EUROPEAN CENTRAL BANK

BANKING SUPERVISION

DANIÈLE NOUY
Chair of the Supervisory Board

Safe and sound banks for a strong economy – The benefits and challenges of European banking supervision

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Outline

1	The benefits of European banking supervision
2	The challenges of European banking supervision
3	The challenges of the European banking sector

Outline

1.1 Root causes of financial crises and necessary reforms

Root causes of recent financial crises

1. **Weaknesses in the regulatory framework**
    - Inadequate requirements for capital / liquidity
    - Limited supervisory powers
    - Poor resolution framework
2. **Banks' behaviour**
    - Excessive risk taking
    - Capital optimisation
    - Regulatory and supervisory arbitrage
3. **Weaknesses in supervision**
    - Insufficiently pre-emptive, rather reactive
    - Lack of cooperation between supervisors
    - Similar banks, same risks – differing supervision

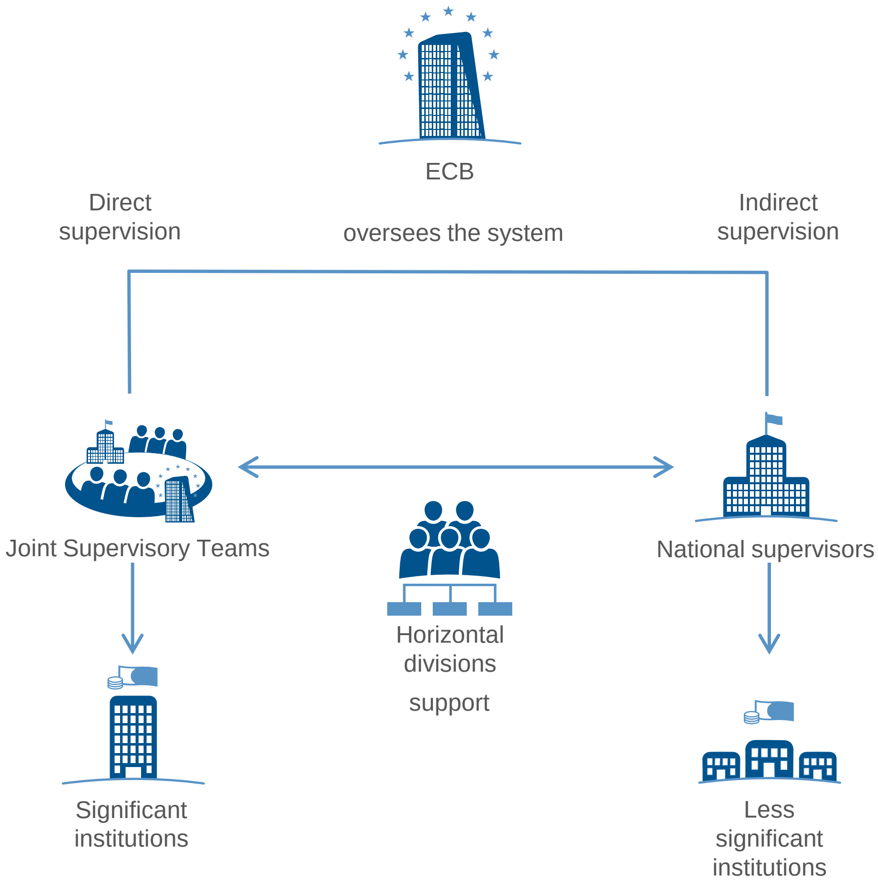
Reforms to prevent future crises

1. **New regulatory framework**
    - Higher standards for capital / liquidity
    - Comprehensive set of rules on Governance and Risk management
    - New tools to deal with failing banks
2. **Banking Union (SSM, SRM & EDIS)**
    - More objective supervision and less regulatory capture
    - Superior risk identification due to benchmarking, peer reviews and best practices
    - Deeper financial market integration due to truly European Framework for European banks
    - Political discussions for the creation of a European Deposit Insurance Scheme are ongoing.

