IN-DEPTH ANALYSIS

Public hearing with Andrea Enria, Chair of the ECB Supervisory Board, presenting the SSM Annual Report 2018

ECON on 21 March 2019

This note is prepared in view of a regular public hearing with the new Chair of the Supervisory Board of the European Central Bank (ECB), Andrea Enria, who will inter alia present the SSM Annual Report 2018. The EP received a copy of that report on a confidential basis, under embargo until Thursday, 21 March 2019, at 9:00 am 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: (i) supervisory disclosure and ECB transparency policy, (ii) leveraged finance, (iii) Brexit (supervisory issues), (iv) summaries of 4 external briefing papers on "The next SSM term: Supervisory challenges ahead" commissioned by the ECON Committee, (v) regulatory and supervisory developments, and (vi) recent ECB publications.

I. Supervisory disclosure and transparency policy at the ECB

At the December 2018 ECON hearing, Andrea Enria committed to promoting disclosure of supervisory information as Chair of the SSM: "*I know this is controversial in the supervisory community, but I am convinced that wider disclosure of supervisory requirements and buffers would prove beneficial for market discipline*".

The following section elaborates on the ECB supervisory disclosure framework in terms of Pillar 2, stress tests data, and supervisory information on individual banks, and then summarises the concerns expressed by the European Court of Auditors regarding access to information at the ECB.

Disclosure of Pillar 2 data and stress tests

As Chair of the SSM, Andrea Enria expressed his view in a recent speech that the SSM should listen to "calls for more clarity and predictability with regard to our [Pillar 2 - SREP] assessment". **Full disclosure has not been suggested so far, but the new Chair of the SSM has supported the disclosure of more specific and less controversial information** (by way of example, "the risk drivers that guide our overall decision"). More recently, speaking to the Financial Times as Chair of the SSM, Mr. Enria went further saying that "*While there is some soft information (...) which should remain part of a private dialogue between the supervisors and the banks, other aspects -- such as the Pillar Two requirements, and maybe even the Pillar Two guidance -- are information which is relevant for investors to understand where the banks are with respect to where the supervisors want them to be. (...) are moving from taxpayers bailing out defaulting financial institutions to the concept of bail-in, where private investors are first in line to take losses. We need to create an environment in*

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which investors have an adequate access to information about the banks they invest in.". Mr. Enria had already expressed a similar view in a speech delivered in November 2018 as Chair of EBA (see box 1).

Box 1: Andrea Enria's position as Chair of EBA on supervisory disclosure of Pillar 2

"The shift from bail-out to bail-in and the "maximum distributable amount" (MDA) – the notion that banks unable to meet the capital requirements and macroprudential buffers are confronted with restrictions to the payments of dividends and coupons on capital instruments – have important implications for market dynamics since the decisions of the supervisory authorities directly affect the payoff of several banks' stakeholders. However, disclosure of supervisory measures – mainly of Pillar 2 requirements and guidance – is still debated and there is no common EU approach.

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 and post bail-in world. Actually, I believe this new approach is feasible only if supervisors accept to publish P2R and P2G, otherwise the loss of information would be a step back with respect to where we stand today. Full transparency would allow investors to get all the relevant information at the same time, instead of getting stress test results first and only later (if at all) the outcome of the SREP".

Source: speech from A. Enria at the National Bank of Romania, November 2018

According to EBA Pillar 2 roadmap, "*institutions are generally expected not to disclose P2G but they are expected to evaluate whether or not that information meets the criteria of insider information and, if so, ensure compliance with provisions of the Market Abuse Regulations*". In keeping with the EBA and ESMA guidance, the ECB SREP booklet states that "*institutions that have publicly traded securities are expected to evaluate whether Pillar 2 requirements meet the criteria of inside information and should be publicly disclosed*".

This has led SSM banks to disclose Pillar 2[1] in a different way, as evidenced below (see chart 1).

Chart 1: SREP disclosures in Eurozone countries for 2017 (source: individual banks' websites)

	# of banks surveyed	Share of banks providing SREP results
Austria	6	67%
Belgium	5	80%
Cyprus	4	75%
Estonia	2	0%
Finland	3	33%
France	11	91%
Germany	20	55%
Greece	4	100%
Ireland	3	100%
Italy	11	100%
Latvia	2	0%
Lithuania	3	67%
Luxembourg	2	0%
Malta	2	50%
Portugal	3	67%
Slovakia	3	0%
Slovenia	3	33%
Spain	13	100%
The Netherlands	6	100%
All countries	106	72%

Source: Andrea Resti "Review of the 2017 SREP results"

[1] In addition to statutory minimum capital requirements (Pillar 1), the supervisory authority can impose a Pillar 2 requirement on banks. This requirement relates to additional, bank-specific risks. The ECB makes a distinction between 'hard' P2 requirements and P2 Guidance (P2G). The P1 and hard P2 requirements together constitute the statutory minimum requirement with which banks must comply at all times. Banks are also expected to comply with P2G imposed by the supervisory authority. However, if a bank fails to comply with P2G, this will not automatically have immediate consequences for dividends, coupons and bonus payments.

Non-euro area supervisors have taken a different approach to disclosure:

> In the UK, banks shall disclose their pillar 2 requirements, but not the component parts of P2R (called Pillar 2A in the UK) nor the pillar 2 guidance (pillar 2B). As explained in Bank of England's consultation paper in 2017 ('Pillar 2A requirements and disclosure'), "*there is clearly a balance to be struck to deliver the optimal benefits of increased transparency*". Bank of England is particularly concerned that "the disclosure of individual Pillar 2A component parts could be misinterpreted if lacking in context";

> In Sweden, Finansinspektionen publishes on a quarterly basis Pillar 2 requirements of individual banks including the extent to which Pillar 2 requirements pertain to systemic risk.

AFME, as industry representation, positioned itself against the disclosure of Pillar 2 guidance: "*banks should not be subject by regulators to any disclosure of their Pillar 2 guidance (P2G). This view is supported, in particular, by the fact that the P2G is not taken into account in the Maximum Distribution Amount (MDA) computation and consequently is not relevant information for holders of Additional Tier 1 (AT1) or Total Loss Absorbing Capacity (TLAC) instruments*[2]. On the other hand, others would consider that P2G provides valuable information about the likelihood of future dividend payments.

