BRIEFING

Single Supervisory Mechanism: Where do we stand one year later?

Hearing of Mrs Danièle Nouy, Chair of the SSM, 19 October 2015

This briefing includes a state of play of issues dealt with by the Single Supervisory Mechanism, a short summary of two expert papers assessing the progress made by those banks which failed the stress tests published in October 2014, and an analysis of the evolution of SSM banks' financial positions from 2013 to June 2015.

Single Supervisory Mechanism (SSM): some current issues

The Supervisory Review and Evaluation Process (SREP)

In the Supervisory Review and Evaluation Process the supervisor takes a holistic approach to assess banks' individual risks, analysing not only banks' capital and liquidity, but also their internal governance, business strategies and processes. The SREP can result in additional capital requirements. Procedurally, the SSM developed a common SREP methodology, based on the National Competent Authorities' (NCAs) previous experiences and best practices. The European Banking Authority (EBA) furthermore issued **guidelines** on how to perform a SREP in December 2014, and expects competent authorities to apply those from 1 January 2016.

Currently the 2015 SREP decisions are about to be finalized. On 29 September 2015, a member of the SSM Supervisory Board has presented **preliminary results** at a meeting in Dublin, stating that almost all banks will have a surplus of capital over the SREP requirements (excl. systemic buffers).

Supervisory options and national discretions (ONDs)

The **insufficient harmonisation** of national discretions and supervisory options is considered as an impediment by the SSM, which has identified more than 150 national options and discretions in the regulation transposing the Basel III framework on capital rules. For those options which fall under the discretion of national supervisors (about 120), the SSM was able to propose a single implementation for the euro area. For the smaller number of options enshrined in national legislation, further convergence requires the involvement of national Parliaments.

In a speech given on 15 September, the Chair of the SSM pointed out that "*... neither the Directive [CRDIV] nor the Regulation [CRR] discusses the rationale of such provisions or requires Member States to converge; discretion is full and unconstrained within the boundaries specified by the legislation. The strong presence of ONDs in the legal framework clearly* ***undermines the level of prudence, comparability and the level playing*** *field that all of the initiatives and innovations that I mentioned earlier strive to achieve*."

For those reasons the SSM has made the harmonisation of ONDs an issue of priority. "*Levelling the level-playing field*" remains high on the agenda of the SSM.

The prudential treatment of sovereign exposures

Under the current prudential treatment, sovereign exposures are considered not to be risky assets. However, a member of the SSM board pointed out in a speech given on 23 June 2015 that from his point of view sovereign exposures "*have not so far received adequate treatment in bank regulation*". The Basel Committee on Bank Supervision has started working on possible options, in particular applying risk weights to sovereign exposures or imposing risk concentration limits.

Capital shortfalls disclosed by the ECB comprehensive assessment

Conclusions by two external experts

Prior to assuming the new banking supervision tasks, the ECB conducted a comprehensive assessment of the 130 largest euro area banks which consisted of an asset quality review and a stress test. The results of that assessment were published on 26 October 2014, both in form of an aggregate report as well as in form of individual documents for each bank.

The ECB was very clear and open in displaying the problem, claiming that its comprehensive assessment found **capital shortfalls of in total €25 billion** at 25 banks. Banks with shortfalls were asked to swiftly address the problem; they had to prepare capital plans within two weeks of the announcement of the results, and were given up to nine months to cover the capital shortfall.

However, until now **there is no systematic information about the actions that banks have taken to address the problem**. That lack of transparency, which might potentially harm confidence into affected European banks, was already highlighted in two interim reports (by T. Breuer and S. Steffen) that were published prior to a previous public hearing with the Chair of the SSM on 31°March 2015.

In their final reports, the same two authors conclude (analysing publically available information such as financial statements and market data) that banks with capital shortfalls made **at least some progress** during the months after the comprehensive assessment:

In his final report, T. Breuer however points out that (p. 18) "*[t]he total of €5.5 billion is considerably smaller than the €9.47 billion the ECB expected in total capital measures ... The reason is that banks partially executed capital measures other than equity issuance, such as asset sales, CoCo conversions, or regulatory capital requirement reductions*.".

In his final report S. Steffen points out (p. 8): "*...that banks that failed the comprehensive assessment experienced a substantial decline in CDS* [credit default swap] *spreads suggesting that actions taken by banks have made bank debt less risky. A substantial amount of capital raised by failed banks since January 2014 supports this interpretation*."

