BRIEFING

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

ECON on 4 September 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 4 September 2019.

The briefing addresses (i) the role and tasks of the Single Supervisory Mechanism (SSM), (ii) individual cases that merit particular supervisory attention; (iii) institutional and organisational issues (Extension of the Banking Union to Bulgaria and Croatia, and memorandum of understanding between the European Court of Auditor (ECA) and the ECB); (iv) the risk assessment of Banking Union banks with a particular focus on leveraged loans, NPL, profitability and sovereign exposures (v) supervisory issues and policies (finalisation of Basel 3 and review of internal models, SSM Supervisory Review and Evaluation Process and transparency of stress tests further to the recently published report from the ECAs: (vi) policy developments and supervisory issues raised on the AML front; (vii) Brexit.

On a more prospective note, this briefing also presents (viii) an external paper on "Lessons from the United States for banking resolution in the Banking Union" which advocates harmonisation and centralisation of bank insolvency proceedings in the Banking Union.

1. Role and tasks of the SSM

The Single Supervisory Mechanism (SSM) is, along with the Single Resolution Mechanism (SRM), one of the pillars or the Banking Union. All **euro area Member States** automatically participate in the SSM. The ECB is responsible for the direct supervision of the most **significant banks** (also referred to as "significant institutions"), which hold almost 85% of total banking assets in the euro area, and for the indirect supervision of all other banks, through National Competent Authorities (NCAs).

The planning and execution of tasks conferred to the SSM is entrusted to an ECB internal and independent body, the Supervisory Board.

The ECB is - in its supervisory role - accountable to the European Parliament and to the Council. Details of its accountability towards the Parliament are laid down in Regulation (EU) No 1024/2013 and in an Interinstitutional Agreement (IIA) between the European Parliament and the ECB. The Chair of the Supervisory Board presents the **annual report** in public to the EP, participates in public **hearings** and may hold **confidential oral discussions,** replies orally or in writing to **EP's**

ECONOMIC GOVERNANCE SUPPORT UNIT (EGOV)
Authors: J. Deslandes, C. Dias, M. Magnus
Directorate-General for Internal Policies

PE 634.378 - 30 August 2019

EN

questions[1] and provides ECON with records of proceedings of all Supervisory Board meetings, including a comprehensive and meaningful account of the Supervisory Board's discussions and an annotated list of its decisions.

For further reading see EGOV briefings "The Single Supervisory Mechanism - Main Features, Oversight and Accountability" and "Single Supervisory Mechanism - Accountability arrangements and legal base for hearings in the European Parliament".

2. Individual cases

Based on information in the public domain, this section gives details on banks whose overall financial or operational performance merits particular attention.

AS PNB Banka

On 15 August 2019, the ECB declared AS PNB Banka in Latvia to be failing-or-likely-to-fail, following the identification of significant capital shortfalls. AS PNB Banka was the sixth-largest bank in Latvia, with total assets of EUR 550 million and total deposits of around EUR 470 million.

AS PNB Banka has notably been in breach of capital requirements since the end of 2017. The bank's debts exceeded its assets and its capital adequacy ratio was below the required minimum. The bank had been called on by the NCAs to restore compliance with prudential requirements on several occasions but consistently failed to implement remediation measures.

The ECB took over direct supervision of AS PNB Banka on 4 April 2019, at the request of the Latvian supervisor. On 25 July 2019, the bank published its audited financial statement for 2018, for which the external auditor had only issued a qualified opinion, stating inter alia that the bank did not recognise sufficient allowances for expected credit losses on loans to and receivables from customers, and that the bank did not recognise sufficient provisions for the impairment of tangible fixed assets. On 12 August 2019, the ECB concluded an on-site inspection, which identified a substantial provisioning shortfall and found objective elements indicating that the assets of the bank were less than its liabilities. The bank failed to provide evidence that it would be able to replenish its capital in line with the timeline under the early intervention decision. AS PNB Banka was hence unable to satisfy requirements for continuing authorisation.

Following the ECB's failing-or-likely-to-fail assessment, the Single Resolution Board determined on 15 August that resolution action was not necessary in the public interest, and announced that the bank will be wound up under national law.

