



EUROPEAN CENTRAL BANK

BANKING SUPERVISION

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Foreword by Mario Draghi, President of the ECB



An essential ingredient for the euro area's recovery is a stable banking sector that serves the economy. And the key lesson we have learned from the crisis is that strong regulation and effective supervision are essential ingredients for a stable banking sector. In fact, excessive deregulation was among the causes of the global financial crisis. So, stronger rules for the financial sector and better supervision actually belong to the growth agenda. And major progress has been made at European and global levels. In November 2014, European banking supervision was established. This was a decisive step, and it has laid the foundations for a more stable banking sector and a more integrated Europe.

Over the past few years, European banks have become more resilient in terms of capital, leverage, funding and risk-taking. Consequently, they have been able to withstand the economic crisis in emerging markets, the collapse in oil prices and the immediate consequences of Brexit. Healthier banks are also able to continuously provide credit, which is much needed to support the economic recovery in the euro area.

European banking supervision has played an essential role in ensuring the sector's resilience. By introducing tough and fair banking supervision – exercised according to the same high standards across the entire euro area – it has instilled trust in the quality of supervision and, consequently, in the stability of banks.

Challenges remain, however. The banking sector's capacity to fully support the euro area's recovery is curtailed by its low profitability. Overcapacities, inefficiencies and legacy assets contribute to banks' low profitability. It is up to the banks themselves to find appropriate answers to these challenges. And for the sake of a strong recovery in the euro area, they must do so quickly.

European banking supervision greatly contributes to a more stable banking sector in the euro area. At the same time, it ensures a level playing field, which is necessary for a single banking market to emerge. However, to ensure that the integrity of the single banking market remains unquestioned, we need to finalise the banking union. Just as we have created common supervision and resolution in the euro area, we have to ensure that depositors are equally safe everywhere.

Introductory interview with Danièle Nouy, Chair of the Supervisory Board

In November 2016 European banking supervision celebrated its second anniversary. Are you satisfied with its performance so far?

Frankly, I am very proud of what we have achieved. Within a very short time, we have created an institution that helps to ensure the stability of the entire European banking sector. European banking supervision is of course very young, and there is still room for improvement. But it works, and it works well. People from all across Europe are working together towards one common goal: a stable banking sector. Some of them work here at the ECB while many more are working at the national supervisory authorities. Together, they form a truly European team of banking supervisors. And it is their dedication that drives our success. I cannot thank them enough; for me, it is a pleasure and an honour to work together with all these people: the staff at the ECB, the national supervisors and, of course, the members of the Supervisory Board.



In a nutshell, what were the key achievements of European banking supervision in 2016?

Three things come to mind: first, we began to effectively address the issue of non-performing loans. We had already set up a task force to deal with this issue in 2015. In 2016 we produced draft guidance for banks on how to deal with high levels of non-performing loans. That has been a major step forward. Second, we continued to improve the solvency of the euro area banking sector. And finally, we further

harmonised banking supervision in the euro area with the goal of supervising all banks according to the same high standards.

What did you do specifically to harmonise supervisory practices?

European prudential law offers a number of options and discretions which give supervisors some leeway in applying the rules. In 2016 we agreed with the national authorities to exercise these options and discretions in a harmonised manner across the euro area and, subsequently, issued an ECB Regulation and a Guide. Another important means of harmonising supervision is the Supervisory Review and Evaluation Process, the SREP. The SREP ensures that all euro area banks are supervised according to the same methods and standards. In 2016 we further refined and adapted the SREP. As a result, our supervisory capital add-ons are now much more closely correlated with the individual risk profile of each bank.

So banks in the euro area are now operating on a level playing field?

We have made good progress towards that goal. However, there are still some uneven patches. Regulation, for instance, remains somewhat fragmented in the euro area. Some of the rules for banks take the form of EU directives, which still have to be transposed into national law. The actual rules differ therefore from country to country, making European banking supervision less efficient and more costly. So if policymakers are serious about the banking union, they must further harmonise the rules. One option would be to rely less on directives and more on regulations as these are directly applicable in all EU Member States. The recent legislative proposal by the European Commission, which revisits many important aspects of the rulebook, presents a good opportunity to further harmonise banking regulation in the EU. We have to make sure this chance is not missed. The final legal text should also ensure that the supervisor has all the necessary tools and flexibility to carry out its duties adequately.

Does the level playing field also extend to those banks not directly supervised by the ECB?

The ECB directly supervises the 130 or so largest banks in the euro area, the significant institutions. The remaining banks (around 3,200), referred to as the less significant institutions, or LSIs, are directly supervised by the national competent authorities. The ECB plays an indirect role in the supervision of LSIs. Together with the national supervisors we support the establishment of uniform standards for supervising LSIs as well. In 2016 we developed a number of such standards. We also extended our approach to options and discretions to smaller banks, and we are working on a harmonised SREP for LSIs. Naturally, we adhere to the principle of proportionality when dealing with LSIs. We adjust the level of supervisory engagement to the risks borne by smaller banks.

Speaking of banks, how are the European banks doing?

Well, the good news is that they have become much more resilient over the past few years; their capital buffers have increased significantly. At the same time, however, they still face risks and challenges. Besides having to work out how they can raise profits in a challenging environment, how they can dispose of legacy assets and how they should deal with cybercrime and other IT risks, they currently face a number of other questions. Will competition from non-banks intensify? Where is the euro area economy headed? How will Brexit affect banks in the euro area? How will other geopolitical issues play out? Banks are operating in a world characterised by risk and change; they have to manage these risks and adjust to the change. Only then will they be able to remain profitable over the long term.

Low interest rates and stronger regulation are often named as particular challenges for banks. What is your view?

For large banks in the euro area, interest income makes up more than half of their total income. So interest rates are indeed an issue and low interest rates are a challenge. In 2017 we will further explore banks' interest rate risk. For instance, this year's stress test will consist of a sensitivity analysis focused on effects of interest rate changes on the banking book. Regarding regulation, rules invariably impose a burden on those who have to comply. But we have to look beyond the banks in this case. Stronger rules help to prevent crises. And we have learnt that financial crises are costly to the economy, to taxpayers and, ultimately, to the banks themselves. Against that backdrop, it would be most welcome if the global regulatory reform were to be finalised as foreseen. Walking back on the global regulatory reform is the last thing we should do. The financial sector transcends national borders, and so must the rules that govern it – that is a major lesson from the financial crisis.

How does banking supervision address the challenges banks are facing?

The risks and challenges I just mentioned are reflected in our supervisory priorities for 2017. First of all, we will further analyse banks' business models and go on exploring their profitability drivers. To that end, our Joint Supervisory Teams will thoroughly examine their respective banks. And we will also assess how developments such as FinTech and Brexit might impact the business models of banks in the euro area. However, at the end of the day, it is of course not our job to prescribe new business models. But we can and will challenge the existing ones. Our second priority is risk management. In the current environment of low profitability and high liquidity, banks might be tempted to embark on a dangerous search for yield. In that context, risk management is more important than ever. And our third priority is credit risk. This mainly refers to non-performing loans – I already mentioned this important issue.

Non-performing loans have indeed been a big issue in 2016. What is the current state of play?

Banks and supervisors have certainly accomplished much already. Nonetheless, non-performing loans, or NPLs, remain a big issue. They are like dead weight in banks' balance sheets: they curb profits, and they limit the capacity of banks to extend credit to the economy. The guidance we devised will help banks to clean up their balance sheets. It fosters consistent forbearance, recognition, provisioning and disclosure for NPLs. And it urges banks with high levels of NPLs to define and implement specific reduction targets. The best practices defined by the guidance constitute our supervisory expectations. Our Joint Supervisory Teams have already started to actively engage with banks on how they plan to implement the guidance. But the issue of NPLs is not just one for banks and their supervisors. How quickly a bank can resolve its NPLs also depends on the national legal and judicial systems. And in some countries, these systems hamper the speedy resolution of NPLs. Here, national policymakers could help the banks. They could make judicial systems more efficient, increase access to collateral, create fast out-of-court procedures and align fiscal incentives.

You mentioned risk management as one of your priorities for 2017. What is behind that?

It is clear that banks always and everywhere need sound risk management – after all, they are in the business of taking and allocating risks. But sound risk management is complex, and it requires a number of elements. First of all, it requires the right culture – a culture where risk management is valued and not seen as a roadblock on the way to higher profits. More formally, sound risk management requires sound governance structures – risk managers must be given a voice that is heard by those who take decisions. In June 2016 we published the results of a related review which showed that many banks still need to improve in this regard. Finally, sound risk management requires good data. That is why in 2017 we will assess how banks comply with relevant international standards. As a related issue, we have launched a major project to assess the internal models that banks use to determine their risk-weighted assets. These internal models are important because risk-weighted assets form the basis for calculating capital requirements. And finally, we will initiate a thematic review to take stock of banks' outsourced activities and scrutinise how they are managing the associated risks.

Looking further ahead, what is your vision for European banking supervision? How does it serve both the public and the banks?

For banks, supervision is like a counterweight that improves stability: banks tend to see the returns, supervisors tend to see the risks; banks tend to care about profitability, supervisors tend to care about stability. By playing their role, banking supervisors prevent banks from excessive risk-taking, thereby helping to prevent future crises. They protect savers, investors, taxpayers and the entire economy.

European banking supervision has the additional benefit of a dedicated European perspective. Looking beyond national borders, it can spot risks early on and prevent them from spreading. Acting independently from national interests, it can be a tough and fair supervisor for all banks in the euro area. So it helps to create a level playing field, with everyone sharing the same opportunities and the same responsibilities. This is the foundation on which a truly European banking sector can grow for the benefit of the entire economy.

1 Supervisory contribution to financial stability

In 2016 euro area banks posted stable profits, but at low levels. At the same time, their risks and challenges remained mostly unchanged compared to those in 2015. The main risk lay in the sustainability of banks' business models and profitability; other major risks included high levels of non-performing loans and geopolitical uncertainties, such as the medium and long-term impact of Brexit. European banking supervision set its supervisory priorities accordingly.

European banking supervision also continued to improve its main tool, the Supervisory Review and Evaluation Process (SREP). As a result, banks' capital requirements were more closely matched to their individual risk profiles. Overall, the capital demand resulting from the SREP 2016 remained broadly stable.

In 2016 European banking supervision made good progress in dealing with non-performing loans. In September it published draft guidance for public consultation. The recommendations and best practices set out in this guidance will help banks to effectively reduce non-performing loans.

1.1 Credit institutions: main risks and general performance

1.1.1 Main risks in the banking sector and supervisory priorities

Main risks for the European banking sector remain unchanged

The risks identified in 2016 remain relevant, for the most part, in 2017. Banks in the euro area are still operating in a business environment characterised by low economic growth. The bleak economic performance impacts on interest rates and economic recovery and is driving the main risks faced by the euro area banking sector depicted in **Chart 1**.

The prolonged period of low interest rates supports the economy and reduces the risk of defaults. However, it also puts pressure on banks' business models as low interest rates squeeze interest income in a context where the overall profitability is already low. Risks to the **sustainability of business models and low profitability** continued to be one of the main concerns for the euro area banking sector in 2016.

Banks need to reduce high stocks of non-performing loans

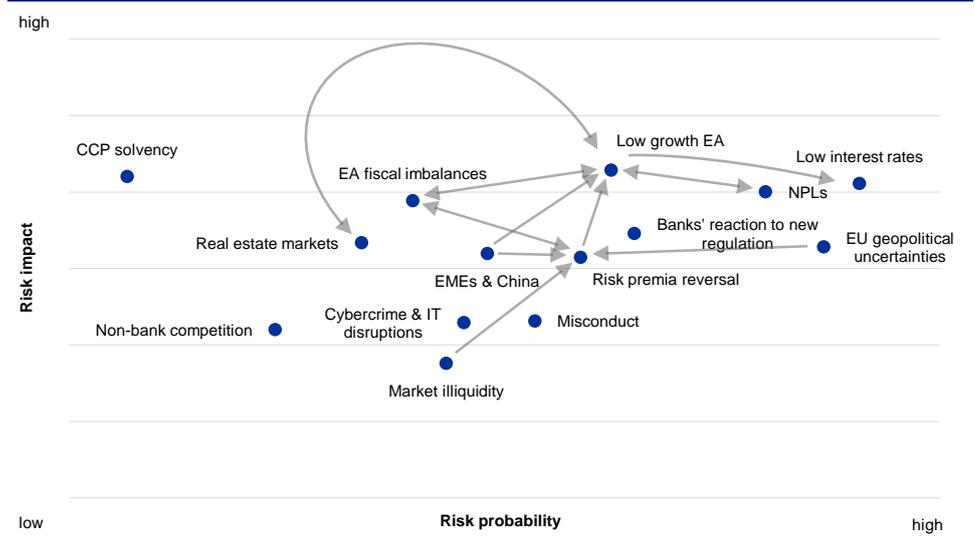
Another source of concern is **high stocks of non-performing loans (NPLs)** in a number of euro area banks. Besides diminishing profitability, they leave the affected banks more vulnerable to shifts in market sentiment. Banks therefore need sound and robust strategies to clean their balance sheets, including active management of the NPL portfolios.

Brexit poses a geopolitical risk for banks

Geopolitical uncertainties are on the rise. Particularly in the context of the UK referendum on **Brexit**, ECB Banking Supervision was in close contact with the most

exposed banks to ensure that they were carefully monitoring the situation and the risks and preparing for the possible outcomes. During this period of time, no material liquidity/funding or operational risks in the banking sector were identified. However, recent political developments may delay investments, leading to sluggish growth.

Chart 1
Risk map for the euro area banking system



Source: ECB; arrows indicate potential transmission channels from one risk driver to another (only main first order effects are represented); NPL: this risk driver is only relevant for euro area banks with high non-performing loan ratios.

Notwithstanding the benefits of a safer and more resilient financial system, ambiguity surrounding **future regulation** is also an issue. The completion of the Basel III review, the determination of **minimum requirement for own funds and eligible liabilities** (MREL) targets will reduce regulatory uncertainty and make the banks' operating environment more stable. In the meantime, banks are also preparing for the implementation of IFRS 9, which will enter into force at the beginning of 2018. On the whole, certain banks may still find it challenging to meet stricter requirements while maintaining adequate profitability.

In 2016 ECB Banking Supervision conducted the **EU-wide European Banking Authority (EBA) stress test** for euro area banks and the **ECB Banking Supervision SREP stress test**.¹ The EU-wide stress test covered 37 large significant institutions (jointly representing roughly 70% of the banking assets under European banking supervision). Stress test results for these banks were published by the EBA on 29 July 2016.² The SREP stress test covered an additional 56 significant institutions in the euro area. Broadly the same methodology was used in both exercises to assess the resilience of financial institutions to adverse market developments and to provide input to the SREP.

¹ In order to give consistent treatment to all significant institutions in the SREP, ECB Banking Supervision conducted the SREP stress test covering those significant institutions that were not subject to the EU-wide EBA stress test.

² The EBA published details of the stress test results on its [website](#).

The stress test outcome showed that:

- the banking system can withstand an even more severe stress impact than the one simulated in the 2014 comprehensive assessment, while maintaining on average the same level of capital after stress;
- the most relevant drivers in terms of the difference between stress test result in the baseline and adverse scenarios were increased loan losses, reduced net interest income and higher revaluation losses of market risk positions;
- banks with lower credit quality and higher NPL ratios perform worse on average, in terms of the stress impact on both loan losses and net interest income; this underlines the importance of addressing high NPL ratios.

A team of roughly 250 members from the ECB and from NCAs/NCBs subjected the stress test results, as calculated by the banks, to a robust quality assurance process. This process drew on the bank-specific knowledge of Joint Supervisory Teams (JSTs), peer benchmarking, the ECB’s own top-down calculations and NCA expertise.

Figure 1
Supervisory priorities for 2016 and 2017

Priorities 2016	Priorities 2017	Supervisory activities for 2017 & beyond	Likely to be continued in 2018
Business models & profitability drivers	 Business models & profitability drivers	Assess banks' business models and profitability drivers	<input type="radio"/>
		Brexit preparations – dialogue with banks	<input checked="" type="checkbox"/>
		Non-bank competition / FinTech	<input checked="" type="checkbox"/>
Credit risk	 Credit risk focus on NPLs and concentrations	Consistent approach to NPLs/ forbore exp. (e.g. deep dives / OSIs)	<input checked="" type="checkbox"/>
Evaluate banks' preparedness for IFRS 9		<input type="radio"/>	
Track exposure concentrations (e.g. shipping/ real estate)		<input checked="" type="checkbox"/>	
Risk governance & data quality	 Risk management	Assess compliance with BCBS 239 - Basel principles on risk data aggregation and risk reporting	<input type="radio"/>
TRIM ¹ Credit risk, market risk and counterparty credit risk models		<input checked="" type="checkbox"/>	
Improvement of banks' ICAAP ² and ILAAP ³		<input checked="" type="checkbox"/>	
Liquidity		Outsourcing	<input checked="" type="checkbox"/>

1 Targeted review of internal models
 2 Internal Capital Adequacy Assessment Process
 3 Internal Liquidity Adequacy Assessment Process
 Note: Thematic reviews are highlighted by a dark blue border.

The quantitative impact of the adverse stress test scenario is one factor in determining the level of Pillar 2 guidance (P2G). The qualitative outcome of the stress tests is included in the determination of the Pillar 2 requirement (P2R)³. Moreover, in addition to risks already identified through the ongoing supervisory assessment, the stress test pointed to key vulnerabilities of euro area banks in the event of an adverse shock. For instance, most loan losses came from unsecured retail and corporate exposures. The stress test also identified lending to certain geographies such as Latin America as well as Central and Eastern Europe as a driver of credit losses.

The **SSM supervisory priorities** set out focus areas for supervision in a given year. They build on an assessment of the key risks faced by supervised banks, taking into account the latest developments in the economic, regulatory and supervisory environment. The priorities, which are reviewed on an annual basis, are an essential tool for coordinating supervisory actions across banks in an appropriately harmonised, proportionate and efficient way, thereby contributing to a level playing field and a stronger supervisory impact (see **Figure 1**).

1.1.2 General performance of significant banks in 2016

Profits of significant institutions in the euro area remained stable

The results of the first three quarters of 2016 show that the profitability of significant institutions remained stable in 2016⁴. The average annualised return on equity for a representative sample of 101 significant institutions stood at 5.8% in the third quarter of 2016, slightly decreasing year on year (6.0% in the third quarter of 2015)⁵. However, it should be noted that, behind these aggregate figures, we observe a great variety of developments.

 **5.8%**
Return on equity in 2016

Recurring revenues contracted in 2016: the aggregate net interest income of significant institutions decreased by 3%, despite a slight increase in loans (+0.5% year on year), particularly in corporate loan volumes (+2.8%). The decrease was concentrated in the first quarter of 2016. Thereafter, interest revenues stabilised. Fee income also decreased (-2.8% year on year), largely reflecting a decline in commissions from asset management and capital markets activities during the first three quarters of 2016. The trend may have been reversed in the fourth quarter of 2016 as capital markets activities picked up again.

³ See also Section 1.2.1.

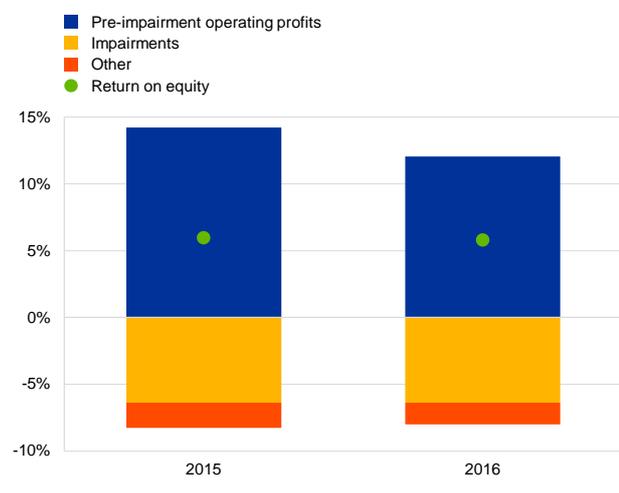
⁴ In this section, data for 2016 refer to the third quarter of 2016.

⁵ Aggregate return on equity stood at 4.8% in the fourth quarter of 2015. On an annualised basis, fourth-quarter figures tend to be lower than third-quarter figures owing to seasonality in some of the underlying items.

Chart 2

Stable level of return on equity in 2016 due to lower impairment charges offsetting the decline in operating profits

(All items are weighted averages displayed as a percentage of equity)



Data for both years are shown as Q3 cumulated figures annualised.
Source: FINREP framework (101 significant institutions reporting IFRS data at the highest level of consolidation).

The negative impact of decreasing revenues was partly mitigated by lower operating expenses (-1%). The cost reduction was particularly pronounced for staff expenses (-1.4% year on year). In view of the restructuring measures recently undertaken by several euro area banks, the trend may continue in the coming quarters.

Improving macroeconomic conditions had a positive effect on impairment charges, which were lower than in 2015: impairments on loans and other financial assets dropped from 5.5% of aggregate equity in the third quarter of 2015⁶ to 4.4% in the third quarter of 2016. Most of the improvement was concentrated in a few jurisdictions, while credit losses had already been at historically low levels in some of the other countries. Past experience suggests that banks tend to book higher impairments in the fourth quarter, which could affect profitability results over the full year.

Extraordinary sources of income supported banks' profitability in 2016 (3.4% of aggregate equity in the third quarter of 2016). However, one-off gains were lower than in 2015 and may not be repeated in the coming quarters.

