BRIEFING

European Parliament

Public hearing with Danièle Nouy, Chair of the Supervisory Board

ECON on 20 November 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).

The following issues are addressed in this briefing: (i) feedback on the EP resolution on Banking Union; (ii) Anti Money Laundering, including external paper commissioned for this hearing; (iii) Brexit; (iv) Cum Ex; (v) stress test results; (vi) supervisory banking statistics; (vii) recent SSM publications, including the 2019 supervisory programme and the thematic review on profitability and business models.

I. Feedback on the EP's Banking Union – Annual Report 2017

The EP adopted on 1 March 2018 the Banking Union - Annual Report 2017, which inter alia calls on the ECB Banking Supervisor to take action on several issues.

The ECB published its response to those **calls for action** on 9 July 2018, addressing most of the issues raised.

The following issues, however, seem to have only been partially addressed or not addressed:

Transparency of solvency assessments: In paragraph 6, the resolution calls on the SSM to reflect on ways to increase transparency when assessing the solvency of credit institutions. The ECB's response has a dedicated section on transparency aspects, focussed on the disclosure of stress test results (see also section V on stress test results). The issue of transparent solvency assessments, however, is not addressed as such.

Uniform reporting system: In paragraph 19, the Resolution calls for the introduction of a uniform reporting system to address the issue that credit institutions have to report the same data several times to different recipients. The ECB's response does not explicitly address the notion of a uniform reporting system, yet it mentions that at the end of 2016, the SRB was granted direct access to relevant supervisory information and data stored in the ECB supervisory IT system. The ECB further outlines that this streamlined and automated exchange of information ensured that the reporting burden on banks was kept to a minimum.

Shadow banking risks: In paragraph 19, the Resolution calls for coordinated action to ensure that the risks and vulnerabilities associated with the EU shadow banking system are appropriately monitored. The ECB's response, however, doesn't specifically mention the shadow banking system.

Economic Governance Support Unit (EGOV)
Authors: J. Deslandes, C. Dias, M. Magnus, M. Peraki
Directorate-General for Internal Policies

PE 624.410- November 2018

EN

SRB as permanent observer: In paragraph 5, the Resolution calls on the ECB to improve the day-to-day cooperation with the Single Resolution Board (SRB), welcoming in this regard if the ECB allowed a representative of the SRB to be a permanent observer at meetings of the ECB' Supervisory Board. The ECB's response does not specifically address the notion of a permanent observer, but it mentions that the rules for the cooperation between the ECB and the SRB are established in the Memorandum of Understanding (MoU), a revised version thereof was published on 6 June 2018[1]. In the revised MoU, the institutional representation of the SRB was left unchanged. This means that the SRB will still only be invited to meetings of the Supervisory Board for items related to the tasks and responsibilities of the SRB. The SRB was not made a permanent observer.

Inter-institutional Agreement with the European Court of Auditors (ECA): In paragraph 5, the Resolution calls for an inter-institutional agreement (IIA) between the ECB and the ECA. In that respect the ECB's response only mentions that it is currently analysing the proposal, seeking clarifications and assessing certain legal aspects.

In this context it may be noted that on 13 November 2018, the EU Contact Committee of EU Supreme Audit Institutions reiterated its perception in public a statement that it still sees deficiencies in the accountability and audit arrangements of the supervisory mechanism for banks in the euro area.

The ECB responded with varying degrees of detail to those elements of the Banking Union Report in which the EP has not explicitly called for action but rather expressed an opinion. For example, in paragraph 20 the Resolution considers that the proportionality principle could be better taken into account in certain supervisory arrangements – the ECB addressed that aspect in a detailed section of its response. In paragraph 13, on the other hand, the EP considers that the capital position of banks can be strengthened by reducing dividend payments - that aspect is not addressed in the ECB' response, even though the ECB has actually issued recommendations on dividend distribution policies in 2015, 2016, and 2018.

II. Anti-Money Laundering

The Commission's proposal to tighten up AML supervision

In its communication of September 2018, the Commission has proposed a three-pronged approach to reinforce the AML supervisory framework:

- Commitment to further develop guidelines and best practices in terms of AML supervision, which do not need any legislative changes;
- Strengthening the AML supervisory framework by entrusting the European Banking Authority ('EBA') with new powers and importantly by requiring the EBA to act in certain domains;
- Conducting a more fundamental review of the AML supervisory framework (i.e. possible need for a new EU body) at a later stage, in accordance with the review clause of the 5th AML Directive (i.e. January 2022).