PNB Banka's shareholders and management, however, issued a press statement on 18 August according to which they will contest the opening of insolvency proceedings in the Latvian courts, claiming that the bank is currently solvent, that its liquidity position is good, and that the SRB has no decision-making power as regards a liquidation under national law.

The Latvian supervisor filed a court application for the opening of insolvency proceedings against PNB Banka on 22 August.

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 and that has a capital shortfall.

For the year 2018, NordLB posted a substantial loss that reduced its CET1 ratio to 6.82% at the end of 2018, way below its supervisory CET1 requirement (pillar 1, pillar 2, and buffers) of 9.60%.

[1] The ECB makes available in its website the responses to such questions.

In April 2019, NordLB, its owners and the Savings Banks Finance Group have agreed on a plan to modify its business model and to increase the bank's capital position, requiring a total cash injection[2] of EUR 2.8 million. Two German federal States shall participate in that capital increase, Lower Saxony with EUR 1.5 billion and Saxony-Anhalt with EUR 200 million. The savings banks shall contribute EUR 1.1 million. All measures will be subject to a State Aid decision. It must be noted that comparable measures coming from public sources were previously found to be State Aid.

What makes the new capital increase different from previous support measures is that the capital will not only come from its owners and shareholders but partially also from the savings banks' mutual support network, to which all German "Landesbanken" and savings banks belong and that is recognized as an Institutional Protection Scheme (IPS), which has a double function: it serves as a mutual protection system and as a deposit guarantee scheme (DGS) in accordance with the DGS Directive.

Article 11(3) of the DGS Directive sets out that "*Member States may allow a DGS to use the available financial means for alternative measures in order to prevent the failure of a credit institution*". However, the current State Aid rules for aid to banks, dating back to 1 August 2013, set out that "*Interventions by deposit guarantee funds to reimburse depositors in accordance with Member States' obligations under Directive 94/19/EC on deposit-guarantee schemes do not constitute State aid. However, the use of those or similar funds to assist in the restructuring of credit institutions may constitute State aid. Whilst the funds in question may derive from the private sector, they may constitute aid to the extent that they come within the control of the State and the decision as to the funds' application is imputable to the State*." A recent ruling by the European Court of Justice points out, though, that one cannot simply equate IPS capital support with State Aid. The Court overturned the Commission's 2015 ruling in case of Banca Tercas that had received support measures by the Italian deposit guarantee fund that were assessed to be State Aid by the Commission. Commission appealed that Court decision. The pending decision in case of NordLB may hence further clarify to what extent IPS contributions actually constitute State Aid.

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[3] 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. As the package of support measures still has to be approved by the current main shareholder, an extraordinary shareholder meeting was convened for 20 September 2019.

2 In addition, NordLB shall benefit from further guarantees by Lower Saxony saving EUR 800 million in capital

3 See press statement of 9 August 2019.

Deutsche Bank

Deutsche Bank, the largest German bank with total assets amounting to EUR 1.437 billion and still among the five largest banks in the euro area, has been showing a weak financial performance over quite some time. In July 2019, the bank announced a fundamental restructuring plan that aims to cut cost and shed activities that are not profitable. To improve profitability, the bank will close its global equities sales and trading operations, scale back its investment banking, and over a four year period cut down its workforce by approximately 20% to 74.000 employees.

End of July, Deutsche Bank announced a net loss of 3.1 billion euros for the second quarter of 2019. The losses mainly resulted from charges related to its restructuring programme, in particular from valuation adjustments to Deferred Tax Assets of EUR 2 billion, impairments on goodwill that amount to EUR 1 billion, and EUR 350 million of impairments on software and provisions for existing service contracts.

The impact of those adjustments on CET1 capital, however, is small, as according to the Capital Requirements Regulation (CRR), intangible assets such as goodwill and Deferred Tax assets are deducted from capital anyway. The bank's CET1 ratio stood at 13.4% at the end of the second quarter, down by 0.3% to 13.7% on a year-to-year basis.

