BRIEFING

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

ECON on 13 June 2016

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 European Parliament and the European Central Bank. The following issues are addressed in this briefing: the increase in SSM supervisory fees, a state-of-play regarding National Options and Discretions, the Comprehensive Assessment of four banks in 2016, two external briefing papers requested in advance of the hearing, the recent proposal by the Basel Committee regarding the use of internal models, and the Commission's 2016 Draft Banking Related Country-Specific Recommendations.

Increase in SSM supervisory fees

According to the ECB's decision on 15 April 2016, SSM supervisory fees for 2016 will **significantly increase by 23.9%** as compared to the amount invoiced in 2015. Total costs add up to EUR 404m. In 2016, the number of ECB staff working on banking supervision shall increase by **160 full-time equivalents** (125 permanent positions and 35 non-permanent positions); another increase, albeit smaller, is expected for 2017.

The Annual Report on supervisory activities 2015, presented in the ECON hearing on 22 March 2016, mentions that the ECB's Governing Council has **decided in September 2015** to increase the relevant headcount over the next two years; the recruitment has already started, the first vacancy notices were published in October 2015 in order to fill the new headcount as early as possible.

The **reasoning** for the increase is set out in chapter 1.3.2 (p. 16ff) of the Annual Report:

"*The original headcount for ECB Banking Supervision was estimated in 2013 on the basis of best efforts and assumptions. At that stage, however, the organisation was still in its start-up phase and only limited direct operational experience was available. As the ECB increased its understanding of the banks it supervises with nearly a year of supervisory experience, it became clear that more resources than anticipated were required for a number of key tasks. [...] For example, it was necessary to reinforce the staffing related to the direct supervision of significant banks, most notably for the small and medium-sized significant banks and banking groups to ensure an adequate minimum engagement level in the Supervisory Examination Programme (SEP), also in the light of the banks' risk profiles. Moreover, for all directly supervised banks, irrespective of their size, but taking into account qualitative criteria, resources are required, among other things, for (i) methodology upgrades, (ii) on-site inspections, and (iii) the review of internal models*."

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The ECB's **reporting obligation on the envisaged evolution** of the structure and amount of the annual supervisory fees is set out in Article 20(2) of Regulation (EU) No 1024/2013 and Article 17(1) of Regulation (EU) No 1163/2014.

Background: According to article 30 of the SSM regulation, the ECB is allowed to levy an annual supervisory fee. More details in this respect are set out in the specific Regulation on supervisory fees of 22 October 2014.

The ECB's internal cost calculation is **split into categories** of direct supervision (to be levied on the significant banks directly supervised) and indirect supervision (to be levied on the less significant banks indirectly supervised); the expenditure primarily consists of costs directly related to the ECB's supervisory tasks, i.e. direct supervision of significant entities and oversight of the supervision of less significant entities, and the performance of horizontal tasks, as well as general expenses related, such as premises, human resources management and information technology services.

As regards the cost **allocation to individual banks**, significant banks have in general to pay more fees than less significant bank; the annual supervisory fee for each bank is the sum of a minimum fee component (fixed at 10% of total costs) and a variable fee component (fixed at 90% of total cost). For small significant banks (total assets below EUR 10bn), the minimum fee component is halved. The variable fee component takes into account on equal terms the bank's size and its risk profile (total risk exposure), measured by risk-weighted assets.

National Options and Discretions - state of play

Although one of the objectives of the Capital Requirements Regulation and Directive ('CRD IV package') was to establish a single rule book for banks in the European Union, banking regulation still contains a number of national options and discretions (NODs), over 150 according to the ECB assessment. The existence of such NODs may have material effects on the capital levels across countries and banks and can negatively impact the capacity of the SSM to supervise banks efficiently. The SSM has launched a thorough work on NODs at the end of last year, including extensive public consultation. Such work resulted in the publication on 24 March 2016 of an ECB Regulation on the exercise of options and discretions available in Union law and an ECB guide (See EGOV briefing on NODs in EU banking regulation). The ECB Regulation is a binding text that will enter into force on 1st October 2016. It harmonises the exercise of 35 'horizontal'[1] options contained in the CRD IV package. It concerns in particular the provisions allowing for a smoother transition towards the new definition of own funds. The ECB guide is a non-binding text, which is immediately applicable. It relates to case-by-case NODs. The objective is to provide guidance for Joint Supervisory teams when assessing a request for exemption from a given bank.

