

Public hearing with Danièle Nouy, Chair of the Supervisory Board, presenting the SSM Annual Report 2017

ECON on 26 March 2018

This note is prepared in view of a regular public hearing with the Chair of the Supervisory Board of the European Central Bank (ECB) who will inter alia present the SSM Annual Report 2017. The EP received a copy of that report on a confidential basis, under embargo until Monday, 26 March 2018, at 15:00 CET. In view of that restriction, this briefing does not refer to that Annual Report in any way.

The following issues are addressed in this briefing: the self-liquidation of directly supervised ABLV, the ECB Addendum on NPLs, the latest release of the ECB's Supervisory Banking Statistics, and external briefing papers provided for the ECON Committee which analyse the 2017 SREP results.

I. Self-liquidation of directly supervised ABLV

The Latvian ABLV Bank, with a balance sheet size of EUR 3.6 billion ([ABLV facts & Figures of Q3 2017](#)) way below the ECB's size-related threshold for direct supervision of EUR 30 billion, was still directly supervised since it was one of the three largest credit institutions in Latvia in terms of asset base (in terms of loan portfolio, however, it only ranked on the seventh place). Though the published financial information indicates that the bank was well capitalized and profitable, the shareholders of ABLV decided at an extraordinary meeting on 26 February 2018 to [voluntarily liquidate the bank](#) as a result of the following events:

On 12 February 2018, the Financial Crimes Enforcement Network (FinCEN) at the US Treasury proposed to ban ABLV from having a correspondence account in the United States due to money laundering concerns (see Boxes 1 and 2 with excerpts taken from the proposal's reasoning), raising severe doubts about the soundness of the bank's business model. FinCEN invited comments on all aspects of the proposed rule to be made within 60 days. After the FinCEN statement, clients started pulling out deposits from ABLV, which eventually resulted in an acute liquidity shortage.

On 18 February 2018, the Latvian banking supervisor - the Financial and Capital Market Commission - imposed a [temporary restriction on payments](#), following the ECB's respective instruction, in order to allow for a stabilisation of ABLV's financial situation.



On 23 February 2018, the ECB determined that ABLV Bank – as well as its subsidiary in Luxembourg – was [failing or likely to fail](#) due to the significant deterioration of its liquidity situation, and was to be wound up under the insolvency laws of Latvia and Luxembourg.

On 24 February 2018, the Single Resolution Board (SRB) decided that it would [not take resolution action](#).

On 9 March 2018, the Luxembourg Commercial Court, however, decided to [refuse the request](#) to place the subsidiary in Luxembourg – ABLV Bank Luxembourg, S.A. – in liquidation. That entity shall now be sold to new investors.

Box 1: Excerpts from the Department of the Treasury’s Proposal of Special Measure Against ABLV Bank, AS as a Financial Institution of Primary Money Laundering Concern

Source: [Federal Register / Vol. 83, No. 33 / Friday, February 16, 2018 / Proposed Rules](#)

II. Summary of Notice of Proposed Rulemaking

This NPRM [notice of proposed rulemaking] sets forth (i) FinCEN’s finding that ABLV Bank, AS (ABLV), a commercial bank located in Riga, Latvia, is a foreign financial institution of primary money laundering concern pursuant to Section 311, and (ii) FinCEN’s proposal of a prohibition under the fifth special measure on the opening or maintaining in the United States of a correspondent account for, or on behalf of, ABLV. As described more fully below, FinCEN has reasonable grounds to believe that ABLV executives, shareholders, and employees have institutionalized money laundering as a pillar of the bank’s business practices. As described in further detail below, ABLV management permits the bank and its employees to orchestrate and engage in money laundering schemes; solicits the high-risk shell company activity that enables the bank and its customers to launder funds; maintains inadequate controls over high-risk shell company accounts; and seeks to obstruct enforcement of Latvian anti-money laundering and combating the financing of terrorism (AML/CFT) rules in order to protect these business practices [...]