As regards stress test data, the key difference between the EBA and the ECB is that EBA publishes individual results of banks included in its stress test sample, while the ECB does not disclose the results on bank level, and only publishes aggregate results (see also the specific section on the 2018 stress test results in that briefing). As the EBA stress test sample also includes significant banks in the euro area, significant banks of the SSM are treated differently in terms of disclosure depending on whether they are included in the EBA or in the ECB sample.

As EBA Chair, Andrea Enria pointed to shortcomings of the EU stress test approach, highlighting in a speech held at the National Bank of Romania on 15 November 2018 that: "*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 argued that the understandability of supervisory decisions could benefit from a clearer, more transparent and better aligned process of integrating stress test results**, and pointed to the merits of full transparency.

If applied within the Banking Union, where appropriate, those policy recommendations would lead to a complete new supervisory framework whereby outcomes of the supervisory review and evaluation process based on stress tests would be made public.

Supervisory disclosure of individual data

Supervisory data published by the ECB ('supervisory banking statistics') are in aggregated form and are limited to 16 key indicators published on a quarterly basis (banking balance sheet composition, performance, capital and leverage, asset quality, funding and liquidity). The ECB also publishes Pillar 3 data[3] of individual banks but only for some key risk indicators. The level of information disclosed by the ECB is much less comprehensive than the EBA transparency exercise[4] or supervisory disclosure in the US.

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[2] That view was expressed in the context of a consultation carried out by the Basel Committee in relation to its new Pillar 3 framework. The Basel Committee suggests as a national option new disclosure requirements on capital distribution constraints that could lead, under certain circumstances, to a bank disclosing its Pillar 2 requirements.

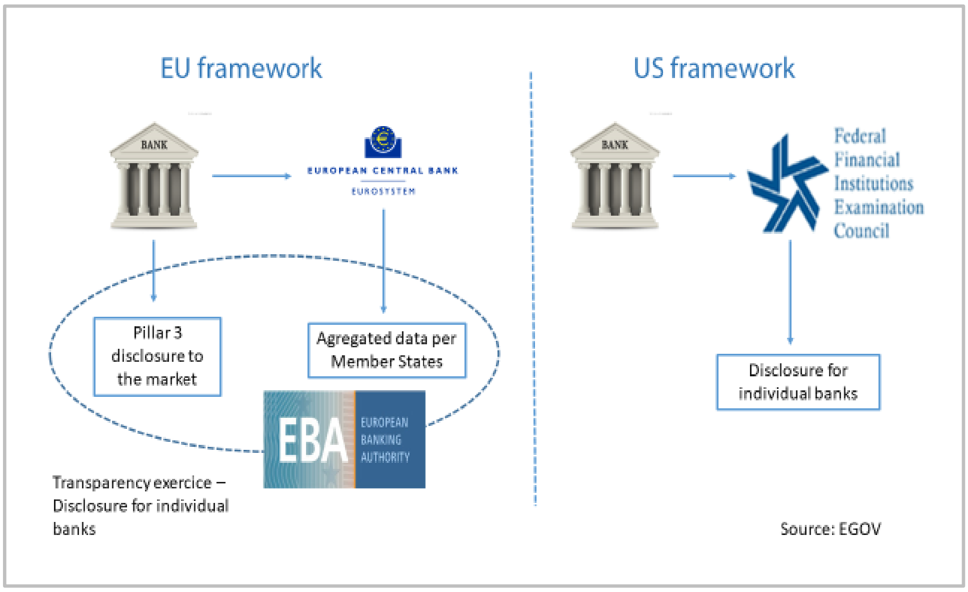
[3] Pillar 3 data are data that banks have to publish as required by the Capital Requirements Regulation. The CRR does not require a particular format or medium.

[4] EBA has carried out 5 transparency exercises. The December 2018 exercise discloses over 900000 data points on about 130 EU banks, including capital positions, risk exposure amounts, sovereign exposures and asset quality.

In terms of supervisory data, A. Enria proposed - as chair of EBA - the creation of a central repository where supervisory and banks' data (pillar 3) would be available along the lines of the US reporting and disclosure framework[5]. The EU and US disclosure framework are summarised in chart 2 below. As explained in a speech by A. Enria EBA's ultimate objective was "*to have Pillar 3 requirements as aligned as possible with supervisory reporting definitions and templates so as to achieve greater integration of different data sources and reduce the burden for banks and data*-users". "*We should envisage a central repository available on the EBA website where all EU banks' pillar 3 data would be collected in an editable format and disclosed*".

If implemented in the Banking Union, where appropriate, **those policy recommendations would mean that the ECB - as the Federal Financial Institutions Examination Council in the US - would disclose supervisory data (corresponding to Banks' Pillar 3 requirements) using uniform definition for individual banks and not only in an aggregated form.**

Chart 2: EU and US disclosure framework



Resolution

As regards the approach to resolution, Andrea Enria, as chair of the EBA, also called for the disclosure of **which banks would be bailed in rather than wound up** in the event of their failure, as well as the projected level of bail-in capital (i.e. MREL) they would be required to hold.

Limits to access to documents at the ECB

In January 2019 the European Court of Auditors (ECA) reiterated to the European Parliament earlier concerns that the ECB denied access to information the ECA considered important. The information requests were made to prepare ECA special reports[6] and, in the Court's view, prevented it from properly carrying out its statutory responsibilities. In November 2018, the ECA, along with the supreme audit institutions of the

[5] In the US, banks file a Consolidated Report of Condition and Income or 'call report' every quarter with their supervisor. Critically. These reports include a wide range of items such as earnings, asset quality, liquidity, and capital. The reports include information on NPLs. The Federal Financial Institutions Council (FFIEC) releases the data on its web page after the relevant supervisor has approved its release, which is generally within a day of the data arriving from a given bank. The dataset is available in a number of file formats to facilitate its easy use.

