European Parliament

BRIEFING

Banking Union Working Group: selected issues (June 2016)

Topics:

- Badwill
- Supervisory Review and Evaluation Process - disclosure
- Publication of stress test results
- Static balance sheet assumption
- High-priority list of Less Significant Institutions
- “Fit and proper” assessment
- Non-performing loans

Badwill

The financial accounting term “Badwill” means that the price paid for assets [or for shares in a company] is **below their fair market value**.

Recording Badwill hence means that the acquirer books the difference between the price paid and the assumed fair market value as an **extraordinary gain/profit** to the income statement.

Badwill - also referred to as “negative goodwill” or a "bargain purchase” - should only occur in exceptional situations[1], for example in a situation of a **forced sale**, if banks are obliged to divest and restructure.

The controversial issue about Badwill is the question whether the purchased assets/shares were actually a genuine bargain, or whether some relevant factors (e.g. contingent liabilities, future payment defaults or other losses), have not been fully recognized/priced-in by the acquirer, resulting in an **overvaluation**.

Before concluding that Badwill has arisen, accounting rules therefore require a thorough reassessment of the acquired assets’ value.

Supervisory Review and Evaluation Process - disclosure

According to CRD IV - Article 97, the Supervisory Review and Evaluation Process (SREP) shall enable competent authorities to evaluate, based on a holistic review:

(a) individual risks to which banks are or might be exposed,

(b) risks that banks pose to the financial system, and

(c) risks revealed by stress testing.

[1] See, for example, S. Boennen, M. Glaum (2014): “Goodwill Accounting: A Review of the Literature”; published working paper, University of Giessen

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In 2015, the SREP was, for the first time, conducted according to a unified methodology throughout the euro area.

The ECB publishes details only on the methodology of the SREP, but **not on individual results.**

National practices about the disclosure of SREP results, however, seem to diverge: For Spanish banks, for example, there is detailed public information available as regards individual banks' pillar 1, pillar 2 (i.e. SREP), countercyclical or systemic risk buffer requirements. According to Reuters, Italian banks were at least instructed to immediately inform the market if - following the SREP - one of their capital ratios is below the level required by the ECB. However, in many countries there is no obligation to disclose SREP results respectively pillar 2 requirements.

Publication of stress test results

EBA will publish the outcomes of the 2016 EU-wide stress test, including **banks' individual results**, at the beginning of Q3 2016.

The **ECB conducts its own stress test** in parallel for significant institutions that are not in the EBA sample. There is **no information about a publication of results** on the ECB's website.

Background: The EBA sample is considerably smaller than in previous years, covering only 53 instead of 123 banking groups as in 2014; 39 out of the 53 banks tested fall under the jurisdiction of the SSM. In the 2016 exercise, there is no "pass/fail" threshold as in previous years.

EBA's timing shall allow to incorporate the results of the stress test into the cycle of the annual supervisory review and evaluation process (SREP).

The ECB uses a methodology said to be consistent with the EBA approach, giving due consideration to the lower size and complexity of the institutions covered.

Static balance sheet assumption

In the context of a stress test, the static balance sheet assumption means that management actions that are theoretically able to improve the situation of a bank (e.g. by down-sizing, divestments etc.) are not taken into account, to improve the comparability of results.

According to **EBA's 2016 stress test methodology**, there are **no exemptions** from the static balance sheet assumption. In particular, that also applies to those institutions that are subject to mandatory restructuring plans formally agreed with the European Commission.

The **ECB/SSM has not published** the methodology that is used in its parallel stress test exercise, and it has not published whether it uses - as an exemption - a "dynamic balance sheet" for banks under mandatory restructuring.

High-priority list of Less Significant Institutions

The ECB supervises Less Significant Institutions (LSIs) indirectly in the sense of an **oversight function**. The intensity of indirect supervision by the ECB is dictated by the priority of an institution, determined based on its size, risk profile and its impact on the domestic financial system. The ECB assigns one of three priority ranks (high, medium, or low priority) to the LSIs whose ranking affects the intensity with which the ECB exercises indirect supervision. The priority determines, for instance, the extent and **frequency of NCAs' reporting requirements** or the ECB's requests for additional information. The ECB cannot, however, issue individual instructions relating to a specific LSI.

The prioritisation process is conducted annually. In 2015, prioritisation was based on relatively rough criteria, resulting in a "high-priority list" with 108 banks. In 2016, the ECB has, in cooperation with the NCAs, developed a refined prioritisation methodology, which led to a shorter "high priority list" with 93 banks.

