Presentation of the SSM 2016 Annual Report by Danièle Nouy, Chair of the Single Supervisory Mechanism (SSM)

ECON on 23 March 2017

This note is prepared in view of a regular public hearing as referred to in Regulation 1024/2013 and the Interinstitutional Agreement between the EP and the European Central Bank. Ms Nouy will inter alia present the SSM Annual report 2016. The EP received a copy of that report on a confidential basis, under embargo until Thursday, 23 March 2016, at 9:00 CET. This briefing therefore does not use or refer to any information provided in that Annual report.

The following issues are addressed in this briefing: key priorities for direct supervision in 2017, the key risks road map for 2017, the Supervisory Banking Statistics for the third quarter 2016, recent relevant publications by the SSM, and a summary of external briefing papers on conduct risk.

SSM's key priorities for 2017

On 15 December 2016, the supervisory arm of the ECB published its 2017 priorities for the direct supervision of significant banks in the euro area.

The three – very generic – priority areas set by the ECB for 2017 are:

- business models and profitability drivers (as in 2016)
- credit risk (as in 2016), with a focus on non-performing loans and concentrations
- risk management (as in 2016)

All current priority areas were already on the agenda last year, the number of priority areas was however reduced from five to three (deprioritising capital adequacy and liquidity as stand-alone areas).

Key risks faced by the euro area banking system – a road map for 2017

The supervisory arm of the ECB cooperated with national supervisors in an annual exercise that aimed to identify the key risks potentially affecting the euro area banking system, and published the outcome on 15 February 2017. The outcome is said to serve as an important input when defining the ECB's supervisory priorities and areas for regular monitoring.

Exploring the situation, the ECB stated that low economic growth in the euro area negatively affects the business environment within which euro area banks operate, corrodes asset quality and feeds back to other risk drivers such as low interest rates and high levels of non-performing loans (NPLs). As regards the continuing low profitability, the ECB found that bank revenues come increasingly under pressure in a "low overall for long" interest rate environment, sparking the need to rethink cost-income structures and to improve cost efficiency. The ECB also noted that historically low asset yields and compressed global risk premia have created a potential for a sudden reversal, potentially significantly affecting asset valuations, collateral requirements and wholesale funding costs.

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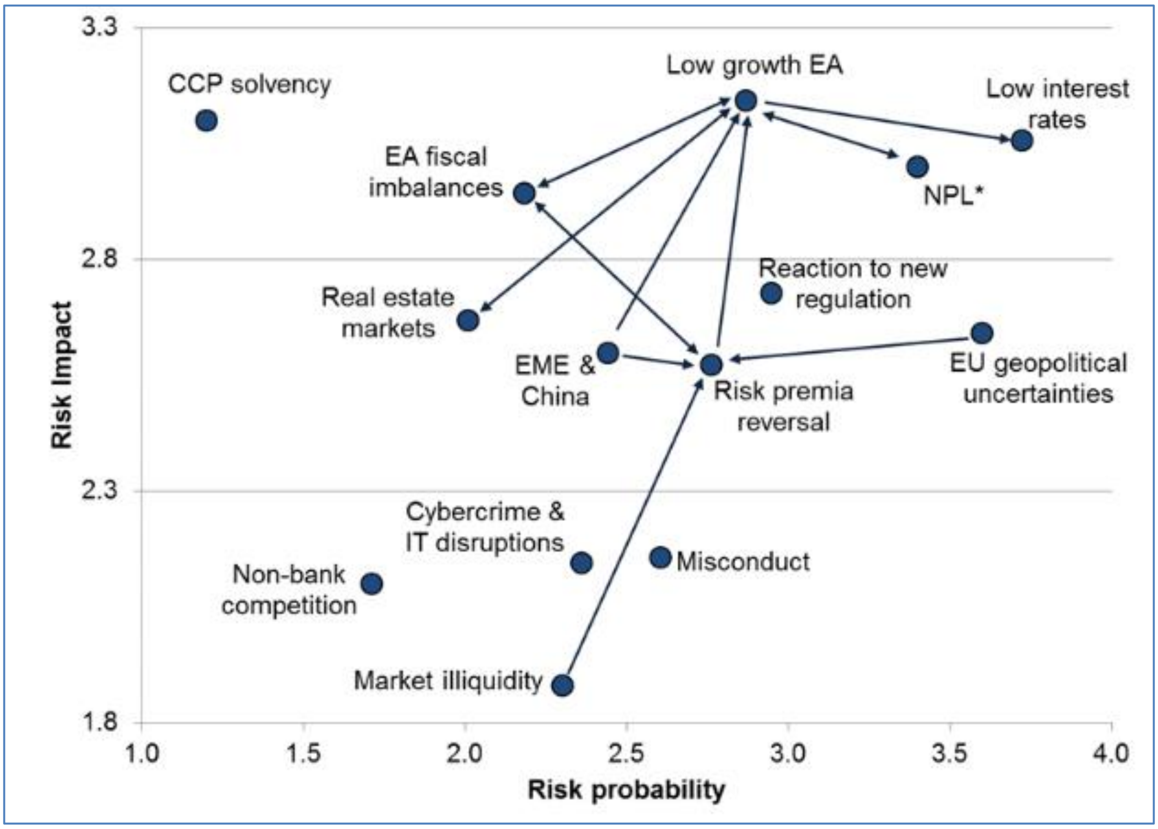
The ECB visualized the risk drivers in a Risk map (see Picture 1), showing how likely the risks are thought to materialise and how much impact they would have.

