BANKING SUPERVISION UNDER THE SSM

INTRODUCTION TO THE FUNCTIONING OF THE ESCB (ESCB INTRO)

FACULTAD DE CIENCIAS ECONÓMICAS Y EMPRESARIALES

UNIVERSIDAD DE VALLADOLID

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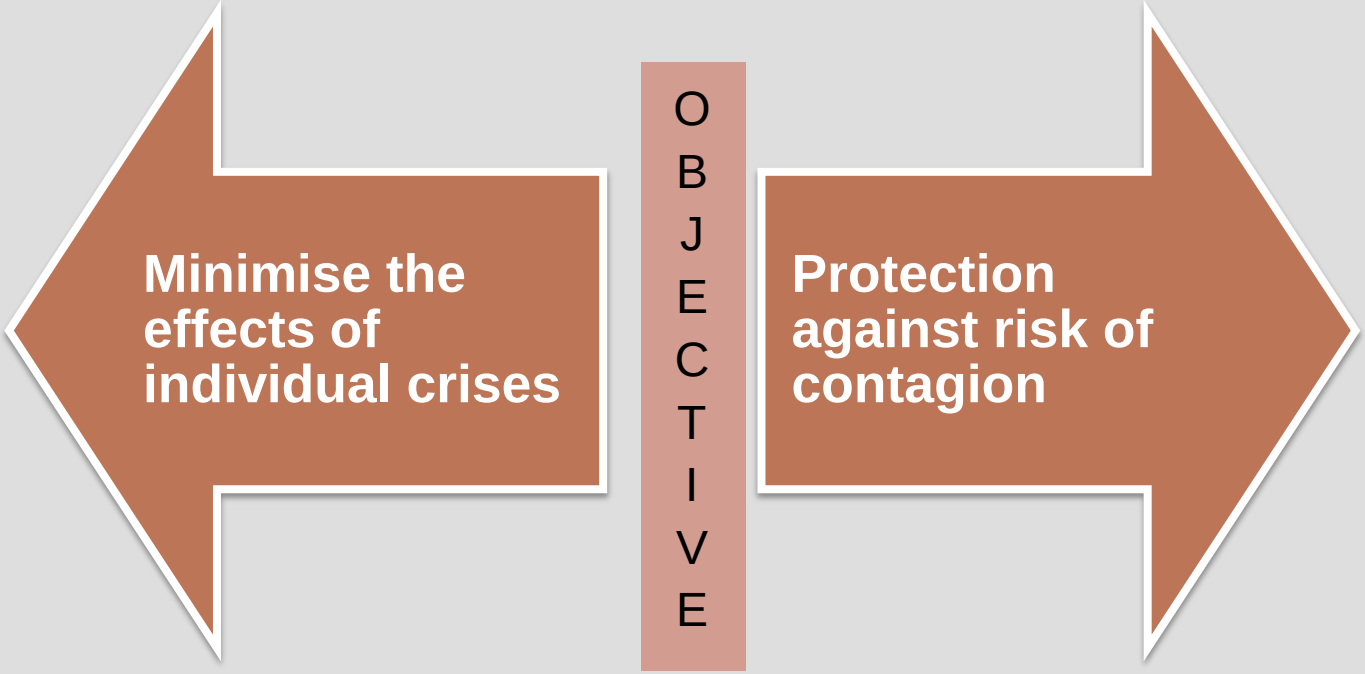
DIRECTORATE GENERAL BANKING SUPERVISION

The views expressed in this presentation are those of the speaker and do not necessarily represent the position of Banco de España

BANKING SUPERVISION UNDER THE SSM: INDEX

BANKING SUPERVISION – WHY?

- **Guarantee confidence** in the banking system
- Important **role** credit institutions play in **economic development**
- Highly **leveraged nature** of the banking business
- **Public's interest** in the proper functioning of the financial system



BANKING SUPERVISION - HOW?

Different models across EU

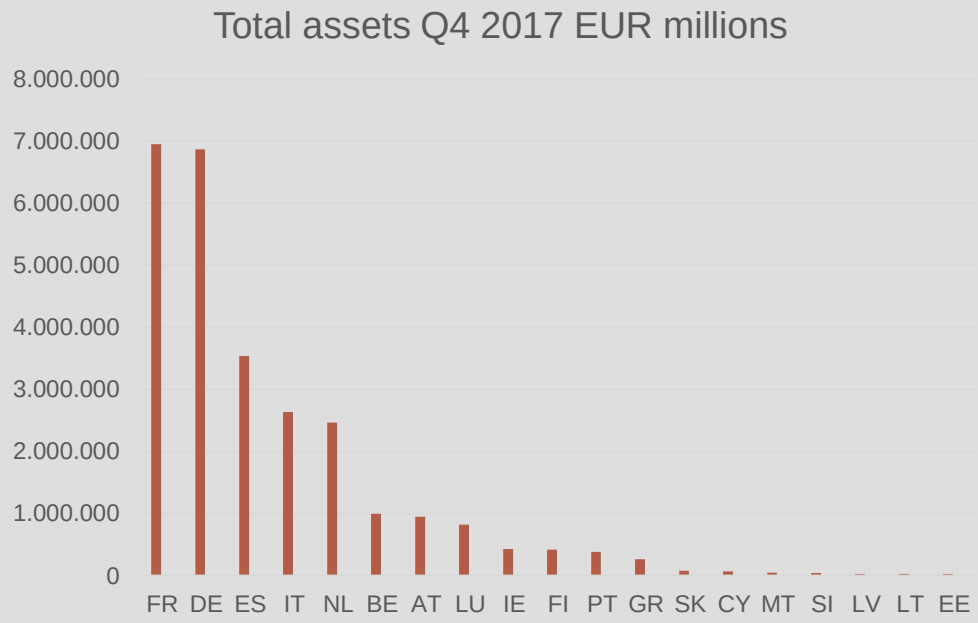
- **Separation of oversight powers by areas:** banking, securities and insurance. Spain, Italy,…
- **One supervisory agent:** jurisdiction over all financial sector. Luxembourg, Denmark,…
- **Supervision by responsibilities:** two agencies, one responsible for aspects of solvency and another responsible for the development of business and transparency ("Twin peaks"). Netherlands, Belgium, UK,…
- **Supervision in the Central Bank** (Spain, Portugal) **or Supervisory authority - Central Bank**: (Germany, Austria,…)

BANKING SUPERVISION - WHAT?

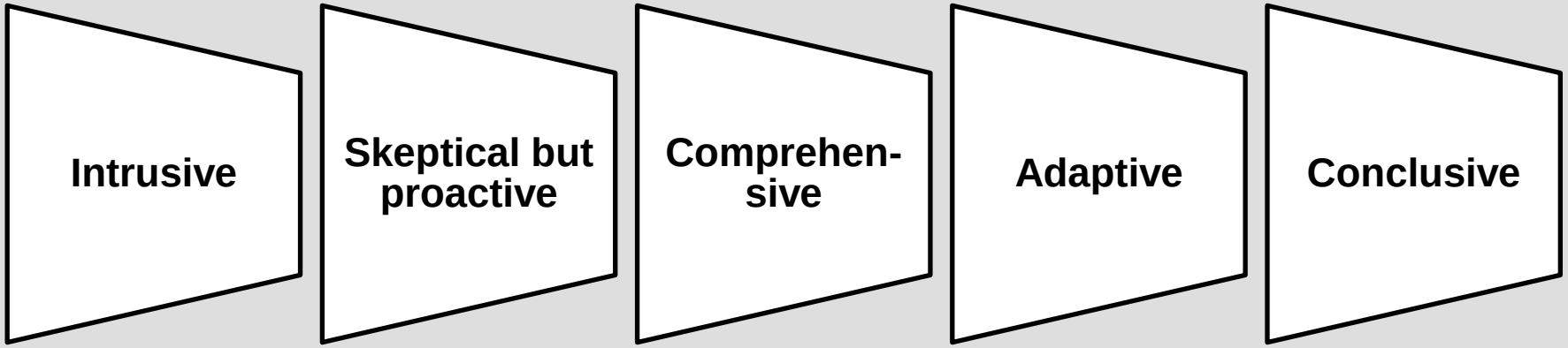
Credit institutions: "an undertaking whose business is to **receive deposits** or other repayable funds **from the public** and to **grant credits for its own account**" (CRD IV definition)

