BRIEFING

European Parliament

Public hearing with Andrea Enria, Chair of the ECB Supervisory Board

ECON on 12 December 2019

This note is prepared in view of a regular public hearing with the Chair of the Supervisory Board of the European Central Bank (ECB), Andrea Enria, which will take place on 12 December 2019.

The briefing addresses (i) Single Supervisory Mechanism (SSM) priorities for 2020, (ii) Banks' profitability issues; (iii) Stress testing developments; (iv) some individual bank cases; (v) supervisory issues and policies (anti-money laundering, Brexit, and impact of Basel III and IFRS9), and (vi) the completion of the Banking Union.

1. SSM Priorities 2020

In October, the ECB published the SSM supervisory priorities for 2020, which are in particular (i) continuing balance sheet repair and (ii) strengthening future resilience. Following-up on Brexit work and preparing for all possible outcomes for a no-deal Brexit is likewise listed as another high-level priority.

Balance sheet repair will focus on the stock and flow of non-performing loans (NPLs), the adequacy of internal models used to calculate regulatory capital requirements, as well as trading and market risks, in particular as regards complex instruments that are marked at fair value.

In order to ensure the future resilience of banks, the ECB will look into credit underwriting criteria and plans to do on-site inspections to assess exposures in areas such as commercial real estate, residential real estate and leveraged finance. Moreover, the ECB plans to continue assessing banks' business models and profitability, as well as IT and cyber risks.

The ECB's supervisory priorities are loosely coupled with the identification of key drivers of banking sector risks, namely (i) economic, political and debt sustainability challenges in the euro area, (ii) business model sustainability, and (iii) cybercrime and IT deficiencies. The reasoning underlying the identification of those risks are set out in more detail in a separate document, the ECB's Risk assessment for 2020.

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2. Banks' profitability issues

Very recently, on 5 December, the rating agency Fitch has come out with a revised sector outlook for western European Banks, changing it to negative as it believes that the deteriorating outlook for GDP growth, combined with low interest rates, will pressure revenue generation and make it challenging for banks to reach profitability targets. The European Banking Authority (EBA) recently pointed to similar concerns in its annual Risk Assessment Report, noting in the press release that "*the streamlining of operating expenses is presumably the main area to improve profitability*".

Meagre average profitability of significant banks has also increasingly drawn attention by bank supervisors. Kerstin af Jochnick, Member of the ECB Supervisory Board, for example highlighted in a speech held in Frankfurt on 15 November that in order to inform public policy, at least four questions would need to be tackled: "*First, to what extent will a more protracted period of low banking profitability than previously envisaged affect financial stability? Second, to what extent is low banking profitability a by-product of competitive market structures? Third, is there a potential trade-off between profitability and competition in terms of their impact on financial stability? Fourth, what could various stakeholders in the banking system do to address these challenges*?"

From her point of view, there are no straightforward answers available, neither for the effects of the very low interest rate environment nor for the role of competition and the relationship between bank profitability and financial stability. That assessment of course questions to what extent policy recommendations to various stakeholders are well founded.

Empirical data on the *status quo*: Supervisory Banking statistics

Since 2016, the ECB publishes Supervisory Banking Statistics on directly supervised significant banks, inter alia covering aggregate information on the banks' profitability. The most recent available data refers to the second quarter 2019.

Table 1 compares the Return on Equity (RoE) as profitability-related indicator for the significant banks under direct ECB supervision, aggregated at country level, for the situation in mid-2019 and mid-2018, based on those statistics. In essence, though the low interest rate environment is a common feature in all Member States, the profitability of significant banks is very heterogeneous, and one can see quite significant changes over a period of one year, both for the better and the worse.

Table 1: Return on Equity of significant banks, comparison between 2019 and 2018

Country	RoE Q2 2019	RoE Q2 2018	Change y-o-y
Belgium	**4,73%**	4,85%	-0,12%
Germany	**0,01%**	3,17%	-3,16%
Estonia	**8,96%**	C	
Ireland	**5,39%**	8,40%	-3,01%
Greece	**2,89%**	-2,19%	5,08%
Spain	**7,76%**	9,03%	-1,27%
France	**6,41%**	6,99%	-0,58%
Italy	**7,73%**	7,69%	0,04%
Cyprus	**10,14%**	3,72%	6,42%
Latvia	**11,71%**	8,48%	3,23%
Lithuania	**C**	11,62%	
Luxembourg	**5,98%**	5,85%	0,13%
Malta	**7,18%**	5,12%	2,06%
Netherlands	**8,50%**	9,96%	-1,46%
Austria	**9,07%**	10,74%	-1,67%
Portugal	**1,33%**	1,89%	-0,56%
Slovenia	**11,89%**	12,04%	-0,15%
Finland	**C**	C	