1.2 Implementing the SSM model of supervision

1.2.1 Refining the SSM SREP methodology

Owing to improvements in the SREP methodology, the correlation of banks' risk profiles with their capital requirements increased

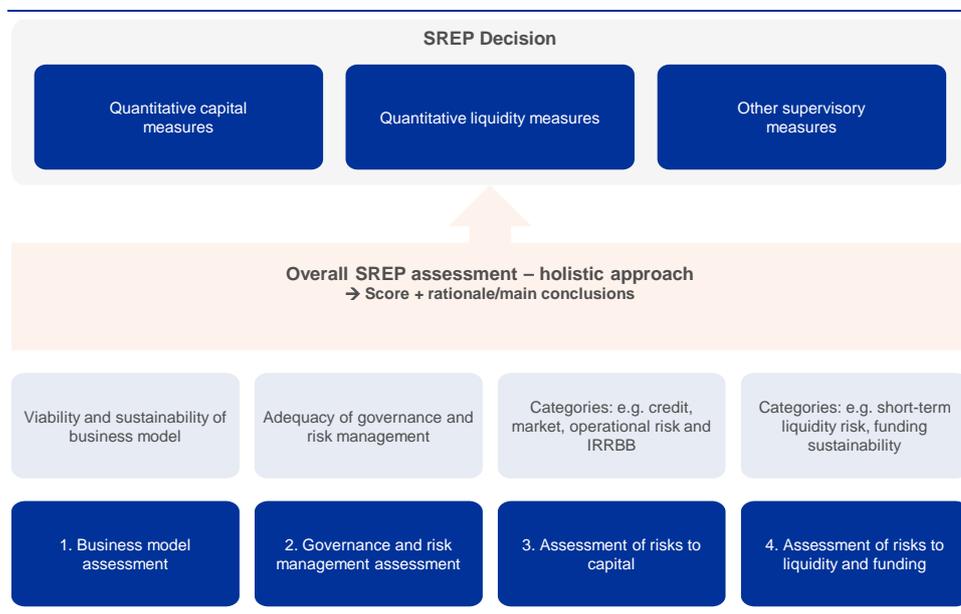
76%
Correlation between capital requirements and risk profiles

Based on a common methodology for the largest banking groups in the euro area, European banking supervision carried out the SREP for the second time in 2016. Again, the objective was to promote a resilient banking system that is able to sustainably finance the euro area economy. The harmonisation already achieved in the 2015 supervisory cycle led to tangible results in this regard. Building on these achievements, the SREP assessment has been enhanced. The enhancements are reflected in an increased correlation of capital requirements with banks' risk profiles (from 68% after the SREP 2015 to 76% after the SREP 2016). At the same time, the general approach of combining quantitative and qualitative elements through constrained expert judgement has been maintained. In addition, the SREP methodology has been further complemented in order to incorporate the results of the 2016 EU-wide stress test.

⁶ The figure for the fourth quarter of 2015 was 5.8%.

Figure 2 gives an overview of the SREP methodology. An update of the relevant [SSM SREP Methodology Booklet](#) was published in December 2016.

Figure 2
SSM SREP methodology 2016



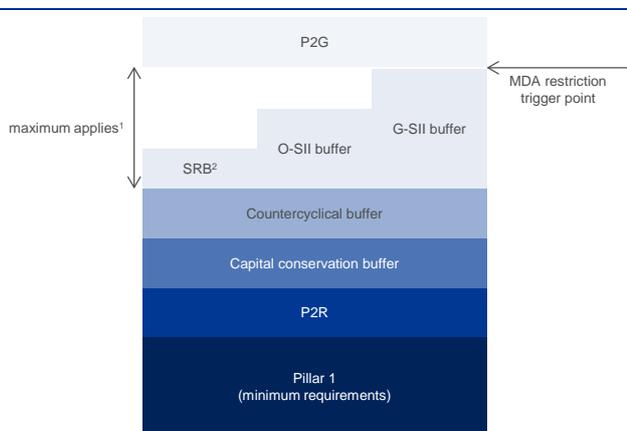
The JSTs delivered the key input for the SREP by assessing, for their respective banks, each of these four elements: **business model, governance and risk management, risks to capital** and **risks to liquidity and funding**.

The SSM SREP methodology was enhanced in 2016

In 2016 the SREP methodology for assessing governance and risk management was enhanced, on the basis of the extensive thematic review on risk governance and appetite⁷ performed by the JSTs in 2015.

⁷ See Section 1.2.5.

Figure 3
P2G is not included in the calculation of the MDA



1) Most common case; specific calculation may occur depending on implementation of CRD IV Article 131(15) by Member State

2) Systemic risk buffer

Notes: Scale not meaningful; implementation of the EBA opinion on MDA and 1 July 2016 press release.

Moreover, in 2016, Pillar 2 guidance (P2G) was introduced as set out by the EBA in July 2016⁸. P2G is complementary to Pillar 2 requirements (P2R) and constitutes a supervisory expectation for banks' capital above the level of binding capital (minimum and additional) requirements and on top of the combined buffers (see **Figure 3**). As a supervisory expectation, P2G is not included in the calculation of the maximum distributable amount (MDA) laid down in Article 141 of the Capital Requirements Directive (CRD IV).

When drawing up P2G, the following elements are taken into account in an holistic approach: in general, the depletion of capital in the adverse scenario of the **stress test**; the specific risk profile of the individual institution and its sensitivity towards the stress scenarios; interim changes in the institution's risk profile since the stress test cut-off date; and measures taken

by the institution to mitigate risk sensitivities.

Although banks are expected to comply with P2G, a failure to comply with it does not trigger automatic restrictions. Should a bank fail to meet its P2G, ECB Banking Supervision will adopt corrective measures that are finely tuned to the bank's individual situation.

SREP CET1 demand remains stable for 2017

The results of the 2016 SREP have kept the overall SREP Common Equity Tier 1 (CET1) demand for 2017 at the same level as in the previous year. All things being equal, the current capital demand in the system also provides an indication for the future.⁹ In a number of individual cases, the SREP CET1 demand changed to reflect the evolution of the risk profile of the respective institutions. In the 2016 SREP, capital shifted from the 2015 Pillar 2 to the newly introduced P2G and the inclusion of the non-phased in part of the capital conservation buffer was eliminated. As P2G is not factored into the respective calculations, the MDA trigger decreased from an average of 10.2% to an average of 8.3%.

In addition to capital measures, more use has been made of qualitative measures to address specific weaknesses of individual institutions. The likelihood of these measures correlates with the risk profile of banks: the higher the risk, the more likely the use of qualitative measures.

SREP 2017 – no substantial changes expected

The SSM SREP methodology is not expected to change substantially in 2017. Nonetheless, ECB Banking Supervision will continue to refine it in line with its forward-looking approach to adequately monitoring banking activities and risks.

⁸ [Information update on the 2016 EU-wide stress test](#)

⁹ Capital demand refers to Pillar 1 plus Pillar 2 requirements, plus the capital conservation buffer, plus Pillar 2 guidance. Irrespective of the phasing-in of this buffer, banks may expect to have positive P2G in the future.

1.2.2 Work on other methodologies

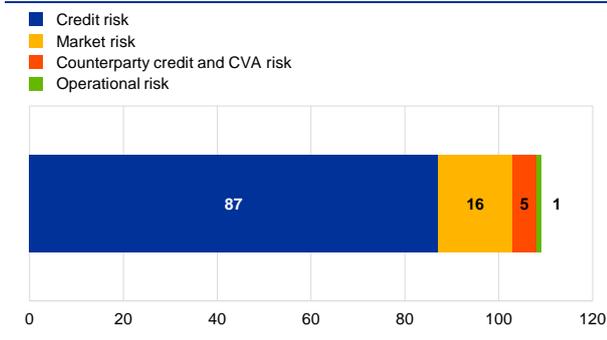
The objectives and the set-up of TRIM have been laid down in detail

 **109**
Internal model investigations launched in 2016

In 2016 conceptual work on internal models focused on the **targeted review of internal models (TRIM)**, which starts in 2017. In preparation for TRIM, ECB Banking Supervision:

- made a representative and risk-based selection of models to be reviewed on-site;
- formulated a supervisory guide for specific risk types and set in place inspection techniques for their validation;¹⁰
- drew up organisational provisions to deal with the increased number of internal model investigations performed on-site in the coming years;
- updated the significant institutions regularly on the project;
- conducted several information-gathering exercises, enabling significant institutions to contribute to the preparatory phase.

Chart 3
Most internal model investigations in 2016 focused on credit risk



Over the past year, 109 internal model investigations were launched at significant institutions, and 88 ECB decisions concerning internal models were issued. These numbers are likely to increase in future when additional investigations are performed in the context of TRIM.

Further progress has been made regarding the **harmonisation of assessment practices** of internal models. ECB and NCA staff represented European banking supervision in European and international fora on issues relating to internal models and participated in various exercises, such as the EBA benchmarking of internal models.

1.2.3 Credit risk: work on non-performing loans

Levels of non-performing loans have increased significantly since 2008

Non-performing loans (NPLs) pose a particular challenge to banks. NPLs have increased significantly since 2008, particularly in Member States that underwent significant economic adjustment processes over the past years. Large amounts of NPLs contribute to low bank profitability and constrain the ability of banks to provide new financing to the economy.

¹⁰ The guide was published on 28 February 2017.



6.49%

Weighted average of gross NPL ratio for significant institutions



€54 billion

Decrease in stock of non-performing loans between the third quarters of 2015 and 2016

The ECB supports banks in resolving legacy NPLs and preventing the build-up of new NPLs

As of the third quarter of 2016, the weighted average gross NPL ratio of significant institutions stood at 6.49%, compared with ratios of 6.85% in the first quarter of 2016 and 7.31% in the third quarter of 2015. Aggregated data for significant institutions show that the stock of NPLs decreased by €54 billion between the third quarters of 2015 and 2016 respectively (of which €15.59 billion in the third quarter of 2016). As of the third quarter of 2016, the stock had reached €921 billion.¹¹

Beginning in 2014 with the comprehensive assessment, the ECB has continued to support the resolution of NPLs through constant supervisory dialogue with affected banks.

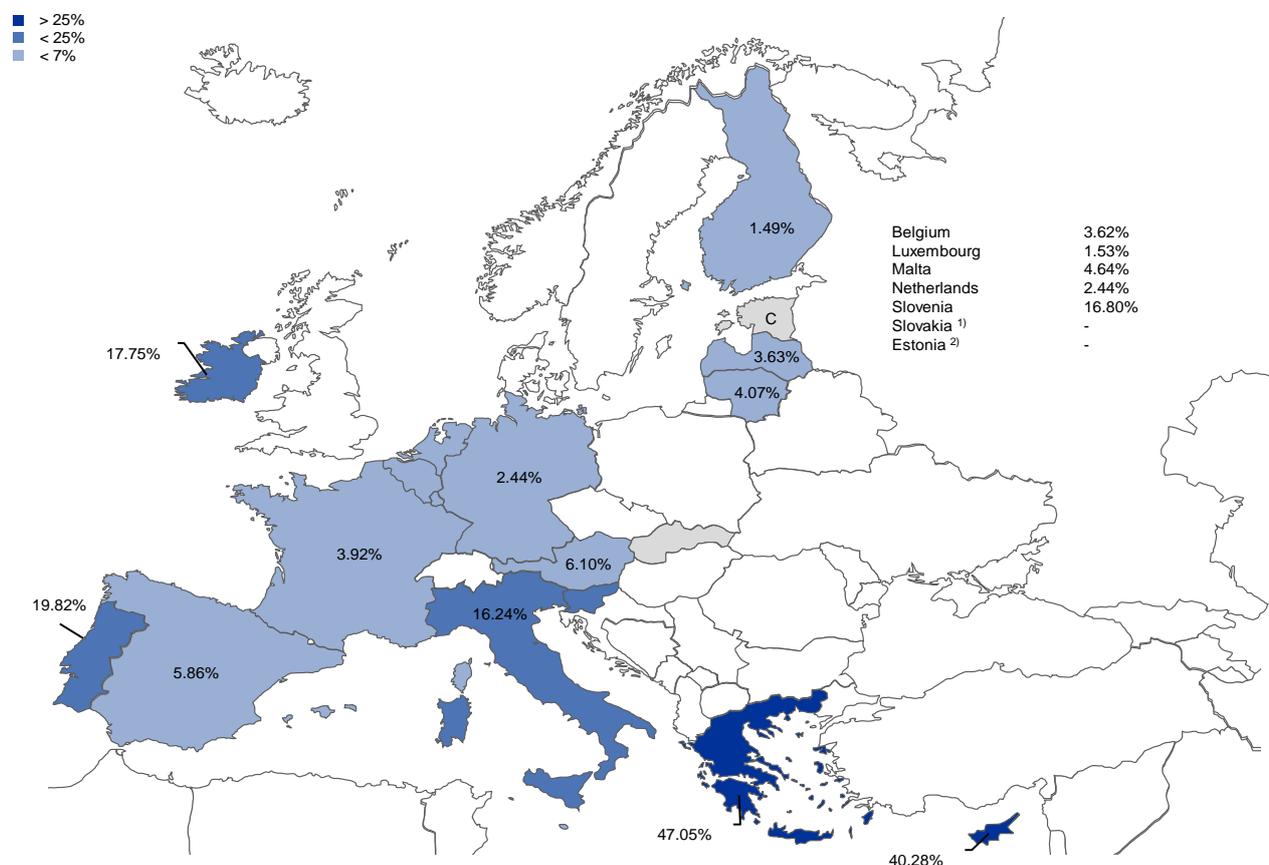
In order to address the challenge of NPLs in a determined and forceful manner, European banking supervision set up a dedicated task force on NPLs in July 2015. The task force, which comprises representatives from NCAs and the ECB, is chaired by Sharon Donnery, Deputy Governor of the Central Bank of Ireland. The objective of the task force is to develop and implement a consistent supervisory approach towards institutions with high levels of NPLs.

Drawing on the work of the task force, the ECB published [guidance on NPLs](#) to banks, for consultation in the period from 12 September to 15 November 2016. A public hearing was held on 7 November. More than 700 individual comments were received and assessed by the task force during the formal consultation process. The final guidance was published in March 2017. This guidance is an important step on the journey towards a significant reduction of non-performing loans.

¹¹ Data refer to significant institutions at the highest level of consolidation for which common reporting on capital adequacy (COREP) and financial reporting (FINREP) are available. The list of banks used for the various reference periods may differ in line with changes to the list of significant institutions and as banks start to report under FINREP obligations. Specifically, 102 banks are covered in the second quarter of 2015, 123 in the first quarter of 2016 (increase in FINREP reporting obligations) and 124 in the second quarter of 2016 (changes in the list of significant institutions and FINREP reporting obligations). The number of entities per reference period is expected to stabilise in future, with any changes resulting from amendments to the list of significant institutions following assessments, generally on an annual basis, by ECB Banking Supervision.

Figure 4

Ratio of non-performing loans in the euro area



Source: ECB.

Notes: Data as of the third quarter of 2016; significant institutions at the highest level of consolidation for which common reporting (COREP) and financial reporting (FINREP) are available.

1) There are no significant institutions at the highest level of consolidation in Slovakia.

2) The value is suppressed for confidentiality reasons owing to the limited size of the sample.

The NPL guidance addresses the main aspects of strategy, governance and operations that are key to successfully resolving NPLs. As detailed below, it provides recommendations to banks and sets out a number of best practices identified by European banking supervision that constitute its supervisory expectations.

- The guidance recommends that banks with a high level of NPLs establish a clear strategy, aligned with their business plan and risk management framework, to effectively manage and reduce their NPL stock in a credible, feasible and timely manner. The bank's strategy should include the setting of quantitative targets at the level of portfolios, supported by a detailed implementation plan.
- It urges banks to put in place appropriate governance and operations structures to deliver effective NPL workout. Towards that end, the banks should closely involve senior management, set up dedicated NPL workout units and establish clear policies linked to NPL workout.

- It provides banks with a consistent methodology for the recognition of NPLs and for the calculation of loan loss provisioning and write-offs in line with international recommendations and best practices.
- It fosters enhanced disclosures of NPLs in order to increase market confidence.

JSTs have started to actively engage with supervised banks to support the implementation of the guidance.

Effectively reducing NPLs requires not only supervisory activities, but also legal and institutional reforms

Addressing NPLs remains a key supervisory priority of European banking supervision. However, resolving NPLs depends on the actions of many different stakeholders; the issue cannot be tackled by supervisors and banks alone. Further regulatory and policy actions at the EU and national level are needed to remove obstacles that prevent banks from resolving their NPLs and restructuring distressed debt.

ECB Banking Supervision, together with the NCAs, conducted a **stocktake of national supervisory practices and legal frameworks** concerning NPLs in eight euro area countries. A final report also covering the remaining euro area Member States will be published in the course of 2017. Some countries have taken proactive and coordinated prudential, judicial and other measures to tackle the issue. Other countries could further improve their legal and judicial framework to facilitate the timely workout of NPLs. In addition, secondary markets for NPLs need to be developed in order to facilitate sales of distressed assets. In this context, it is necessary to foster the development of an NPL servicing industry, to improve data quality and access to data, and to remove tax and legal impediments to debt restructuring.

1.2.4 On-site supervision

Second cycle of on-site inspections



185

On-site inspections were approved for 2016

The second cycle of on-site inspections was part of the overall 2016 supervisory examination programme (SEP) planning that was approved in January 2016. In July 2016 the semi-annual planning update cancelled some on-site inspections and approved additional ones for the second half of the year. In total, 185 on-site inspections were approved for the year 2016.

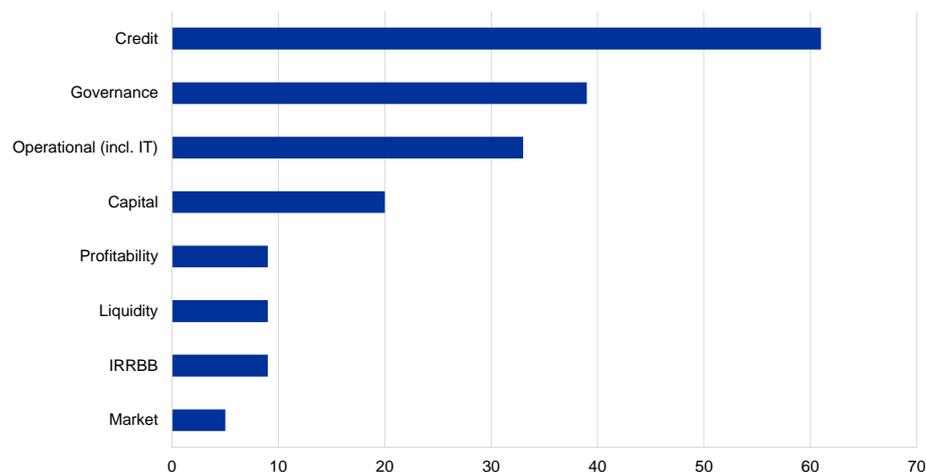
The planning of on-site inspections was further improved in 2016

To further develop and improve the planning of on-site inspections, the following strategic actions were implemented in 2016 and used for the 2017 planning cycle. First, a **targeted engagement level** formalises the enhanced risk-based approach by providing indicative targets for the number of missions per institution and topic over a three-year horizon. Second, the **blind spot tracker** identifies potential inspection gaps or outliers that still need to be addressed. Third, the duration of the missions is shortened to optimise the timely treatment of their findings.

Chart 4

On-site inspections mainly focused on credit risk, governance and operational risks

Number of inspections by main risk category



On-site inspections are planned and staffed in close cooperation with the NCAs, which continue to provide most of the heads of mission and team members. As of 31 December 2016, the NCAs had provided 167 or 90% of the heads of mission while 10% of the heads of mission were provided by ECB Banking Supervision.

Table 1

Authorities providing the Head of Mission

Total OSI approved	ECB		Non-home NCA		Home NCA	
185	18	9.73%	17	9.19%	150	81.08%

In 2016 ECB Banking Supervision led 18 missions across euro area countries. The primary focus was on credit risk, with capital requirements a close second.

Cross-border staffing of missions is now supported by an on-site inspection tool, “Market Place”. This instrument enables all NCAs to access the list of forthcoming on-site inspections which are suitable for staffing by **mixed/cross-border teams**¹², and to register their interest in participating in, or leading, these on-site inspections.

In total, 74 mixed-team missions took place, accounting for 40%¹³ of the total number of on-site inspections.

¹² Meaning at least one on-site inspector is not a national of the country where the bank is established.

¹³ Including JST participation in on-site inspections.

Table 2

Mixed team overview

Total OSIs approved	ECB and NCA on-site inspectors		Mix of NCA on-site inspectors		JST members and ECB and/or NCA on-site inspectors	
185	20	10.81%	27	14.59%	27	14.59%

To ensure close collaboration with the NCAs on all topics relating to on-site inspections, ten network meetings were held in 2016 along with 15 bilateral meetings with individual NCAs. Seminars and workshops for heads of mission were organised in order to foster consistency of on-site inspection-related work within European banking supervision. A web-based community page now provides a platform for communicating with all internal ECB stakeholders and SSM-wide partners.

Ongoing monitoring activities

The ECB's Centralised On-Site Inspections Division (i) reviews during the preparatory phase the pre-inspection note in which the JST sets out the mission objectives, (ii) monitors the progress of the on-site inspections and (iii) carries out quality checks on all inspection reports to ensure a consistent application of the on-site inspection methodology.

The Centralised On-site Inspections Division takes a risk-oriented approach. It dedicates extra resources for the monitoring of critical missions, thereby ensuring that the Supervisory Board is informed in good time, should the outcome of an on-site inspection give rise to major concerns. The ECB and the NCAs perform all activities in close liaison, in order to support the development of a mutual understanding and a common approach.

