of the large-scale multi-annual targeted review of internal models.

The ECB anticipates managed expenditure growth in 2018 primarily for the direct supervision of significant institutions. While budgeted expenditure for regular tasks has stabilised, there continue to be external factors which necessitate an increase in resources for the coming year, as outlined in Chapter 1 on the supervisory priorities for 2018. Most notably this includes the United Kingdom’s withdrawal from the EU and the 2018 biennial supervisory stress tests for significant institutions. As a result, as explained in more detail in Section 5.4, the Governing Council took a decision in September 2017 to further increase the number of ECB staff working in banking supervision as of 2018.

6.1 Expenditure for 2017

The expenditure incurred by the ECB for the conduct of supervisory-related tasks primarily consists of the direct expenses of the ECB Banking Supervision Directorate General and the Secretariat to the Supervisory Board. The supervisory function also relies on shared services provided by the ECB’s existing business areas (see Section 5.6.2).

In April 2017 the Governing Council adopted the ECB decision on the amount to be recovered via supervisory fees in 2017. This decision set the estimate for annual expenditure for banking supervisory tasks at €464.7 million. At the end of 2017, the ECB’s expenditure for supervisory tasks stood at €436.7 million. This was 6% less than estimated in 2017.

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92 In accordance with Article 29 of the SSM Regulation.
than estimated, resulting in a surplus of €27.9 million, compared with the expenditure estimated for 2017. In accordance with the applicable ECB Regulation on supervisory fees (“the Fees Regulation”), this surplus will be offset in full against the total amount to be levied in 2018. 94

Table 7
Breakdown of expenditure for ECB Banking Supervision (2015-17)

<table>
<thead>
<tr>
<th>Description</th>
<th>Actual expenditure 2017</th>
<th>Estimated expenditure 2017</th>
<th>Actual expenditure 2016</th>
<th>Actual expenditure 2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Salaries and benefits</td>
<td>215.0</td>
<td>208.6</td>
<td>180.6</td>
<td>141.3</td>
</tr>
<tr>
<td>Rent and building maintenance</td>
<td>53.0</td>
<td>55.0</td>
<td>58.1</td>
<td>25.5</td>
</tr>
<tr>
<td>Other operating expenditure</td>
<td>168.8</td>
<td>201.1</td>
<td>143.4</td>
<td>110.3</td>
</tr>
<tr>
<td>Expenses related to banking supervision tasks relevant for supervisory fees</td>
<td>436.7</td>
<td>464.7</td>
<td>382.2</td>
<td>277.1</td>
</tr>
</tbody>
</table>

Source: ECB.
Note: Totals and subtotals may not add up owing to rounding.

Salaries and benefits

Salaries and benefits comprise all salary-related expenditure, including overtime, allowances and costs in relation to post-employment benefits and other long-term benefits, for supervisory staff and staff of the shared services.

The actual expenditure for 2017 salaries and benefits was €215.0 million, representing 103% consumption of total planned expenditure for banking supervisory tasks. The overspend in this category is attributable to the inclusion of €12 million for staff post-employment benefits such as retirement benefits and other long-term benefits (e.g. disability). These benefits have been valued using the International Accounting Standard IAS 19 “Employee Benefits”. The accounting standard establishes the principle that the cost of providing employee benefits should be recognised in the period in which the benefit is earned by the employee, rather than when it is paid or payable.

Rent and building maintenance

At the end of the financial year, the actual expenditure on rent and building maintenance including depreciation of premises-related assets stood at €53.0 million. The costs for 2017 are consistent with the costs estimated in the ECB decision on the amount to be recovered via supervisory fees in 2017.

Other operating expenditure

The category “other operating expenditure” includes costs such as consultancy, IT services, statistical services, depreciation for fixed assets (other than premises-related), business travel and training.

Overall, the budgetary performance in this category stands at €168.8 million. The underspend for the most part results from an overestimation of the budgetary needs for activities such as business travel and training as well as lower than planned expenditure on consultancy services.