Total assets 2017Q4 EUR millions		%
FR	6.945.690	25,7%
DE	6.864.068	25,4%
ES	3.536.447	13,1%
IT	2.633.168	9,7%
NL	2.462.927	9,1%
BE	993.776	3,7%
AT	948.861	3,5%
LU	821.689	3,0%
IE	428.193	1,6%
FI	418.810	1,6%
PT	381.242	1,4%
GR	262.546	1,0%
SK	77.632	0,3%
CY	67.652	0,3%
MT	47.775	0,2%
SI	41.750	0,2%
LV	28.554	0,1%
LT	27.324	0,1%
EE	25.325	0,1%

TOTAL ASSETS € 27.013 Millions

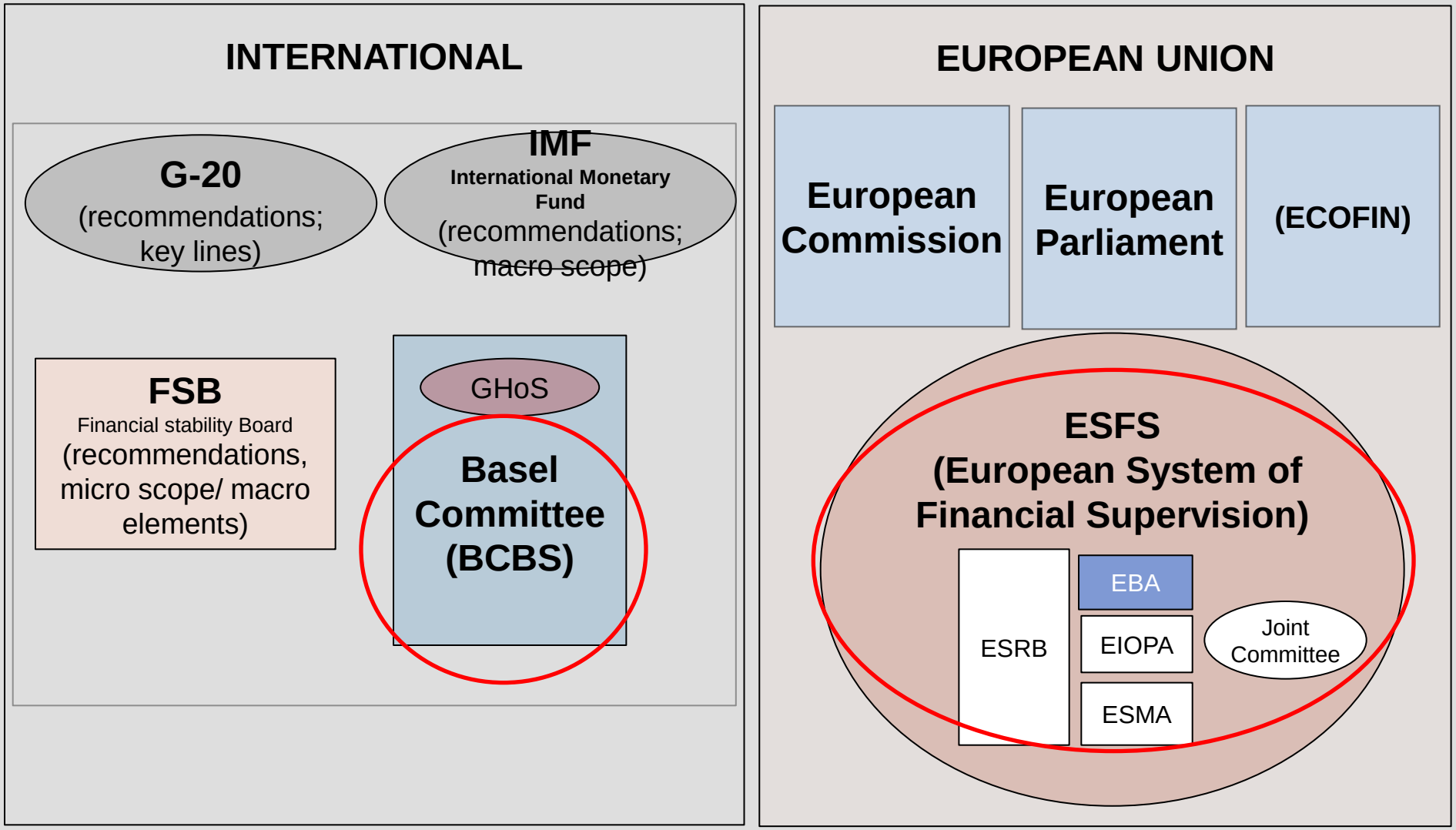


What is “good supervision”?



Ability to act	Will to act
• Legal authority • Adequate resources • Clear strategy • Robust internal organisation • Effective working relationships with other agencies	• Clear and unambiguous mandate • Operational independence • Accountability • Skilled staff • Healthy relationship with industry • Effective partnership with boards

3. INTERNATIONAL AND EUROPEAN SUPERVISORY FRAMEWORK



Basel Committee on Banking Supervision (BCBS)

- ✓ Aim: to enhance **financial stability** by improving **supervisory know-how** and the **quality of banking supervision** worldwide.
- ✓ Setting **minimum standards** for the regulation and supervision of banks.
- ✓ Decisions have **no legal force**.

Evolution of the Basel framework (1)

- **Basel I (1988)**
  - **Minimum capital requirements.** Focused principally on **credit risk**
- **Market Risk Amendment (1996)**
  - Capital requirements for **market risk**

Evolution of the Basel framework (2)

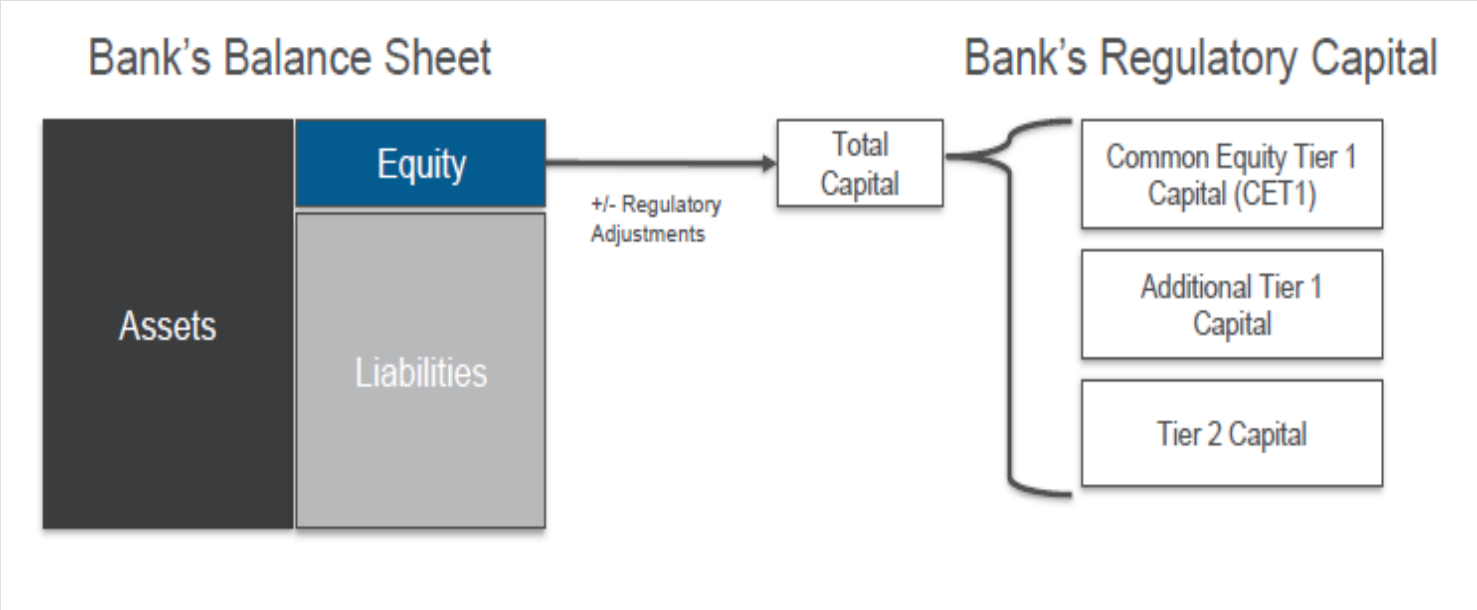
- **Basel II (2004)**
  - Capital allocation **more risk sensitive**
  - Capital requirements for **operational risk**
  - **"Three pillars"** concept: Pillar 1 - **Minimum Capital Requirements**
    Pillar 2 - **Supervisory Review**
    Pillar 3 - **Market discipline**
- **Basel III (2010)**

  Need for strengthening of the Basel II framework in view of weaknesses in the banking sector (**too much leverage**, **inadequate liquidity buffers**, **poor governance and risk management**).