In Slovakia, there are no significant institutions at the highest level of consolidation

Source: Supervisory Banking Statistics, Q2 2019 and Q2 2018, table 02.02.2; the letter "C" marks that the ECB suppressed a value for confidentiality reasons

External briefing papers on profitability

In view of concerns about the banks' profitability and subsequent effects, ECON Coordinators had requested the experts appointed to the panel on bank supervision to assess what the main factors for the subdued profitability of significant banks in the Banking Union are, and whether the ECB's supervisory response to that situation is conclusive and exhaustive.

Bertay and Huizinga clearly point out that from their point of view, low profitability numbers cannot be attributed to cyclical factors, as the European economy has been performing reasonably well in recent years. They conclude that the subdued profitability rather seems to be a structural problem that is caused by overbanking, with too many bank assets chasing too few profitable banking sector opportunities. That situation should be a supervisory concern, as an inadequate level of bank profitability can have negative implications for financial stability, and lead to a misallocation of lending to weak firms.

To address the root problem of overbanking, Bertay and Huizinga recommend that the ECB should use its existing supervisory powers to require significant banks with unsustainably low profitability to restructure reducing their overall size.

Farina, Krahnen, Pelizzon and Wahrenburg critically analysed what conclusions could be drawn from the SSM Thematic Review on Profitability and Business Models that the ECB published in September 2018, as it does not reveal any easily identifiable common factors that would explain superior or inferior profitability of banks. Like Bertay and Huizinga, they caution that low profits may be related to an overbanking status in the market as a whole. They find in particular that the link between profitability and industry structure (e.g. level of exit, industry concentration and intensity of consolidation) does not receive sufficient attention in the ECB review. While they concede that a supervisory review of micro and macroeconomic profitability drivers and bank management practices may be helpful in understanding potential risks, they also see the danger that the law enforcement role of the supervisor may be compromised by its alternative consulting role as "coach", indirectly stabilising a suboptimal institutional architecture of the banking market.

The policy recommendation of Farina, Krahnen, Pelizzon and Wahrenburg is straightforward: "*The regulator should not diminish, to the extent possible, the dynamism of the industry. In our view, playing a consulting role to the industry would generate exactly the opposite effect than the one intended*."

Moreover, mentioning the clear evidence in the ECB's Review on Profitability that profitability has no or only a weak relation to the bank's business model, they find it incomprehensible why the obvious conclusion from that finding is not heeded, namely to reject the business model-approach as a meaningful concept for supervisory guidance. Recommendations on business models would not only lack substance, but also blur responsibilities: "*The "business model approach to supervisory guidance", therefore, entails the risk of regulatory capture, caused by overstepping the mandate, and becoming too close to the supervisee*." One should note that one of the reasons underlying the setting up of the Single Supervisory Mechanism has been to avoid and limit supervisory capture.

The concern that the ECB as supervisor may take too much influence on what should quintessentially be a decision by the bank's management, at its own responsibility and peril, is somewhat shared by Resti. He in particular finds that supervisors should not prevent banks from embracing higher-risk businesses that generate additional returns. "*Once banks have in place adequate risk management systems, capital and liquidity, they should not be restrained from investing e.g. in speculative-grade loans, or in the management of non-performing exposures, which will otherwise accrue to an ever-growing shadow banking system*".

Finally, Bruno and Carletti likewise mention excess capacities and fragmentation along national lines that hamper the performance of some euro area banks. They remind readers of the fact that the banking union should in principle provide ideal conditions for banks to capitalise on new cross-border merger and acquisition opportunities. The reason why cross-border bank consolidation remains limited to date would therefore merit further investigation.

3. Stress testing developments

ECB outline of the future of stress testing

On 27 November 2019, Andrea Enria gave a speech on "The future of stress testing - some further thoughts[1]" in a research workshop on the same topic that was organised by (EBA).

Enria set out that stress tests in their current form are meant to achieve five high-level goals at the same time, making the stress test exercise quite complex and resource-intensive:

- First, they help supervisors to determine how much capital banks should hold.
- Second, they assist banks in their efforts to improve their risk management capabilities.
- Third, they support supervisory on-site inspections.
- Fourth, they help supervisors to assess the risk profiles and vulnerabilities of banks in a quantitative manner.
- Fifth, they provide transparency on the risk profile of banks, thus helping to foster market discipline and raise market confidence.