The largest single activity generating cost in this category is the multi-annual TRIM project. In 2017 the cost of the related external support amounted to €45.1 million, an underspending of €10.9 million on the initial budgetary estimate. The project is expected to be completed in 2019. More detailed information on the TRIM project can be found in Section 1.5.

In addition to the TRIM project, other operating expenditure in 2017 incorporated the external support that was utilised for the conduct of “regular” on-site supervision tasks, preparation for the impact of changes to IFRS 9 (Financial Instruments) and preparation for Brexit, all of which are explained in Chapters 1 and 3.

Expenditure in 2017 by supervisory tasks

The ECB groups its costs according to two approaches: (i) “for what”, which is shown by the above expenditure categories of salaries and benefits, rent and building services and other operating expenditure, and (ii) “what for”, which is a classification based on task-based functions. The ECB also uses these classifications to identify the split of the annual costs to be recovered via annual supervisory fees from supervised entities based on their supervisory status as significant or less significant.

For the ECB’s supervisory tasks, the principal activity-based groupings are:

- direct supervision of significant banks or banking groups;
- oversight of the supervision (indirect supervision) of less significant banks or banking groups;
- performance of horizontal tasks and specialised services.

The classification is determined on the basis of the costs incurred by the business areas of the ECB that are responsible for the respective supervisory tasks. The cost category “direct supervision of significant banks or banking groups” is mostly composed of the costs of JSTs and on-site inspections. It also includes the costs associated with the TRIM project. The oversight of the supervision of less significant banks or banking groups encompasses oversight activities and authorisation tasks. Horizontal tasks and specialised services comprise activities such as the work of the Secretariat to the Supervisory Board, macroprudential tasks, supervisory policymaking, statistical services and dedicated legal services.
The methodology defined in Article 8 of the Fees Regulation for the split of annual supervisory fees provides that the costs associated with horizontal tasks and specialised services are allocated proportionally based on the full cost of the supervision of significant supervised banks and those overseeing the supervision of less significant supervised banks, respectively.

For each grouping, the costs reported below include the allocation of shared services provided by the ECB’s support business areas.

<table>
<thead>
<tr>
<th>Table 8</th>
<th>Cost of the ECB’s supervisory tasks by function (2015-17)</th>
</tr>
</thead>
<tbody>
<tr>
<td>($ millions)</td>
<td>Actual expenditure 2017</td>
</tr>
<tr>
<td>Direct supervision of significant banks</td>
<td>242.9</td>
</tr>
<tr>
<td>Oversight of less significant banks</td>
<td>24.0</td>
</tr>
<tr>
<td>Horizontal tasks and specialised services</td>
<td>169.8</td>
</tr>
<tr>
<td>Total expenses related to banking supervision tasks relevant for supervisory fees</td>
<td>436.7</td>
</tr>
</tbody>
</table>

Source: ECB.  
Note: Totals and subtotals may not add up owing to rounding.

6.2 Feeing framework 2017

Together with the SSM Regulation, the Fees Regulation provides the legal framework within which the ECB levies an annual supervisory fee for the expenditure it incurs in conducting its supervisory tasks. The Fees Regulation establishes the methods for:

1. determining the total amount of the annual supervisory fee;
2. calculating the amount to be paid by each supervised institution;
3. collecting the annual supervisory fee.

Update on the review of the ECB’s supervisory fee framework

In 2017 the ECB initiated a review of its supervisory fee framework. This review focuses on the methodology and criteria for calculating the annual supervisory fee to be levied on each supervised entity and group. This concerns, in particular, the provisions of the Fees Regulation which are relevant for defining the methodology by which the annual supervisory fee is calculated, allocated and levied, namely Part III (Determining the annual supervisory fee) and Part V (Invoicing) of the Fees Regulation. The recovery of expenditure incurred by the ECB for the conduct of its supervisory-related tasks is provided for in Article 30 of the SSM Regulation and hence does not fall within the scope of the review.
The ECB conducted a public consultation regarding the review of the supervisory fee framework from 2 June to 20 July 2017. In total, 13 responses were received, mainly from banking associations. This compares with 31 responses received in 2014 when the framework was established. The NCAs were consulted via the Supervisory Board.