Work on methodologies

The on-site methodology used by all European banking supervision inspectors is being developed and continuously updated. In 2016 the existing **credit risk methodology** was revised in order to provide heads of mission with practical guidance on how to perform credit file reviews. The updated methodology now provides for:

- a set of commonly used techniques for sampling exposures and a sample size floor;
- guidance on the classification of exposures;
- techniques for calculating individual and collective impairments;
- guidance on collateral evaluation.

The **IT risk methodology** was also revised to reflect new supervisory priorities related to IT risk, such as cyber risk and data quality. It also reflects the Basel Committee on Banking Supervision (BCBS) 239 Principles for effective risk data aggregation and risk reporting in conjunction with the associated thematic review.

Two specific issues are being addressed through two separate methodology working groups: (i) a horizontal review of shipping portfolios to analyse and compare the quality of these portfolios and the risk management approaches of the most relevant significant institutions, and (ii) the strengthening of the IT risk assessment methodology so as to further develop the best supervisory practices, in particular regarding cyber risk.

Finally, a guide to on-site inspections is under preparation, which will explain how on-site inspections are conducted and will provide a useful reference document for banks subject to such missions.

1.2.5 Work on thematic reviews

Business models and profitability drivers

In 2016 European banking supervision launched a thematic review for the in-depth assessment of the business models and profitability drivers of most significant institutions.

Banks' business models and profitability drivers remain a key priority for European banking supervision

Banks' business models and profitability drivers are a key priority for European banking supervision. Profitable banks can generate capital organically and thus maintain adequate buffers, while maintaining a reasonable risk appetite, and lending to the real economy. However, in the current environment, euro area banks' profitability is not only challenged by low interest rates and continued high impairment flows (see Section 1.1). It is also challenged by structural factors, such as overcapacity in some markets, tougher competition from non-banks, increasing customer demand for digital services as well as new regulatory requirements.

The thematic review addresses banks' profitability drivers both at firm level and across business models. Spanning two years, the review has several objectives. Besides assessing banks' ability to mitigate weaknesses in their business models, it will monitor how weak profitability impacts on banks' behaviour and it will enrich horizontal analysis, in particular by pooling the insights gained by the JSTs and harmonising their follow-up across banks.

In the first year of the thematic review, European banking supervision's toolkit for the assessment of banks' business models and profitability has been enriched in several ways. The **business model classification** of significant institutions was improved to facilitate peer comparison among individual banks. The classification complements other benchmarking criteria such as firm size, risk rating or geography. In addition, several dedicated benchmarking tools have been developed to support JSTs in assessing their banks' profitability.

ECB Banking Supervision has also collected **data on banks' forecasted profit and loss results as well as the underlying assumptions**. Results show that banks' revenues will remain under pressure in the short term. This is mainly due to low interest rates weighing on net interest income, but also on weaker loan growth, which, on average, falls short of banks' own expectations. This exercise will be repeated this year.

ECB Banking Supervision has also developed detailed **guidance to support JSTs' profitability analysis at firm level** in 2017. The guidance covers several aspects related to banks' profitability, from banks' core capacity to generate revenues to their ability to steer profits. Bilateral discussions between supervisors and banks should ensure that the business models and profitability drivers of all significant institutions are assessed in depth by the end of the thematic review in 2017. A proportionate approach will be applied in order to take into account the size and complexity of individual institutions.

The results of the in-depth assessment conducted by all JSTs will inform the SREP, primarily in 2018, as well as the supervisory engagement and planning for individual institutions. The analyses will offer the opportunity to benchmark banks' practices across comparable institutions.

IFRS 9 financial instruments

ECB Banking Supervision is carrying out a two-year thematic review, extending over 2016 and 2017, to scrutinise how banks implement the new accounting standard IFRS 9, the main focus lying on the **new impairment model**. The review also assesses whether banks are taking into account the principles established by the Basel Committee guidance on credit risk and accounting for expected credit losses. The EBA incorporated these principles into its consultation paper on draft Guidelines on credit institutions' credit risk management practices and accounting for expected credit losses.

The scope of the thematic review extends to all significant institutions that apply International Financial Reporting Standards (IFRS). The specific objectives of the review are to (i) evaluate how institutions are prepared for the introduction of IFRS 9, (ii) assess the potential impact on institutions' provisioning practices, and (iii) help to foster high-quality implementation of IFRS 9.

In 2016 ECB Banking Supervision developed a relevant internal **supervisory assessment methodology**. This methodology takes into account the regulatory developments, emerging best practices and implementation issues, based on discussions with practitioners (institutions, auditors, consultants). Furthermore, ECB Banking Supervision, in cooperation with leading accounting experts, provided training on IFRS 9 and the assessment methodology for around 250 supervisors.

Based on the assessment methodology, the thematic review was launched in coordination with an EBA survey¹⁴ for more than 100 significant institutions in December 2016, with the JSTs evaluating the level of preparedness of banks and their implementation practices. This evaluation is to be followed by a horizontal analysis which, taking into account the results of the above-mentioned EBA survey, will benchmark banks against their peers. The results of the thematic review are expected to contribute to a proper and consistent implementation of IFRS 9 and its provisioning policies by 1 January 2018, the effective date of IFRS 9.

Risk data aggregation and risk reporting

Sound risk management rests on firm-wide data quality, effective risk data aggregation and internal reporting practices. However, a key lesson from the financial crisis was that certain banks were unable to fully identify risk exposures. The reasons were a lack of adequate risk information together with weak risk data aggregation practices. The affected banks' ability to take timely decisions was seriously damaged, with wide-ranging consequences for the banks themselves and the financial sector as a whole.

Against this backdrop, the thematic review on risk data aggregation and risk reporting was among the 2016 supervisory priorities. Its objective was to assess the effectiveness of risk data aggregation and risk reporting practices as well as related IT infrastructure. This assessment is mainly guided by the **BCBS 239 Principles for effective risk data aggregation and risk reporting**.

In early 2016 ECB Banking Supervision launched the thematic review on effective risk data aggregation and risk reporting for a subset of banks under its direct supervision. The sample included two groups of banks. First, those banks which were involved in the BCBS 239 self-assessment performed by the Basel Committee in 2013 and 2014 – this group was largely identical with the group of banks classified as global systemically important banks at the time. Second, a further set of banks was included in the sample in order to broaden it.

The thematic review is being performed by JSTs with the support of a centralised working group, comprising members of the ECB and NCAs. The latter provide operational guidance and ensure consistent application. The work is carried out in line with the principle of proportionality and was divided into two main phases in 2016. During Phase 1 appropriate operational guidelines for analysing and assessing the compliance status were developed, with a focus on risk type (credit risk, liquidity risk, counterparty credit risk, operational risk, interest rate risk in the banking book – IRRBB – and market risk). Phase 2 comprised a deep-dive analysis of the liquidity risk and credit risk dimensions. First, banks in scope were asked to provide a specific set of liquidity and credit risk data in a compressed period of time (fire drill exercise). Second, the same banks were requested to show their data

¹⁴ [Second impact assessment of IFRS 9 on EU banks](#).

extraction as well as their management and reporting process for selected credit and liquidity metrics from an end-to-end perspective (data lineage exercise¹⁵).

Figure 5

Phase 2 of the thematic review on effective risk data aggregation and risk reporting focused on credit and liquidity risk

Module	BCBS 239 Principle	
Governance and IT infrastructure	1. Governance	
Risk data aggregation	2. Data architecture and IT infrastructure	
	3. Accuracy and integrity	
	4. Completeness	
	5. Timeliness	
	6. Adaptability	
Risk reporting	7. Accuracy	
	8. Comprehensiveness	
	9. Clarity and usefulness	
	10. Frequency	
	11. Distribution	

Several banks will need time to fully comply with BCBS 239

The results of the thematic review will help in developing further supervisory actions and will feed into the next SREP cycle. The analysis of the overall results will allow for overarching conclusions. BCBS 239 Principles expected global systemically important banks (G-SIBs) to be compliant by January 2016 and domestic systemically important banks within three years of their designation (i.e. after end-2019). However, G-SIBs' full compliance with BCBS 239 will not be achieved in the near future as several banks' implementation schedules will run until the end of 2018 or beyond. Compliance with BCBS principles is an ongoing process. Hence, changes in banks' business models and risk profiles should be properly addressed and banks need to periodically assess the adequacy of their risk data aggregation and risk reporting capabilities.

Risk governance and appetite

In 2016 European banking supervision continued to work on banks' governance. Its work built on the results of the thematic review on governance and risk appetite that was performed in 2015 in order to promote consistency and compliance with highest standards.

In 2016 European banking supervision clarified its supervisory expectations on governance and risk appetite

In early 2016 all 113 JSTs involved in the thematic review sent follow-up letters to their institutions requesting them to implement specific actions. Over the course of

¹⁵ Data lineage is defined as a data life cycle that includes the data's origins and where the data move over time: adopting an "end-to-end approach" refers to optimising effectiveness and efficiency in the process by eliminating as many middle layers or steps as possible.

the year, JSTs actively monitored the [implementation of these recommendations](#) as part of their ongoing supervision.

The thematic review had a positive impact in helping to enhance the effectiveness of banks' management bodies and risk management functions. Nearly all banks are now developing board self-assessments, succession planning processes and frameworks to prevent conflicts of interest within their boards. Some banks are also adjusting the composition of their boards. In addition, the quality of relevant documentation received by boards has improved, and banks have started to define and implement a risk appetite dashboard.

As some of the recommendations are still being implemented, follow-up activities will continue in 2017. The JSTs will pay specific attention to the capacity of boards to independently challenge senior management and to the inclusion of the risk perspective in the decision-making process. The JSTs will also closely monitor (i) the comprehensiveness of risk appetite frameworks (particularly regarding the inclusion of non-financial risks), (ii) the effectiveness of limits, (iii) the interplay between risk appetite and strategy, as well as (iv) the deployment of the risk appetite framework.

In addition, 25 banks have been subjected to two in-depth analyses since end-2016. These analyses cover risk appetite limits and the board's oversight of the internal control functions. These investigations will be concluded in the first half of 2017.

In June 2016 the ECB published the [SSM supervisory statement on governance and risk appetite](#), which aims to guide institutions towards the implementation of international best practices. In addition, on 23 June 2016, ECB Banking Supervision organised a [conference on governance](#) with top executive and non-executive directors in order to enhance the dialogue between banks' boards and supervisors¹⁶. In 2017, the ECB will continue to foster dialogue with banks' boards and play an active role at EU and international level in the definition of international standards.

Leveraged finance

In 2016 the ECB published a draft guidance on leveraged transactions for public consultation

From end-November 2016 to end-January 2017, the ECB held a public consultation on its [draft guidance on leveraged transactions](#). The guidance aims at developing clear and consistent definitions, enabling consistent monitoring, and defining adequate measures with regard to leveraged transactions. The draft guidance followed on from a thematic review, which was launched as part of the SSM Supervisory Priorities for 2015.

The review included an in-depth survey of euro area banks' activity and risk management frameworks with regard to leveraged finance. During the first half of 2016, 17 JSTs sent follow-up letters to their institutions requesting them to implement specific actions – pertaining, in particular, to risk management practices – and develop action plans to remediate the findings from the review.

¹⁶ [Enhanced dialogue between boards and supervisors: towards a sound governance framework.](#)

In addition, the ECB decided to define general supervisory expectations in the form of the above-mentioned guidance. The guidance recommends that banks put in place a unique and overarching definition of leveraged transactions. Moreover, they should clearly define their strategy for leveraged transactions and their appetite for underwriting and syndicating such transactions. Banks should also make sure that realised transactions adhere to their risk appetite standards. This can be achieved through a solid credit approval process and regular monitoring of leveraged portfolios. Finally, regular comprehensive reports about leveraged transactions should be produced and sent to banks' senior management.

In 2017 the ECB will follow up on the public consultation and issue the final guidance on leveraged transactions. It will complement this approach with a dedicated monitoring of key developments in the most relevant banks' appetite for leveraged transactions.

1.2.6 Indirect supervision of less significant institutions and supervisory oversight

The [SSM Regulation](#) mandates the ECB to ensure the effective and consistent functioning of the SSM and thus entrusts it with an oversight function, while NCAs retain the primary responsibility for the supervision of less significant institutions (LSIs). On the basis of the overarching objective of this function, i.e. to ensure that high supervisory standards are consistently applied across the entire euro area, ECB Banking Supervision has cooperated with NCAs in developing an operational framework for the indirect supervision of LSIs.

Joint supervisory standards and common methodologies related to LSI supervision

Joint supervisory standards and common methodologies seek to drive convergence towards consistent high-quality practices

Joint supervisory standards (JSSs) and common methodologies are important tools for consistently applying high supervisory standards across the euro area. They serve as vehicles for converging towards common supervisory practices by providing guidance on how to conduct supervisory processes.

JSSs are being developed together with the NCAs and are fully in line with the EU single rulebook and with EBA standards and guidelines. In 2016 JSSs on [supervisory planning](#) and [recovery planning](#), which were largely developed in 2015, were completed.

Following the finalisation of these standards, significant work on a number of additional standards was carried out over the course of 2016.

The JSS for the [conduct of on-site inspections at LSIs](#) covers the definition and objectives of on-site inspections as well as the main principles to be followed in their conduct. It also covers the planning of inspections as part of the supervisory examination programme as well as the minimum level of engagement in terms of

frequency, duration and resources. Moreover, the standard provides guidance related to the inspection process itself, covering the main steps of an on-site inspection: preparation, investigation, reporting, and follow-up.

Another JSS developed in 2016 relates to the **supervision of car financing institutions (CFIs)**. CFIs are credit institutions whose main business activity is granting leasing contracts or loans to finance the purchase of motor vehicles. Based on an initial review of risks related to this business model, the primary objective of this JSS is to ensure a consistent, high-quality and proportionate approach to the supervision of CFIs within European banking supervision.

Work was started on a JSS on the **licensing of LSIs with FinTech business models**, i.e. institutions whose banking-related activities centre on technologically-enabled innovation. The aim of this JSS is to ensure that the specific risks related to these innovative business models are addressed appropriately in the licensing process, according to standards equivalent to those applying to other types of credit institutions.

ECB Banking Supervision also established a **crisis management cooperation framework** for the ECB and the NCAs. The purpose of the LSI Crisis Management Cooperation Framework is to assist the tasks of the NCA as responsible authority for LSI crisis management and of the ECB as responsible authority for deciding on common procedures.

In 2016 the ECB, together with the NCAs, also made further progress in developing a **common methodology for the Supervisory Review and Evaluation Process (SREP) for LSIs**. As the SREP is the main tool of banking supervision, its harmonisation will be an important step towards fostering convergence in LSI supervision. The project was initiated in 2015. The work started in 2016 focused on capital and liquidity quantification. It will be subject to a trial in 2017, with the objective of having a common SREP system for a first subset of LSIs from 2018 onwards. The proposed SREP methodology for LSIs is derived from the SSM SREP methodology for significant institutions; it will be applied to LSIs in a proportionate manner and adjusted to their specificities.

ECB and NCA cooperation on LSI supervision

Cooperation between the ECB and the NCAs is essential in developing consistent and high-quality LSI supervision. More generally, cooperation entails a range of ongoing processes for day-to-day activities and the definition of joint supervisory standards and methodologies related to LSIs. Under the auspices of the ECB, NCAs share their different experiences and enhance their knowledge of the euro area's LSI sector and its supervision.

The development of supervisory standards for LSIs was backed by a growing number of projects undertaken jointly by the ECB and the NCAs. In addition, cooperation between the ECB and NCAs contributed to ensuring the continuous monitoring of the LSI sector.

Workshops and projects among the NCAs and the ECB complemented the regular strands of work on LSI supervision

The year under review saw a significant increase in the number of such joint initiatives. For example, workshops were held on NCAs' SREP methodologies to share knowledge across the SSM in the light of the start of work on the SREP methodology for LSIs. Regarding individual LSIs, joint activities related to several technical missions and five on-site inspections dedicated to the analysis of certain LSI risk areas. Moreover, staff exchanges between NCAs and the ECB were initiated.

Day-to-day cooperation on LSI supervision focuses on reviewing and fostering the consistent application of high supervisory standards by the NCAs. To ensure consistency of outcomes, the commonalities and differences across the euro area LSI sector as well as national specificities need to be understood.

With regard to LSIs, the ECB strongly adheres to the principle of proportionality

The principle of proportionality is of fundamental importance for indirect LSI supervision and hence strongly embedded in both the ongoing processes and the development of joint standards and methodologies. Mindful of this principle, the ECB, together with the NCAs, has developed a dedicated **prioritisation framework**. This framework classifies LSIs into low, medium and high priority, based on their intrinsic riskiness and their potential impact on the relevant domestic financial system. The classification allows for aligning the level of supervisory focus and the intensity of supervisory activities to the risks borne by the institution.

A dedicated notification framework is a core element of day-to-day cooperation between the ECB and NCAs

On an ongoing basis, the NCAs submit notifications to the central notification point within the ECB's Directorate General Microprudential Supervision III (DG MS III) via a **dedicated notification framework**. This enables the ECB to compare and review practices against the SSM's supervisory standards. For example, NCAs submit ex ante notifications of material supervisory procedures and draft material decisions related to high-priority LSIs, covering a wide range of supervisory issues (e.g. capital, liquidity, SREP, internal governance). They also submit notifications regarding any rapid and significant deterioration in the financial situation of LSIs. The objective of such notifications is to ensure that the ECB is informed about relevant cases in a timely manner, allowing it to assess and discuss the most appropriate course of action together with the relevant NCA. In all, ECB Banking Supervision received 79 notifications from NCAs in 2016.

Experience with the notification framework has revealed the need to further enhance the consistency of the notification processes across NCAs. A working group is therefore exploring ways of improving the procedures and criteria for notification requirements.

Furthermore, the specialised **country desks** within DG MS III are in continuous dialogue with NCAs in order to monitor developments in the banking sector that may affect LSIs. Through notifications, they collect information and follow the situation of high-priority LSIs. They also monitor developments in relation to institutions that are facing a significant deterioration in their financial situation or liquidity stress (which could evolve into a crisis case) and require ECB decisions concerning qualifying holdings, withdrawal and licensing. In some cases, the country desks also cooperate with the NCAs in carrying out the on-site activity related to LSIs.

Finally, the ongoing cooperation between the ECB and the NCAs is supported by continuous efforts to further align the processes and methodologies for supervising the LSI sector. The NCAs' supervisory activities and tasks in respect of LSIs and the analysis and identification of risks and vulnerabilities in the LSI sector are regularly summarised, inter alia, in the form of dedicated reports, which are shared with supervisors across the euro area. Cooperation and interaction also relies heavily on sharing and exchanging data. Towards that end, the ECB and the NCAs are developing mechanisms to enhance the exchange of information.

Box 1

Institutional protection schemes

Significant advance in work on institutional protection schemes that began in 2015¹⁷

In some Member States, savings banks and cooperative banks have established institutional protection schemes (IPs). These IPs protect their member institutions and, in particular, ensure their liquidity and solvency. Overall, 50% of the euro area's total number of credit institutions are members of an IP, representing around 10% of the banking sector's total assets. Work that had started in 2015 on the development of a common approach towards assessing IPs, with a view to establishing a consistent supervisory treatment of IPs across the euro area, was completed in 2016.

Guide on the approach for the recognition of IPs for prudential purposes

A [guide on the approach for the recognition of IPs for prudential purposes](#) was developed in the context of the ECB's work on options and discretions available in EU law. Following a public consultation, the guide was finalised and published in July 2016. The guide seeks to ensure coherence, effectiveness and transparency regarding the supervisory policy that will be applied when assessing IPs. This is of particular importance as the official recognition of an IP leads to a different treatment of some of the prudential requirements under the Capital Requirements Regulation (CRR), namely a 0% risk weight for exposures to other IP members and the removal of limits on large exposures to other IP members.

Coordination and cooperation for “mixed” IPs regarding decision-making and ongoing monitoring

IPs typically consist of both significant institutions and less significant institutions (“mixed” IPs). It is therefore particularly important that both the ECB and the NCAs treat IPs in the same way. For this purpose [an ECB guideline addressed to the SSM competent authorities \(comprising the ECB and NCAs\)](#) was adopted and published in November 2016. It sets out the principles for coordination between the ECB and the NCAs on IP-related supervisory decisions and for the ongoing monitoring of IPs. It ensures that NCAs apply the same criteria when they assess IP applications from less significant institutions. In addition, monitoring groups made up of ECB and NCA staff were established in 2016 and have started their monitoring activities. The ECB's guideline does not affect IP approvals that had been previously granted. However, a reassessment may be considered in

¹⁷ The work conducted in this respect was described in the ECB Annual Report on supervisory activities 2015 page 43.

the event of major structural changes in an IPS or possible incidents that may give rise to doubts regarding an IPS's compliance with the relevant legal requirements.

1.2.7 Macroprudential tasks

In 2016 the ECB engaged in discussions with the national authorities with regard to the use of macroprudential instruments in the euro area¹⁸. In order to ensure that microprudential and macroprudential tools effectively complement each other, the **Macroprudential Forum** serves as a platform for discussion for Governing Council and Supervisory Board members, bringing together the microprudential and the macroprudential perspectives across the SSM. In this forum, the microprudential supervision and macroprudential policy representatives exchange views and share information. In turn, their exchange feeds into the macroprudential process by exploiting synergies and the expertise of the supervisory function to identify common positions, for instance on prudential matters. These joint discussions, however, do not involve any formal decision-making, in line with the separation principle and the integrity of the decision-making by the Governing Council and the Executive Board (Article 12.1 of the Statute).