S. Steffen evaluated the performance of those banks based on market data performance measures, based on a stress test and on an event study around the announcement of seasoned equity offerings, using both share prices and CDS data.

The recapitalisation of Greek banks

Significant and continuous deposit outflows strongly weakened the liquidity position of Greek banks: **from mid-December 2014 to end-June 2015, more than 25% of total deposits were withdrawn**. Since banks (and Greece) had lost access to money markets, they had to rely on **central bank refinancing**. In February 2015, the ECB lifted the waiver granted to Greek government bonds, which then became ineligible for regular refinancing operations. In the meantime, it allowed Greek banks to rely on ELA, and successively increased the ceiling in order to accommodate the rising needs of the Greek banking system. Mrs Nouy repeatedly (in January, April, May) indicated that Greek banks were solvent and strong enough to go through this crisis situation.

The imposition of **capital controls** in Greece since the end of June 2015 is likely to have long-lasting effects on the quality of Greek banks' loan portfolios. A **forward-looking assessment of the four core banks is being carried out by the SSM so that banks raise additional capital by the end of 2015,** in line with the Memorandum of Understanding (MoU) agreed on 19 August 2015.

After the publication of the stress tests (probably by end-October 2015), the Greek banks will have to raise capital from private investors, with the Hellenic financial Stability Fund acting as a backstop. A buffer of up to EUR 25 billion has been envisaged under the programme for that purpose. If banks can not cover the capital needs stemming from the asset quality review and the baseline scenario of the stress test from private sources, they will be put into resolution. At this junction, the likelihood that some or all of them go into such resolution process is hard to project.

The amount of the capital shortfall will depend on the assumptions used in the stress test and on the requirement set by the SSM. Press reports claim that the threshold set for the baseline scenario and the stress scenario (9.5% and 8% respectively according to Reuters) will be stricter than the one used in 2014 (8% and 5.5% respectively).

EGOV analysis of the evolution of SSM banks' financial positions since December 2013

This section briefly describes the main features of banks financial performances since December 2013, (cut-off date of the Comprehensive Assessment carried-out by the ECB). The analysis relies on financial data retrieved from Bankscope© on a total of 87 banks supervised by the SSM, for which financial statements are available in Bankscope© relating to 2013, 2014, and the first half of 2015. Those banks are grouped according to their size:

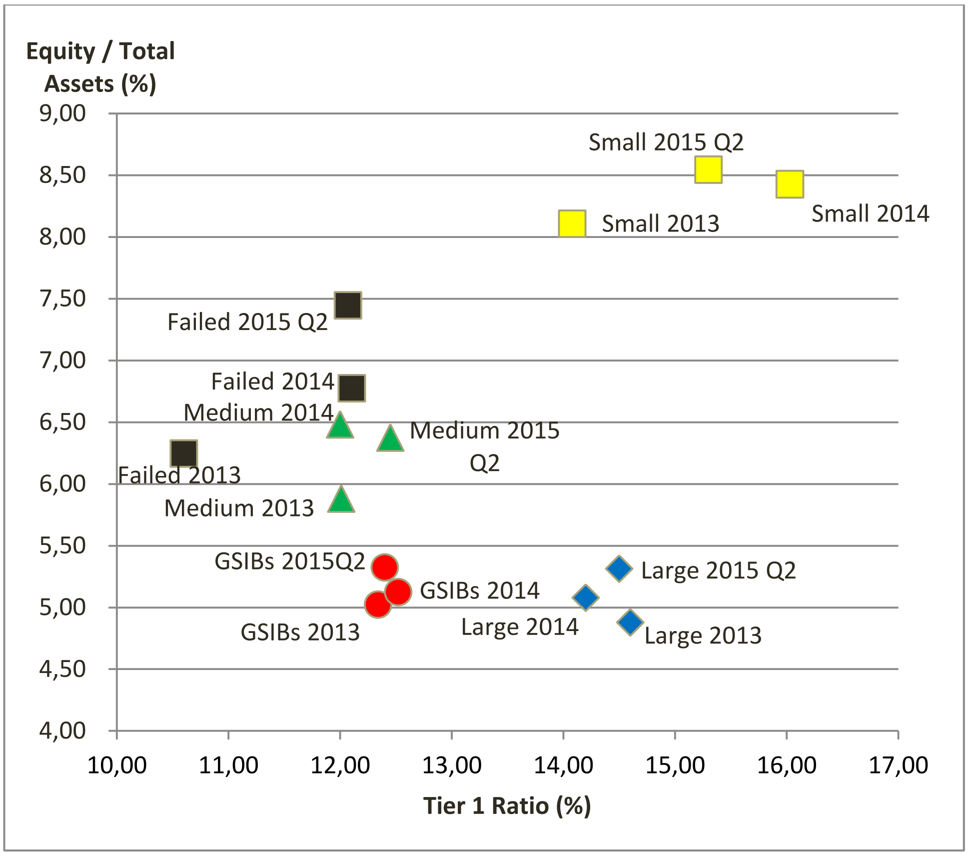
- ● 9 **GSIB banks**, as defined by the FSB (cf. GSIB list)
- ◆ 13 **large banks**, with total assets of more than EUR 200 billion (and not GSIBs);
- ▲ 27 **medium banks**, with assets between EUR 50 billion and EUR 200 billion;
- □ 38 **small banks**, with assets of less than EUR 50 billion.