The outcome of the review has not yet been finalised, but a preliminary assessment of the comments indicates that the core provisions and principles of the framework are well accepted. The majority of respondents requested additional clarifications on certain elements of the framework and/or process-related improvements such as a more streamlined statistical data (fee factor) collection procedure. Where possible, in the course of 2017 the ECB implemented “quick wins” based on the comments received, such as content-related improvements to its website.

The outcome of the review will be published on the ECB’s banking supervision website in the second half of 2018.

### Total amount levied

In 2017, the ECB levied a total amount of €425.0 million in fees for the expenditure it incurred by conducting its supervisory tasks. This is based on the expected expenditure for the full year, amounting to €464.7 million, adjusted for: (i) the surplus of €41.1 million carried forward from the 2016 fee period, and (ii) €1.4 million reimbursed to individual banks for previous fee periods.

The amount to be recovered via annual supervisory fees is split into two parts. This split is related to the status of supervised entities as either significant or less significant, reflecting the varying degrees of supervisory scrutiny by the ECB.

#### Table 9

<table>
<thead>
<tr>
<th>Total income from banking supervision tasks</th>
<th>Actual income 2017</th>
<th>Estimated income for banking supervision tasks 2017</th>
<th>Actual income 2016</th>
<th>Actual income 2015</th>
<th>Actual income 2014</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Supervisory fees</strong></td>
<td>436.7</td>
<td>464.7</td>
<td>382.2</td>
<td>277.1</td>
<td>30.0</td>
</tr>
<tr>
<td>of which:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>fees on significant entities or significant groups</td>
<td>397.5</td>
<td>427.7</td>
<td>338.4</td>
<td>245.6</td>
<td>25.6</td>
</tr>
<tr>
<td>fees on less significant entities or less significant groups</td>
<td>39.3</td>
<td>37.0</td>
<td>43.7</td>
<td>31.5</td>
<td>4.4</td>
</tr>
<tr>
<td>Other</td>
<td>15.3</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td></td>
</tr>
<tr>
<td><strong>Total income from banking supervision tasks</strong></td>
<td>452.0</td>
<td>464.7</td>
<td>382.2</td>
<td>277.1</td>
<td>30.0</td>
</tr>
</tbody>
</table>

Source: ECB.

As explained in Section 6.1, there is a net surplus of €27.9 million between the actual expenditure incurred for banking supervisory tasks in 2017 and the amount levied in the same year. The split of expenditure between the categories of significant banks
and less significant banks is performed on the basis of the proportion of costs incurred for the relevant functions in 2017. As the actual costs for the direct supervision of significant banks are lower than planned, there is a rebalancing of the distribution of expenditure for horizontal tasks towards the category of less significant banks. The decision in April 2017 estimated a split of 92% for significant supervised banks and 8% for less significant supervised banks. The actual ratio based on actual expenditure is a split of 91% for significant supervised banks and 9% for less significant supervised banks. This means that there is a deficit in the total amount that was levied on less significant banks for 2017, i.e. the less significant banks will need to pay €2.3 million extra with the 2018 fee. Notwithstanding this adjustment, the fee for less significant banks was lower in 2017 than what they were charged in 2016, i.e. €39.3 million as compared with €43.7 million.

Individual supervisory fees

At bank level, the fees are calculated according to a bank’s importance and risk profile, using annual fee factors supplied by all supervised banks with a reference date of 31 December of the preceding year. The supervisory fee calculated per bank is then charged via annual payments due in the final quarter of each financial year.