3. Institutional and organisational issues

Forthcoming enlargement of the Banking Union to Croatia and Bulgaria

Bulgaria and Croatia are in the process of joining the European Exchange Rate Mechanism II (and the Euro) and, consequently, the Banking Union. For this purpose, Croatia and Bulgaria requested to establish a "close cooperation" with the SSM, respectively in May 2019 and July 2018.

Banks that are expected to be directly supervised by the SSM are subject to a preliminary Comprehensive Assessment that comprises two parts, namely an asset quality review (AQR) - which assesses the actual values of banks' assets - and a stress test:

- Results for Croatian banks are expected in May 2020;
- In relation to Bulgarian Banks, following the AQR, two banks have seen a significant drop in their CET1 ratio, namely First Investment Bank AD (CET1 ratio down by 11.2 percentage points, from 15.7% to 4.5%), and, less critically though, Investbank AD (CET1 ratio down by 5.2 percentage points, from 15.2% to 10%). With significantly lower levels of capital available, those two banks ended up with negative CET1 ratios in the adverse scenario of the stress test, pointing to recapitalisation needs in the total amount of EUR 313 million.

As part of the Euro accession process, Croatia[4] and Bulgaria[5] committed to particular actions to enhance their supervisory framework.

[4] Regarding Croatia, the latest available Commission Convergence Report (May 2018) concluded the country was fulfilling all the criteria to join the euro. The ECB Convergence Report (May 2018) notes, in addition, that the country needs to address shortcomings in auditing, governance and accounting standards. In its letter of 4 July 2019 to the Eurogroup, ECB, and Commission, the Croatian Government and Central Bank make a number of commitments regarding the development of the macro-prudential framework, the comprehensive assessment of its banking sector, and strengthening of anti-money laundering legislation.

[5] Regarding Bulgaria, the latest available Commission Convergence Report (May 2018) concluded that "...*the legacy issues linked to weak governance, asset quality and supervision have not yet been fully dealt with*". In its letter of 3 July 2018 to the Eurogroup, ECB, and Commission, the Bulgarian authorities commit to develop the macro-prudential framework, enhance supervision of the non-banking financial sector, identify and address gaps in the insolvency framework, strengthen the AML framework, and improve the governance of state-owned enterprises.

Memorandum of Understanding between the ECA and the ECB

On 28 August 2019, the ECA announced that it has agreed a Memorandum of Understanding with the ECB on sharing sensitive bank-specific data for auditing purposes. The document is said to set out the arrangements for document and information exchange to guarantee full access to all the information needed to perform audits on the ECB's banking supervision. Previously, the ECA has repeatedly pointed to an "audit gap" due to a restricted access to information.

4. Risk assessment and analysis

Statistics

Since the second quarter 2016, the ECB publishes aggregate Supervisory Banking Statistics on directly supervised significant banks; the dataset regularly reports on general statistics, balance sheet composition and profitability, capital adequacy, leverage and asset quality, funding, liquidity, and data quality.

The most recent available data refers to the first quarter 2019, an overview of which is shown in table 1.

Table 1: Overview of key indicators from the ECB's Supervisory Banking Statistics

Main figures (EUR billions; percentages)	Q1 2018	Q1 2019	Change/diff.
Balance sheet composition			
Total assets	21.060,06	22.695,68	7,8%
Total liabilities	19.662,00	21.184,16	7,7%
Equity	1.398,06	1.511,51	8,1%
Key indicators			
Return on equity	6,61%	5,76%	-0,9%
Cost-to-income ratio	67,43%	69,18%	1,8%
Capital adequacy and leverage			
CET 1 ratio (transitional definition)	14,16%	14,34%	0,2%
Leverage ratio (transitional definition)	5,36%	5,40%	0,0%
Asset quality			
Level 3 as a share of total assets, measured at fair value	0,93%	0,84%	-0,1%
Non-performing loans ratio	4,70%	3,67%	-1,0%
Funding			
Loan-to-deposit ratio	118,64%	118,04%	-0,6%
Liquidity			
Liquidity coverage ratio	141,90%	149,71%	7,8%

Source: ECB Supervisory Banking Statistics

Compared to the situation one year ago, significant banks in the euro area have lately seen:

- a notable **decline in average profitability** and an increase of the Cost-to-Income ratio;
- a marginal improvement of the CET1 ratio;
- a further **improvement of the NPL ratio,** its lowest level since 2015.