III. Background on Latvia’s Non-Resident Deposit Sector and ABLV Bank

1. Latvia’s Non-Resident Deposit Banking Sector

Due to geography, linguistic profile, and a stable and developed banking system, Latvia serves as a financial bridge between the Commonwealth of Independent States (CIS),⁷ European Union (EU) and U.S. financial systems. While it lacks a legal framework that formally separates domestic banking business and non-resident banking, most Latvian banks conduct the majority of their business in either domestic retail/commercial banking or non-resident banking services, not both. Non-resident banking in Latvia allows offshore companies, including shell companies, to hold accounts and transact through Latvian banks. CIS-based actors often transfer their capital via Latvia, frequently through complex and interconnected legal structures, to various banking locales in order to reduce scrutiny of transactions and lower the transactions’ risk rating. [...] The Latvian banking system’s reliance on NRD funds for capital exposes it to increased illicit finance risk.

2. ABLV Bank

Established in 1993, ABLV Bank, AS (ABLV) is headquartered in Riga, Latvia. According to data provided by the Association of Latvian Commercial Banks, ABLV is the second largest bank in Latvia by assets, with the equivalent of roughly \$4.6 billion as of March 31, 2017. ABLV is Latvia’s largest NRD bank by assets. As further described below, the majority of ABLV’s customers are high-risk shell companies registered outside of Latvia. [...]

Box 2: Excerpts from the Department of the Treasury’s Proposal of Special Measure Against ABLV Bank, AS as a Financial Institution of Primary Money Laundering Concern

Source: [Federal Register / Vol. 83, No. 33 / Friday, February 16, 2018 / Proposed Rules](#)

IV. Finding ABLV To Be a Foreign Financial Institution of Primary Money Laundering Concern

[...] According to information available to FinCEN, ABLV executives, shareholders, and employees have institutionalized money laundering as a pillar of the bank’s business practices. ABLV management orchestrates, and permits the bank and its employees to engage in, money laundering schemes. Management solicits the high-risk shell company activity that enables the bank and its customers to launder funds, maintains inadequate controls over high-risk shell company accounts, and is complicit in the circumvention of AML/CFT controls at the bank. [...]

In addition, ABLV management seeks to obstruct enforcement of Latvian AML/ CFT rules. Through 2017, ABLV executives and management have used bribery to influence Latvian officials when challenging enforcement actions and perceived threats to their high-risk business.

ABLV’s business practices enable the provision of financial services to clients seeking to evade financial regulatory requirements. Bank executives and employees are complicit in their clients’ illicit financial activities, including money laundering and the use of shell companies to conceal the true nature of illicit transactions and the identities of those responsible. ABLV is considered innovative and forward leaning in its approaches to circumventing financial regulations. The bank proactively pushes money laundering and regulatory circumvention schemes to its client base and ensures that fraudulent documentation produced to support financial schemes, some of which is produced by bank employees themselves, is of the highest quality. [...]

ABLV does not mitigate these risks effectively. ABLV does not adequately conduct know-your-customer (KYC) checks or customer due diligence (CDD) on a number of its customers, does not collect or update supporting documentation from its customers to justify transactional activity, and uses fraudulent documentation in some of its CDD files. Furthermore, the bank has had deficiencies in its internal control system, including insufficient customer due diligence and monitoring of transactions. [...]

Ninety percent of ABLV’s customers are high-risk per ABLV’s own risk rating methodology and are primarily high-risk shell companies registered in secrecy jurisdictions. [...]

In view of those events, Ms Nouy reminded in a public statement on 22 February 2018 of the [responsibilities for combatting money laundering](#) in the SSM framework: She pointed out that breaches of anti-money laundering can be symptomatic of more deeply rooted governance deficiencies within a bank but the ECB does not have the investigative powers to uncover such deficiencies, that being a task of national anti-money laundering authorities.

II. ECB Addendum on NPLs

On 15 March 2018, the ECB published the final [Addendum to ECB Guidance to banks on non-performing loans](#), which sets out the supervisory expectations for new NPLs, taking into account the results of the public consultation on the draft Addendum which ran from 4 October to 8 December 2017.