In response to comments received via the public consultation on the supervisory fee framework, the supervisory fees webpages were enhanced in October 2017 (to coincide with the issuance of the annual fee notices) with an improved “estimate your fee” section. By using the additional data provided and following the examples given, supervised banks and banking groups can better estimate their own supervisory fees.

The supervisory fee is set at the highest level of consolidation within Member States participating in the SSM. It contains a variable fee component and a minimum fee component. The latter applies equally to all banks and is based on 10% of the total amount to be recovered.  

95 For the smallest significant banks, with total assets below €10 billion, the minimum fee component is halved.
Article 7 of the Fees Regulation provides that the following changes in the situation of an individual bank require an amendment of the corresponding supervisory fee: (i) a change in the supervisory status of the supervised entity, i.e. the entity is reclassified from significant to less significant or vice versa; (ii) a new supervised entity is authorised; or (iii) an existing authorisation is withdrawn. Changes related to previous fee periods which resulted in new supervisory fee decisions by the ECB until April 2017, i.e. when the decision on the total amount of fees to be levied in 2017 was taken, added up to €1.4 million. That amount was reimbursed in early 2017 and taken into account in the total amount to be levied as approved in April 2017. Thereafter, additional amendments to individual supervisory fees levied were identified, resulting in a further net refund of €0.3 million. This amount will be taken into account in the total amount to be levied on supervised entities in 2018.

More information on supervisory fees is available on the ECB’s banking supervision website. The relevant pages are updated regularly with useful, practical information and are published in all official EU languages.

Other income related to banking supervisory tasks

The ECB is entitled to impose administrative penalties on supervised entities for failure to comply with obligations under EU banking prudential regulation (including ECB supervisory decisions). The related income is not considered in the calculation of the annual supervisory fees. The ECB Fees Regulation ensures that neither damages payable to third parties nor administrative penalties (sanctions) payable to the ECB by supervised entities have any influence on the supervisory fee. The administrative penalties on supervised entities are recorded as income in the ECB’s profit and loss account.

In 2017, the ECB adopted three sanction decisions imposing five penalties for an overall amount of €15.3 million. Of this amount, €11.2 million is considered uncertain to be collected as the banking licence of the entity that the penalty has been imposed upon has been withdrawn and the entity is currently in liquidation. Following

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**Figure 8**

The variable fee component is determined by a bank’s importance and its risk profile

| Bank’s importance measured via total assets (TA) | Supervisory fee calculated at highest level of consolidation within participating Member States |
| Bank’s risk profile measured via total risk exposure (TRE) | importance and risk profile are equally weighted when calculating the fee |

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the prudence principle, an allowance for the full amount of this claim was created at year-end.

Detailed information on the Enforcement and Sanctions activities can be found in Section 4.2 of this report.
7 Legal instruments adopted by the ECB

The following table lists the legal instruments concerning banking supervision that were adopted in 2017 by the ECB and published in the Official Journal of the European Union and/or on the ECB’s website. It covers legal instruments adopted pursuant to Article 4(3) of Regulation (EU) No 1024/2013 and other relevant legal instruments.

7.1 ECB regulations

**ECB/2017/25**

**ECB/2017/26**

7.2 ECB legal instruments other than regulations

**ECB/2017/6**

**ECB/2017/9**

**ECB/2017/10**
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 (OJ C 120, 13.4.2017, p. 2)

**ECB/2017/11**
ECB/2016/40

ECB/2016/41

ECB/2016/42
Decision (EU) 2017/935 of the European Central Bank of 16 November 2016 on delegation of the power to adopt fit and proper decisions and the assessment of fit and proper requirements (OJ L 141, 1.6.2017, p. 21)

ECB/2017/16

ECB/2017/17
Decision (EU) 2017/937 of the European Central Bank of 23 May 2017 nominating heads of work units to adopt delegated decisions on the significance of supervised entities (OJ L 141, 1.6.2017, p. 28)

ECB/2017/21

ECB/2017/23
The European banking sector in figures

Since December 2016, the ECB has published aggregate data on the balance sheet composition, profitability, solvency and credit risk of significant institutions on its banking supervision website. The scope of the published data was expanded in 2017 to include information on leverage and liquidity coverage ratios. These supervisory banking statistics are disclosed on a quarterly basis and include geographical breakdowns and breakdowns according to bank classification.

