EUROPEAN CENTRAL BANK

BANKING SUPERVISION

DANIÈLE NOUY
Chair of the Supervisory Board

The European banking sector: New rules, new supervisors, new challenges

Università La Sapienza, 21 November 2016

Content

1 New rules

- **Root causes of financial crises and necessary reforms**
- **Overview over reforms**
- **Basel III – From global rules to European regulation**
- **Basel III – Finalising the post-crisis reforms**
- **Resolving and restructuring banks**

2 New supervisors

3 New challenges for supervisors …

4 … and for banks

5 Conclusion

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[1])**
   - More objective supervision and less regulatory capture
   - Superior risk identification due to benchmarking, peer reviews and best practices
   - Deeper financial market integration fostered by a level playing field for banks across the euro area
   - Political discussions for the creation of a European Deposit Insurance Scheme are ongoing

Banking union provides basis for tougher, more harmonised supervision

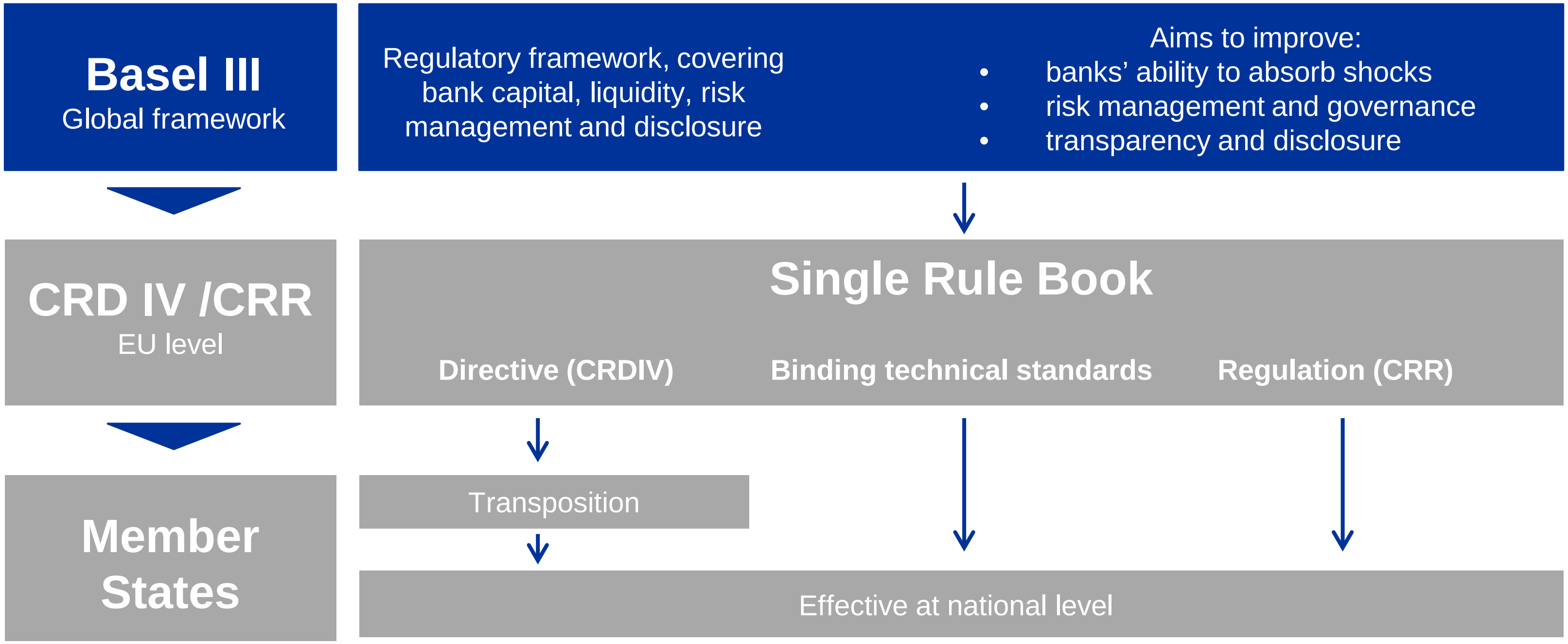
[1]SSM: Single Supervisory mechanism; SRM: Single Resolution Mechanism; EDIS: European Deposit Insurance Scheme