In comparison to the draft Addendum, the final version in particular addresses concerns about the proposed date of application and replaces in the final text the initially specified cut-off date of 1 January 2018 by 1 April 2018; addresses concerns about the eligibility of all forms of credit risk

mitigation for banks using the IRBA approach by clarifying in the final text that collateral eligible under the CRR will also be considered for the purpose of the supervisory expectations set out in the Addendum, ensuring a level playing field across banks using standard and internal model-based approaches; addresses a lack of clarity on how partial write-offs are to be considered within the supervisory expectations by amending that partial write-offs made since the most recent NPE classification can be considered as provisioning in the linear path assessment and contribute to the existing coverage ratio of the bank; and addresses concerns about negative economic effects resulting from moral hazard, on the side of debtors (strategic defaults) and of creditors (quicker legal enforcement) by not including in the final text the supervisory expectations for the linear path for secured exposures during the first two years to remove potential adverse incentives to pursue a legal route too quickly where viable forbearance solutions might be more effective.

For the secured parts of NPLs, the ECB acknowledged that an assumption of collateral enforcement is not always appropriate in the first couple of years, when viable forbearance solutions are implementable and more efficient.

In the final Addendum text, the linear path is hence not considered during the first two years for the secured parts of NPLs, the supervisory expectations are rather to see a coverage of 40% after 3 years of NPE vintage, 55% after 4 years, 70% after 5 years, 85% after 6 years, and full coverage after 7 years.

The ECB underlined again the nature of the Addendum: the Addendum is not in itself a Pillar 2 measure, and does not aim to impose any obligations on banks. The Addendum provides an indication of what the ECB expects from banks when they assess the risks they are exposed to. In this respect, the accounting allowances of a bank serve as a starting point for the supervisory dialogue in determining whether these allowances adequately cover expected credit risk losses. The accounting allowances are then compared with the supervisory expectations set out in the Addendum, using timelines which, in principle, may point to a deterioration of the exposures' quality. Banks are expected to discuss why their respective approaches differ from the supervisory expectations set out in the Addendum. If the ECB is satisfied with the explanations, then no further action is proposed. However, if, after giving due consideration to a bank's explanations and in view of the specific circumstances of that bank, the ECB is still of the view that that bank's provisions do not adequately cover the expected credit risk, a supervisory measure under the Pillar 2 framework might be considered.

The nature of the ECB Addendum is hence different from the [Commission's proposed Regulation](#) regarding the minimum loss coverage for NPLs, which aims to set a statutory prudential backstop (Pillar 1 measure) and in its design follows a progressive path rather than a linear path. (For more information on NPLs in the Banking Union also see a previous related [EGOV briefing](#)).

III. Supervisory Banking Statistics

Since the second quarter 2016, the ECB publishes aggregate [Supervisory Banking Statistics](#) on directly supervised significant banks; the dataset regularly reports on

- > general statistics
- > balance sheet composition and profitability
- > capital adequacy, leverage and asset quality
- > funding
- > liquidity
- > and data quality

The data published on 23 January 2018 for the [third quarter 2017](#) show that, compared to the situation one year ago, there is again an improvement across the board of main indicators:

Most notably, as regards asset quality, the **average NPL ratio** of the most significant banks improved by 1.34 percentage points from 6.49% in Q3 2016 to 5.15% in Q3 2017.

The banks' *profitability* also saw a considerable improvement, as the average Return on Equity increased by 1.63 percentage points from 5.40% in Q3 2016 to 7.03% in Q3 2017.

As regards the **banks' funding**, the Loan-to-Deposit ratio likewise improved by 4.76 percentage points from 122.30% in Q3 2016 to a more solid level of 117.54% in Q3 2017.

The **average capitalisation level** saw an improvement as well, being 0.63 percentage points higher in a year-to-year comparison: CET 1 ratios stood on average at 13.69% in Q3 2016 and at 14.32% in Q3 2017. In this context, however, one should keep in mind that the improvement is nearly exclusively due to a denominator effect: While the amount of total equity has only increased marginally, the amount of risk-weighted assets has come down by some 4.5% over the one year period, resulting in the improved capital ratio mentioned above.