[1] Horizontal NODs: NODs that apply to all banks as opposed to case-by-case NODs that apply to individual banks upon request

The ECB guide should be complemented by two addendums:

- **A draft guide on the recognition of institutional protection schemes (IPS),** which was open for public consultation from 19/02/2016 until 15/04/2016.

  An IPS is a contractual or statutory liability arrangement of a group of banks which protects the member institutions and in particular ensures their liquidity and solvency. The recognition of an IPS leads to waiving some prudential requirements for individual banks that are part of the IPS in a way comparable to the way the entities of a consolidated banking group are treated. Such treatment is justifiable only if the requirements set out in the legislation are met, such as the ability of the IPS to support its members in difficulty. The consultation document sets out the approach to be followed by the ECB when assessing whether those requirements have been met. In cooperation and agreement with the National Competent Authorities (NCAs), the assessment criteria included in the consultation document will also be used by NCAs for less significant institutions as IPAs typically consist of both banks directly supervised by the ECB and banks supervised by NCAs. According to the ECB, IPS are currently recognised in three Euro Area Member States: Austria, Germany and Spain. About 50 % of all credit institutions in the Euro Area, representing around 10 % of the total assets of the Euro Area banking system.

- A **draft addendum covering 8 additional case-by-case NODs**, which is open for public consultation from 18/05/2016 until 21/06/2016.

  The options and discretions covered in that addendum refer to capital waivers (Article 7 of the CRR), exclusion of intragroup exposures from the calculation of the leverage ratio (Article 429(7) of the CRR), the use of International Financial Reporting Standards (IFRS) for the valuation of assets and off-balance sheet items (Article 24(2) of the CRR), the calculation of risk-weighted exposure amounts of intragroup exposures (Article 113(6) of the CRR), the materiality of collateral outflows from downgrade triggers (Article 30(2) of Commission Delegated Regulation (EU) 2015/61), the cap on inflows (Article 33(2) of Commission Delegated Regulation (EU) 2015/61)), the combination of the functions of Chairman and CEO (Article 88(1)(e) of CRD IV), and the internal adequacy assessment process for credit institutions permanently affiliated to a central body (Article 108(1) of CRD IV).

In terms of impact, as the addendum consists entirely of case-by-case NODs, the ECB’s view is that an ex-ante quantification of the impact of their implementation is not possible as this will depend on applications from the credit institutions themselves.

With the draft guide on IPS and the addendum to the guide, the ECB considers that the NODs policy package is, for the time being, concluded. Subsequently a consolidated version of the ECB guide on options and discretions, including the addendum and the approach for the recognition of IPS will be published (the two latest consultations do not impact on the ECB Regulation as they only relate to case-by-case exemptions).

Comprehensive assessment of four banks in 2016

In the course of 2016, the ECB will undertake a comprehensive assessment of four banks which are likely to become subject to direct ECB supervision.

In line with the established practice, those banks will undergo an initial comprehensive assessment, including an asset quality review and a stress test. Results are expected to be published in November 2016.

The banks that are currently assessed are:

Abanka d.d. (Slovenia)

Abanka is the third-largest Slovenian bank (behind NLB and NKBM) with total assets of EUR 2.5 bn as of June 2015 and provides corporate and retail banking services to its customers, mainly in Slovenia. In December 2013 the Bank was **recapitalised by the State** which became the only shareholder. The difficulties faced by the bank came from the wide-scale deterioration of the economy in Slovenia, with non-performing loans amounting to 14% of overall bank loans in October 2012. The bank also benefited in 2014 from a transfer of its distressed loans to the public bad bank established in Slovenia (BAMC). On 5 October 2015 Abanka merged with Banka Celje, in line with the restructuring plan approved by the European Commisison. As of June 2015, the bank had 832 employees, 40 branches and reported a capital adequacy ratio of 20%.

