BRIEFING

Regular public hearing with Danièle Nouy, Chair of the Single Supervisory Mechanism

ECON on 9 November 2016

This note was prepared in advance of a regular public hearing referred to in Regulation 1024/2013 and in line with the Interinstitutional Agreement between the European Parliament and the European Central Bank. The following issues are addressed: Results of the EBA 2016 EU-wide stress test and their relevance for banks' capital requirements, including some methodological issues and conduct risk; ongoing revisions of the Basel III framework; abstracts of three external briefing papers; the ECB guidance on non-performing loans; and EBA's latest Risk Dashboard.

Results of the EBA 2016 EU-wide stress test

On 29 July 2016, the European Banking Authority (EBA) published the results of its latest EU-wide stress test exercise both at aggregate and individual level for the 51 participating banks from 15 EU and EEA countries.

As the EU banking sector had significantly bolstered its capital base in recent years, the starting point of most banks was this year considerably better than in previous exercises.

The hypothetical losses stemming from EBA's crisis scenario - mainly driven by credit losses - would approximately offset the capital increases achieved since 2011, reducing the average Common Equity Tier 1 (CET1) capital ratio[1] of 12.6 % at the end 2015 to 9.2% at the end of 2018, which is still well above regulatory minimum capital requirements.

This time, there was no formal threshold setting out how much capital banks would need to be left with in the crisis scenario ("adverse scenario"), hence none of the participating banks officially passed or failed this stress test exercise. Interested parties can, however, still make their own assessment, as the granular information published by EBA for each bank includes, among other relevant information, its capital position, risk exposures, and sovereign holdings.

Overall, the results were said to have demonstrated the resilience of the EU banking sector to an adverse scenario, yet they show a large dispersion across jurisdictions and banks.

As can be seen in chart 1, which shows the drop (the "delta") in the level of CET1 capital from the starting point (year end 2015) over an assumed time period of three years, the results differ at country level (the differences are even larger at bank level): If the hypothetical stress scenario materialised, Irish banks would on average be faced with the lowest level of capitalisation (average CET1 ratio of 5.2%), while Swedish banks would on average still be comfortably capitalised (CET1 ratio of 16.6%).

[1] In this briefing, the cited CET1 ratios are all "fully-loaded", meaning that they take into account the application of all new capital requirement rules, if not explicitly stated otherwise.

Authors: M. Magnus, A. Margerit and B. Mesnard

Chart 1: Stress test effect on banks' fully loaded CET1 ratios, at country level

Countries	Starting point Dec-15	Adv. scenario Dec-18	Delta 2018/2015 (in bps)
Total	**12,57%**	**9,22%**	**-335**
Austria	11,40%	7,22%	-418
Belgium	14,80%	11,32%	-348
Denmark	16,42%	13,97%	-245
Finland	19,16%	14,61%	-455
France	12,50%	9,57%	-292
Germany	13,30%	9,44%	-387
Hungary	12,94%	9,22%	-372
Ireland	12,24%	5,21%	-703
Italy	11,41%	7,62%	-380
Netherlands	13,18%	8,96%	-422
Norway	14,31%	14,30%	-1
Poland	13,42%	11,44%	-198
Spain	10,45%	8,13%	-232
Sweden	18,97%	16,61%	-236
United Kingdom	12,49%	8,51%	-398

Source: EBA 2016 EU-wide stress test results

EGOV has already published a specific detailed briefing on the EBA 2016 EU-wide stress test results.

Stress test relevance for capital requirements

Every bank has to comply with the legal requirements that lay out the minimum amount of capital it has to hold, often referred to as "Pillar 1".

In order to align the capitalisation of a bank with its individual risk profile, supervisors regularly carry out a so-called Supervisory Review and Evaluation Process (SREP) which has four key elements: a business model analysis, an assessment of internal controls, an assessment of potential losses and risks to a bank's funding situation. The SREP may lead to additional capital requirements, "Pillar 2 buffers", as well as other measures deemed necessary to address identified issues (such as, for example, the corporate governance structure or management processes).

The results of a stress test also test feed into the SREP, though not being a key element. Supervisors discuss the quantitative impact with the participating banks, and as a result may decide to ask for a level of capitalisation that goes beyond the "Pillar 1" and "Pillar 2 buffers". That element is called "capital guidance".

From a bank's point of view, the main difference between "Pillar 1" and "Pillar 2 buffers" on the one hand and "capital guidance" on the other hand is that the capital guidance element does not lead to binding restrictions about how much the bank may pay out in form of bonuses, dividends, or discretionary coupons (such restriction is otherwise known as Maximum Distributable Amount - MDA).