Banks' profitability

Performance of banks in 2018 and more recently in Q2019 shows a diverging picture:

- **In 2018**, the profitability of banks, measured by Return on Equity (RoE), somewhat **improved** compared to 2017. According to SSM, RoE increased from 6.3% in 2017 to 6.7% in 2018;
- In **Q1 2019**, however, banks' RoE (5.8%) is **considerably lower** than in Q1 2018 (6.6%).

The SSM's analysis of banks' profitability in 2018 points to the "*lower net impairment flows from financial assets which partly reflect the ongoing reduction in NPL*" as key driver for the improvement. In terms of going forward, the SSM noted that "*in the coming years, banks will not be able to rely on* *lower impairment level to improve profitability*", and urged banks to improve operational efficiency (typically measured in terms of the Cost-to-Income ratio).

Looking at the ECB statistics[6] for Q1 2019, the recent notable decline in profitability seems to be mainly due to significant changes in "net other operating income and expenses", the residual category that typically includes company restructuring charges, results of run-off activities, and litigation charges. Related losses overcompensate positive developments in the banks' net interest income, which despite the low interest rate environment has increased by 4.5% on a year-to-year basis.

Non-Performing Loans (NPL)

NPLs significantly came down to their lowest level since 2015 (average of 3.67% for SSM banks in Q12019). Nevertheless, according to Andrea Enria, "the problem of NPLs is not solving itself – and it has not yet been resolved" (June 2019 speech). The SSM pointed to the following issues requiring closer supervision:

- **Stock of NPL** is still very high in particular in certain Member States. According to the May 2019 joint risk reduction monitoring report, this holds particularly true in particular in Cyprus, Greece and Portugal;
- In relation to **NPL Vintage**, "Many of the NPLs that we see on banks' balance sheets have been there for years". "For those banks with the highest levels of NPLs, more than half of their NPLs are older than two years and more than a quarter are older than five years";
- Inflows of **new NPLs** are still on the high side. According to the SSM, "It also seems that some banks with high NPLs are still reporting increasing default rates".

This led the SSM to "*urge banks to stem this inflow by rethinking their underwriting standards and engaging with distressed debtors*". While NPLs have not been resolved, the SSM remains positive and upbeat in view of efforts that banks are stepping up: "*looking at the most recent NPL strategies, their plans for the future are quite ambitious. Most importantly, they are particularly aggressive in dealing with the older vintages of NPLs. These strategies, by the way, are a formal part of the SREP, and our supervisory teams closely monitor and challenge the progress banks make. In 2018, many banks overshot the targets by more than 25%*".

On the policy side, the SSM has revised its supervisory expectations for prudential provisioning for new non-performing loans, aligning the provisioning time frames to the treatment set out in the April 2019 Regulation as regards minimum loss coverage for non-performing exposures. While the supervisory expectations for coverage of the stock of NPLs remain unchanged, NPLs arising from new loans (originated after that Regulation entered into force) are "*in principle subject solely to pillar 1 treatment*". This means that the SSM does not generally expect higher provisioning for those loans. However, the SSM further notes that it will "*pay close attention to the risk*".

In terms of completing the Banking Union, Eurogroups' terms of reference for the backstop to the Single Resolution Fund[7] condition its early introduction by 2020 on sufficient progress in risk reduction, as measured by quantitative targets in terms of NPL[8]. In that context, the **question is raised as to whether NPL reduction would be sufficient to allow for an early introduction of the backstop to the Single Resolution Fund**.

[6] See table "T02.01.1 Profit and loss figures by reference period" in the ECB' Supervisory Banking Statistics

[7] For further background information on the backstop to the SRF, see EGOV Briefing "Completing the Banking Union"

[8] "to be assessed with the aim of 5% of gross NPLs and 2,5% net NPL (i.e. ratio of NPL and advances net of allowances and credit risk adjustment to total net loans and advances) on all banks in the BU, and on adequate build-up of bail-inable liabilities". For further details about the backstop to the SRF, see EGOV Briefing 'Completing the banking Union (2015-2019).