More than 100

Macroprudential notifications received from national authorities

In 2016 the ECB received over 100 macroprudential **policy notifications from national authorities**. Most notifications referred to quarterly decisions on setting countercyclical capital buffers and to decisions on the identification and capital treatment of global and other systemically important credit institutions. Following the BCBS methodology, the ECB and national authorities identified eight global systemically important institutions¹⁹ headquartered in France, Germany, Italy, the Netherlands and Spain and allocated them to buckets entailing phase-in capital buffer rates from 0.75% to 1.5% in 2018. (On completion of the phase-in in 2019, the final buffer levels for those banks will range from 1.0% to 2.0%.) In addition, national authorities also decided on the capital buffer rates for 110 other systemically important institutions, in line with the ECB methodology for assessing such institutions and determining their buffers. Furthermore, the ECB received notifications on the implementation of the systemic risk buffer and risk weight floors from a number of national authorities, as well as notifications regarding the reciprocation of macroprudential measures taken in other Member States.²⁰

Finally, in 2016, the ECB stepped up its communication by releasing its first **macroprudential statement** following discussions at the Macroprudential Forum.

¹⁸ In accordance with the tasks conferred on the ECB under Article 5 of the SSM Regulation.

¹⁹ The identified G-SIIs (with fully phased-in buffer requirements as of 2019) are BNP Paribas, Groupe BPCE, Groupe Crédit Agricole, Deutsche Bank, ING Bank, Banco Santander, Société Générale and UniCredit Group.

²⁰ Further information can be found in the [ECB Macroprudential Bulletin, Issue 2/2016](#).

2 Authorisations, enforcement and sanctioning proceedings

Although it only directly supervises significant institutions, the ECB is the competent authority for all euro area credit institutions for granting or withdrawing banking licences and assessing the acquisition of qualifying holdings (known collectively as “common procedures”). The ECB is also responsible for the fit and proper assessment of members of the management bodies of significant credit institutions and for passporting procedures. All in all, a substantial proportion of European banking supervision decisions relate to authorisation processes.

More than 3,000 authorisation procedures were notified to the ECB in 2016, mostly relating to fit and proper assessments. Significant efforts were made in improving processes in terms of simplicity and proportionality and in developing policy guidance on a number of issues.

The ECB also fulfilled its duty to ensure effective mechanisms for reporting of breaches of relevant EU law. In 2016, 102 breach reports were received, 73 of which were within the remit of the ECB’s supervisory tasks. These reports mainly concerned governance issues and the calculation of own funds and capital requirements.

2.1 Developments in the number of significant institutions and in common procedures

2.1.1 Changes in the number of institutions under the ECB’s direct supervision

Comprehensive assessment 2016

A comprehensive assessment is a requirement for all banks that become or are likely to become subject to direct ECB supervision based on the significance criteria set out in Article 6(4) of the SSM Regulation.

The sample of banks subject to the comprehensive assessment includes those which show an increased likelihood of becoming significant at the start of the following calendar year without prejudice to the outcome of the full significance assessment, which can only be finalised once all relevant information (e.g. audited financial statements for the prior year-end) is available.

From March to November 2016 the ECB conducted a comprehensive assessment of the following four banks:

- Abanka d.d. (Slovenia)
- Akciju sabiedrība "Rietumu Banka" (Latvia)
- Banca Mediolanum S.p.A. (Italy)
- Citibank Holdings Ireland Limited (Ireland)

The 2016 comprehensive assessment was similar to the rigorous exercises undertaken for a total of 130 banks in 2014 and 9 banks in 2015. It consisted of an asset quality review (AQR) and a stress test.

The **AQR** component was performed following the methodology applied in the 2014 and 2015 exercises. It was a prudential rather than an accounting exercise. It provided a point-in-time assessment of the carrying values of banks' assets as at year-end 2015 and determined whether there was a need to strengthen individual banks' capital bases. The identification of additional non-performing exposures and increases in specific and collective provision levels constituted the main drivers of AQR adjustments to CET1.

The **stress test** component used the methodology applied in the 2016 EBA stress test. The AQR results served as a starting point for the stress test, which projected the evolution of banks' capital positions over three years (2016-2018) under a baseline scenario and an adverse scenario.

The threshold ratios applied for identifying capital shortfalls were maintained at the same levels as in 2014 and 2015: a CET1 ratio of 8% for the AQR and the baseline scenario of the stress test, and a CET1 ratio of 5.5% for the adverse scenario of the stress test. The maximum of the shortfalls in the different components of the exercise determined a bank's overall capital shortfall. A summary of the results of the three participating banks which consented to their disclosure is shown in **Table 3**.

Table 3
Comprehensive assessment 2016

Bank name	Starting point CET1 ratio ¹	CET1 ratio post AQR ¹	CET1 ratio baseline scenario ²	CET1 ratio adverse scenario ²	CET1 shortfall (in € millions)
Abanka d.d.	23.00%	22.60%	23.80%	10.00%	0
Banca Mediolanum S.p.A.	19.70%	19.70%	23.00%	17.70%	0
Citibank Holdings Ireland Ltd	14.70%	13.30%	12.70%	10.40%	0

(1) CET1 ratio as at 31 December 2015, except for Citibank Holdings Ireland Limited, where 31 March 2016 was used as the reference date.

(2) Lowest CET1 ratio over the three-year horizon of the stress test.

None of the three banks fell below the relevant thresholds based on the impact of the AQR and stress test. Consequently, they do not face capital shortfalls as a result of the comprehensive assessment. However, the banks are expected to undertake actions to address qualitative findings from the AQR such as deficiencies in policies, and processes as well as weaknesses in data systems. This is consistent with the approach taken in the previous exercises in 2014 and 2015.

Annual assessment of significance

In compliance with the [SSM Framework Regulation](#), the ECB reviews at least once per year whether a supervised entity or supervised group fulfils any of the criteria by which banks are classified as significant as stipulated in Article 6(4) of the SSM Regulation, such as total assets, cross-border activities, etc.

This annual assessment takes place in parallel to the comprehensive assessment. It covers credit institutions, financial holding companies, and mixed financial holding companies established in the euro area, as well as branches of credit institutions established in other EU Member States.

Following the assessment, banks are classified as either significant or less significant. Significant banks and banking groups are directly supervised by the ECB. Less significant institutions are supervised by their national competent authority, subject to the oversight of the ECB.

In the course of its 2016 review, the ECB and the NCAs of participating Member States jointly assessed whether (i) entities currently classified as significant still fulfil the respective criteria, (ii) entities currently classified as less significant newly meet the criteria, and (iii) exceptional circumstances and particular circumstances identified in the previous year continue to apply.

New significant institutions

Following the annual assessment of 2016 conducted in mid-November 2016, the number of significant institutions decreased from 129 to 127: Citibank Holdings Ireland Limited²¹ was newly identified as significant owing to a material increase in size and became subject to direct ECB supervision as of 1 January 2017. At the same time, WGZ Bank ceased to exist after merging with DZ Bank, and restructuring at two groups led to their no longer being classified as significant (State Street bank Luxembourg S.C.A and RFS Holdings B.V.).

It should be noted that the list of significant institutions is updated throughout the year. As at end-2016, the number of significant institutions had further declined to 126. The most recent version of the list can be found on the [ECB's banking supervision website](#).

²¹ Citibank Holdings Ireland Limited is the holding company at the highest level of consolidation for the banking entity Citibank Europe plc. Citibank Europe plc is the sole subsidiary of Citibank Holdings Ireland Limited.

Table 4

Significant and less significant institutions in the SSM following the 2016 annual assessment

	Total Assets (in € billions)	Number of entities	
		at consolidated level	at solo level
Significant institutions	21,114.75	127	951
Less significant institutions	5,354.62	2,972	3,275
Total	26,469.37	3,099	4,226

Total assets as at 30 December 2016, reference date 31 December 2015 (or the latest available); reference date for the group structures of less significant institutions is 15 November 2016.

2.1.2 Common procedures (licences and qualifying holdings), fit and proper assessments and passporting procedures

The number of procedures remained broadly stable

 **3,182**
Authorisation procedures notified to the ECB in 2016

In 2016 a total of 3,182 authorisation procedures were notified to ECB Banking Supervision by NCAs, comprising 24 licence applications, 42 licence withdrawals, 178 lapsing of licence²², 142 acquisitions of qualifying holdings, 2,544 management and supervisory board appointments²³ and 252 passporting procedures.

In total, 2,686 authorisation procedures were approved by the Supervisory Board and the Governing Council in 2016²⁴. Another 214 authorisation procedures not requiring a formal ECB decision have been completed, comprising mainly passporting procedures and lapsing procedures.

Apart from lapsing of licences, the number of common procedures remained broadly stable compared with the previous year, some modest deviations being considered within normal margins. For fit and proper and licensing, the number of procedures decreased; for withdrawals, it increased slightly. The number of qualified holding procedures remained fairly stable. The increase in lapsing procedures partly reflects side effects (e.g. merger of a group of over 100 affiliated banks into one single entity). However, it is also the result of improved processes and an increased awareness of the need to notify these procedures to the ECB.

²² Lapsing of an authorisation means that, where national law provides for it, the authorisation ceases to exist without requiring a formal decision to that effect; it is a legal effect that takes place as soon as a specific, well-defined trigger occurs, e.g. the express renouncement of a licence by the entity or the fact that the institution itself ceases to exist, for instance due to a merger with another company.

²³ Including a limited number (15) of requests for additional directorships.

²⁴ These 2,686 authorisation procedures were incorporated in 1,191 ECB legal acts (see **Figure 7** in Section 4.2). Some legal acts cover more than one authorisation procedure (e.g. fit and proper assessments of several members of the management bodies of the same significant institution or acquisitions of qualifying holdings in different subsidiaries resulting from a single transaction).

Table 5Most authorisation procedures notified to the ECB concern fit and proper assessments²⁵

Licensing			Withdrawal of licence			Lapsing of licence			Qualifying holdings			Fit and proper			Passporting		
2014	2015	2016	2014	2015	2016	2014	2015	2016	2014	2015	2016	2014	2015	2016	2014	2015	2016
7	37	24	5	26	42	0	26	178	9	134	142	115	2,729	2,544	34	431	252

Note: In previous ECB annual reports on supervisory activities, withdrawals and lapsing procedures were reported together. Owing to the increase in lapsing cases, the procedures are now reported separately.

The number of passporting procedures decreased owing to improvements in the notification process

In the case of passporting procedures, the significant decrease mainly results from improvements in the notification process. NCAs can now include in one single procedure information regarding multiple passports for the same supervised entity or set of services. Without this improvement, the overall number of passporting procedures would have been similar to last year's.

Developments in common procedures

With regard to licensing, there are more business models that integrate traditional banking services with mobile devices

Most licensing procedures related to existing credit institutions that either needed to restructure (e.g. a merger or split-up of banks/banking groups, generating the need for a new entity to be licensed) or to extend their licences following proposed changes in the activities undertaken. Among the completely new banks that were licensed, an increase was observed in business models which integrate traditional banking services with mobile devices. This trend reflects the stronger focus on technological innovation in the banking sector. Examples of such FinTech business models were the introduction of an online bank product aimed at technology providers wishing to offer products with integrated banking services and the insourcing of banking services via mobile solutions.

Withdrawal and lapsing procedures largely arise from credit institutions voluntarily terminating their banking activities or from banks that enter into a merger or undertake a restructuring. Nonetheless, a limited, but relevant, number of withdrawal procedures were triggered by (non-voluntary) liquidation or resolution of the institutions concerned (all of which were LSIs).

To a large extent, qualifying holding procedures, as in 2015, related to mere internal reorganisations (e.g. intra-group consolidations), often reflecting cost-cutting policies. Other qualifying holding procedures concerned acquisitions of stakes in banks by equity funds and sovereign funds, involving particular aspects relating to complex corporate structures, possible short-term investment horizons or the use of leveraged funding (specific acquirers²⁶).

²⁵ As the cut-off date for 2014 was 15 January 2015, there is a limited overlap between the numbers for 2014 and 2015.

²⁶ "Specific acquirers" are characterised by complex corporate structures, non-transparent corporate governance, short-term investment strategies or the use of substantial debt or quasi-debt funding (e.g. private equity funds).

Developments in fit and proper assessments

Generally, there are three types of fit and proper procedures, depending on the role of the appointee: executive members of the management body, non-executive members of the management body, and key function holders²⁷. Approximately two-thirds of the fit and proper procedures concern non-executive members. The remaining one-third concerns executive members of the management body. The number of assessments of key function holders is negligible²⁸.

Many of the assessments involved deeper analysis; approximately a fifth of all cases raised concerns, mostly relating to time commitment and experience. In many of these cases the ECB imposed conditions, obligations or recommendations to address specific concerns, for example by making the decision conditional on taking additional training or on relinquishing a function outside the bank owing to a conflict of interest or time commitment issue.

In 2016 measures were implemented to improve the average processing time for fit and proper procedures with significant success. The backlog was significantly reduced, with around 98% of all fit and proper procedures being approved within the national legal deadlines.

In 2016 fit and proper assessments were made more efficient

Changes in the authorisation work processes

In 2016 additional efforts were made to accelerate the processing, both to cope with the high inflow of authorisation procedures and to reduce the number of outstanding pending procedures. Building on the experiences gained in 2015, internal work processes were improved and the cooperation between the NCAs and the ECB gathered pace.

In the second half of 2016, an authorisations module was introduced in IMAS²⁹. This system facilitates improved and more automated workflows for the ECB and the NCAs, an important step towards the ultimate objective of complete straight-through processing of procedures.

Development of policy stances

Despite the harmonisation achieved through CRD IV and EBA guidelines and regulatory standards, applicable provisions implementing CRD IV into national law and supervisory practices for authorisation procedures still differ across Member States. Against that background, ECB Banking Supervision has continuously worked

Together with the NCAs, ECB Banking Supervision seeks to harmonise authorisation procedures

²⁷ Key function holders are employees who are not members of the management body but have a significant influence over the direction of the institutions under the overall responsibility of the management body, e.g. credit risk officers, compliance officers, etc.

²⁸ The clarification that the ECB is competent to assess key function holders where national law requires was not made until the end of 2016, for implementation as of 2017.

²⁹ IMAS is an information management system for European banking supervision. See also Section 4.6.

towards harmonisation by developing policy stances in cooperation with the NCAs and relevant ECB business areas, with a view to achieving common supervisory practices for authorisation procedures.

In addition to the policy stances already approved in 2015 (such as those on reputation, time commitment and collective suitability), further stances were developed on the use of interviews as a tool for information gathering during fit and proper assessments, including recommended practices on conducting interviews. Fit and proper interviews will, as a rule, become mandatory for newly appointed CEO and chairman positions at significant stand-alone banks and top banks of groups once ECB Banking Supervision has published its **Guide to fit and proper assessments**³⁰. Policy stances were also developed on (i) the assessments of candidates' experience, (ii) the uniform application of conditional approvals, and (iii) re-assessments. The process for assessing additional non-executive directorships and the combination of chairman/CEO positions was also covered.

For qualifying holdings, policy stances were developed that focus on the assessment of the "specific acquirers" as well as on the scope, procedural aspects and format of the decisions adopted by the ECB. Additional work on practices for assessing qualifying holding criteria is well advanced and is expected to be finalised in 2017.

To support the effective implementation of these policy stances, ECB Banking Supervision has invested significantly in training for staff and in communication towards the banking sector and the wider public.

With regard to **licensing**, work has started on developing policy stances relating to scope, assessment of licensing criteria and procedural issues relating to the process of granting licences. Another project has been started to develop a common European banking supervision stance on the granting of banking licences to FinTech companies.

2.2 Reporting of breaches, enforcement and sanctioning proceedings

2.2.1 Enforcement and sanctioning

Under the SSM Regulation and the SSM Framework Regulation, the allocation of enforcement and sanctioning powers between the ECB and the NCAs depends on the nature of the alleged breach, the person responsible and the measure to be adopted (see ECB [Annual Report on supervisory activities 2014](#)).

³⁰ The draft [Guide to fit and proper assessments](#) was published for public consultation on 14 November 2016 in parallel to, and fully consistent with, the EBA consultation of its revised Guidelines on suitability. Publication of the final guide is expected in the second quarter of 2017.

In 2016 the sanctioning proceedings launched by the ECB significantly increased



42

Enforcement and sanctioning proceedings launched by the ECB in 2016

During the initial phase of European banking supervision, the focus was mainly on gaining knowledge of the prudential situation of the supervised entities (only four proceedings were initiated in 2015, of which two were also completed in 2015). In the course of 2016, the ECB launched 41 sanctioning proceedings and one enforcement proceeding which were related to suspected breaches committed by 36 significant supervised entities.

Taking into account two proceedings that were ongoing at end-2015, the ECB handled 44 proceedings in 2016, 42 of them regarding sanctions and two related to enforcement measures (see [Table 6](#)).

Table 6
ECB enforcement and sanctioning activity in 2016

	Sanctioning proceedings	Enforcement proceedings	Total
Ongoing proceedings at year-end 2015	1	1	2
Proceedings initiated during 2016	41	1	42
Proceedings handled during 2016	42	2	44
of which proceedings closed	5	1	6
of which ECB requests addressed to NCAs to open proceedings	3	-	3
of which ongoing proceedings at year-end 2016	34	1	35

Altogether, 30 out of the 42 sanctioning proceedings handled in 2016 relate to suspected breaches of directly applicable EU law (ECB decisions and regulations included). These proceedings concern 26 significant supervised entities and relate to the areas of own funds, reporting, public disclosure, liquidity and large exposures. Two of the proceedings were closed during 2016, owing mainly to the absence of a legal basis for imposing sanctions in the specific cases at hand. The investigation of the other alleged breaches is ongoing.

The remaining 12 out of the 42 sanctioning proceedings are related to suspected breaches of national law transposing CRD IV provisions and concern significant supervised entities or natural persons. These proceedings involve suspected breaches with regard to governance, including internal control mechanisms, management body functions and remuneration. Three of these proceedings were closed during 2016 owing to the non-materiality of the suspected breaches. During 2016, the ECB also addressed three requests to NCAs to open sanctioning proceedings within the remit of their national competences.

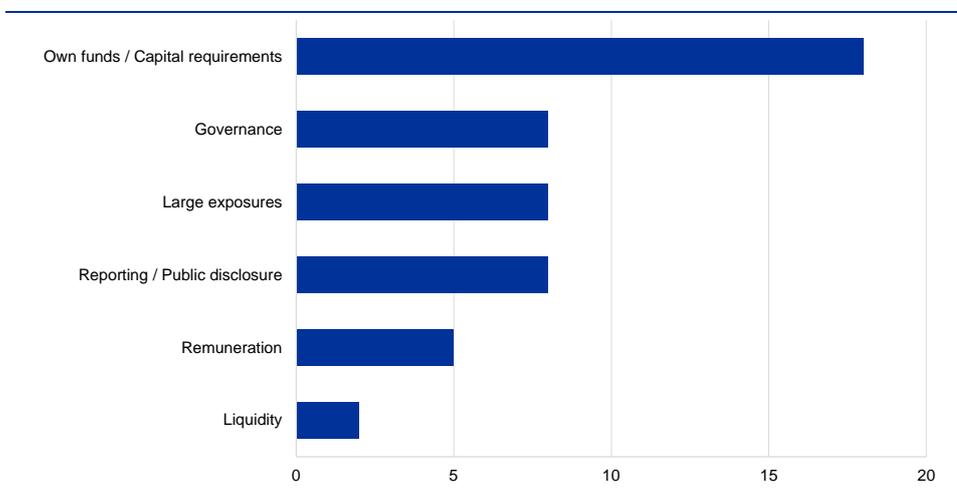
The two enforcement proceedings handled in 2016 concerned a suspected breach of national remuneration rules and non-compliance with an ECB supervisory decision. One of the proceedings was closed in 2016 owing to the absence of a legal basis for imposing effective enforcement measures in that specific case, while the other is ongoing.

A complete breakdown by area of infringement of the suspected breaches subject to the enforcement and sanctioning proceedings handled in 2016 by the ECB is displayed in [Chart 5](#).

The smooth cooperation between the ECB and the NCAs is a key element in the exercise of the ECB's enforcement and sanctioning powers

Chart 5

Enforcement and sanctioning proceedings mostly relate to own funds and capital requirements



If the ECB has reason to suspect that a criminal offence may have been committed, it requests the relevant NCA to refer the matter to the appropriate authorities for investigation and possible criminal prosecution, in accordance with national law. In this context, one request was submitted in 2016 to the relevant NCA and four other sets of facts were under consideration at year-end 2016.

2.2.2 Experience with reporting on breaches under Article 23 of the SSM Regulation

It is the ECB's duty to ensure that effective mechanisms are put in place that enable any person to report breaches of relevant EU law (a process commonly referred to as "whistle-blowing"). Accordingly, the ECB set up a breach reporting mechanism (BRM) which includes a [pre-structured web platform](#) that is accessible through the ECB's banking supervision website.



