EUROPEAN CENTRAL BANK

BANKING SUPERVISION

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ECB Banking Supervision

Achievements and Challenges

Prometeia conference "Europe: risks and opportunities"

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Overview

1. EU post-crisis reform: where do we stand?
2. Achievements of ECB banking supervision
3. Challenges for banks and policymakers
4. Supervisory responses
5. Conclusions

1. EU post-crisis reform: main steps

- **new banking legislation (2013, but currently under review)**

- **new pan-euro area banking supervisor (2014)**

- **new crisis management framework (2015-2016) including:**
  - pan-euro area resolution authority (2015)
  - pan-euro area resolution fund (partly implemented)
  - pan-euro area deposit insurance (not implemented)

overall, the framework is comprehensive and well advanced, but remains incomplete

ACHIEVEMENTS

2. Achievement #1: organizational set-up

Set-up of ECB banking supervision ***(quick overview)*****:**

- **Supervisory Board**
- **Supervisory structure/staff**
- **Joint Supervisory Teams**
- **On-site supervision**

2. Achievement #2: the SREP

SREP methodology at a glance: four key elements

SREP assessment encompasses 4 areas:

(scoring and qualitative input)

- **1. Business model assessment**
- **2. Governance and risk management assessment**
- **3. Assessment of risks to capital**
- **4. Assessment of risks to liquidity and funding**

SREP decisions include:

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

2. Achievement #3: harmonisation of options and discretions

The Supervisory Board agreed on how to apply the margins of flexibility in the CRR/CRD, previously available to the national authorities, in a harmonised way across European banking supervision

ECB Guide
on options and discretions
available in Union law

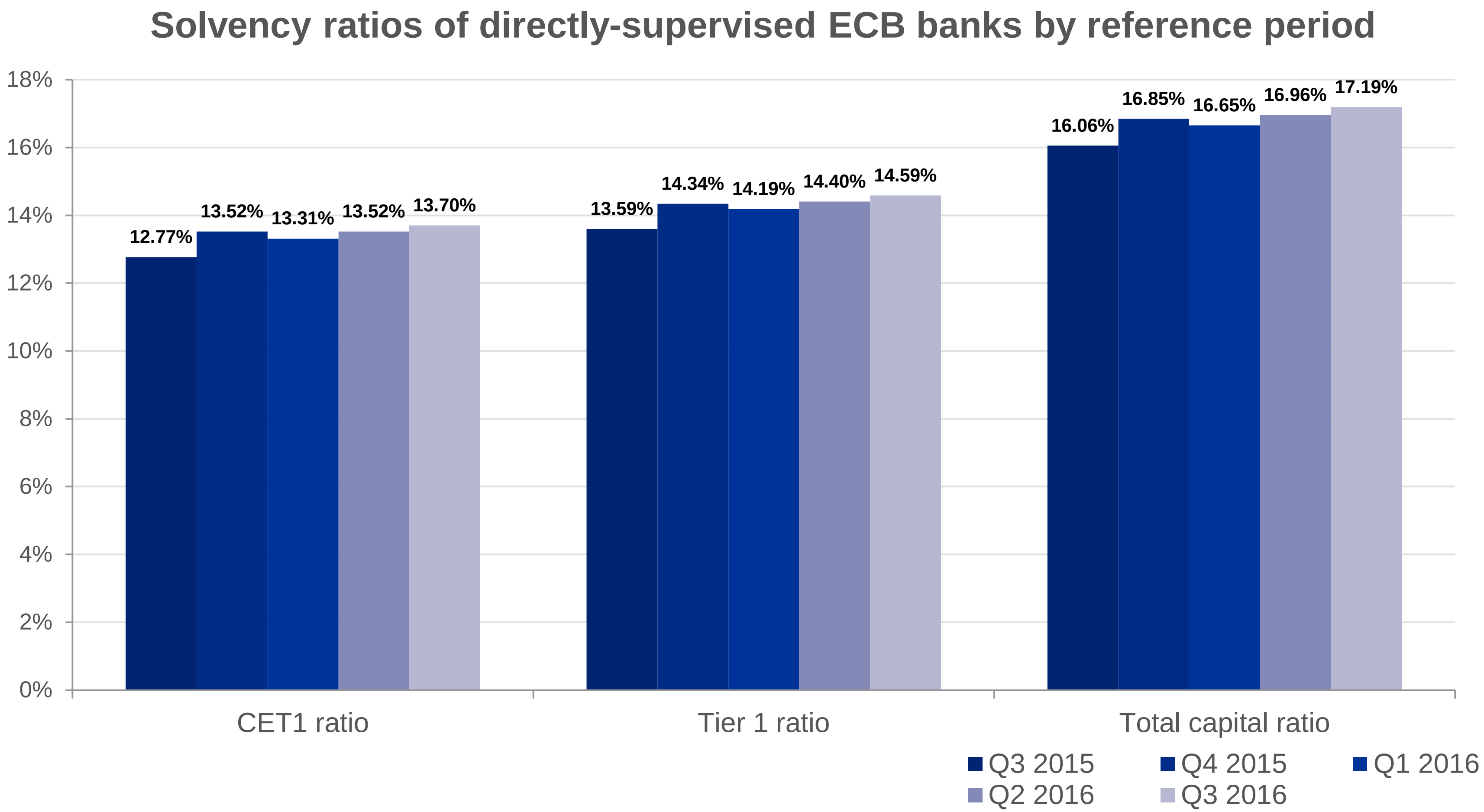
2. Achievement #4: guidance on non-performing loans