Picture 1: Risk map of the SSM banking system 2017



Source: [ECB Supervision Newsletter](), published on 15 February 2017
Note: Risk impact and probability were scored between 1 (low) and 4 (high).

The **risk driver** shown in the top right corner of the Risk map, low interest rates, is hence the one with the highest likelihood and impact. Ms Nouy already warned in a speech held in February last year that low interest rates may eat into banks' profitability and could push them into riskier investments. However, low interest rates not only affect banks' interest income but also the funding side, interest expenses. Still, in a recent empirical study Borio, Gambacorta and Hofmann find a positive relationship between the interest rate structure and bank profitability, resulting from two contrasting forces: On the one hand, the level of short-term interest rates and the slope of the yield curve are positively associated with banks' net interest income, reflecting their positive effect on bank margins and on returns from maturity transformation, respectively. On the other hand, higher interest rates boost loan loss provisions, consistent with their impact on debt service costs and default probabilities, and depress non-interest income (cp. BIS Working Papers No 514: "The influence of monetary policy on bank profitability", October 2015).

In the context of risk materialising, it's worth to note that two Italian mid-tier regional lenders supervised by the ECB, **Banca Popolare di Vicenza and Veneto Banca**, requested **state aid** on 17 March 2017 to fill capital gaps, according to information in the press (see, for example, Reuters).

Supervisory Banking Statistics

Since the second quarter 2016, the ECB publishes aggregate *Supervisory Banking Statistics* on the directly supervised significant banks; that dataset covers inter alia the balance sheet composition and profitability of those banks.

The data published by the ECB on 31 January 2017 for the third quarter 2016 show that compared to the previous year, net interest income has only slightly decreased (from EUR 200.1 billion to EUR 198.6 billion), while overall profits have even slightly increased (from EUR 55.6 billion to EUR 57.1 billion).

In sum, the overall **profitability** of directly supervised banks has not changed a lot over the last year. What has, however, significantly changed is composition of profits, due to changes regarding some income and expense items. "Other net operating income" came down by more than 30%; that is a residual category which can include, for example, recurring items such as income on insurance activities as well as non-recurring one-off gains (see table 1: a reduction from EUR 45.8 billion in Q3 2015 to EUR 31.9 billion in Q3 2016). That loss of income was, on the other hand, overcompensated by even higher savings from a reduction in "impairment and provisions" (the overall amount of loss provisioning went down by EUR 17.8 billion). Since the management of credit risk is still one of the SSM's key priorities, the question whether credit risk is adequately provisioned should be prominent on the supervisor's radar.