Citibank Europe plc (Ireland)

Citibank Europe plc, part of the consumer division of the American multinational investment banking and financial services corporation Citigroup, is headquartered in Dublin where it had a presence since 1965. In 2015, it had branches in the Czech Republic, Hungary, Romania, Slovakia, Bulgaria, and Poland.

According to its Annual report for 2015[2], Citibank Europe plc had in 2015 on average nearly 4.000 employees, its total assets per year end 2015amounted to EUR 24.5bn, and its total capital ratio stood at 32%.

The group informed clients in June 2015 that Citibank Europe plc would take over the business and clients from the UK-based Citibank International Ltd., in order to have a single streamlined and "EU-passported" bank operating with a branch network in 21 countries across Europe. Citibank Europe shall eventually become the **single point of entry** for aligned banking and other products and services **across the EU**. According to an article by Reuters, UK rules which require banks to hold a higher level of cash in reserve than other European countries might also have been a factor behind that move.

The merger, executed on 1 January 2016, involved the transfer of EUR 29.9bn in assets and of EUR 25.4bn in liabilities, recorded at book value. Since the merger, the bank sold its consumer-focused business in the Czech Republic in the first quarter 2016, indicating its business strategy to exit the consumer-focused operations in 11 markets.

Rietumu Banka (Latvia)

Rietumu Banka Group, established in 1992 in Latvia, has become the third largest banking group by assets in 2015, with approximately 1000 employees. Its total assets amount to EUR 3.8bn as at December 2015, due to a strong assets growth (plus 9% compared to 2014) of which loans to customers represent only a comparatively small part (29%). The banking services offered mainly to corporate

[2] The reporting currency of that Annual Report is USD; all figures were recalculated based on the ECB's EUR USD reference rate as at 31/12/2015.

customers and affluent individuals are deposit taking and customer accounts maintenance, lending, issuing guarantees, cash and settlement operations, and operations with securities and foreign exchange. Major non-banking companies held by the group include leasing and consumer finance companies, repossessed real estate and other repossessed collateral maintenance companies.

Given that the banking activities with customers from **Russia, Belarus, and other CIS** countries play a commercially important role, the bank highlights that the recently turbulent geopolitical and economic environment and higher exchange rate volatility, especially the devaluation of the Russian Ruble, has been a significant challenge. For 2015, the annual report of Rietumu Banka Group nevertheless shows a profit of EUR 70 m (after tax), equivalent to a RoE of 17.5% (after tax), and a total capital adequacy ratio of 19.2%.

According to an article published by the Latvian public broadcaster LSM on 18 April 2016, Rietumu Banka currently faces the prospect of being charged by **French prosecutors** over its alleged role in money laundering and tax-avoidance procedures.

Banca Mediolanum S.p.A. (Italy)

Banca Mediolanum S.p.A. is an Italian bank that in 2015 took over its former parent company Mediolanum S.p.A. (an insurance and financial conglomerate) by a reversed merger operation. With a total asset volume amounting to EUR 44 bn as at December 2015, the merged entity **passed the threshold** of EUR 30 bn as of which banks are directly supervised by the SSM (in terms of market capitalization, Banca Mediolanum S.p.A. ranks even higher among Italian banks than in terms of balance sheet size).

The merged entity provides retail banking, asset management services, as well as life and non-life insurance services in Italy, Spain and Germany; as at December 2015, it had approximately 2650 employees, a CET1 ratio of 19.7%, a Loan to Deposit ratio of 52.7%, a NPL ratio of 1.4%, and a Return on Equity ratio of 22.6%.

