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BRIEFING

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

ECON on 25 June 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. The following issues are covered in this briefing: national discretions in the implementation of the CRD IV package, ECB Regulation on reporting of supervisory financial information, ECB recommendation on prudent dividend policy, the EP's vote on banking structural reform, data collection on credit risk, the EBA SREP guideline, an external briefing on the development of bank structures, and developments in the banking industry according to some key indicators (annex 1).

National discretions in the implementation of the CRD IV package

On 1 January 2014, the new rules of the so-called CRD IV package entered into force: Directive 2013/36/EU and Regulation (EU) No 575/2013 transpose the Basel III standards into EU law, set stronger prudential requirements for banks and require them to keep sufficient capital reserves and liquidity.

However, those two pieces of legislation contain a **large number of national discretions** and options which may be applied on the basis of national circumstances. The European Banking Authority (EBA) provides an overview table and eleven complementary tables (all in Excel format) of the options and discretions that are set out in those two legal texts. The EBA's overview table lists 67 items, grouped in 23 categories, that that can be individually set or defined at national level; the nature of those options ranges from, for example, governance issues such as restrictions for variable elements of remuneration, topics such as the minimum amount of initial capital that investment firms need to have in order to hold client money, national exemptions for large exposure limits regarding claims on regional governments or local authorities of Member States, to national choices as regards the phasing out of deductions from Common Equity Tier 1, Additional Tier 1 and Tier 2 items.

Some of the options are only applicable during a transitional phase; the number of national discretions should hence become smaller over time. In general terms, though, a true level playing field is best served by convergent supervisory practices and standards.

ECB Regulation on reporting of supervisory financial information

In order to carry out its supervisory tasks, the ECB needs access to complete, regular and consistent data on the credit institutions in the SSM area. So far, however, supervisory financial reporting has been mandatory only for banks applying International Financial Reporting Standards (IFRS) at the consolidated level.

On 26 March 2015, the ECB therefore published Regulation (EU) 2015/534 which **extends** mandatory supervisory **financial reporting requirements** to all supervised entities. That regulation

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specifies the standardised format and required breakdown of financial information as well as the frequency of reporting to national competent authorities and the ECB. As a consequence, all significant supervised groups will have to report the required information to the ECB with a reference date of 31 December 2015.

In accordance with the proportionality principle, less significant supervised entities are, however, only subject to simplified reporting requirements, and there are exemptions from the reporting requirements for small subsidiaries in non-participating Member States or third countries. Smaller entities also benefit from a longer implementation period: the applicable reference date for data provided by individual entities which form part of a supervised group is 30 June 2016; less significant groups and entities have an additional one-year grace period and shall use 30 June 2017 as their first reference date.

ECB recommendation on prudent dividend policy

On 29 January 2015, the ECB issued a recommendation to banks on their **dividend distribution** policies for the financial year 2014, directly addressing the significant banks and asking national supervisors to follow the same line as regards less significant banks.

That recommendation was made in light of the challenging macroeconomic environment which squeezes banks' profitability and affects their capacity to build up capital.

Essentially, banks which still have to build up capital to comply with increasing capital standards were told to be cautious when distributing dividends. The "fully loaded" capital ratio, i.e. the threshold that is legally required only as of January 2019, will not only comprise a total capital ratio of 8% and the required countercyclical capital buffer, but may also include buffers adopted by national competent authorities in order to cover macro-prudential or systemic risk identified at the level of a Member State.

In its recommendation, the ECB distinguishes between **three categories of banks**:

- Some banks have already reached their "fully loaded" capital ratios, i.e. the threshold that is legally required only as of January 2019; those banks were told to distribute dividends conservatively, that is to take into account potential effects stemming from deteriorating economic and financial conditions.
- Other banks, which have not yet reached the fully loaded capital ratios, were likewise asked to distribute dividends conservatively, and to restrict pay-outs to the extent that the required capital can be gradually built up, taking at least a linear path to reach that objective.
- Finally, those banks for which the overall results of the comprehensive assessment in 2014showed a **capital shortfall** were told in principle **not to distribute any dividends**.

Vote on banking structural reform

In February 2012, the Commission established a High-level Expert Group to examine possible reforms to the structure of the EU's banking sector in order to strengthen financial stability. The Group presented its final report on 2 October 2012 ("Liikanen report").