The **Liquidity Coverage Ratio** (LCR) is in a year-to-year comparison 2.63 percentage points higher, with 140.27% in Q3 2017 compared to 137.64% in Q3 2016; compared to the previous quarter, though, it lost 2.41 percentage points.

Table 1: Overview of key indicators from the ECB's Supervisory Banking Statistics

	Q3 2016	Q4 2016	Q1 2017	Q2 2017	Q3 2017
Balance sheet composition (EUR billions; percentages)					
Total assets	22,338.52	21,723.24	21,928.62	21,422.48	21,298.36
Total liabilities	20,927.30	20,324.05	20,498.73	20,015.75	19,877.56
Equity	1,411.22	1,399.19	1,429.89	1,406.73	1,420.80
Non-performing loans ratio	6.49%	6.15%	5.90%	5.48%	5.15%
Key performance indicators					
Return on equity	5.40%	3.22%	7.06%	7.08%	7.03%
Return on assets	0.34%	0.21%	0.46%	0.46%	0.47%
Capital and leverage ratios					
CET 1 ratio	13.69%	13.77%	13.74%	13.88%	14.32%
Tier 1 ratio	14.57%	14.71%	14.75%	14.88%	15.32%
Total capital ratio	17.18%	17.29%	17.44%	17.56%	17.98%
Leverage ratio (transitional definition)	5.30%	5.39%	5.29%	5.32%	5.39%
Leverage ratio (fully phased-in definition)	4.99%	5.03%	5.04%	5.08%	5.17%
Funding					
Loan-to-deposit ratio	122.30%	120.06%	119.39%	118.26%	117.54%
Liquidity					
Liquidity coverage ratio	137.64%	135.80%	141.67%	142.68%	140.27%

Source: [ECB Supervisory Banking Statistics](#)

While the development of key indicators at aggregate level looks overall positive (see table 1), a closer look at the details reveals some notable differences in particular among different size classes of significant banks.

Table 2: CET1 capital ratio of directly supervised banks by size class (Q3 2017 and Q3 2016)

	<i>Common Equity Tier 1 ratio (Q3 2017)</i>	<i>Common Equity Tier 1 ratio (Q3 2016)</i>
Banks with total assets		
<i>Less than €30 billion</i>	17,73%	17,00%
<i>Between €30 billion and €100 billion</i>	16,67%	15,65%
<i>Between €100 billion and €200 billion</i>	16,06%	15,13%
<i>Between €200 billion and €300 billion</i>	14,16%	13,98%
<i>More than €300 billion</i>	13,90%	13,76%
G-SIBs	13,24%	12,45%
Total	14,32%	13,70%

Source: ECB Supervisory Banking Statistics for Q3 2017 and Q3 2016, extract from table T03.01.3

The capital ratios, for example, tend to fall with an increasing size of the bank; already in 2016 the largest banks, global systemically important banks (G-SIBs), had capital ratios that were more than 25% below those of the smallest banks under ECB supervision, and that situation has not changed in 2017 (see table 2).

On the other hand, however, the ratio of NPLs in G-SIBs is way lower than that in the smallest bank under direct ECB supervision, it was less than a third of the average level found in the smallest banks, and that situation has likewise not changed since 2016 (see table 3).

Table 3: Non-performing loans ratio of directly supervised banks by size class (Q3 2017 and Q3 2016)

	<i>Non-performing loans ratio (Q3 2017)</i>	<i>Non-performing loans ratio (Q3 2016)</i>
Banks with total assets		
<i>Less than €30 billion</i>	11,72%	15,23%
<i>Between €30 billion and €100 billion</i>	10,48%	13,33%
<i>Between €100 billion and €200 billion</i>	6,95%	8,88%
<i>Between €200 billion and €300 billion</i>	2,83%	4,24%
<i>More than €300 billion</i>	4,38%	4,72%
G-SIBs	3,54%	4,53%
Total	5,15%	6,49%

Source: ECB Supervisory Banking Statistics for Q3 2017 and Q3 2016; extract from table T03.07.03 (2017) and T03.05.03 (2016)

Analysing the sources of the banks' higher profitability, which on average improved by 31% on a year-to-year basis, we find that the main source of banks' income – net interest income – in fact slightly declined. However, that trend was overcompensated by mainly two factors that are relevant both in relative and absolute terms: On the one hand, the net trading income increased by some 62.3%, while impairments and provisions came down by some 14.2% on the other hand (see table 4). However, income from trading activities is a source of income that is mainly available to large and very large banks; in Q3 2017, more than 78% of the aggregated trading income was booked by the 8 GSIBs in the sample.