27%

Increase in number of breach reports received by the ECB in 2016

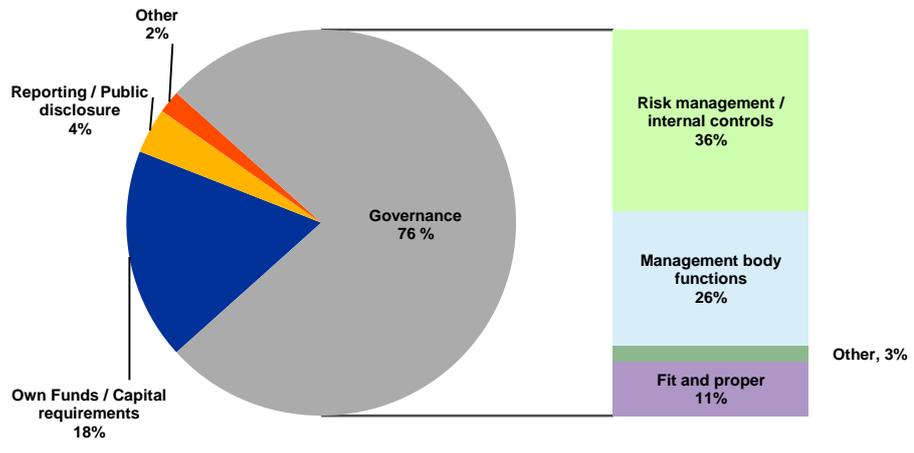
In 2016, 100 breach reports were received by the ECB, representing a 27% increase on the previous year. Of these, 70 referred to alleged breaches of relevant EU law, 68 of which were considered to be within the remit of the ECB's supervisory tasks (two breach reports fell within the remit of the NCAs' supervisory tasks). The remainder referred mainly to national issues not related to prudential requirements and, therefore, fell outside the scope of the BRM (e.g. consumer protection).

Among the most common alleged breaches reported were governance issues (76%) and inadequate calculation of own funds and capital requirements (18%). The complete breakdown is shown in [Chart 6](#). Governance-related issues referred

mainly to risk management and internal controls, management body functions and fit and proper requirements³¹.

Chart 6

Alleged breaches reported in the breach reporting mechanism mainly concern governance issues



The main investigatory actions taken since November 2014 in relation to the breach reports received were:

- on-site inspections (37% of the cases),
- requests for an internal investigation/audit or documents/explanations to the supervised entity (31% of the cases).
- internal assessment with existing documentation (32% of the cases).

Some of the reports received have led or may contribute to the initiation of sanctioning proceedings

Five reports resulted in, or may contribute to, the initiation of sanctioning proceedings against three supervised entities.

³¹ “Risk management and internal controls” comprises the mechanisms or processes that an entity needs to have in place for the adequate identification, management and reporting of the risks it is or might be exposed to. “Management body functions” refers to the extent to which the persons who effectively direct the business of an institution – or those who are empowered to set the institution’s strategy, objectives and overall direction, and oversee and monitor management decision-making – comply with their responsibilities.

3 The SSM as part of European and global supervisory architecture

European and international cooperation is one of the key priorities for ECB Banking Supervision. Consequently, the ECB has already negotiated and signed important Memoranda of Understanding (MoUs) with a number of other institutions, such as the Single Resolution Board (SRB) and the European Securities and Markets Authority (ESMA). Work continues towards concluding MoUs with supervisory authorities, national market authorities and the supervisory authorities of non-euro area EU Member States. European banking supervision is also contributing to the work of supervisory colleges, which play an important role for supervised banks with a presence in non-euro area countries.

In 2016 European banking supervision further contributed to the EU's recovery and resolution framework. It assessed the recovery plans drawn up by banks and it was consulted by the SRB with regard to resolution plans. The ECB was also active in European and international fora which are developing policies related to crisis management.

With a view to global rules for the banking sector, the ECB was involved in the work of the Basel Committee on Banking Supervision, participating in more than 30 groups, sub-groups and task forces of the Committee. ECB Banking Supervision also contributed to the work of the EBA and was granted the right to participate in the plenary meetings of the Financial Stability Board (FSB).

3.1 European and international cooperation

3.1.1 Cooperation with other national/EU supervisory authorities

In 2016 the ECB initiated overall 24 negotiations for the conclusion of cooperation agreements with banking supervisory authorities of the non-euro area EU countries, third countries and EU market supervisors. Four of those MoUs have already been concluded.

Cooperation within the European Economic Area

The ECB has extensive exchanges with supervisory authorities from EU countries.

In line with Article 3(6) of the SSM Regulation, the ECB is working towards the conclusion of its own MoUs with nine NCAs from non-euro area EU countries. As cooperation and exchange of information between competent authorities within the

EU already take place under the terms of CRD IV, MoUs with European national competent authorities lay down additional details on cooperation.

In December 2016 the ECB concluded an MoU with the supervisory authorities of Sweden, Norway, Denmark and Finland with regard to supervising branches that are considered significant under CRD IV. The MoU covers matters related to ongoing supervision, such as participation in supervisory colleges, the exchange of information and on-site inspections.³²

The ECB is also in discussion with EU national market authorities regarding the signature of an MoU based on the template previously devised by the ECB in cooperation with ESMA. Such an MoU has already been signed with one authority. Negotiations are under way with two other national market authorities.

The ECB has also entered into MoUs with both the EBA and ESMA.

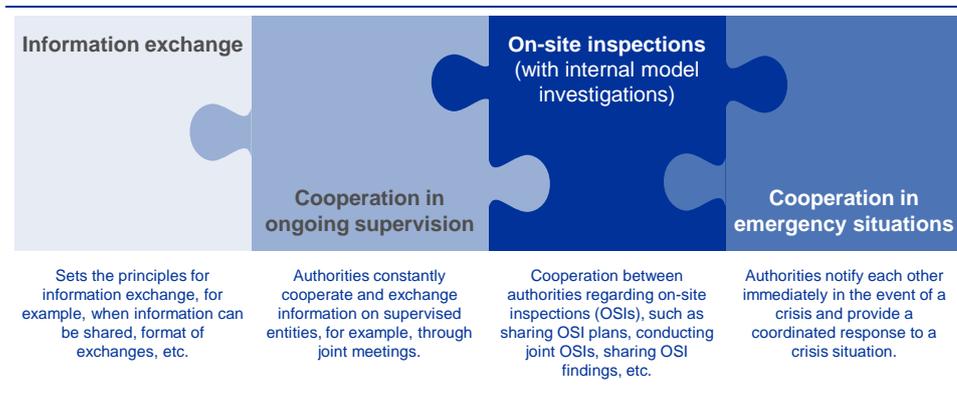
Cooperation with third country authorities

Over time, MoUs between NCAs and third countries will be replaced with MoUs between the ECB and third countries

Where feasible, the ECB joined the existing MoUs that NCAs from euro area countries had signed with supervisory authorities from third countries before the SSM was established, so as to facilitate ongoing supervision. Over time, these MoUs will be progressively replaced with the ECB's own MoUs with the third country authorities.

Figure 6

Four areas of supervision covered in the MoUs under negotiation by the ECB



³² This MoU is designed to facilitate cooperation on significant branches between ECB Banking Supervision and the Nordic authorities (and for the latter among themselves), both inside and outside the euro area. Therefore, the MoU not only covers euro area entities but also a broader range of entities under the supervision of these Nordic authorities. Furthermore, in addition to banking supervision tasks, the MoU also covers consumer protection, payment services and systems as well as anti-money laundering. Hence, the MoU's scope goes beyond the tasks of ECB Banking Supervision. However, the degree of cooperation between the signatory authorities remains subject to EU law. Consequently, ECB Banking Supervision will participate in the MoU only with regard to its supervisory tasks.

In 2016 the ECB initiated MoU negotiations with ten third country supervisory authorities. The objective is to facilitate the performance of the respective supervisory tasks. To this end, the MoUs are intended to cover, inter alia, information exchange, cooperation in ongoing supervision as well as in emergency situations, the conduct of on-site inspections and internal models investigations.

In 2016 and early 2017, the ECB entered into MoUs with two third country supervisory authorities, one on supervision of credit institutions and one on the exchange of information regarding systemically important institutions.

Colleges of supervisors

Colleges of supervisors are key to coordinating the supervision of cross-border banking groups

Colleges of supervisors are permanent yet flexible coordination structures that bring together the competent authorities involved in supervising cross-border banking groups. Colleges play an important role for SSM banks with a presence in non-euro area countries.

In 2016 the ECB strengthened the performance of these colleges with the aim of making the European framework for information exchange, joint risk assessments, and joint decisions on capital and liquidity requirements more effective, in accordance with CRD IV.

 **45** Colleges of supervisors in which the ECB participates

In its capacity as consolidating supervisor, ECB Banking Supervision is responsible for the organisation and functioning of 29 EU colleges. These colleges comprise the relevant EU members, the EBA and, as observers, those authorities that supervise the material subsidiaries and branches that each banking group has in third countries. These include the most relevant supervisory authorities in the global banking and financial markets.

For each significant institution for which the ECB is the consolidating supervisor, JSTs have established the relevant processes and procedures to ensure that each college functions properly.³³

As host supervisor of significant institutions in the euro area that are headquartered in non-participating EU Member States (seven banking groups), ECB Banking Supervision has actively contributed to the colleges of the cross-border banking groups, through appropriate JST representation.

For other internationally active significant institutions in the euro area, in 2016 ECB Banking Supervision acted as consolidated supervisor for four banking groups that are headquartered in participating Member States but which only have material cross-border activity outside the EU. At the same time, ECB Banking Supervision contributed as host supervisor to the colleges of five cross-border banking groups headquartered in third countries and with subsidiaries which are significant institutions in the euro area.

³³ As required by [Commission Delegated Regulation \(EU\) 2016/98](#) and [Commission Implementing Regulation \(EU\) 2016/99](#).

State of play on close cooperation

EU Member States whose currency is not the euro may participate in the SSM under a regime of close cooperation. The main conditions for this are set out in Article 7 of the SSM Regulation and the procedural aspects are provided for in [Decision ECB/2014/5](#). No formal requests for close cooperation were received in 2016.

3.1.2 Involvement in the EU's recovery and resolution framework

The EU's recovery and resolution framework provides an important anchor for promoting banking sector stability in the EU. ECB Banking Supervision plays a major role within this framework. The involvement of ECB Banking Supervision in this area increased in 2016, partly as a result of the further operationalisation of the Single Resolution Mechanism.

The involvement of ECB Banking Supervision in tasks related to the EU's recovery and resolution framework is increasing

Assessing **recovery plans** is a key task in ECB Banking Supervision's work towards increasing the resilience of significant institutions in periods of heightened stress. The 2015 cycle for the submission of recovery plans for which the assessment was conducted in 2016, was transitional. When the institutions submitted the recovery plans to the ECB, the Bank Recovery and Resolution Directive (BRRD) had not been transposed in all Member States and some of the relevant regulations on drafting recovery plans had not yet been implemented. ECB Banking Supervision's objective was to receive a first set of recovery plans for all institutions and to ensure that those plans would soon be in a position to meet the minimum requirements set by the BRRD and relevant Commission Delegated Regulations. For plans with significant deficiencies, banks were required to take remedial action before the next submission of the plan.

Based on these assessments, the ECB conducted benchmarking exercises, which revealed key areas for improvement in the areas of the completeness and quality of data, the credibility of recovery options, the severity of scenarios and the calibration of recovery indicators, among other things. This in turn fed into the feedback letters sent to banks at the end of the assessment. The recovery plans for 2016 were submitted in September and December 2016, and the assessment of those plans is currently under way. This will ensure that banks have credible recovery options that they can implement to restore their resilience in times of stress.

ECB Banking Supervision regularly interacts with the SRB on issues related to resolution planning

In 2016 the SRB and the ECB implemented the bilateral Memorandum of Understanding establishing rules for cooperation and information exchange which was concluded at the end of 2015. More generally, the ECB shared recovery plans and other information and data with the SRB as agreed in the Memorandum of Understanding.

The SRB consulted ECB Banking Supervision in 2016 on the draft resolution plans for a number of significant institutions. The ECB made its assessment and sent feedback to the SRB. Fruitful discussions and a valuable exchange of information between the ECB and the SRB also took place in the context of the SRB's task of setting minimum requirements for own funds and eligible liabilities (MREL).

An ECB representative participated in SRB meetings, while the SRB Chair was invited to several meetings of the Supervisory Board, promoting a high-level dialogue between the two boards. Constructive participation by ECB and SRB staff in the committee structures of the SRB and the ECB respectively also enabled increased cooperation at the technical level, in parallel with the interaction between Joint Supervisory Teams and Internal Resolution Teams regarding individual banks. At the end of the year, the ECB made a technical change to its systems, allowing SRB staff and Board members direct access to the supervisory information IT system and the data stored in the supervisory platform in line with the provisions of the Memorandum of Understanding, replacing the previous practice of manually sharing the information. This makes information exchange more efficient and ensures that the reporting burden on banks is kept to a minimum.

In 2016 ECB Banking Supervision contributed to European and international fora which are developing policies related to crisis management. For instance, ECB Banking Supervision provided input to the European Commission's legislative proposal published in November 2016 to amend, among other aspects, the MREL framework and the creditor hierarchy in the BRRD. In addition, the ECB participated in the committees of the EBA and FSB responsible for developing regulatory standards on crisis prevention and management.

Furthermore, in the fourth quarter of 2016 the ECB participated in an exercise involving the heads of relevant authorities from the United Kingdom, the United States and within the banking union to enhance cooperation between jurisdictions in the event of a failure of a major cross-border bank, building on ongoing work by international authorities.

3.1.3 EBA Review Panel

ECB Banking Supervision actively participated in the EBA Review Panel, which is responsible for conducting peer reviews to strengthen consistency in supervisory outcomes.

In 2016 the EBA Review Panel performed a peer review on the Implementing Technical Standards (ITS) on supervisory reporting requirements ([Commission Implementing Regulation \(EU\) No 680/2014 of 16 April 2014](#)).

The objective of the peer review was to assess the supervisory practices of the competent authorities regarding the supervisory reporting obligations of institutions. The review assessed the processes that have been put in place, such as the procedures and IT systems for collecting data, ensuring the quality of that data, updating the reporting framework and using the EBA Q&A tool, and also looked into issues of governance.

The peer review concluded that the ECB has fully comprehensive processes in place in all the areas assessed.

3.1.4 IMF Financial Sector Assessment Programs

The IMF's Financial Sector Assessment Programs (FSAPs) are comprehensive, in-depth assessments of a country's financial sector. They encompass (i) the identification of key vulnerabilities and the assessment of the resilience of the financial sector; (ii) the assessment of a country's financial stability policy framework and its supervisory framework and practices; and (iii) the evaluation of financial safety nets and the financial system's capacity to manage and resolve a financial crisis.³⁴

The ECB is heavily involved in IMF Financial Sector Assessment Programs for euro area countries

IMF FSAPs are country-based exercises, and national authorities accordingly take the lead. Nevertheless, alongside the respective national authorities, the ECB is heavily involved in these surveillance exercises in euro area countries, on account of its responsibilities in the areas of microprudential banking supervision and macroprudential policy.

In 2016 the IMF concluded the FSAP exercises for Finland, Germany, Ireland and the Netherlands and launched those for Luxembourg and Spain, which are due for completion in the course of 2017. The FSAP exercises for Belgium, France and Italy are scheduled to be launched later this year, and are likely to be finalised in 2018.

Given the nature of IMF FSAPs, most of their results and recommendations will continue to be addressed to the respective national authorities. However, in view of the new banking supervisory architecture in the euro area, those recommendations related to the well-functioning of the SSM may be addressed to the ECB, as legally appropriate. Going forward, in order to ensure that the IMF surveillance and advice continues to be effective and relevant, it will need to fully reflect the policymaking framework and respective competences at the levels of the individual Member States, the euro area and the EU.

3.2 Contributing to the development of the European and international regulatory framework

3.2.1 Contribution to the Basel process

In January 2016 the Group of Governors and Heads of Supervision (GHoS), the oversight body of the Basel Committee on Banking Supervision (BCBS), endorsed the fundamental review of the market risk standard. In addition, it set out a work programme for the BCBS for 2016, agreeing that the BCBS would finalise its work to reduce excessive variability in risk-weighted assets by revising the risk-weighted framework as well as the calibration of the leverage ratio as part of the process of finalising the Basel III package. ECB Banking Supervision has been actively involved in policy work and quantitative impact studies on both.

³⁴ For further information on the three modules of IMF FSAPs and the main objectives of the ECB's involvement, see Section 4.1.2 of the ECB Annual Report on supervisory activities 2015.

The Basel III reforms have not been finalised yet

In January 2017 the GHoS welcomed the progress made by the BCBS towards completing the post-crisis regulatory reforms. It noted, however, that more time was needed to finalise the reform proposals before the GHoS could review them. The work is expected to be completed in the near future.

More generally, ECB Banking Supervision participates in more than 30 groups, sub-groups and task forces of the BCBS. In addition to the revised market risk framework, the following reforms were agreed during the course of 2016: treatment of interest rate risk in the banking book, revisions to the securitisation framework, and a standard for the regulatory capital treatment of banks' investments in total loss-absorbing capacity (TLAC). The BCBS also issued public consultations on the regulatory treatment of accounting provisions and Pillar 3 disclosure requirements.

Contribution to the work of the EBA

At the EU level, ECB Banking Supervision continued to work together with the EBA towards the shared objective of harmonising prudential rules for financial institutions, which is key to ensuring consistent supervision across the European banking sector.

In 2016 ECB Banking Supervision representatives participated in more than 35 EBA sub-structures (standing committees and sub-groups) and in the main committee, the EBA Board of Supervisors, in which ECB Banking Supervision participates as a non-voting member.

ECB Banking Supervision actively contributes to all the working groups in which it participates. On Pillar 2, for instance, ECB Banking Supervision worked in close cooperation with the EBA in 2016 regarding the development and implementation of actions aimed at deepening **supervisory convergence in Supervisory Review and Evaluation Processes (SREP) and Pillar 2 measures**. In particular, it has actively participated in the development of guidelines on the SREP (EBA Guidelines 2014/13), on interest rate risk in the banking book (EBA Guidelines 2015/08 on IRRBB), on the EBA opinion on the interaction of Pillar 1, Pillar 2 and combined buffer requirements and restrictions on distributions published on 16 December 2015, and in the development of a common EU approach to Pillar 2 capital guidance. In addition, ECB Banking Supervision cooperated with the EBA in the preparation of the EBA annual report on supervisory convergence.

ECB Banking Supervision also worked closely with the EBA in developing the regulatory products defined as part of the **Internal Ratings-Based Approach (IRB)**³⁵ review. The ECB co-chairs the EBA Task Force on Model Validation, whose objective is to assist the EBA in fulfilling its regulatory mandates related to credit risk, with a particular emphasis on IRB-related tasks.

³⁵ The internal ratings-based approach (commonly referred to as "the IRBA") is one of the possible approaches that institutions can use to calculate capital requirements for credit risk. The framework includes two broad approaches that a bank can follow: the foundation approach (FIRB), whereby banks calculate their own probability of default (PD) parameter, whereas the other risk parameters are provided in the CRR; and the advanced approach (AIRB), whereby banks calculate all their own risk parameters.

In this context, the ECB worked together with the EBA and many other NCAs in the development of several regulatory products that have been planned as a result of the EBA's work on identifying the main drivers of variability in the implementation of IRB models. These regulatory products take the form of Regulatory Technical Standards (RTS) and Guidelines (GL) and are being introduced sequentially over the next few years.

With regard to the **leverage ratio**, ECB Banking Supervision was closely involved in the EBA's preparatory work on the report which provides recommendations on the calibration of the leverage ratio for institutions in the EU (published in August 2016).³⁶ In particular, ECB Banking Supervision assisted the EBA by coordinating the underlying quantitative analyses. This report was produced pursuant to the CRR and serves as an important basis for the EU Commission's introduction of the leverage ratio into the minimum requirements of Pillar 1.

3.2.2 Implementation of options and national discretions in the CRR/CRD IV

In 2015 the ECB initiated a project with the objective of harmonising options and national discretions (ONDs) in the CRR, CRD IV and Commission Delegated Regulation (EU) 2015/61³⁷, which grant some discretion to supervisors or national legislators regarding the implementation of the relevant EU legislation.

In 2016 the ECB finalised the OND project, following the conclusion of two public consultations.³⁸ Accordingly, the ECB adopted a **Regulation** and a **Guide** in order to harmonise the application of all ONDs falling under the ECB's direct competence.³⁹ The implementation of these instruments allows for a homogeneous application of over 130 supervisory options and discretions in the prudential framework and contributes significantly towards reducing the regulatory divergence across the euro area. Significant banks can carry out their business operations in the participating Member States under uniform rules and consistent criteria that guide supervisory assessments.

The ECB, in very close collaboration with the NCAs, has expanded the OND project to the supervision of less significant institutions. The aim is to ensure a level playing field and the consistent application of high supervisory standards across the euro area, while taking full account of the principle of proportionality. A draft Guideline and a Recommendation to the NCAs were subject to a public consultation between 3 November 2016 and 5 January 2017. Taking into account the outcome of the consultation, the two instruments are expected to be adopted in late spring 2017.

In 2016, ECB Banking Supervision finalised its options and discretions project for significant institutions



More than 130

Options and discretions which are now uniformly exercised throughout the euro area

In 2016, ECB Banking Supervision extended the options and discretions project to less significant institutions

³⁶ EBA report on the leverage ratio requirements under Article 511 of the CRR.

³⁷ Commission Delegated Regulation (EU) 2015/61 of 10 October 2014 to supplement Regulation (EU) No 575/2013 of the European Parliament and the Council with regard to liquidity coverage requirement for Credit Institutions.

³⁸ See the **ECB Annual Report on supervisory activities 2015** for a detailed description of the rationale, substance and process of the ECB's project on supervisory options and discretions.

³⁹ With an exclusive focus on significant institutions.

Despite the significant efforts made by ECB Banking Supervision towards harmonisation, regulation remains fragmented along national lines. The reason for this is that parts of the regulation take the form of EU directives, which have to be transposed into national law. This leaves room for differences in national transposition which in certain cases leads to a fragmented regulatory framework. This makes European banking supervision less efficient and more costly. Legislative action by policymakers is therefore needed to reduce the remaining regulatory differences which are considered unjustified from the perspective of prudential supervision. This includes those options and national discretions over which only legislators have control.