Some important statistics relevant to the period under review are presented below. It should be noted that the sample of banks used in the various reference periods differs, as the list of significant institutions has changed.

A trend towards higher capital ratios in the latest reporting periods can be observed at the highest level of consolidation (see Table 10). The total capital ratio stood at 17.98% in the third quarter of 2017, up from 17.18% one year earlier. Similar increases can be observed for the CET1 and Tier 1 ratios. The leverage ratio has marginally improved, under both the transitional and fully phased-in definitions. The liquidity coverage ratio stood at 140.27% in the third quarter of 2017, up from 137.64% one year before.

Table 10
Total capital ratio and its components, leverage ratio and liquidity coverage ratio, by reference period

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Q3 2016</th>
<th>Q4 2016</th>
<th>Q1 2017</th>
<th>Q2 2017</th>
<th>Q3 2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>CET1 ratio</td>
<td>13.69%</td>
<td>13.77%</td>
<td>13.74%</td>
<td>13.88%</td>
<td>14.32%</td>
</tr>
<tr>
<td>Tier 1 ratio</td>
<td>14.57%</td>
<td>14.71%</td>
<td>14.75%</td>
<td>14.88%</td>
<td>15.32%</td>
</tr>
<tr>
<td>Total capital ratio</td>
<td>17.18%</td>
<td>17.29%</td>
<td>17.44%</td>
<td>17.56%</td>
<td>17.98%</td>
</tr>
<tr>
<td>Leverage ratio (transitional)</td>
<td>5.30%</td>
<td>5.39%</td>
<td>5.29%</td>
<td>5.32%</td>
<td>5.39%</td>
</tr>
<tr>
<td>Leverage ratio (phased-in)</td>
<td>4.99%</td>
<td>5.03%</td>
<td>5.04%</td>
<td>5.08%</td>
<td>5.17%</td>
</tr>
<tr>
<td>Liquidity coverage ratio</td>
<td>137.64%</td>
<td>135.80%</td>
<td>141.67%</td>
<td>142.68%</td>
<td>140.27%</td>
</tr>
</tbody>
</table>

Source: ECB.
Notes: Significant institutions at the highest level of consolidation for which common reporting on capital adequacy (COREP) and financial reporting (FINREP) are available. Specifically, there were 122 significant institutions in the third quarter of 2016, 121 in the fourth quarter of 2016, 118 in the first quarter of 2017, and 114 in the second and third quarters of 2017. The number of entities per reference period reflects changes resulting from amendments to the list of significant institutions following assessments by ECB Banking Supervision, which generally occur on an annual basis, and mergers and acquisitions.

The quality of banks' assets has also improved, as the overall NPL ratio has been steadily decreasing, from 6.49% in the third quarter of 2016 to 5.15% in the third quarter of 2017 (see Chart 13).
Banks’ total assets and liabilities (see Chart 14 and Chart 15) reflect the data for the (changing) sample of entities at specific points in time. Bearing this in mind, by and large, the main balance sheet items have remained stable over time, although the composition of assets shows an increasing trend for the item “cash, cash balances at central banks, other demand deposits” and a decreasing trend for the items “debt securities” and “derivatives”. Moreover, the composition of liabilities shows a decreasing trend in “derivatives” and “debt securities issued”, and a slight increase in “deposits”.

Chart 13
Asset quality: non-performing loans and advances by reference period

Source: ECB.
Notes: sample as in Table 10.