Its main shareholders are Ennio Doris, the founder of the enterprise, and former Prime Minister Silvio Berlusconi's holding company Fininvest. In October 2014, the **Bank of Italy ordered Fininvest**, the holding owning 30 percent of Mediolanum, **to sell** a stake of just over 20 percent because Berlusconi was no longer considered fit to own more than 10 percent of a financial company after being convicted for tax fraud. According to a press release published by Fininvest, 3 March 2016 **the Italian Council of State repealed** the forced sale requested by the Bank of Italy.

Key features of the EBA 2016 stress test

Summary of two external briefing papers received in advance of the hearing

The members of the Banking Union Expert panels regularly provide briefings and background information for regular hearings in ECON. For this hearing, ECON coordinators chose the following topic:

How relevant are the new elements in the 2016 stress test design?

The two briefing papers received on this subject can be summarised as follows:

Resti finds in his briefing paper that the 2016 EU-wide stress test has mainly four new elements, as it 1) includes "conduct risk" (also known as financial misconduct risk), 2) pays greater attention towards risks originated by foreign exchange ("FX") exposures, including the risk that the bank's debtors may struggle to repay foreign currency-denominated loans following a sharp devaluation in their home currency, 3) no longer uses a "pass/fail" threshold that partitions tested banks into "safe" and "unsafe" ones, and 4) makes use of a smaller sample of tested banks.

Resti points out that first two items cover areas that, at least in principle, were already included in the previous stress test exercises. However, by specifying the methodology how to address them, the 2016 stress test may help **enhance the accuracy and reliability of the results**, stepping up pressure on banks (and local supervisors) on issues that are increasingly sensitive for the European banking industry. Nevertheless, those refinements are unlikely to address the traditional weaknesses of the European stress tests: the lack of a unified supervisory culture, differences across legal and fiscal frameworks, ambiguity about the political will to rescue weak institutions and uncertainty on how "burden sharing" is to be achieved in practice.

According to Resti, the decision to **move away from a binary outcome** (which can provide a false sense of security for "pass banks" or cast stigma on "fail" ones) has a real advantage, as investors who take stress results into account are now forced to make themselves more familiar with the technicalities behind them, gaining a better awareness of the simplifying (and sometimes unrealistic) assumptions that are used to simulate stressed capital levels.

The reduction in the EBA sample is from his point of view on the one hand welcome, as it eases the workload faced by supervisors, but on the other hand Resti warns that it may end up **generating additional opacity**, rather than restoring transparency and market confidence, as the EU-wide stress test is paralleled by similar exercises carried out by competent authorities, sometimes on the basis of different scenarios and methodologies.

Given that several tens of banks are no longer part of the publicly-disclosed sample, investors may wonder whether supervisors have reservations about their financial shape; the fact that, for example, in 2016 none of the Portuguese banks is part of the sample anymore could trigger concerns about their current resilience levels.

Resti therefore recommends that in order to offset the **informational damage** caused by the reduction in the 2016 stress test sample, EBA should consider to deploy a new "transparency exercise" to provide detailed historical data for institutions not participating in the stress test, which would also improve comparability with past exercises.

Huizinga focusses in his briefing paper in particular on the appropriateness of the exchange rate (FX) risk assessment and related hedges, as well as on loss projections related to conduct risk. As regards FX lending, Huizinga points out that this new element in the stress test is in principle useful, given that it may have only a weak correlation with overall macroeconomic risk, and that its independent impact on bank solvency cannot otherwise be inferred from stress test results.

Huizinga criticises, however, that the adverse macroeconomic scenario is limited to a **one sided** test only, looking only at the effects of a depreciation of the euro vis-à-vis other major currencies such as the US dollar. That is somewhat arbitrary given the unpredictability of the euro exchange rate. Alternatively, it would have made sense to require banks to perform a **two-sided exchange** rate risk test by considering scenarios of both euro depreciation and appreciation against other major currencies.

Huizinga furthermore criticises that banks are not required to report the independent, marginal impact of exchange rate movements on the revaluation of **both assets and offsetting hedges**. The partial consideration, looking only at the exchange rate risk for FX lending but not for asset revaluation, will not deliver sufficient information to infer the overall marginal exchange rate risk for bank solvency.