EU banks face important regulatory changes

1. Basel III Capital framework	• Revised Capital requirements • Leverage Ratio • Liquidity Ratios	• More capital and of better quality • Target excessive leverage • Address full balance sheet besides capital
2. FSB[1] 'Too big to fail'	• Extra capital for very large banks • Total Loss Absorbing Capacity	• Force banks to take into account their relevance for the financial system • In doing so, the banks must also take into account the possibility that they might fail
3. EU Crisis management	• Single Resolution Mechanism • Recovery and Resolution Plan	• Preference for early intervention ➔ resolution only if need to be • Public intervention only under systemic risk

[1]FSB: Financial Stability Board

1.3 Basel III – From global rules to European regulation



- Basel III was developed at the global level by the Basel Committee on Banking Supervision (BCBS) in response to the global financial crisis.
- In the EU, Basel III is implemented through the Capital Requirements Directive (CRD IV) and the Capital Requirements Regulation (CRR).

Main challenges

- Many banks use internal models to calculate how much capital they must hold to cover their risks.
  - However, not all credit risk exposures can be modelled sufficiently reliably or consistently.
- Several solutions are currently being discussed by the Basel Committee:
  - Constraining model-results where appropriate, or removing modelling altogether for some exposures.
  - Revising the standardised approach for credit risk.
  - Revising the framework for operational risk, including the option of replacing the current modelling approach with a risk-sensitive standardised approach.
- In finalising Basel III, it is important that …
  - … there will be no significant overall increase in capital requirements,
  - … the impact on different jurisdictions is considered,
  - … the credibility of the risk-based capital framework is restored, excessive variability in model-results is reduced and simplicity as well as comparability are promoted.

Resolution – Shielding the taxpayers and correcting incentives for banks

- The failure of a large bank might have consequences for the entire financial system – they are 'too big to fail'.
  - ➔ During the financial crisis, governments were induced to bail out failing banks with taxpayers' money in order to prevent a systemic crisis.
  - This, however, creates moral hazard: banks are tempted to take on too much risk, knowing that they will be saved by the government if things go wrong.
- In order to solve the 'too big to fail'-problem, mechanisms have been created that allow for an orderly resolution of failing banks.
- In Europe, it is the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) that ensure orderly failures of banks.
  - Among other things, banks are required to present resolution plans, which lay out how the institution can be orderly resolved in case of failure.
  - Banks also have to hold a certain amount of loss absorbing capacity in order to be able to cover losses in case of failure.

How do supervision (ECB) and resolution (Single Resolution Board, SRB) interact?

Preparation and planning	Early intervention	Resolution trigger	Resolution

Development of stress level

Preparation and planning

Recovery planning & assessment of recoverability

- ECB responsible
- SRB to be consulted

Resolution planning (including Minimum Requirement for own funds and Eligible Liabilities - MREL) **and assessment of resolvability**

- SRB responsible
- SSM to contribute

Early intervention

Early intervention

- ECB responsible
- Notification to the SRB

Resolution trigger

Assessment of 'failing or likely to fail' (FOLTF)

- ECB in consultation with SRB
- SRB after informing ECB, and if the ECB does not assess FOLTF within 3 calendar days

Resolution

Determination of conditions for resolution

- SRB in cooperation with ECB

Choice of resolution scheme

- SRB

Implementation of resolution measures

- National Resolution Authorities, supported by ECB/NCAs[1]

Business as usual — Distressed situation — Failure or likely failure

[1]NCA: National Competent Authority

1 New rules

2 New supervisors

- **The architecture of European banking supervision**
- **The legal framework of European banking supervision**
- **The main tool of European banking supervision: SREP**