Enria suggested that the future of stress testing could lie in a split it up into three parts, namely a

- supervisory view,
- bank view, and
- macro view.

For the supervisory view, stress test would still be based on a constrained bottom-up approach: Banks use their internal models to project how a common stress scenario affects their capital positions, subject to several constraints to make the results comparable. The banks' calculations of the capital depletion would need to be challenged by the supervisors who compare them with top-down models, bottom-up benchmarking and internal expert knowledge. The results would eventually give an input for determining Pillar 2 guidance. Taking inspiration from the way the buffers for global systemically important banks are determined, banks could be sorted by capital depletion and assigned to "buckets" of capital add-ons required.

The efficiency gains are thought to stem from narrowing the focus on capital depletion and approximating the required capital add-on; supervisors and banks would no longer have to agree on very granular details, making the quality assurance process lighter. That approach, however, would go hand-in-hand with the publication of only a smaller amount of data.

The bank view – the new element of the exercise – would then supposedly have to maintain transparency and make the results more realistic. Though fundamentally based on the same methodology, it would relax some of the constraints and allow banks to better account for their individual situation and might therefore predict more accurately how the stress scenario would affect their balance sheet.

Banks would have to publish the results of the bank view at a similar level of granularity to the current stress test, and they would need to explain which constraints they had relaxed and how, taking the supervisory view serving as benchmark. That approach could potentially strengthen market discipline.

The third element of future stress tests would finally be the macro view, supposed to supplement the supervisory view with a top-down sensitivity analysis at the aggregate level; in future, the macro view could benefit from more reliable ECB models and longer time series of consistent data.

[1] The November speech was preceded by an intervention in September at the European Systemic Risk Board annual conference where Enria outlined his initial thoughts on the subject. For some additional information please see EGOV Briefing.

The European Court of Auditors' special report on stress testing

In July, the European Court of Auditors (ECA) published its Special report on EU wide stress test that are regularly initiated and coordinated by EBA. That report was overall quite critical as regards the reliability and comparability of the stress test results produced by the banks under the current bottom-up approach, and it made a number of concrete recommendations how to improve the methodology, suggesting inter alia to complement the current bottom-up procedure with top-down elements, to introduce alternative stress scenarios, and to increase the informative value of stress-test related publications.

ECB Stress Test 2019

In October, the ECB published final aggregate results of its 2019 stress test exercise, a sensitivity analysis of liquidity risk. Bank supervisors need to conduct a supervisory stress test at least annually (as input to the Supervisory Review and Evaluation Procedure, or SREP) according to Article 100 CRDIV; EU-wide stress tests coordinated by EBA are carried out biennially, the ECB fills the gaps in between with stress tests that focus on topical issues.

Aggregate high-level results have limited informational value for outside observers; the ECB's key message from that exercise was that for the vast majority of banks, liquidity reserves were found to be adequate to counterbalance the net outflows in the simulated stress situation. In its simulation, the ECB had calibrated the deposit outflows based experience from real crisis cases, with material deposit outflows from retail clients and even quicker and higher deposit outflows from corporate clients; structural funding risk and a systemic liquidity crises, going along with general changes in risk premia, were however excluded from the exercise.

Even without access to details at bank entity level, there are at least three high-level results that seem worth noting:

- The ECB observed "cliff effects" for a number of banks right after the time horizon of a Liquidity Coverage Ratio (LCR) calculation, meaning there was a significant liquidity drop after day 30. Those cliff effects could be the result from optimisation strategies (e.g. with collateral swaps etc.) that banks pursue in order to gloss up LCR figures.
- The ECB observed that many banks report unencumbered assets (meaning they are free and clear of any other creditor claims) whose eligibility to be mobilised into additional collateral was unknown; those assets accounted for 19% of total assets. In a similar vein, the ECB found that some banks underestimate the impact triggered by a rating downgrade and noted that banks with actual downgrade experience on average report higher impacts than their peers. Ideally, the stress test exercise has incentivised banks to get more information on the eligibility status and rating effects.
- The ECB also points out that the stress test exercise revealed significant data quality issues; following ECB quality control checks, banks changed on average 25% of the reported data points, and several banks re-stated their regulatory liquidity reports. In order to achieve reliable results, the ECB needed to do a meticulous quality control check that could not be substituted by the banks' internal control system. The fact that in some cases the ECB received even deliberate misrepresentations was made clear elsewhere: In his September speech on the future of stress tests, Andrea Enria said "[...] *we have seen several instances of banks colluding to game the stress test, helped by external advisers. Data are collected from banks before they submit them to supervisors, and then each bank is informed of its position vis-à-vis its peers. This helps the banks to align before and during the stress test in order to collectively adjust the results and minimise the impact. We are very determined to avoid a repeat of these practices in future exercises*."