Table 1: Profit and loss figures of ECB directly supervised banks
(year-to-date, for the third quarter 2016 and 2015, in EUR millions)

Profit and loss	Q3 2015	Q3 2016
Net interest income	200.149,47	198.599,13
Net fee and commission income	100.110,39	98.633,28
Net trading income	17.369,80	17.277,07
Exchange differences, net	-1.939,39	2.728,29
Net other operating income	45.805,07	31.901,38
Operating income [1)]	361.495,34	349.139,16
Administrative expenses and depreciation	-222.112,69	-224.060,05
Net income before impairment, provisions and taxes	139.382,65	125.079,12
Impairment and provisions [2)]	-72.682,54	-54.888,15
Other	9.125,81	9.877,14
Profit and loss before tax from continued operation	75.825,92	80.068,11
Profit and loss before tax from discontinued operation [3)]	220,49	-2.222,37
Tax expenses or income	-20.400,54	-20.730,71
Net profit/loss	**55.645,86**	**57.115,03**

Source: ECB Supervisory Banking Statistics, January 2017, T02.01.1 (arrow connector added)

Note: 1) Operating income before administrative expenses and depreciation are deducted; 2) Provisions include provisions for "commitments and guarantees given" and "other provisions"; 3) This item includes also "extraordinary profit or loss before tax".

The aggregate *Supervisory Banking Statistics* give furthermore some information on the situation of **NPLs** of directly supervised banks, an issue that also ranks high in the Risk map due to its likelihood and impact. The data shows in table T03.05.1 that over the one-year period under review (Q3 2016 as compared to Q3 2015), the average NPL ratio has improved from 7.31% in Q3 2015 to 6.49% in

Q3 2016. At the same time, the **coverage ratio** for NPLs - a measure of a bank's ability to absorb potential losses from its NPLs - has improved from 45.07% in Q3 2015 to 45.75% in Q3 2016 (there is presumably a denominator effect in that improvement).

As can be seen in table 2, however, the situation of significant banks with regard to NPLs was very heterogeneous at country level:

Table 2: Asset quality: Non-performing loans and advances by country

Country (Q3 2016)	Loans and advances	Non-performing loans and advances	Non-performing loans ratio
Belgium	428,51	15,50	*3,62%*
Germany	2.717,92	66,43	*2,44%*
Estonia	C	C	C
Ireland	212,94	37,80	*17,75%*
Greece	242,40	114,06	*47,05%*
Spain	2.324,16	136,10	*5,86%*
France	3.820,74	149,86	*3,92%*
Italy	1.664,43	270,34	*16,24%*
Cyprus	51,72	20,83	*40,28%*
Latvia	C	C	*3,63%*
Lithuania	17,01	0,69	*4,07%*
Luxembourg	73,93	1,13	*1,53%*
Malta	12,43	0,58	*4,64%*
Netherlands	1.785,17	43,58	*2,44%*
Austria	341,10	20,79	*6,10%*
Portugal	182,53	36,18	*19,82%*
Slovenia	15,04	2,53	*16,80%*
Slovakia	-	-	-
Finland	269,14	4,02	*1,49%*
Total	**14.183,79**	**920,99**	***6,49%***

Source: ECB Supervisory Banking Statistics, January 2017, T03.05.2

Note: There are no significant institutions at the highest level of consolidation in Slovakia

In this context, please note that on 20 March 2017, the ECB published its Guidance to banks on non-performing loans; that Guidance clarifies the ECB's expectations regarding NPL identification, management, measurement and write-offs in areas where existing regulations, directives or guidelines are silent or lack specificity. It also specifically warns that some forbearance measures, granted to borrowers in financial difficulties to help them out of their plight and return to a financially sustainable situation, just delay necessary actions to tackle asset quality issues and lead to a misrepresentation of asset quality on the balance sheet.