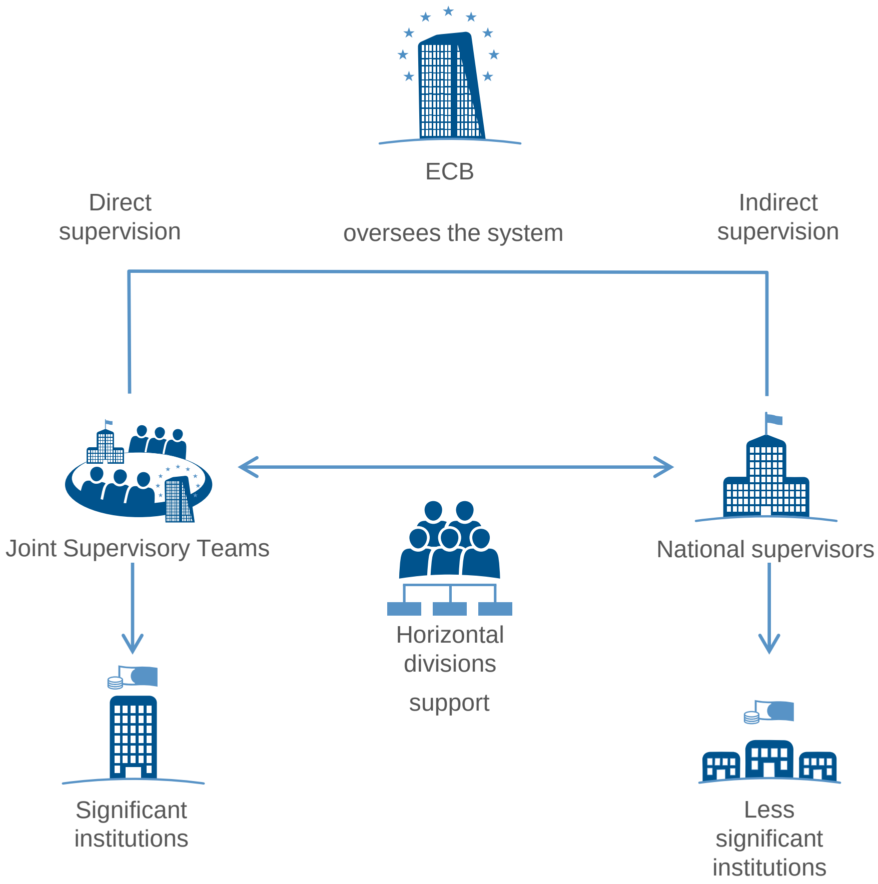
3 New challenges for supervisors …

4 … and for banks

5 Conclusion

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

Distribution of tasks within the SSM



Key SSM facts

1. The Single Supervisory Mechanism (SSM) is the **largest banking supervisory authority of the world.**
2. Currently **127 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.**

2.2 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) is the main tool of banking supervision

- **Level playing field:** SREP is being conducted according to…
  - …a common methodology ➔ banks across the euro area are assessed according to the same yardstick.
- **High standards of supervision:**
  - Follows guidelines from the European Banking Authority and draws on best practices from across the euro area.
  - Proportionality, flexibility and continuous improvement.
  - Based on the SREP assessment, supervisors can demand capital add-ons, and additional measures tailored to banks' specific weaknesses (such as additional reporting requirements).
  - Methods are constantly being refined.
- **Sound risk assessment:**
  - Combination of quantitative and qualitative elements – expert judgement and data analysis.
  - Holistic & forward-looking assessment of institutions.

How does the SREP work?

SREP methodology at a glance: four key elements

SREP Decision

- Quantitative capital measures
- Quantitative liquidity measures
- Other supervisory measures

Overall SREP assessment - Holistic approach

→ Score + Rationale/main conclusions

1. Business model assessment	2. Governance and Risk Management assessment	3. Assessment of risks to Capital	4. Assessment of risks to Liquidity and Funding
Viability and Sustainability of Business Model	Adequacy of Governance and Risk Management	Categories: e.g. Credit, Market, Operational Risk	Categories: e.g. Short Term Liquidity Risk, Funding Sustainability

Feeds into the Supervisory Examination Programme (SEP)

3. New challenges for supervisors

1	New rules
2	New supervisors
3	**New challenges for supervisors …**

- **Furthering regulatory harmonisation**
- **Improving decision-making and delegation**
- **Creating a community of European banking supervisors**