3.2.3 Contribution to the work of the FSB

In 2016 ECB Banking Supervision continued contributing to the work of the Financial Stability Board (FSB), in particular in the areas of crisis management (through the FSB Resolution Steering Group), as well as governance, misconduct risk and compensation matters, through the relevant FSB sub-structures.

At its meeting on 21 July 2016 in Chengdu, the FSB Plenary agreed⁴⁰ to amend its procedural arrangements in order to allow for the participation of an ECB Banking Supervision representative in **FSB Plenary meetings**. The Vice-Chair of the Supervisory Board has thus become the ECB Banking Supervision representative at the decision-making level of the FSB.

ECB Banking Supervision is committed to stepping up its contribution to the work of the FSB in view of agenda changes to be expected under the upcoming German Presidency of the G20. The focus will move from the finalisation of outstanding post-crisis financial reforms to their full, timely and consistent implementation.

ECB Banking Supervision
participates in FSB Plenary
meetings

⁴⁰ See FSB press release (2016) "[Meeting of the Financial Stability Board in Chengdu on 21 July](#)".

4 Organisational set-up of ECB Banking Supervision

In 2016 the Supervisory Board and the Governing Council took about 1,800 decisions through the non-objection procedure. As in the previous year, most of these decisions concerned fit and proper assessments of bank managers. Given the high number of decisions, the ECB took steps to further streamline the decision-making process. Most importantly, it designed a framework for the adoption of certain types of supervisory decisions by means of delegation.

Regulatory fragmentation in the euro area poses a challenge to European banking supervision

Decision-making is still challenged by the diverse ways in which the Member States have transposed CRD IV into national law. This results in regulatory fragmentation, which hampers the work of European banking supervision towards ensuring a level playing field. It also increases bureaucracy and raises costs, as it requires the ECB to build expertise in each of the 19 different national legislative frameworks. The regulatory framework is further being fragmented because some Member States are converting non-binding supervisory practices into binding legal acts. In addition, national transpositions of CRD IV and national regulatory requirements that go beyond EU law have, in some cases, led to a debate about the ECB's exact supervisory powers. In 2016 the ECB, in close cooperation with the European Commission, clarified the delineation of the ECB's and the NCAs' respective competences, identifying the cases in which the ECB is directly competent to exercise supervisory powers granted under national law.

4.1 Discharging of accountability requirements

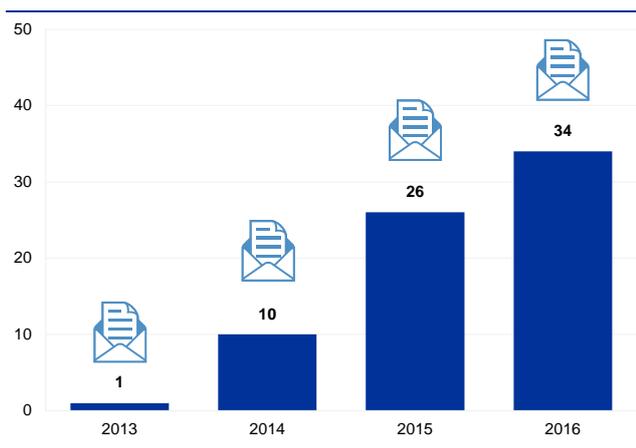
ECB Banking Supervision continued to engage closely with the European Parliament and the EU Council

This Annual Report has been produced as one of ECB Banking Supervision's main accountability channels in accordance with the SSM Regulation. The Regulation provides that the conferral of supervisory tasks on the ECB should be balanced by appropriate transparency and accountability requirements. Maintaining and fostering the [accountability framework](#) – established on the basis of the Interinstitutional Agreement between the European Parliament and the ECB and the Memorandum of Understanding between the EU Council and the ECB – continued to be among the ECB's priorities in 2016.

With regard to the European Parliament, in 2016 the Chair of the Supervisory Board spoke before Parliament's Committee on Economic and Monetary Affairs for the presentation of the 2015 ECB Annual Report on supervisory activities ([22 March](#)), two ordinary public hearings ([13 June](#) and [9 November](#)), and three ad hoc exchanges of views (22 March, 13 July and 9 November). Among the key issues discussed were non-performing loans, the SREP and legislative dossiers in the area of banking supervision.

In the course of 2016 the ECB published on its [website](#) 34 replies to questions from MEPs on supervisory matters. The letters explained the legal framework as well as the ECB's policies on a broad range of supervisory topics, such as the 2016 EBA stress test exercise, the ECB's supervisory actions, the SREP and non-performing loans.

Chart 7
Replies to questions from Members of the European Parliament increased in 2016



Moreover, in line with the Interinstitutional Agreement, the ECB transmitted the records of proceedings of its Supervisory Board meetings to the European Parliament. In 2016 a new format was introduced to further improve the records of proceedings, which now provide the European Parliament with better information on the issues that were discussed during the Supervisory Board meetings. The European Parliament expressed its satisfaction with this new format.

With regard to the EU Council, in 2016 the Chair of the Supervisory Board attended two meetings of the Eurogroup in banking union composition: on 22 April the Chair presented the 2015 ECB Annual Report on supervisory activities, and on 9 November she attended an exchange of views on topics including the EBA stress tests, the 2016 SREP, non-performing loans and

the harmonisation of the options and national discretions in the CRR/CRD IV.

As part of the reporting requirements under the SSM Regulation, representatives of the ECB involved in banking supervision took part in exchanges of views with national parliaments.

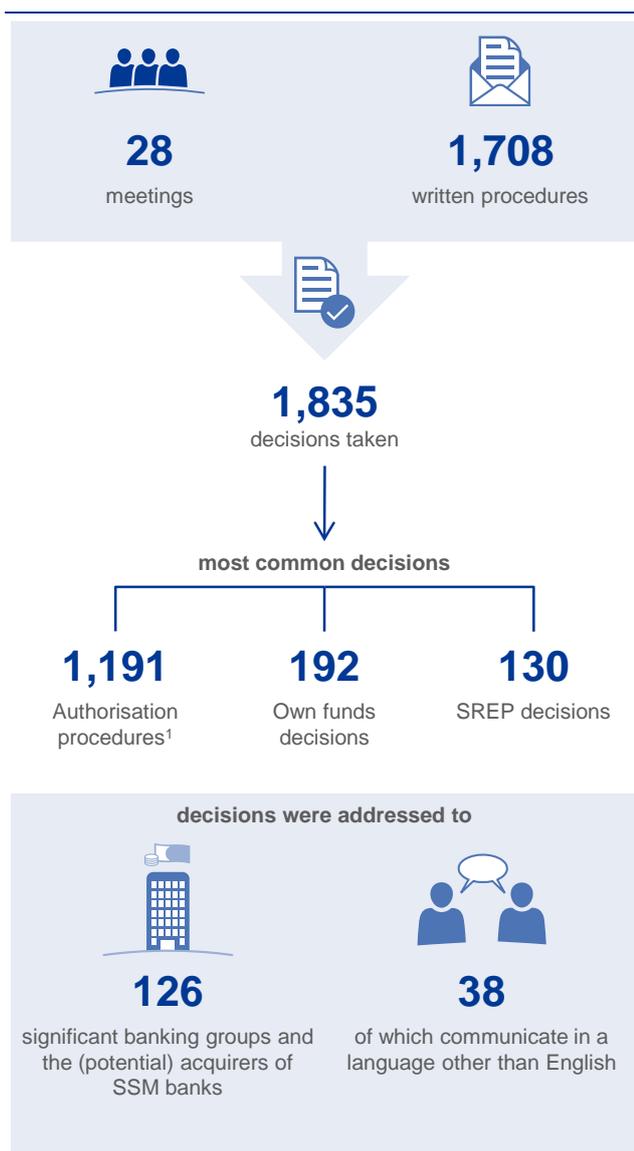
Interaction with the European Court of Auditors

As part of the European Court of Auditors' (ECA) audit of the "operational efficiency of the management of the ECB", conducted under Article 20(7) of the SSM Regulation, ECB Banking Supervision had extensive exchanges with the ECA. The ECA published its [first special report on the Single Supervisory Mechanism, "Good start but further improvements needed"](#), in November 2016. The ECA focused on the operational efficiency of the management of the ECB in the area of banking supervision and acknowledged the ECB's achievements in setting up European banking supervision. Nevertheless, the report contains 13 recommendations on which the ECB gave its preliminary views in the report itself and on which it is currently following up. The key ECA recommendations focus on four areas: (i) governance (e.g. streamlining the supervisory decision-making process); (ii) accountability (e.g. developing and making public a formal performance framework); (iii) Joint Supervisory Teams (e.g. ensuring that national authorities participate fully and proportionately in JST work); and (iv) on-site supervision (e.g. strengthening the presence of ECB staff in on-site inspections).

4.2 Decision-making

4.2.1 Supervisory Board and Steering Committee

Figure 7
Decisions by the Supervisory Board in 2016



Notes: The numbers in this figure relate to individual supervisory decisions addressed to supervised entities or their potential acquirers and instructions to NCAs on SIs or LSIs. In addition, the Supervisory Board took decisions on a number of horizontal issues (e.g. common methodologies) and institutional issues.

1) The 1,191 decisions on authorisation procedures cover 2,686 individual procedures (see Section 2.1.2).

A total of 28 meetings of the Supervisory Board took place in 2016. Of these, 24 were held in Frankfurt am Main and four were held via teleconference. At these meetings, the Supervisory Board discussed a wide range of issues, regarding both individual banks and more general policy issues. In 2016, the Supervisory Board took the majority of its decisions by written procedure⁴¹. As in 2015, most of these decisions concerned fit and proper assessments.

A very large number of decisions concerned individual banks (see [Figure 7](#)) and were adopted via the non-objection procedure. In this two-step process, individual draft decisions are first submitted to the Supervisory Board for approval. Thereafter, the final draft decisions are sent to the Governing Council for adoption by non-objection. Thirty-eight of the 126 banking groups directly supervised by the ECB in 2016 asked to receive formal ECB decisions in an EU official language other than English.

In addition to bank-specific decisions, the Supervisory Board decided on several horizontal issues, most notably the application of common methodologies and frameworks in specific areas of its supervision. Some of these decisions were drawn up by temporary structures mandated by the Supervisory Board. These structures comprised senior managers from the ECB and the NCAs. They carried out preparatory work on the SREP methodology and on a consistent supervisory approach towards institutions with high levels of non-performing loans. The Supervisory Board also finished its work on the exercise of options and discretions available in EU law. The relevant [Addendum to the ECB Guide on Options and Discretions](#) was published in August 2016.

⁴¹ Under Article 6.7 of the [Supervisory Board's Rules of Procedure](#), decisions may also take place by written procedure, unless at least three members of the Supervisory Board who have a voting right object. In such cases, the item is put on the agenda of the subsequent Supervisory Board meeting. A written procedure normally requires at least five working days for consideration by the Supervisory Board.

Supervisory Board

Front row (from left to right):
Mathias Dewatripont, Elisa Ferreira, Tatiana Dubinova (alternate for Vladimír Dvořáček), Julie Dickson, Anneli Tuominen, Danièle Nouy, Sabine Lautenschläger, Jeļena Ļebedeva (alternate for Pēters Putniņš), Cyril Roux, Alexander Demarco

Middle row (from left to right):
Raimund Röseler (alternate for Felix Hufeld), Ignazio Angeloni, Luc Coene, Zoja Razmusa, Norbert Goffinet, Claude Simon, Marko Bošnjak, Fernando Restoy Lozano

Back row (from left to right):
Helmut Ettl, Jouni Timonen, Andreas Dombret, Fabio Panetta, Andreas Iltner, Karol Gabarretta, Andres Kurgpõld (alternate for Kilvar Kessler), Vytautas Valvionis (alternate for Ingrida Šimonytė), Yiangos Demetriou, Ilias Plaskovitis, Jan Sijbrand, Robert Ophèle.



In 2016, the ECB further streamlined its decision-making processes

The ECB took steps to further streamline its decision-making process in 2016. In addition to standardising certain parts of the documentation and the bundling of related decisions into single written procedure, the ECB designed a **framework for adopting certain types of supervisory decisions by means of delegation**. In 2017 the framework will allow for the delegation to senior managers in ECB Banking Supervision of most decisions in two areas: the assessment of fit and proper requirements and the amendment of the significance of supervised entities. It aims to achieve a broad scope of delegation for routine decisions that involve limited discretion. The delegation of decision-making powers will make the supervisory decision-making process much more efficient. It will also enable the Supervisory Board and the Governing Council to focus on high-impact issues and decisions that require more in-depth assessment.

Luc Coene, ECB representative on the Supervisory Board, passed away on 5 January 2017.

The official statement can be found on the ECB website.

The Steering Committee provides support to the Supervisory Board and carries out the preparatory work for its meetings. It includes eight members of the Supervisory Board. In 2016, it held 18 meetings, all of them in Frankfurt am Main.⁴² In April, the usual rotation of the five NCA members, who are appointed for a one-year term, took place.

⁴² See Article 26(10) of the SSM Regulation.

Chair	Danièle Nouy	Cyprus	Yiannos Demetriou (Central Bank of Cyprus)
Vice-Chair	Sabine Lautenschläger	Latvia	Pēters Putniņš (Finanšu un kapitāla tirgus komisija) Zoja Razmusa (Latvijas Banka)
ECB representatives	Ignazio Angeloni Luc Coene (until 5 January 2017) Julie Dickson Sirikka Hämäläinen (until June 2016)	Lithuania	Ingrīda Šimonytė (Lietuvos bankas) (until 1 August 2016) Vytautas Valvonas (Lietuvos bankas) (since 15 February 2017)
Belgium	Mathias Dewatripont (Nationale Bank van België/Banque Nationale de Belgique)	Luxembourg	Claude Simon (Commission de Surveillance du Secteur Financier) Norbert Goffinet (Banque centrale du Luxembourg)
Germany	Felix Hufeld (Bundesanstalt für Finanzdienstleistungsaufsicht) Andreas Dombret (Deutsche Bundesbank)	Malta	Karol Gabarretta (Malta Financial Services Authority) Alexander Demarco (Bank Ċentrali ta' Malta/Central Bank of Malta)
Estonia	Kilvar Kessler (Finantsinspeksioon) Madis Müller (Eesti Pank)	Netherlands	Jan Sijbrand (De Nederlandsche Bank)
Ireland	Cyril Roux (Central Bank of Ireland/Banc Ceannais na hÉireann) (until 28 February 2017) Ed Sibley (Central Bank of Ireland/Banc Ceannais na hÉireann) (since 01 March 2017)	Austria	Helmut Ettl (Finanzmarktaufsicht) Andreas Ittner (Oesterreichische Nationalbank)
Greece	Ilias Plaskovitis (Bank of Greece)	Portugal	Elisa Ferreira (Banco de Portugal)
Spain	Fernando Restoy Lozano (Banco de España) (until 31 December 2016) Javier Alonso (since 1 January 2017)	Slovenia	Stanislava Zadavec Capriolo (Banka Slovenije) (until 5 April 2016) Marko Bošnjak (Banka Slovenije) (from 6 April 2016 until 13 March 2017) Primož Dolenc (Banka Slovenije) (since 14 March 2017)
France	Robert Ophèle (Banque de France)	Slovakia	Vladimír Dvořáček (Národná banka Slovenska)
Italy	Fabio Panetta (Banca d'Italia)	Finland	Anneli Tuominen (Finanssivalvonta) Jouni Timonen (Suomen Pankki) (until 28 February 2017) Olli Rehn (Suomen Pankki) (since 01 March 2017)

Additionally, the Steering Committee had 15 meetings in its extended composition, that is, with the participation of senior representatives from all 19 NCAs. Of these meetings, ten were held in Frankfurt am Main and five via teleconference. The meetings were dedicated to managing the 2016 stress-testing exercise.

4.2.2 Activities of the Administrative Board of Review

In 2016 eight requests for an administrative review of ECB supervisory decisions were filed with the Administrative Board of Review⁴³ (see **Chart 8**).

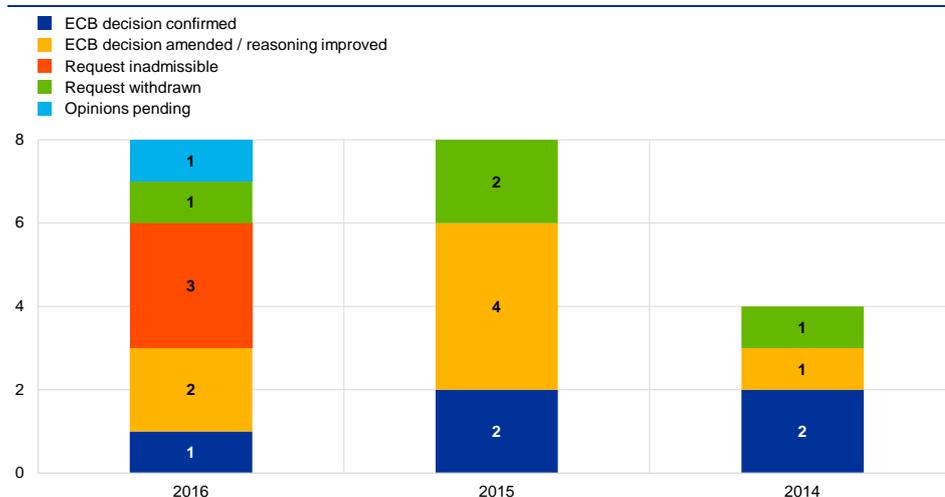
In most cases, the Administrative Board's opinions did not give rise to legal proceedings. It was therefore effective in reducing the cost of reviewing supervisory decisions for all the parties involved. This "procedural economy" was one of the main reasons identified by the EU legislators for establishing the Board.⁴⁴

⁴³ The Administrative Board of Review is composed of five members: Jean-Paul Redouin (Chair), Concetta Brescia Morra (Vice-Chair), Javier Aristegui Yáñez, André Camilleri and Edgar Meister; and two alternates: René Smits and, since 3 February 2016, Ivan Šramko.

⁴⁴ Recital 64 of the SSM Regulation.

Chart 8

Number of requests for review unchanged from 2015



Source: ECB.

Topics under review and issues of relevance

The requests submitted to the Administrative Board of Review touched upon several topics and types of supervisory decisions: corporate governance, compliance with supervisory requirements, and withdrawal of a licence.

The review of ECB decisions in 2016 mainly concerned their compliance with procedural rules, including due process requirements, accurate statement of the facts, sufficient grounds in the statement of reasons and compliance with the proportionality principle. The Administrative Board also had to examine the cooperation between the ECB and NCAs, which in some cases involved banks outside the SSM (that were part of a significant banking group directly supervised by the ECB).

The review of ECB decisions was challenging particularly due to regulatory fragmentation (diverse transposition of European law at national level) and the remaining wide scope for national discretions.

In 2016 the Administrative Board held oral hearings in two cases. Oral hearings provide the applicants with the opportunity to be heard, and the ECB with the opportunity to present its views. Over time, oral hearings have proven to be an important element of the review process.

4.3 ECB Banking Supervision staffing

Since the start of the SSM on 4 November 2014, it has become clear that more resources than initially anticipated are required for a number of key tasks. In



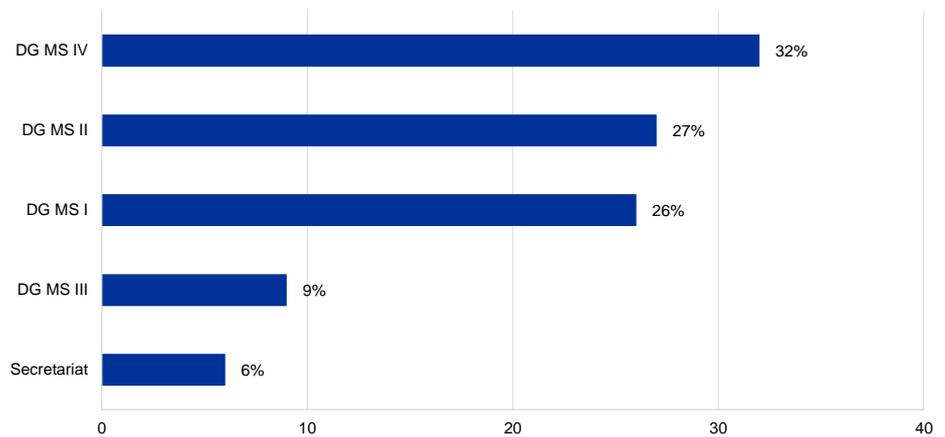
160
Additional positions
approved for
supervisory-related
activities in 2016

September 2015, the ECB's Governing Council therefore decided to increase the relevant headcount following a staggered approach over 2016 and 2017.

For 2016, an additional 160 (permanent and limited) positions in the supervision-related business areas were approved. The respective recruitment procedures, starting with managerial and adviser positions, were organised in a transparent, competitive, and top-down manner. The selection of candidates was aimed at recruiting employees with the highest level of ability, efficiency and integrity. In line with the ECB's standard recruitment procedure, all candidates had to demonstrate not only the required sound technical competencies, but also behavioural competencies and managerial skills, as appropriate. **Chart 9** illustrates the breakdown of the approved headcount positions for the five **ECB business areas** dealing with banking supervision as at 31 December 2016.

