

BRIEFING

Presentation of the SSM Annual Report by Danièle Nouy, Chair of the Single Supervisory Mechanism

ECON on 22 March 2016

This is a note prepared in advance of a regular public hearing as referred to in Regulation 1024/2013 and as in line with the Interinstitutional Agreement between the European Parliament and the European Central Bank. On 16 March, the ECB submitted to Parliament a draft of the Annual report on a confidential basis, which is under embargo until Tuesday, 22 March 2016 at 9:00. This briefing does therefore not rely on information provided in that Annual report. The following issues are addressed in this briefing: SSM's key priorities for 2016, a state-of-play regarding National Options and Discretions (NODs), a state-of-play regarding Non-Performing Loans (NPLs), the recent discussion on Pillar 2 capital requirements effecting the Maximum Distributable Amount (MDA), the EBA 2016 stress test, and a summary of external briefing papers provided in advance of the hearing. More detailed briefings on NODs, NPLs and MDA are also available on the homepage of the EP.

SSM's key priorities for 2016

On 6 January 2016, the Single Supervisory Mechanism (SSM) published its [2016 priorities](#) for supervising the significant banks in the euro area.

The five key risks (supervisory priorities) for 2016 are:

- **business model and profitability risk;**
- credit risk;
- capital adequacy;
- risk governance and data quality; and
- liquidity.

Those priorities, which are of high-level nature and not exhaustive, are expected to steer concrete supervisory actions in 2016; for each priority, the SSM will carry out a number of related activities.

Business model and profitability risk is ranked the highest with the others varying in importance across countries. Table 1 overleaf outlines the key risks, proposed supervisory actions and the expected outcome for each action. The SSM noted in its publication on 6 January 2016 that in some cases the implementation of supervisory actions would take more than 12 months.

Profitability and interest rates

On 23 February 2016, Ms Nouy gave a [speech](#) in London in which she warned that low interest rates eat into banks' profitability and could push them into riskier investments.

Empirical studies indeed suggest that higher interest rates and a steeper yield curve have a positive effect on banks' profitability (e.g. [Borio, Gambacorta, Hofmann](#)).

Banks will nevertheless have to cope with a situation of low interest rates for a while. In his [introductory statement](#) to the press conference on 10 March 2016, the President of the ECB said: "...the Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time...".

Table 1: Key risks, supervisory actions and outcomes

Risk	Supervisory Action(s)	Outcome
Business model and profitability risk	Thematic review of banks' profitability drivers	Identify banks with structurally low profitability
Credit risk	Task force on NPLs	Propose follow-up actions for institutions with high levels of NPLs
	Thematic review of IFRS 9	Understanding of banks' provisioning practices and how banks are preparing for IFRS 9
Capital adequacy	Review of quality and consistency of banks' ICAAP	An analysis of banks' internal stress-testing capacities
	Review of banks' internal models	An analysis of banks' preparedness of TLAC and MREL
Risk governance and data quality	Clarify supervisory expectations to banks' boards	Boards will know the type and level of risk information required for sounder business decisions
	Thematic review of compliance with BCBS principles	Including risk aggregation, risk reporting and IT infrastructure
Liquidity	Dialogue on ILAAP	Effective scrutiny of the reliability of banks' progress in ensuring sound frameworks for managing liquidity and funding risk

Source: EGOV based on SSM priorities 2016

National Options and Discretions - State of play

(For details see EGOV Briefing '[National options and discretions in EU banking regulation](#)')

On 11 November 2015, the ECB published a [draft Regulation](#) and [draft Guide](#) on the exercise of national options and discretions (NODs), conceived with the overall **objective to foster the harmonisation of supervisory practices and the establishment of a level playing field within the SSM area**, and launched a related public consultation (open until 16 December 2015). The draft ECB Regulation and guide should be finalised and adopted in the coming weeks, following the public consultation.

According to the SSM explanatory memorandum accompanying the draft Regulation and Guide, *'[NODs] may have material effects (...) on the comparability of capital ratios that make it difficult for markets and the public to gauge the capital strength of banks. (...) [They] also add a layer of complexity and costs which is particularly burdensome for firms operating across borders and leaves room for regulatory arbitrage (...)'*.