4. Update on individual bank cases

Based on information in the public domain, this section gives details on banks whose overall financial or operational performance has been calling for particular attention. There are a number of cases of potential breaches of anti-money laundering cases affecting European banks; for a short listing of such cases, please see section 5 of this briefing note.

NordLB

Norddeutsche Landesbank (NordLB) is a large German bank (total assets EUR 154 billion) in public ownership (some 63% are owned by the federal States of Lower Saxony and Saxony-Anhalt, the rest by savings banks) that is directly supervised by the ECB. The bank posted a substantial loss for the year 2018. NordLB's Interim half year Group report points to a significant capital shortfall, as its CET1 ratio and Tier 1 ratio fall below the regulatory minimum requirements (see table 2).

Table 2: NordLB's capital situation as at 30 June 2019

(in %)	Common equity tier 1 capital ratio	Tier 1 capital ratio	Total capital ratio
Regulatory requirement (in accordance with Article 92 (1) CRR)	4.50%	6.00%	8.00%
Additional requirement according to SREP (P2R in accordance to Article 16 (2) litera a regulation (EU) nr. 1024/2013)	2.50%	2.50%	2.50%
	7.00%	**8.50%**	**10.50%**
Capital conservation buffer (§ 10c KWG)	2.50%	2.50%	2.50%
Countercyclical capital buffer (§ 10d KWG)	0.07%	0.07%	0.07%
Capital buffer for otherwise system relevance (§ 10g KWG)	1.00%	1.00%	1.00%
Total requirement	**10.57%**	**12.07%**	**14.07%**
30 Jun. 2019	**6.63%**	**7.34%**	**12.51%**

Source: NordLB Interim Group report as at 30 June 2019, p. 20

In April 2019, NordLB, its owners and the Savings Banks Finance Group agreed on a plan to modify its business model and to increase the bank's capital position, requiring a total cash injection of EUR 2.8 billion (EUR 1.5 billion from the federal State Lower Saxony with and EUR 200 million from Saxony-Anhalt, as well as EUR 1.1 billion from the savings banks via the Institutional Protection Scheme). NordLB shall moreover benefit from guarantees given by Lower Saxony that lower the bank's capital requirements.

On 5 December, DG Competition issued a press release with the following statement: "*The European Commission has found Germany's plans to strengthen the capital position of state-owned Norddeutsche Landesbank – Girozentrale (NordLB) to be free of any State aid. The measures involve a direct investment of €2.8 billion as well as investments to carry out the necessary structural changes and downsizing of the bank to ensure that NordLB continues to operate profitably on the market. The Commission found that the planned measures are carried out on market terms, meaning that the State receives a remuneration in line with what a private operator would also accept in the same circumstances. Therefore, the measures involve no State aid within the meaning of EU rules. The European Central Bank, as responsible supervisor, has given its approval to the plan on 29 November 2019.*".

Apart from what is stated in the Commission's press statement, there is currently no other source available that would allow to examine the Commission's assessment. DG Competition's no-aid assessment apparently rest on its perception that a private operator would have accepted the same terms under market conditions (if the transaction is compliant with the Market Economy Operator Principle, it does not constitute State aid). That assessment has however been questioned by some experts.

According to DG Competition's press statement, the expected return on investment is derived from the business plan that the bank has submitted: "*The Commission's assessment of the business plan showed that this transformation will enable the bank to return to profitability, ensuring that the public shareholders and the Institutional Protection Scheme receive a return to their investment into shares of the bank in line with market conditions*."

One may note in this context that the Commission has already approved a restructuring plan for NordLB in 2012. Point 145 in that State aid decision set out that "*The bank expects to remain profitable and continuously improve its yearly results over the whole restructuring period. Further, in 2016 the after-tax ROE will reach a level of [≥ 7.2]%, which is relatively low, but the Commission considers it sufficient for a number of reasons*", concluding in point 148 "*Consequently, the Commission considers that the restructuring plan submitted by NORD/LB fulfils the requirements of the Restructuring Communication with regard to the restoration of the long-term viability*."

What actually happened, however, was that the bank closed the financial year 2016 with a significant loss of EUR 2 billion after taxes; see NordLB's Group Annual Report of 2016.

For some additional information, please see a previous EGOV briefing.