[6] ECA special report 29/2016: Single Supervisory Mechanism - Good start but further improvements needed; ECA special report 23/2017: Single Resolution Board: Work on a challenging Banking Union task started, but still a long way to go; ECA special report 02/2018: The operational efficiency of the ECB's crisis management for banks.

Member States, had claimed for reinforcing the powers of audit institutions to the breath and extent pre-existing Banking Union[7]. Earlier, in March 2018, in response to a MEP, the ECB argued that it had provided the information compatible with the breath of ECA mandate and its own statutory confidentiality limitations and independence

The EP Resolution on Banking Union (Banking Union - Annual Report 2017) called for an interinstitutional agreement between the ECB and the ECA. In its response to the remarks made by the EP in its Resolution, the ECB explained that that proposal was being examined, including seeking clarifications and assessing certain legal aspects. **An interinstitutional agreement among ECA and the ECB is apparently being discussed but its scope and whether it would respond to both institutions concerns is still unknown**.

In the same vein, in its report assessing the functioning of the SSM, the Commission stressed that the ECB should "*strike the right balance when labelling documents as confidential, so as to avoid any undue restrictions to the procedural rights of parties concerned by its decisions*". In particular, the Commission noted that "*It would be useful to take advantage of the growing jurisprudence developed by the ABoR by ensuring more transparency over the work undertaken by the ABoR, for instance through publication on the ECB's website of summaries of ABoR decisions and with due observance of confidentiality rules*".

II. Leveraged finance

The increased volume of "leveraged finance[8]" has recently led US, EU, and international supervisory authorities to caution against related financial stability risks. In November 2018, the **International Monetary Fund** (IMF) issued a strong warning[9] ("Sounding the Alarm on Leveraged Lending"): "*We warned in the most recent Global Financial Stability Report of October 2018 that speculative excesses in some financial markets may be approaching a threatening level. For evidence, look no further than the $1.3 trillion global market for so-called leverage loans [...]*".

Which exposure of SSM banks to leveraged finance?

Risks are particularly acute in the US, but also materialise in the Banking Union. In the ECB May 2018 Financial Stability Review, the ECB cautioned that "*Signs of potential mispricing are also evident in the larger leveraged loan market. [...] a significant relaxation of underwriting standards for US and European leveraged loans has been observed in recent years. This increases the likelihood that defaults will be delayed and recovery rates will be lower should the creditworthiness of the borrowers deteriorate.*"

The SSM has so far not disclosed the extent to which banks are exposed to leveraged finance in the Banking Union. In its May 2018 Financial stability review, the ECB only noted that "*Increasing exposures towards some riskier segments (e.g. consumer lending, leveraged loans) warrant closer monitoring*".

In contrast, the Bank of England's Financial Stability Report of November 2018, which provides data and information of UK banks' exposures, took some comfort of the fact that the UK banks direct exposure to leveraged lending is comparatively small.

The **Financial Stability Board** (FSB) has recently launched an examination of the leveraged loan market to further identify risks and **possible contagion effects**. That report, to be published in autumn 2019, is

[7] "*EU and Member State auditors said: "We are witnessing the paradoxical situation that the audit competencies regarding banking supervision are now overall more limited than prior to the introduction of the Single Supervisory Mechanism in 2014.*".

[8] The concept of "leveraged finance" refers to transactions that entail an elevated risk for the lenders or investors providing the funds, and it comprises: (i) leveraged loans - loans to highly indebted firms or to firms that are owned by financial sponsors (private equity investment firms), and (ii) high yield bonds - bonds issued by firms with a non-investment grade credit rating, by highly indebted firms, or by firms with otherwise elevated risk (e.g. start-ups). Leveraged loans are typically used to finance a buyout, merger or acquisition.

[9] Reference document: Global Financial Stability Report of October 2018

expected to further analyse the degree to which banks, including SSM banks, are exposed to leveraged finance risks. This particularly requires further understanding of ultimate risk holders.

Is the ECB guidance on leveraged finance efficient?

Leveraged loans are deemed risky because the loan takers' accumulated debt amounts to a multiple of its annual earnings, putting into question whether the loans taken can be repaid in full if the economic situation deteriorates. The usual indicator for the level of indebtedness is the ratio of earnings before interest, tax, depreciation and amortisation (EBITDA) to total debt.

The ECB/SSM has already adopted in May 2017 a guidance on leveraged transactions10 that, however, seems less effective than expected. That guidance particularly asks banks to prepare regular comprehensive reports for the senior management about trends in the leveraged markets and characteristics of a credit institution's leveraged transactions.

Recent aggregate data from the credit rating agency Standard and Poor's, however, reports that the leverage of **European leveraged loans has reached a multiple of 5.4 times EBITDA in November 2018, the highest value since the multiple of 6 times in 2007 before the onset of the financial crisis**.

That Standard and Poor's article moreover states that the ECB's guidelines on leverage were "*already deemed toothless by the European market*".

In addition, the effectiveness of underwriting standards imposed to banks (and not to other sectors) have been questioned by the IMF: "*There is evidence that these actions have contributed to a shift of activities from banks to institutional investors*". Policymakers were therefore invited to "*develop new tools to address deteriorating underwriting standards*". In that respect one researcher, D. Schoenmaker, suggested applying underwriting standards across the board: "*the guidance on leveraged finance for the borrowing companies (gross debt should not exceed six times EBITDA) should be given to all suppliers of finance*".