Recent SSM publications

Since the last regular public hearing of the Chair of the SSM on 9 November 2016, the ECB published a number of guidance documents that are summarized as follows:

Guide for the Targeted Review of Internal Models (TRIM) (28/02/2017)

The TRIM project focuses on inappropriate internal modelling which takes advantage of the freedom granted by the current regulation, leading to an unwarranted variability in risk-weighted assets (which, importantly, form the basis for calculating capital requirements).

The ECB guide informs about the principles for the general (i.e. non-model specific) topics selected for harmonisation, for example regarding data quality, internal validation, third party involvement etc.

On-site investigations will then explore the range of practices for which targeted harmonisation seems advisable.

Multi-year plan on SSM Guides on ICAAP and ILAAP (20/02/2017)

The ECB initiated a multi-year project to develop comprehensive SSM Guides on the Internal Capital Adequacy Assessment Process (ICAAP) and the Internal Liquidity Adequacy Assessment Process (ILAAP), in line with CRDIV requirements and EBA guidelines.

In a first step, the ECB has primarily set out key principles regarding ICAAP and ILAAP.

The ECB stresses that both processes are, above all, internal processes for which the significant banks remain responsible, implementing them in a proportionate manner (the ECB will assess them accordingly).

As regards capital, banks are notably expected to aim for appropriate management buffers that go beyond Pillar2 Guidance buffers.

List of supervised entities (as of 15 November 2016 - December update) (22/12/2016)

129 bank and banking groups were directly supervised by the ECB on 1 January 2016, that number has come done to 126 over the course of the year according to the most recent list of supervised entities, published on 22 December 2016.

The following entity was added to the list:

- Citibank Holdings Ireland Ltd; Ireland

The following entities are no longer directly supervised:

- WGZ Bank AG Westdeutsche Genossenschafts- Zentralbank, Germany
- State Street Bank Luxembourg S.C.A, Luxembourg
- RFS Holdings B.V., The Netherlands

Moreover, two entities merged:

- Banco Popolare – Società Cooperativa and Banca Popolare di Milano S.c. a r.l., formed a new entity, Banco BPM Società per Azioni, which is likewise directly supervised.

Unfortunately, the ECB's accompanying press releases do not name individual entities added to or taken from the list, making it burdensome to find the changes.

SSM SREP Methodology Booklet - 2016 edition (15/12/2016)

Relevant details of the ECB's approach to the supervisory review and evaluation process (SREP) such as the legal basis, the methodology applied, information on results etc. are set out in a key publication named SREP Methodology Booklet; a first version was published on 19 February 2016, the updated version was published on 15 December.

Compared to the previous version, we noted some significant changes in the updated version:

