EUROPEAN CENTRAL BANK

BANKING SUPERVISION

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European Banking Supervision – The why, the how, the what

Baden-Badener Unternehmergespräche

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European banking supervision …

1. … The why
2. … The how
3. … The what
4. … The future

European banking supervision …

1 …The Why

- **Lessons from the crisis**
- **The objectives of European banking supervision**
- **The philosophy of European banking supervision**

2 … The how

3 … The what

4 … The future

1.1 The lessons from the crisis

Root causes of recent financial crises

Banks behaviour

- Excessive risk taking
- Capital optimisation
- Regulatory and supervisory arbitrage

Weaknesses in banking regulation

- Inadequate requirements for capital and liquidity
- Inadequate resolution frameworks (“too big to fail”-problem)
- Inadequate treatment of sovereign debt

Weaknesses in banking supervision

- Insufficiently proactive, rather reactive
- Insufficient cross-border cooperation
- Similar banks, same risks, but different supervision

Reforms to prevent future crises

Global reform of banking regulation

- Higher standards for capital and liquidity (Basel III)
- New rules on Governance and Risk management
- New tools to deal with bank failures (bail-in)

European banking supervision

- Impartial European supervisor – less influence of national interests
- Potential to early-on identify and address cross-border problems
- Potential to supervise banks in the entire euro area according to the same high standards

European banking supervision has been the biggest step of financial integration in Europe since the introduction of the euro

1.2 The objectives 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."*

SSM objectives

Resilient banking system

- Identification of relevant risks
- Fair and consistent assessment of risks
- Timely and tough intervention in case of identified risks and deficiencies
- ➔ Tough and forward-looking supervision of credit institutions

Financial Integration

- Development of harmonised supervisory methodologies and approaches
- Consistent application of the regulatory and supervisory frameworks across the euro area
- ➔ Creation of a supervisory level playing field

The philosophy of European banking supervision

- **Promote forward-looking and risk-based supervision based on strong and comprehensive analyses**
- **Address potential problems proactively in a timely manner**
- **Ensure harmonisation of procedures and good quality of decisions that promote consistently high standards across the entire euro area**
- **Adopt multiple perspectives on risk and have in-depth interactions with banks during the on-going supervisory activities**
- **Use on-site inspections as a fundamental element of European banking supervision**