Banking union provides basis for tougher, more harmonised supervision

European banking supervision is based on co-operation between national supervisors & the ECB

Distribution of tasks within the SSM



Key SSM facts

1. The SSM is the **world's largest banking supervisor**
2. Currently **129 banking groups (1,200 banks)** in 19 countries under direct ECB supervision. More than **80 %** of euro-area banking assets under direct ECB supervision.
3. Around **3,200 smaller institutions** are directly supervised by the national competent authorities (NCAs), with the ECB being responsible for the system at large.
4. Banking assets under direct and indirect ECB supervision amount to **more than 26 trillion Euros ➔** about **2.6 times euro-area GDP.**

1.3 The legal framework of European banking supervision

Article 1 SSM Regulation

"This Regulation confers on the ECB specific tasks […] relating to the prudential supervision of credit institutions, with a view to ***contributing to the safety and soundness of credit institutions and the stability of the financial system*** *within the Union and each Member State, with full regard and duty of care for the* ***unity and integrity of the internal market based on equal treatment of credit institutions*** *with a view to preventing regulatory arbitrage."*

Objectives of European banking supervision

1. **Resilient banking system**
   - Identification of relevant risks
   - Fair and consistent assessment of risks
   - Timely and tough intervention in case of identified deficiencies
   - **Tough and forward-looking supervision** of credit institutions
2. **Financial integration**
   - Development of harmonised supervisory methodologies and approaches
   - Consistent application of the supervisory framework across all participating countries
   - Creation of a **supervisory level playing field**

The Supervisory Review and Evaluation Process (SREP)

- **Level playing field:** SREP is being conducted according to…
  - …a common methodology.
  - …a common decision-making process allowing for peer comparisons and transversal analyses on a wide scale.
- **High standards of supervision:**
  - Follows EBA guidelines and draws on best practices within the SSM
  - Proportionality, flexibility and continuous improvement.
  - Supervisory decisions − not only additional capital but also additional measures tailored to banks' specific weaknesses.
  - Methods are constantly being refined: SREP decisions of 2016 will be composed of a Pillar 2 Requirement (P2R) and a Pillar 2 Guidance (P2G).
- **Sound risk assessment:**
  - Combination of quantitative and qualitative elements.
  - Holistic & forward-looking assessment of institutions' viability taking into account their specificities.

Outline

Scope and guiding policy principles

167 ONDs identified in CRR/CRDIV & Delegated Acts:

Out of scope

45 ONDs addressed to Member States or relating to macro prudential powers

➔ **no harmonisation via the SSM**

In scope

122 ONDs addressed to Competent Authorities (in first package)

+ 8 additional O&Ds (in second package)

➔ **harmonisation via the SSM possible**

Prudence, harmonisation & level playing field

International Standards: Basel framework and EBA

Banks' legitimate expectations

Focus on Significant Institutions

Policy transposed into two instruments

ECB REGULATION

Main Features:

Legally binding act, generally and **directly applicable** to all credit institutions directly supervised by the ECB

[applicable since 1 October 2016]

Content:

General ONDs of CRR and LCR Delegated Act:

- Transitional CRR rules on capital (definition of applicable percentages)
- Definition of default (past due) in credit risk
- Large Exposures exemptions
- LCR general treatments

ECB GUIDE

Main Features:

Non-binding legal instrument providing **guidance** to JSTs on how to treat **individual banks'** applications

[applicable since April 2016]

Content:

Case-by-case ONDs of CRR, LCR Delegated Act and CRD:

- Capital & Liquidity waivers
- LCR specific/preferential treatments
- Governance & cooperation arrangements
- Risk Weight & Leverage Ratio exemptions
- IFRS reporting

Current fragmentation at national level reduces the benefits of European banking supervision

- Although ONDs have been harmonised, regulation remains fragmented along national lines ➔ uneven patches on the playing field.
- Member States are free to choose the form and method of transposing the CRDIV Directive into national law ➔ differences at national level unavoidable.
- There are cases where it is not clear whether certain national provisions implement or complement the Directive.

