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Supervision Newsletter
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European Central Bank (ECB)

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Supervision Newsletter

Introduction

In February 2019, the ECB published an update of its Supervision Newsletter including six articles on banking supervision, Brexit, liquidity and cyber risk, ICAAP/ILAAP, and algorithmic trading

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 **February 2019 Supervision Newsletter** which includes six articles.
- Along with them, the ECB has also published **key data** on the banking sector and some findings regarding the **on-site inspections**. Further, an **interview with Sabine Lautenschläger**[1] on banking supervision and harmonised regulation is provided.

Articles

1. Andrea Enria takes helm of ECB Banking Supervision
2. Brexit: meeting supervisory expectations
3. ECB tests banks' sensitivity to liquidity risk
4. ECB guides to ICAAP and ILAAP
5. IT and cyber risk (the SSM perspective)
6. Algorithmic trading: trends and regulation

1. Vice-Chair of the Supervisory Board of the ECB. For further information see 'European banking supervision is well established, but we still need more harmonised regulation'

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Banking supervision / Brexit

In January 2019, Andrea Enria was designated ECB Chair of the Supervisory Board. Further, the JSTs have confirmed that most UK branches plans have been already aligned to EU regulatory framework

Andrea Enria takes helm of ECB Banking Supervision[1]

- In January 2019, Andrea Enria became **ECB Chair of the Supervisory Board**. Under his leadership at the EBA, this authority developed for example, a specific definition of bank capital, a common definition of NPLs and FBLs, etc.
- The new Chair stated out that **consolidation** is important to absorb the excess capacity generated in the run-up to the crisis, and to achieve true banking union. Further, in a fast-changing and highly competitive environment, banks need to be willing to act on several fronts: performing in-depth analyses of their **business models**, tackling **low-profitability**, addressing the persistence of **excess capacity** in the system, and embracing **new technologies**.
- Mr. Enria would also like to see more attention paid to **market risk** and **funding risk** as an increasingly volatile environment, they will need to be monitored more closely. Further, it also considers vital for banks to continue working on **governance** and their **business culture** to prevent excessive risk-taking. Regarding **transparency**, Mr. Enria plans to follow up on demands for greater supervisory openness and disclosure.

Brexit: meeting supervisory expectations[2]

- In August 2018, the ECB published '**Supervisory expectations on booking models'** to clarify how the ECB intends to apply the CRD IV provisions for governance and risk management. In this regard, the Joint Supervisory Teams (JSTs) of outgoing banks have assessed the **plans for 46 UK branches** corresponding to 42 banks from 11 SSM countries, confirming that most banks have been already aligned or are well advanced in aligning.
- Despite the UK **temporary permissions** regime approved in November 2018, SSM banks may need to obtain ECB approval for their third-country branches in London by the end of March 2019. Further, the ECB also provides expectations on **booking models**, **access to financial market infrastructures (FMIs)** and **business models**.
- Given the uncertainty arising from the current political discussions, and independently of a possible transition period, banks with **incomplete plans** need to act now to develop the post-Brexit target operating model.

1. For further information see: Andrea Enria takes helm of ECB Banking Supervision
2. For further information see: Brexit: meeting supervisory expectations

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2019 Sensitivity analysis of liquidity risk / ICAAP and ILAAP

The ECB announced that it will carry out a sensitivity analysis of liquidity risk in 2019. Furthermore, it also issued Final Guides to ICAAP and ILAAP whose insights will feed into all SREP assessments

ECB tests banks' sensitivity to liquidity risk area[3]

- In order to test the bank's resilience to liquidity shocks, the ECB launched **a sensitivity analysis of liquidity risk**, which constitutes the supervisory stress test for 2019, involving about **100 significant institutions** directly supervised by the ECB. In the exercise, banks have to simulate the impact of **idiosyncratic liquidity shocks** on their expected cash flows over a **six-month stress horizon**; and the results will feed the SREP.
- In particular, this exercise compares banks' expected **short-term cash flows under stress** against available unencumbered collateral, enabling supervisors to calculate their "survival period". Moreover, banks must simulate the impact of: i) an **adverse shock**; and ii) an **extreme shock**, in which they face liquidity outflows of increasing intensity.
- There will be **no direct impact on capital requirements**, as s this would not be an appropriate way to address liquidity risks. Instead, the outcomes may lead to additional liquidity requirements and to supervisory requests to strengthen specific maturity buckets in order to improve the overall resilience of individual banks.

ECB guides to ICAAP and ILAAP[4]

- Two important processes are central to making banks more resilient and avoiding adverse situations: i) the internal capital adequacy assessment process (**ICAAP**), and ii) the internal liquidity adequacy assessment process (**ILAAP**). Both processes should ensure that banks identify, effectively manage and cover their capital and liquidity risks at all times. In this regard, the ECB published **Final Guides to the ICAAP and ILAAP** in November 2018.
- These **Final Guides** replace the expectations published in 2016, and provide more detailed ICAAP and ILAAP principles as well as further explanations and examples.
- The insights from **both processes feed into all SREP assessments** and supervisors' decisions about capital and liquidity requirements. Among other things, both the qualitative and quantitative aspects of the ICAAP could play an enhanced role in the calculation of **additional capital requirements** on a risk-by-risk basis.