Following up on the recommendations made therein, the Commission adopted its proposal for a regulation ("**banking structural reform**") to stop the biggest banks from engaging in the risky activity of proprietary trading on 29 January 2014.

The proposed regulation and related amendments or changes were subject to a vote in the ECON committee on 26 May 2015. In the final vote, however, that draft did not obtain a majority, with 30 votes against and 29 in favour. ECON will now reconsider the proposal.

On 19 June 2015, the Council agreed its negotiating stance on structural measures to improve the resilience of EU credit institutions. On the basis of this mandate, the incoming Luxembourg presidency will start negotiations with the European Parliament as soon as the latter has adopted its position.

Data collection on credit risks

AnaCredit, shorthand for Analytical Credit Dataset, was initiated in 2012 in order to make available within the European System of Central Banks (ESCB) a set of granular and frequent data on credit and credit risk. The ECB considers this dataset to be highly relevant for its conduct of monetary policy as well as for other central banking functions, such as financial stability surveillance, collateral management measures and macro-prudential analysis

The ECB sets out in its 2015 annual report on financial integration that the availability of a granular credit dataset would also be beneficial for micro-prudential supervision, allowing for the assessment of borrower creditworthiness by credit institutions with an internal-ratings based approach. Following-up on related questions posed at the ECON Committee hearing on 31 March 2015, the ECB's letter of 21 April 2015 confirms that the ECB in its banking supervision role would be a key user of AnaCredit.

The current timetable for the project is to adopt the relevant ECB regulation requiring the data to be reported by credit institutions to the National Central Banks in the summer months of 2015, while its implementation will happen in three stages starting in end-2017 and finishing in mid-2020.

Under current plans, credit institutions would have to report detailed information on borrower attributes (e.g. institutional sector, size), credit data variables (e.g. type of loan, collateral type, original and remaining maturities), and credit data measures (e.g. credit drawn, arrears, collateral value, interest rate) at borrower level, with the reporting threshold for all covered instruments (loans, derivatives, and off-balance sheet exposures) set at EUR 25 thousand. In some countries this is already done to a varying degree, but the ESCB Task Force on AnaCredit discovered substantial differences in terms of coverage and data content, which require a harmonisation of definitions and coverage across Member States. Some countries do not collect granular credit data at all, meaning they would have to set up the processes from scratch.

Capital Requirements and the Supervisory Review and Evaluation Process (SREP)

In the context of forging a consistent supervisory culture, the EBA was tasked with preparing guidelines on the common procedures and methodologies for the **supervisory review and evaluation process** (SREP). Those guidelines were published in December 2014 and shall be applied from **1 January 2016.**

The common SREP framework shall enhance the link between an institution's risk profile, its risk management and risk mitigation systems, and its capital planning.

The guidelines use a **scoring-based approach** whereby specific elements of the SREP framework are assessed and scored on a scale of 1-4 (positive grades) and F (negative grade). The **four key elements** upon which the individual institution will be scored are:

1. Business Model Analysis (BMA)
2. Assessment of internal governance and institution-wide controls
3. Assessment of risks to capital and adequacy of capital to cover these risks
4. Assessment of risks to liquidity and adequacy of liquidity resources to cover these risks.

As stated above, the guidelines are comprehensive but some of the key points to note are:

- The **overall SREP assessment** is based both on individual and group assessments, and must reflect any supervisory findings made over the course of the previous 12 months.
- The SREP framework utilises the **principle of proportionality** categorising institutions according to systemic importance.
- The business model analysis shall inter alia scrutinize whether banks are viable, judging their **ability to generate acceptable returns** over the following 12 months, and whether the business model is sustainable, judging – based on strategic plans and financial forecasts – their ability to generate acceptable returns over a forward-looking period of at least 3 years.
- **Internal governance and institution-wide controls** will inter alia be judged by looking at the organisation of the management body, remuneration practices, and the adequacy of resolution planning.

External paper: Have European banks actually changed since the start of the crisis?

Harry Huizinga, Tilburg University, and Ata Can Bertay, Ozyegin University, have written an external briefing paper which analyses the general **trends in banks' key structures over the past decade**, focussing on banks that are directly supervised by the ECB since November 2014, and comparing the results with those for even larger banks identified as global systemically important (G-SIBs) in the Eurozone.

The time span allows seeing the effects of the crisis on the one hand and reactions to the crisis on the other hand, giving an indication to what extent banks have been moving in the direction of better performance and greater stability.