The ECB published a guidance to banks on how they should tackle non-performing loans - addressing key aspects regarding the strategy, governance and operations.

Guidance also requests banks to define and implement plans to reduce NPLs in a realistic but ambitious manner.

Guidance to banks on non-performing loans

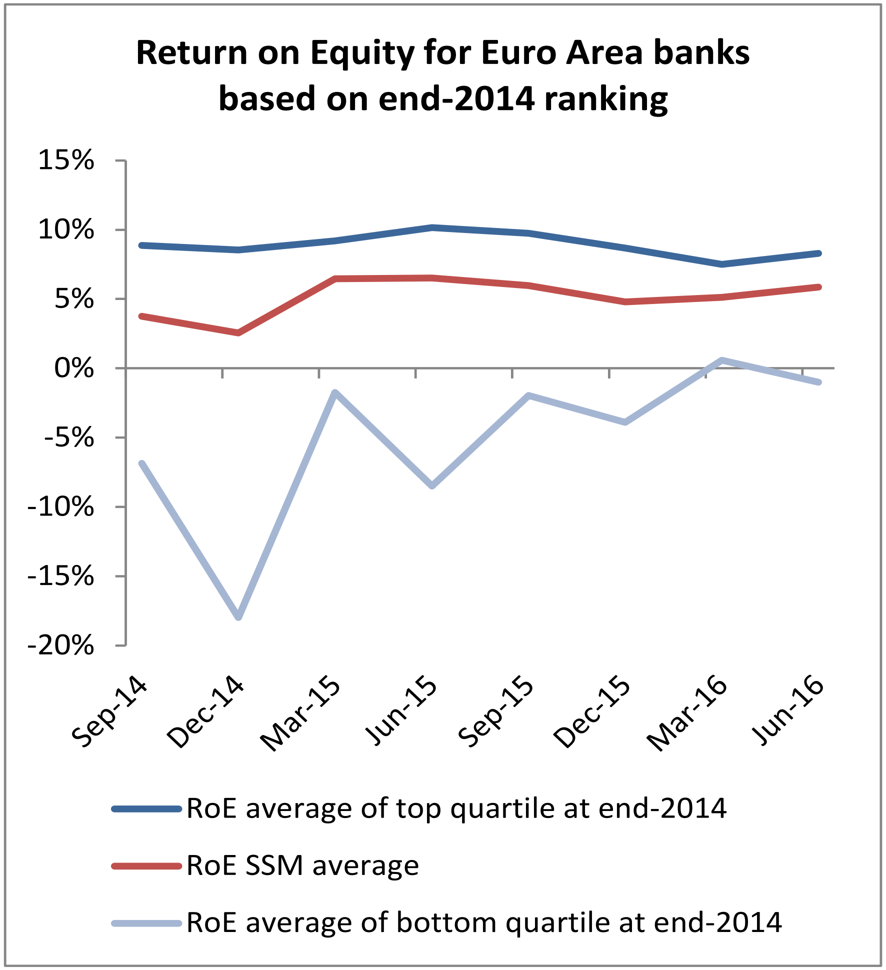
2. Achievement #5: better capitalised banking system



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. The list of banks used for the various reference periods may differ as the list of significant institutions changes and as banks start to report under FINREP obligations. Specifically, there are 102 banks in the third quarter of 2015, 117 in the fourth quarter of 2015 (increase in FINREP reporting obligations), 123 in the first quarter of 2016, 124 in the second quarter of 2016 (changes in the list of significant institutions and FINREP reporting obligations) and 122 in the third quarter of 2016. The number of entities per reference period is expected to stabilise in future, with any changes resulting from amendments to the list of SIs following assessments by ECB Banking Supervision, which generally occur on an annual basis.