For more detailed information, please see separate EGOV briefing "Leveraged finance: a supervisory concern in the Banking Union?" (March 2019)

III. Brexit: Supervisory issues

In a recent speech addressing Brexit issues, Sabine Lautenschläger, Vice Chair of the ECB Supervisory Board, particularly emphasised the risks and shortcomings that the supervision of third countries branch at national level entails: *"Third-country branches are still subject to national rules and supervision. This leaves European banking supervision without a full picture of what banks are doing and what risks they pose. Banks, on the other hand, can seize the opportunity and engage in regulatory arbitrage. (...) I am well aware, of course, that it is not us supervisors who make the rules. The issues I have just mentioned are for legislators. I hope, though, that they will recognise that revised rules would go a long way towards mitigating post-Brexit and other risks."*

There is no granular information available to assess neither institutions' preparedness for Brexit nor the timeframes to implement the transition plans. The ECB mentioned in February 2019 that Joint Supervisory Teams discussed implementation periods for Brexit transition that are proportionate to individual banks' specific situations and will closely monitor progress. More recently, A. Enria added that "*We will have seven additional significant institutions coming under our remit as a result of Brexit, 17 new less significant institutions. (...) We are asking banks to provide us with their target operating models on how they will gradually move assets from the UK to the euro area, and we expect around €1.2 trillion of assets to be moved to*

[10] In that guidance, leveraged transaction are defined as all types of loans where the borrower's post-financing level of leverage exceeds a total debt to EBITDA ratio of 4.0 times, and all loans where the borrower is owned by a financial sponsor (private equity firm).

be under the supervision of the SSM. This is concentrated -- let's say 90 per cent -- in the seven largest institutions. (...) The most important thing I want to stress is that we are prepared for Brexit but it's something unprecedented. We cannot rule out that there will be market disturbances (...).".

As early as 2017, the ECB warned banks to plan for a worst case scenario (i.e. no withdrawal agreement, no transition and no equivalence decisions) and has since been preparing for all operational aspects related to a possible relocation of UK-based banks to the EU post-Brexit. It has laid down procedures for the relocation of banks to the euro area in the context of Brexit that are kept updated[11] on its website. The ECB also clarified in November 2018 that all banks which are expected to come under direct supervision by the ECB will be subject to a comprehensive assessment.

To ensure the continuity of services provided by UK firms in the EU in a no-deal scenario, some Member States have implemented or are in the process of adopting "temporary permission regimes" that would allow UK firms to keep providing (certain) services on a temporary basis in a given Member State pending authorisation (for an overview of such regimes in Member States, see legal analysis provided by Norton Rose). By way of example, in Germany, Bafin has been authorised to declare – for the purpose of avoiding disadvantages for the operability and stability of the financial market – that UK banks and financial services providers which currently provide services on a cross-border pass-ported basis either through a branch or through mere services without a branch, shall be deemed to be allowed to continue doing so on the basis of the currently existing rules for a period of up to 21 months post Brexit, provided the services are closely connected to contracts that existed at the time of withdrawal.

While a temporary permission regime governs the provision of financial services in a given Member State (in the same way financial institutions may establish a third country branches or access a national placement regime), **it must be noted that the ECB is the only authority responsible for authorising banks in the EU.**

In relation to services provided by EU Banks in the UK, the ECB particularly stressed that the "temporary permissions regime" the UK has adopted does not exempt SSM banks from requiring ECB approval for their UK branches.

For further information on passporting rights, equivalence, continuity of derivative contracts see separate EGOV briefing (Updated March 2019).

IV. Summaries of four external briefing papers on "The next SSM term: Supervisory challenges ahead"

In view of the change at the helm of the ECB's supervisory board, ECON Coordinators requested the experts appointed to the standing panel on bank supervisory issues:

> to briefly look back at how the ECB/SSM has over the past years performed against the main goals it was supposed to accomplish,
> to look forward at the supervisory challenges ahead in the next ECB/SSM term, and
> to reflect upon which modified supervisory practices would facilitate the scrutiny work.

Those question were dealt with in four briefing papers that can be summarised as follows (for more details please see the individual briefing papers).

A **shared concern** in all briefing papers is that **effective market discipline** should be improved by disclosing more detailed supervisory information on SREP outcomes.

[11] Last update at the time of writing: 2 August 2018.

Martin R. Götz, Tobias H. Tröger and Mark Wahrenburg

The three authors first look at the past developments of banks under direct SSM supervision, and they find in particular that the group of **weakly capitalised banks have not seen a notable improvement of key performance indicators under direct SSM supervision**. In fact, those weakly capitalised still face elevated levels of nonperforming loans, are less cost-efficient and reduced their share of subordinated debt financing over the last years.

To improve supervisory outcomes within the SSM going forward, Götz, Tröger and Wahrenburg suggest that, firstly, **market discipline should be fostered by enhanced supervisory disclosure**. Supervisors spend a considerable amount of time analysing and comparing the respective capabilities of individual banks, but their insights are usually restricted to the publication of highly aggregated results. The risk management practices of banks could therefore benefit from more detailed information regarding their individual strength and weaknesses. Moreover, streamlining the administration could improve the cost efficiency of banking supervision. And lastly, given that the efficacy of European bank supervision rests on the interplay with many different institutions, their paper underlines the need for continuing and intensifying coordination among regulatory bodies, namely the SSM, National Competent Authorities and resolution authorities.

Andrea Resti

Andrea Resti identifies in his paper two types of challenges that the SSM must confront going forward. The first is vulnerabilities related to the European banking sector, which could have financial stability implications if not addressed. Those **vulnerabilities include the low profitability of banks, the increased role of the shadow banking sector, and conduct risk and poor governance**. The second type of challenge is that stemming from the SSM itself.

Andrea Resti first turns to the complexity of the regulatory framework, arguing in favour of more harmonised rules and enforcement mechanisms. Second, the strain on supervisory resources and the **potential risks associated with the use of external consultants** is highlighted. Lastly, his paper recommends **increased accountability and transparency**. Accountability and transparency can be enhanced, e.g., through greater disclosure on resources and objectives, SREP and other internal methodologies, and on decisions taken by the SSM's Administrative Board of Review. In addition, Resti argues that the European Court of Auditors should be entitled to assess the soundness of the SSM's processes, without interfering with individual supervisory decisions.

Harry Huizinga

Harry Huizinga's paper focuses on two ways in which overall bank supervision and oversight can be improved in the next SSM term. Firstly, the ECB could encourage **more effective market discipline of banks by disclosing additional information on SREP outcomes**. To improve market discipline, the ECB should consider facilitating the publication of additional bank-specific supervisory information. Harry Huizinga in particular suggests that the ECB could require banks to **disclose their Pillar 2 guidance capital requirements** that banks currently often do not reveal. In addition, the ECB could enhance its cooperation with the EBA to increase the coverage of SSM banks in the EU-wide transparency and stress test exercises, regularly assess the quality of banks' Pillar 3 reports as part of its supervisory review, and could potentially use market information on banks' valuation and cost of funding to inform its supervisory work.

