

EUROPEAN COURT OF AUDITORS' FINDINGS ON THE ECB'S SUPERVISION OF BANK'S CREDIT RISK: A BALANCED VIEW



On May 12, the European Court of Auditors (“ECA”) published a special report on European Union (“EU”) supervision of banks’ credit risk. It concluded that the European Central Bank (“ECB”) has stepped up its efforts but more is needed to increase assurance that credit risk, in particular non-performing loans (“NPLs”), is properly managed and covered.

Background

Regulators shoulder the immense responsibility of upholding the safety, stability and soundness of the banking system. While we often perceive regulators to be infallible, there is no such thing as a perfect regulator, just as there is no such thing as a perfect anything.

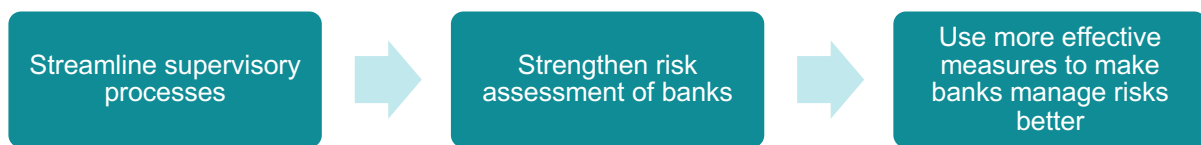
The ECB directly supervises over a hundred significant institutions within the framework of the Single Supervisory Mechanism (“SSM”) through the Supervisory Review and Evaluation Process (“SREP”), which covers an assessment of risks to capital, one of which is credit risk.



In the face of challenges arising from the current macroeconomic environment, credit risk is a significant priority for the ECB, which has reiterated its concerns over banks' credit risk deficiencies. However, the ECA audit report highlights broader issues in the supervision of credit risk which perhaps reveals a more systemic problem than simply a lack of compliance.

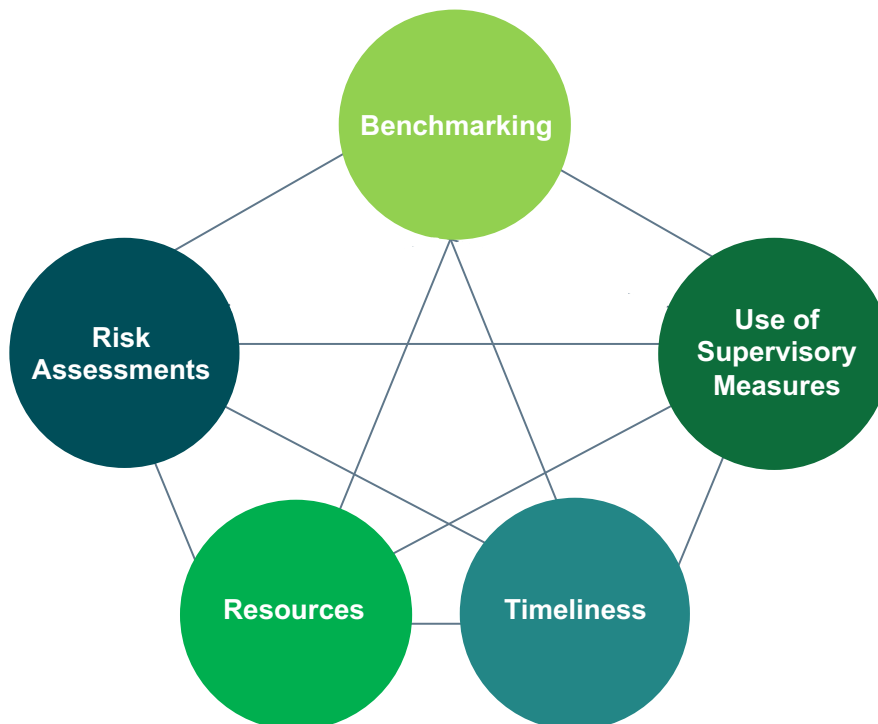
The focus of the audit was on the ECB's supervisory activities in relation to credit risk mainly during the 2021 SREP cycle, but in some cases also on actions prior to this. The audit covered the activities of horizontal ECB directorates with responsibility for supervisory methodology, on-site inspections and the supervision of specific banks. The audit examined whether the ECB's approach to supervision of credit risk and specifically in addressing legacy NPLs was operationally efficient. The ECA assessed the relationship between resources employed, including staff, tools and processes, and out outputs.