In addition, a cross-section subgroup of banks was created to focus on those banks that failed the stress test carried-out by the ECB in 2014 (■ "**failed banks**"; data available for 19 out of 25 banks).

The below analysis focuses on 8 financial indicators, and assesses the evolution of the median value of those indicators for each group of banks. For a comprehensive description of the methodology and a definition of each financial indicator, see Annex 1.

Capital Adequacy

Graph 1: Capital adequacy of SSM banks from December 2013 to June 2015



Source: EGOV calculations based on Bankscope© data

Graph 1 shows the evolution of capital adequacy from December 2013 to June 2015, using two indicators, the tier 1 ratio (regulatory capital / risk weighted assets) and a leverage ratio (accounting equity / total assets). The tier 1 ratio takes into account the regulatory treatment of different categories of assets (e.g. sovereign exposures are considered as not risky, while some assets/holdings will be fully deducted from regulatory capital).

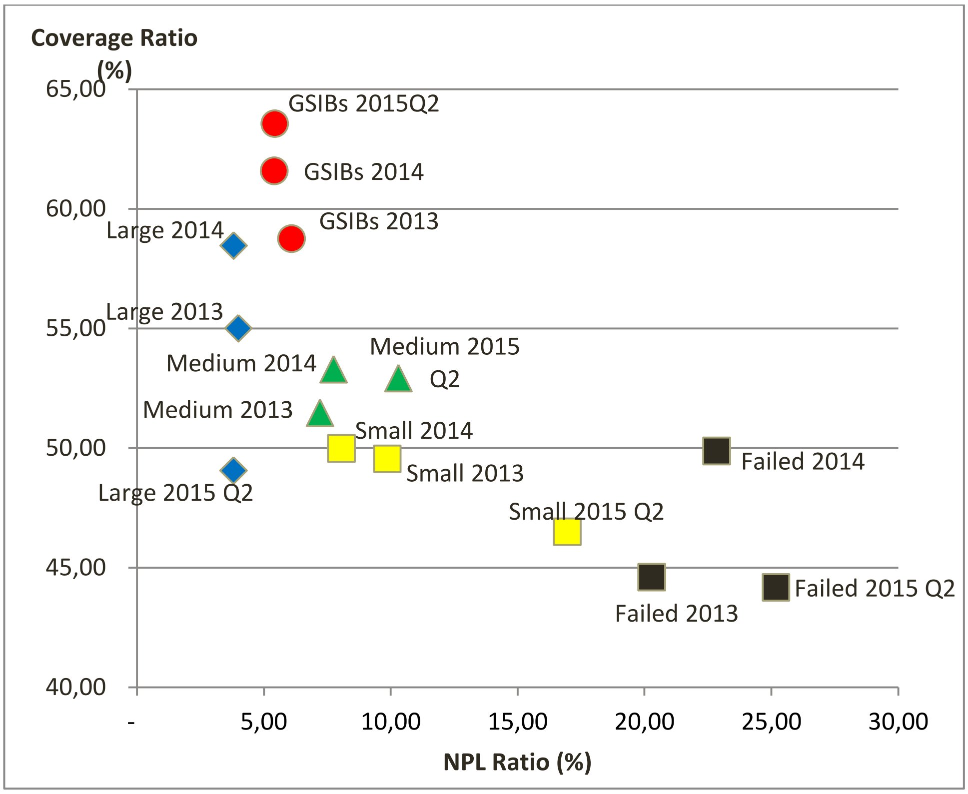
A sharp increase in regulatory capital adequacy can be noticed for the failed banks, with a median tier 1 ratio increasing from 10.6% to 12.07%, at a level close to the one of GSIBs and medium banks. The group of small banks also benefited from a significant improvement in the median tier 1 ratio, but the starting point was much higher (from14.08% to 15.3%).