  Main innovations:

  - **Additional buffers to capital** to **increase capacity to absorb losses.**
  - **Leverage ratio** (non-risk based).
  - **Liquidity requirements** to absorb shocks to funding.
  - Additional proposals for **systematically important banks**

5. REGULATORY CAPITAL



Generally two types of regulatory capital ratios:

- Risk Based Ratios = $\frac{Regulatory\ Capital}{Risk\ Weighted\ Assets\ (RWA)}$
- Leverage Based Ratios = $\frac{Regulatory\ Capital}{Measure\ of\ Total\ Assets}$

RWA << Total Assets

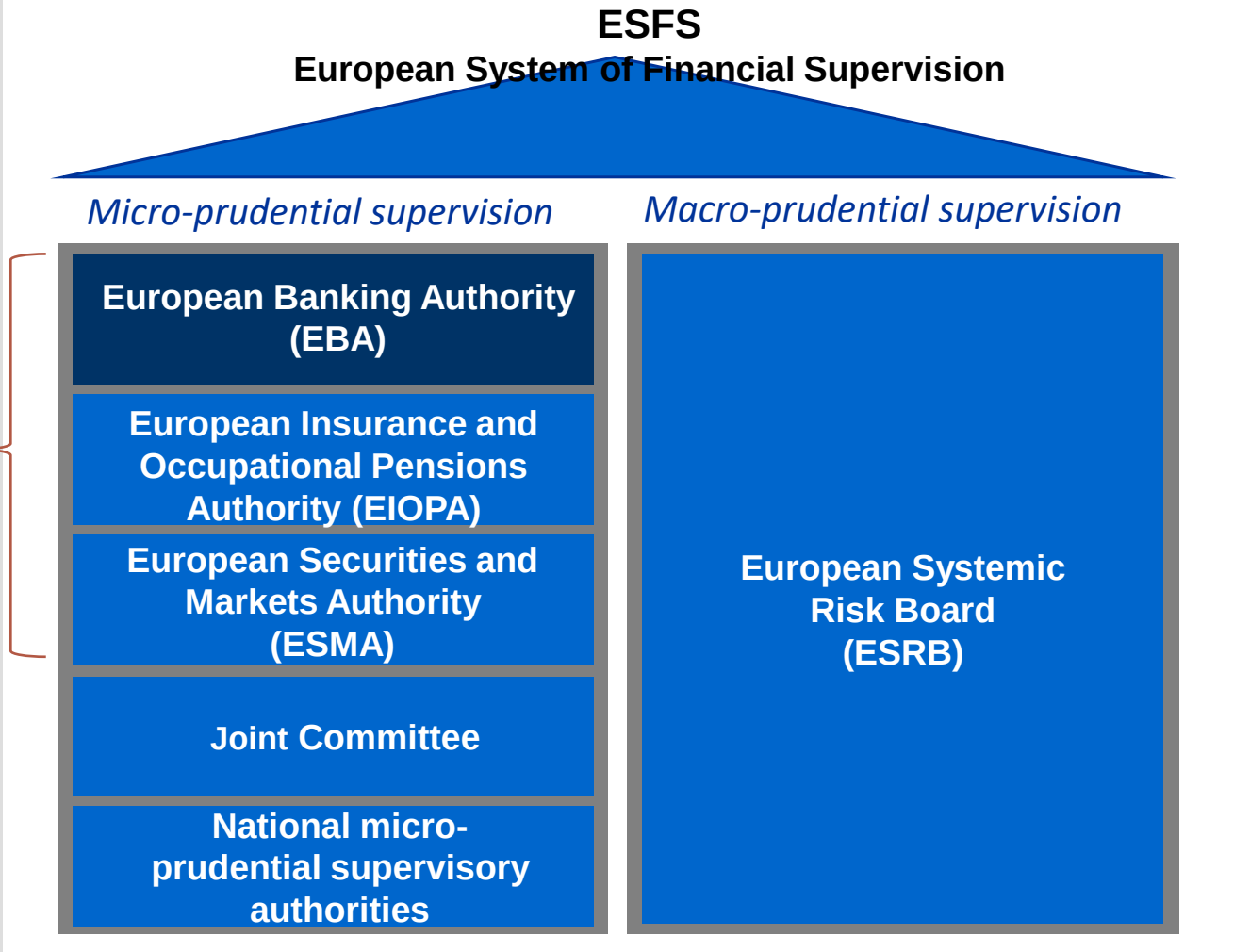
6. SUPERVISORY FRAMEWORK IN THE EU

- 2008: Mandate of the EC
- 2009: **Larosière Report**
- 2011: creation of the **European System of Financial Supervision (ESFS)**

ESAs

Objectives:

- Develop a **common supervisory culture**
- Facilitate a **single European financial market**

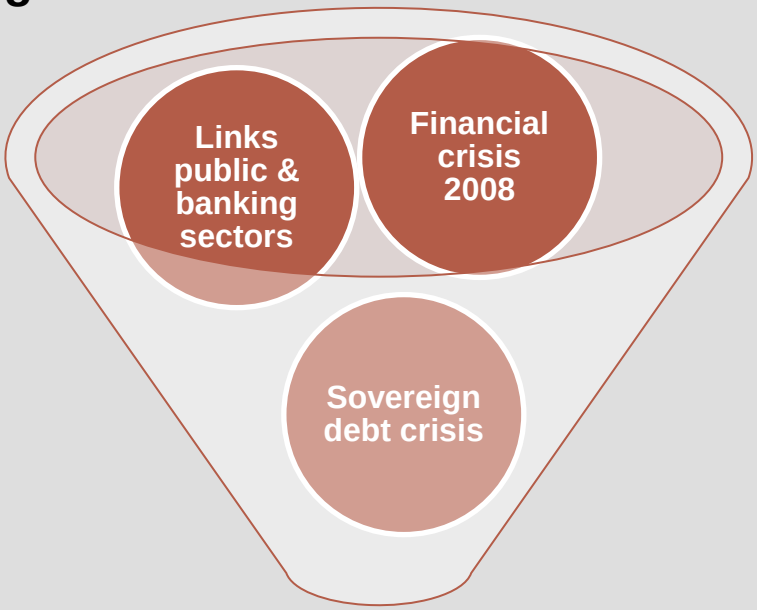


6. SUPERVISORY FRAMEWORK IN THE EU

- **EBA:** European **micro-prudential supervision** for **credit institutions**, financial conglomerates, investment firms and payment institutions.

  Tasks: sound, effective and consistent regulation and supervision; stability and effectiveness of the financial system; preventing regulatory arbitrage; equal level of supervision; consumer protection; international supervisory coordination. Drafts and implements technical standards, issues guidelines and recommendations.
- **EIOPA:** European micro-prudential supervision for **insurance undertakings**.
- **ESMA:** European micro-prudential supervision for **securities markets and their participating institutions**.
- **Joint Committee** of the ESAs: overall and cross-sectoral supervisory consistency.
- **ESRB**: **macro-prudential oversight** of the financial system as a whole. Prevention and mitigation of systemic risks to financial stability in the EU through issuing warnings and recommendations for action.

Why the Banking Union?