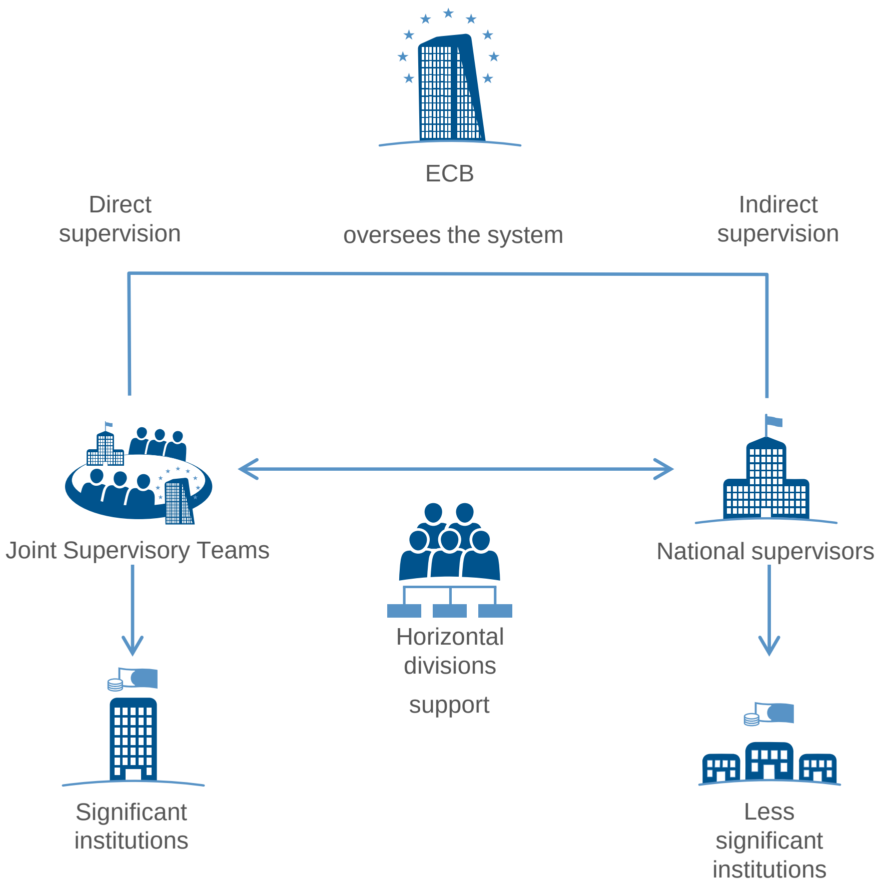
European banking supervision …

EU banks face far reaching regulatory reforms

BCBS – Basel III framework	• Revised capital requirements including a leverage ratio • New liquidity requirements	• More capital and of better quality • Target model risk and excessive leverage • Address full balance sheet structure besides capital
FSB – Too big to fail	• Capital surcharges for global systemically relevant banks (G-SIBs) • Total Loss Absorbance Capacity (TLAC)	• Force banks to take into account their systemic role under both a going concern and a gone concern scenario
EU – Bank recovery and resolution	• Bank recovery and resolution directive (BRRD) • Single resolution mechanism (SRM) • Recovery and Resolution Plans	• Preference for early intervention • Orderly resolution of banks only if necessary • Private investors to bear costs of banks' failure
EU – Structural Reforms	• Prohibition of proprietary trading • Separation of trading activities	• Complementary to both i) FSB measures to reduce systemic risk; ii) BRRD (separation to ease resolution) • Addresses cross-subsidies between retail banking and more risky activities