CHALLENGES

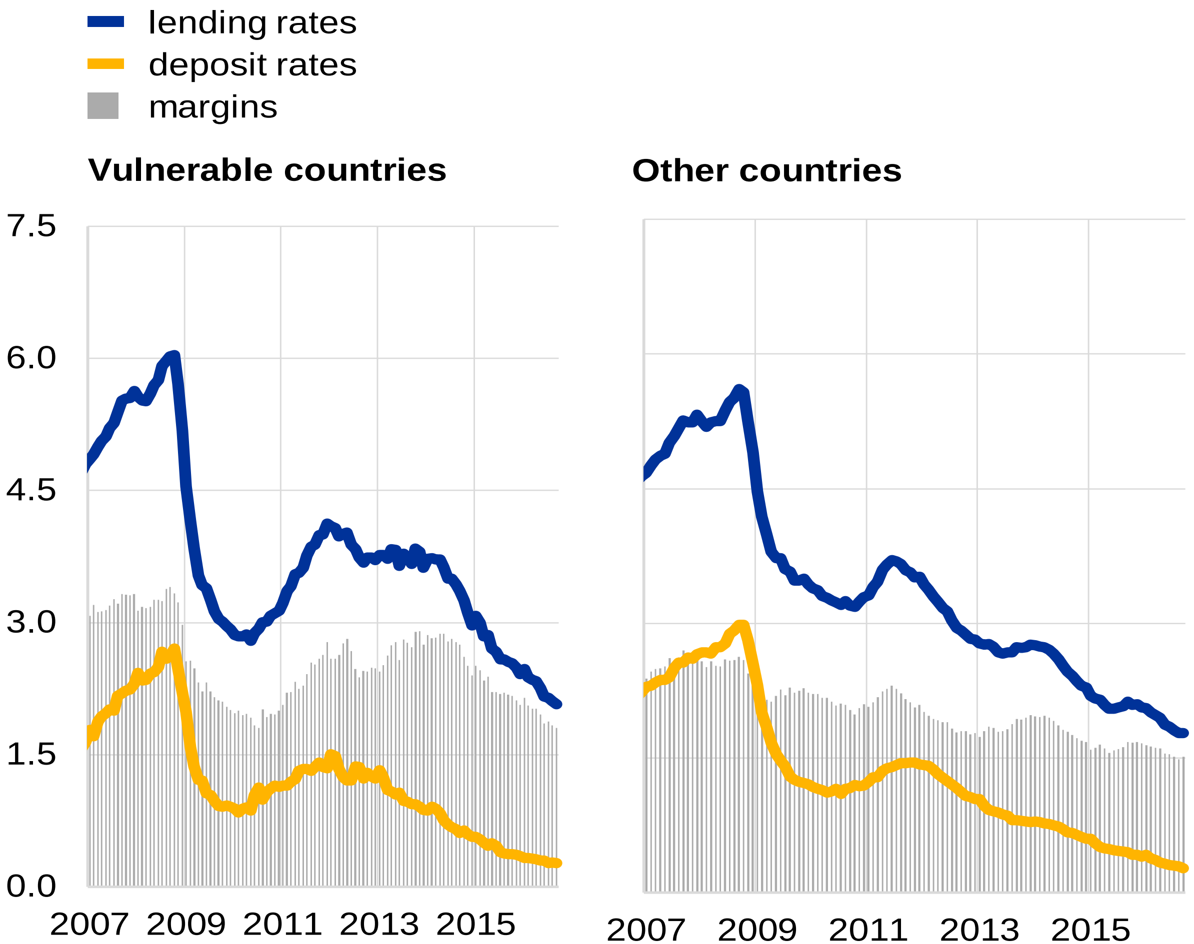
Weak bank profitability; large variance across banks…



Source: ECB. FINREP and ECB calculations. Notes: top and bottom quartile banks were kept fix based on end-2014 RoE. The chart then tracks the evolution of the average RoE for these two groups as well as the average for the entire sample of Euro Area banks (93 significant institutions). Subsidiaries of foreign institutions have been excluded from the sample.