Moreover, Harry Huizinga recommends **revising the current SSM guidance on the corporate governance** of banks promoting shareholder-friendly boards, arguing that shareholders tend to promote excessive risk taking vis-à-vis other stakeholder, as bank shareholders tend to benefit more from excessive bank risk taking than other stakeholders.

Brunella Bruno and Elena Carletti

To Brunella Bruno and Elena Carletti the European banking system appears healthier and sounder than in the pre-SSM period, yet they see challenges for the future supervision of significant banks. First, they find that more should be done to **foster financial integration**. Second, accountability and transparency can be strengthened, for example, by **disclosing more information on the SREP process**. Third, complexity in the supervision framework should be minimised to reduce compliance costs. Lastly, it is argued that supervision should not lose sight of its ultimate goal - supporting economic growth. In support of this aim, more nuanced supervisory decisions, supported by stronger empirical research to reduce the risk of unintended effects is recommended.

V. Other developments

Money laundering

Cooperation on AML matters has been recently reinforced. The 5th anti-money laundering Directive requires the conclusion of an agreement on the practical modalities of information exchange between AML authorities and prudential supervisors with the aim of preventing the misuse of financial system for money laundering and terrorist financing. This MoU between the ECB and all relevant AML authorities was concluded in January 2019. **In due time, information on implementing the agreement, namely statistics on information exchanged and followed up, would be useful, insofar as this is not limited by confidentiality rules.**

Danièle Nouy announced last November in ECON that the ECB would be creating an "AML office"[12]. **No further information is available on the current status of such a project**.

Further cases of alleged AML breaches have been reported. The financial press[13] and journalists' associations like Organised Crime and Corruption Reporting Project continue reporting cases of alleged AML breaches involving European banks. Two of such cases are Nordea Bank and Swedbank AB, which seem to be linked to the Danske case[14]. ING NV, Credit Agricole, Deutsche Bank AG, Raifeissen Bank International, ABN AMRO Group NV, Rabobank, Turkiye Garanti Bankasi, have also been identified in the press. Speaking to the Financial Times, A. Enria noted that "*We are prudential supervisors, we are not primarily responsible for conduct. There are limits to what we can do. (...) But via our focus on governance and internal controls we can and should contribute to address these issues. (...) You ultimately need stronger European arrangements, though. We can help, but we cannot fully substitute for a lack of such arrangements.*".

For further information on AML matters, please see separate EGOV briefing. That briefing also discusses the policy debate as to whether and how AML supervision should be strengthened in the EU.

[12] "*We are also working on intensifying our prudential work on this topic, by creating a coordination function for SSM related AML issues within ECB Banking Supervision, in full respect of the allocation of anti-money laundering responsibilities within the current legal framework. This "AML office" is intended to fulfil three roles. First, it will act as a single point of entry with respect to the direct exchange of AML information between the ECB and AML authorities. Second, the AML Office will set-up and chair "an AML Network" among Joint Supervisory Teams in charge of the banks whose business model leads to a high level of money laundering risks. Third, it will act as a centre of expertise on the SSM related AML/CTF issues. On this basis, the AML Office will contribute to the development of ECB positions on AML topics.*"

[13] Here, here and here.

[14] The TAX3 report adopted on the 27 February further elaborates on AML issues, namely deploring the recent AML breaches in the financial sector (points 223 to 226 in particular). The report also calls for enhanced cooperation among the various institutions involved in AML matters (points 231 to 240).

New TLTRO funding support

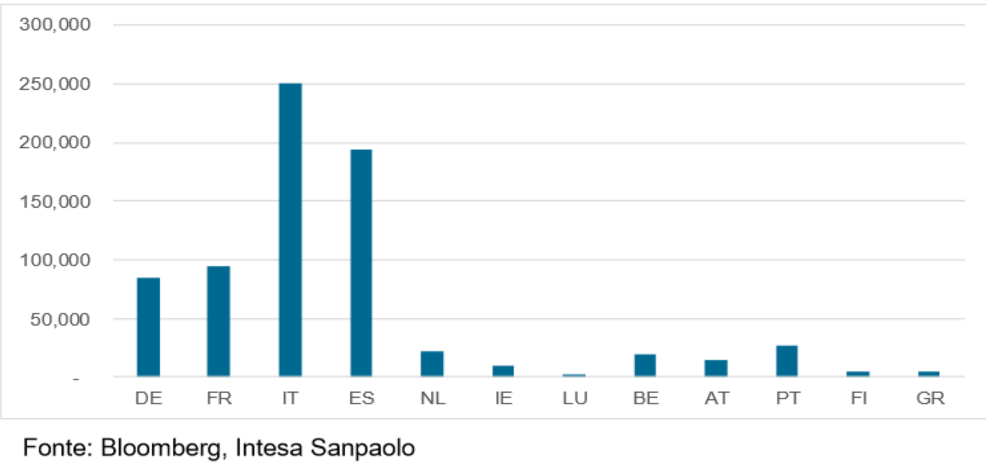
On 7 March 2019, the Governing Council of the ECB announced that it would keep the interest rates on main refinancing operations as well the marginal lending and deposit facilities unchanged (currently at 0.00%, 0.25% and -0.40%), and that a new series of targeted longer-term refinancing operations (TLTRO-3) will be launched to help to preserve favourable bank lending conditions[15].

In his introductory statement, Mario Draghi, President of the ECB, set out that "*The policy measures decided today, and in particular the new series of TLTROs, will help to ensure that bank lending conditions remain favourable going forward*." While motivated by monetary policy considerations, the new TLRO support has also been driven by "regulatory compliances" considerations[16].

