Supervision Newsletter
August 2018

European Central Bank (ECB)

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Supervision Newsletter
Introduction

In August 2018, the ECB published an update of its Supervision Newsletter including five articles on the following issues: internal governance, real estate, recovery plan, Brexit, and supervision

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 **August 2018 Supervision Newsletter** which includes five articles.
- Along with them, the ECB has also published **key data** on the banking sector and some findings regarding the **profitability pressure** of banks. In addition, an **interview with Ed Sibley**[1] on the diversity to governance, culture and risk profile is provided.

Articles

- **1. Good governance in a changing environment**
- **2. Developments in residential real estate lending: a mixed picture**
- **3. Recovery planning: the ECB experience**
- **4. Brexit: counting down**
- **5. Building a common supervisory approach for smaller banks**

1. Deputy Governor of the Central Bank of Ireland and member of the Supervisory Board of the ECB. For further information see ['Diversity is the bulwark against groupthink'](#).

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Good governance / Real estate

The ECB has developed a comprehensive approach to supervise governance in a new financial environment and has also assessed the residential real estate market in euro area countries

Good governance in a changing environment[1]

As a result of the ECB's supervisory engagement and work on governance, four areas have emerged where banks need to make improvements in the coming period:

- **Fit and proper assessments** (including reputation, experience, or conflicts of interest). Despite the significant achievements, further harmonisation and supervisory convergence are needed to create a level playing field.
- **Board independence**. Banks need to have a sufficient number of independent members on their boards, which should be independent thinkers too. Thus, they must have an acute understanding of the board's oversight function.
- **Risk appetite frameworks (RAF)**. Despite the design of the RAF has significantly improved across banks, most still need to implement and embed their RAF in their decision-making processes (e.g. challenge to senior management).
- **Risk data aggregation**. So far, not many banks currently meet the BCBS' standard on RDA&RR.

Developments in residential real estate lending: a mixed picture[2]

- As part of its ongoing analyses, the ECB has assessed the credit risks related to **residential real estate exposures** in euro area countries and has found that, on average, **house prices** are now **5% above** the peak reached in the second quarter of 2008. Although house price developments at individual country level do not yet signal pronounced risks from a microprudential perspective, there are **signs of sharp increases** in parts of the euro area.
- Further, there are some indications that **lending standards are easing**. On average, banks now allow borrowers to finance a slightly higher amount of the value of their house with a loan (higher LTV ratio from 77% in 2016 to 78% in 2017). However, these results should be interpreted with caution given the limited availability of data.
- In conclusion, although there is **no evidence** that euro area banks are currently exposed to a **high-risk mortgage lending environment**, for some the risk of **losses** on their residential real estate lending portfolios is i**ncreasing**. Thus, the ECB considers that residential real estate exposures require closer scrutiny by supervisors.

1. For further information see: [Good governance in a changing environment]
2. For further information see: [Developments in residential real estate lending: a mixed picture]

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Recovery plan / Brexit

The ECB is sharing best practices to help banks improve their plans. Further, the ECB has provided its expectations regarding the UK withdrawal from EU, in order to mitigate the risks associated with it

Recovery planning: the ECB experience[3]

- After assessing three cycles of recovery plans, from 2015 to 2017, the ECB now shares with the banking industry the **best practices** it has identified in five areas: recovery options; overall recovery capacity (ORC); recovery indicators, playbooks, which are implementation guides for recovery plans; and dry runs, which are 'live' simulation exercises that help banks test key parts of their recovery plans, train staff to react in crises and identify areas for improvement.
- In this regard, the ECB highlights that banks tend to **largely overestimate their ORC** (e.g. by implementing their recovery options they register an increase of 13 p.p. of their CET1 ratio). An adequate estimation of ORC is crucial for supervisors to assess whether a bank can actually overcome a crisis situation by implementing its recovery plan.
- Another key issue is whether banks can **implement their recovery plans in a timely and effective manner** in situations of stress. To this end, the ECB identifies two best practices for achieving this goal: playbooks and dry runs.

