BRIEFING

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

ECON on 31 March 2015

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. On 25 March, the ECB submitted to Parliament a draft of the Annual report on a confidential basis, which is under embargo until Tuesday, 31 March 2015 at 15:00. This briefing does therefore not rely on information provided in that Annual report. The following issues are covered in this briefing: SSM achievements and priorities, follow-up on the outcome of the Comprehensive Assessment, Common procedures for the supervisory review, overview of risks in the banking sector, and follow-up on sovereign debt in banking.

SSM achievements and priorities

The Chair of the SSM, Danièle Nouy, recently summarized the achievements made so far (foremost the completion of the comprehensive assessment, as well as the integration of the national competent authorities into the SSM, the adoption of supervisory decisions on Pillar 2 capital, and the finalisation of a common manual for supervision) and laid out what the **main future challenges** are in a **speech** given on 17 March 2015 at the SZ Finance Day 2015 in Frankfurt.

The first issue she flagged in that speech was insufficiently **harmonised regulation** across countries, which makes it harder to deliver consistent supervision and a level playing field. There are for example national options when it comes to the speed of phasing-in Basel III definitions of bank capital, and different ways of treating deferred tax assets, goodwill and equity holdings in insurance company subsidiaries.

The second issue she flagged is to foster the **effective interaction** between all 4000 supervisors, whether located at the ECB or the national competent authorities.

The third challenge Ms Nouy flagged concerns the setting of the right priorities for the SSM, namely **following up on the comprehensive assessment,** eliminating national discrepancies, and reviewing internal models. She demonstrated the importance of that issue by referring to the review of the banks **internal models**[1], used to calculate their risk-weighted assets and capital needs. Considerable heterogeneity exists in that area, but given that there are almost 7000 such internal models used, the SSM may need to stretch out their review over several years.

Finally, Ms Nouy mentioned that the SSM would also need to focus on some qualitative issues, in particular the banks' **credit risk management** and the sustainability of banks' **business models**.

According to an interview with Ms Nouy in the Financial Times, the SSM may have to ask the European Parliament for more harmonisation in regulation if it wants to achieve its objective to eliminate national discrepancies.

[1] The discretion in the use of internal models was already put up for discussion in a previous briefing for ECON provided in October 2014.

Authors: Marcel Magnus and Jockum Backman

Follow-up on the outcome of the ECB's comprehensive assessment

On 26 October 2014, the ECB presented the long-awaited results of its comprehensive assessment. In its related press statement, the ECB prominently stated that at 25 out of 130 participant banks, **capital shortfalls** were detected that in total amounted to €25 billion.

As a **consequence**, each of those banks had to submit **capital plans** within two weeks of the public disclosure of the results. Those capital plans had to show in detail how shortfalls stemming from the asset quality review or the baseline stress test scenario could be addressed within six months, and how those that stem from the adverse stress test scenario could be addressed within nine months.

The ECON committee has requested a review on how much **progress** has been made with mitigating actions since the public disclosure of the capital shortfalls.

Considering that the overall timeframe for addressing the capital shortfalls has not yet elapsed, the two external experts contracted for that review, Mr Breuer and Mr Steffen, could so far only submit **interim results** on the progress made as regards the capital shortfalls disclosed. Both contractors will provide their final assessments by October 2015.

In his interim report, **Breuer** points out that at present there is still a lack of transparency which might potentially harm confidence into affected European banks, and summarizes the situation as follows:

- *"For six banks there is **no public information** whether or not a capital plan is required.*
- *For nine banks, for which a capital plan might be required, it is not clear whether a capital plan was approved by the ECB.*
- *For ten banks it is either not transparent whether a capital plan if required has been completed or whether it has not yet been completed."*

In a similar vein, **Steffen** writes in his interim report that "*Overall, there is **insufficient information** about actions taken by the banks after the comprehensive assessment that has been publicly disclosed and that can be used to assess these actions*."

Based on the analysis of four different metrics[2], Steffen furthermore finds that "*Our **preliminary results suggest that actions** that have so far been taken by banks that have failed the stress test in 2014 **might not have been successful**. Share prices and market-to-book (MTB) ratios have further declined and these banks exhibit higher systemic risk relative to before the results have been disclosed and relative to banks that have passed the stress tests*."

Common procedures for the supervisory review (SREP)

On 19 December 2014, the European Banking Authority (EBA) published its final guidelines for **common procedures and methodologies for the supervisory review and evaluation process** (SREP). Those guidelines shall forge a consistent supervisory culture across the Single Market and provide a common framework for the work of supervisors in the assessment of risks to banks' business models, their solvency and liquidity.