This communication builds on the analysis conducted by a Joint Working Group involving the ECB/SSM.

For further background information, see EGOV Briefing: "Money Laundering: recent cases from an EU banking supervisory perspective" (update November 2018).

In the Commission's communication and the draft action plan for AML being discussed ahead of the December ECOFIN Meeting, the ECB is specifically asked to (i) conclude a broad multilateral

[1] The new MoU, in particular, provides for an automatic exchange of information on a continuous basis, without any explicit request or justification, regarding information explicitly mentioned in the annex of Memorandum. The previous MoU provided for exchange of information on a voluntary basis (in the absence of an explicit request)

Memorandum of Understanding with all relevant AML/CFT authorities in line with the 5th Anti-Money Laundering Directive by 10 January 2019 and to (ii) ensure that practical arrangements are operational to allow AML/CFT concerns to be consistently factored in when performing supervisory tasks by mid 2019.

Position of the ECB/SSM

Further to the publication of Commission's communication and legislative proposal on EBA, the President of the ECB, at the EP ECON Committee September monetary dialogue reiterated the need for the EU to establish an EU Authority for AML supervision. This echoes positions voiced by the SSM in previous hearing (See Box 1). In particular, the Chair of the SSM further explained in a letter dated 3 May 2018 the limits of what the existing supervisory and coordination framework may achieve: "*as anti-money laundering concerns both the supervisory and criminal/judicial spheres, reviewing the [AML] Directive may not suffice to ensure cooperation is smooth and all-encompassing. Establishing a European AML authority could bring about such a degree of improved cooperation*".

Box 1: ECB's public statements in relation to a possible new EU supervisory architecture

In an interview in March 2017, Danièle Nouy emphasised that whether money laundering and financing of terrorism should be supervised centrally, is a "decision for politicians and legislators to make", but the Single Supervisory Mechanism cannot take on such responsibility for the following reason: "we already have many tasks which require our full attention. Moreover, we already work closely with the 19 national competent authorities that undertake banking supervision for the countries of the euro area. [...] As anti-money laundering is not necessarily located in the NCAs or NCBs, it would mean having additional "partners" within the SSM, which would add complexity".

In addition, at the April 2018 TAX3 hearing on AML, the ECB explained that there may be legal impediments to entrusting ECB with further responsibilities in the field of AML given the legal basis (Article 127(6)) on which the SSM has been established. AML regulation applies to all financial sector while Article 127(6) explicitly rules out ECB supervisory tasks for insurance.

At the 26 March ECON Committee hearing, reacting at the ABLV case, Danièle Nouy called for an EU agency to be set up to police anti-money laundering rules: "we need an European institution that is implementing in a thorough, deep, consistent fashion this legislation in the Euro area [...] We need to change the situation. It's not sustainable to stay in that situation". Of particular concern were "countries that are not equipped with enough staff and enough expertise".

Papers analysing the Commission's action plan

At the request of the ECON Committee, external papers have been commissioned to further analyse whether Commission's communication of September 2018 and the Joint Working Group report lives up to the objective of a more efficient AML supervisory framework.

> H. Huizinga

In a paper commissioned by the ECON Committee ('The supervisory approach to anti-money laundering: an analysis of the Joint Working Group's reflection paper'), H. Huizinga takes the view that "*suggestions for better cooperation and information sharing among AML and prudential supervisors risk being ineffective as long as the* ***underlying incentives*** *to engage in international regulatory competition towards low enforcement of AML standards are* ***not addressed***". In that respect, H. Huizinga pleas for AML supervision to be carried out at a European level.

This conclusion is predicated on an analysis of the cooperation incentives that AML supervisors face. For Huizinga, the benefits of money laundering (high bank profits) accrue nationally, while the costs of money laundering (financial crime) are shared internationally.

Huizinga's analysis is further underpinned by some statistical evidence that suggests that smaller countries (in terms of GDP) are more likely to have lower AML standards (assessed by AML/CFT scores of the FATF). While prior research from Yepes (IMF) suggests that compliance with international AML standards is positively correlated to GDP per capita, in the EU, AML standards, in addition, appears to be positively correlated with economic size. That statistical finding is for Huizinga consistent with *"recent EU experience"*. This could reflect that smaller countries lack the resources to implement high standards or alternatively that they are less engaged in implementing high standards.