…due to narrower margins…

Loan and deposit interest rates and margins on new business
(percentage per annum)

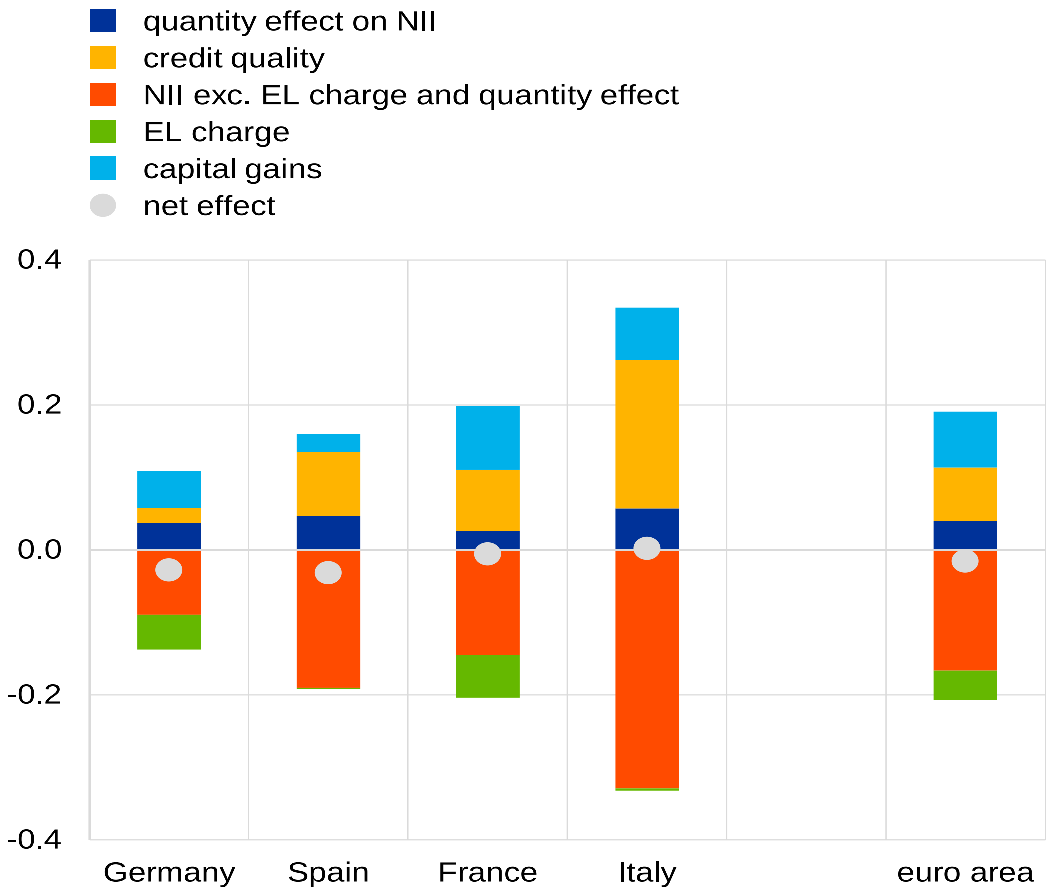


Sources: ECB and ECB calculations.
Notes: Loan and deposit composite rates are calculated using the corresponding outstanding amount volumes as weights.

Latest observation: September 2016.

… in spite of capital gains, improved credit quality

Estimated effect of monetary policy on bank profitability over the period 2014-17
(percentage point contribution to return on assets)



Sources: ECB calculations based on U. Albertazzi and L. Gambacorta, (2009), "Bank profitability and the business cycle", *Journal of Financial Stability*. Capital gains are based on consolidated data for 68 euro area banking groups under direct ECB supervision and in the 2014 EU-wide stress test. Euro area figures are weighted average for the countries included in the sample using the ECB's consolidated banking data for the weight of each country's banking system in the euro area aggregate. NII stands for net interest income and EL for excess liquidity.

