BRIEFING

Public Hearing with Danièle Nouy, Chair of the Single Supervisory Mechanism

Committee briefing for the attention of ECON on 18 March 2014

This is a note prepared in advance of a regular public hearing as referred to in Regulation 1024/2013 and as in line with the Interinstitutional Agreement between the EP and the ECB. Prior to this hearing, the ECON Chair addressed on 11 March 2014 a series of written questions to the SSM Chair.

I. Recent developments

►On 11 March 2014 the ECB published its manual on the **methodology for phase 2 of the asset quality review** (AQR). The manual provides guidance for the national competent authorities (NCAs) and their third-party support on carrying out the exercise. It follows the portfolio selection (i.e. phase 1) and will run until August 2014. It will be succeeded by final phase 3, to be completed in October 2014 when the results will be released together with the results of the stress test conducted in cooperation with the EBA.

►The SSM Supervisory Board held its third meeting on 27 February 2014. Although the Interinstitutional Agreement between the EP and the ECB provides that "*the ECB shall provide Parliament's competent committee at least with a comprehensive and meaningful record of the proceedings of the Supervisory Board that enables an understanding of the discussions, including an annotated list of decisions*", **no records have been provided so far.** The ECB indicated that the matter is still under discussion.

►On 6 February 2014 the ECB adopted rules on the appointment of **the ECB representatives** to the SSM Supervisory Board for non-renewable term of 3 to 5 years and thereafter appointed three ECB representatives to the Board on 7 March 2014: *Sirkka Hämäläinen* (former member of the ECB Executive Board), *Julie Dickson* (Superintendent of Financial Institutions at the Canadian regulator OSFI) and *Ignazio Angeloni* (ECB Director General Macro-Prudential Policy and Financial Stability).

►On 7 February 2014 the ECB launched a public consultation on the draft framework regulation, which is to regulate how the **ECB will cooperate with NCAs**. Final version is to be published by 4 May 2014.

►On 4 February 2014, the ECB submitted its **first Quarterly Report** on the progress in the operational implementation of the SSM to the EP, the Council and the COM with presentation by the SSM Chair on the same day in ECON.

►On 31 January 2014 the ECB adopted rules on **close cooperation** with the NCAs of participating Member States whose currency is not the euro, lining out the criteria for the ECB´s positive decision on a close cooperation as well as the reasons for suspension or termination of such relationship.

Authors: M. Hauptman, C. Bourgault, S. de Finance

II. Set up of the SSM

The SSM will be responsible for the euro area as well as non-euro area Member States that choose to participate. It will be in charge direct oversight of banks, although in a differentiated manner and in close cooperation with national supervisory authorities.

Its Supervisory Board is responsible for planning and carrying out the ECB's supervisory tasks and proposing complete draft decisions for adoption by the ECB Governing Council.

Concerning the significant banks, the SSM will exercise direct supervision, while for the **less significant institutions (LSI),** National Competent Authorities (NCAs) remain responsible for the day-by-day supervisory activities, but the ECB retains important strategic functions, including regarding initial licensing, withdrawals of licenses and the assessment of acquisitions of qualifying holdings, which are handled jointly.

The ECB is currently drafting internal rules on **separation between monetary and supervisory policy** applied both at decision making level as well as staff level.

As stated in the letters of the ECB President of 15 November 2013 and 10 January 2014, there are **five work streams** (working groups) in the process of establishment of the SSM:

- Initial mapping of the euro area banking system;
- Legal considerations for establishing the SSM;
- Development of the supervisory model;
- Preparation of the supervisory reporting framework;
- Preparation of comprehensive assessment.

III. Comprehensive Assessment

On 4 February 2014, the ECB adopted its decision on **identifying the banks** subject to the comprehensive assessment (see Annex 2). The process of comprehensive assessment (risk assessment + AQR + stress test) concerns all of the 128 banks deemed significant under SSM over which the ECB will have direct oversight as of November 2014. These banks cover approximately 85% of euro area bank assets.