Against this background, further information exchange and cooperation as proposed by the Joint Working Group on AML are seen as "useful", but does not seem up to task of getting the incentives right. It is emphasised that increased powers for the European Banking Authority are not likely to be exercised frequently and may have only a limited disciplining effect on national AML supervisors. For Huizinga, only a more radical reform that would bring about an EU-level AML/CFT supervisor would be effective in obviating national AML/CFT regulatory competition. For this purpose, H. Huizinga suggests **entrusting the ECB with AML supervision** in view of the synergies in data collection and supervision.

> J. Kirschenbaum and N. Véron (Bruegel)

In a Bruegel policy contribution dated October 2018 ('A better European Union architecture to fight money laundering' - which was not commissioned by EGOV) Kirschenbaum and Véron concur that the crux of the issue lies in the disconnect between EU integrated financial markets and national AML supervision. While recognising that insufficient administrative capacity can be a more acute problem in very small countries, they note that undue influence from certain special interests or other forms of institutional failure can affect larger countries as well. As J. Kirschenbaum and N. Véron put it: "*As long as at least one weak link exists, the entire AML system is at risk of failure*". In that perspective, only a significant element of EU-level supervision can break that vicious circle. In that respect, Bruegel recommends a "*unitary architecture centred on a new European AML Authority that would work on the basis of deep relationships with national authorities such as financial intelligence units and law enforcement agencies*". Bruegel calls for leaders to take a decision at short notice with a mandate for the next Commission to propose legislation accordingly.

Bruegel discusses two supervisory models:

- In an **enhanced two-tier architecture** that builds on the present situation, the ultimate responsibility for AML supervision of individual firms would remain at national level ('supervisor of supervisors'). This corresponds to the 'European Supervisory Authorities' model whereby ESAs (EBA in banking) are tasked with ensuring convergence of supervisory practices but, as a general rule, do not directly supervise firms;
- In a **"unitary" architecture**, an European agency would have ultimate AML supervisory responsibility over firms. This corresponds to the SSM model. This model only covers AML supervision and not the FIU and law enforcement pillars of the AML framework.

Bruegel policy contribution discards a two-tier architecture on the following grounds. Even with forceful capacity at the hub, weak links will inevitably remain. While an effective two-tier system may be able to spot malpractice, a unitary system is bound to do so at an earlier stage. Against this background, a two-tier architecture along the lines of what the Commission has suggested in September 2018 is only a temporary solution.

In contrast, a unitary architecture would entail a significantly simpler system, essentially resolving all issues of information sharing between AML supervisors and of allocation of tasks between home and host authorities within its geographical scope. The absence of a Single Rule Book in AML (i.e. national law transposing directives as opposed to regulation) is not seen as a major obstacle to direct supervision (by way of example, the ECB/SSM already applies Pillar 2 measures on the basis of national law transposing the CRD).

In terms of architecture, Bruegel advocates for **a new European AML Authority** established on the legal basis of Article 114 of the TFEU, as used to establish the three European Supervisory Authorities[2]. This is seen as the most promising option, considering the followings drawbacks of alternative options:

- Downsides to entrusting the ECB with AML supervision are the following (i) SSM does not cover the entire single market; (ii) legal basis of Article 127(6) is limited in scope ("credit institutions and other financial institutions with the exception of insurance undertakings"); (iii) too much authority in the same institution;
- Entrusting the ESAs with direct powers would come up against the following difficulties: (i) limitations of cross-sector oversight; (ii) EBA does not have experience or mandate for direct supervision; (iii) governance issues as all supervisors in the Board of Supervisors do not have AML responsibilities. A joint venture of the three ESAs would suffer from too much complexity and a deficit of accountability in the corresponding governance arrangements.

According to Bruegel, the **staff needs** of an effective European AML Authority could "**easily reach several hundred**, especially if (as might be desirable) is granted AML supervisory authority over all categories of obliged entities including non-financial entities. In contrast, it must be noted that Commission's proposal plans 10 FTE at the EBA to deal with AML issues (see EGOV Briefing: "Money Laundering: recent cases from an EU banking supervisory perspective").

III. Brexit

On 1st November 2018, Michel Barnier reiterated the view that the "*EU may grant and withdraw equivalence in some financial services autonomously. As with other 3rd countries, EU [is] ready to have close regulatory dialogue with UK in full respect for autonomy of both parties*". This means that equivalence is not expected to be governed by Treaty-based commitments.

For further information on the UK and EU positions on equivalence and broader issues raised by the loss of the EU passport, see EGOV Briefing (updated in September 2018): 'Third Country equivalence in banking and financial regulation'.