4	… and for banks
5	Conclusion

Harmonised supervision requires harmonised regulation

- The Capital Requirements Directive and Capital Requirements Regulation contain a number of so called Options and Discretions (ONDs).
  - Under an option, supervisors are given a choice on how to comply from a range of alternative provisions
  - Under a national discretion, supervisors are given the choice whether to apply a given provision or not.
- At the national level, these ONDs were exercised differently.
  - This made it difficult to ensure a consistent overall level of regulatory capital across Member States and to compare the capital positions of banks.
  - It also negatively affected the ECB’s ability to supervise banks efficiently from a truly European perspective.
  - And it created room for regulatory arbitrage and added costs for banks operating across borders.
- ➔ In order to provide a level playing field and contribute to the safety and soundness of banks, the ECB addressed the issue of ONDs …

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 ONDs (in second package)

➔ **harmonisation via the SSM possible**

Prudence, harmonisation & level playing field

International Standards: Basel framework and EBA[1]

Banks' legitimate expectations

Focus on Significant Institutions

[1]EBA: European Banking Authority

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

Content:

- General ONDs of CRR[1] and LCR[2] 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[3] on how to treat **individual banks'** applications

Content:

Case-by-case ONDs of CRR, LCR Delegated Act and CRD[4]:

- Capital & Liquidity waivers
- LCR specific/preferential treatments
- Governance & cooperation arrangements
- Risk Weight & Leverage Ratio exemptions
- IFRS[5] reporting

[1]CRR: Capital Requirements Regulation; [2]LCR: Liquidity Coverage Ratio; [3]JST: Joint Supervisory Team; [4]CRD: Capital Requirements Directive
[5]IFRS: International Financial Reporting Standards

Regulation remains fragmented along national lines – benefits of European banking supervision reduced

- Although ONDs have been harmonised, regulation remains fragmented along national lines ➔ uneven patches on the playing field.

- The reason is that parts of European regulation take the form of a EU Directive such as the Capital Requirements Directive (CRDIV):

  ➔ Member States can choose the form and method of transposing the CRDIV into national law. Differences at national level are therefore unavoidable.

- The resulting differences create bureaucracy and costs, are not in line with the idea of a European banking union and a single banking market.
  - If policymakers are serious about creating a European banking union, they should eliminate the remaining regulatory differences.

- Also, there are cases where it is not clear whether certain national provisions implement or complement European regulation.

  ➔ Legal uncertainty whether the ECB is competent to exercise the provisions directly or, has to instruct the national competent authority to do it.

Decision-making at the SSM - Delegation

- At present, all supervisory decisions have to be approved by the supervisory Board and adopted by the Governing Council of the ECB (‘non-objection procedure’).
  - ➔ In 2015 alone, 1,500 supervisory decisions were taken through that process, including many routine decisions.

- Having so many routine decisions clogging the channels of decision-making, makes the process burdensome and less efficient.
  - ➔ The ECB and the national supervisors are working on delegation possibilities.

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[1]

[1]NCA: National Competent Authority

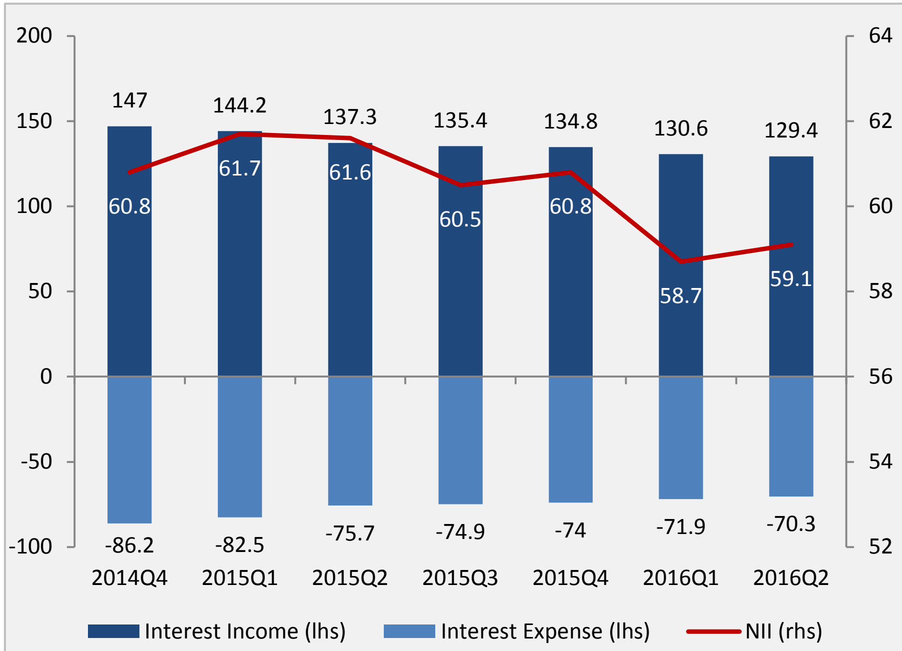
1	New rules
2	New supervisors
3	New challenges for supervisors …
4	… and for banks