Non-performing loan burdens focused in a few jurisdictions

(2016Q3 data, EUR million and percentages)

Country	Total Loans	Gross NPLs	Gross NPL ratio	Impairments on NPLs	Coverage ratio	Net NPL ratio	Cost to income ratio
AT	248,516	12,088	4.9%	6,188	51.2%	2.4%	65.2%
BE	428,506	15,501	3.6%	6,585	42.5%	2.1%	58.9%
CY	51,718	20,833	40.3%	8,015	38.5%	24.8%	51.0%
DE	2,357,014	63,045	2.7%	25,402	40.3%	1.6%	77.3%
EE	14,755	212	1.4%	60	28.3%	1.0%	n / a
ES	2,324,159	136,099	5.9%	60,447	44.4%	3.3%	51.8%
FI	269,136	4,018	1.5%	1,070	26.6%	1.1%	49.4%
FR	3,670,920	137,742	3.8%	69,104	50.2%	1.9%	68.7%
GR	242,402	114,060	47.1%	55,026	48.2%	24.4%	49.5%
IE	212,941	37,803	17.8%	14,372	38.0%	11.0%	56.8%
IT	1,690,028	271,337	16.1%	128,318	47.3%	8.5%	67.6%
LT	17,010	693	4.1%	230	33.3%	2.7%	45.6%
LU	61,932	1,130	1.8%	359	31.7%	1.2%	n / a
LV	9,884	359	3.6%	99	27.7%	2.6%	42.0%
MT	12,428	576	4.6%	205	35.6%	3.0%	n / a
NL	1,700,714	43,576	2.6%	15,719	36.1%	1.6%	58.5%
PT	182,529	36,140	19.8%	15,399	42.6%	11.4%	61.4%
SI	14,519	2,439	16.8%	1,625	66.6%	5.6%	60.0%
SK	31,206	1,434	4.6%	775	54.1%	2.1%	n / a
TOTAL	**13,540,317**	**899,085**	**6.6%**	**408,999**	**45.5%**	**3.6%**	**64.2%**

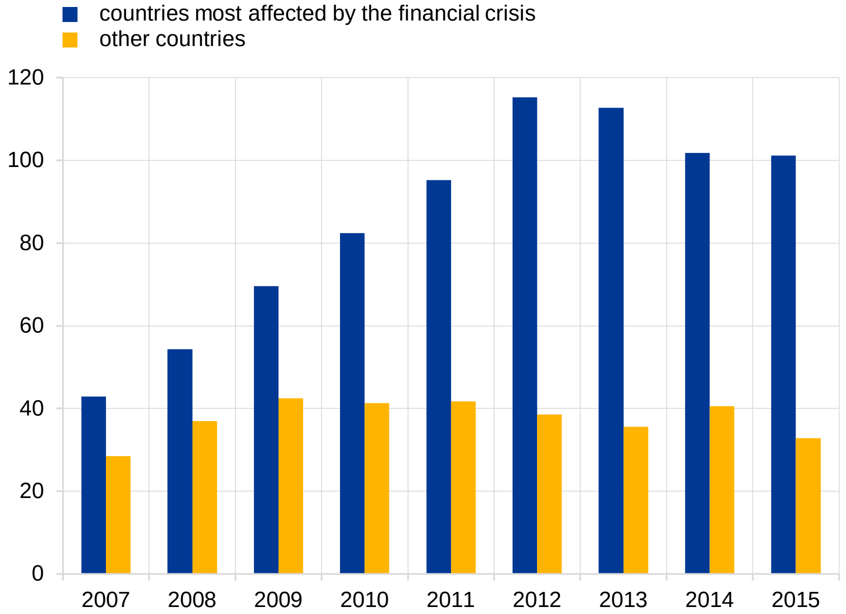
Source: ECB.
Notes: All country-level ratios are computed as weighted averages.
Loan data refer to a sample of 115 significant institutions.
Cost-to-income data refer to a constant sample of 101 IFRS-reporting significant institutions.

‘Legacy’ assets still weighing on banks’ balance sheets

Texas ratio and impaired loan ratio evolution in the euro area

Ratio of non-performing loans to tangible equity and loan loss reserves for euro area significant banking groups