EGOV has already published a specific detailed briefing on the relevance of the MDA.

EBA stress test 2016: Methodological issues raised in the public domain

Some methodological issues regarding the EBA stress test (roles and responsibilities, the treatment of non-recurring expenses and that of specific divestments) were raised in the public domain[2].

As regards roles and responsibilities, the EU-wide stress test involved a close cooperation in particular between EBA, national competent supervisory authorities and the European Central Bank, respectively that of its supervisory arm, the SSM. Those institutions had nevertheless different roles:

EBA was responsible for

- developing the Common Methodology
- coordination of the exercise
- final dissemination of the results

Competent authorities, including the SSM, were responsible for

- conveying the instructions on how to complete the exercise
- ensuring the correct application of the Common Methodology
- all required follow-up measures

As regards the treatment of non-recurring expenses (so-called "one-off adjustments"), banks had to make estimates about the future development of their income and expenses in line with the Common Methodology developed by EBA. A specific assumption was that "Administrative and other operating expenses" were assumed to not fall below the value observed in 2015.

Under certain strict conditions, however, banks were allowed to adjust that level of expenses, namely if they provided uncontroversial evidence that some parts of the expenses seen in 2015 would not recur. Overall, 21 banks adjusted their cost projections based on approved one-off events. EBA's aggregate report sets out that those adjustments reduced the applicable cost basis by EUR 16 billion in the adverse stress test scenario.

The other question discussed in the public domain is whether the general principle set out in the Common Methodology that planned divestments not completed before 31 December 2015 should not be taken into account in the projections, even if they were agreed upon before that date, was respected in all cases.

EGOV has already published a specific detailed briefing on those methodological issues.

The element of "conduct risk" in the EBA stress test

This year, EBA added the assessment of "conduct risk", which by others is called "misconduct risk"[3], as a compulsory element to the design of the EU-wide stress test.

EBA describes conduct risk as "*the current or prospective risk of losses to an institution arising from an inappropriate supply of financial services, including cases of wilful or negligent misconduct*"[4].

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[2] See, for example, the article by Laura Noonan, Caroline Binham and James Shotter published on 10 October 2016 in the Financial Times, and references by Reuters and in The Irish Times and New York Post.
[3] The term "misconduct risk" is actually used in the nomenclature of the European Systemic Risk Board
[4] See EBA the 2016 EU-Wide Stress Test – Methodological Note, point 338, p. 89

In concrete terms, the "inappropriate supply of financial services" actually means, for example, activities such as the sales of toxic securities and mortgage abuses, the manipulation of foreign exchange markets, the manipulation of interest rate benchmarks, tax evasion assistance, abusive credit card procedures, or inadequate money-laundering controls.

The importance of conduct risk was already highlighted in a study published by the European Systemic Risk Board (ESRB) in July 2015: "[*T]he number and scale of misconduct cases recently observed, as well as the related penalties and redress costs, means that misconduct issues may have the potential to create systemic risks*"[5]. Conduct risk related penalties can have a significant impact on a bank's overall financial results.

Many banks have been fined during the last years in the United States and Europe for illegal practices[6]. However, banks are under no obligation to disclose those costs, and the banks' annual reports are not very telling in this respect either as fines are typically aggregated with other legal costs. Given the lack of sufficiently granular, publicly accessible information, estimates about the total impact of those fines are typically surrounded by some degree of uncertainty[7].

However, while supervisors have included conduct risk in the context of the EBA stress test exercise, the information disclosed is highly aggregated. The EBA report discloses that the aggregate cumulative conduct risk losses for the 51 participating banks add up EUR 71 billion over the three year period (which translates into a reduction of the average transitional CET1 capital ratio by 80 bps), and that 15 banks estimated an impact of conduct risk above EUR 1 billion. The EBA report hence only indicates that at the individual bank level some bad news about fines are still to come but not which bank is actually exposed. To our knowledge, there is only one bank that has commented in a publically available statement[8] about the impact of the conduct risk element on its stress test results, all other press statements that we have reviewed remain silent about that subject.

Bank regulation: Ongoing revisions of the Basel III framework

The Basel Committee on Banking Supervision (BCBS) initiated in 2012 a comprehensive review of the risk-weighted capital framework, aiming at finalizing the so-called Basel III reform package and ensuring its consistent implementation, "*which will help strengthen the resilience of the global banking system, maintain market confidence in regulatory ratios and provide a level playing field for banks operating internationally*".