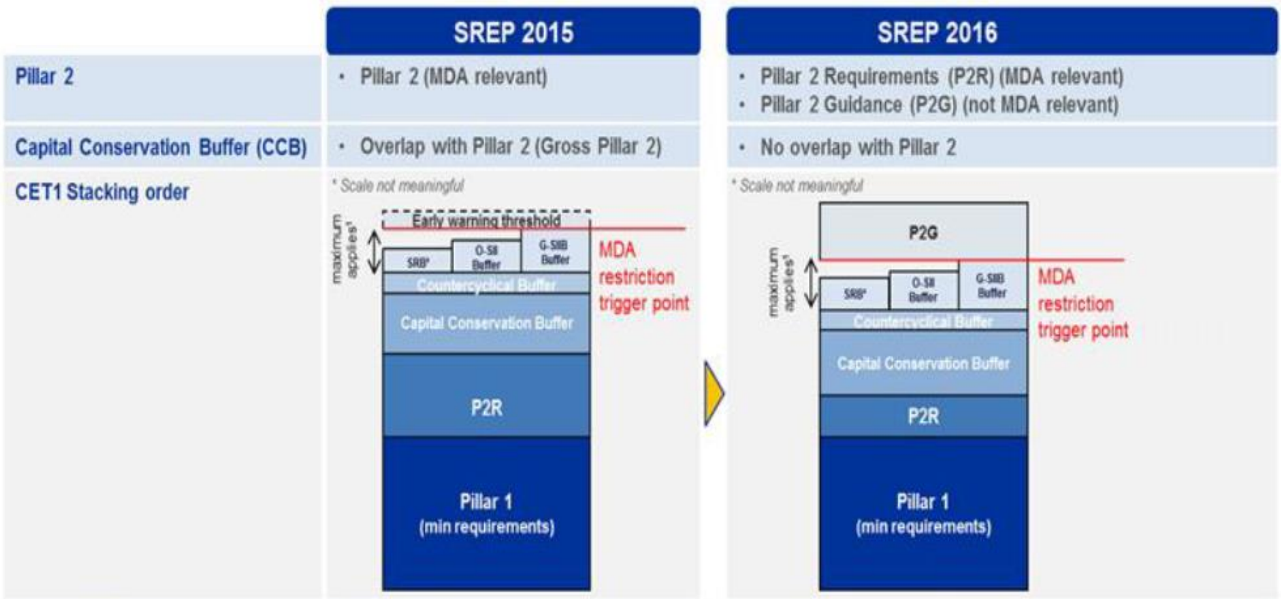
As regards the **legal basis**, in particular as regards the question which capital requirements can lead to restrictions for the distribution of profits, the ECB added

- the "Opinion of the European Banking Authority on the interaction of Pillar 1, Pillar 2 and combined buffer requirements and restrictions on distributions" that was published on 16 December 2015,
- and the information "EBA clarification of the use of 2016 EU-wide stress test results in the SREP process", published on 1 July 2016.

The Booklet documents that the application of the EBA opinion had on average a material impact on the banks' discretion regarding the distribution of profits, otherwise limited by the concept of the maximum distributable amount (MDA): The so-called MDA trigger - which restricts the distribution of profits - fell from an average of 10.2% of CET1 demand in 2015 to a mere 8.3% in 2016.

The treatment was hence very different in 2015 and 2016 (see picture 2):

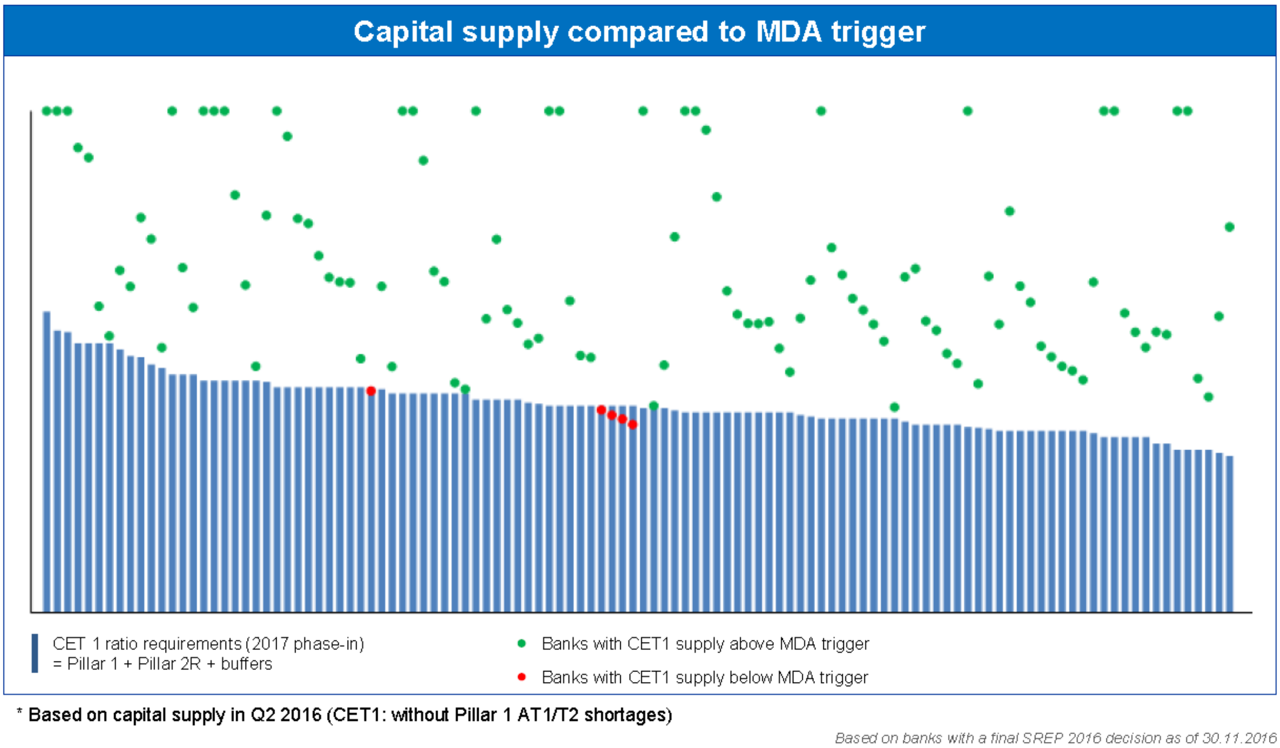
Picture 2: Comparison between profit distribution restrictions in 2015 and 2016