Balance sheet composition remains stable (with sample size changing)

Chart 14
Composition of assets by reference period

Source: ECB.
Notes: sample as in Table 10.
Chart 15
Composition of liabilities and equity by reference period

(€ billions)

Source: ECB.
Notes: sample as in Table 10.
Glossary

Banking union: one of the building blocks for completing Economic and Monetary Union, which consists of an integrated financial framework with a single supervisory mechanism, a single bank resolution mechanism, and a single rulebook, including for harmonised deposit guarantee schemes, which may evolve into a common European deposit insurance scheme.

Basel Committee on Banking Supervision (BCBS): the primary global standard-setter for the prudential regulation of banks and a forum for cooperation on banking supervisory matters. Its mandate is to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability. BCBS members include organisations with direct banking supervisory authority and central banks.

Basel III: a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision as a reaction to the financial crisis of 2008. Basel III builds upon the Basel II rulebook. Its aim is to strengthen the regulation, supervision and risk management of the banking sector. The measures aim to improve the banking sector’s ability to absorb shocks arising from financial and economic stress, improve risk management and governance, and strengthen banks’ transparency and disclosures.

Comprehensive assessment: financial health checks which the ECB is required to carry out prior to assuming direct supervision over a credit institution. Comprehensive assessments help to ensure that the banks are adequately capitalised and can withstand possible financial shocks. The assessment comprises an asset quality review and a stress test.

CRR/CRD IV: Capital Requirements Regulation and Directive: Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms (CRR) and Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (CRD IV). They are often jointly referred to as CRD IV.

European Banking Authority (EBA): an independent EU authority established on 1 January 2011 as part of the European System of Financial Supervision to ensure effective and consistent prudential regulation and supervision across the EU banking sector. Its main task is to contribute to the creation of the European single rulebook in banking, the objective of which is to provide a single set of harmonised prudential rules throughout the EU.
Failing or likely to fail (FOLTF): there are four reasons why a bank can be declared failing or likely to fail: (i) it no longer fulfils the requirements for authorisation by the supervisor; (ii) it has more liabilities than assets; (iii) it is unable to pay its debts as they fall due; (iv) it requires extraordinary financial public support. At the time of declaring a bank failing or likely to fail, one of the above conditions must be met or be likely to be met.

Financial Stability Board (FSB): an international body that promotes international financial stability. It does so by coordinating national financial authorities and international standard-setting bodies as they work towards developing strong regulatory, supervisory and other financial sector policies. It fosters a level playing field by encouraging coherent implementation of these policies across sectors and jurisdictions.

Fit and proper assessment: supervisory authorities assess whether candidates for the management bodies in banks are fit and proper. The ECB takes such fit and proper decisions for directors of the 118 biggest banks in the euro area, whereas fit and proper decisions for less significant institutions are taken by the national supervisors, except in the case of a new bank licence.

Internal model: any risk measurement and management approach applied in the calculation of own funds requirements that is proprietary to a credit institution and requires prior permission by the competent authority in accordance with Part Three of the CRR.

Joint Supervisory Team (JST): a team of supervisors composed of ECB and NCA staff in charge of the supervision of a significant supervised entity or group.

Less significant institution (LSI): any institution that is supervised by NCAs. In contrast, significant institutions are directly supervised by the ECB.

Level 1, 2 and 3 assets: the three asset classes are distinguished based on the inputs used to determine the value of assets. Level 1 assets are traded in active markets, thus inputs such as quoted prices can be used to value them. Level 2 assets are traded in inactive markets, thus inputs other than quoted prices used for level 1 assets are required. These inputs should be directly or indirectly observable. Level 3 assets are traded in markets with either no or very little activity. Thus, there is no observable data available to value them. These assets need to be valued using the best information available about the assumptions market participants would use when pricing such assets.