Chart 9

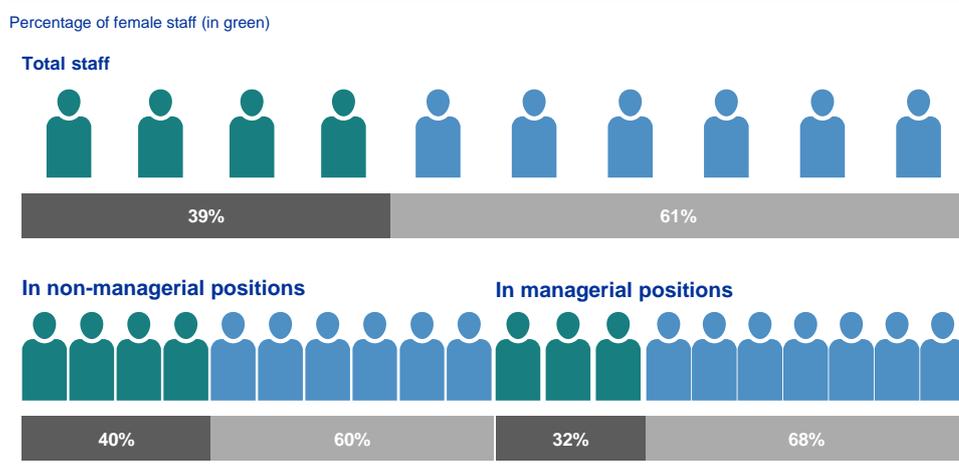
Breakdown of approved headcount positions for core ECB Banking Supervision areas as at 31 December 2016



By the end of 2016, approximately 97% of the approved headcount for the core SSM business areas was, or was in the process of being, filled via recruitment.

Regarding gender diversity, the distribution is shown in **Figure 8**:

Figure 8
Gender diversity in ECB Banking Supervision



141.5
Additional positions approved for supervisory-related activities in 2017

In September 2015 the Governing Council also endorsed a provisional additional increase in headcount for banking supervision staff for 2017, and asked the ECB to submit a report in the course of 2016 to validate the actual requirement based on the lessons learned from the first 18 months of SSM operation and the expected resource gains. This report was coordinated by the Chair and Vice-Chair of the Supervisory Board. Based on the findings of the report, in December 2016 the Governing Council approved 141.5 new permanent and limited FTEs (full-time equivalent positions) for 2017, taking into account (i) new needs triggered by the increase in the number of tasks since 2015 (in particular, an increased number of significant institutions to supervise and the establishment of the new EU crisis management framework); (ii) the need to allow NCAs time to meet their commitments regarding the staffing of JSTs; and (iii) resource gains identified by the ECB (e.g. synergies in the supervision of host entities belonging to the same non-SSM group).

Box 2

Working together in Europe

For European banking supervision to succeed, it is paramount that colleagues from the ECB and NCAs grow together as a team of European banking supervisors collaborating at the level of both the JSTs and the horizontal functions. Among other things, this means getting to know each other, exchanging views and learning from each other in order to foster a common SSM culture. In this spirit, the ECB, together with the NCAs, launched the following initiatives in 2016.

SSM training curriculum

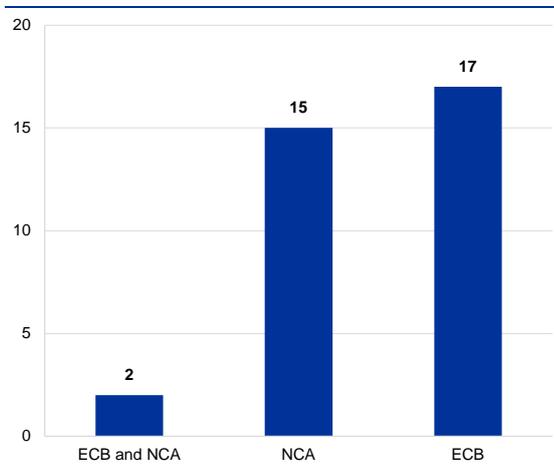
The SSM's greatest asset is its people. The ECB and NCAs therefore strive to ensure that their staff is equipped with the necessary skills to perform their tasks, and that they can develop their competencies over time.

Training plays an important role in this process. Developing a common approach to training for supervisors will contribute to:

- a consistent approach to supervision;
- a common supervisory culture;
- intra-SSM mobility, flexibility and employee development;
- the creation of economies of scale and greater expertise within the SSM.

Chart A

Joint effort: NCA/ECB training courses organised in 2016



As a result of the joint effort of the supervisory community, 34 system-wide training courses were held in 2016, hosted by both NCAs and the ECB. Fourteen of these had been newly-designed and over 1,200 places were offered to SSM staff. In 2017 more than 60 system-wide training courses will be offered.

Regular JST workshops

JSTs are the backbone of the SSM. To contribute to building a single team of European banking supervisors, the ECB launched one-day workshops in 2016. These “Working in a JST” workshops take place in Frankfurt am Main and other euro area locations. At these dynamic and interactive workshops, supervisors share sound practices that may have already been

implemented in some teams to make their internal cooperation more effective and efficient. The workshops also provide an opportunity for JST members from across the euro area to exchange views during practical exercises. More generally, they foster collaboration and increase openness and transparency among members of the same JSTs.

SSM traineeships

In 2016 the ECB launched the first SSM Traineeship Programme with the aim of creating a pool of young talent for the entire SSM. As part of this programme, graduates have the opportunity to move across institutions within the SSM, which helps them to gain valuable pan-European work experience and allows them to contribute to a common European banking supervisory culture. On 1 October 2016, 26 out of the 33 participants in the SSM Traineeship Programme 2016 opted to join national supervisors in several European countries for a four-month assignment. For most of them this was their second placement at a national competent authority in addition to time spent at the ECB. At the end of their secondments all the SSM trainees will return to the ECB in Frankfurt am Main to share what they have learned and provide feedback about the programme and their experiences of the SSM’s working culture.

4.4 Implementation of the Code of Conduct

Under Article 19(3) of the SSM Regulation, the ECB is required to have a [Code of Conduct](#) that governs ECB staff and management involved in banking supervision and that addresses in particular any concerns regarding conflicts of interest. The relevant provisions are contained in the ECB's Ethics Framework, which is implemented by the Compliance and Governance Office (CGO). The CGO advises all ECB staff on ethical issues.



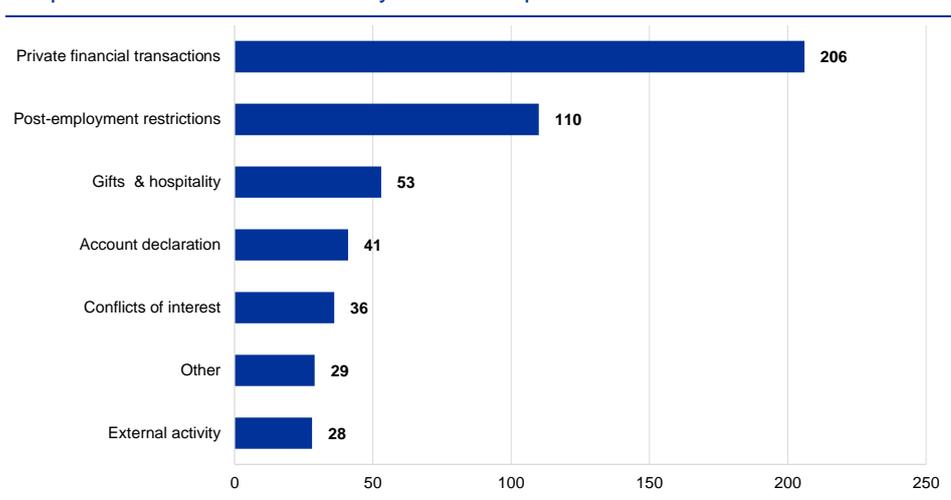
More than 1,500

Requests received by the Compliance and Governance Office in 2016

Throughout 2016 more than 1,500 requests were received by the CGO from ECB staff members relating to a wide range of topics. One-third of those came from staff involved in banking supervision and concerned, inter alia, private financial transactions, post-employment restrictions, gifts and hospitality and other concerns regarding conflicts of interest (see [Chart 10](#)). The CGO identified a limited number of instances of non-compliance, roughly one-third of which related to staff and management involved in banking supervision. None of those instances related to intentional misconduct or other serious instances of non-compliance.

Chart 10

Requests received in 2016 mostly concerned private financial transactions



Of those members of staff and management involved in banking supervision who resigned from their post in 2016, no case triggered a cooling-off period in line with the Ethics Framework.

With a view to achieving an adequate corporate and ethics culture across the SSM, the NCAs have communicated to the ECB the measures they have taken to implement and comply with the [ECB's Guideline](#) setting out the common principles of an Ethics Framework for both the ECB and NCAs. A dedicated ethics task force facilitated these activities and continued to support the Governing Council in this respect.

The ECB's Ethics Committee advises members of those bodies that are involved in the ECB's decision-making processes on ethical issues. It issued SSM-related

advice in 2016 on eight occasions. For example, the Ethics Committee recommended a six-month extension to an abstention period, previously established for a member of the Supervisory Board, following the resignation of the member's spouse from a non-executive role on a board of a supervised bank. The recommendation was given in order to exercise prudence and to mitigate any possible perceptions of conflicts of interest. In addition, members of the Supervisory Board and other participants in Supervisory Board meetings notified the Ethics Committee of post-employment occupational activities in public or international organisations and corporations outside the financial sector. These were assessed as unproblematic by the Ethics Committee. The Ethics Committee also advised on the appropriate level of compensation to be paid to a former member of the Supervisory Board during the applicable cooling-off period.

4.5 Application of the principle of separation between monetary policy and supervisory tasks

In the course of 2016, the principle of separation between monetary policy and supervisory tasks mainly related to the exchange of information between different policy areas.⁴⁵ In line with [Decision ECB/2014/39 on the implementation of separation between the monetary policy and supervision functions of the ECB](#), this exchange of information was subject to a need-to-know requirement: each policy area had to demonstrate that the information requested was necessary to achieve its policy goals. The majority of cases did not relate to individual banks' data. Access to confidential information was granted directly by the ECB policy function owning the information; intervention by the Executive Board to solve possible conflicts of interest was not necessary. Under Decision ECB/2014/39, the involvement of the Executive Board was nonetheless required in nine instances to allow the sharing of non-anonymised FINREP and COREP data⁴⁶, and other raw data. Access to the data was granted temporarily to ensure that the need-to-know requirement was fulfilled at all relevant points in time. Separation at the decision-making level did not raise concerns, and no intervention by the Mediation Panel was required.

⁴⁵ Decision ECB/2014/39 also contains provisions relating to organisational aspects.

⁴⁶ FINREP (FINAncial REPorting) and COREP (COmmon REPorting) form part of the EBA's Implementing Technical Standards (ITS). FINREP deals with the collection of financial information from banking institutions; it represents a standardised format of their annual accounts (balance sheet, profit and loss and detailed annexes). COREP deals with the collection, also in a standardised format, of information relative to the Pillar 1 calculation, i.e. details on own funds, deductions and capital requirements (credit, market and operational risk) as well as large exposures.

4.6 Data reporting framework and information management

Developments in the data handling framework

In accordance with the SSM Framework Regulation the ECB is responsible for organising the processes relating to the collection and quality review of data reported by supervised entities.⁴⁷

The main objective is to ensure that the SSM uses reliable and accurate supervisory data. Therefore, the ECB maintains close cooperation with NCAs' reporting units, which are the first recipients of prudential reporting by credit institutions and which perform the first quality checks on this data. To achieve its objective, the ECB collaborates with the NCAs (and supervised entities in case of direct reporting to the ECB) using the "sequential approach"⁴⁸.

The **sequential approach** is currently being enhanced, in both its short and long-term forms. Under the short-term approach, as discussed with stakeholders in 2016, NCAs are requested to transmit data to the ECB by the ECB remittance date, irrespective of the status of any NCA-internal validation rules. This approach aims to ensure that (a) the time lag between the submission of reports by entities and the availability of data to SSM supervisors is shortened, and (b) the contents of NCA/ECB databases are aligned. Under the long-term approach, the intention is to identify best practices in each NCA and to propose harmonised best practices.

Once received by the ECB, the data reports are forwarded in different formats to the IMAS⁴⁹ system in order to make the data available to end-users, such as JSTs and horizontal functions within the SSM. Selected data from a subset of institutions (mainly significant institutions) are also forwarded automatically to the EBA upon receipt.

The frequency of data collection ranges from monthly, quarterly and semi-annual to annual, and data from both significant institutions and less significant institutions are available from the reference period of December 2014 (as applicable) onwards.

In particular, in the course of 2016 and following the official publication of the underlying legal acts⁵⁰, the SSM started to collect on a regular basis the reports for the additional liquidity monitoring metrics (ALMM) and the supervisory benchmarking portfolios (SBP), as well as the reports for the liquidity coverage ratios (LCR) and the leverage ratios (LR), according to modified reporting frameworks.

⁴⁷ Article 140(4) of the SSM Framework Regulation.

⁴⁸ The "sequential approach" is the framework for the transmission of supervisory data from banks to the NCAs, from the NCAs to the ECB, and from the ECB to the EBA.

⁴⁹ IMAS: Information Management System for the SSM.

⁵⁰ Legal acts: ALMM: Regulation (EU) 2016/313 of 1 March 2016 with regard to additional monitoring metrics for liquidity reporting; SBP: Regulation (EU) 2016/2070 laying down implementing technical standards for templates, definitions and IT-solutions to be used by institutions when reporting to the EBA and to competent authorities; LCR: Regulation (EU) 2016/322 of 10 February 2016 with regard to reporting of the liquidity coverage requirement; LR: Regulation (EU) 2016/428 of 23 March 2016 with regard to the reporting of the leverage ratio.

Since 2016 the ECB has published extensive data on the European banking sector

The ECB produces regular supervisory statistics, key risk indicators, reports and dashboards for end-users. Additionally, aggregated banking data⁵¹ covering significant institutions at the highest level of consolidation have been published on the ECB's banking supervision website since 2015. In 2016 these data were extensively enhanced in terms of additional statistics and more in-depth breakdowns (e.g. by geography and bank classification); public disclosure is also now quarterly (see also Section 7).

Data handling and dissemination within the SSM – IMAS

The IMAS system continues to be a crucial element in supporting central SSM processes and ensuring a harmonised supervisory approach across all euro area countries. In 2016 IMAS significantly evolved not only by covering SSM supervisory processes such as the SREP, on-site inspections, operational planning and authorisation procedures more widely, but also by making its interface more user-friendly, reinforcing the capacity for information analysis and generally enriching the contents available.

With regard to the functioning of IMAS, the ECB maintains Reporting Instructions (e.g. on the transmission and quality of ITS data, usage of the database and how to search for specific information) and provides technical support to end-users.

Box 3

Efforts towards more transparency

Since the ECB took over its new supervisory tasks it has faced questions as to whether it is sufficiently transparent and accountable. Transparency implies delivering a clear and timely explanation of the ECB's policy decisions and procedures; accountability refers to the ECB's responsibility for its actions vis-à-vis EU citizens and their elected representatives. Transparency provides the public with the means to assess the ECB's performance against its objectives. For this reason, in 2016 greater efforts towards increasing the transparency of ECB Banking Supervision were made.

ECB Banking Supervision has been increasingly engaged in communicating with the general public: on 23 March 2016, the Chair and Vice-Chair of the Supervisory Board held the first annual press conference, explaining how the ECB carried out its supervisory activities in 2015. Moreover, ECB Banking Supervision published the SREP methodology booklet, disclosing its supervisory approach. Policy messages were conveyed through 42 speeches and 18 interviews given by the Chair, Vice-Chair and ECB Representatives of the Supervisory Board and published on the ECB's banking supervision website. In 2016, the Chair's and Vice-Chair's meetings calendars were regularly disclosed, and ECB Banking Supervision provided information and sought feedback from lawmakers and the general public in the context of:

- 7 public consultations launched;

⁵¹ See "European banking sector in figures". Please also refer to [SSM Banking Statistics](#).

- 1,295 public enquiries received, of which 608 enquiries on general banking supervision issues, 619 complaints about banks and 68 enquiries about supervised entities;
- 34 replies to questions from MEPs on supervisory matters published.

In 2016 ECB Banking Supervision stepped up its direct interaction with supervised banks. By means of publications, press releases, workshops and explanatory calls, ECB Banking Supervision explained the SREP and stress test methodologies to banks. Moreover, the ECB sought feedback from the industry: the European Banking Federation’s annual survey on the “SSM supervisory experience” showed that ECB Banking Supervision has made progress in communicating effectively and clearly. Regarding the SREP specifically, 13 meetings and one teleconference were held with banking associations. The ECB also held an exchange of views with representatives from the office of the European Ombudsman, Ms Emily O’Reilly, on the transparency of the SREP. In a [letter to the Chair](#), Ms O’Reilly expressed her contentment with the ways in which the ECB ensured transparency in the way the SREP is conducted and made some further recommendations.

Since December 2016, ECB Banking Supervision has published aggregate data on the balance sheet composition, profitability, solvency and credit risk of supervised banks. These [supervisory banking statistics](#) are disclosed on the ECB’s banking supervision website on a quarterly basis and include breakdowns according to geography and bank classification.

Transparency is also ensured through the ECB’s public access regime. The ECB’s Decision on public access to ECB documents⁵² is in line with the objectives and standards applied by other EU institutions and bodies with regard to public access to their documents. It increases transparency, while at the same time taking into account the independence of the ECB and the NCAs and ensuring that certain matters specific to the performance of the ECB’s tasks remain confidential. Members of the public submitted an increased number of requests for public access to documents relating to the supervisory tasks of the ECB in 2016.

⁵² [Decision \(EU\) 2015/529](#) of 21 January 2015 amending Decision ECB/2004/3 on public access to European Central Bank documents (ECB/2015/1, OJ L 84, 28.3.2015, p. 64.) Under these rules, any member of the public has a right of access to ECB documents, subject to certain conditions set out in the ECB decision. The decision sets out grounds for refusing access to documents, e.g. the confidentiality of the proceedings of the ECB’s decision-making bodies, the Supervisory Board or other internal bodies.

5 Reporting on budgetary consumption

The SSM Regulation provides that the ECB must be able to dispose of adequate resources to carry out its supervisory tasks effectively. These resources are financed via a supervisory fee borne by the entities under ECB supervision.

The expenditure incurred for supervisory tasks is separately identifiable within the ECB's budget.⁵³ The budgetary authority of the ECB is vested in its Governing Council. This body adopts the ECB's annual budget following a proposal of the Executive Board in consultation with the Chair and Vice-Chair of the Supervisory Board for matters related to banking supervision. The Governing Council is assisted by the Budget Committee (BUCOM), which consists of members from all the NCBs of the Eurosystem and the ECB. BUCOM evaluates the ECB's reports on budget planning and monitoring and reports on them directly to the Governing Council.

The ECB anticipates expenditure growth in 2017 for the direct supervision of significant institutions. This growth is related to the different activities foreseen in “[ECB Banking Supervision: SSM priorities 2017](#)”, most notably the launch of the targeted review of internal models (TRIM). Furthermore, as explained in Section 4.3, in December 2016 the Governing Council took a decision to further increase the number of ECB staff working on banking supervision as of 2017. By contrast, the expenditure incurred for the indirect supervision of less significant institutions in 2017 is expected to remain at a level comparable to 2016.

5.1 Expenditure for 2016

The expenditure incurred by the ECB for the conduct of supervisory-related tasks primarily consists of the direct expenses of the [ECB Banking Supervision Directorates General and the Secretariat to the Supervisory Board](#). The supervisory function also relies on shared services provided by the existing business areas of the ECB, including premises, human resources management, administrative services, budgeting and controlling, accounting, legal, communication and translation services, internal audit, statistical and information technology services.

In April 2016 the Governing Council adopted the ECB decision on the amount to be recovered via supervisory fees in 2016. This decision set the estimate for annual expenditure for banking supervisory tasks at €423.2 million.⁵⁴ At the end of 2016 the ECB's expenditure for supervisory tasks stood at €382.2 million. This was 10% less than estimated, resulting in a surplus of €41.1 million compared with the expenditure estimated for 2016. In accordance with the applicable [ECB Regulation on](#)

Expenditure in 2016 was 10% lower than estimated

⁵³ In accordance with Article 29 of the SSM Regulation.

⁵⁴ Decision (EU) 2016/661 of the European Central Bank of 15 April 2016 on the total amount of annual supervisory fees for 2016 (ECB/2016/7).

supervisory fees (“the Fees Regulation”) this surplus will be offset in full against the total amount to be levied in 2017.⁵⁵

Table 7

Cost of ECB Banking Supervision in 2016

(€ millions)

	Actual expenditure 2016	Estimated expenditure 2016	Actual expenditure 2015	Actual expenditure 2014
Salaries and benefits	180.6	193.6	141.3	68.9
Rent and building maintenance	58.1	53.0	25.5	13.2
Other operating expenditure	143.4	176.7	110.3	74.8
Total expenditure for banking supervision tasks	382.2	423.2	277.1	156.9

Note: Totals and subtotals in the table may not add up owing to rounding.

The year-on-year increase in total expenditure incurred for supervisory tasks in 2016 is primarily explained by the full-year impact of decisions and developments that took place in the course of 2015. These include the increase in the total number of ECB staff working on banking supervision, the relocation to permanent premises and the provision of statistical and IT infrastructure.

Other cost increases are related to the ECB’s involvement in the biennial stress test conducted by the EBA. The related efforts were, as far as possible, covered by re-prioritising tasks and drawing on NCA staff and external consultants. The cost of the external resources amounted to €2.2 million for NCA secondees and €8.2 million for consultants.

Salaries and benefits

Salaries and benefits comprise all salary-related expenditures, including overtime, allowances and costs in relation to post-employment benefits, for supervisory staff and staff of the shared services.