The ECB has identified **over 150 options and discretions in CRD IV/CRR including some laid down in the Liquidity Coverage Ratio Delegated Act**. For a selected number of these options and discretions, where the impact could be material, the ECB has conducted a quantitative impact assessment accompanying the draft Regulation and Guide. According to the ECB impact assessment

the following NODs are the ones with the most significant and quantifiable immediate impact: i) Transitional arrangements for the definition of own funds -in particular the impact of allowing for a 10 year phase-in for the deduction of Deferred Tax Assets; ii) The possibility -granted on a case-by-case basis- not to deduct holdings in insurance subsidiaries for banks subject to supplementary supervision under the Financial Conglomerate Directive.

As a response to the above-mentioned issues, the draft ECB Regulation aims at harmonising the exercise of 35 horizontal options and discretions. It concerns in particular transitory provisions allowing for a smoother transition towards the new definition of own funds, notably the possibility to phase-in the deduction of Deferred Tax Assets (DTAs) over 10 years (instead of 5 years in Basel III). It proposes a common approach for the treatment of all transitional arrangements (e.g. it notably foresees an acceleration of the deduction of DTAs from banks' own funds, from 10 to 6 years). It also covers some permanent NODs relating to qualifying holdings, supervisory reporting, definition of default, credit risk mitigation measures, large exposures or the liquidity framework.

The ECB draft Guide is a non-binding text which provides guidance as regards case-by-case NODs to be used by SSM teams when assessing a request for exemption from a given bank, in particular the possibility not to deduct holdings in insurance companies. In the draft Guide, such possibility is maintained but disclosure requirements are enhanced.

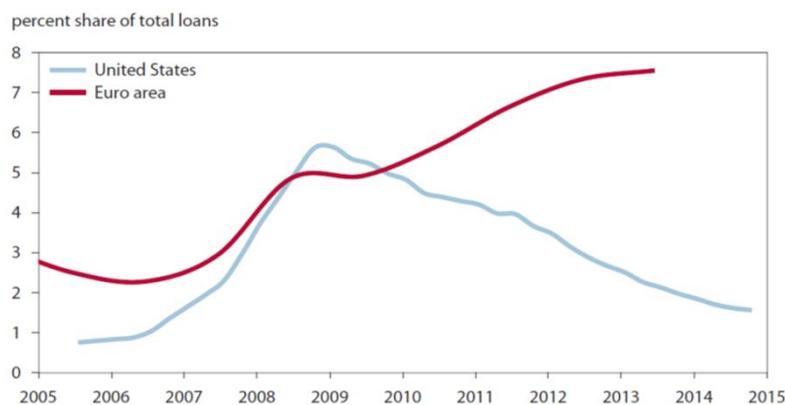
It should be noted that the above action of the SSM is **limited to banks under its direct supervision in the Euro Area** (i.e. 'significant banks'). To extend the common interpretation of NODs to less significant banks or foster convergence within the EU as a whole, an amendment of EU law may be necessary. In its [Communication of 24 November 2015 'Towards the completion of the Banking Union'](#), the Commission acknowledges that '(...) *There is a need to reduce national options and discretions in the application of prudential rules. [Notwithstanding the on-going work by the SSM] there remains scope to eliminate some of the remaining options and discretions through EU regulatory measures. The Commission will work (...) with a view to aligning, as necessary, the use of national options and discretions (...)*'. In its report on the ['Banking Union-Annual report 2015'](#), the European Parliament: '(...) *stands ready to cooperate at the legislative level in order to further improve regulatory and supervisory harmonisation; emphasises the need for the review of national options and discretions to guarantee a level playing field across the Banking Union (...)*'.

The challenge of non-performing loans in the euro area

(For details see EGOV Briefing ['Non-performing loans in the Banking Union: stocktaking and challenges'](#))

Since the start of the crisis, the level of non-performing loans has soared in some Member States, in particular crisis-hit countries, pushing the European average to unprecedented levels. While the average rate of non-performing loans is now slowly decreasing in the EU, from 6.4% in December 2014 to 5.9% at the end of September 2015, it remains higher than in other major developed countries (less than [2%](#) for the United States and Japan at the end of 2015). Figure 1 presents the evolution of NPL ratios in the United States and in the euro area from 2006 to 2014. While NPL ratios rapidly increased in both areas in both areas from 2007 to 2009, the trends diverged radically from 2010 to 2014, with a rapid resolution of NPLs in the United States while Euro area banks continued piling up bad debts.