Maximum distributable amount (MDA): breaches of the combined buffer requirement (CBR) lead to mandatory restrictions on distributions (e.g. dividends, coupon payments on AT1 capital instruments, discretionary bonuses). A bank which fails to meet its CBR will be automatically prohibited from distributing more than the MDA. The MDA is the bank’s distributable profit multiplied by a factor ranging
between 0.6 and 0, depending on by how much CET1 capital falls short of the CBR.

**Minimum requirement for own funds and eligible liabilities (MREL):** requirement for all EU credit institutions, with the aim of enabling credit institutions to absorb losses in case of failure. The MREL was issued by the European Commission in the Bank Recovery and Resolution Directive (BRRD). It has the same goal as the TLAC requirement. However, the specific capital requirements prescribed by the MREL are calculated differently, following criteria set by the EBA.

**National competent authority (NCA):** a public authority or body officially recognised by national law, which is empowered by national law to supervise institutions as part of the supervisory system in operation in the Member State concerned.

**Non-objection procedure:** standard decision-making process established by the SSM Regulation for the ECB’s supervisory activities. The ECB’s Supervisory Board takes draft decisions, which are submitted to the ECB’s Governing Council for adoption. Decisions are deemed to be adopted unless the Governing Council objects within a defined period of time, not exceeding ten working days.

**Non-performing loans (NPLs):** under paragraph 145 of Annex V of the EBA ITS on Supervisory Reporting, these are loans that satisfy either or both of the following criteria: (a) material exposures which are more than 90 days past due; (b) the debtor is assessed as unlikely to pay its credit obligations in full without realisation of collateral, regardless of the existence of any past-due amount or of the number of days past due.

**Options and national discretions (ONDs):** options are provisions in EU law that give competent authorities or Member States a choice on how to comply with the 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.

**Passporting procedures:** procedures concerning the freedom of establishment and the freedom to provide services in other Member States of any credit institution authorised and supervised by the competent authorities of another Member State, provided that such activities are covered by the authorisation (as regulated by Articles 33 to 46 of CRD IV).

**Qualifying holding:** a holding in a credit institution which represents 10% or more of the capital or of the voting rights, or which makes it possible to exercise a significant influence over the management of that credit institution.

**Significant institution (SI):** the criteria for determining whether banks are considered significant – and therefore under the ECB’s direct supervision – are set out in the SSM Regulation and the SSM Framework Regulation. To qualify as
significant, banks must fulfil at least one of these criteria. Notwithstanding the fulfilment of the criteria, the SSM may declare an institution significant to ensure the consistent application of high-quality supervisory standards. Overall, the ECB oversees directly 118 significant banking groups.

**Single Supervisory Mechanism (SSM):** a mechanism composed of the ECB and NCAs in participating Member States for the exercise of the supervisory tasks conferred upon the ECB. The ECB is responsible for the effective and consistent functioning of this mechanism, which forms part of European banking union.

**SSM Framework Regulation:** the regulatory framework setting out the practical arrangements concerning the cooperation between the ECB and the national competent authorities within the Single Supervisory Mechanism, as provided for in the SSM Regulation.

**SSM Regulation:** the legal act creating a single supervisory mechanism for credit institutions in the euro area and, potentially, other EU Member States, as one of the main elements of European banking union. The SSM Regulation confers on the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions.

**Supervisory Review and Evaluation Process (SREP):** the process used to guide the supervisory review of significant and less significant credit institutions and to determine whether (on top of minimum requirements) possible additional requirements should be applied with respect to own funds, disclosure or liquidity, or whether any other supervisory measures should be applied.
### Abbreviations

#### Countries

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Country</th>
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<td>BE</td>
<td>Belgium</td>
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<td>United Kingdom</td>
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<td>US</td>
<td>United States</td>
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</table>

In accordance with EU practice, the EU Member States are listed in this report using the alphabetical order of the country names in the national languages.