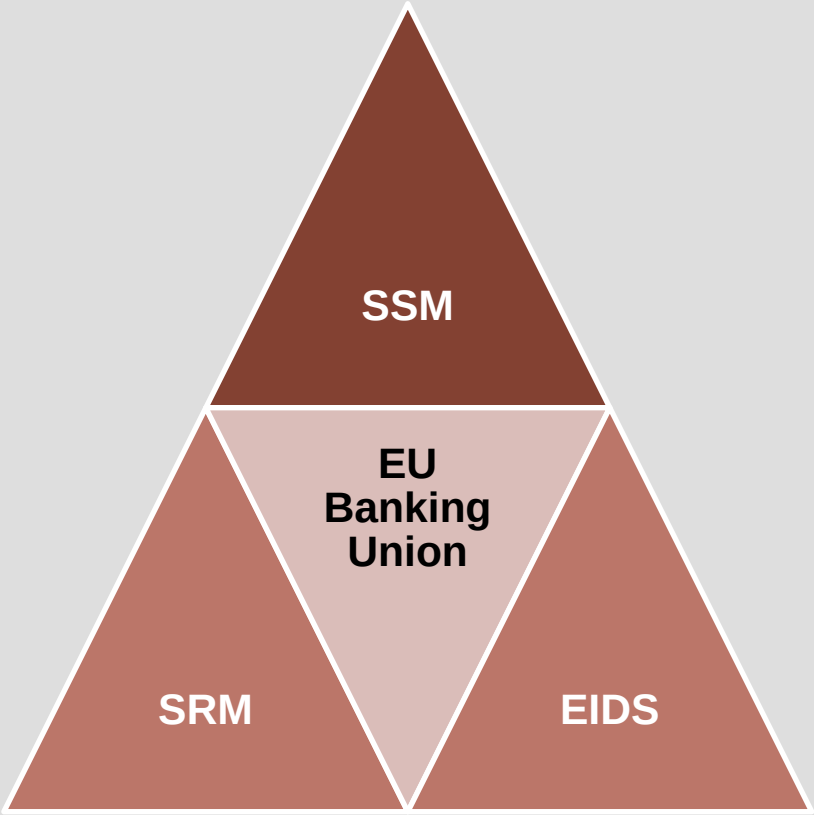
Problems can easily spill over national borders → **Financial distress in other EU countries**

The purpose of the Banking Union is to make European banking:

more transparent	by consistently applying **common rules and administrative standards** for supervision, recovery and resolution of banks
unified	by treating national and cross-border banking activities **equally** and by **delinking** the financial health of banks from the countries in which they are located
safer	by **intervening early** if banks face problems in order to help **prevent** them from failing, and – if necessary – by **resolving** banks efficiently

7. EU BANKING UNION

The EU Banking Union is based on the three following pillars:



- **Single Supervisory Mechanism (4.11.2014)**: system of financial supervision composed by the ECB and the NCAs of the participating member states.
- **Single Resolution Mechanism (31.12.2015):** designed to ensure that the resolution of a failing bank can be managed efficiently with minimal cost to taxpayers and the real economy.
- **European Insurance Deposit Scheme (under discussion):** new banking union-wide deposit insurance scheme

Banking Regulatory Reforms

BCBS - Basel III framework	Revised capital requirements + Leverage ratio. New liquidity requirements	**More capital** and of better quality Target **excessive leverage**
FSB – Too Big To Fail	Capital surcharges for G-SIBs. Total Loss Absorbance Capacity (TLAC)	Force banks to take into account their **systemic role**
EU – Bank Recovery and Resolution	Bank Recovery and Resolution Directive (BRRD) Single Resolution Mechanism (SRM)	Preference for **early intervention**. Orderly **resolution** only if necessary. **Bail-in** rules (private investors to bear costs of banks' failure

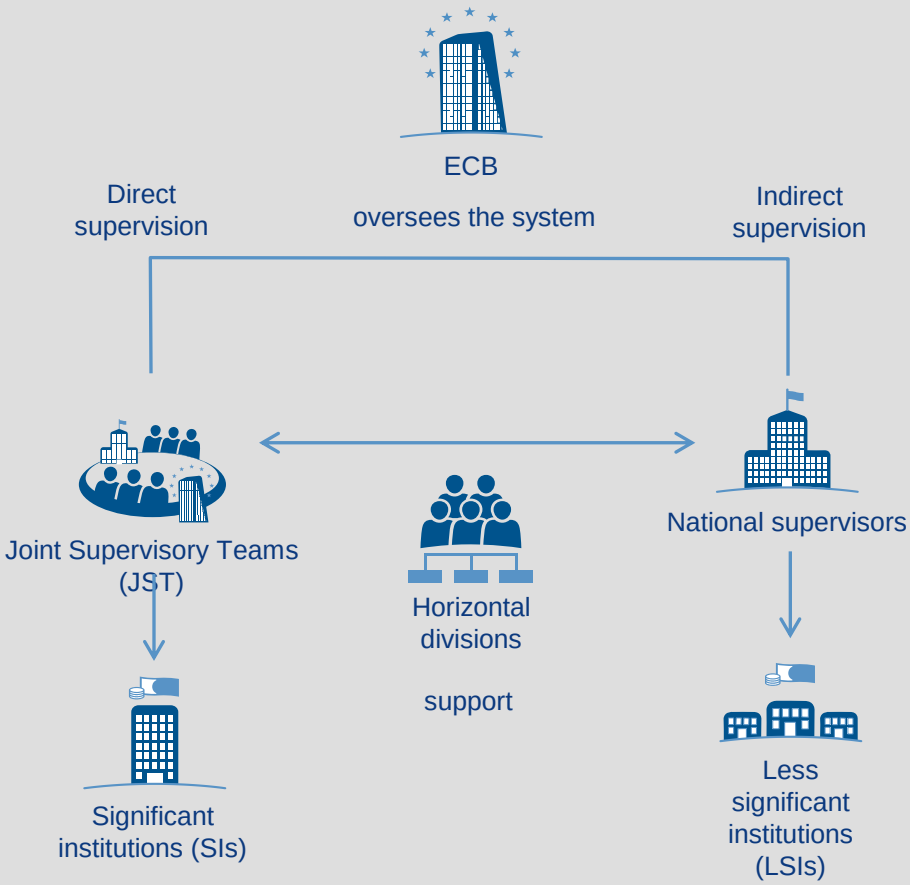
8. SSM - INTRODUCTION

Key steps to the launch of the SSM:

- **29 June 2012**: Euro area Heads of State or Government decide to **assign supervisory tasks to the ECB** within a **Single Supervisory Mechanism**.
- **12 September 2012:** **European Commission** presents **draft regulation** which assign specific supervisory tasks to the ECB (SSM Regulation). Roadmap towards banking union.
- **23 October 2013:** ECB starts **Comprehensive Assessment.**
- **3 November 2013:** **SSM Regulation** enters into force. Provides that the **ECB** assumes its **full supervisory tasks on 4 November 2014**.
- **15 May 2014:** **SSM Framework Regulation** comes into force. Legal structure for the ECB's cooperation with NCAs.
- **26 October 2014:** ECB publishes **results of Comprehensive Assessment.**
- **4 November 2014: SSM becomes operational**

The SSM is an integrated system of supervision based on cooperation between the ECB and National Supervisors (NCAs)

Distribution of tasks within the SSM



Key SSM facts

1. The Single Supervisory Mechanism (SSM) is one of the world's largest banking supervisors.
2. At Q1 2018 with 109 banking groups in 19 countries under direct ECB supervision – including 7 out of 30 G-SIBs. More than 80% of Euro Area Banking Assets under direct ECB supervision.
3. Circa 4,000 smaller institutions are directly supervised by the national competent authorities (NCAs), with the ECB being responsible for the system at large.
4. Banking assets under SSM supervision amount to more than 27 trillion euro (Q1 2018).
5. Key distinction: significant & less significant.