The actual expenditure for 2016 salaries and benefits was €180.6 million, representing 47% of the total expenditure for banking supervisory tasks. Actual expenditure in this category has a consumption rate of 93% compared with estimated expenditure, representing an underspend of €13.0 million. This underspend is partly related to a lower average occupation rate than projected. By the end of 2016 approximately 97% of the approved headcount for the core SSM business areas was filled or being filled through recruitment.

⁵⁵ Article 9 of Regulation (EU) No 1163/2014 of the European Central Bank of 22 October 2014 on supervisory fees (ECB/2014/41).

Rent and building maintenance

At the end of the financial year the actual expenditure on rent and building maintenance including depreciation of premises-related assets stood at €58.1 million. In 2016 ECB Banking Supervision completed its move to permanent premises. Owing to confirmed needs for room space, the actual expenditure is €5.1 million above the projected estimate.

Other operating expenditure

The category “other operating expenditure” includes costs such as consultancy, IT services, statistical services, depreciation for fixed assets (other than premises-related), business travel and training.

Overall, the budgetary performance in this category stands at €143.4 million, which is below the expenditure projected in April 2016. The underspend in this category for the most part reflects the establishment phase of the supervisory function and an overestimation of the budgetary needs for activities such as business travel and training.

In addition to the biennial EBA stress test exercise, other operating expenditure in 2016 incorporates the external support that was called upon to contribute to the “regular” comprehensive assessments, the conduct of on-site supervision and the preparatory phase of the TRIM review, all of which are explained in detail in Section 1.

5.2 Feeing framework 2016

Together with the SSM Regulation, the Fees Regulation provides the legal framework under which the ECB levies an annual supervisory fee for the expenditure it incurs in conducting its supervisory tasks. The Fees Regulation establishes the methods for: (i) determining the total amount of the annual supervisory fee; (ii) calculating the amount to be paid by each supervised institution; and (iii) collecting the annual supervisory fee.

In 2016 the ECB completed the second supervisory fee cycle. A review of the Fees Regulation will take place in the course of 2017, in particular with regard to the methods and criteria used to calculate the annual supervisory fee. Further information on how supervised entities can contribute to the review will be published on the ECB’s banking supervision website.

 **€404.5 million**
Fees levied by the ECB
for conducting
supervisory tasks

Total amount levied

In 2016 the ECB levied a total amount of €404.5 million in fees for the expenditure it incurred by conducting its supervisory tasks. This is based on the expected expenditure for the full year 2016, amounting to €423.2 million, as adjusted for: (i) the surplus of €18.9 million carried forward from the 2015 fee period; (ii) other income related to interest on late payments of €0.1 million; and (iii) €0.3 million reimbursed to individual banks for the 2014-2015 fee period.

The amount to be recovered via annual supervisory fees is split into two parts. This split is related to the status of supervised entities as either significant or less significant, reflecting the varying degrees of supervisory scrutiny by the ECB. The amount is then determined on the basis of the costs incurred by the business areas of the ECB that are responsible for the supervision of significant supervised entities and those overseeing the supervision of less significant supervised entities, respectively.

Table 8
Supervisory fees split between significant institutions and less significant institutions

(€ millions)

	Actual income 2016	Estimated income for banking supervision tasks 2016	Actual income 2015	Actual income 2014 ⁵⁶
Supervisory fees	382.2	423.2	277.1	30.0
of which:				
Fees on significant entities or significant groups	338.4	376.0	245.6	25.6
Fees on less significant entities or less significant groups	43.7	47.2	31.5	4.4
Other	0.0			
Total income from banking supervision tasks	382.2	423.2	277.1	30.0

As explained in Section 5.1, there is a surplus of €41.1 million between the actual expenditure incurred for banking supervisory tasks in 2016 and the amount levied in the same year. This surplus will be offset in full against the total amount to be levied in 2017. It will be allocated to the categories of significant institutions and less significant institutions based on the actual costs that were allocated to the relevant functions in 2016.

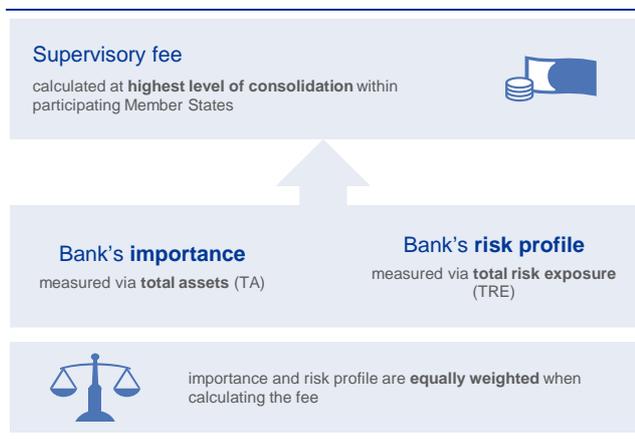
Individual supervisory fees

At bank level, the fees are calculated according to a bank's importance and risk profile, using annual fee factors supplied by all supervised banks with a reference date of 31 December of the preceding year. The supervisory fee calculated per bank

⁵⁶ For 2014, the ECB recovered via supervisory fees its banking supervision-related costs for the period commencing in November 2014, which is when it assumed its supervisory tasks.

is then charged via annual payments payable in the final quarter of each financial year.

Figure 9
The variable fee component is determined by a bank's importance and its risk profile



The supervisory fee is set at the highest level of consolidation within Member States participating in the SSM. It contains a variable fee component and a minimum fee component. The latter applies equally to all banks and is based on 10% of the total amount to be recovered⁵⁷.

For the calculation of the annual supervisory fees payable in 2016, the fee debtors submitted information on the fee factors with a reference date of 31 December 2015 to the NCAs by 1 July 2016. On 8 August 2016 the ECB made the submitted fee factors data available to fee debtors and invited them to comment within five working days if they considered the data to be incorrect. The ECB then calculated the individual fee per bank and banking group.

Article 7 of the Fees Regulation provides that the following changes in the situation of an individual bank require an amendment of the corresponding supervisory fee: (i) a change in supervisory status of the supervised entity, i.e. the entity is reclassified from significant to less significant or vice versa; (ii) a new supervised entity is authorised; or (iii) an existing authorisation is withdrawn. In the course of 2015, such changes, which resulted in new supervisory fee decisions by the ECB, added up to €0.3 million. That amount was reimbursed in early 2016 and taken into account in the total amount to be levied as approved in April 2016. Thereafter, additional amendments to individual supervisory fees levied in the first invoicing cycle (November 2014 to end-2015) were identified, resulting in a further net refund of €0.4 million. This amount will be taken into account in the total amount to be levied on supervised entities in 2017.

These changes primarily concerned less significant institutions, resulting in a smaller number of LSIs at the highest level of consolidation. As a consequence, in particular for the minimum fee component, the percentage increase in the individual supervisory fee payable in 2016 for some individual banks was unavoidably higher than what may have been expected given the percentage increase in the total amount to be levied.

The ECB is currently processing 2016-related applications for amendments under Article 7 of the Fees Regulation. The amounts reimbursed or levied will be offset in full against the total amount to be levied in 2017.

⁵⁷ For the smallest significant banks, with total assets below €10 billion, the minimum fee component is halved.

More information on [supervisory fees](#) is available on the ECB's banking supervision website. These pages are updated regularly with useful, practical information and are published in all official EU languages.

6 Legal instruments adopted by the ECB concerning banking supervision

The following table lists the legal instruments concerning banking supervision that were adopted in 2016 by the ECB and published in the Official Journal of the European Union and/or on the ECB's website. It covers legal instruments adopted pursuant to Article 4(3) of the SSM Regulation and other relevant legal instruments.

ECB regulations

- **ECB/2016/4**
[Regulation \(EU\) 2016/445](#) of the European Central Bank of 14 March 2016 on the exercise of options and discretions available in Union law (OJ L 78, 24.3.2016, p. 60)

ECB legal instruments other than regulations

- **ECB/2016/1**
[Guideline \(EU\) 2016/256](#) of the European Central Bank of 5 February 2016 concerning the extension of common rules and minimum standards to protect the confidentiality of the statistical information collected by the ECB assisted by the national central banks to national competent authorities of participating Member States and to the ECB in its supervisory functions (OJ L 47, 25.2.2016, p. 16)
- **ECB/2016/7**
[Decision \(EU\) 2016/661](#) of the European Central Bank of 15 April 2016 on the total amount of annual supervisory fees for 2016 (OJ L 114, 28.4.2016, p. 14)
- **ECB/2016/19**
[Decision \(EU\) 2016/1162](#) of the European Central Bank of 30 June 2016 on disclosure of confidential information in the context of criminal investigations (OJ L 192, 16.7.2016, p. 73)
- **ECB/2016/37**
[Guideline \(EU\) 2016/1993](#) of the European Central Bank of 4 November 2016 laying down the principles for the coordination of the assessment pursuant to Regulation (EU) No 575/2013 of the European Parliament and of the Council and the monitoring of institutional protection schemes including significant and less significant institutions (OJ L 306, 15.11.2016, p. 32)
- **ECB/2016/38**
[Guideline \(EU\) 2016/1994](#) of the European Central Bank of 4 November 2016 on the approach for the recognition of institutional protection schemes for

prudential purposes by national competent authorities pursuant to Regulation (EU) No 575/2013 of the European Parliament and of the Council (OJ L 306, 15.11.2016, p. 37)

- **ECB/2016/44**
[Recommendation](#) of the European Central Bank of 13 December 2016 on dividend distribution policies (OJ C 481, 23.12.2016, p. 1)

7 The European banking sector in figures

Since December 2016 aggregate data on the balance sheet composition, profitability, solvency and credit risk of supervised banks have been provided on the [ECB's banking supervision website](#). These supervisory banking statistics are disclosed on a quarterly basis and include breakdowns according to geography and bank classification.

The most important statistics relevant to the period under review are presented below.

A trend towards higher capital ratios since the beginning of 2015 can be observed if we examine the sample of SIs at the highest level of consolidation (see Table 1). The total capital ratio stood at 17.2% in the third quarter of 2016, up from 16.1% one year previously. Similar increases can be observed for the CET1 ratio and the Tier 1 ratio.

Table 1
Total capital ratio and its components by reference period

(Percentages)

Indicator	Q3 2015	Q4 2015	Q1 2016	Q2 2016	Q3 2016
CET1 ratio	12.77%	13.52%	13.31%	13.52%	13.70%
Tier 1 ratio	13.59%	14.34%	14.19%	14.40%	14.59%
Total capital ratio	16.06%	16.85%	16.65%	16.96%	17.19%

Source: ECB.

Notes: Significant institutions at the highest level of consolidation for which common reporting on capital adequacy (COREP) and financial reporting (FINREP) are available. The list of banks used for the various reference periods may differ as the list of significant institutions changes and as banks start to report under FINREP obligations. Specifically, there were 102 banks in the second and third quarters of 2015, 117 in the fourth quarter of 2015 (increase in FINREP reporting obligations), 123 in the first quarter of 2016, and 124 in the second quarter of 2016 (changes to the list of significant institutions and FINREP reporting obligations). The number of entities per reference period is expected to stabilise in future, and any changes will result from amendments made to the list of significant institutions following assessments by ECB Banking Supervision, which generally occur on an annual basis.

Furthermore, the overall NPL ratio has been steadily decreasing, from 7.3% in the third quarter of 2015 to 6.5% in the third quarter of 2016.

Table 2
Asset quality: non-performing loans and advances by reference period

(Percentages)

Indicator	Q3 2015	Q4 2015	Q1 2016	Q2 2016	Q3 2016
Non-performing loans ratio	7.31%	7.03%	6.85%	6.61%	6.49%

Source: ECB.

Notes: Sample as in Table 1.

Loans and advances in the asset quality tables are displayed at gross carrying amount. In line with FINREP, held-for-trading exposures are excluded, whereas cash balances at central banks and other demand deposits are included.

Banks' total assets and liabilities (see Tables 3a and 3b) reflect the data for the sample of entities at specific points in time. The sample of banks used in the various reference periods differ as (a) the list of significant institutions has changed and (b) banks that prepare their consolidated accounts under national accounting standards (nGAAP) and those that report only at solo level have started submitting FINREP.

Table 3a

Composition of assets by reference period

(€ billions)

Assets	Q3 2015	Q4 2015	Q1 2016	Q2 2016	Q3 2016
Cash, cash balances at central banks, other demand deposits	1,011.60	1,134.46	1,189.56	1,231.65	1,282.37
Loans and advances	12,967.14	13,153.08	13,445.87	13,652.70	13,589.86
Debt securities	3,275.76	3,291.75	3,375.98	3,351.15	3,194.58
Equity instruments	459.61	461.48	425.82	410.40	429.42
Derivatives	2,420.54	2,220.54	2,457.12	2,577.69	2,349.47
Investments in subsidiaries, joint-ventures and associates	160.53	160.44	162.31	161.45	161.88
Intangible assets and goodwill	139.36	140.12	139.67	139.37	137.93
Other assets	1,138.15	1,127.82	1,219.55	1,234.89	1,210.33
Total assets	21,572.69	21,689.69	22,415.88	22,759.31	22,355.83

Source: ECB.

Note: Sample as in Table 1.

Table 3b

Composition of liabilities and equity by reference period

(€ billions)

Liabilities and equity	Q3 2015	Q4 2015	Q1 2016	Q2 2016	Q3 2016
Deposits	12,650.34	12,787.77	13,032.87	13,227.54	13,120.28
of which: non-financial corporations	2,180.05	2,312.31	2,283.00	2,332.80	2,409.42
of which: households	5,223.31	5,377.59	5,391.24	5,490.26	5,489.20
Debt securities issued	3,743.74	3,930.51	4,005.10	4,008.59	3,969.26
Derivatives	2,455.44	2,268.58	2,515.64	2,634.02	2,415.64
Provisions ¹⁾	133.93	144.96	146.59	152.15	152.99
Other liabilities	1,287.15	1,180.39	1,323.76	1,339.23	1,285.13
Equity	1,302.08	1,377.49	1,391.92	1,397.77	1,412.53
Total liabilities and equity	21,572.69	21,689.69	22,415.88	22,759.31	22,355.83

Source: ECB.

Note: Sample as in Table 1.

1) In line with IAS 37.10 and IAS 1.54(l).

8 Glossary

Basel Committee on Banking Supervision (BCBS): the primary global standard-setter for the prudential regulation of banks and a forum for cooperation on banking supervisory matters. Its mandate is to strengthen the regulation, supervision and practices of banks worldwide with the purpose of enhancing financial stability. BCBS members include organisations with direct banking supervisory authority and central banks.

Banking union: one of the building blocks for completing Economic and Monetary Union, which consists of an integrated financial framework with a single supervisory mechanism, a single bank resolution mechanism, and a single rulebook, including for harmonised deposit guarantee schemes, which may evolve into a common European deposit guarantee scheme.

Basel III: a comprehensive set of reform measures, developed by the Basel Committee on Banking Supervision in response to the financial crisis of 2008. Basel III builds upon the Basel II rulebook. Its aim is to strengthen the regulation, supervision and risk management of the banking sector. The measures aim to improve the banking sector's ability to absorb shocks arising from financial and economic stress, improve risk management and governance, and strengthen banks' transparency and disclosures.

Comprehensive Assessment: financial health checks which the ECB is required to carry out prior to assuming direct supervision over a credit institution. Comprehensive assessments help to ensure that banks are adequately capitalised and can withstand possible financial shocks. The assessment comprises an asset quality review and a stress test.

CRR/CRD IV: Capital Requirements Regulation and Directive: [Regulation \(EU\) No 575/2013](#) on prudential requirements for credit institutions and investment firms (CRR) and [Directive 2013/36/EU](#) on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms (CRD IV). They are often jointly referred to as CRD IV.

European Banking Authority (EBA): an independent EU authority established on 1 January 2011 as part of the European System of Financial Supervision to ensure effective and consistent prudential regulation and supervision across the EU banking sector. Its main task is to contribute to the creation of the European single rulebook in banking, the objective of which is to provide a single set of harmonised prudential rules throughout the EU.

Financial Stability Board (FSB): an international body that promotes international financial stability by coordinating national financial authorities and international standard-setting bodies as they work towards developing robust regulatory, supervisory and other financial sector policies. It fosters a level playing field by encouraging consistency in the implementation of these policies across sectors and

jurisdictions.

Fit and proper assessment: in accordance with CRD IV supervisory authorities must assess whether candidates for the management bodies in banks are fit and proper. The ECB takes such fit and proper decisions for directors of the 126 biggest banks in the euro area, whereas fit and proper decisions for less significant institutions are still taken by the national supervisors, except in the case of a new banking licence.

Internal model: any risk measurement and management approach applied in the calculation of own funds requirements that is proprietary to a credit institution and requires prior permission by the competent authority in accordance with Part Three of the CRR.

Joint Supervisory Team (JST): a team of supervisors composed of ECB and NCA staff in charge of the supervision of a significant supervised entity or a significant supervised group.

Less significant institution (LSI): a less significant institution is any institution that is supervised by national competent authorities (NCAs). By contrast, significant institutions (SIs) are those banking groups that are directly supervised by the ECB.

Maximum distributable amount (MDA): breaches of the combined buffer requirement (CBR) lead to mandatory restrictions on distributions (e.g. dividends, coupon payments on AT1 capital instruments, discretionary bonuses). A bank which fails to meet its CBR will be automatically prohibited from distributing more than the MDA. The MDA is the bank's distributable profit multiplied by a factor ranging between 0.6 and 0, depending on by how much CET1 capital falls short of the CBR.

Minimum requirement for own funds and eligible liabilities (MREL): a requirement for all EU credit institutions with the aim of enabling credit institutions to absorb losses in the event of their failure. The MREL requirement was issued by the European Commission in the [Bank Recovery and Resolution Directive \(BRRD\)](#). It has the same goal as the TLAC requirement. However, the specific capital requirements prescribed by the MREL are calculated differently, following criteria set by the EBA.

National competent authority (NCA): a public authority or body officially recognised by national law, which is empowered by national law to supervise institutions as part of the supervisory system in operation in the Member State concerned.

Non-objection procedure: a standard decision-making process established by the SSM Regulation for the ECB's supervisory activities. The Supervisory Board takes draft decisions, which are submitted to the Governing Council for adoption. Decisions are deemed to be adopted unless the Governing Council objects within a defined period of time, not exceeding ten working days.

Non-performing loans (NPLs): paragraph 145 of Annex V of the EBA ITS on supervisory reporting provides that "non-performing loans are those that satisfy

either or both of the following criteria: (a) material exposures which are more than 90 days past-due; (b) the debtor is assessed as unlikely to pay its credit obligations in full without realisation of collateral, regardless of the existence of any past-due amount or of the number of days past due.”

Options and national discretions (ONDs): options are provisions in EU law that give competent authorities or Member States a choice on how to comply with a provision selecting from a range of alternatives. National discretions are provisions in EU banking law that give competent authorities or Member States a choice as to whether or not to apply a given provision.

Overall capital requirements (OCR): the sum of the total SREP capital ratio (sum of own funds requirements as set out in Article 92 of the Capital Requirements Regulation and additional own funds requirements), capital buffer requirements and macroprudential requirements.

Passporting procedures: procedures concerning the freedom of establishment and the freedom to provide services in other Member States by any credit institution authorised and supervised by the competent authorities of another Member State, provided that such activities are covered by the authorisation (as regulated by Articles 33 to 46 of CRD IV).

Pillar 2 guidance (P2G): a supervisory tool setting non-legally binding capital expectations above the level of overall capital requirements (OCR). It is complementary to Pillar 2 requirements (P2R). P2G is not MDA relevant and a failure to meet Pillar 2 guidance does not result in automatic action by the supervisor.

Qualifying holding: a holding in a credit institution which represents 10% or more of the capital or of the voting rights or which makes it possible to exercise a significant influence over the management of that credit institution.

Significant institution (SI): the criteria for determining whether banks are considered significant – and therefore under the ECB's direct supervision – are set out in the SSM Regulation and the SSM Framework Regulation. To qualify as significant, banks must fulfil at least one of those criteria. Notwithstanding the fulfilment of the criteria, the SSM can decide at any time to classify an institution as significant to ensure that high supervisory standards are applied consistently.

Single Supervisory Mechanism (SSM): a mechanism composed of the ECB and national competent authorities in participating Member States for the exercise of the supervisory tasks conferred upon the ECB. The ECB is responsible for the effective and consistent functioning of this mechanism, which forms part of the banking union.

SSM Framework Regulation: the regulatory framework setting out the practical arrangements concerning the cooperation between the ECB and the national competent authorities within the Single Supervisory Mechanism, as provided for in the SSM Regulation.

SSM Regulation: the legal act creating a single supervisory mechanism for credit institutions in the euro area and, potentially, other EU Member States, as one of the main elements of Europe's banking union. The SSM Regulation confers on the ECB specific tasks concerning policies relating to the prudential supervision of credit institutions.

Supervisory Manual: a manual detailing the general principles, processes and procedures as well as the methodology for the supervision of significant and less significant institutions, taking into account the principles for the functioning of the SSM. It describes the procedures for cooperation within the SSM and with authorities outside the SSM. The Supervisory Manual is an internal SSM staff document; a shorter [Guide to banking supervision](#), explaining how the SSM operates and detailing the SSM's supervisory practices, was published in September 2014.

Supervisory Review and Evaluation Process (SREP): the process used to guide the supervisory review of significant and less significant credit institutions and to determine whether (on top of minimum legal requirements) possible additional requirements should be applied with respect to own funds, disclosure or liquidity, or whether any other supervisory measures should be applied.

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Postal address 60640 Frankfurt am Main, Germany
Telephone +49 69 1344 0
Website www.bankingsupervision.europa.eu

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