Banca Carige

Banca Carige is a middle-sized Italian bank (total assets of EUR 22 billion) that is directly supervised by the ECB. At the end of 2018, the bank failed to raise around EUR 400 million capital from its shareholders which led to a resignation of board members. On 2 January 2019, the ECB therefore appointed three temporary administrators.

In February 2019, Banca Carige published a Strategic Plan aiming to reduce the bank's risk profile and redefine its business model. The bank's recapitalisation scheme published in February was modified in the meantime, now[2] asking for a EUR 700 million share capital increase, of which different tranches are taken by the Voluntary Intervention Scheme of the Italian Interbank Deposit Protection Fund (EUR 313 million against conversion of subordinated bonds subscribed in November 2018), the Italian Interbank Deposit Protection Fund itself (EUR 239 million), the private banking group 'Cassa Centrale Banca - Credito Cooperativo Italiano' (EUR 63 million), and the bank's current shareholders for an amount of EUR 85 million. The capital increase is accompanied by other measures. Nearly the whole portfolio of non-performing assets (EUR 3.1 billion) shall be transferred to the asset management company owned by the Ministry of Economy and Finance 'Società per la Gestione di Attività' (SGA) and other financial institutions.

In September 2019, Ignazio Angeloni, former ECB Supervisory Board member, wrote an article in the FT in which he points to some weaknesses in the framework for dealing with ailing institutions. Angeloni claims that supervisors are currently reluctant of taking tough action against fragile banks as they cannot be sure what will happen if one goes bust. He refers to the Carige case as an example for which "*a domestic rescue is prepared, supported by the national deposit insurance fund and a mix of small and public lenders. No new business plan, asset-quality review or stress test is available. The bank has announced half-year losses more than five times its market value*." In other words, the solution for Carige seems to have been primarily secured at national level.

On 25 November 2019, the temporary administrators appointed by the ECB wrote in a letter to the bank's staff that they began the prospectus approval process for the capital increase. In the same letter, the temporary administrators also announced that they would not become part of the future management team. CONSOB, the Italian competent authority, approved the prospectus last 3 December. In its press release, Carige notes that it is in breach of its capital requirements. For some additional information, please see a previous EGOV briefing.

[2] See press statement of 9 August 2019.

5. Supervisory issues and policies

Anti-money laundering (AML)

The AML framework has been considerably strengthened, on the back of high profile cases, through the 5th AML Directive (pending transposition) and the implementation of the Council December 2018 Action Plan. The Commission has assessed the existing framework on its July 2019 Communication and related reports[3], but has refrained at this stage from proposing new actions. The Ecofin, on the other hand, adopted Conclusions on 5 December calling for the Commission "*to further consider the possibility of creating a coordination and support mechanism that encourages and facilitates the cross-border work of Financial Intelligence Units (…) to further explore (…) whether some aspects could be better addressed through a regulation (…) to explore in particular the possibilities, advantages and disadvantages of conferring certain responsibilities and powers for anti-money laundering supervision to a Union body*". A number of Member States called on 8 November for setting up a "*supervisory mechanism*" at EU level comprising the national supervisors and a central body for better tackling money laundering. Additionally, AML features high in ECB concerns for the year to come, as set out in its Risk Assessment for 2020, as involvement in cases of money laundering poses significant risks to banks and their viability, and it is often connected to weak governance and poor risk controls.

The ECB has in the past advocated a new EU body responsible for AML (26 March 2018 ECON Committee hearing) and has made clear that its mandate does not encompass money laundering (see SSM public statement of February 2018 and Recital 28 of the SSM Regulation). Nevertheless, Recital 20 of the Capital Requirements Directive (CRD V) states that *"(…) [Together with the authorities responsible for AML/CFT], the competent authorities in charge of authorisation and prudential supervision have an important role to play in identifying and disciplining [AML-related] weaknesses. Therefore, such competent authorities should consistently factor money laundering and terrorist financing concerns into their relevant supervisory activities (…)*". The ECB has identified a number of tools through which it can possibly address money laundering concerns (letters dated 3 May 2018 and of 19 September 2019 of the Chair of the SSM). In addition to SREP, this include the assessment of qualified shareholders, withdrawal of the authorisation for all credit institutions in the euro area[4] and fit and proper assessment. This position has been reiterated in a recent speech by Yves Mersch. In addition, the ECB has set up an internal "AML office". At his hearing in ECON on 21 March 2019, Andrea Enria, clarified that the ECB was in the process of hiring people for that AML office. Nevertheless, quite a number of EU banks have been involved in possible cases of money laundering. Deutsche Bank paid € 15 million in December 2019 related to deficiencies in anti-money laundering controls, Anglo-Austrian Bank (former Bank Meinl) licence was redrawn in November amid concerns over money laundering, Bank Winter saw itself involved in laundering Russian money, ABN Amro is reportedly being investigated for money laundering, SEB has been involved in anti-money laundering investigations, just to name a number of most recent cases. The recent EBA report on risks and vulnerabilities in the EU banking sector highlights supervisors' concerns at banks' insufficient awareness and expertise as well as a lack of senior management preparedness to take responsibility for AMF related risks.