... focussed on prudential supervision

Responsibility of the ECB for institutions within the euro area

- Credit institutions and (mixed) financial holding companies
- Micro-prudential supervision

Key tasks

- Licensing, qualifying holdings, fit and proper, governance
- Own funds, liquidity, risk management, reporting
- Supervisory reviews, stress testing, recovery planning

- Early prudential intervention
- Macro-prudential supervision

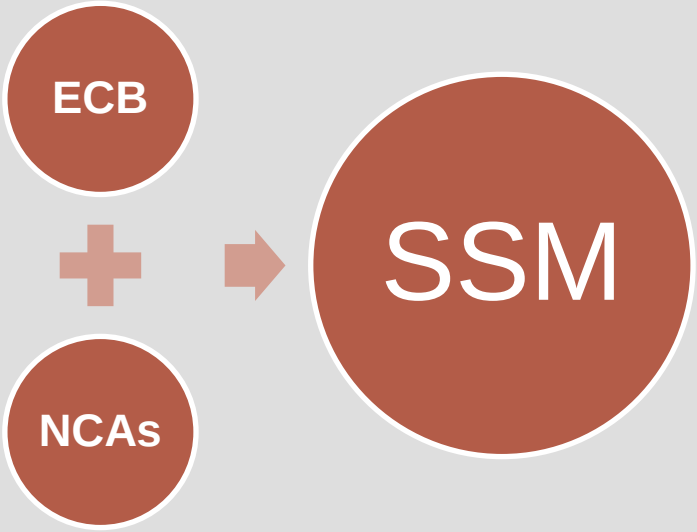
<u>Based on an exclusive competence of the ECB with regard to significant institutions</u>

No responsibility of the ECB

- Insurance undertakings, investment firms, payment services providers
- Resolution of credit institutions
- Consumer protection, money-laundering or terrorism financing[1]

[1] The ECB is competent for the smooth operation of payment systems (oversight function)

8. SSM - INTRODUCTION



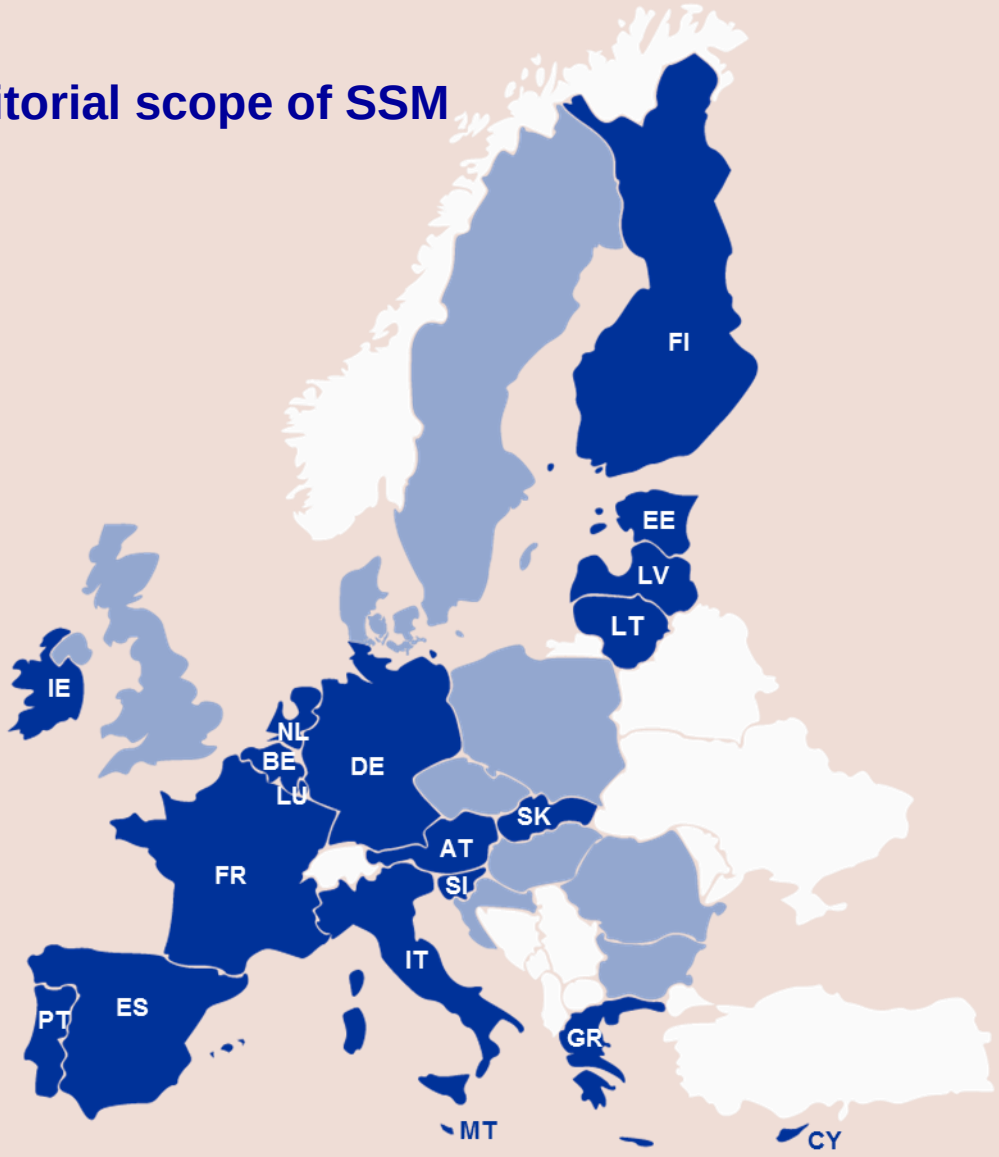
Responsible for the **prudential supervision** of **all credit institutions** in the participating Member States.

Three main objectives		
Ensure **the safety and soundness** of the European banking system	Increase **financial integration and stability**	Ensure **consistent supervision**

8. SSM - INTRODUCTION

Member State
Belgium (BE)
Germany (DE)
Estonia (EE)
Ireland (IE)
Greece (GR)
Spain (ES)
France (FR)
Italy (IT)
Cyprus (CY)
Latvia (LV)
Lithuania (LT)
Luxembourg (LU)
Malta (MT)
Netherlands (NL)
Austria (AT)
Portugal (PT)
Slovenia (SI)
Slovakia (SK)
Finland (FI)

Territorial scope of SSM



ECB's supervisory powers

Micro-prudential tools

- Grant or withdraw **bank licences**
- Authorise **acquisitions** of qualified holdings
- Monitor **compliance** with all **prudential requirements** laid down in EU banking rules
- Conduct **investigations and on-site inspections**
- Set **prudential requirements** (own funds, large exposure limits, liquidity, leverage and disclosure, internal governance and controls, "fit and proper tests")
- Carry **out supervisory reviews**
- Impose **corrective measures and sanctions**

Macro-prudential tools

- Define **higher requirements for capital buffers** than applied by national supervisory authorities and set a buffer rate if the national supervisor has not done so

KEY DISTINCTION

All significant and less significant banks in the participating countries through **direct** and **indirect supervision**.

Significance criteria for Significant institutions (Sis)	
Size	Total assets > **€ 30 billion**
Economic importance	for the specific country or the EU economy as a whole
Cross-border activities	Total assets > **€ 5 billion** + ratio of its cross-border assets/liabilities in more than one other participating Member State to its total assets/liabilities is above **20%**
Direct public financial assistance	It has requested or received funding from the European Stability Mechanism or the European Financial Stability Facility
A supervised bank can also be considered significant if it is one of **the three most significant banks** established in a particular country	

LESS SIGNIFICANT INSTITUTIONS (LSIs)

- National supervisors are responsible for the ongoing supervision of LSIs
- LSIs assets represented around 15% of SSM banking assets (2017)
- Germany, Austria and Italy have approximately 85% of all LSIs
- Many LSIs are traditional retail banks, but a number have specialised business model also

8. SSM - SUPERVISED ENTITIES

SIs Updated overview

Source ECB – Q1 2018

Supervisory Banking Statistics - First quarter 2018

Total assets by location of ultimate parent (%)

- **Groups with ultimate parent in SSM: 97.85%** - refers to SIs supervised by the ECB at the highest level of consolidations
- **Groups with ultimate parent in EEA (outside SSM): 1,09%** - refers SIs supervised by ECB, whose highest level of consolidation is outside the SSM and in the EEA
- **Groups with ultimate parent outside EEA: 1.06%** - refers to SIs supervised by ECB, whose highest level of consolidation is outside the EEA

Significant institution by classification (size) – Banks with total assets (number)