#### Others

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>BCBS</td>
<td>Basel Committee on Banking Supervision</td>
</tr>
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<td>BCPs</td>
<td>Basel core principles</td>
</tr>
<tr>
<td>BRM</td>
<td>Breach reporting mechanism</td>
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<td>BU.COM</td>
<td>Budget Committee</td>
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<tr>
<td>CCyB</td>
<td>Countercyclical capital buffers</td>
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<tr>
<td>CFI</td>
<td>Car financing institution</td>
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<tr>
<td>CGO</td>
<td>Compliance and Governance Office</td>
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<tr>
<td>COI</td>
<td>Centralised On-Site Inspections Division</td>
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<td>COREP</td>
<td>Common reporting</td>
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<tr>
<td>EBA</td>
<td>European Banking Authority</td>
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<td>ECA</td>
<td>European Court of Auditors</td>
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<td>ECB</td>
<td>European Central Bank</td>
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<td>ECL</td>
<td>Expected credit loss</td>
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<tr>
<td>ECOFIN</td>
<td>Economic and Financial Affairs Council</td>
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<tr>
<td>ECON</td>
<td>Committee on Economic and Monetary Affairs</td>
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<tr>
<td>EME</td>
<td>Emerging market economy</td>
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<tr>
<td>ESCB</td>
<td>European System of Central Banks</td>
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<tr>
<td>ESMA</td>
<td>European Securities and Markets Authority</td>
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<tr>
<td>ESRB</td>
<td>European Systemic Risk Board</td>
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<td>EU</td>
<td>European Union</td>
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<td>EUR</td>
<td>euro</td>
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<tr>
<td>FINREP</td>
<td>Financial reporting</td>
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<tr>
<td>FMIs</td>
<td>Financial market infrastructures</td>
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<tr>
<td>FOLTf</td>
<td>Failing or likely to fail</td>
</tr>
<tr>
<td>FRTB</td>
<td>Fundamental review of the trading book</td>
</tr>
<tr>
<td>FSAP</td>
<td>Financial Sector Assessment Program</td>
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<tr>
<td>FSB</td>
<td>Financial Stability Board</td>
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<tr>
<td>FTE</td>
<td>Full-time equivalent position</td>
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<tr>
<td>IFRS</td>
<td>International Financial Reporting Standards</td>
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<tr>
<td>IMAS</td>
<td>SSM Information Management System</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>IPS</td>
<td>Institutional protection scheme</td>
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<tr>
<td>IRRBB</td>
<td>Interest rate risk in the banking book</td>
</tr>
<tr>
<td>ITS</td>
<td>Implementing Technical Standards</td>
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<tr>
<td>LR</td>
<td>Leverage ratio</td>
</tr>
<tr>
<td>MEP</td>
<td>Member of the European Parliament</td>
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<tr>
<td>MoU</td>
<td>Memorandum of understanding</td>
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<tr>
<td>MREL</td>
<td>Minimum requirement for own funds and eligible liabilities</td>
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<td>NCB</td>
<td>National central bank</td>
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<td>NPLs</td>
<td>Non-performing loans</td>
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<td>NSFR</td>
<td>Net stable funding ratio</td>
</tr>
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<td>ONDs</td>
<td>Options and national discretions</td>
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<td>OSI</td>
<td>On-site inspection</td>
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<td>RWA</td>
<td>Risk-weighted assets</td>
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<td>SEP</td>
<td>Supervisory examination programme</td>
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<td>SRB</td>
<td>Single Resolution Board</td>
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<td>SREP</td>
<td>Supervisory Review and Evaluation Process</td>
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<td>SRF</td>
<td>Single Resolution Fund</td>
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<tr>
<td>SSM</td>
<td>Single Supervisory Mechanism</td>
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<tr>
<td>TLAC</td>
<td>Total loss-absorbing capacity</td>
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<tr>
<td>TRIM</td>
<td>Targeted review of internal models</td>
</tr>
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</table>

#### Conventions used in the tables

- "-" data do not exist/data are not applicable
- "." data are not yet available