“Fit and proper” assessment

The “fit and proper” assessment has a gatekeeping function: A bank’s board members shall be capable of taking decisions that safeguard the safety and soundness of their own bank, and possibly that of the wider banking sector.

In the first full year of ECB Banking Supervision, the Supervisory Board took more than 2,500 such decisions. Fit and proper decisions for the less significant banks are taken by national supervisors, except in the case of a new bank license.

Since the fit and proper requirements stem from CRD IV, the ECB has to **apply the national law** that differs widely across countries.

Ms Nouy mentions the issue in her introductory statement to ECON on 13 June 2016: “*Both fit and proper assessment criteria and current processes are in **urgent need of further harmonisation**. In the current set-up one could have a situation where the same person is assessed for similar positions in different member states with a different outcome due to the applicable criteria*.”

Non-performing loans

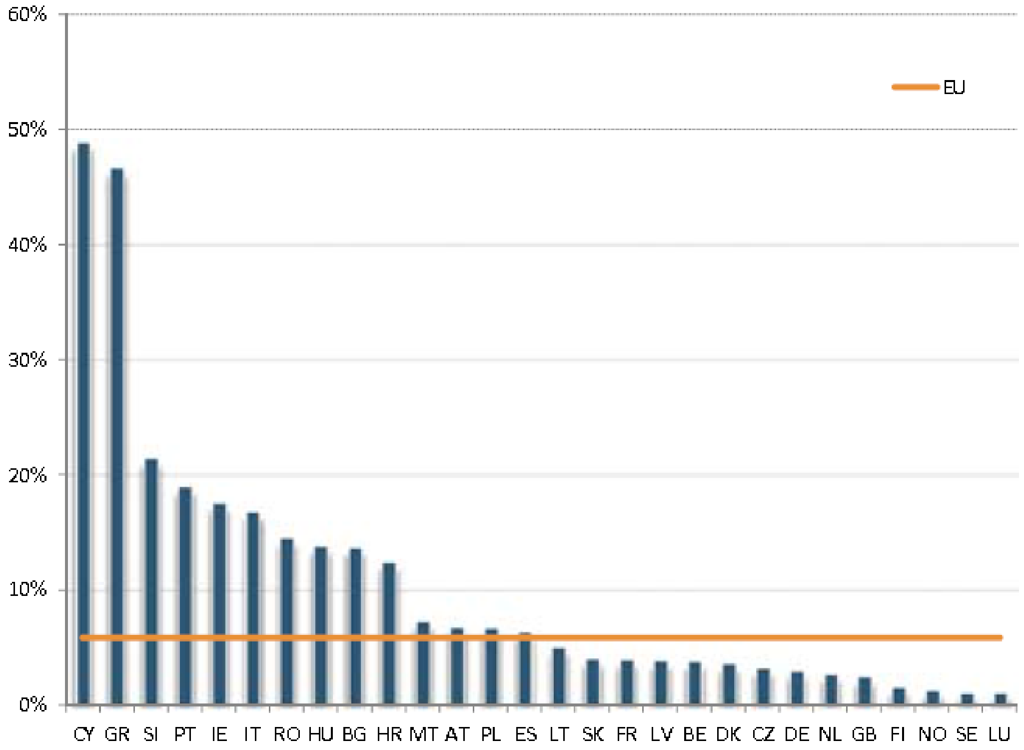
According to the SSM priorities published for 2016, the elevated levels of non-performing loans (NPLs) deserve increased supervisory attention. The deterioration in the credit quality of loans to corporates and/or households as well as in credit standards is a source of concern in a number of SSM countries, particularly those hit hard by the crisis. The ECB has set up a task force on NPLs that is reviewing the situation and that shall propose follow-up actions.

In the annex, please find information on the country dispersion of NPLs and on the dispersion of NPLs by the size class of banks, based on EBA data as of December 2015.

As regards the ECB’s 2016 Comprehensive Assessment, details on the 2016 stress test, and the status quo of Options and National discretions (ONDs), please also see the EGOV briefing for the SSM hearing in ECON on Monday, 13 June.

Annex

Country dispersion of non-performing loans (source: EBA Risk Dashboard Q4 2015, p. 12)



Non-performing loans by size class (source: EBA Risk Dashboard Q4 2015, p. 12)