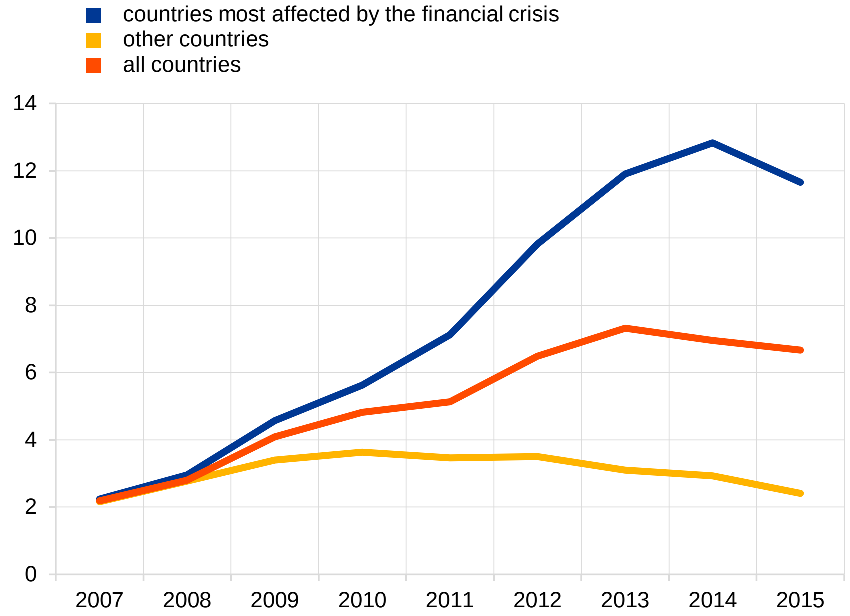
(2007-2015; percentages; median values)



Source: SNL Financial.
Notes: Based on publicly available data for a sample of significant banking groups. Countries most affected by the financial crisis are Cyprus, Greece, Ireland, Italy, Portugal, Slovenia and Spain.

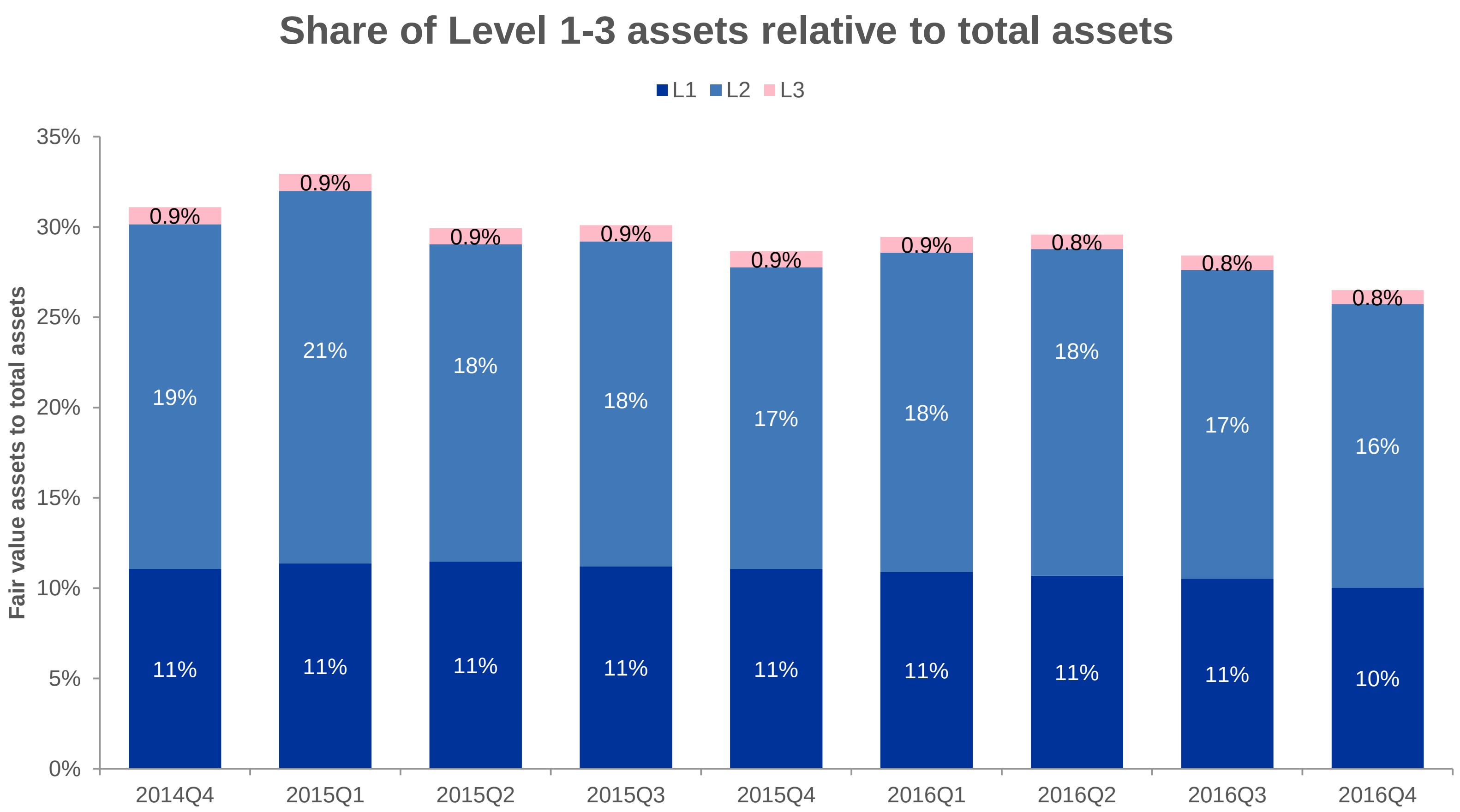
Impaired loan ratios for euro area significant banking groups