Source: SSM SREP Methodology Booklet - 2016 edition (p. 37)

On substance, in 2016 most of the banks that were directly supervised by the ECB had capital levels above the MDA-trigger, just 5 banks (see graph 1) had capital levels below the MDA-trigger and were hence subject to distribution restrictions (e.g. suspension of dividends or bonuses, non-payment of AT1 coupons).

Graph 1: Banks with CET1 supply below MDA trigger



Source: SSM SREP Methodology Booklet - 2016 edition (p. 10)

Finally, as regards the **disclosure** of SREP results, the Booklet states on p. 43 that in September 2016 the ECB implemented the EBA opinion; paragraph 24 of that opinion reads: "*Competent authorities should consider using the provisions of Article 438(b) of the CRR to require institutions to disclose MDA-relevant capital requirements [...], or should at least not prevent or dissuade any institution from disclosing this information*". In short, banks may therefore publish SREP capital requirements that lead to MDA-restrictions.

Recommendation ECB/2016/44 on dividend distribution policies (15/12/2016)

The ECB recommendation, which is addressed both to the management of significant banks as well as to the national competent authorities with regard to less-significant banks, makes clear that banks that have not yet reached their 'fully loaded' Common Equity Tier 1 capital ratio (i.e. without applying the transitional provisions set out in the CRD IV Regulation), should distribute their net profits in a conservative manner, and only pay out dividends to the extent that, at a minimum, a linear path towards the required fully loaded capital requirements is secured. Moreover, banks in breach of capital requirements should, of course, in principle not distribute any dividends.

Letter to CEOs on variable remuneration policy (15/12/2016)

The ECB reiterated the same message that banks, when making an award of variable remuneration (bonuses), should apply a policy that is consistent with a conservative – at a minimum, a linear – path towards a bank's fully-loaded capital requirements. Unlike the recommendation on dividend distribution policies, that message in form of a letter was sent, however, only addressed to the management of significant banks.

Summary of external briefing papers on

"Fines for misconduct in the banking sector – what is thesituation in the EU?"

Due to the number and scale of cases in which banks were in recent years fined for misconduct, namely for the wilful or intentional disregard of laws, ethics or internal governance and controls, that issue has a potential to create systemic risks; the European Systemic Risk Board (ESRB) already published a dedicated Report on misconduct risk in the banking sector in 2015.