In that respect, it must be noted that "Available Stable Funding" is fundamental for banks to meet the Net Stable Funding Ratio (NSFR). A TLTRO-2 allotment will fully count (100%) as stable funding, provided the residual duration of that allotment is longer than one year; thereafter, for residual durations of up to six months, its weighting will drop to 50%, and for residual durations of less than six months it will go down to zero. Replacing a TLTRO-2 allotment (by early repayment) with a **TLTRO-3 allotment can therefore facilitate banks to meet the applicable NSFR requirements, absent of which other sources of eligible stable funding would have to be found.**

Intesa Sanpaolo highlighted in a presentation given at the ECB's Money market contact group in September 2018 that the management of TLTRO repayments is an important factor for all Euro area banks, in particular though for banks in those countries in which the take-up of the TLTRO-2 operations was relatively higher (see chart 3). BBVA estimated that banks in Italy and Spain account for at least 60% of total TLTRO.

Chart 3: Current TLTRO-2 operations - Allotted funds by country (EUR bn, estimates)



Source: Presentation given by Intesa San Paolo at the ECB

ECB stress test results

On 1 February 2019, the results of the ECB 2018 stress test exercise were published. That stress test exercise was based on the same methodology as the EBA 2018 stress test exercise (results thereof already published

[15] The new series of quarterly TLTROs will start in September 2019 and end in March 2021, and banks will be entitled to borrow up to 30% of the stock of eligible loans at an interest rate indexed to that of the ECB's main refinancing operation (currently at 0.00%) over the TLTROs' maturity of two years. Further details on the precise terms shall be communicated in due course.

[16] At the ECB press conference, Mario Draghi further explains that "The design of the TLTRO responds to a variety of objectives. The key objective derives from how the situation of bank funding looks like over the next few years. In the coming years we will have a congestion for bank funding caused by the coming to maturity of the existing TLTROs, the coming to maturity of sizable amounts of bank bonds, various regulatory compliances".

in November 2018), only the sample was different: the EBA analysed the 48 largest banks in Europe, while the ECB analysed the remaining[17] 54 medium-sized banks under direct supervision ("SREP banks").

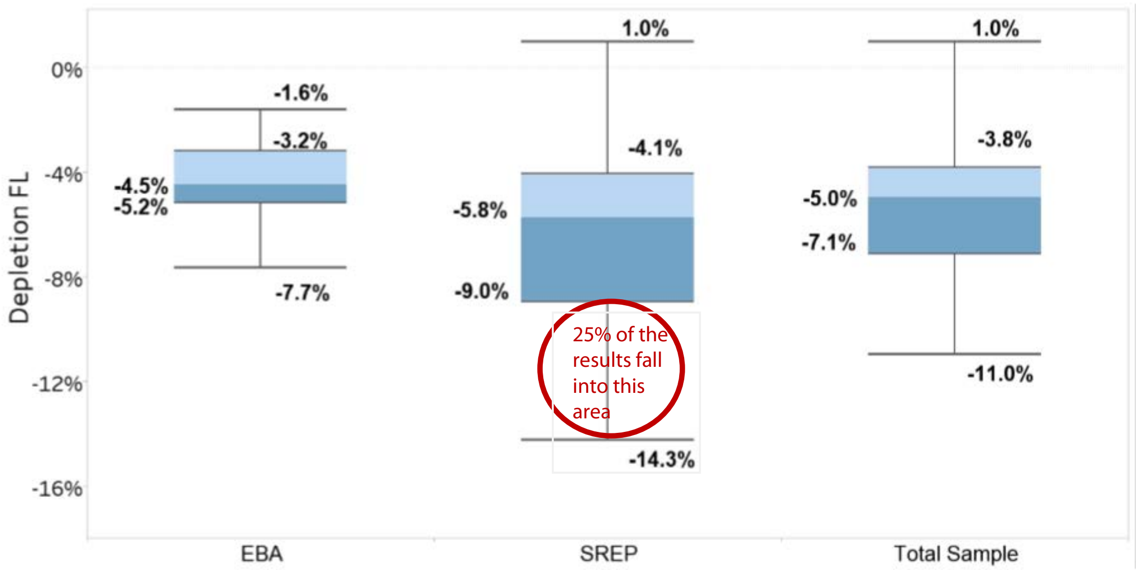
The objectives of the ECB's stress test exercise were (i) to assess the resilience of banks to adverse market developments, (ii) to give input to the Supervisory Review and Evaluation Process, and (iii) to ensure a consistent treatment of all banks under direct ECB supervision.

The key difference between the two exercises is that the EBA published detailed results on bank-level (including results for 33 banks directly supervised by the ECB), while **the ECB has only published the results in aggregate form.**

A box-and-whisker plot in the ECB publication reveals (see chart 4) that **the average impact of the - identical - stress test scenario was significantly higher for SREP banks, and that there was a higher dispersion of the depletion of capital in the adverse scenario.** The CET1 capital ratio of the most affected SREP bank was reduced by (at least) [18] 1430 basis points, an effect much higher than the one seen in the EBA sample. Moreover, there was not only a very strong effect on individual banks (that might be considered outliers), but 25% of the SREP banks in the ECB sample actually saw a reduction by more than 900 basis points, more than the maximum effect seen in the EBA sample.

Those aggregate results suggest that some SREP banks could be in a difficult situation if the adverse scenario actually materialised; in order to make an informed judgement in this regard, however, **one would need to have the results at bank level, as they are provided for the EBA sample.**

Chart 4: Depletion of the CET1 ratio in the third year of the adverse scenario for the EBA and ECB sample (SREP banks)



Source: ECB SSM-wide stress test 2018 Final results, February 2019, p. 15 (complemented by EGOV)

For a critical assessment of the scenarios chosen for the EBA and ECB 2018 stress test exercises ("*How demanding and consistent is the 2018 stress test design in comparison to previous exercises*"), also please see the related previous briefings by R. Haselmann and M. Wahrenburg, and A. Resti.

[17] Some significant banks directly supervised by the ECB were not part of either stress test, mostly because they are subsidiaries of banks already covered by the EBA exercise or in the process of merging or restructuring.

[18] That is the value of the depicted lower whisker; however, the ECB uses a "Tukey box plot" that restricts the shown observed depletion to a multiple (1.5 times) of the interquartile range; there may hence be a more extreme outlier that is not shown.