Banks' holding of sovereign exposures

The May 2019 ECB financial stability review notes that "*banks' exposures to domestic sovereign debt were broadly stable on aggregate, but some banks remain vulnerable to a possible aggravation of sovereign risk concerns***". "***Banks' holdings of domestic sovereign debt remain elevated or have even increased since early 2018 in some euro area countries, including Italy and Portugal*". According to the ECB, the capital position of banks with sizeable holdings of fair-valued sovereign bonds remain vulnerable to sudden increases in sovereign risk premia.

At the March 2019 ECON Committee hearing, the Chair of the SSM committed to taking supervisory measures in relation to banks' holding of sovereign exposures: "*when I was at the EBA and there was an excessive problem of sovereign exposures at European banks, we took the responsibility of imposing a, what we called then, a buffer, a capital buffer under Pillar 2 to take care of these excessive risk. So this has been done in the past. That can be done in the future*".

Leveraged loans

The increased volume of "leveraged finance[9]" has recently led US, EU, and international supervisory authorities to caution against related financial stability risks. In November 2018, the **International Monetary Fund** (IMF) issued a strong warning. For more detailed information, see EGOV briefing "Leveraged finance: a supervisory concern in the Banking Union?" (March 2019). In a supervisory letter published in May 2019 ("Keeping an eye on banks' leveraged lending"), the SSM mentioned that it will continue to "assess the potential need for further action".

5. Supervisory issues and policies

Banks are likely to face significant capital needs in a near future, driven in particular by future legislative developments (i.e. finalisation of Basel 3). In contrast, the 2018 SREP exercise indicates that additional supervisory capital requirements are stable. Further disclosure, as recommended by the European Court of Auditors (ECA), would help understand banks' capital planning.

Future capital needs arising from the finalisation of Basel 3

According to EBA, the full implementation of Basel III in the EU, under the most conservative assumptions, increases the weighted average minimum capital requirement (MRC) by 24.4%, leading to an aggregate capital shortfall of EUR 135.1 bn (of which 91,1bn of CET1). The final Basel III minimum requirements are expected to be implemented by 1 January 2022 and fully phased in by 1 January 2027. Commission is preparing a legislative proposal.

Importantly, the final Basel III rules introduce an "output floor" that limits the amount of capital benefit a bank can obtain from its use of internal models, relative to using the standardised approaches. That output floor applied to risk-weighted assets purports to "*reduce excessive variability of risk-weighted assets and to enhance the comparability of risk-weighted capital ratios*". In other words, banks' calculations of risk-weighted assets deriving from internal models cannot, in aggregate, fall below 72.5% of the risk-weighted assets computed by the standardised approaches. This limits the benefit a bank can gain from using internal models to 27.5%. For a presentation of the Final Basel rules, see Basel Committee's presentation and EGOV Briefing.

[9] The concept of "leveraged finance" refers to transactions that entail an elevated risk for the lenders or investors providing the funds, and it comprises: (i) leveraged loans - loans to highly indebted firms or to firms that are owned by financial sponsors (private equity investment firms), and (ii) high yield bonds - bonds issued by firms with a non-investment grade credit rating, by highly indebted firms, or by firms with otherwise elevated risk (e.g. start-ups). Leveraged loans are typically used to finance a buyout, merger or acquisition.

The capital impact is almost entirely driven by large globally active banks[10] (See Table 2). The main drivers of that capital increase are (i) for large banks the output floor as well as the new prudential framework for operational Risk and (ii) for smaller banks changes to the standardised approach to credit risk.