  ➔ *legal uncertainty whether the ECB is competent to exercise the provisions directly or, has to instruct the national competent authority to do it*.
- The resulting differences create serious complications for European banking supervision and are an obstacle on the way to a single financial market.

  ➔ *Further regulatory harmonisation based on EU regulations rather than EU directives would make European banking supervision more effective and level the playing field for the banks.*

Decision-making at the SSM - Delegation

- At present, all of the SSM decisions are adopted by the supervisory Board's and go to the Governing Council of the ECB in draft form for adoption ('non-objection procedure').

  ➔*In 2015 alone, 1,500 supervisory decisions were taken through that process, including many routine decisions, that could have been decided by the staff.*

- In order to allow the ECB's decision-making bodies to concentrate on important issues, the ECB is working on a delegation framework for specific routine decisions.

  ➔*This delegation framework will provide a clear basis for taking delegated routine decisions (in particular for so-called 'fit and proper decisions').*

Creating a common European culture

- **A challenging task ….**
  - 26 national authorities from 19 different countries, speaking different languages, having different national supervisory cultures and traditions
- **… tackled from a mutual basis …**
  - Shared objective: safe and sound banking system
  - Common methodologies and harmonised approaches
- **… through “a smart structure” …**
  - Strong Joint Supervisory Teams for supervising banks
  - Several networks of experts for “horizontal” issues
- **… as well as constant dialogue and improvement**
  - Meetings & workshops
  - Staff exchanges
  - System-wide training
  - Special traineeship programme with NCAs
  - Feedback in both directions

The SRM will make the banking sector safer by avoiding bail-outs and worst-case scenarios

- The objective of the SRB is to ensure an orderly resolution of failing banks with minimum impact on the real economy and public finances.
- It **establishes uniform rules and procedures** for failing significant banks under ECB supervision and other cross-border groups.
- It **removes obstacles to resolution** e.g., banks' internal organisation and operations, cross border recognition of resolution measures, discretions in national law.

The interaction of supervision (ECB) with resolution (SRB) for Significant Institutions

Preparation and planning	Early intervention	Resolution trigger	Resolution
Recovery planning & assessment of recoverability • ECB responsible • SRM to be consulted **Resolution planning (including MREL) and assessment of resolvability** • SRM responsible • SSM to contribute	**Early intervention** • ECB responsible • Notification to the SRB	**Assessment of FOLTF** • ECB in consultation with SRB • SRB after informing ECB and if the ECB does not assess FOLTF in 3 calendar days • SRB to be notified	**Determination of conditions for resolution** • SRB in cooperation with ECB **Choice of resolution scheme** • SRB **Implementation of resolution measures** • NRAs • Supported by ECB/NCAs

Development of stress level →

Business as usual → Distressed situation → Failure or likely failure

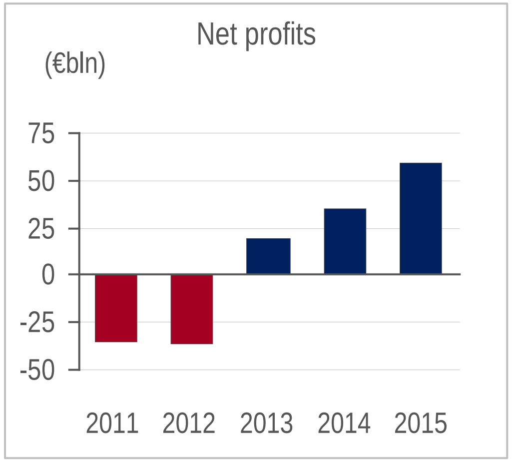
A European Deposit Insurance Scheme is the missing third pillar of the Banking Union