(2007-2015; percentage of loans, median values)



Source: SNL Financial.
Notes: Based on publicly available data for a sample of 55 significant banking groups. Countries most affected by the crisis include Cyprus, Greece, Ireland, Italy, Portugal, Slovenia and Spain.

Fair-valued assets represent around 30% of total assets
(fairly distributed across countries)



Source: ECB staff calculations, FINREP.

Notes: constant sample of 100 significant institutions. Subsidiaries that are significant institutions are excluded to avoid double counting.

Credit risk dominates in overall exposures

Risk exposures in selected countries (EUR bn) (Q3 2016)	Total euro area	Germany	Spain	France	Italy
Credit risk-weighted exposure amounts	**6,894.32**	1,025.46	1,357.32	2,040.01	928.80
Standardised approach (SA)	**3,107.20**	327.35	818.69	828.98	552.80
Internal ratings based approach (IRB)	**3,779.70**	696.30	538.11	1,208.98	C
Risk exposure for contributions to the default fund of a CCP[1)]	**7.41**	1.82	0.52	2.05	C
Settlement/delivery risk exposure amount	**0.17**	C	C	C	C
Market risk exposure amount	**319.33**	101.55	54.44	69.62	45.54
Market risk exposure under SA[2)]	**128.05**	41.69	33.22	18.03	14.89
Market risk exposure under IM approach[3)]	**191.28**	59.86	21.22	51.60	30.65
Operational risk exposure amount	**818.18**	170.59	133.49	228.71	95.21
Operational risk exposure under BIA[4)]	**65.67**	6.29	C	10.90	13.51
Operational risk exposure under TSA/ASA[5)]	**324.43**	39.61	98.70	75.29	15.85
Operational risk exposure under AMA[6)]	**428.08**	124.69	C	142.52	65.85
Risk exposure for credit valuation adjustment	**94.37**	31.97	5.11	23.86	7.78
Other [7)]	**27.96**	C	C	C	C
Total risk exposure amount	**8,154.33**	**1,330.04**	**1,556.51**	**2,377.24**	**1,077.56**

Source: ECB. Notes: Significant institutions at the highest level of consolidation for which common reporting (COREP) and financial reporting (FINREP) are available. Only relevant components of risk exposures have been reported. C: the value is suppressed for confidentiality reasons.1) CCP stands for central counterparty.2) SA stands for standardised appraoch.3) IM stands for internal model.4) BIA stands for basic indicator approach.5) TSA stands for traditional standardised approach. ASA stands for alternative standardised approach. 6) AMA stands for advanced measurement approach.7) Includes "additional risk exposure amount due to fixed overheads", "total risk exposure amount related to large exposures in the trading book"" and "other risk exposure amounts".