For the **stress test component** of the comprehensive assessment, the ECB announced to cooperate closely with the EBA and to apply the methodology and parameters agreed and announced by EBA on 31 January 2014. The latter will conduct an EU-wide stress test on a **sample of 124 EU banks** which cover at least 50% of each national banking sector, and will be run at the highest level of consolidation. The ECB will in parallel conduct **a stress test of 128 banks under the SSM**, incorporating results of the on-going AQR.

The stress test will cover credit, market, funding and securitisation risks. As announced by the EBA, **sovereign exposures** in held-to-maturity portfolios will be treated in the same way as other credit exposures in that portfolio, i.e., the impact of the scenarios on the default and loss parameters will be calculated and will result in larger provisions. Sovereign exposures in the available-for-sale and held-for-trading portfolios will be marked-to-market, in line with the scenarios employed.

In case of shortfalls, **the order of claims** under comprehensive assessment will be as follows: private resources, national public funds, and only then European public funds. As in line with the European Council Conclusions of June 2013, all Member States participating in the SSM will have appropriate arrangements in place, including **national backstops** as soon as possible.

The ECB furthermore announced that the AQR will include a quantitative and qualitative review of "**hard-to-value assets"** (so-called level-3 assets; those are typically assets that become illiquid when the underlying markets dry up). The ECB has identified **29 banks** which have material trading book exposures from hard-to-value assets; as a misstatement of related fair values could have a material impact on the Common Equity Tier 1 capital ratio, those banks will be subject to a more specifically tailored AQR of their trading books.

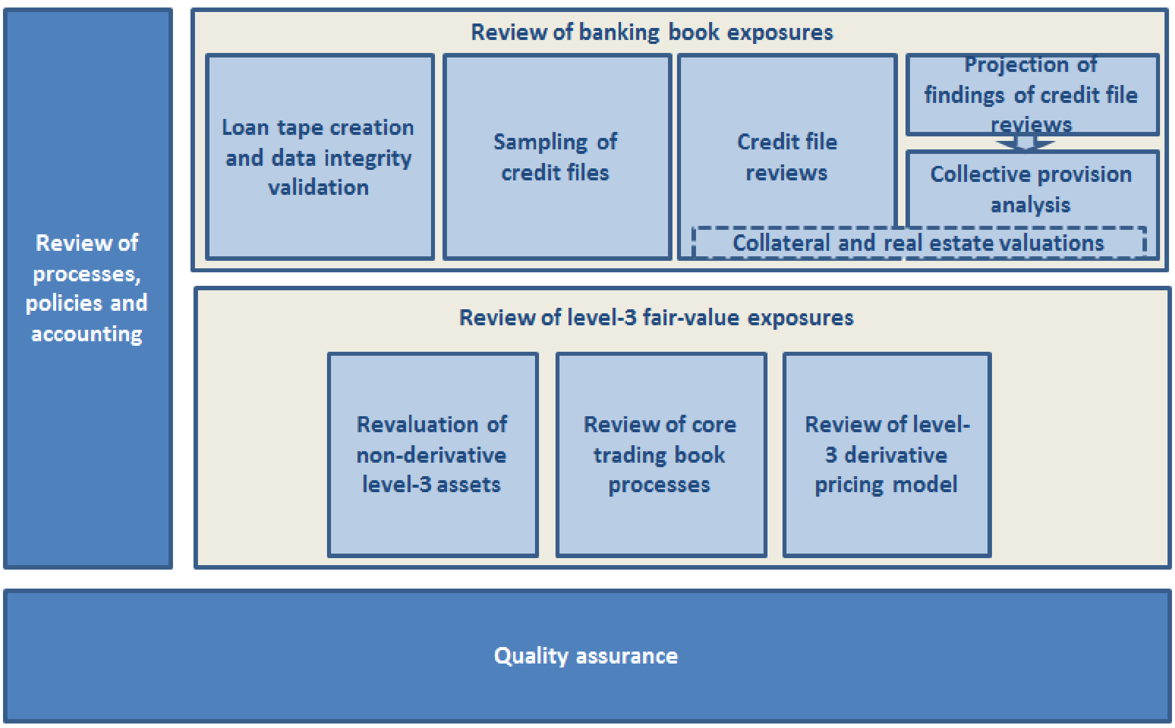
On 6 March 2014 Basel Committee published results on the **Basel III monitoring exercise**. A total of 227 banks participated in the current review, comprising 102 large internationally active "Group 1 banks" (defined as internationally active banks that have Tier 1 capital of more than €3 billion) and 125 "Group 2 banks" (representative sample of all other banks). Data as of 30 June 2013 show that shortfalls in the risk-based capital of large internationally active banks generally continue to shrink, but to increase for the other banks surveyed.