Relocation process of UK-based bank in the Euro area

As part of banks' preparation to Brexit, banks have been requested by the ECB to submit complete applications by the end of Q2 2018 for the ECB to complete the authorisation process by the end of March 2019. For banks that fail to meet the Q2 2018 target date, the ECB made it clear that it cannot guarantee that the authorisation process will be completed by the end of March 2019. Looking at the action taken by banks so far, the ECB reported in August 2018 that most banks have submitted their license applications and Brexit plans. It was also noted that a "*smaller number of banks with limited activities in the EU have not yet done so and other banks have not yet made their final decisions. They lack detailed plans about their future set-up in the euro area, or have not shown sufficient progress in their relocation activities.* ***This approach raises concerns as time is limited and the uncertainty over reaching a final political agreement remains***" [our emphasis].

The ECB has *particularly* insisted on the importance it attaches to adequate local risk management and governance structures in the euro area so as to **avoid the creation of 'empty shells'** in the euro area. This led the SSM to specifically address booking models and 'back branching'.

[2] In a model based on a specific EU agency established under Article 114, it must be noted that enforcement of supervisory actions may come up to legal constraints imposed by the Meroni doctrine".

- In terms of **booking models**, the ECB has made it clear that "*it will assess whether banks implement (or plan to implement) appropriate local-based governance and risk management frameworks, and employ staff to identify and manage risk originating locally*". The Chair of the EBA further emphasised in September 2018 that "all the local exposures [should not] be managed locally" as "back-to-back operations [...] are the backbone of global investment banking".
- **Back-branching** refers to a situation where a legal entity established in the EU would serve its EU clients via its branch located in a third country (the UK). The ECB has put clear limits to back-branching by clarifying in its Frequently Asked Questions on relocation that the "*ECB and the national supervisors believe that the purpose of branches in third countries is to meet local needs. The ECB and national supervisors do not expect that branches in third countries perform critical functions for the credit institution itself or provide services back to customers based in the EU*".

In terms of firms' preparedness to Brexit, the Commission emphasised in its 13 November communication on Brexit contingency planning that the "transfer of activities and capacity-building in the EU27 is ongoing and should be accelerated, **but it will not be possible to complete it in time in all areas by March 2019**". This is particularly relevant for derivatives contracts in banking (see below).

Continuity of derivatives contracts

Analysis conducted by the industry (AFME together with ISDA)[3] and the Bank of England points to the legal uncertainty of OTC derivatives contract continuity post-Brexit given diverging national approaches across EU Member States. The Bank of England called for 'public solution' to secure the continuity of derivatives contracts on financial stability grounds. This concern has recently been echoed by the IMF and German BaFIN. In its October 2018 Global Financial Stability Report, the IMF further cautioned that "for derivatives, ensuring the continuity of contracts is one of the most pressing issues".

On the other hand, Vice-President Dombroskis at a press conference in July 2018 took the view that "Overall, even after Brexit, the performance of existing obligations can generally continue," citing derivatives contract as example. This has been confirmed in Commission's communication on Brexit contingency planning adopted on 13 November 2018[4].

This issue has been investigated by the ECB and the Bank of England in the context of a **joint technical working** group set up in April 2018.

- With respect to **cleared derivatives**, the Bank of England already announced in December 2017 that it would recognise the equivalence of non UK CCP. Likewise, Vice President Dombrovskis made it clear in October 2018 that EU banks and companies could continue using UK-based clearing houses to process derivatives trades even if Brexit negotiations

[3] ISDA and AFME consider that Brexit will not make it illegal for firms to perform contractual obligations under existing contracts in most (if not all) Member States, and thus should not affect the legal validity of existing transactions. Nevertheless, firms may need to be authorised in the EU and vice versa in the UK for the performance of some "lifecycle events" (e.g. exercise of options, transfers of collateral...). This means that firms may need to repaper and "novate" their contract (i.e. seek the individual consent of the relevant clients and counterparties). This may pose considerable challenges for some stakeholders, according to the industry. Challenges include new licence or change to license, involvement of UK Court for transferring portfolios, legal uncertainty in some MS, clients' consent.