In view of the impact that fines can have on banks' financial results, EBA added the assessment of conduct risk as a compulsory element to the EU-wide stress test that was carried out in 2016. As reported in a previous EGOV briefing of 4 November, the information that EBA later on disclosed specifically on conduct risk was highly aggregated, just indicating that the aggregate cumulative conduct risk losses for the 51 banks participating in the EU-wide stress test would add up to EUR 71 billion over the three year period (which translated into a reduction of the average transitional CET1 capital ratio by 80 bps).

Given the importance of the topic and the limited information available, the ECON committee commissioned a panel of experts to analyse the situation in the EU in comparison to other relevant jurisdictions. The findings in the related **external briefing papers** (all published under the title "*Fines for misconduct in the banking sector – what is the situation in the EU?")* can be summarised as follows:

Elena Carletti points out in her paper that in the US, the highest money penalties imposed on banks were not related to breaches of prudential supervisory requirements but to the mis-selling of financial products – a criminal offence falling under the remit of the Department of Justice.

Carletti finds that misconduct in the banking sector – despite its detrimental effects on both financial stability of the banking sector and the real economy – does not have a single legal definition. This makes addressing this risk particularly challenging in jurisdictions such as the US, where oversight and enforcement powers are distributed within a complex supervisory architecture repartitioning competences among numerous bank and activity-specific agencies. Even where a narrow definition of misconduct is adopted – that is the inappropriate supply of financial services – without adequate coordination, such complexity comes at the price of diluting enforcement action and exasperating informational asymmetries of the supervisor. The US experience shows that coordination and a holistic approach to the activities of banks is a precondition for an enforcement through money penalty regimes, in particular in cases of criminal bank misconduct such as fraud.

The US repartitions of oversight over the banking sector between various federal and state agencies, depends on the type of banking activity and the place of authorisation of the bank. In addition, the Department of Justice (DoJ) has played an essential role in enforcing rules related to misconduct through the imposition of money penalties for banks which have engaged in fraudulent activity over the course of the crisis.

By looking at the US legal framework as well as empirical evidence concerning the levels of fines imposed, Carletti's paper argues that the level of the fines in the US can be explained by the active pursuit by the DoJ of criminal misconduct, which sought further to overcome limitations stemming from a lack of adequate coordination by different bank supervisors.

The US system for addressing bank misconduct through fines delivers a number of lessons for the EU with regard to the design of bank enforcement architecture and the need to develop common approaches across national and EU levels to avoid regulatory arbitrage.

Martin R. Götz and Tobias H. Tröger find in their paper that prudent banking regulation hinges on the ability of regulators to ensure that banks are stable and safe: The execution of enforcement action to correct deficiencies in banks' management and/or financial health is an important tool that allows supervisors to sanction banks in case they violate safe and sound banking practices and/or law.

Like Carletti, Götz and Tröger also compare the legal framework for supervisors in the Banking Union with the situation in the U.S. that governs the execution of enforcement actions against banks. However, they do not consider and examine liability based on criminal offenses in their in-depth analysis (which is included in Carletti's analysis) and rather focus on monetary penalties issued by supervisory authorities instead because European banking regulation does not provide for any sanctioning powers based on criminal offenses.

Consequently, Götz and Tröger analyse the legal provisions that allow imposing monetary penalties to sanction violations of prudential banking regulation (preconditions, range of fines) and observe no material variations with regard to typical misconduct. Important differences exist, however, with regard to the distribution of enforcement powers. While each supervisor in the U.S. has the independent authority to initiate enforcement actions and levy fines against the institutions that fall under its remit, the authority to execute enforcement actions in the Banking Union (SSM) is split between the European Central Bank (ECB) and national competent authorities (NCA).

Empirical evidence, mostly from the U.S., indicates that banks change their behaviour when they are subject to an enforcement action. In particular, existing studies highlight that banks become safer once regulators intervene. Regarding lending, other work has found that banks issue more favourable loan terms once they are subject to an enforcement action.