As to leverage, the position of all groups is better as of June 2015 than back in December 2013. However, the two groups with the lower (median) ratio of equity / total assets, the GSIBs and the large banks, are also the group which reported the smallest increase in that indicator, which remains below 5.5%. Conversely, the group of failed bank reported the most spectacular improvement with an increase by 120 basis points, from 6.25% to 7.45%.

Conclusion 1: The **capital position of all SSM banks has significantly improved** since December 2013, and the progress was even more noticeable for those banks which had failed the stress test.

Asset Quality

Graph 2: Asset quality of SSM banks from December 2013 to June 2015



Source: EGOV calculations based on Bankscope© data

In graph 2, the evolution of non-performing loans (NPLs), as a % of gross loans (NPL ratio), is reported together with the evolution of the coverage ratio (loan loss reserves / non-performing loans), which gives an indication as to how much reserves have been booked by the bank on those non-performing loans.

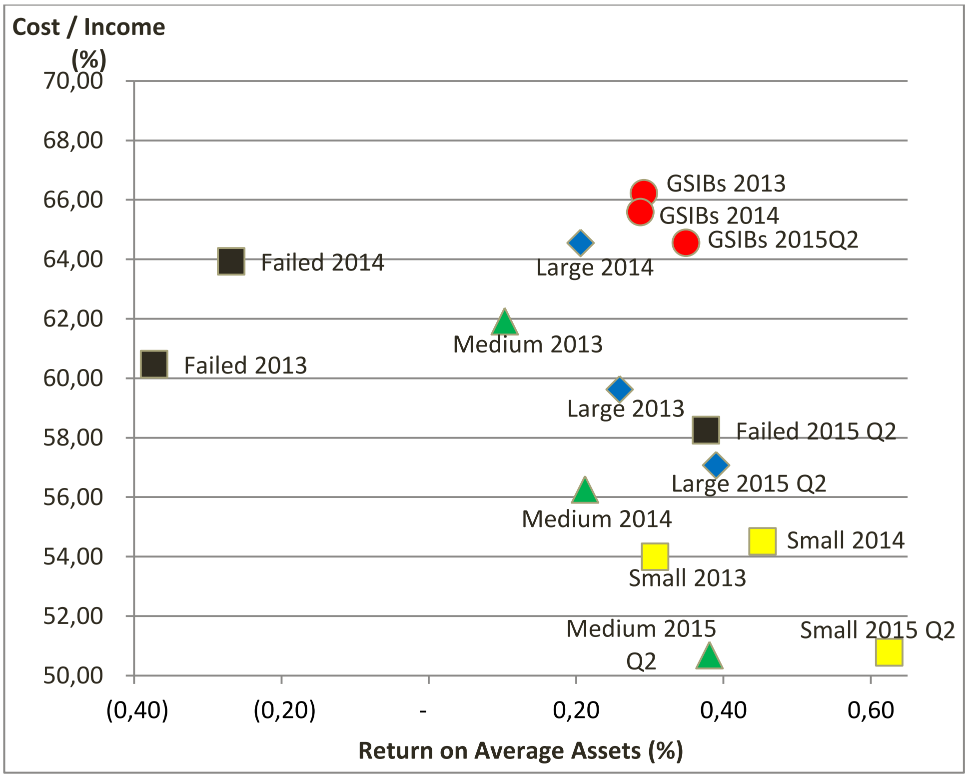
The NPL ratio relies heavily on the overall economic environment, and is therefore to a large extent country-specific, but also reflects the intrinsic quality of the risk management of individual banks. The median NPL ratio has significantly increased for the medium banks (from 7.2% to 10.3%) and dramatically for the small banks (from 9.9% to 17.0%) and the failed banks (from 20.3% to 25.2%). For those groups of banks the NPL ratio extremely high, which reflects the worrying situation of NPLs in Southern Europe.

Regarding the coverage ratio, the situation is not homogenous, with GSIBs progressing well (from 58.8% to 63.6%), while medium and small banks reports lower coverage ratio at the end of June 2015 compared to the situation at the end of December. But at the end of 2014, all groups of banks had reported better coverage ratio, reflecting the impact of the asset quality review carried out by the ECB.