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

5	Conclusion

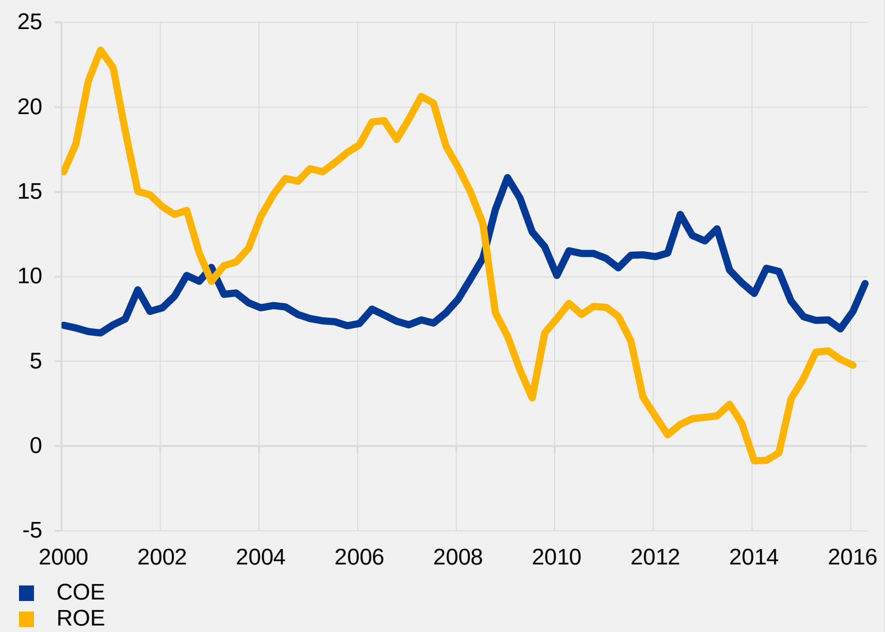
Profitability remains a source of concern due to the low interest rate environment

Decline in aggregate Net Interest Income (bn EUR; 2014 – 2016)



Source: Finrep, aggregate data for 101 SIs

Return on equity and cost of equity and for listed euro area banks (Q1 2000 – Q2 2016; percentages)



Sources: Bloomberg, Datastream, Consensus Economics, ECB calculations.

- 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 profitability has been improving, European bank stocks have lost around a quarter of their value from January to November 2016. That largely reflects a re-evaluation of their profitability prospects.

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.
- Digitalisation of banking services offers opportunities for greater efficiency, new distribution channels and new sources of income.
- In some national banking sectors, excess capacity is increasing competition and depressing margins. Here, the sector may benefit from consolidation, including 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 was submitted 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.

Content

The road ahead …

- **A lot has changed during the first 2 years of European banking supervision, …**
- **… 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.

Backup

SSM Traineeships: principles and calendar for first year

One year immersion in the heart of the European Banking Supervision System

Mobility of trainees across SSM institutions creates a unique opportunity for young graduates and job entrants to:

- ✓ gain hands-on work experience
- ✓ acquire practical knowledge and exposure to the working of the SSM, in particular of the Joint Supervisory Teams

A common induction period to get ready for the external assignment

Trainees will be assigned first tasks in JST and follow a specific training curriculum in order to:

- **integrate** into their new role and into the organisation
- **prepare** for the move to NCAs later on

External assignments to embrace the full dimension of SSM

Trainees will contribute towards the team's work while gaining a broad overview of the banking supervision.

One of the 2 external assignments might be replaced by 4 months in ECB

A common closure period to share ideas and prepare for the future

Back to the ECB, trainees will:

- **share** their experience gained in several NCAs
- **finalise** the tasks they have been assigned
- **get ready** to enter job market through preparatory activities

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.

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.