Huizinga concludes in more general terms that the innovations in the 2016 stress test only go **halfway** in providing the information necessary to assess the impact of exchange rate movements on overall bank stability.

Analysing data provided by the Bank for International Settlements (BIS) on the currency composition of banks' claims and liabilities on an aggregate level (not capturing off-balance-sheet items), Huizinga finds that liabilities by themselves provide an incomplete hedge of the exchange rate risk associated with foreign currency bank claims in the Eurozone, given that on average, more assets than liabilities are denominated in foreign currencies (the net position is nevertheless small).

As regards the **conduct risk** assessment, Huizinga picks up on the fact that banks are required to use either a more sophisticated **qualitative approach** or a simpler quantitative approach to project future losses from misconduct, depending on the severity of past misconduct losses; specifically, banks that lost more than 10 basis points of CET1 capital due to misconduct fines during the 2011-2015 period are required to apply the qualitative approach.

In order to put that 10 basis point **threshold** into perspective, Huizinga analyses the impact of fines and settlements related to the LIBOR manipulation for some of the major EU banks involved, and finds that the impact relative to CET1 capital was in all cases well beyond the threshold level, ranging from an impact equivalent to 64 basis points for Barclays to a staggering impact of 495 basis points for Deutsche Bank.

Huizinga concludes that by asking banks to essentially recalculate their provisions for historical risk events, the 2016 stress test appears to recognize that **existing provisions** may be inadequate, if banks have unduly applied too much discretion in determining their provisions for known misconduct events, and that at least supervisors can gain some additional insight into the situation.

Bank regulation: Basel Committee proposes to constrain the use of internal models

The **credibility of banks' internal rating models** has come increasingly under fire since the financial crisis: The average risk weights of large European banks have decreased over time, while the riskiness of underlying business transactions has arguably risen. This has been seen as a sign that risk weights - and the internal rating models used to generate them - have been "tweaked" to improve risk-weighted capital ratios without raising new capital.

As a result, the **Basel Committee on Banking Supervision**, whose members include the ECB, the U.S. Federal Reserve and representatives from 26 other national competent authorities, launched a consultation on 24 March 2016 aiming to set up a system of "floors" whereby the risk weights generated by internal ratings could not fall below certain "benchmarks" derived from the "standardised approach to credit risk" according to the Basel II and III framework. The Basel Committee asked for comments on the **consultative document** "Reducing variation in credit risk-weighted assets – constraints on the use of internal model approaches" until 24 June 2016.

That **reform proposal** is seen to have a **potentially significant impact** on the capital requirements of a number of banks that are directly supervised by the SSM, in particular those hat make intensive use of internal rating models.

On 6 June 2016, the Institute of International Finance (IIF), which has some 500 members from the banking, finance, and insurance industry, sent in response to that consultation a 83-page letter in which it claims to support the goal to reduce RWA variance but then essentially argues that the prosed approach is too blunt, and therefore asks for a number of changes and more risk-sensitive standards for lending.

Results of empirical research[2], however, question whether a refinement of complex internal models can lead to a sufficiently strong correlation between the underlying risk and capital requirements, which in turn may speak in favour of "blunt standardisation".

Banking related Country-Specific Recommendations

The Commission's draft 2016 "banking CSRs" primarily address the **high level of non-performing loans** in **BG, IE, HR, IT, PT, and SI,** while cyclical **vulnerabilities in the real estate sector** were raised as an issue for **SE** and **NL.**

Five countries have disappeared from the list of addressees of banking CSRs in 2016: ES and UK (where progress was assessed as 'substantial' by the Commission in 2015) as well as AT, MT and HU where the Commission assessed that 'some progress' was made in 2015 (See EGOV Briefing 'Thematic analyses: country-specific recommendations on banking issues').

[2] Compare, for example, the findings of F. Vallascas and J. Hagendorff (2013): "The risk sensitivity of capital requirements: evidence from an international sample of large banks", Review of Finance 17 (6), pp. 1947-1988