Figure 1: The evolution of NPL ratios in Europe and in the US



Source: [PIIE](#), 2016, p24

Given that NPL have a detrimental impact on growth, the resolution of this debt overhang is critical for the economic recovery in the euro area. Many measures were taken in various jurisdictions to address the issue of non-performing loans. The Egov briefing lists the main initiatives to date in several Member States.

Impaired assets measures have been implemented in most countries in order to relief banks from the burden of NPL, through the establishment of ad hoc or system-wide bad banks or asset protection schemes.

Some Member States have also taken measures to develop the **secondary market for NPL**: facilitating the transfer of NPL to non-bank entities (NPL service providers, investment funds), shortening court procedures, improving loss recognition, enhancing the market for the sale of collaterals and the information available to potential investors.

The quality and **efficiency of insolvency frameworks** appears to be critical for a swift reduction of non-performing loans. In particular, laws facilitating the restructuring of over-indebted borrowers (corporates or households) were enacted in Spain, Ireland and Greece, with the aim to accelerate in-court and out-of-court proceedings.

Finally under-provisioning remains a major impediment to NPL restructuring since loss recognition constitutes a prerequisite to any form of debt resolution. **Enhanced supervisory oversight**, coupled with **adequate tax frameworks**, can provide strong incentives for banks to proactively manage their NPL portfolios.

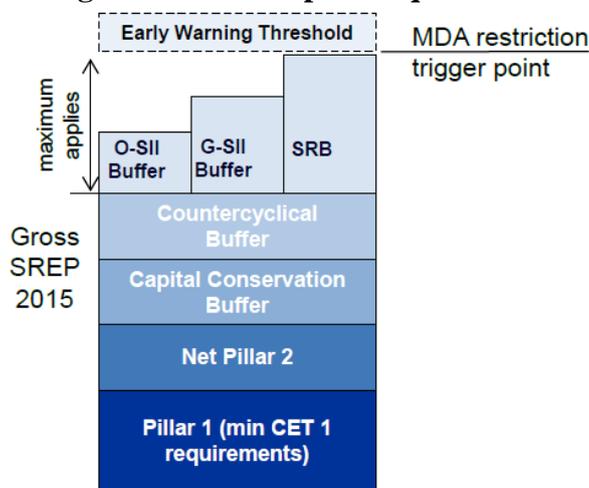
Relationship between Pillar 2 capital requirements and restrictions on profit distribution

(For details see EGOV Briefing '[What to do with profits when banks are undercapitalized: Maximum Distributable Amount, CoCo bonds and volatile markets](#)')

If a bank posts losses or reports zero profit, and breaches regulatory buffers, applicable rules restrict it in making payments of dividends, bonuses or coupons on certain bonds. There is currently a discussion going on how to correctly interpret the related rules.

The Maximum Distributable Amount (MDA) is the maximum amount of earnings that a bank can distribute in the form of dividends, bonuses or interest on Additional Tier 1 instruments if it breaches its capital requirements. On [16 December 2015](#) the European Banking Authority (EBA) issued an opinion on the methodology for calculating of the MDA. It provides that to calculate the amount of CET1 shortfall, the supervisor shall consider, in addition to the combined buffer, the overall capital requirements including the pillar I requirements and **the pillar II requirements**. On [19 February 2016](#) the ECB published the *SREP methodology booklet*, which confirms the EBA opinion that pillar II requirements shall be fully taken into account both for the trigger and the calculation of the MDA (See figure 1).

Figure 1: CET1 capital requirements



Source: [ECB](#)

It was reported in the press ([Bloomberg](#), [Handelsblatt](#), [Reuters](#)) that the Commission proposed, in a note to the Commission Expert Group on Banking, Payments and Insurance, to clarify the interactions between Pillar II requirements, Pillar II capital guidance and automatic restrictions on earning distribution. The European Parliament, in its 2015 annual report on the Banking Union, had called for such a clarification, emphasizing the need to guarantee a level playing field in the EU and to clarify the aim of the MDA mechanism.