The ECA's recommendations to the ECB were broadly to:



Identified Shortcomings

The shortcomings identified by the ECA can broadly be categorised as:



The following table provides further details on the five key observations made by the ECA on the ECB's shortcomings in managing banks' credit risk as well as the ECB's response to each point:



	ECA Observations	ECB Response
Benchmarking	<ul style="list-style-type: none">• The ECB's benchmarking tools, comprised of a comprehensive range of visualisation and comparison tools, are well designed and used by Joint Supervisory Teams ("JSTs") to put bank-specific findings into perspective.• However, certain tools use thresholds that are out-of-date, requiring systematic adjustments by JSTs to compensate for the positive bias.• The tools are also insufficiently integrated with other systems used to carry out and document SREP assessments, increasing the burden on JSTs to manually cross-check against the expectations for JSTs outlined in the SREP Manual and IT tools used for qualitative assessments.	<ul style="list-style-type: none">• In 2022, the ECB reviewed its methodology for assessing credit risk levels within the SREP, which is expected to further improve the methodological support provided to supervisory teams for the assessment of institutions' credit risk levels, also in relation to the benchmarking processes and capabilities available to supervisors.• Since 2022, an independent supervisory risk function (the Directorate Supervisory Strategy and Risk) has performed benchmarking of SREP scores and measures, acting as a second line of defence.
Risk Assessments	<ul style="list-style-type: none">• The ECB converts the European Banking Authority's (EBA) SREP guidelines and the EBA Guidelines on the management of NPLs and forborne exposures in its guidance to JSTs to ensure consistent off-site supervision of credit risk• However, the ECB did not define objective criteria for the exercise of the JSTs discretion. The ECB listed factors for JSTs to take into account but no instructions on doing so to ensure consistency.• Additionally, the ECA was of the view that the ECB did not fully assess certain elements in line with the relevant EBA guidelines, particularly for the assessment of credit risk on the quality of performing loans and materiality of NPLs per portfolio.• Despite such incomplete assessments, banks were assigned mid-level scores and such positive scores can have a downstream impact on supervisory measures.	<ul style="list-style-type: none">• The aforementioned review also improved the focus points communicated to supervisory teams in order to help ensure consistency and expanded the underlying information basis and improving the quantity, granularity and quality of key risk indicators available for the assessment.• The SREP methodology for assessing credit risk controls will be reviewed in the course of 2023 with a view to be implemented in 2024.• The approach chosen by the ECB ensures that banks in the same situation are treated equally as supervisory measures are tailored to the individual situation of each bank, calibrated to make sure that they are proportionate by considering bank-specific circumstances.



Resources

- The ECB allocates resources to JSTs based on size, complexity and risk of the banks. However, a significant share of activities that banks need to assess are unplanned, such as asset sales or mergers. This impacts negatively on planned SREP work. While the ECB has a process to fill temporary resource needs but it is cumbersome to fill positions in time to meet demands of the job.
- The ECB no longer assesses whether allocated resources are sufficient to carry out specific tasks to its own standards and is therefore less able to link needs with resources.
- National supervisors continue to fall short of providing staffing to JSTs in line with their commitments and the ECB's attempts for escalations have not resulted in additional resources.

- The ECB rejected the recommendation on staffing levels. The ECB sets staffing levels in response to the relevant needs, assessing all requests independently of the central banking function on the basis of established principles and governance arrangements for the institution as a whole.
- Nonetheless, the ECB will continue to assess and support the resource needs of the supervisory function within the existing budgetary governance procedures.
- The ECB wished to emphasise that it has no formal powers to compel national competent authorities to respect staffing commitments.

Timeliness

- While the SREP is thorough, it is not efficient especially during the dialogue and approval phase just before the decision is sent to banks. In 2021, this occurred 13 months after the reference date. During this time, bank's risks can change and the SREP decision is therefore out-of-date when issued.