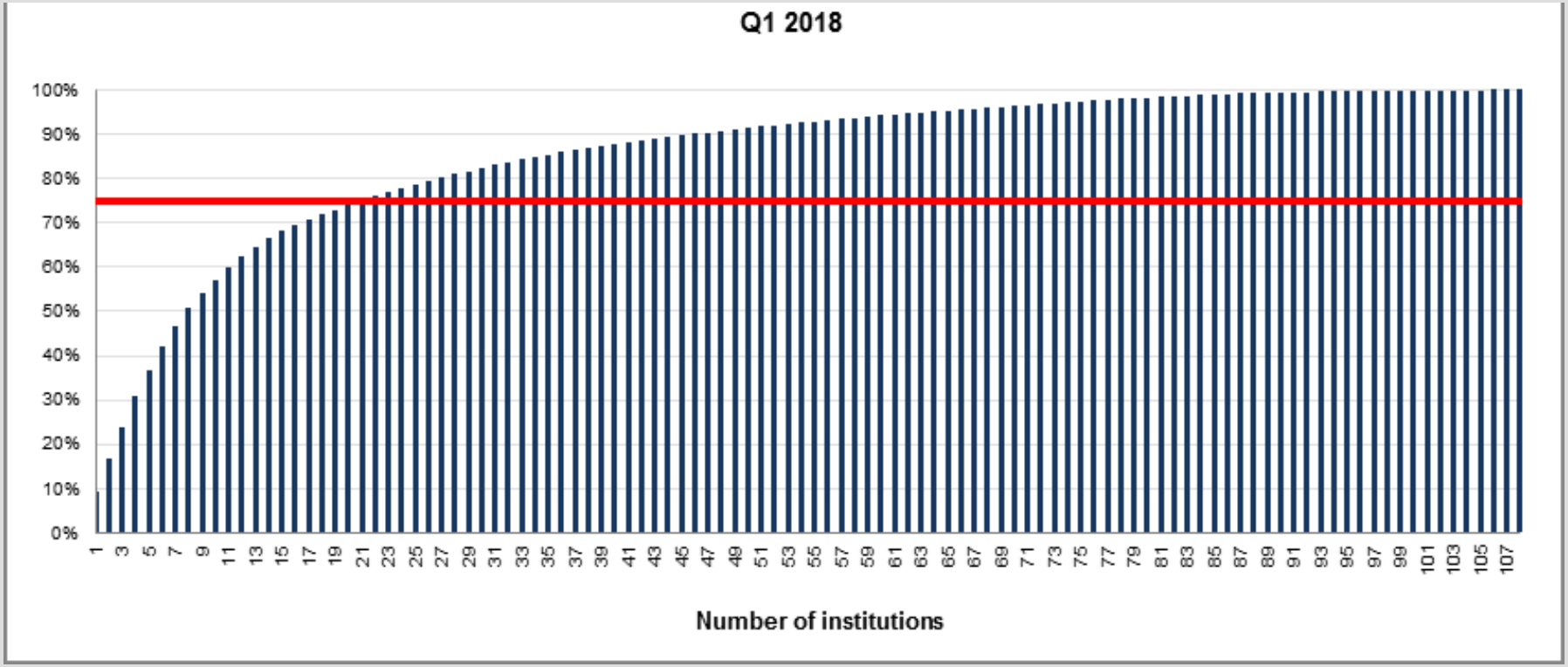
• Less than €30 billion:	27
• Between € 30 billion and € 100 billion:	45
• Between € 100 billion and € 200 billion:	14
• Between € 200 billion and € 300 billion:	7
• More than € 300 billion:	8
• G- SIBs	7

SIs Updated overview

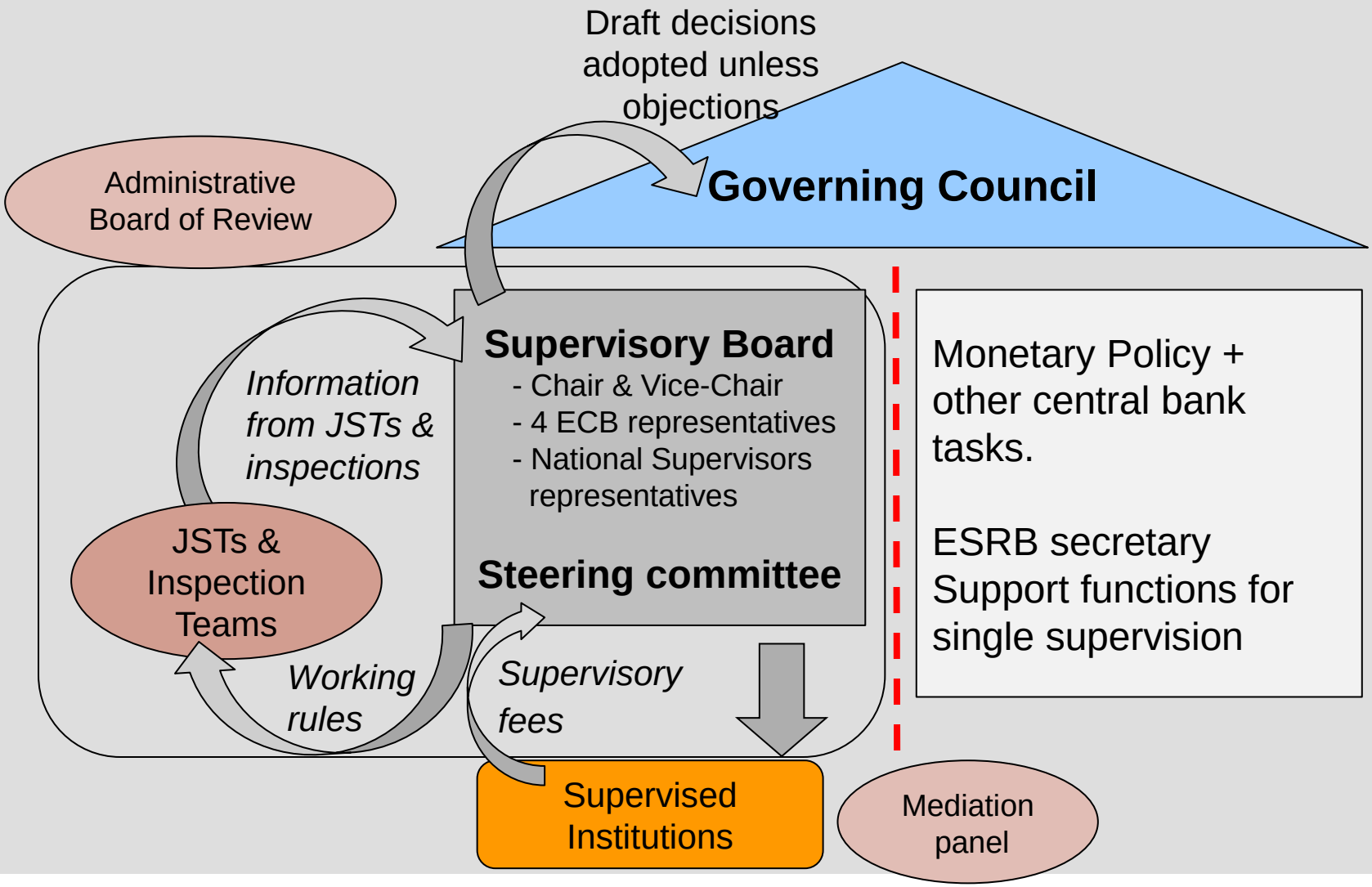
Source ECB. Notes

CONCENTRATION OF TOTAL ASSETS

Significant institutions at the highest level of consolidation for which common reporting (COREP) and financial reporting (FINREP) are available. The charts show the cumulative percentage of the total assets in the sample which is covered when the total assets of each institution, ordered from the largest to the smallest, are added.



8. SSM ORGANISATION & GOVERNANCE



8. SSM ORGANISATION & GOVERNANCE

Governing Council

6 members of Executive Board

Governors of the national central banks of the 19 euro area countries

Responsibilities:
The Governing Council is the sole ECB decision making body for the prudential supervision of credit institutions established in Member States participating in the SSM

Supervisory Board

Chair

Vice-Chair

4 ECB Reps

Reps of the 19 NCAs (NCBs)

Responsibilities:
- Internal body that plans and executes the supervisory tasks conferred on the ECB
- Carries out the preparatory work regarding the ECB's supervisory tasks, in the interest of the Union as a whole
- Proposes complete draft decisions for adoption by the Governing Council

Steering Committee

Chair

Vice-Chair

1 ECB Rep

5 Members representing NCAs
(1 year rotation)

Responsibilities:
- Supports the activities of the Supervisory Board
- Executes preparatory tasks in the interest of the Union
- Has no decision-making powers

8. SSM – STRUCTURE

Direct Supervision

Micro-prudential Supervision I

Joint Supervisory Teams

± 30 credit institutions

Micro-prudential Supervision II

Joint Supervisory Teams

± 90 credit institutions

Indirect Supervision

Micro-prudential Supervision III

- Supervisory Oversight & NCA Relations
- Institutional & Sectoral Oversight
- Analysis & Methodological Support