That reform package entails inter alia a review of the banking book which aims to ensure maximum consistency in risk-weight calculations across banks and jurisdictions, and ensure standardised approaches are sophisticated enough to be used as credible backstops when internal models are not fit for purpose. In addition, the treatment of securitization was deemed insufficient particularly as regards the calibration of risk-weights and the lack of incentives for proper risk management.

What are the proposals?

First, the BCBS has again assessed whether the interest rate risk of the banking book should carry a

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[5] See "Report on misconduct risk in the banking sector - June 2015", published by the European Systemic Risk Board, p. 4

[6] The business press lately provided ample anecdotal evidence of individual cases.

[7] Compare, for example, the data provided in the ESRB report and in the "Conduct Cost Project report 2015" issued by the CCP research foundation with that in the Financial Times database,

[8] Compare "Stress test: a message to employees from John Cryan" issued by Deutsche Bank on 29 July 2016

Pillar 1 requirement (minimum level to be complied with by all institutions) or a Pillar 2 requirement (bank specific add-on). The new standards update the principles governing the management of interest rate risk in the banking book, with more extensive guidance, stricter supervision, and enhanced disclosure requirements, but falls short of imposing pillar 1 requirements on interest rate risk.

On securitisation, the BCBS has reviewed and simplified the overall framework, with a new hierarchy of approaches, a lower reliance on external ratings, and a significant increase in requirements. In addition, the framework was amended to factor-in the Simple, Transparent and Comparable (STC) securitisation criteria as defined by the BCBS and the International Organization of Securities Commissions (IOSCO), leading to a reduction in the risk weight floor for senior exposures from 15% to 10%.

The review of the standardised approach has focussed on improving the risk-sensitiveness of the measurement while avoiding excessive reliance on external ratings. To start with, some categories of exposures have been excluded from the scope of internal rating based (IRB) modelling, in order to avoid too much variability (banks, large corporates, specialized lending, and equity). The use of external ratings would also be subject to the bank carrying out due diligence on the counterparty. The revised standardised approach introduces new risk drivers for unrated exposures as well as residential mortgages and commercial real estate. One consequence would be to increase capital requirements on mortgages with loan-to-value (LTV) ratios of more than 0.8 or when the repayment relies on cash flows generated by the property, while decreasing requirements for those with LTV ratio below 0.4.

For the internal models, floors would be introduced on key parameters such as the probability of default (PD), the exposure at default (EAD), and the loss given default (LGD). The modelling of PD would be stable over time to reduce cyclicality, while a number of amendments to the modelling of all parameters aim at improving the comparability between banks.

The overall issue of interactions between input floors, output floors and the leverage ratio (which also acts as a floor for capital requirements) has yet to be assessed by the BCBS, which plans to address it when finalizing its global review of the Basel III framework.

Other main elements in BCBS' comprehensive review and the Basel III reform package are the review of the trading book and the revised standardized measurement approach for operational risk.

EGOV has already published a specific detailed briefing on the ongoing revisions of the Basel III framework.

Abstracts taken from three external briefing papers received in advance of the hearing on "Banks' internal rating models - time for a change? The system of floors as proposed by the Basel Committee"

Briefing paper by Harry Huizinga: "*This briefing paper reviews evidence showing that the adoption of an International Ratings Based (IRB) approach to estimating risk weights by banks has been associated with reductions in average reported risk weights. Several economic studies find that the lower reported risk weights using the IRB methodology to some extent reflect downward risk manipulation by banks. In a system of floors, the purpose of an aggregate output floor should be to prevent wholesale bank-level downward risk weight manipulation, giving rise to effective bank undercapitalization and a heightened probability of bank failure. Input floors can play a* *useful role alongside an aggregate output floor, if they are targeted to address the problem of potential mismeasurement of risk*."

Briefing paper by Andrea Resti: "*In this note, we discuss the proposal for a reform of internal rating models outlined by the Basel Committee. We first present internal rating models (which currently generate roughly 50% of supervisory capital in the European Union) and the reasons why they have been increasingly criticised. We then review the key proposals circulated by the Basel Committee: the removal of internal models for "low-default portfolios" (where defaults are too infrequent to allow adequate calibration); additional constraints on internal models' estimates ("input floors"); an "output floor" tying the capital requirements generated by internal ratings to those that would emerge from the standardised approach. We than explain why, in our opinion, floors represent a technically flawed answer, and suggest a number of supervisory actions that may be pursued, instead, to restore internal models' credibility, without causing an excessive burden for banking authorities. Such actions, which have already been explored by the EU in the last few years, should be embraced wholeheartedly by supervisors, to ensure that increased transparency on implementation and validation practices may restore market confidence in internal models*."