For further information on the policy debate regarding a possible strengthening of the AML supervisory architecture, see EGOV Briefing.

[3] The accompanying reports address (a) the assessment of AML risks affecting the EU; (b) the cooperation between FIUs; (c) the interconnection of national centralised automated mechanisms on bank accounts; and (d) a *post-mortem* exercise on AML cases affecting the banking system.

[4] Subject to the EU law safeguards and once the ECB is made aware of the relevant facts. The ECB would have to assess whether a supervisory action (and which) is warranted. The ECB can request the cooperation of the relevant national authority in gathering the necessary information once suspicions of money laundering are detected.

Brexit

According to Commission's June 2019 fifth preparedness report (Communication), firms have made significant progress with their contingency planning, including establishment in the EU27 Member States, modification ('repapering') or termination of cross-border contracts, and adaptation of business models, whilst residual issues remain notably in what concerns contract management and access to infrastructures. The Commission recognised, however, that the no-deal scenario will necessarily result in some market fragmentation in financial services. In its 4 September Communication, the Commission further notes that it will continue monitoring the situation in particular in what concerns central counterparties. In a recent speech, Vice President Dombrovskis clarified that the Commission would be prolonging the temporary equivalence decision granted to the UK CCP beyond March 2020, to further cater for possible financial instability and give institutions enough time to adjust to the UK leaving the EU.

In its publication "Brexit: stepping up preparation", the ECB holds a more nuanced assessment of banks' preparation. According to the SSM, "*so far banks have transferred significantly fewer activities, critical functions and staff to euro area entities than originally foreseen as part of their plans for Brexit*". With respect to the continuity of uncleared derivatives contracts, ECB urges banks to implement effective risk mitigation measures (novation of contract, i.e. new contract). Andrea Enria gave some reassurance in an interview to the Finnish press: "*So in terms of processes, we have done the best preparation we could, the banks did what we asked them to do and a contingency plan is in place. Having said that, it is an event which can always be accompanied by shocks and turbulence in financial markets, so it is something that is giving us a bit of a headache*". The ECB November Supervisory Newsletter still maintains a note of caution: "*Recent data indicate that a number of banks are making insufficient progress with novation. This is due to a combination of factors, including banks' reliance on contingency measures adopted at the national level in EU Member States and difficulties in negotiations with clients. However, it should be noted that most of these national measures are temporary in nature and do not replicate passporting rights within the Single Market.*". The ECB also noted that action is still needed in all areas of the ECB's supervisory expectations.

On 4 December the ECB announced that it will supervise 4 additional institutions due to Brexit relocations: UBS Europe SE, J.P. Morgan AG, Morgan Stanley Europe Holding SE and Goldman Sachs Bank Europe SE.

For further background information on banks' preparedness to Brexit, see EGOV Briefing "Equivalence in banking and financial legislation" which outlines Brexit-related supervisory issues and ECB Q&A webpage.

Impact of Basel III and IFRS9

Upon the European Commission request for technical advice, EBA has provided two assessments and policy recommendations[5] (August 2019 and December 2019) on the implementation of the Basel III reforms[6]. According to the December 2019 EBA conservative assessment, the current minimum capital requirement (including Pillar 2 and macroprudential buffers) will have to increase by 23,6% once Basel III is fully implemented (this estimation is somewhat lower compared to the August 2019, which stood at 24,4%). The estimated capital increase translates into an aggregate total capital shortfall of EUR 124,8 billion (of which EUR 83,0 billion of CET1, see table 3).

[5] During the two abovementioned assessment rounds, the EBA has provided policy advice on the following Basel III reform components: Output floor, Operational risk, Credit risk, SFTs and Credit valuation adjustment and market risk.

[6] The Group of Governors and Heads of Supervision endorsed Basel III reform package in December 2017. The main objectives of this reform package are to reduce excessive variability of risk-weighted assets and to improve comparability of banks' capital ratios. This reform package enters into force on 1 January 2022, except for the output floor, that should be phased-in from 2022 to 2027.