The process of portfolio selection was supposed to conclude in February 2014, while the ECB has been working closely with the NCAs to publish **finalised AQR methodology in the first quarter** of 2014. The AQR's execution phase will then commence with the deployment of teams of bank inspectors for the conduct of credit file reviews and other necessary activities. The ECB will also deploy teams to oversee these processes in each country. In parallel, the development of the scenarios for use in the stress test will continue and they will be made available at the end of April.

Before assuming its supervisory tasks in November 2014, the ECB will **publish detailed results** of the comprehensive assessment, as well as any recommendations relating to individual banks.

As to the **language**, the supervised entities may address the ECB in any of the EU official languages. First comprehensive assessments tables will be however sent in English unless a bank requests otherwise.

Schematic overview of the AQR methodology



Source: ECB, Note on the comprehensive assessment, February 2014

IV. Selected remarks in the public domain (as regards SSM and AQR)

Recent OECD paper on the "*State of the Banking Sector in Europe*" argues in favour of the introduction of **complementary market-based leverage ratios** in addition to the regulatory capital ratio: a market value-based leverage ratio of 3% as required by Basel III (the OECD supports a level of 5%), non-performing loans indicators and the book-value leverage ratio. The researchers find a substantial need for recapitalization for the EU banking sector. In a basic scenario to restore capital to 3% of total assets, €84 billion would be needed for the largest 60 banks vs. €365 billion in a stronger scenario to restore capital to 5%. In addition, if a general market fall materializes (adverse stress-test scenario) the expected shortfall amounts to €241 billion. In addition, the analysis of a sample of 22 major EU banks reveals that only well-capitalized banks (i.e. leverage ratio above 4%) support new lending to the economy. By contrast, weakly capitalized banks improve their capital position by deleveraging, thereby hampering new lending.

In a paper on the recapitalisation of banks supervised by the SSM requested by the ECON Committee for a Monetary Dialogue, the authors point out the **uncertainties** concerning the role of the ECB in deciding whether a bank should be resolved rather than recapitalised. The ECB may ask the bank to increase its capital. But it may be difficult for the ECB to force a bank to restructure.

A recent paper on the SSM by Eddy Wymeersch points among others to some **governance weaknesses of the SSM** set-up due to "*Europe's particular constitutional organisation, where Member States keep a large part of power*". The internal institutional built-up within the ECB is far from clear, especially the relationship between the Governing Council and the Supervisory Board. In addition, will the two bodies be able to overcome the particular national interests of its members? The relationship with the NCAs will also be one of the crucial elements in the further SSM development: on the one hand concerns about NCAs being eliminated from the most challenging part of the supervisory tasks, but on the other, the ECB reliance on the expertise and knowledge of seconded national experts and other NCAs staff.

A paper on major reshapes of EU financial system by Nicolas Véron suggests that the interaction of governments, NCAs and the ECB will become **increasingly tense** as the AQR approaches finalization. In the past these factors resulted in the failure of the bank stress test process, which severely undermined credibility of the EBA. However, the balance of interests is different this time and euro area Member States have a stake in the ECB credibility and thus in euro's sustainability.