The guidelines will apply from 1 January 2016 and are addressed to all competent authorities across the Union, **including the SSM**.

[2] The four different metrics are: Market-to-book ratio; Capital shortfall in a systemic crisis; Capital shortfall in a systemic crisis, and Share prices

Vulnerabilities in the banking sector

EBA summarises the main risks and vulnerabilities in the banking sector in the European Union in its "**Risk Dashboard**" by looking at the evolution of several key risk indicators. On 16 March, EBA last updated its Risk Dashboard; the data for 55 EU banks refers to the fourth quarter 2014. Key findings were:

- The **positive trend of increasing capital ratios** continued during the quarter, mainly driven by an increase in retained earnings and capital issuances which outpaced the growth of RWAs.
- The **quality of EU banks' loan portfolios stabilised**, but on a low level. However, there are significant differences between banks in different countries.
- **Profitability** in the banking sector **remains volatile** and is low compared to past years.
- The aggregated **loan-to-deposit ratio** decreased and is at an **all-time low**. However, there are substantial differences between countries.

The following table, summarizing all main current risks in the banking sector, is taken from EBA's Risk Dashboard (with small modifications, in particular a shortened display of the reasoning):

Table: Extract from Risk Dashboard Q4 2014 - Overview of the main risks and vulnerabilities in the EU Banking sector

	Bank risk	Risk drivers	Level of risk: Level	Level of risk: Forward Trend	Contributing factors/interactions (extractions)
Capital	Credit risk	Asset quality		→	Asset quality remains a major challenge together with the credibility of banks' risk weighted assets. Banks remain vulnerable to exogenous shocks.
Capital	Market risk	Volatility and risk of decreasing market liquidity		↑	Geopolitical tensions and political risks rise again. Market volatility continues to be affected by the diverging monetary policy stances by global central banks.
Capital	Operational risk	IT risk, litigation risk		→	IT and internet related risks (e.g. cyber-risks) are growing further. Litigation costs have become increasingly onerous and unpredictable.
Capital	Concentration risk, IRRBB and other	Interest rates		→	Low interest rates help maintain asset quality and improve affordability of bank credit. However, low interest rates also provide incentives for increased risk taking.
Capital	Reputational and legal	Index/FX investigations, mis-selling		→	Confidence in banks continues to be affected by legacy practices. Litigation costs have been substantial and continue to materialize.
Capital	Profitability	Margins, provisions, business model changes		→	Non-performing loans still stand close to their peak and interest income generation opportunities are still reduced. Legal costs have and will continue to materialize.
Liquidity & Funding	Access to funding and maturity distribution	Market funding and liquidity		↑	Banks benefited from strong investor demand for European banks' debt. No real shortage of market funding has been observed. There is an ongoing high risk of contracting liquidity in the funding market.
Liquidity & Funding	Funding structure	Reliance on central bank funding		→	Even though more and more banks have returned to funding markets many institutions rely on central bank funding. The share of market funding as well as through deposits from customers remained rather stable.
Environment	Regulatory environment	Regulatory initiatives		→	Regulatory clarity has further improved, though execution risks remain ahead.
Environment	Fragmentation	Continued lack of confidence, sovereign/bank link		→	Geographical fragmentation in respect of asset quality, bank restructuring and of funding conditions continues in the EU.
Environment	Sovereign risk	Fiscal policy & effectiveness, debt restructuring		→	Non-negligible fiscal deficits persist throughout the EU. It is not yet clear if fiscal policy will coincide with monetary policy to reduce deflationary risks.
Level	High	Medium	Low		The level of risk summarises, **in a judgmental fashion, the probability of the materialisation of the risk factors and the likely impact on banks.** The assessment takes into consideration the evolution of market and prudential indicators, NSAs and banks' own assessments as well as analysts' views.
Trend	↑ Increasing	→ Stable	↓ Decreasing		

Source: EBA Risk dashboard Q4 2014 (the table has been shortened by EGOV)

Sovereign risk

Both the EBA Risk Dashboard Q4 2014 and a recent study produced by the European Systemic Risk Board (ESRB) point to the risks that banks are facing with regard to their exposures to sovereign debt.

Using detailed information that was recently published by EBA and ECB at the level of individual banks (reference date: 31/12/2013), EGOV calculated the banks' Average Net Exposure to Home Sovereign at country level and provided an "At a Glance" briefing on that issue. Our calculation shows that the levels of exposure varied considerably across Europe (the average values shown, however, blur the fact that the levels of exposure also vary considerably within each country):

Map: Banks' average Net Exposure to Home Sovereign as at 31/12/2013