Table 2: Impact of Basel III on banks' capital position

Scope	Current CET1 Capital	Revised CET1 ratio	CET1 shortfall (EUR bn)	T1 capital shortfall	Total capital shortfall	Tier 1 MRC change[11]	Impact of Output floor
All banks	14,4%	11,5%	**91,1**	127,5	**135,1**	24,4%	9,1%
Large	14,2%	11,4%	91.0	126,8	134,1	25.0%	**9,5%**
Of which G-SII	12,7%	9,9%	**53,5**	69,0	**82,8**	28,6%	7,6%
Of which O-SII	15,4%	12,5%	33,6	51,5	43,8	23,6%	12,1%
Medium	17,4%	15,2%	0,1	0,8	0,9	11,3%	0,9%
Small	17.0%	16.0%	0.0	0.0	0,1	5,5%	0.0%

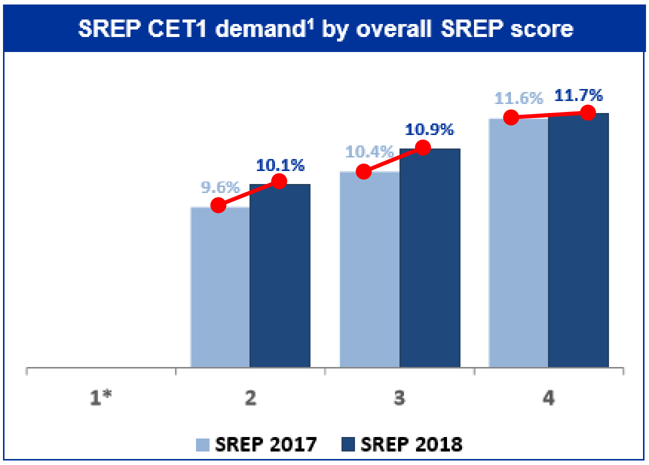
Source: EBA

Outcome of the 2018 SREP process

The Supervisory Review and Evaluation Process (SREP) is an annual "holistic assessment" of the banks' strategies, processes and risks, in which the ECB takes a forward-looking view to determine how much additional capital each bank needs to cover its specific risks. The SREP exercise is therefore of key importance to make the banks in the euro area safe and sound.

The ECB communicates individual SREP results only to banks. In April 2019, however, the ECB published an overview of its SREP for 2018, depicting aggregate results. That overview shows that the average overall demand for all banks (pillar 1 + pillar 2) increased from 10.1% CET1 capital in 2017 to 10.6% CET1 in 2018. The average increase, however, is not due to higher supervisory demands, but solely[12] due to higher legal Capital Conservation Buffer (CCB) requirements phased-in in 2018.

Graph 1: Comparison of 2017 and 2018 SREP capital demands for banks on four-grade scale



Source: SSM SREP Methodology Booklet - 2018 SREP decisions applicable in 2019 - p. 6 (red lines amended)

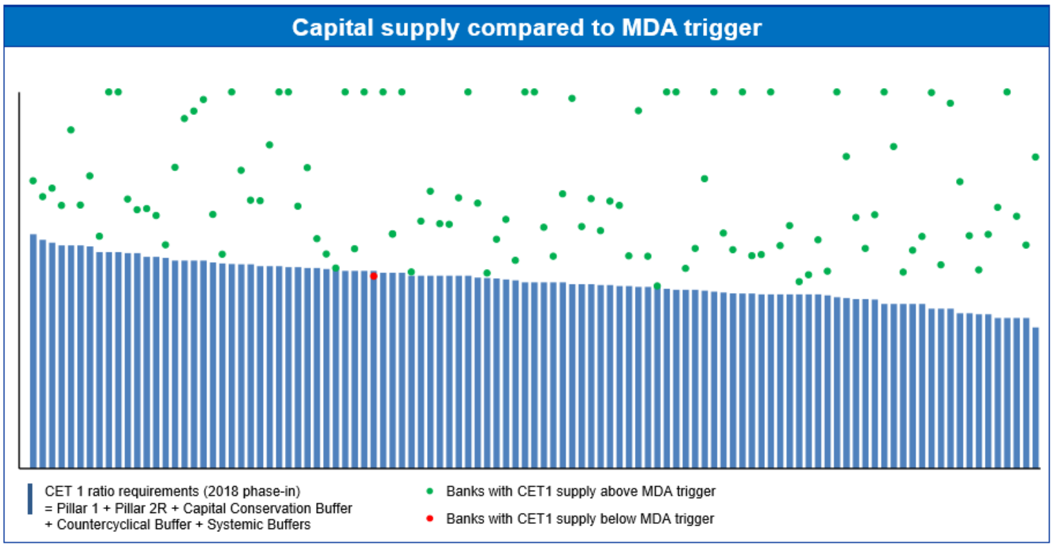
10 90% of the 135bn shortfall relates to 75 significant institutions, and about 60% falls on the 8 EU Global Sifis.
11 As % of current minimum capital requirements (MRC).
12 The phase-in of the CCB counts for on average +50 bps , P2R increases by 10 bps, and P2G decreases by 10 bps.