The change in the results of the last assessment in December is due to revised framework for market risk (namely, the fundamental review of the trading book[7]) and lower impact of output floor[8]. It is important to note that due to different business models Basel III reform package has larger short-term impact on the EU banks. Banks in the EU tend to hold originated loans in their balance sheets (therefore, also need to hold respective capital buffers for these loans) compared to the US banks that usually securitise loans and transfer them to other companies and not keep them in their balance sheets.

An in depth macroeconomic impact assessment carried out by EBA in close cooperation with the ECB revealed that finalisation of the Basel III reforms will have a negative impact on bank lending only in the short run[9], which will result in transitionary costs. Nevertheless, the long-term benefits outweigh the costs and will have a positive overall impact[10] for the EU economy, as both the probability of a future crisis and the severity of it would decrease.

Table 3: Capital ratios and shortfalls, by size

	CET1 capital			Tier 1 capital			Total capital		
	Current ratio (%)	Revised ratio (%)	Shortfall (EUR billion)	Current ratio (%)	Revised ratio (%)	Shortfall (EUR billion)	Current ratio (%)	Revised ratio (%)	Shortfall (EUR billion)
All banks	**14.4**	**11.6**	**83.0**	**15.3**	**12.4**	**119.0**	**17.9**	**14.4**	**124.8**
Large	14.2	11.4	82.9	15.2	12.2	118.2	17.8	14.3	123.8
of which: G-SIIs	12.7	10.1	46.8	13.8	10.9	62.6	16.2	12.8	75.3
of which: O-SIIs	15.4	12.5	32.2	16.3	13.3	49.5	19.2	15.6	41.1
Medium	17.3	15.2	0.1	17.5	15.4	0.8	18.9	16.6	0.9
Small	17.0	16.0	0.0	17.2	16.1	0.0	18.3	17.1	0.1

Source: EBA.

An additional negative day-one impact of 51 basis points (bps) on banks' average CET1 capital, as well as a 9% increase in average provisions should arrive from the implementation of IFRS9 accounting standards, as estimated by the EBA. The distribution of impact is not uniform across the banks - banks that are using Internal Ratings–Based approach (IRB) for calculating their credit risk will experience significantly smaller negative impact (19 bps on simple average CET1 capital) compared to the banks that are using Standardised Approach (SA) for credit risk (157 bps on simple average CET1 capital). However, the impact on provisions is smaller on the SA banks (7,4%) than on the IRB banks (11,4%). It must be noted, that the EBA impact assessment is closely linked to the expected macroeconomic outlook and due to recently downwards revised economic projections, the actual impact might be more tangible.

6. Completing the Banking Union

In a speech in London the 30 October, A. Enria stated that "*I believe the most urgent priorities that the banking union faced have been addressed. (...) Notwithstanding these achievements, we have to acknowledge that the banking union is still an incomplete construct*". As elements necessary for an effective Banking Union, A. Enria points to:

[7] The trading book comprises of financial instruments, foreign exchange, and commodities that are available for sale and hence, under Basel requirements must be marked-to-market on a daily basis. Contrary, the banking book comprises of similar assets that are expected to be held to maturity, therefore, are not required to be marked to market and are usually held at historical cost.

[8] Output floor is a limit on the amount of capital benefit that a bank can obtain from its use of internal models, relative to using the standardised approaches.

[9] The need for banks' to adjust their balance sheets would lead to a temporary contraction in loan supply, which, according to the EBA estimation, will result in the average annual GDP growth being 0,2 percentage points lower in the first 4 years.

[10] Based on EBA estimation, the implementation of Basel III reforms will have net benefits of around 0,6% of annual GDP level.

(i) Further deepening the single rule book and in particular, ensuring that the SSM is not "*forced to apply different decisions to similar situations*";

(ii) Complete the third pillar of the Banking Union (EDIS), to avoid two identified shortcomings of the current situation: (a) reinforce depositors confidence as to their level of protection to avoid deposits dislocation due to perceived weaknesses in some systems; (b) mitigate home-hosts concerns (to allow dismantling ring fencing measures imposed during the crisis and foster integration);

(iii) Facilitate the removal of "*the excess capacity still in the system*" where supervision "*should ensure that the merged entities provide sufficient reassurance about their capital trajectory, the sustainability of their business plan and the effectiveness of their governance arrangements*" and should not be an obstacle to "*healthy transactions*". A. Enria reported that supervisors are beginning to simplify their administrative processes and on making actions transparent and predictable - and "*stabilise our way of operating*" after actions that were seen by market participants as simply raising capital requirements.