[4] "Not-cleared 'over-the-counter' derivative contracts between EU and UK counterparts will, in principle, remain valid and executable until maturity. There does not appear to be any generalised problem of contract performance in the case of a no-deal scenario. Certain so called life-cycle events (for example contract amendments, roll-overs and novations) may however in certain cases imply the need for an authorisation or an exemption, given that the counterparty is no longer an EU firm".

failed — but on a strictly short-term and conditional basis, in the context of an equivalence decision. For this purpose, the Commission's communication on Brexit contingency planning urges UK-based infrastructures to pre-apply to the European Securities and Markets Authority (ESMA) for recognition;

- Unlike cleared derivatives, the Commission's communication on Brexit contingency planning does not deem it necessary to adopt contingency measures for **OTC derivatives**. Market participants are encouraged to continue preparing for this situation by transferring contracts and seeking the relevant authorisations. In contrast, the Bank of England has suggested a temporary permissions regime[5].

In its July 2018 opinion on firms' preparedness to Brexit, EBA reiterated the need for financial institutions to consider all options for the purpose of mitigating possible risks attached to these contracts, including making the necessary changes to those contracts (amendment, novation, transfer, etc.).

To further support the novation of contracts, ESMA has proposed in 8 November 2018 a one-year exemption from the obligation to centrally clear over-the-counter derivatives novated from a UK to an EU27 counterparty in case of a no deal scenario. The exemption would operate through a proposed amendment to the three Commission Delegated Regulations on the clearing obligation under the European Market Infrastructure Regulation (EMIR). The proposed amending Regulation, if endorsed by the EC, are subject to EP and Council scrutiny.

Supervision

With Brexit, **third countries branches of UK-based banks** are expected to expand their business, which may raise concerns in terms of how national authority would coordinate their supervisory actions. In that respect, the FSAP conducted by the IMF on the euro area recommended non only that the SSM be responsible for the supervision of systemic investment firm (as suggested by Commission in the Investment Firm Review), but also that "*EU branches of non-EU banks, especially the large ones forming or growing in advance of Brexit be brought under the SSM*". For smaller investment firm, the IMF suggests that supervision of smaller investment firms by national authorities become more harmonised, under the aegis of ESMA.

With respect to **branches of SSM banks**, the UK has placed a greater emphasis on the degree of cooperation it would expect from the EU competent authorities. In its December 2017 consultation paper, the Bank of England outlined conditions for firms to operate in the UK through branches. In terms of supervisory approach, for systemic wholesale branches, the Bank of England would assess "*the degree of* ***influence and visibility*** that ***it has over the supervisory outcomes for the firm as a whole and the wider group***" [our emphasis]. This is meant to ensure that the home state supervisor (i.e. ECB in the Banking Union) "*delivers an outcome that is consistent with the PRA's objective*". Failing appropriate supervisory cooperation mechanism, branches may be requested to 'subsidiarise'.

In terms of **supervisory arrangements**, the 13 November Commission's communication on Brexit contingency planning invites the ESAs to start preparing **cooperation arrangements** with UK supervisors to ensure that exchange of information related to financial institutions after the withdrawal date in the case of a no deal scenario

[5] Under the temporary permissions regime (which is akin to a temporary equivalence) inbound firms are allowed to continue operating in the UK within the scope of their current permissions for a limited period after Brexit, while seeking full UK authorisation. The UK FCA is consulting stakeholders on the contours of this framework since October 2018. That temporary permission regime" would inter alia ensure continuity of derivatives contracts by allowing firms to continue operating in the UK for a limited period of time.

IV. Cum ex

On 18 October 2018, the investigation of 38 journalists from twelve European countries, coordinated by CORRECTIV, a non-profit investigation centre in Germany, revealed that "Cum-Ex" schemes allowed to defraud tax authorities across Europe by an amount of approximately EUR 55 billion, involving several EU banks. "Cum-Ex" (also known as "dividend arbitrage") is a term that describes a certain type of tax fraud[6].

The ECB/SSM was already asked earlier in March 2016 whether the SSM would have an eye on "cum-ex" schemes. The SSM, at the time, considered the matter as "conduct risk" that would initially fall under national competencies. The Vice-Chair of the ECB's Supervisory Board, Mrs Lautenschläger, replied: "*[W]e are **not in charge of conduct risk**. That's BaFin's work. But: we have to take up the results of the investigation of the prosecutor, the results of the findings of BaFin, and have to ask ourselves what kind of impression and what kind of assessment do we then have with regard to governance and risk management*".