The ECB groups banks according to their individual risk profiles on a four-grade scale. As one would expect, riskier banks (category 4) hold on average more capital than less risky banks. As shown in graph 1, however, the riskier banks (category 4) have seen a considerable smaller increase in total capital demands (10 basis points) than less risky banks (50 basis points).

Most banks have actually capital levels above the demanded level. That additional capital is needed to meet additional buffer requirements, or market expectations.

The ECB overview contains a graph depicting - in anonymised form - the actual levels of capital versus the demanded level of capital (see graph 2).

Graph 2: Actual capital levels versus capital demands



Source: SSM SREP Methodology Booklet - 2018 SREP decisions applicable in 2019 - p. 10

The ECB graph showing actual versus demanded levels of capital, however, has **shortcomings**:

- The vertical in the graph has no label, no scale, and the zero line is not shown; it is therefore not possible to say by what extent the actual levels of capital exceed the demanded level.
- The graph makes clear that at least one bank does not meet the level of capital demanded by the supervisor (point in red). The visual impression suggests that in at least four cases the actual levels of capital are very close to the capital demands, but due to the lack of scaling it is impossible to tell how tight the situation actually is.
- The observations have to be counted manually to check completeness (107 points in the graph). The number of banks directly supervised by the ECB is larger.

The ECB overview does not seem to disclose information as to which exact bank has a capital level below the MDA (Maximum Distributable Amount) threshold, even though that information is potentially of public interest since it ought to be subject to certain restrictions on dividend and coupon payments. In that respect, the then Chair of EBA, Andrea Enria emphasised that "*the shift from bail-out to bail-in and the "maximum distributable amount" (MDA) – the notion that banks unable to meet the capital requirements and macroprudential buffers are confronted with restrictions to the payments of dividends and coupons on capital instruments – have important implications for market dynamics since the decisions of the supervisory authorities directly affect the payoff of several banks' stakeholders. However, disclosure of supervisory measures – mainly of Pillar 2 requirements and guidance – is still debated and there is no common EU approach*".

Need for further transparency of stress test and pillar 2 as recommended by the ECA report

In July, the European Court of Auditors (ECA) published its Special report on EU wide stress test that are regularly initiated and coordinated by the European Banking Authority (EBA). That report has a particular view on the EBA 2018 stress test exercise, which included and later on published detailed information about the individual results for in total 48 very large European banks, 33 of them under direct supervision of the ECB[13].

Overall, that report is 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 makes a number of concrete recommendations how to improve the methodology. A key point raised in the ECA report concerns the lack of information about the banks individual supervisory capital requirements: "*The EBA published a wide range of data on the stress-test results, thereby enhancing transparency. However, pillar 2 capital requirements, and therefore the overall capital requirements were not published. Thus, the most crucial information for understanding the implications of the stress tests was not available*."

It must be noted that at the December 2018 ECON hearing, Andrea Enria **committed to promoting disclosure of supervisory information** as Chair of the SSM**:** "*I know this is controversial in the supervisory community, but I am convinced that wider disclosure of supervisory requirements and buffers would prove beneficial for market discipline*".

6. Anti-money laundering

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. Recently, the Commission has assessed the existing framework on its July 2019 Communication and related reports[14], but has refrained at this stage from proposing new actions. In contrast, the ECB has in the past advocated a new EU body responsible for AML (26 March 2018 ECON Committee hearing). For further information on the policy debate regarding a possible strengthening of the AML supervisory architecture, see EGOV Briefing.