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

Distribution of tasks within the SSM

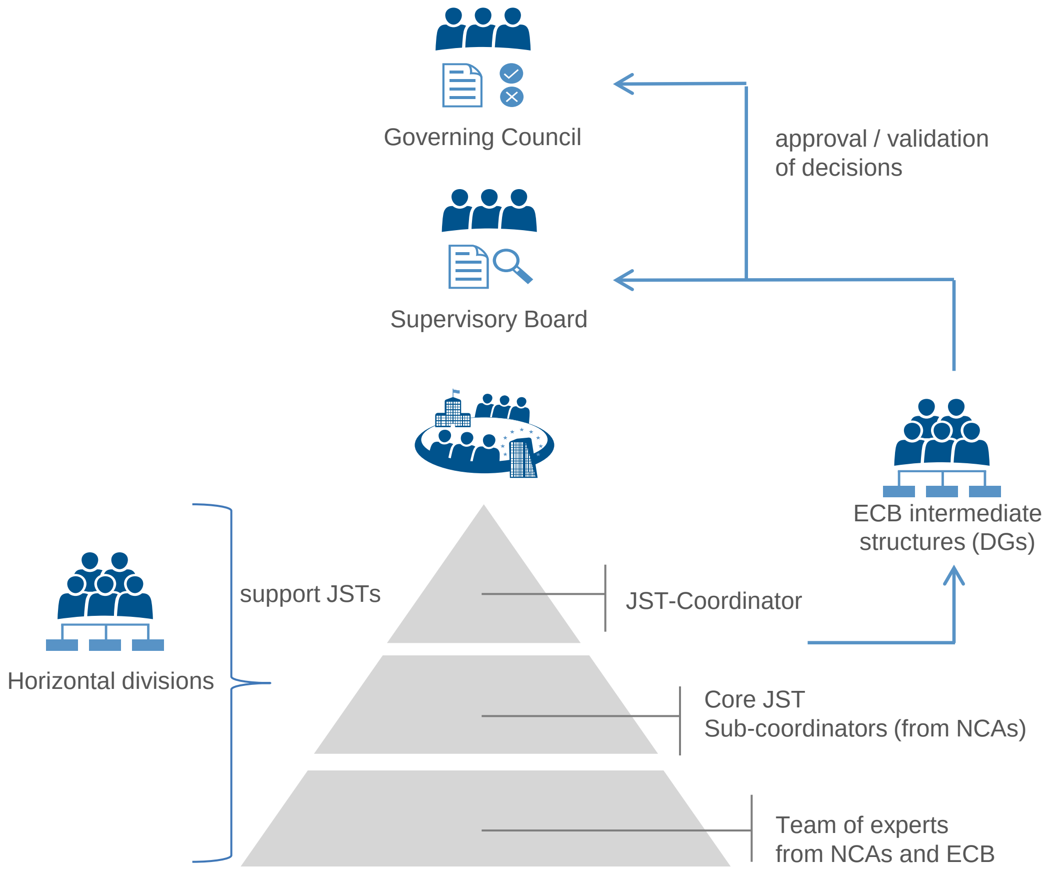


Key SSM facts

1. The SSM is one of the **world's largest banking supervisors**
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 **3,500 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**

Significant institutions are supervised by Joint Supervisory Teams (JSTs)

Functioning of the JSTs



- Established for every banking group
- comprising staff from ECB and national competent authorities (NCA)
- Responsible for day-to-day supervision and for implementing the annual supervisory programme
- Responsible for implementing decisions of the Supervisory Board / Governing Council

ECB staff providing the European perspective

NCA staff providing national and market expertise

Less significant institutions (LSI) are supervised by national competent authorities (NCA)

Distribution of tasks regarding LSIs

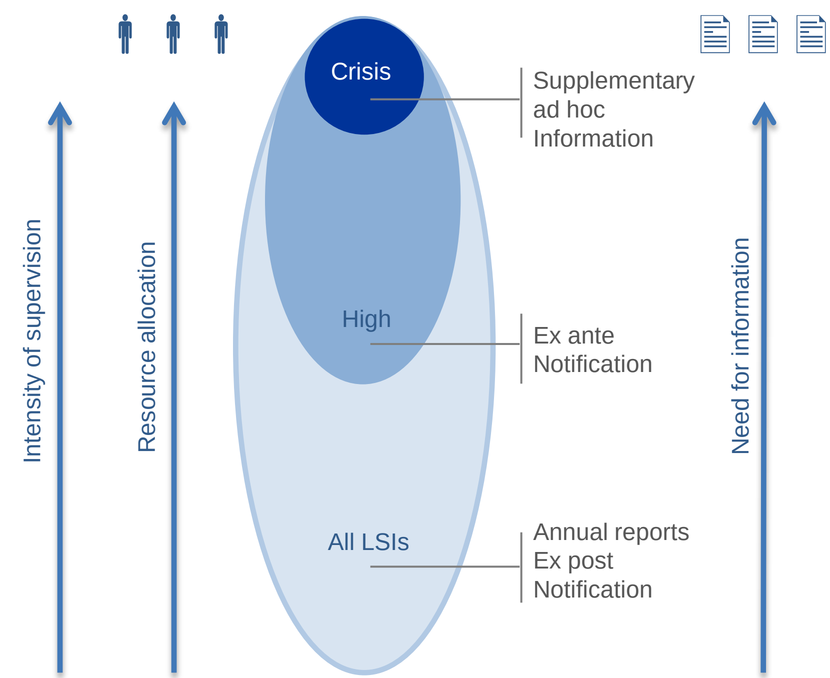
ECB intermediate structures (GDs)

- ECB with overall responsibility
- ECB compares at SSM-level and between sectors
- ECB provides expert support
- ECB promotes best practices
- The ECB grants or withdraws banking licenses and assesses acquisitions of qualifying holdings

National supervisors

- NCAs bear primary responsibility for supervision
- No duplication of national tasks at ECB level

Indirect ECB-supervision of LSI



Gradual approach, based on priority scores of LSIs

Quantitative & qualitative information from NCAs is analysed

The Supervisory Review and Evaluation Process (SREP) – The basics

- **The SREP is the main instrument of banking supervision**
- **Sound risk assessment of each institution:**
  - Combination of quantitative and qualitative elements
  - Holistic assessment of institutions' viability taking into account their specificities
  - Forward-looking perspective
- **High and harmonised standards**
  - SREP in 2015 for the first time conducted according to a harmonised methodology
  - Draws on leading practices within the SSM and as recommended by international bodies (including EBA guidelines on SREP)
  - Contributes to a level playing field for banks in the entire euro area
- **The outcome:** additional capital requirements based on each bank risk profile, and other supervisory measures on liquidity, risk management, …