3. For further information see: ECB tests banks' sensitivity to liquidity risk
4. For further information see: ECB guides to ICAAP and ILAAP

IT and cyber risk / ALGO trading

The ECB has addressed on IT and cyber risk through thematic reviews, on-site inspections, etc. Further, it also have analysed the trends and regulation in the ALGO trading to mitigate related risks

IT and cyber risk (the SSM perspective)[5]

- Today's banks strongly rely on complex IT systems, which means the potential impact of a **cyber-attack on banks** is significant and ensuring their cyber security is vital. Institutions such as the EU, EBA, BCBS and Europol are investigating cyber security to address the risks it may concerns.
- In this regard, the ECB has focused on **IT and cyber risk** since the early days of the SSM and has addressed it from various angles: i) carrying out various **thematic reviews** on the topic in 2015, 2016 and 2017; ii) setting up a **cyber incident reporting process**; iii) carrying out frequent **on-site inspections** with a focus on IT and cyber security; and iv) contributing significantly to the development of EBA's upcoming **Guidelines on IT risk and cyber security**.
- However, it is **banks' own responsibility to safeguard their cyber security** in terms of personnel (e.g. training staff) and technical side (e.g. simplifying IT landscape), including cyber risk in general risk management procedures.

Algorithmic trading: trends and regulation[6]

- Algorithmic (ALGO) trading entails risks stemming from potential failures of algorithms, IT systems and processes. In recent years, a number of major **ALGO trading failures** have resulted in substantial losses, fines and reputational damage for credit institutions and investment firms.
- **MiFID II** and its delegated acts introduced comprehensive requirements to **mitigate the risks for credit institutions** and investment firms engaging in ALGO trading related to, among others, governance, staffing (qualifications, or skills), business continuity arrangements, pre-trade controls, surveillance, security, and reporting.
- National market supervisors have been given the mandate to **enforce the MiFID requirements** vis-à-vis investment firms and credit institutions engaging in ALGO trading. The ALGO trading incidents could also be linked to operational risk as defined in the CRR. Thus, ALGO trading risks would also be considered indirectly by the ECB, within op. risk.

5. For further information see: IT and cyber risk – the SSM perspective
6. For further information see: Algorithmic trading: trends and existing regulation

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Key data / Guide to on-site inspections / Interview

Along with these articles, key data, a Guide to on-site inspections and an interview with Sabine Lautenschläger Vice-Chair of the ECB Supervisory Board are also provided

Key data[7]

- The ECB has published **Supervisory Banking Statistics for 3Q18** on the following aspects of significant institutions:
  - General statistics
  - Balance sheet composition and profitability
  - Capital adequacy, leverage and asset quality
  - Funding
  - Liquidity
  - Data quality
- The ECB has also published selected **Pillar 3 information** on: i) solvency and leverage ratios; and ii) an overview of RWAs as published by G-SIIs and O-SIIs pursuant to the EBA Guidelines 2016/11 on disclosure requirements.

Guide to on-site inspections[8]

- The ECB, following a public consultation, published a **Guide to on-site inspections** and internal model investigations.
- In this regard, the ECB launched **269 on-site missions** at the directly supervised banks in 2018. The missions focused on inspecting, among others, credit, governance, IT, capital and market risks; and included 113 internal model investigations.
- 60 missions were **'cross-border'** or **'mixed-team'**, meaning that the head of the mission and/or a number of team members came from the ECB or another national supervisory authority.

'European banking supervision is well established, but we still need more harmonised regulation'

Interview

- Sabine Lautenschläger, whose five-year mandate as Vice-Chair of the ECB Supervisory Board ends in February 2019, talks about **shocks during the creation of European banking supervision**, ongoing challenges such as Brexit and governance, and the need for a more harmonised implementation of the supervisory rules.

7. Source: ECB, Supervisory Statistics 3Q18
8. Source: Guide to on-site inspections and internal model investigations

Annex

Overview of Supervisory Banking Statistics

The ECB has provided data for the 3Q18[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 3Q18, which includes data from **109 significant institutions** at the highest level of consolidation for which **COREP** and **FINREP are available**.

	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018
Balance sheet composition (€ billions; %)					
Total assets	21,298.37	20,749.86	21,060.05	21,246.63	21,223.50
Total liabilities	19,877.56	19,325.22	19,662.00	19,852.55	19,817.48
Equity	1,420.81	1,424.64	1,398.06	1,394.08	1,406.02
Non-performing loans ratio	5.15%	4.93%	4.73%	4.40%	4.17%
Key performance indicators					
Return on equity (ROE)	7.03%	5.92%	6.61%	6.88%	6.85%
Cost-to-income ratio	62.94%	64.22%	67.43%	65.85%	65.10%
Capital and leverage ratios					
CET 1 ratio	14.32%	14.64%	14.16%	14.10%	14.18%
Tier 1 ratio	15.32%	15.63%	15.34%	15.30%	15.40%
Total capital ratio	17.97%	18.14%	17.81%	17.76%	17.83%
Leverage ratio (transitional definition)	5.39%	5.60%	5.37%	5.36%	5.32%
Leverage ratio (fully phased-in definition)	5.17%	5.41%	5.14%	5.14%	5.11%
Funding					
Loan-to-deposit ratio	117.58%	116.94%	118.64%	118.53%	118.42%
Liquidity					
Liquidity coverage ratio (LCR)*	140.34%	143.56%	141.90%	140.91%	140.93%

* 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.

1. Source: ECB. Cut-off date: 31 December 2018.