The EP has decided to hold an ECON/TAX3 joint public hearing on 26 November aiming at examining the existing loopholes and financial crimes following the scandal. At the EP plenary session of 23 October, Commissioner Moscovici referred to the tax transparency and exchange of information already embedded in European legislation and to recent amendments demanding declaration of aggressive tax strategies offered by a number of professionals to their clients, pending transposition. He also mentioned the exchange of information between tax authorities and those involved in money laundering.

V. Stress test results

On 2 November 2018, the EBA published the results of its 2018 EU-wide stress test, which involved 48 banks from 15 EU and EEA countries (33 thereof under direct supervision of the ECB), covering some 70% of total EU banking sector assets.

The hypothetical stress scenario resulted in an average reduction of -395 bps of the participating banks' CET1 capital ratio (fully loaded), that in such a scenario would on average stand at 10.1% at the end of 2020. The individual results in the stress scenario were quite divergent from the average, ranging from a CET1 ratio of just 6.67% in the euro area (and 6.37% in the non-euro area) at the lower end to a CET1 ratio of 33.96% at the upper end. There was, however, no official pass-fail threshold that banks were expected to pass in that stress test exercise.

From a methodological point of view, the main difference to previous exercises was related to the approach to credit risk, now aligned with IFRS 9. Moreover, banks had been asked to follow specific provisions and constraints in relation to level 2 and level 3 financial instruments, to take the liquidity and modelling uncertainty related to those instruments into account.

The financial press has in particular commented on the unexpectedly weak results of Barclays and Lloyds in the UK, while the poor results of others (like NordLB, grappling with underperforming shipping loans) came apparently less as a surprise; the results for the large Italian banks were said to be better than expected.

The varying impact of the EBA stress test on banks in different MS is to a large extent due to the fact that - while the stress test uses the same risk drivers for all banks in the test - the applicable

[6] The basic concept of a "cum ex" fraud scheme is that multiple parties claim an unjustified tax refund in relation to only one particular dividend payment. The scheme involves the sale or transfer of a stock of shares shortly before dividend payments (subject to withholding taxes) are made. The expression "Cum Ex" refers to the fact that shares can be sold with (cum) or without (ex) dividend coupons.
Other schemes ("cum-cum") take advantage of different tax treatments of dividends in different jurisdictions: the holder transmits the shares to entities subject to no or lower tax on dividends and recoups the shares later, thus gaining on the difference resulting from the differing tax.

parameters were very different from one MS to another. For example, the assumed cumulative growth shock was assumed to be very strong in Sweden (GDP decline of 10.4 %) but much lower in Spain (GDP decline of 0.8 %). In light of those differences, researchers criticised that the EU-wide stress test is de facto a ***"country-by-country"* stress test** (see Haselmann and Wahrenburg 2018, p. 10; our emphasis).

The stress test seen results have also met with the critical reception of Finance Watch, which pointed in their comment in particular to the fact that the results of the **ECB's own stress test exercise** (conducted concurrently on a sample of approximately 60 banks under direct ECB supervision) are **not disclosed.** Finance Watch highlighted that the "*'second tier' of 'significant' Euro area banks has proven in the past to be at least as vulnerable as the largest, 'global' and 'other systemically important' institutions*" and has produced some of the costliest taxpayer-funded interventions.

The current Chair the EBA and nominated successor of the Chair of the ECB's Supervisory Board, Andrea **Enria** also pointed to shortcomings in the current EU stress test approach, highlighting in a speech held at the National Bank of Romania on 15 November 2018 that (p. 11): "*The decoupling of stress test results and supervisory actions and the inconsistency between the transparency of the former and the **opaqueness** of the latter are, in my view, the **main shortcoming** of the EU approach compared to the US. Regardless of the amount of data we publish, this aspect alone makes the **informative value of the results limited** and creates uncertainty on future dividend policies*." [our emphasis]

Looking at **possible ways forward**, Enria argues that the understandability of supervisory Pillar 2 decisions could benefit from a clearer, more transparent and better aligned process of integrating stress test results, and points to the merits of full transparency: "*I am aware that the publication of Pillar 2 requirements (P2R) and guidance (P2G) is still a controversial matter and there are different views on its merits, but I do not think that the approach of providing only partial information to the markets is tenable in a post MDA [maximum distributable amount] and post bail-in world*".