Conclusion 2: While SSM banks have increased their coverage ratio at the end of 2014, in the aftermaths of the comprehensive assessment, they continue to suffer from the difficult economic environment, especially in Southern Europe, which has a detrimental impact on the quality of their loan portfolios. **Asset quality remains an acute challenge for many SSM banks**.

Profitability

Graph 3: Profitability of SSM banks from 2013 to June 2015



Source: EGOV calculations based on Bankscope© data

Graph 3 reports the evolution of the cost / income ratio and of the return on average assets for all groups of banks. The cost / income ratio is an indicator of the operational profitability of the bank (how much income is consumed by operational costs), while the return on average assets typically encompasses other parameters as the cost of risk (loan loss reserves and other impairments).

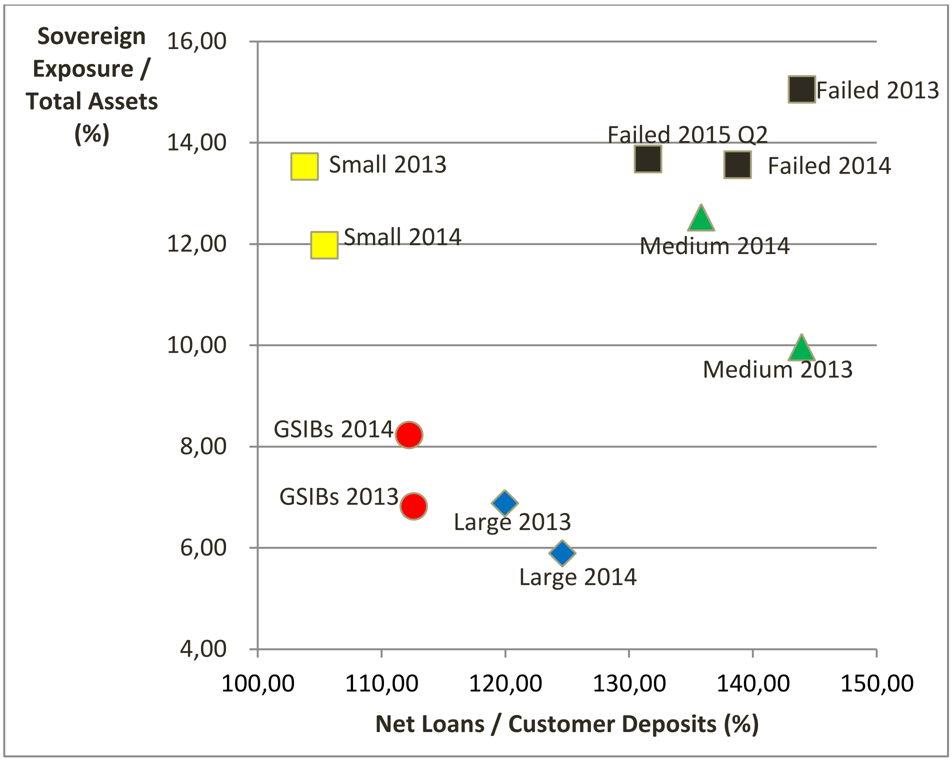
For all groups of banks the median cost / income ratio has decreased since December 2013, which highlights the restructuring efforts made by most banks during that period. Small and medium banks report the best performances in that regard, with cost / income ratios close to 50%, while the median ratio for GSIBs remains above 64%.

An interesting feature in graph 3 is the evolution of the return on average assets for the failed group, since it turned positive in Q2 2015 (at levels comparable to other groups), while it was negative both in 2013 and 2014. The median return on average assets has also improved for all groups of banks, to reach about 0.4% and even 0.6% for small banks.

Conclusion 3: The **operational profitability has improved for all groups of banks** since 2013. In particular, the group of banks which had failed the stress test now reports a return of average assets similar to those of other SSM banks.

Liquidity and sovereign exposure

<u>Graph 4: Liquidity and sovereign exposure of SSM banks from December 2013 to June 2015</u>



Source: EGOV calculations based on Bankscope© data

Graph 4 shows the evolution of the median loans / deposits ratio and of the median sovereign exposure of the 5 groups of banks at the end of 2013 and 2014. A high loans / deposits ratio usually reflects a strong reliance of the bank on external funding, which can become problematic in case of liquidity shortage on the markets. The sovereign exposure is an indicator of the bank-sovereign nexus, albeit the data reported in graph 4 is not limited to the *domestic* sovereign exposure.