Brexit: counting down[4]

- The ECB informed banks of its **expectation** that they should submit their **Brexit plans** and their applications for authorisation as credit institutions operating in euro area countries by the end of the **2Q18**, at the latest.
- Most banks have indeed submitted their licence applications and Brexit plans, although a smaller number of banks have not yet done so and other banks have not yet made their final decisions. All banks affected by Brexit should act before **March 2019** to **mitigate the risk associated with losing access to the EU single market**. Actions to be taken include, the relocation and recruitment of key staff; the on-boarding of clients, or the establishment of infrastructure such as information technology.
- On the supervisory side, the ECB will continue to closely **follow banks' preparations** and will counter any effort by them to establish empty shells in the euro area. According to the ECB, now it is up to the **banks to speed up** their work and complete their preparations during the final count-down to Brexit.

3. For further information see: Recovery planning: the ECB experience
4. For further information see: Brexit: counting down

Common supervisory approach / Key data / Profitability pressure

In order to include smaller banks, the ECB has established a common supervisory approach. Along with these articles, key data and information on profitability pressure are also provided

Building a common supervisory approach for smaller banks[5]

- From this year onwards, a **common methodology** will be applied to the annual supervisory assessment of all euro area banks, **including the less significant institutions (LSIs)**, operating within the SSM framework. In particular, supervisors will apply the common Supervisory Review and Evaluation Process (SREP) methodology at least to the **high-priority LSIs in 2018** and roll it out to all LSIs by 2020.
- A harmonised approach to the supervision of around **3,000 smaller banks** in the euro area ensures that they are **treated the same way** by their supervisors and **compete under the same conditions**. Taken together, direct ECB supervision of large banks and a harmonised methodology for supervising smaller banks contribute to the improvements made to banking supervision in the euro area since the creation of the EU banking union.

Key data[6]

- The ECB has published **Supervisory Banking Statistics for 1Q18** 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 shows that the **total capital ratio** of ECB-supervised banks **decreases** from 18.14% in the 4Q17 to 17.72% in the 1Q18, due to the overall decrease in CET1 capital, and the introduction of IFRS 9, among others.

Profitability Pressure[7]

In **2017** significant banks in the euro area had an average **return on equity** (RoE) of just **6%**. The reasons under this low profitability level were:

- **Legacy issues**
- **High levels of impairments**
- **Economic environment**
- **Low interest rates**
- **High competition**

5. For further information see: Building a common supervisory approach for smaller banks
6. Source: ECB, Supervisory Statistics 1Q178. See: annex 7. Source: Profitability pressure

Annex

Overview of Supervisory Banking Statistics

The ECB has provided data for the 1Q18[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 1Q18, which includes data from **108 significant institutions** at the highest level of consolidation for which **COREP** and **FINREP are available**.

	Q1 2017	Q2 2017	Q3 2017	Q4 2017	Q1 2018
Balance sheet composition (€ billions; %)					
Total assets	21,928.62	21,376.42	21,298.37	20,749.82	20,381.61
Total liabilities	20,498.73	19,969.69	19,877.56	19,325.19	19,036.98
Equity	1,429.89	1,406.73	1,420.81	1,424.63	1,344.62
Non-performing loans ratio	5.90%	5.49%	5.15%	4.93%	4.81%
Key performance indicators					
Return on equity	7.06%	7.08%	7.03%	5.92%	6.63%
Return on assets	0.46%	0.47%	0.47%	0.41%	0.44%
Capital and leverage ratios					
CET 1 ratio	13.74%	13.88%	14.32%	14.63%	14.05%
Tier 1 ratio	14.75%	14.88%	15.32%	15.62%	15.26%
Total capital ratio	17.44%	17.56%	17.97%	18.14%	17.72%
Leverage ratio (transitional definition)	5.29%	5.33%	5.39%	5.59%	5.33%
Leverage ratio (fully phased-in definition)	5.04%	5.08%	5.17%	5.40%	5.11%
Funding					
Loan-to-deposit ratio	119.39%	118.16%	117.54%	116.90%	118.45%
Liquidity					
Liquidity coverage ratio (LCR)*	141.72%	142.79%	140.35%	143.58%	142.45%

*Information from 107 banks out of the total sample that are required to report liquidity information at the highest level of consolidation in the SSM.

1. Source: ECB. Cut-off date: 30 June 2018.

