Supervision Newsletter
May 2018

European Central Bank (ECB)

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Supervision Newsletter
Introduction

In May 2018, the ECB published an update of its Supervision Newsletter including five articles on the following issues: Brexit, IFRS 9, anti-money laundering, bank failure, and sanctioning / enforcement

Introduction

- Since 2016 the ECB has published regular updates of its **Supervision Newsletter** in order to address those issues that are significant for the purpose of the EU supervisory framework. In this context, the ECB has published its **May 2018 Supervision Newsletter** which includes five articles.
- Along with them, the ECB has also published **key data** on the banking sector and the **bank lending survey** results for the first quarter of 2018. In addition, an **interview with Anneli Tuominen**[1] on the role of national supervisors in Finland is provided.

Articles

1. **Brexit: impact of a potential transition period**
2. **IFRS 9: credit institutions' progress with implementation**
3. **The ECB and anti-money laundering (AML)**
4. **Bank failing or likely to fail**
5. **Enforcement, sanctions and reporting breaches**

1. Director General of Finland's Financial Supervisory Authority and member of the Supervisory Board of the ECB. For further information see 'We have more muscle to enforce our goals'.

The ECB expects banks to prepare for all possible contingencies if no Brexit transition period is agreed. Further, the ECB has identified different progress levels in banks implementing IFRS 9

Brexit: impact of a potential transition period[1]

- On 19 March, the EU and the UK reached an **agreement** on certain key withdrawal issues, including the **transition period** which would apply from the date the withdrawal agreement enters into force until 31 december 2020. The content of this agreement will not be known until **late 2018**, so banks shall prepare for all possible contingencies.
- The ECB and national supervisors expect banks to come up with **credible Brexit plans** as soon as possible. Banks that are planning to relocate activities to the euro area should send their **authorization applications** at the latest by the **end of the 2Q18** to make sure that they can continue to serve their customers after 30 March 2019.
- Independently of any transition period agreed, the ECB has already communicated its intent to provide **flexibility** in order to enable banks to meet certain **supervisory expectations** and build up their capabilities in the euro area.

IFRS 9: credit institutions' progress with implementation[2]

- IFRS 9 brings **substantial changes** to the accounting regime for credit institutions. In 2016, the ECB launched a thematic review to assess **institutions' preparedness** to a consistent implementation of IFRS 9. This review showed that institutions had progressed differently by the end of 1Q17. Thus, the institutions were divided into **two batches**:
  - The **first batch** of institutions had been fully assessed by the JST in 1Q17 and recommendations were issued.
  - The **second batch** received a warning letter in 1Q17 urging them to intensify their work on IFRS 9.
- Both first and second-batch institutions are doing relatively well on aspects related to the implementation of the definition of default and business model assessment. The **main areas for improvement** relate to the implementation of validation and back-testing, the incorporation of forward-looking information and the measurement of ECL. The fully-loaded impact of the CET1 ratio is of **36 b.p. for first-batch** and **44 b.p. for second-batch institutions**.
- The ECB will monitor **progress in the implementation** of the remedial actions that institutions should apply.

1. For further information see: Brexit: impact of a potential transition period
2. For further information see: IFRS 9: credit institutions' progress with implementation

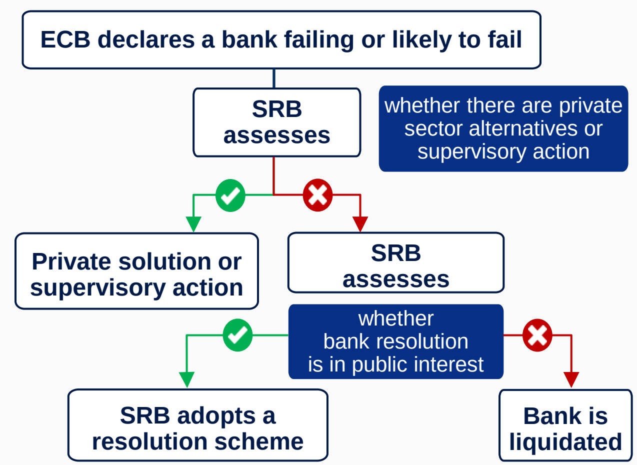
The ECB cannot investigate breaches of AML legislation although it can take facts identified as given and use its Pillar 2 powers. Further, the ECB is part of the procedure of assessing if a bank is failing

The ECB and anti-money laundering[3]

- The supervision and enforcement of the AML/CFT legislation **are not among the ECB's competences** as both are national competences. However, breaches of AML/CFT provisions can be symptoms of unsound governance and internal control. In this regard, the ECB sets out the limits between its competences and those of other authorities.
- The delineation between the different competences corresponds to the **demarcation between fact-finding** (other authority) and **evaluating those facts** and **assessing conclusions** that should be drawn from them (ECB).
- Indeed, the ECB **cannot** determine if **breaches** of AML legislation have taken place as that competence lies solely with the AML authority. Once such breaches have been established by the AML authority, the ECB can take the facts thus identified as given and use its **Pillar 2 powers** (mainly through the SREP).