ANNEXES:

1. Legal Base for Hearings/Meetings of the SSM with the EP
2. Financial institutions included in the comprehensive assessment

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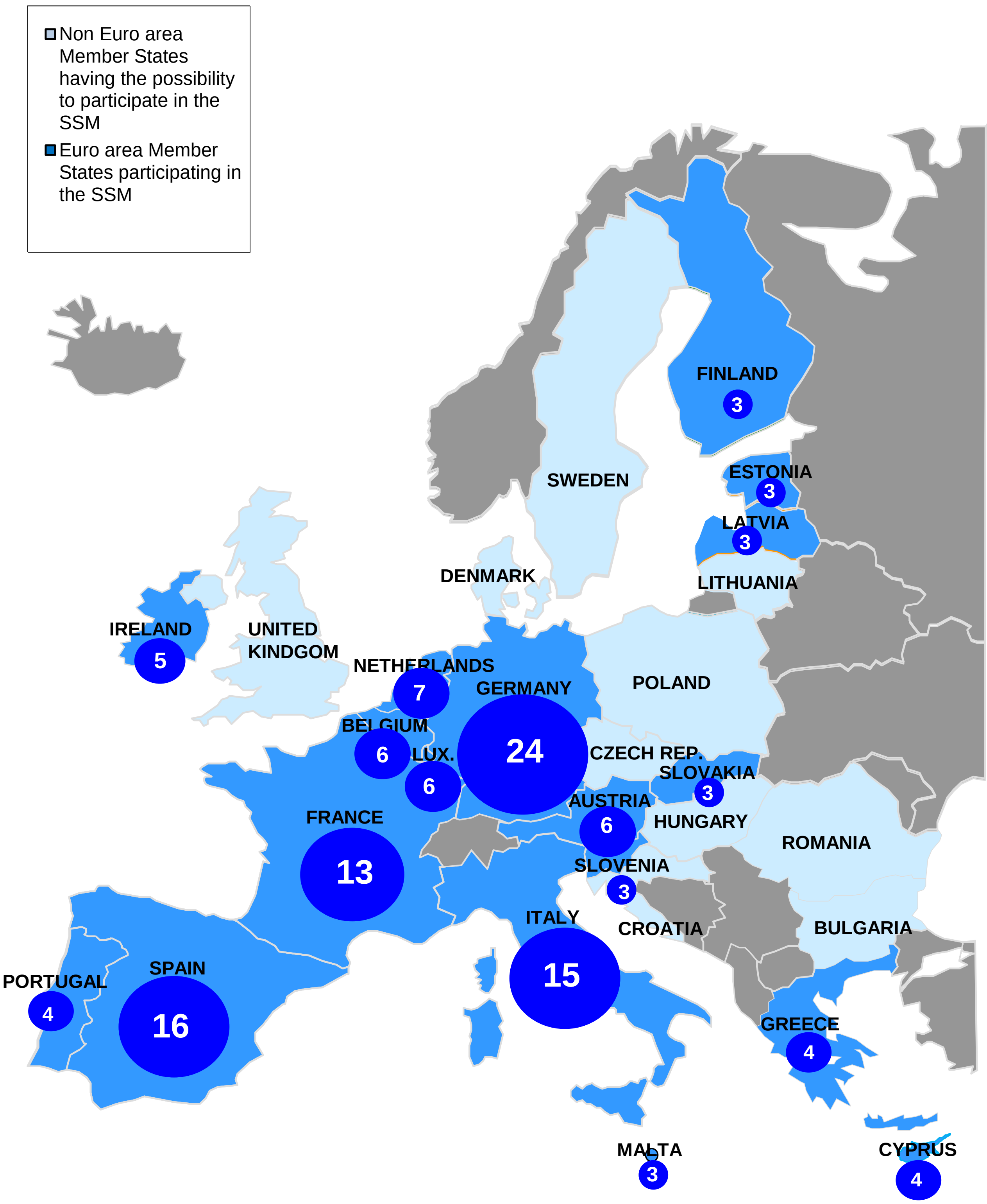
ANNEX 1: Legal Base for Hearings/Meetings of the SSM with the EP