SUPERVISORY RESPONSES

4. Supervisory response (1)

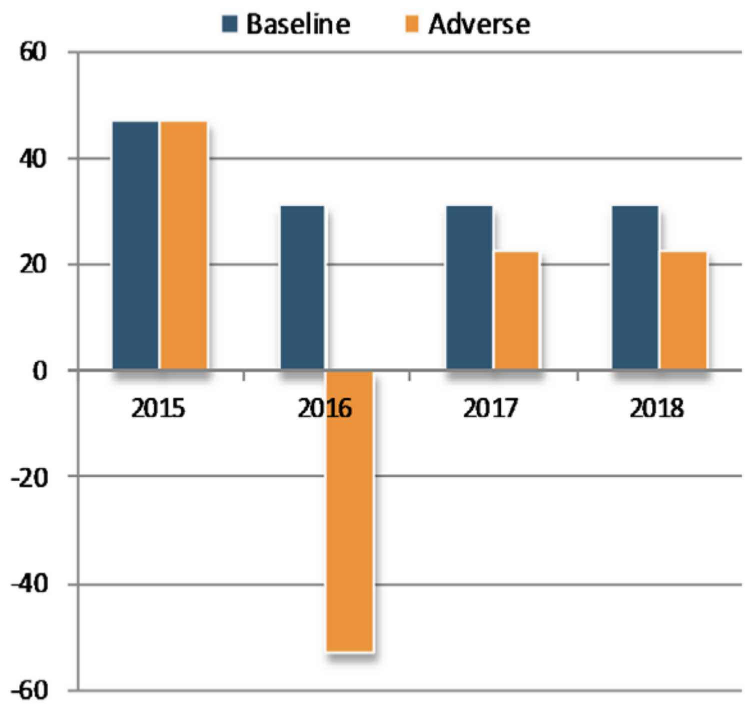
- **Profitability challenge**
  - ***thematic review of banks' business models and profitability drivers***
  - ***also exploring the risks for banks' business models emanating from Fintech and non-bank competition*.**
- **Normalization of interest rate cycle**
  - ***stress test to be conducted in 2017 will focus on interest rate risk in the banking book***
  - ***analyzing how different interest rate shocks affect bank assets and liabilities valued at amortized cost***

4. Supervisory response (2)

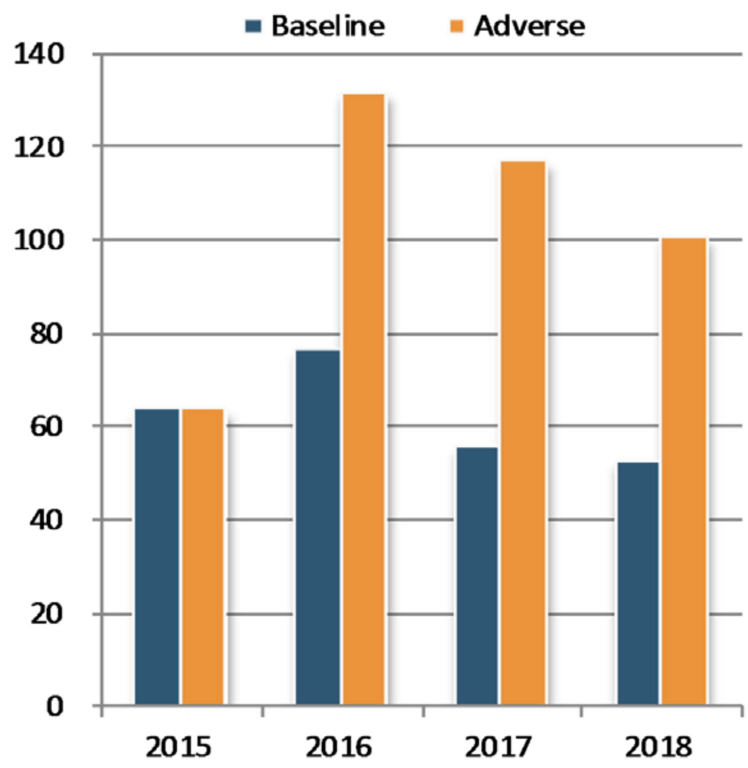
- **Credit risk**
  - *ECB NPL guidance and follow-ups*
  - *Joint Supervisory Teams to liaise with individual banks*
- **Market risk**
  - *“Targeted Review of Internal Models” (TRIM)*
  - *on-site inspections and reviews of valuation and risk control processes*
  - *targeted analyses of fair value instruments at selected banks*

Market risk impact in the adverse scenario of the 2016 stress test was comparable to that of credit risk

2016 ST – Market risk impact
(EUR bn)



2016 ST – Credit risk impact
(EUR bn)



Source: EBA 2016 stress test

5. Conclusion

- **ECB Supervision: quick and successful set-up**
- **A clear regime change**
- **Room for improvement; progress still ongoing**
- **NPLs are a major challenge for the system**
- **Other risks are being carefully monitored through SREP, TRIM and regular supervision**
- **Other challenges in the background: overbanking, cost structures, regulation, Fintech, …**