Bank failing or likely to fail[4]

- Since 2014, the ECB is responsible for **assessing** whether a bank is **failing or likely to fail** and closely monitors how individual banks deal with the risks they face and discusses possible **actions**.
- The **procedure to declare a bank failing or likely to fail** (see chart) starts with the ECB declaration if certain conditions on authorisation, assets, debts or public financial support are met (e.g. the bank's assets are less than its liabilities, or will be in the near future).
- However, experience shows that a **misalignment** can exist between the trigger for **EU resolution framework** and the trigger for liquidation **under national law**. An **harmonisation** of both triggers is necessary.



Legend chart: yes no

3. For further information see: The ECB and anti-money laundering: what we can and cannot do
4. For further information see: What happens when a bank is failing or likely to fail?

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Sanctioning and enforcement / Key data / Bank lending survey 1Q18

Under the power to adopt enforcement measures, the ECB has established a breach report mechanism to report breaches. Along with these articles, key data and 1Q18 bank lending survey are also provided

Enforcement, sanctions and reporting breaches[5]

- Under the SSM, the ECB was given the power to adopt **enforcement measures** and to impose **non-pecuniary and pecuniary penalties**. In this regard, the ECB has focused its sanctioning activity on the following areas: capital requirements, large exposures, liquidity, reporting obligations and governance.
- By 31 December 2017 the ECB had imposed **5 penalties amounting to 15.3 M€**. The ECB also submitted 12 requests to NCAs to open proceedings, which so far have led to total penalties of 5.1 M€.
- Due to difficulties in identifying breaches, the ECB has set up a **Breach Reporting Mechanism (BRM)** to encourage persons with knowledge of such wrongdoing to report it. By December 2017, the ECB received 280 breach reports.

Key data[6]

- The ECB has published **Supervisory Banking Statistics for 4Q17** on the following aspects of significant institutions:
  - General statistics
  - Balance sheet composition and profitability
  - Capital adequacy, leverage and asset quality
  - Funding
  - Liquidity
  - Data quality
- These statistics for 4Q17 shows that the **NPL ratio** has steadily decreased since 2015, reaching a weighted average of **below 5%** in the 4Q17. About 60% of NPLs are to non-financial corporations and 36% to households.

1Q18 Bank lending survey

- According to the Eurosystem's bank lending survey, banks in the euro area increased their **lending to households by 2,9%** in February 2018 compared to the previous year. The annual growth rate of loans to non-financial corps stood at 3.1%.
- This increase was in part facilitated by banks **easing their internal guidelines or loan approval criteria** for loans to enterprises as well as for house purchase loans to households.
- The increased level of bank lending is a **positive** sign as it reflects the **recovery** of the euro area economy.

5. For further information see: Enforcement, sanctions and reporting breaches
6. Source: ECB, Supervisory Statistics 4Q17. See: annex 7. Source 1Q18 Bank lending survey

Annex

Overview of Supervisory Banking Statistics

The ECB has provided data for the 4Q17[1] on balance sheet composition, key performance indicators, capital and leverage ratios, funding and liquidity, among others

The following table provides an overview of the ECB Supervisory Banking Statistics for the 4Q17, which includes data from **111 significant institutions** at the highest level of consolidation for which **COREP** and **FINREP are available**.

	Q4 2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017
Balance sheet composition (€ billions; %)					
Total assets	21,737.69	21,928.62	21,376.42	21,298.37	20,752.63
Total liabilities	20,337.29	20,498.73	19,969.69	19,877.56	19,327.26
Equity	1,400.40	1,429.89	1,406.73	1,420.81	1,425.37
Non-performing loans ratio	6.15%	5.90%	5.49%	5.15%	4.92%
Key performance indicators					
Return on equity	3.21%	7.06%	7.08%	7.03%	5.98%
Return on assets	0.21%	0.46%	0.47%	0.47%	0.41%
Capital and leverage ratios					
CET 1 ratio	13.78%	13.74%	13.88%	14.32%	14.58%
Tier 1 ratio	14.72%	14.75%	14.88%	15.32%	15.57%
Total capital ratio	17.30%	17.44%	17.56%	17.97%	18.08%
Leverage ratio (transitional definition)	5.39%	5.29%	5.33%	5.39%	5.57%
Leverage ratio (fully phased-in definition)	5.04%	5.04%	5.08%	5.17%	5.38%
Funding					
Loan-to-deposit ratio	120.02%	119.39%	118.16%	117.54%	116.91%
Liquidity					
Liquidity coverage ratio (LCR)*	136.09%	141.72%	142.79%	140.39%	143.63%

* Only banks that are required to report liquidity information at the highest level of consolidation in the SSM are aggregated in the LCR shown above.

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1. Source: ECB. Cut-off date: 7 April 2018.