Table 4: Aggregated profit and loss figures of directly supervised banks by reference period

Profit and loss	Q3 2016	Q3 2017	Change y-to-y
Net interest income	198.353,91	194.529,99	-1,9%
Net fee and commission income	98.478,85	101.654,29	3,2%
Net trading income	17.281,26	28.051,18	62,3%
Exchange differences, net	2.726,11	547,74	-79,9%
Net other operating income	31.961,01	21.219,15	-33,6%
Operating income	348.801,13	346.002,35	-0,8%
Administrative expenses and depreciation	-223.723,56	-218.645,15	-2,3%
Net income before impairment, provisions and taxes	125.077,58	127.357,20	1,8%
Impairment and provisions	-54.908,05	-47.115,70	-14,2%
Other	9.877,02	15.056,51	52,4%
Profit and loss before tax from continued operation	80.046,55	95.298,01	19,1%
Profit and loss before tax from discontinued operation	-2.204,22	3.164,86	-243,6%
Tax expenses or income	-20.680,86	-23.565,51	13,9%
Net profit/loss	57.161,47	74.897,35	31,0%

Source: ECB Supervisory Banking Statistics for Q3 2017, extract from table T02.01.1

IV. Recent SSM publications

List of supervised entities

The most recent [ECB list of supervised entities](#) was published on 2 March 2018. Changes to previous lists are not singled out. The number of directly supervised entities currently stands at 118, compared to 119 according to the list published on 5 December 2017. We find that Luminor, a bank newly established by Nordea and DNB, was added to the list as financial services provider in Estonia, Latvia and Lithuania. VTB Bank AG in Austria, and Danske Bank Plc in Finland were taken off the list.

Other SSM publications

On 2 March 2018, the ECB launched a public consultation on [draft guides for banks on their capital and liquidity management](#), which sets out the supervisor's related expectations. The consultation runs until 4 May 2018.

On 31 January 2018, the ECB announced that – as part of the 2018 EU-wide EBA stress test – it will carry out the [stress test at 37 directly supervised banks](#), the sample includes four Greek banks. The stress test will be based on the EBA's methodology, templates and scenarios, and results of individual banks are expected to be published by 2 November 2018. However, in order to complete the test before the end of the third European Stability Mechanism stability support programme for Greece, the timetable for the four Greek banks will be accelerated and the results are expected to be published in May 2018.

V. Summary of recent external briefing papers on the 2017 SREP results

On request of ECON coordinators, the panel experts were asked to assess the outcome of the ECB's Supervisory Review and Evaluation Process (SREP) in 2017. The SREP can be considered as the core activity of the ECB's supervisory arm that aims to assess each bank's individual risk profile. The SREP decisions summarise all related supervisory findings and show where a bank stands in terms of capital requirements and risk management procedures. The ECB's SREP decisions in particular define which amount of Common Equity Tier 1 capital directly supervised banks are expected to hold, in view of their individual risk profile.

In December 2017, the ECB published the [SSM SREP Methodology Booklet - 2017 edition](#) - which describes in the first section the main outcome of the ECB's 2017 SREP exercise on an aggregated basis. The panel experts were asked to analyse that publication in order to

- > gauge the information content, in particular in comparison to its previous version,
- > highlight areas that in future would merit a more detailed description by the ECB,
- > check whether some banks individually disclose their SREP results and compare whether individually disclosed SREP results are systematically better or worse than aggregate SREP results,
- > and examine whether the aggregate or individual disclosure of 2017 SREP results resulted in any notable capital market effects (equity and debt).