In that note, the Commission takes the same view on the stacking order as defined by the EBA and endorsed by the ECB, and confirms that an institution doesn't comply with the combined buffer if Pillar I and Pillar II requirements are not met. However, the note then further elaborates on Pillar 2 capital requirements, which are basically those additional capital requirements that are imposed by

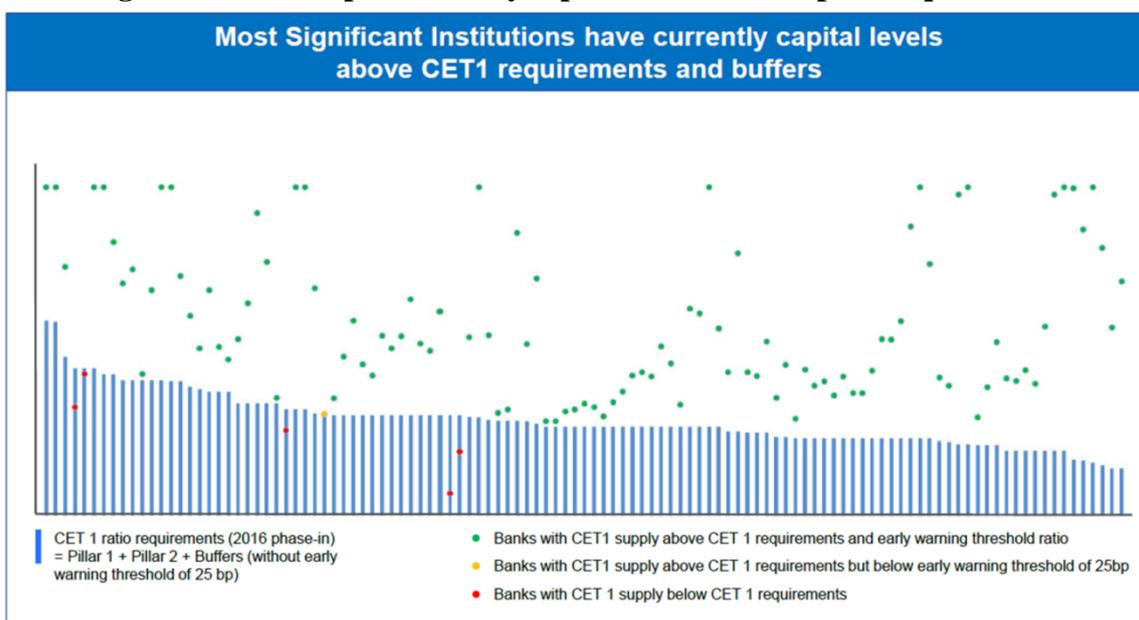
the bank supervisor to address the specific risk profile of each institution, arguing that hypothetical situations where an institution would not meet its capital requirements under a stress scenario.

The Commission note apparently aims to address concerns that different approaches in determining Pillar II requirements could undermine the [level playing field](#) in the financial sector, and clearly points out that Pillar 2 capital requirements should on the one hand be subject to public disclosure, and on the other hand only be imposed via a reasoned appealable administrative act.

By clarifying that adverse scenarios should not be taken into account in Pillar II requirements, the Commission introduces more flexibility for the supervisor, since the breach of the Pillar II capital guidance will not lead to automatic restrictions on earning distribution. It therefore mitigates the concern that restrictions on earning distribution would apply as soon as a bank reports a capital shortfall under an adverse scenario of a stress test. In [Bloomberg's view](#) "[T]he commission is considering changing the way some of those levels are defined to increase banks' flexibility about making the payouts, a move that amounts to a softening of standards."

Indeed, the probability that banks meet the MDA trigger point directly depends on where the threshold is set. Figure 3 below shows that a number of banks report capital positions just over the combined buffers (including Pillar I and Pillar II requirements).

Figure 2: CET1 capital actually reported vs CET1 capital requirements



Note: CET1 supply level capped for readability purposes

Source: [ECB](#)

Key features of the EBA 2016 stress test

The EBA has a mandate to initiate and coordinate the EU-wide stress tests, in cooperation with the European Systemic Risk Board (ESRB). The aim of such tests is to assess the resilience of banks to adverse market developments.

On 24 February, EBA formally [launched](#) the 2016 exercise; relevant [technical details](#) were already published on 5 November 2015. The exercise is carried out at the highest level of consolidation on a sample of large banks which have a minimum of EUR 30 billion in assets and in total cover 70% of the banking sector in the EU.