Below additional information can be found on the main themes identified.

(i) The deepening of the single rule book

Further harmonising the single rulebook in banking has been supported by the ECB in the past. In particular, the then Vice Chair of SSM, Sabine Lautenschläger, in a speech in January 2016, identified a number of areas (notably, fit and proper requirements) that would merit further harmonisation, insofar coordination and cooperation are insufficient. Looking forward at implementation of the Banking package, **it might be interesting to further understand where the ECB considers the single rule book is not sufficiently harmonised and where amendments are necessary**. It should be noted that in a recent report assessing risks and vulnerabilities of the EU banking sector, EBA points for considering further harmonising application of capital buffers across the EU: differences in the application and setting of the O-SII buffer are creating unlevel playing filed and may pose hurdles for cross-border mergers.

For **further information** on the single rulebook, see EGOV Briefing: "Banking Union: completing the Single Rule Book (July 2019).

(ii) Completing the third pillar of Banking Union

In line with the December 2018 Euro Summit, a High Level Group on EDIS has been set up by the Eurogroup. By June 2019, no concrete conclusions were reached, but an interim report under the authority of its Chair outlined "*where further work could be done in the coming institutional cycle*" for a steady state Banking Union. This includes the design of EDIS, home/host issues (i.e. liquidity and solvency waiver), insolvency law and resolution as well as the regulatory treatment of sovereign exposures (RTSE). The Eurogroup is expected to come up with proposals ahead of the December 2019 Euro Summit. At its November 2019 meeting, the President of the Eurogroup noted that "*this is still a difficult discussion and we will need to move step by step*". In November Ministers were updated by the Chair of the HLWG on latest progress and informed of further work planned until December. The President of the Eurogroup noted after the meeting that discussions are focusing on "*the features of a steady state banking union, including a fully-fledged EDIS but also other elements such as insolvency laws, cross-border integration, regulatory treatment of sovereign exposures and a safe asset*." He also referred that Ministers took note of a German paper and that he sensed "*a new mood in the room and I hope that next month we will be able to agree on a roadmap to start political negotiations on this very important file.*". Nevertheless, in its December meeting in inclusive format, Ministers failed to make significant progress on EDIS. The letter (dated 3 December 2019) of the HLWG Chair to the Eurogroup President sets out a roadmap covering the four areas identified earlier and foresees continuation of technical and political discussions on the main features and set-up of EDIS. The Eurogroup President letter to the President of the Euro Summit refers Ministers took note of the report and that work would continue with a further report foreseen for June 2020.

(iii) Addressing "excess capacity" in the banking system

ECB stance towards excess capacity has been set out at a number of times. In the ECB Supervisory Letter of November 2019, A. Enria notes that "*The sector needs to consolidate*. (...) "*as a supervisor it is not my job to actively promote – or discourage – any form of bank consolidation.*". He also points out that "*It is true that there is excess capacity in the European banking sector, and this has been the case for quite some time now. Instead of exiting the market, many weak banks drag on and put pressure on margins for all other banks. As a result, European banks are less profitable than they could be.*". The banks business models sustainability has been identified by the ECB as one of its priorities for 2020 in October 2019. ECB further refers that it will "*continue assessing banks' business models and profitability, also in the light of increasing digitalisation, complemented by horizontal analyses*.". **Further information on how supervisors intend to address these risks might be warranted**.

The December HLWG Chair letter to the Eurogroup President also addresses cross border integration as part of the roadmap to completing the Banking Union (spanning until 2024). Three avenues for work are identified:

(a) Assessing the current state of play on obstacles to further integration including an impact assessment of the effect of gradually removing the identified obstacles and on potential safeguards,

(b) Assessing potential measures to enhance cross-border integration (including further incentivising geographical diversification in prudential regulation and whether adjustments to prudential requirements - risk weighted assets (RWA) and leverage ratio - within a group are unduly inflated due to internal MREL) and if adjustments to prudential requirements are justified to strengthen cross-border integration,

(c) Stocktaking the use of existing capital and liquidity waivers and treatment of intragroup flows in the liquidity coverage ratio, the obstacles to "branchification" and the impediments of operationalising resolution strategies in relation to cross-border banking groups.

For **further information on the completion of the Banking Union**, see:

- EGOV Briefing "Banking Union: what next?" (July 2019)
- EGOV Briefing "Banking Union: defusing the home/host debate" (July 2019).

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