VI. 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 26 October 2018 for the second quarter 2018, compared to the situation one year ago, **overall shows an uneven development** across the spectrum of indicators. The indicators for capitalisation levels (CET1 ratio, Tier 1 ratio, and Total capital ratio) on average all improved, while the leverage ratio approximately stagnated, and the Liquidity Coverage ratio even fell. The actual **capitalisation** levels very much depend on the **size of a bank** and tend to be notably higher in smaller banks (Banks with total assets of less than EUR 30 billion, for example, had an average CET1 ratio of 18.03% in Q2 2018, while that of the largest banks - G-SIBs - stood at only 12.48%; that effect is rather consistent across all size classes and capitalisation ratios; T03.01.3).

The average **Non-performing loans (NPL) ratio** declined by more than 1% on a year-to-year basis (Q2 2017: 5.43%, Q2 2018: 4.40%; T03.07.1), but still shows large differences on a country-by-country basis (T03.07.2). The average coverage ratio for non-performing exposures improved in the same period from 44.74% (Q2 2017) to 46.44% (Q2 2018; T03.08.3). For further information on NPL, see EGOV Briefing ('Non Performing Loans in the Banking Union, update, October 2018).

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

	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018
Balance sheet composition (EUR billions; percentages)					
Total assets	21,422.48	21,298.37	20,749.86	21,060.05	21,246.63
Total liabilities	20,015.75	19,877.56	19,325.22	19,662.00	19,852.55
Equity	1,406.73	1,420.81	1,424.64	1,398.05	1,394.08
Non-performing loans ratio	5.43%	5.15%	4.93%	4.73%	4.40%
Key performance indicators					
Return on equity	7.08%	7.03%	5.92%	6.61%	6.88%
Return on assets	0.46%	0.47%	0.41%	0.44%	0.45%
Capital and leverage ratios					
CET 1 ratio	13.88%	14.32%	14.64%	14.16%	14.10%
Tier 1 ratio	14.88%	15.32%	15.63%	15.34%	15.30%
Total capital ratio	17.56%	17.97%	18.14%	17.81%	17.76%
Leverage ratio (transitional definition)	5.33%	5.39%	5.60%	5.37%	5.36%
Leverage ratio (fully phased-in definition)	5.08%	5.17%	5.41%	5.14%	5.14%
Funding					
Loan-to-deposit ratio	118.31%	117.58%	116.94%	118.63%	118.01%
Liquidity					
Liquidity coverage ratio	142.79%	140.35%	143.58%	141.90%	140.91%

Source: ECB Supervisory Banking Statistics

As with capitalisation levels, the actual NPL ratios also very much depend on the size of a bank and tend to be notably higher in smaller banks (table 2):

Table 2: Asset quality: non-performing loans and advances by size of bank

Category (Q2 2018)	Loans and advances EUR billion	Non-performing loans EUR billion	NPL ratio
Banks with total assets			
Less than €30 billion	**293,44**	**30,34**	***10,34%***
Between €30 billion and €100 billion	**1.982,93**	**178,74**	***9,01%***
Between €100 billion and €200 billion	**1.366,94**	**75,11**	***5,49%***
Between €200 billion and €300 billion	**1.264,00**	**37,38**	***2,96%***
More than €300 billion	**4.182,23**	**146,23**	***3,50%***
G-SIBs	**5.845,02**	**189,35**	***3,24%***
Total	**14.934,56**	**657,15**	***4,40%***

Source: ECB Supervisory Banking Statistics for the second quarter 2018, T03.07.3

As regards the banks' **profitability**, indicated by the Return-on-Equity (RoE), the average RoE fell slightly from 7.08% (Q2 2017) to 6.88% (Q2 2018). On a country-by-country basis, the results are again quite diverse, ranging from a negative return of Greek banks (RoE of -2.19% in Q2 2018) to an average positive RoE of 12.04% in Slovenia (T02.02.2). Moreover, those banks that the ECB - based on its Supervisory Review and Evaluation Process - classified as banks with a low risk, performed on average better (RoE of 7.72% in Q2 2018) than those that were classified as banks with a medium or high risk (RoE of 5.04% in Q2 2018; T02.02.3).

VII. Recent SSM publications

Guide to on-site inspections and internal model investigations

The guide describes the on-site inspection process from the decision to launch the inspection to the follow-up stage, and sets out best practices to foster fruitful cooperation between inspected banks and ECB inspection teams.

The guide also delineates which issues are not looked into during on-site inspections. The guide clearly sets out that inspections related to consumer protection and **money laundering** issues remain under the responsibility of national authorities and are hence not covered.

Thematic review on profitability and business models

The report on the outcome of the ECB's in-depth assessment of banks' profitability drivers, launched in 2016, aims in particular to provide methodologies to facilitate consistent business model analysis at firm level by the Joint Supervisory Teams (JSTs).