The ECB has made clear in the past 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), which was adopted by the European Parliament in April 2019 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 (letter dated 3 May 2018 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[15] and fit and proper assessment. In addition, the ECB has set up an internal "AML

[13] The ECB also applied the EBA methodology for its internal stress test exercise, covering an additional group of 54 medium-sized banks under direct supervision; those results, however, were only made public in aggregate form.

[14] 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.

[15] 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.

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.

7. 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 a recent publication (Brexit: stepping up preparation), the SSM 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). More recently, 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*".

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.

8. Completing the BU

The need for a comprehensive approach

Further to the conclusions of the December 2018 Euro Summit, the High Level Working Group (HLWG) on European Deposit Insurance Scheme (EDIS) mandated by the Eurogroup has not reached, in June 2019, concrete conclusions, but 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 supervisory issues, insolvency law and resolution as well as the regulatory treatment of sovereign exposures. As the Chair of the HLWG put it, "*progress will be needed in all areas and therefore a comprehensive approach building on a package of measures is needed*". This echoes concerns expressed by the Chair of the SSM: "*the banking union is far from complete and the banking sector remains largely segmented along national lines. We need help from [...] legislators at the European and national levels to improve this situation*".

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).
- EGOV Briefing: "Banking Union: completing the Single Rule Book (July 2019).

Further integrating the EU crisis management framework

The Eurogroup is considering ways to improve the resolution framework. As reported by the Chair of the High Level Working Group HLWG on EDIS, "*Broad agreement exists on the need for a **harmonisation** of necessary parts **of bank insolvency law**, including with regard to cross-border groups and the ranking of creditors, while the toolbox for resolution might need to be expanded.*"

Further harmonisation of bank insolvency law in the EU has been advocated by the ECB, the SRB, the IMF and other international organisations, coupled, where appropriate, with new institutional developments:

- The Chair of the SRB, Elke König put it, *"the ultimate goal [...] must be to have in place an EU liquidation regime alongside an EU resolution regime*". In a hearing at the ECON committee, the Chair of the SRB portrayed that FDIC model as a way to wind up small and medium-size institutions while protecting insured depositors;
- In his introductory remarks at the European Parliamentary Week in February 2019, the Chair of the SSM, Andrea Enria, advocated "*a common framework for bank liquidation, enabling a smooth managed exit of defaulted banks from the market, as is the case in the United States, for instance*";
- As part of its July 2018 assessment of the Euro-Area, the IMF recommended to entrust the SRB with administrative liquidation powers, along the lines of the US Federal Deposit Insurance Corporation (FDIC).

In a paper commissioned by the ECON committee ("An effective Regime for non-viable banks: US experience and considerations for EU reform), Gelpern and Véron argue that EU policy makers can draw valuable insights from the US regime for non-viable banks, with the US experience giving support to arguments in favour of harmonisation and centralisation of bank insolvency proceedings and deposit insurance in the Banking Union.

The Commission announced in its April 2019 report on the BRRD review that it will particularly engage in a comprehensive discussion of a further possible harmonisation of insolvency law, "*tak[ing] into account the interaction with policy developments in relation to deposit insurance, including the work of the High Level Group established by the Eurogroup, and the review of the Deposit Guarantee Scheme Directive*". The Commission plans to establish a working group involving Member States, relevant stakeholders and representative of the European Parliament to further discuss its study on the differences between bank insolvency laws and on their potential harmonisation (to be published in autumn).

Further **harmonisation of insolvency law raises the issue of its interaction with EDIS, and the appropriate sequencing of harmonised insolvency rules**, where appropriate. In that respect, the Chair of the SRB suggested an incremental approach "*Proposals for harmonisation across the board will inevitably be fraught with political perils and resistance. An incremental approach – such as the one exemplified by the recent harmonisation of the ranking of unsecured debt instruments in insolvency – may be a more palatable solution. The ultimate goal, however, must be to have in place an EU liquidation regime alongside an EU resolution regime*".

For **further background information**, see EGOV Briefing "Further harmonising insolvency law from a Bank resolution perspective" and EGOV Briefing "Liquidation of Banks: towards a FDIC for the Banking Union?" (February 2019).

Disclaimer and Copyright

Contact: egov@ep.europa.eu
This document is available on the Internet at: www.europarl.europa.eu/supporting-analyses