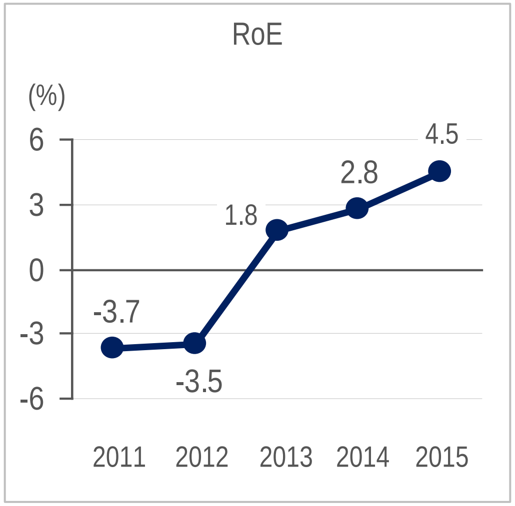
- So far, deposits are protected by national Deposit Guarantee Schemes (DGSs).
- The European Commission made a proposal in November 2015 for a European Deposit Insurance Scheme (EDIS).
- Treating depositors equally across Member States would increase their confidence in the safety of deposits.
- Negotiations at political level will start as soon as sufficient further progress has been made on the measures on risk reduction.

Outline

- **Low interest rates and their effect on profitability**
- **The response: adjusting business models**
- **Non Performing Loans (NPLs): a key issue in some Member States**

Low interest rates put pressure on the profitability of banks





- The average Return on Equity for Significant Institutions increased in 2015 to 4.5% on average from 2.8% in 2014.
- **Why to worry about profitability?**
  - Aggregate figures conceal rather diverse developments across institutions;
  - Decreasing impairments and non-recurring revenues were the main drivers of improved profitability: credit losses are expected to keep easing but positive one-off items will also decrease;
  - Growth in fee income played a role, but it remains to be assessed to which extent it can keep growing;
  - Low interest rates start taking their toll: high yielding assets come to maturity or are prepaid; decrease of interest expenses is limited by the zero lower bound on deposits;
  - Although banks' profitability has been improving, between the beginning of 2016 and the end of September European banks' stocks have lost almost 26% of their value which largely reflects a re-evaluation of their profitability prospects.

Dynamic sample of banks (95 before 2013, 102 thereafter): main trends are confirmed on an identical sample of banks

Banks need to rethink their business models and adapt them to the changed environment

- Banks have scope to **reduce costs** and **should become less dependent on interest income**. Fee income is often proposed as an alternative source of revenue.
- **Digitalisation** for example offers opportunities for greater efficiency, new distribution channels and new sources of income.
- **Excess capacity and fragmentation** along national lines are to some extent hampering the profitability and performance of some euro area banking sectors. Lenders may benefit from further cross-border consolidation.
- For European banking supervision, it is important to ensure that the adaptation of business models does not go along with excessive risk-taking.

Draft guidance to banks on non-performing loans has been published for public consultation:

- This guidance applicable to all banks directly supervised by the ECB focus on:
  - **NPL strategy**, e.g. need to define own NPL reduction targets and alignment with performance/ remuneration frameworks;
  - **NPL governance and operational capacities**, e.g. dedicated NPL workout units;
  - **Viable forbearance solutions**, e.g. limited use of short-term forbearance measures;
  - **Compliant and prudent NPL recognition**;
  - **Sound NPL provisioning and collateral valuation approaches**, also taking into account appropriate liquidation costs;
  - Beyond the banks, **Member States should improve their legal and judicial frameworks in order to facilitate the timely workout of NPLs**.

The road ahead …

- **A lot has been done during the first 2 years, …**
- **… Nevertheless, there is still a long road ahead**. We are working hard to:
  - strengthen banking systems,
  - further harmonise banking supervision, and
  - forge a common European supervisory culture.
- **Banking union needs to be completed** with a European Deposit Insurance Scheme.
- **Banks need to rethink their business models** to adapt them to the post-crisis challenging economic and financial world.