The interaction of supervision with resolution of Significant Institutions

Preparation and planning | Early intervention | Resolution trigger | Resolution

Development of stress level

Recovery planning & assessment of recoverability

- ECB responsible
- SRM to be consulted

Resolution planning and assessment of resolvability

- SRM responsible
- SSM to contribute

Early intervention

- ECB responsible
- Notification to the SRB

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 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

Business as usual | Distressed situation | Failure or likely failure

European banking supervision …

Beginning of 2016 marked by increased volatility in financial markets

- **Recently, financial markets have experienced a flare-up of uncertainty**
  - Share prices of European banks have been extremely volatile, on some days rising or falling in double digits

- **Three groups of drivers:**
  - State of the global economy (weak growth, uncertainty with regard to China, geopolitical tensions, low oil prices, problems in emerging markets …)
  - Regulatory uncertainty (particularly with regard to the new bail-in regime)
  - Idiosyncratic issues (worries regarding specific banks that affected the general level of confidence)

- **Nevertheless, the banking system has become much more resilient over the past few years**
  - Liquidity profile of banks has improved
  - Capital ratios have improved …

In 2016, euro-area banks face several key risks

Business models and profitability

- Prolonged period of low interest rates
- High level of impaired assets on banks' balance sheets

Credit risk

- Deterioration of credit quality
- Deterioration of credit standards in some countries

Reversal of the search for yield

- On asset side: lower valuations
- On liabilities side: higher funding costs and increased collateral requirements

Conduct and governance risks

- Potential impact on profits due to high litigation costs
- Impact on banks' reputation

Vulnerabilities in emerging markets economies

- Direct exposures are quite limited
- Possible second-round and contagion effects

IT risks

- Increased reliance on complex IT systems
- Possible operational losses, reputational damage and business disruption

Key risks are identified in close collaboration with NCAs as well as macro-prudential functions and are translated into operational supervisory actions ➔ Supervisory priorities

The Supervisory Priorities for 2016 define how the identified key risks will be addressed

Supervisory Priorities		Activities[1]	
Business models and profitability drivers	2015	Challenge banks' business models	
	2015	Assess banks' profitability drivers (thematic review)	2017
		Investigate banks' IRRBB approaches across business models	
Credit risk		Implement a consistent approach to non-performing loans (NPLs)	
	2015	Evaluate impact of IFRS 9 on provisioning (thematic review)	2017
		Track sovereign and real estate exposure concentrations	
Capital adequacy	2015	Follow-up on capital quality and implementation of harmonised SSM OND approach	
		Harmonise supervisory approach to banks' ICAAP including stress testing	2017
		Examine banks' preparedness for gone-concern scenarios (MREL/ TLAC)	
Risk governance and data quality	2015	In-depth analysis on risk governance for selected SIs (follow up on "internal governance and risk appetite" 2015 thematic review)	
		Assess compliance with BCBS principles on risk data aggregation and risk reporting (thematic review)	
Liquidity		Harmonise supervisory approach to banks' ILAAP	2017

1 **Thematic reviews are highlighted with dark blue border**
2015 arrows indicate a direct continuity from a previous initiative
2017 arrows reflect a two year horizon in the proposed approach

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Great progress has been made, but we are not yet where we want to be …

- **The SSM is looking back on a successful first year …**
  - In line with its objectives, it proved to be a fair-handed and intrusive supervisor
  - In 2015 the main instrument of banking supervision, the SREP, has been applied according to a harmonised methodology for the first time

- **… Nevertheless, there is still a lot to do:**
  - We will further harmonise banking supervision in the euro area
  - We will make the decision-making process more efficient
  - We will continue improving our supervisory toolkit in order to be able to identify and assess the risks faced by banks and take appropriate action
  - We will continue developing a team spirit within the ECB and the NCAs in order to promote a common supervisory culture and a truly integrated supervisory mechanism

As we gain experience and grow closer together, we will approach our objectives at an increasing pace