Table 1: Remaining steps to complete the Banking Union

Remaining steps	Where do we stand?	Possible legislative or supervisory measure
A more integrated risk management for cross-border groups	> Intragroup exposures are subject to large exposures limits that are a Member State option under CRR (i.e. not implemented by ECB) > No agreement on possible liquidity and solvency waivers for subsidiaries as part of the Banking package	> Absent legislative changes, some provisions of the existing framework, if implemented, do support further integration of risk management (e.g. intragroup financial support under BBRD)
Higher degree of harmonisation of EU banking rules	> While prudential rules laid down in the CRR (Capital Requirements Regulation) are directly applicable, the ECB has to apply national law transposing the CRD > The CRD includes critical supervisory issues, e.g. corporate governance, fit and proper, supervisory powers and pillar 2, which may vary from one Member States to another.	> Replacing Directive-based requirements by a regulation (to be decided, where appropriate, by new Commission) > EBA has particularly supported a regulation to conduct the fit and proper assessment.
Supervision of investment firms	> Investments firms are supervised at national level including third country branches. The Investment Firm Review that is currently being negotiated by the co-legislator would subject Category 1 Investment firms to the supervision of the ECB > Supervision of third country branches remains at national level.	> Agreement on the Investment firm review to be reached > New legislative developments on the supervision of third countries branches, where appropriate
Resolution financing	> Reporting in June 2019 on how to improve provision of liquidity in accordance with the December 2018 Eurogroup conclusions	> To be discussed in S2 2019 by Eurogroup
"Framework for bank liquidation (as is the case in the US)"	> Commission has launched a study on a possible harmonisation of insolvency law, as part of an EP pilot project (to be released in Spring) > ECON has commissioned external papers on that issue (to be published in May)	> To be decided by the new Commission, where appropriate
"A more European Approach" to AML	> ESA review that includes an enhanced role for EBA in AML being discussed by the co-legislator	> Commission's report due by January 2022 as to whether an EU body is needed

Additional line of defence via auditors

In January 2019 Metro Bank, a UK based company, informed investors it had uncovered mispriced loans in its balance sheet, leading to a capital shortfall. Late February, the bank announced a capital increase to fill the gap and reported the miscalculation had been identified by the Prudential Regulation Authority and not the bank itself. In a comment to financial press, Bill Coen, secretary-general of the Basel Committee on Banking Supervision, said that "*involving external audit to play a role in assessing a bank's risk weightings is a very interesting prospect*," and "*I see the merit in having another line of defence to ensure assets are [given] the proper risk weighting*." The UK accounting body (Institute of Chartered Accountants in England and Wales) had, earlier in 2015, pushed for auditing bank ratios, arguing that although being the most looked-at indicators, bank ratios were not audited as part of the banks' financial statements. In 2016 the Institute released an exposure draft and in May 2017 disclosed an assurance framework on banking regulatory ratios.

The discussion brings to the fore **whether additional assurances are needed to complement and validate banks' ratios and RWA and which role auditors could effectively play**, bearing in mind the scope of activities they can perform, potential conflicts of interests and past experiences on quality of audits.

Completing the Banking Union

In its introductory remarks at the European Parliamentary Week in February 2019, "Banking Union – Challenges Ahead", A. Enria identified six "remaining steps towards completing the banking union" and called for legislative actions in that respect: (i) integrated risk management for cross-border groups; (ii) higher degree of harmonisation (" the application of different rules and processes in each Member State unduly complicates the conduct of supervisory tasks and jeopardises the level playing field"); (iii) supervision of investment firms by the ECB; (iv) resolution financing ; (v) framework for bank liquidation; (vi) a more European approach to AML. Those steps are further explained below (see table 1).

For further information:

> EGOV Briefing "Completing the Banking Union" (Update February 2019)

> EGOV Briefing "Money Laundering: recent cases from an EU banking supervision perspective" (Update February 2019)

> EGOV Briefing "Liquidation of banks: towards an EU FDIC?" (February 2019)

> EGOV Briefing "Towards new arrangements to finance banks under resolution? (July 2018)

Industry developments

Since the last hearing with the former Chair of the ECB Supervisory Board on 20 November 2018, there were some important industry developments concerning directly supervised significant banks (Banca Carige, Nord LB and Deutsche Bank/Commerzbank)

On 2 January 2019, the ECB's put **Banca Carige** into "temporary administration", after the bank had failed to raise capital and most of its board had stepped down. On 6 March 2019, the Italian Senate approved a set of support measures that had already passed the Chamber of Deputies. In a letter dated 14 February 2019, the current Chair shared view that it would have been preferable to appoint a more gender-balanced team of temporary administrator. For more details on the Banca Carige case, please see a previous EGOV briefing.

On 2 February, the universal bank in public ownership **NordLB**, Germany's seventh largest bank by assets, issued an ad-hoc announcement that points to significant losses in 2018, according to which capital ratios fell below the supervisory minimum: "*[…] the management board of the bank has decided to create a comprehensive additional risk provision for the entire NPL portfolio for the 2018 financial year, resulting in a total risk provision for the 2018 financial year of up to EUR 2.5 billion. Based on the currently available figures for the 2018 financial year, this will result in an annual loss for the NORD/LB group of approximately EUR 2.7 billion after tax. […] The aforementioned loss for the 2018 financial year will have a corresponding effect on the capital ratios in such a way that the common equity tier 1 capital ratio will decrease to about 6 to 6.5 % and thus the **thresholds required by supervisory law will temporarily not be met***." (our emphasis)

In its press release NordLB furthermore sets out that the bank and its public owners have turned down a joint offer by two private financial investors, and instead focus on finding a solution with the German Savings Banks Association. **The indicated approach raises questions as to whether the bank will benefit from State aid.** For more details on the NordLB case, please see a separate EGOV briefing.

On 17 March, Germany's two largest listed banks, Deutsche Bank and Commerzbank, both published press releases stating that they had begun exploratory talks to evaluate the benefits of a merger that could create the euro area's second-largest lender by assets. Without referring in particular to these talks, A. Enria commented to the Financial Times that "*It's undeniable that European banks (...) are not perceived by the* *market as particularly strong and profitable. (...) Having said that, I don't particularly like the idea of national champions, of European champions; I think that, especially when you are a supervisor, you shouldn't promote any particular structural outcome.* ".