The analysed variables include indices of banks' overall business model, size, off-balance sheet exposures, and internationalization, as well as variables that inform about banks' asset portfolios, funding strategies and capitalization.

The authors conclude that the effects of the recent economic and financial crisis on the Eurozone banking system are still apparent: on average, the overall performance is currently poor, as banks realized a negative return on assets of minus 0.13% in 2013.

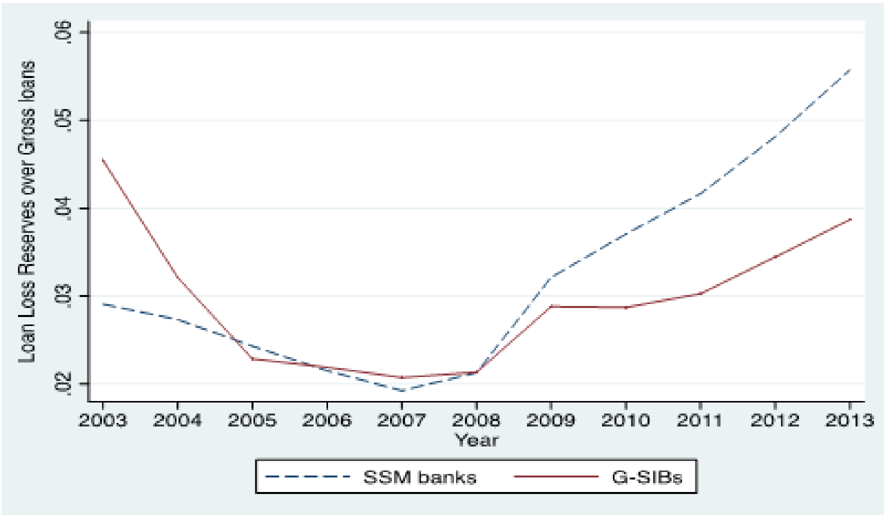
The authors find some evidence that banks have indeed changed since the start of the crisis in ways that make them more stable. Banks have started to raise a larger share of their overall funding in the form of **customer deposits**, and they have reduced their share of loans in total assets. Both developments make banks more stable. In addition, Eurozone G-SIBs have materially reduced their reliance on relatively risky non-interest sources of income such as **trading income**, which should make them more stable.

On the negative side, Huizinga and Bertay find that directly supervised banks have only slightly reduced their size relative to GDP since reaching a peak in 2007. This suggests that many banks remain too-big-to-fail. Banks have furthermore become more **exposed to sovereign debt** after the crisis, while G-SIBs have increased their exposure in the form of **off-balance sheet items** after the crisis. Both trends potentially imply larger bank risk. Large increases in the ratio of regulatory capital to risk-weighted assets after the crisis have been accompanied by only small increases in the ratio of equity to assets, suggesting that effective capitalization has increased only slightly.

Following the comprehensive assessment exercise, the ECB was rather upbeat about the results, writing in the Financial Stability Report of November 2014 that "...*long-lingering concerns about the asset and collateral valuation of significant banks in the euro area, NPL recognition as well as provisioning practices have largely dissipated*".

However, the results presented by Huizinga and Bertay show for example that **provisioning for loan losses** has in the past been unduly based on overly optimistic assessments of loan quality during periods of high economic growth, and that loan loss reserves tend to reflect past losses, rather than future losses, as it is intended. It therefore seems questionable whether concerns about provisioning practices rightly dissipated.

Chart: Loan loss reserves over gross loans



Source: Bankscope and authors' own calculations.

Huizinga and Bertay hence recommend that the ECB should use its **supervisory tools** to bend banking trends towards increased bank stability. Supervisory tools could, for instance, be applied to a greater extent to reduce risky off-balance sheet exposures at very large banks, and to improve the procedures that banks use to reserve for future loan losses.

The authors finally point out that according to the ECB Annual Report on Supervisory Activities published in March 2015, there are **no quantifiable objectives** for bank supervision in terms of banking aggregates among the supervisory priorities set out for 2015.

Annex 1: Developments in the banking industry according to some key indicators

The following charts are based on financial data for those banks that are under direct supervision of the Single Supervisory Mechanism, aggregated at country level. The source of the underlying data is The Banker Database, insofar as available, and refers to the year-end 2014, respectively year-end 2013. The results should be read with caution as missing data can have a significant distortive effect. There are no results shown at aggregate country level if the data would refer to only one bank.