Horizontal functions & specialised expertise

Micro-prudential Supervision IV

- Authorisation
- Centralised on-site Inspections
- Crisis Management
- Enforcement & Sanctions
- Methodology & Standards Development
- Risk Analysis
- Planning & Coordination of SEP
- Supervisory Policies
- Supervisory Quality Assurance
- Internal Models
- COO Unit

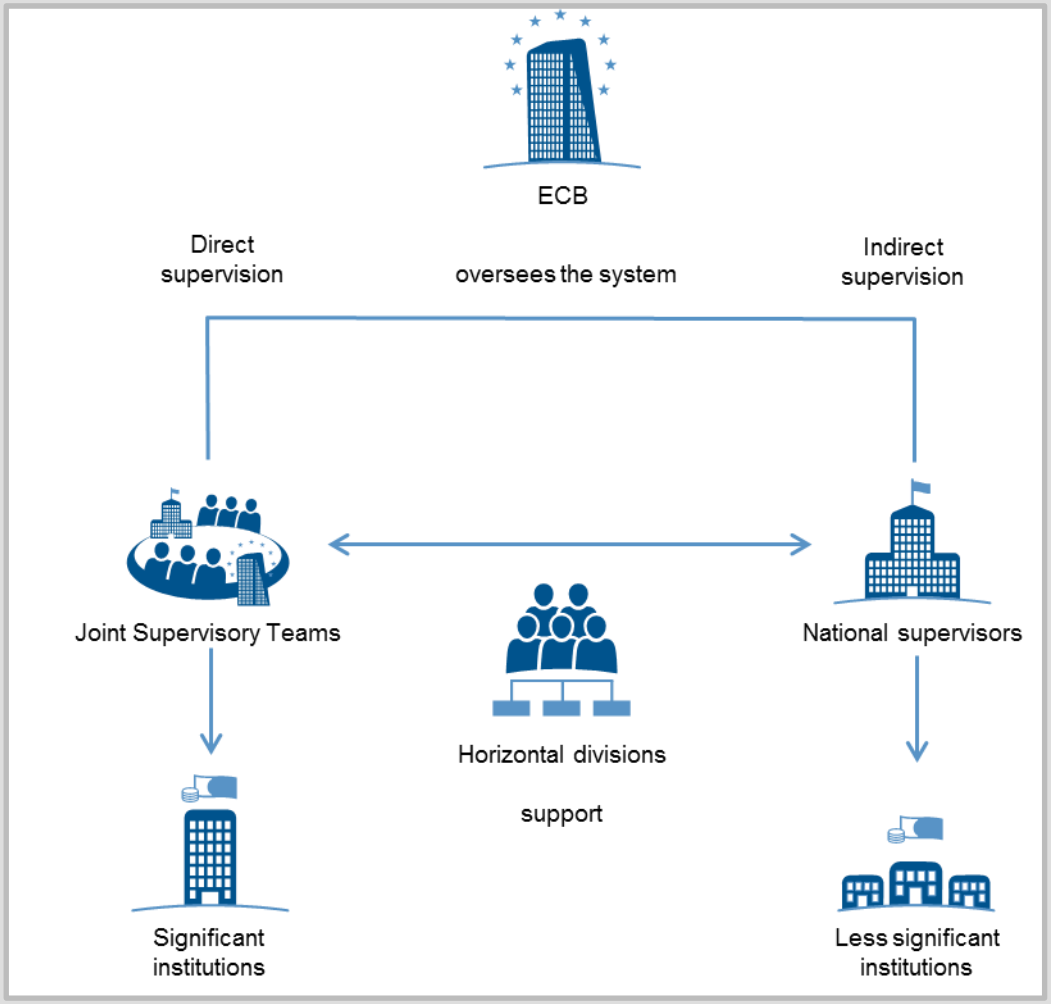
Secretariat

Secretariat to the Supervisory Board

- Decision-Making Process
- Decision-Making Policy

- **DG-MS 1 & 2**: conduct of day-to-day supervision of significant institutions by the **JSTs**
- **DG-MS 3**: oversight of the supervision of less significant institutions, performed by **NCAs**
- **DG-MS 4**: ensure consistency, early identification of risks and promote best practices, via **expert networks** within the ECB and NCAs
- **SSB**: support **supervisory decision-making** (including SB meetings/WP and review of documentation) and assistance to the ABoR, the MP and the discharge of accountability

Structure of the SSM: Distribution of tasks



8. SSM - FUNCTIONING

A bank supervisor needs to know to **which risks the supervised banks are exposed**.

It is the foundation of doing supervision – as it enables the SSM to investigate the correct topics in banks.

One cannot assess every risk in every bank (resource constraints).

Therefore, the **SSM focuses** on the **most important risks for the next 1-3 years,** the so-called "Supervisory Priorities".

Every JST receives a **yearly to do list for every bank**.

Thus guaranteeing that each bank receives at least a **minimum level of supervision**.

This is important, as the SSM must ensure **supervision** of **all banks in the same way**.

8. SSM – FUNCTIONING: SUPERVISORY PRIORITIES

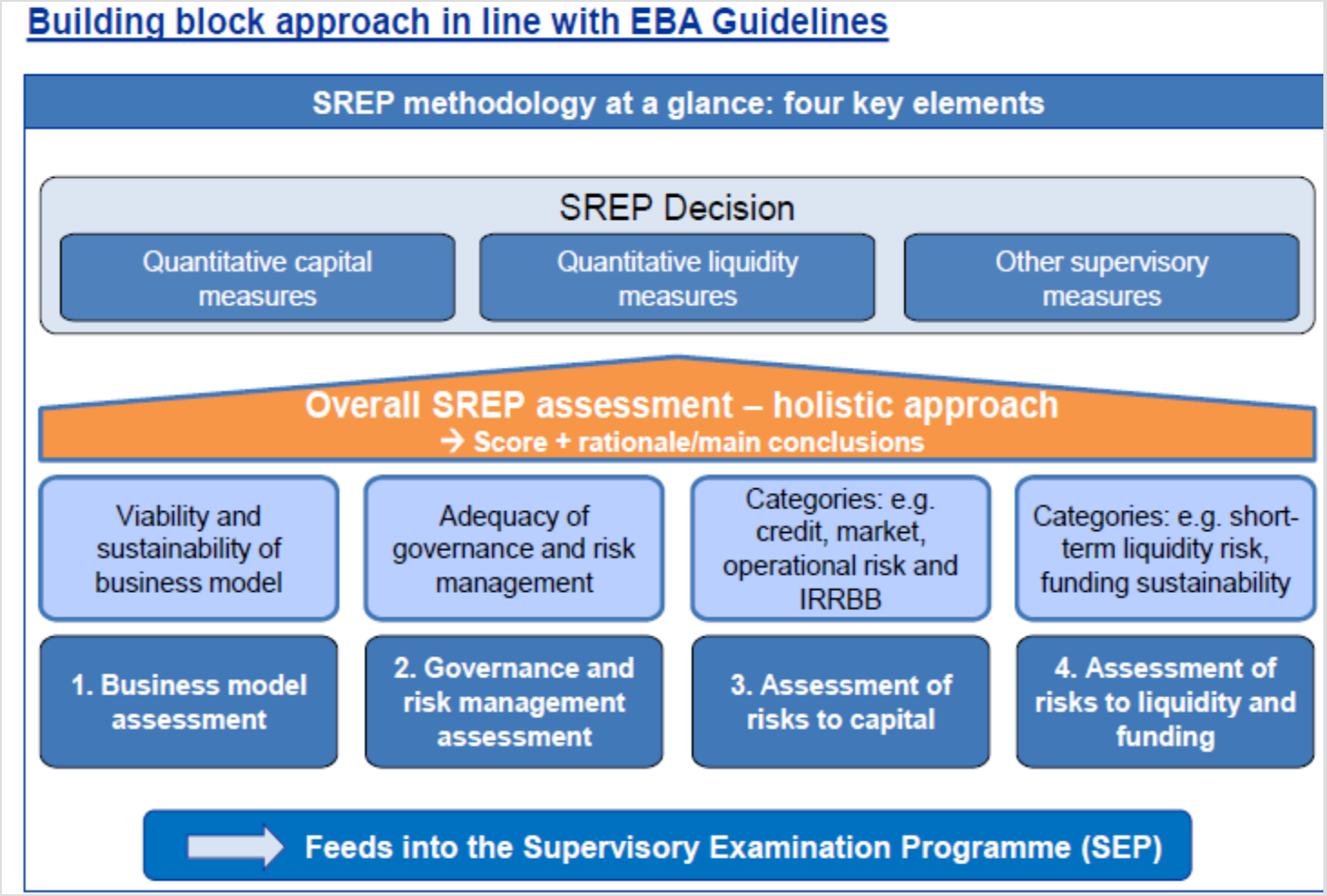
2017		2018
	Sustainbility of the business model	
Thematic review of Business Models		Implications of the interest rate for the income statement
	Quality of credit porfolios	
Assessment of impaired assets		Review of strategies to reduce non-performing assets
Thematic review of adaptation to IFRS 9		Checking the adequacy of provisioning and write-downs
	Risk Management	
Thematic review of Data aggregation and risk reporting		Monitoring of IFRS 9 implementation progress
Review of internal models Adaptation to new regulations		Review of internal models Preparations for Brexit
Risks of Outsourcing Improvement of the ICAAP		EBA Stress Test for SIs Improvement of the ICAAP