EU-wide stress tests are based on common methodologies, scenarios, and key assumptions, and have in previous years been already been carried out in 2014, 2011, 2010, and 2009. As in previous years, this exercise will again assess the resilience of EU-banks under a common macroeconomic **baseline scenario** and an **adverse scenario**. According to EBA, the [adverse scenario](#), as designed by ESRB, “*reflects the four systemic risks that are currently assessed as representing the most material threats to the stability of the EU banking sector*”. A sudden rise in risk premia across all financial asset classes is considered to be the most significant systemic risk, which could furthermore trigger low domestic demand and weak profitability, result in debt sustainability concerns both for the public and the private sector, and finally cause stress in particular in the growing shadow banking sector, leading to some spillover effects.

Compared to previous EU-wide stress tests, the 2016 exercise is in some respects different:

Scope: While the 2014 exercise covered a large sample of 123 banks in total, in the 2016 exercise the **sample is considerably smaller**, covering just 51 banks. There is, for example, no Greek bank included, on the grounds that they have already been subject to the ECB's 2015 Comprehensive Assessment which also included a stress test. Out of those 51 banks, 37 fall under direct supervision of the ECB, while 14 banks are headquartered in non-euro area countries and hence fall under the supervision of National Competent Authorities.

Our reading of the methodology is that the 2016 exercise pays more attention to foreign currency risk: Banks with significant **foreign currency exposure** were asked to take into account indirect credit risk from foreign currency lending that is related to the depreciation of local currencies, and market risk effects due to a revaluation of trading portfolios.

This time, the EBA has also asked all participating banks to project losses arising from conduct risk, meaning the current or prospective risk of **finances, indemnities, compensation payments** etc. that may arise from an inappropriate supply of financial services, including cases of wilful or negligent misconduct.

Unlike the 2014 EU-wide stress test exercise, which used a "hurdle rate" of 8% CET1 ratio for the baseline scenario, and 5.5% CET1 for the adverse scenario, there are **no hurdle rates** defined for the 2016 exercise, meaning there will be no clear "pass" or "fail" judgement as in the past. Results of the stress test shall rather be discussed with individual banks and communicated to supervisors who can then define mitigating actions in the context of the next Supervisory Review and Evaluation Process (SREP). EBA will in any case publish the results of the stress test in early Q3 2016.

Summary of external briefing papers provided in advance of the hearing

The members of the Banking Union Expert panels shall regularly provide briefings and background information for regular hearings in ECON. For this hearing, there were two topics chosen. The related briefing papers can be summarised as follows:

Should the marketing of subordinated debt be restricted/different in one way or the other? What to do in the case of mis-selling?

[Götz and Tröger](#) find a considerable heterogeneity in European banks' reliance on subordinated debt financing across countries. They point out that an important prerequisite for the efficiency of bail-in is that debt holders are able to bear the cost of a bail-in, and doubt whether households in general fulfil that criterion. They also find it highly doubtful whether households are able to charge adequate risk premia. Götz and Tröger hence argue that European bank supervisors should ensure that banks' bail-in bonds are only held by sophisticated investors such as insurance companies, pension funds or very wealthy individuals.

[Carletti and Masciandaro](#), on the other hand, find that at least from the perspective of financial stability bail-inable debt is well placed in the hands of households because they generally tend to respond more slowly to negative information about a bank or the banking system than sophisticated institutional investors. They point to the risk that institutional investors are very reactive to the imposition of losses or any other bad news, which in the end may however lead to increased contagion and systemic risk.

[Resti](#), pointing at the lack of publically available data on subordinated bank bonds, looks into the available empirical data, figuring out what percentage of total regulatory capital is actually composed of Tier 2 capital, inferring that a significant share of Tier 2 issues is presumably held by households. Resti observes that the BRRD has made it easier to resolve ailing banks while keeping their core operations in business and minimising public support, which in turn increases the actual risk faced by subordinated bondholders. He finally argues that, rather than prohibiting the sale of subordinated debt to small investors, supervisors should tackle the risk originating from self-placement practices through a thorough and uniform implementation of consumer protection rules.

An effective dialogue between supervisors and auditors – how can its implementation be monitored?

[Huizinga](#) looks into a new element that has recently been added to the legal framework for statutory audits, which now includes the provision that banking supervisors and auditors shall formally establish an effective dialogue. Huizinga makes clear that a prerequisite for an effective dialogue is that the supervisor is able to recommend the resolution of failed banks without a need to resort to regulatory forbearance, including the acceptance of inflated financial reports. The introduction of bail-in as the main avenue to resolve failed banks hence offers the prospect of ending the need for regulatory forbearance, and of improving the quality of accounting data.

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