For those banks which reported high loans / deposits ratio at the end of 2013, the ratio significantly decreased in 2014, from 144% to 136% for medium banks and from 144% to 139% for the group of failed banks. For that group of banks the median loans / deposits ratio continued to decreased in the first half of 2015 (at 132%) while it stabilized for other groups of banks.

As to the median sovereign exposure, there is no homogenous trend among the 5 groups of banks. It increased strongly for the group of medium banks (from 10% to 12.5% of total assets), which is about twice the median amount of equity / total assets for those banks (6.5%) at the end of 2014. The overall sovereign exposure is high for medium, small and failed banks at the end of 2014, with median values ranging between 12% and 13.6%.

Conclusion 4: The reliance of SSM on external funding has decreased from December 2013 to December 2014. The **sovereign exposure remains particularly high for medium and small banks**, as well as for those banks which had failed the stress test carried out by the ECB.

Annex 1 Methodology and detailed results

Sample:	87 banks supervised by the SSM, and which financial statements were available in the Bankscope© database for December 2013, December 2014 and June 2015, representing more than 95% of the total assets of banks supervised by the SSM (n=87); The sample excludes notably the Greek banks, since their financial statements are not published as of 30 June 2015.
GSIBs:	As per the definition of the FSB (n=9)
Large banks:	Banks with total assets of more than EUR 200 billion as of 31 December 2014, and not GSIBs (n=13).
Medium banks:	Banks with total assets of more than EUR 50 billion as of 31 December 2014 and less than EUR 200 billion (n=27).
Small banks:	Banks with total assets of less than EUR 50 billion as of 31 December 2014 (n=38).
Failed banks:	Banks which failed the ECB stress test (n=19).
Equity / Total assets:	Equity / Total assets as reported by Bankscope©.
Tier 1 ratio:	Tier 1 ratio as reported by Bankscope©.
Coverage ratio:	Loan loss reserves / Impaired loans as reported by Bankscope©.
NPL ratio:	Impaired loans / Gross loans as reported by Bankscope©.
Cost / Income ratio:	Cost / Income ratio as reported by Bankscope©.
Return on average assets:	Return on average assets as reported by Bankscope©.
Loans / Deposits:	Net loans / Customer deposits as reported by Bankscope©.
Government exposure / Total assets:	(Debt securities government + Deferred tax assets) / Total assets as reported by Bankscope©.
Values:	Median values for each group of banks at each accounting date. Missing values are ignored.

Table 1: Financial performance of SSM banks since 31 December 2013 (median values, %)

Bank Name	Period	Tier 1 Ratio	Equity / Total Assets	NPL Ratio	Cove-rage Ratio	Return On Ave-rage Assets	Cost / Income	Net Loans / Customer Deposits	Govern-ment Exposure / Total Assets
GSIBs	2013	12,34	5,02	6,09	58,75	0,29	66,22	112,61	6,82
GSIBs	2014	12,52	5,12	5,41	61,59	0,29	65,59	112,23	8,23
GSIBs	2015Q2	12,40	5,32	5,43	63,56	0,35	64,56	111,77	
Large SSM banks	2013	14,60	4,88	4,00	55,01	0,26	59,62	119,96	6,88
Large SSM banks	2014	14,20	5,08	3,81	58,46	0,21	64,55	124,61	5,89
Large SSM banks	2015Q2	14,50	5,31	3,81	49,06	0,39	57,07	122,90	
Medium SSM banks	2013	12,01	5,88	7,21	51,47	0,10	61,92	143,94	9,97
Medium SSM banks	2014	12,00	6,48	7,75	53,29	0,21	56,26	135,82	12,53
Medium SSM banks	2015Q2	12,45	6,38	10,30	52,92	0,38	50,69	135,64	
Small SSM banks	2013	14,08	8,11	9,87	49,55	0,31	54,00	103,78	13,53
Small SSM banks	2014	16,03	8,43	8,06	49,98	0,45	54,51	105,39	11,98
Small SSM banks	2015Q2	15,30	8,55	16,96	46,50	0,63	50,78	106,29	
Failed banks	2013	10,60	6,25	20,29	44,60	- 0,37	60,47	143,96	15,05
Failed banks	2014	12,11	6,78	22,85	49,88	- 0,27	63,93	138,77	13,57
Failed banks	2015Q2	12,07	7,45	25,18	44,18	0,38	58,26	131,52	

Source: EGOV calculations based on Bankscope