Supervisory Review and Examination Process (SREP)

Legal basis Art. 97 CRD

- **Main instrument** of banking supervision
- High and **harmonised standards** of supervision
- **Level playing field**:
  - *Common methodology & decision-making process*
- **Sound risk assessment** of each institution
  - *Quantitative and qualitative elements (Risk level & Risk control)*
  - *Holistic assessment*
- **Three perspectives**:
  - ***Supervisory*** *(RAS) – Risk Assessement System*
  - ***Bank's*** *(ICAAP/ILAAP)*
  - ***Forward looking*** *(Stress tests)*

8. SSM SREP - OVERVIEW



Source: ECB_ SREP Methodology booklet_2017

8. SSM - SREP OVERVIEW

Three phases in on-going risk assessment for each of four elements

Phase 1 Data gathering	Phase 2 Automated anchoring score	Phase 3 Supervisory judgement
Main sources: • quarterly ITS • STE reports	• Scoring risk level • Formal compliance checking of risk control	Adjustments based on additional factors and considering banks' specificities and complexity

Risk level (RL) vs. risk control (RC)

	1. Business model	2. Internal governance and RM	3. Assessment of capital risks	4. Assessment of liquidity risks
RL	✓	n/a	✓	✓
RC	n/a	✓	✓	✓

→ Combined score (RL + RC)

n/a: not applicable

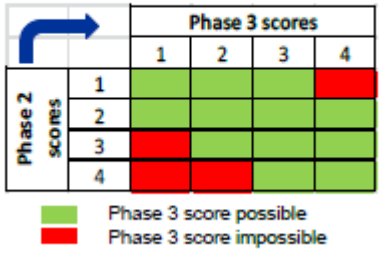
The intensity of the supervisory engagement is decided based on banks' risk profile and size

Source: ECB_ SREP Methodology booklet_2017

8. SSM - SREP OVERVIEW

- Fair flexibility on a four-grade scale where Phase 2 score can be improved by one notch and worsened by two notches based on supervisory judgement
- Ensures the right balance between:
  - a common process, ensuring consistency across SSM banks and defining an anchor point
  - the necessary supervisory judgment, to take into account the specificities and complexity of an institution
- Adjustments go in both directions and are fully documented by the JST in the integrated IT system
- Departing from constrained judgement not allowed as a rule
- Constrained judgment used ***effectively*** by JSTs for ***all*** risk categories ***in both directions*** – improving as well as worsening Phase 2 scores

Scale of the constrained judgement



Source: ECB_ SREP Methodology booklet_2017

8. SSM SREP: OUTCOME

Outcomes:

1. Holistic, forward-looking **assessment of the overall viability** of the institution:
   Overall SREP score:

1	2	3	4

   Constraint judgement: +2 / -1

2. **SREP decision**:
   a) **additional own funds requirements.**
   b) quantitative liquidity requirements.
   c) other supervisory measures (e.g. restriction or limitation of business, requirement to reduce risks, additional or more frequent reporting obligations).

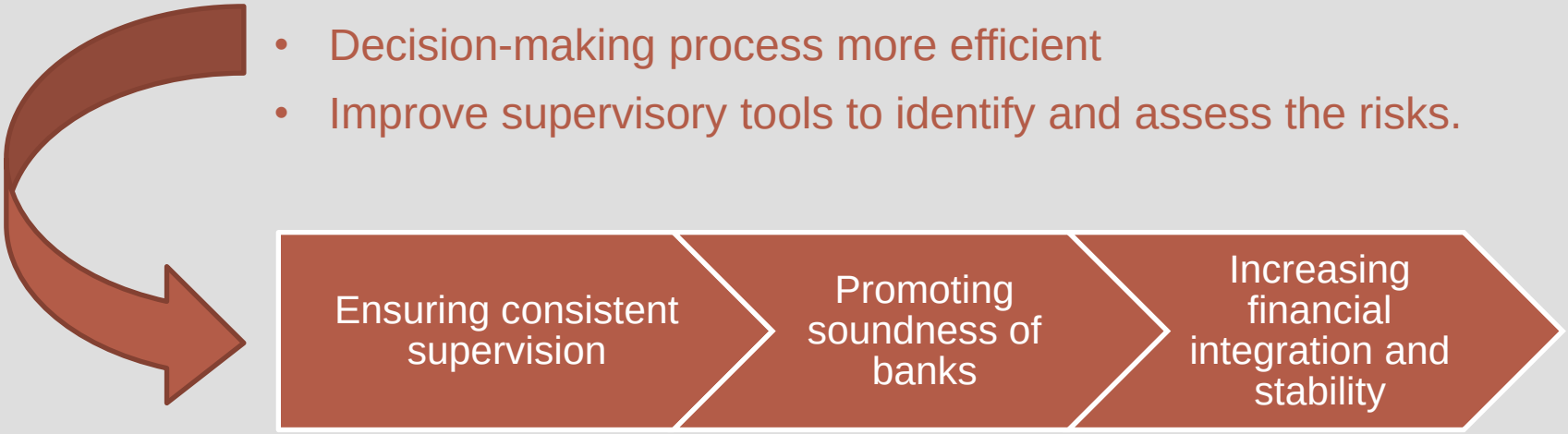
3. Input to the determination of the **minimum level of supervisory engagement** for a specific institution as part of the **Supervisory Examination Programme** (SEP).

What's next?

Great progress has been made…but…

…**there is still a lot do:**

- Further harmonisation and coordination ECB-NCAs
- Decision-making process more efficient
- Improve supervisory tools to identify and assess the risks.



SOURCE: Banco de España

DG Banking Supervision – Dec 2017

Credit Institutions	Groups	% Assets
Groups of Significant institutions	13	94.3%
Subgroups of Spanish institutions dependent on groups of foreign SIs	7	1.0%
Less significant institutions	69	4.7%

8. BANCO DE ESPAÑA

SOURCE: Banco de España

Directorate General Banking Supervision staff	
Directors and other managers	42
Bank examiners / Inspection auditors	281
Senior analysts / Lawyers / Experts	19
IT auditors	45
Junior analysts	42
Administrative staff	48
Total	**477**

8. BANCO DE ESPAÑA

SOURCE: Banco de España

The staff of the Directorate General Banking Supervision have the following functions:

- 165 persons have functions relating to ongoing supervision of SIs conducted through JSTs set up by the SSM
- 21 persons have functions relating to ongoing supervision of LSIs supervised directly by the Banco de España and indirectly by the SSM
- 21 persons have functions relating to institutions whose supervision has not been taken on by the SSM
- 111 persons have functions relating to on-site inspections or review of internal models
- 102 persons have cross - departmental functions
- 65 persons have other functions.

BdE Supervisory functions (cont.)

- **Direct supervision of Less Significant Institutions**
- **Cooperation in Common procedures (SSM)**: authorisations, acquisitions of qualifying holdings and withdrawal of authorisations
- **Participation** in the networks organised by the SSM for **horizontal functions.**

2) Supervision of areas not transferred to the SSM

- **Other institutions**: specialised lending institutions, payment institutions, electronic money institutions, currency-exchange bureaux, mutual guarantee and re-guarantee companies, appraisal companies, banking foundations, SAREB.
- **Market conduct** and **consumer protection**.
- Prevention of **Money Laundering** and terrorism financing.
- Investigation of **unauthorised activities.**

Thank you for your attention!

BANCO DE ESPAÑA
Eurosistema

DIRECTORATE GENERAL BANKING SUPERVISION