VI. Recent ECB publications

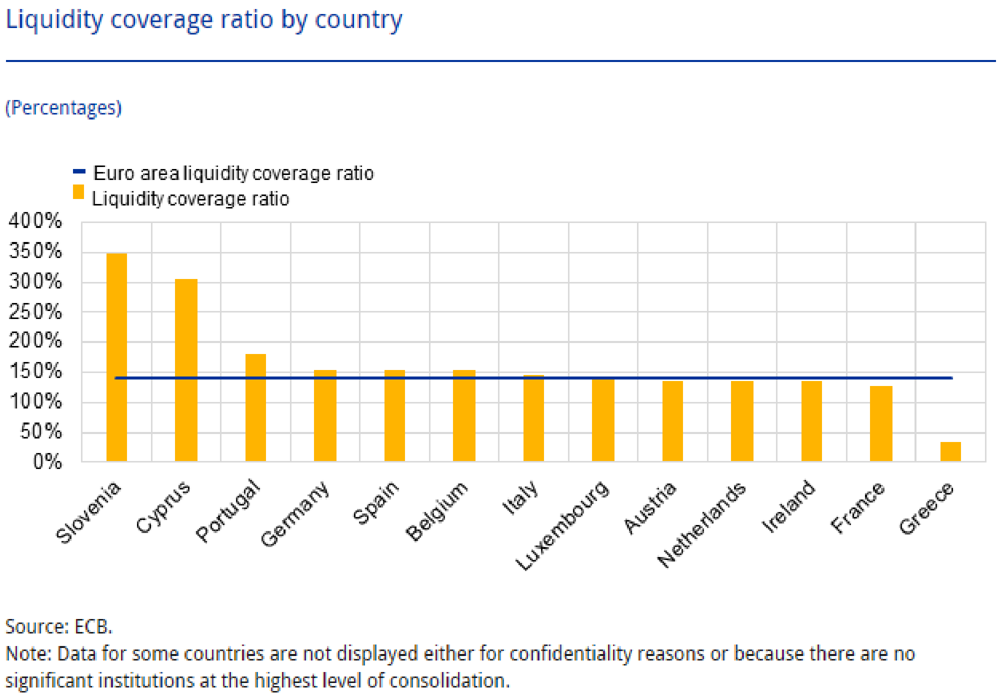
Supervisory Banking Statistics

The ECB reports on the significant banks' balance sheet composition, profitability, capital adequacy, leverage, asset quality, funding, and liquidity situation in aggregate form in the Supervisory Banking Statistics since the second quarter of 2016. In January 2019, the ECB has for the first time published an accompanying press release that points to selected observations.

That press release points to a positive development of the **non-performing loans ratio that in the third quarter of 2018 fell further to 4.17%, which "*was the lowest level since supervisory banking statistics were first published in the second quarter of 2015*".**

The press release notably also depicts the significant institutions' average liquidity coverage ratio (LCR), aggregated at country level, for the third quarter of 2018. According to the Commission Delegated Regulation (EU) 2015/61 Article 4 and 38, credit institutions shall maintain a LCR of at least 100 % as from 1 January 2018. The significant banks in Greece, however, on average apparently only had a LCR of 33.09% in the third quarter of 2018 (see chart 5). The related footnote to the graph in the ECB press release reads "*The figures for Greek banks are affected by external factors that temporarily hinder the use of the LCR as an appropriate liquidity risk indicator.*" **Those external factors, however, are not spelled out in the ECB's press release.**

Chart 5: The significant institutions' average LCR at country level, in 3Q 2018



Source: ECB press release of 25 January 2019, chart 6

Non-confidential version of a failing-or-likely-to-fail assessment

On 24 February 2018, the ECB published the non-confidential version of its Failing-or-Likely-to-Fail assessment adopted on 23 February 2018 regarding ABLV Bank, AS. The assessment lays out developments in the liquidity position of ABLV Bank and the supervisory assessment undertaken by the ECB, which ultimately led to its conclusion that the entity was 'failing or likely to fail'.

That assessment is subject to confidentiality and professional secrecy rules. Omitted information makes it difficult to fully understand the ECB's conclusion that there "*is, or there are objective elements to support a determination that the entity will, in the near future, be unable to pay its debts or other liabilities as they fall due*'".

Comparing this non-confidential version of the ECB's assessment to similar publications of public interest by the Single Resolution Board (SRB), it must be noted that the SRB in case of Banco Popular, another bank deemed 'failing or likely to fail', had to amend the amount of information disclosed, following the SRB Appeal Panel's decision that "[...] *such redactions make this document [the SRB's Provisional Valuation Report] almost unintelligible*" (see Appeal Panel's Final Decision in case 52/2017).

For further information regarding the voluntary liquidation of ABLV Bank and subsequent developments see previous EGOV briefing.

Letters to banks on their dividend distribution policy

In line with established practice, the ECB sent letters in January 2019 to directly supervised banks with recommendations on their dividend distribution policies. The recommendations are in form and content very similar to those made in the previous three years, asking banks to pursue a conservative distribution policy and distinguishing between three different situations: (i) banks that satisfy all applicable capital requirements are expected to distribute their net profits in dividends in a conservative manner, (ii) banks that do not reach all capital requirements calculated on a "fully loaded basis" (after the transition phase) should only pay-out dividends to the extent that there is a linear path towards reaching fully loaded capital requirements, and (iii) banks in breach of any capital requirements should in principle not distribute any dividends. The letter moreover reminds banks, as before, that they are also expected to meet "Pillar 2 guidance".

We noted a slight change of wording, though. The letters sent in previous years stated that "*All other things being equal, the capital demand can be expected to remain broadly stable*." The letters sent in January 2019, on the other hand, state that "*institutions are also expected to take into account the potential impact on capital demand due to future changes in the Union's legal, regulatory and accounting frameworks. In the absence of specific information to the contrary, the future Pillar 2 requirements and Pillar 2 guidance used in capital planning are expected to be at least as high as the current levels.* "

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