[Andrea Resti](#) looks in his report at the methodology used by the ECB to carry out the SREP, as well as at the aggregate results disclosed by the supervisors and the figures released over time by individual banks. Resti points to that fact the Single Supervisory Mechanism has disclosed a qualitative summary of the criteria it follows when carrying out the SREP, but has not shared hard rules with the public regarding, e.g., how different risk profiles are combined, or how individual risks are scored and merged together to assist the decision on capital add-ons. Resti recommends that disclosures to banks could be improved, inter alia, by using a standard template in the communication of SREP results, making it possible for institutions to monitor SREP determinants over time and to challenge supervisory models and calculations if necessary. A fixed, detailed template would also make it easier for the European Banking Authority to perform comparisons across banks and jurisdictions, strengthening a convergence process that has already produced remarkable results. When illustrating the drivers of SREP capital add-ons, he also suggests that supervisors should pay special attention to explaining differences between their own quantifications and the banks' internal risk assessments.

As for the communication of SREP results to the public, Resti finds that the pros and cons look harder to assess. Supervisory evaluations, unless properly understood, may trigger undesirable reactions by customers and market counterparties, thus exacerbating the very weaknesses that they are meant to address. In the case of banks with listed financial instruments, however, Pillar 2 add-ons meet the definition of inside information provided in the Market Abuse Regulation ("MAR") and should therefore be publicly disclosed.

The SSM only reports on aggregate Pillar 2 capital requirements, but Resti finds that many institutions disclose their own figures to the public, including listed banks that feel that SREP results qualify as "inside information" under MAR.

Analysing the disclosed data, Resti finds that on an aggregate basis the overall SREP score remains roughly unchanged over time; among its determinants, the least satisfactory one appears to be governance and risk management, which is also showing a deteriorating trend. The latest data signal an increase in the binding portion of capital requirements (the one triggering constraints on dividend and coupon payments); this is mostly due to the gradual implementation of the Basel III accord and is offset by a drop in the non-binding portion of the SREP requirements. As for individual disclosures, Resti finds that they are less frequent in some EU countries, like Germany and Austria, and focus mostly on binding capital requirements; the average Pillar 2 add-on for banks that choose to report their SREP figures looks broadly in line with the aggregate requirement disclosed by the SSM, signalling that no "self-selection bias" apparently occurs.

Overall, Resti's review supports the view that a higher degree of disclosure may trigger greater uniformity in how the SREP is implemented across institutions and Member States, as well as greater consistency between SREP analyses and the supervisory priorities declared by the SSM ahead of each new SREP cycle.

[Harry Huizinga](#) overall finds that the 2017 SREP information that is in the public domain is insufficient to evaluate the efficacy of the SREP as conducted by the ECB in terms of improving the regulatory and market discipline of banks. The publication of full bank-level SREP information (by either the ECB or the individual banks) would facilitate such an evaluation, but he agrees with Resti in the opinion that full disclosure is undesirable as it exposes the banks with the weakest supervisory reviews to potentially very severe market discipline. However, Huizinga finds that the ECB could improve the information provision about the SREP by requiring banks that choose to reveal any capital regulatory information to disclose a complete breakdown of their CET1 demand to improve data comparability across banks and hence potentially market discipline.

Huizinga's paper reviews the 2017 SREP results with a view to assessing their capital market implications and seeing whether the information provision about the SREP results could be improved. Aggregated SREP information cannot be meaningfully applied to assess capital market reactions to the SREP results. However, as the ECB neither prevents nor dissuades institutions from disclosing their CET1 demand stemming from the SREP, individual disclosures could be used for an analysis of capital market reactions. In the 2017 SREP round, 28 banks were identified as having disclosed information on their regulatory CET1 demand by way of a press release. That corresponds to about a quarter of the 119 banks that were directly supervised by the ECB as of December 5, 2017. Larger banks were found to be more likely to disclose their regulatory CET1 demand, and Huizinga suggests that this could maybe the case because they are under more intense pressure to reveal their SREP outcome to ward off potential insider trading based on this information.

Since bank-level SREP disclosures are voluntary, they were expected to be biased towards news that are favourable to investors in bank securities. Consistent with that assumption, Huizinga finds that bank stock returns on average are positive on SREP disclosure days, although the average return is not statistically.

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