Briefing paper by Rainer Haselmann and Mark Wahrenburg: "*We provide an assessment of the BCBS proposal on restricting the IRB approach and introducing RWA floors. If well enforced, risk-sensitive capital regulation results in a more efficient credit allocation compared to the SA. Thus, IRB should be maintained. Further, the use of IRB output floors potentially results in unintended negative side effects. Input floors are likely a valuable tool to achieve RWA comparability. Finally, the proposed measures have a potential detrimental impact for European banks as compared to others*."

ECB public consultation on guidance on non-performing loans

On 12 September 2016, the ECB launched a public consultation on guidance to banks on how they should tackle non-performing loans (NPLs). The consultation period runs until 15 November. A public hearing is organized on 7 November 2016. The ECB, together with eight national supervisory authorities, also conducted a stocktaking of national supervisory practices and legal frameworks concerning NPLs which was published on the same day.

The NPL draft guidance provides recommendations to banks for the handling of NPLs and deals with all aspects (i.e. strategy, governance and operations). It notably recommends to banks with a high level of NPLs that they ultimately reduce their NPL stock in a 'credible, feasible and timely manner'. The bank's strategy should include the setting of quantitative targets by portfolio and a detailed implementation plan. The guidance urges banks to put in place appropriate governance and operations structures to be able to work out NPLs effectively, including involving the bank's management or setting up dedicated NPL workout units. The document also aim at guiding banks when valuing immovable property held as collateral for NPLs. The guidance is also meant as a reference document for supervisors when evaluating banks' handling of NPLs. The ECB acknowledges that 'it will take some time until NPLs have been reduced to reasonable levels'.

EBA updated Risk Dashboard

On 30 September 2016, the EBA published the periodic update of its Risk Dashboard. That report summarises the main risks and vulnerabilities in the banking sector by the evolution of a set of Risk Indicators (RI) across the EU in Q2 2016. The update shows an increase in EU banks' capital ratios, while the low profitability and the high level of NPLs remain a concern.

Regarding capital ratios, The CET1[9] ratio continues its positive trend, with an increase by 10 bps[10] in the second quarter of 2016, from 13.4% to 13.5%, on the back of better retained earnings and lower market risks. Both the CET1 and the CET1 "fully loaded" show a noticeable increase compared to June 2015 (+70 bps and +90 bps respectively).

The overall asset quality is also improving, albeit some countries continue to report very high levels of NPLs. The weighted average NPL ratio stands at 5.5%, decreasing by 10 bps over the second quarter of 2016, and by 50 bps since June 2015. However, Greece (46.9%, +30 bps quarter-on-quarter), Cyprus (47.4%, -110 bps), Portugal (19.7%, +50 bps), Slovenia (19.2%, -50bps) and Italy (16.4%, -20bps) continue to report NPL ratio above 15%. Five other countries (Ireland, Hungary, Bulgaria, Romania and Croatia) report NPL ratio between 10% and 15%. The situation is still deteriorating in Greece and Portugal. Regarding coverage ratios, the overall trend is positive (+10 bps quarter-on-quarter, +30 bps year-on-year).

The quarterly overall profitability is stable at 5.7% (return on equity - RoE), again with significant differences among Member States. Two countries report negative RoE (Greece and Portugal, at -16.2% and -4.5% respectively). The four other countries featuring a RoE below the EU average are Italy (2.3%), Germany (2.7%), the United Kingdom (5.0%) and Cyprus (5.2%). The cost-to-income ratio has on average recently decreased to 62.7%, following a peak observed in March 2016 (66.0%). Four countries, however, including the three largest euro area economies (Germany, France, Italy), report cost-to-income ratios above 65%.

Finally, the loan-to-deposit ratio has also improved over the last quarter to 120.5% (-110 bps), confirming a longer-term trend (-420 bps since June 2015).

ECB new guidance on options and discretions

On 3 November, the ECB published a consolidated version of its Guide on Options and Discretions available in Union law. The updated Guide combines the ECB approach for the recognition of institutional protection schemes and the addendum to the Guide, both published earlier this year.

On the same day, the ECB launched its public consultation on the exercise of options and discretions by NCAs in relation to less significant institutions, giving interested parties the opportunity to comment on the draft guideline. The deadline for submitting comments is 5 January 2017.

EGOV has already published a specific detailed briefing on National Options and Discretions (NODs) in EU banking regulation.

[9] Core Equity Tier one ratio
[10] basis points