Accountability, Access to Information, Confidentiality	
Regulation (EU) 1024/2013 conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions	
Art.20	1. The *ECB shall be accountable to the EP* and to the Council for the implementation of this Regulation. [...] 3. The Chair of the Supervisory Board of the ECB shall present that *report* [on the execution of the tasks conferred upon it by this Regulation] *in public* to the EP [...]. 5. At the request of the EP, the Chair of the Supervisory Board shall participate in a *hearing* on the execution of its supervisory tasks by the competent committees of the EP. 6. The ECB shall reply *orally or in writing to questions* put to it by the EP [...]. 8. Upon request the Chair of the Supervisory Board shall hold *confidential oral discussions* behind closed doors with the Chair and Vice-Chairs of the competent committee of the EP concerning its supervisory tasks where such discussions are required for the exercise of the EP's powers under the TFEU. [...] 9. The ECB shall *cooperate sincerely* with any investigations by the EP, subject to the TFEU. [...]
Interinstitutional Agreement between the EP and the ECB	
Part I	1. The ECB shall submit every year a *Report to the EP* ("Annual Report") on the execution of the tasks conferred on it by Regulation (EU) No 1024/2013. The Chair of the Supervisory Board shall present the Annual Report to the EP at a *public hearing*. [...] 2. The Chair of the Supervisory Board shall participate in *ordinary public hearings* on the execution of the supervisory tasks on request of the competent committee of the EP. The EP's competent committee and the ECB shall agree on a calendar for two such hearings to be held in the course of the following year. [...] In addition, the Chair of the Supervisory Board may be invited to *additional ad-hoc exchanges of views* on supervisory issues with the EP's competent committee. Where necessary for the exercise of EP's powers under TFEU and the EU law, the Chair of its competent committee may request *special confidential meetings* with the Chair of the Supervisory Board in writing, giving reasons. [...] On a reasoned request by the Chair of the Supervisory Board or the Chair of the EP´s competent committee, and with mutual agreement, the ordinary hearings, the ad hoc exchanges of views and the confidential meetings can be attended by the *ECB representatives in the Supervisory Board or senior members of the supervisory staff* (Director Generals or their Deputies). The ordinary hearings, ad-hoc exchanges of views and the confidential meetings can cover all aspects of the activity and functioning of the SSM covered by the SSM Regulation. [...] Only the Chair of the Supervisory Board and the Chair and the Vice-Chairs of the EP's competent committee may attend the confidential meetings. [...] 4. The ECB shall provide Parliament's competent committee at least with a *comprehensive and meaningful record* of the proceedings of the Supervisory Board that enables an understanding of the discussions, including an annotated list of decisions. [...]

Appointment procedures	
Regulation (EU) No 1024/2013 conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions	
Art. 26	3. After *hearing* the Supervisory Board, the ECB shall submit a proposal for the *appointment* of the Chair and the Vice-Chair to the EP for approval. [...]
Interinstitutional Agreement between the EP and the ECB	
Part II	The ECB shall provide the EP's competent committee with the shortlist of candidates for the position of the Chair of the Supervisory Board. [...] A *public hearing* of the proposed Chair and Vice-Chair of the Supervisory Board shall be held in the EP's competent committee. The EP shall decide on the *approval* of the candidate proposed by the ECB for Chair and Vice- Chair through a vote in the competent committee and in plenary [...].
Committee of Inquiry	
Interinstitutional Agreement between the EP and the ECB	
Part III	Where the EP sets up a *Committee of Inquiry* [...] the ECB [...] shall assist a Committee of Inquiry in carrying out its tasks in accordance with the principle of sincere cooperation.

ANNEX 2: Financial institutions included in the comprehensive assessment



Source: ECB