Main conclusions include the following:

> Banks' profitability remains under pressure, partially as a result of **structural problems**, namely that litigation costs have not totally abated and that heavy cost structures inherited from the previous expansionary cycle persist (there are still 40 or more branches per 100,000 inhabitants in many countries and more than 400 employees per 100,000 inhabitants in most),
> The profitability **situation differs widely** across institutions (banks that have outperformed over the last years are geographically spread out and have differing business models),
> Insufficient **strategic steering** of profitability may exacerbate banks' challenges and is being closely monitored by JSTs.

The report is mainly **descriptive** and does not specifically analyse how different strategic choices actually impact the profitability of banks.

In terms of going forward, the report mentions that the results of the thematic review will feed into the 2018 Supervisory Review and Evaluation Process and might also trigger further on-site missions and analysis.

Concerns about structural problems and heavy cost structures have already led the ECB to take specific and targeted **supervisory actions.** According to Greek press reports, the ECB has asked the four **Greek banks** under direct ECB supervision - Piraeus, National, Alpha and Eurobank - to significantly **cut down their branch networks and staff.**

Report on recovery plans

That report aims to encourage banks to consider the lessons learned and best practices presented in the report when updating their recovery plans. Based on the experience of three cycles of recovery plan assessments, the ECB concluded that recovery plans are still not always operational during a stress situation and that their usability could be improved.

ECB Risk Assessment for 2019

In its risk assessment for 2019, the ECB has identified the following "three most prominent risk drivers affecting the euro area banking system": (i) **geopolitical uncertainties** (i.e. Brexit, trade protectionism, and global regulatory fragmentation), (ii) the stock of **non-performing loans** (NPLs) and potential build-up of future NPLs, and (iii) **cybercrime and IT disruptions**. With respect to NPL, the ECB emphasises that the ongoing search for yield might increase the potential for a build-up of future NPLs. In that respect, Euro area banks have reported an **easing of credit standards** for loans to enterprises and to households for house purchase in the first quarter of 2018.

Compared to last year's risk assessment, the ECB points to a substantial decrease in risks stemming from economic and fiscal conditions, mostly due to a favourable cyclical momentum. At the same time, geopolitical uncertainties and risks of repricing in financial markets have increased. In addition, digitalisation exacerbates the risks related to banks' IT systems and cyberattacks.

Other risks include the potential repricing in financial markets, the low interest rate environment, banks' reaction to new and existing regulations[7], euro area economic and fiscal conditions, cases of misconduct, developments in real estate markets, structural business challenges, non-bank competition and climate-related risks.

SSM Supervisory Priorities 2019

The SSM has set the following "high level priorities" for 2019: (i) credit risk; (ii) risk management and (iii) activities comprising multiple risk dimensions (i.e. Brexit preparations and trading risk and asset valuations). Those supervisory actions are meant to address the risks identified above (See Table 3).

Other supervisory actions include (i) the review of banks' internal capital and liquidity adequacy assessment processes, and (ii) the continuation of the targeted review of internal models (TRIM) with a focus on exposures to medium-size/large corporate and specialised lending.

Table 3: Mapping of supervisory priorities with ECB risk assessment

Risk assessment	Planned supervisory actions
Geopolitical uncertainty	The SSM to closely monitor the implementation of banks' Brexit plans
Non-Performing Loans	The SSM to follow-up on NPL guidance by engaging with affected institutions to define bank-specific supervisory expectations
Easing of credit standards	The SSM to assess the quality of bank's underwriting criteria with a focus on new lending
IT and cyber risk	ECB to launch a number of on-site inspections on IT risk-related topics. Cyber incidents to be reported under the SSM cyber incident reporting process
Risks of repricing in financial markets	The 2019 stress test will seek to assess banks' reliance against liquidity shocks. The ECB to conduct on-site work on trading and market risks and engage dialogue with banks on their preparation for the Fundamental Review of the Trading Book rules.

Source: EGOV based on SSM Supervisory Priorities 2019

Disclaimer and Copyright

Contact: egov@ep.europa.eu
This document is available on the Internet at: www.europarl.europa.eu/supporting-analyses

[7] The ECB notes that while tighter regulation helps to safeguard a resilient and stable banking system in the medium and long term, in the short term this can challenge banks' profitability and impose risks on the banking sector, such as banks failing to adapt on time or postponing strategic decisions or investments.