Detailed data on regulatory intervention in Europe is only scarcely publicly available; it is particularly inaccessible with regard to the ECB's practice. Götz and Tröger therefore focus on the evolution of enforcement actions by U.S. regulators. Their analysis indicates that U.S. regulators are quite active in sanctioning banks and issue on average about 500 enforcement actions against banks in the U.S. per year. The data also shows that the activity of U.S. regulators has increased since the financial crisis. Regarding the issuance of monetary penalties against banks in the U.S. they find that the aggregate amount of fines was very large in 2014 and 2015, where U.S. regulators issued total fines of more than 2 billion USD. This activity was primarily driven by monetary penalties against large banks in the U.S. due to wrongdoings in money laundering and their trading behaviour in foreign exchange markets.

Götz and Tröger conclude by focusing on the interplay between different supervisors regarding the execution of enforcement actions. To ensure that enforcement actions contribute to financial stability, it seems of utmost importance to them that supervisory authorities have adequate sanctioning powers at their disposal that allow them to react swiftly and effectively once relevant infringements of the regulatory framework are detected. Two things are particularly important. First, the regulatory framework has to allow that sanctions are set within the efficient range to correct social harm and serve as a deterrent and thus should not be truncated at suboptimal levels. Their analysis indicates that regulators in the Banking Union have the ability to set fines at efficient levels. Second, the procedure for imposing sanctions has to be practically workable. An inefficient overlap of competences of multiple agencies may compromise the incentive effects of enforcement actions. Regarding the Banking Union, it is important to note that the hub and spokes-approach of the SSM with its division of competences between the ECB and NCA provides an additional impediment to the effective sanctioning of banks. From their point of view, those shortcomings should not be neglected.

Andrea Resti finally focuses in his paper on empirical data that shows the situation in the EU. Based on public-domain figures collected by the CCP Research Foundation, Resti figures out that misconduct costs have been rising strongly for large European banks in 2011-2015, and end-2015 provisions show that the trend is expected to continue. Although no European lender matches the costs experienced by large US banks, several ones have crossed the EUR 10 bn threshold, including most large UK institutions, BNP Paribas and Deutsche Bank.

On the other hand, news on operational losses associated with conduct risk events occurred in Europe (as collected by the ORX Association) suggest that the trend may have slowed down somewhat in 2015-2016. This, however, does not include costs suffered by European banks in non-European jurisdictions, like some large fines and settlements taking place in the US. The distribution of losses looks highly skewed, with a few extreme cases associated with very high costs. More than 55% of the total costs originate from the provision of traditional banking services aimed at individuals, families and SMEs, like commercial banking and retail banking.

A drill-down exercise based on Italian data shows that – while large banks clearly generate stronger systemic risk due to their size – small and mid-sized institutions have experienced higher misconduct costs per unit of total assets. Additionally, banks that ended up requiring resolution or some other form of extraordinary support show a substantially higher incidence of conduct risk losses, even in the initial years, when most extraordinary interventions still had to materialize.

Resti also finds that less than a quarter of the EU's competent authorities have established dedicated teams or units on conduct risk, while slightly more than half include conduct risk in their supervisory examination programmes.

Resti warns that if fines and settlements simultaneously hit a large number of banks, originating systemic risks that may undermine the stability of the financial system. Furthermore, misconduct costs may be passed on to customers, or translate into job cuts and lower dividends paid out to shareholders (including retail investors). Hence, while ex post penalties clearly play a beneficial role, by discouraging inappropriate managerial choices and ensuring that past extra-profits are recuperated, they should from his point of view not be the main regulatory answer to banking misconduct. Other preventive tools should also be deployed, including:

- the improvement of the quality of bank governance,
- suitable remuneration schemes that condone inappropriate marketing practices,the use of whistle-blowing policies,
- and the improvement of the clarity of regulations to remove grey areas and discourage borderline practices.