- The ECB acknowledged the length of the SREP cycle and is considering ways to reduce it. However, JSTs are required to consider all relevant events occurring after the cut-off date which could have an impact on the SREP assessment so that the decision is up-to-date.

Use of Supervisory Measures

- The ECB's current methodology for the calculation of additional capital requirements does not follow a risk-by-risk approach but rather a bundling of risk scores. As the ECB is unable to break down the capital add-on for a bank into individual risk drivers, this means that there is no assurance that the calculated Pillar 2 requirements ensure a sound coverage of risks. The ECB's methodology provides for higher Pillar 2 requirements as overall risk scores increase. However, worse overall risk scores did not result in proportionally higher Pillar 2 requirements, resulting in unequal treatment.
- JSTs have considerable discretion in responding to material deficiencies related to credit risk, however, in practice, the ECB relies more on recommendations rather than requirements and there was no escalation in measures despite non-implementation of recommendations nor any remediation of persistent weaknesses in banks' credit risk management as the score remained weak.

- The ECB is of the view that its Pillar 2 requirement methodology is in line with EBA SREP guidelines published in March 2022 and that there are different ways of determining Pillar 2 capital requirements on a risk-by-risk basis. It is not necessary to precisely quantify every individual risk to which an institution is exposed. While this may create a false sense of precision, this has been taken into account when the methodology was expanded in 2021 by looking at individual risks. The ECB makes constant improvements to its methodology on the basis of the lessons learned from each SREP cycle.
- The ECB aims to ensure that its use of measures and powers is tailored to the specific situation in question and will continue to improve the way that it applies its supervisory measures on a case-by-case basis.



Considerations for Banks

SREP Lifecycle	<p>The overall length of the SREP process means that banks under the ECB supervision do not receive the formal, legal result of the process in a timely manner. However, the ECB is considering ways to reduce the length of the SREP cycle and it is likely that banks may in future receive decisions more quickly.</p> <p>Nonetheless, banks should be prepared and continue to communicate with supervisors so that all relevant events occurring after the cut-off date which could have an impact on the SREP assessment are taken into consideration.</p>
Guidance from JSTs	<p>The lack of uniformity in supervision by JSTs has been a complaint arising from banks in recent years. However, the ECB regularly conducts reviews of the SREP process and has committed to improve anchor points communicated to JSTs in order to ensure consistency.</p> <p>While the methodological support provided to JSTs undergoes continuous improvement, JSTs are bound by the principle of constrained judgement, guided by the SREP methodology so that the JST is able to consider the specificity and complexity of each institution.</p>
Management of Credit Risk	<p>Aggregate volumes of non-performing loans continue to decrease, however, shortcomings in credit risk management continue to be a priority for the ECB.</p> <p>Although the ECA may view the ECB's assessment of credit risk as being incomplete in certain respects, there are no outstanding recommendations from the EBA regarding the ECB's SREP and Pillar 2 requirements methodologies. Banks should therefore conduct robust internal credit risk assessments and be in a position to swiftly identify and mitigate any build-up of risks in their exposures to sectors that are more sensitive to the current macroeconomic environment.</p>

About Avantage Reply

Avantage Reply, part of the Reply group, specialises in financial services consulting with a focus on Risk Transformations, Treasury and Capital, Quantitative Modelling and Regulatory Advisory. We are well-placed to assist with reviewing and enhancing existing ICAAP frameworks and ensuring SREP readiness in alignment with EBA guidelines. We have proven delivery experience across various legal entity structures and business models. With operations in the UK and across Europe, we are able to adapt to clients' specific requirements. Our wealth of expertise allows us to effectively support our clients to implement and comply with the evolving regulatory landscape. Please get in touch to discover how we can help your firm.

Resources:

- European Court of Auditors' Special report 12/2023: EU supervision of banks' credit risk, available at <https://www.eca.europa.eu/EN/publications/SR-2023-12>.
- European Central Bank's comments to special report dated 27 March 2023, available at https://www.eca.europa.eu/Lists/ECARepplies/ECB-Replies-SR-2023-12/ECB-Replies-SR-2023-12_EN.pdf.
- European Central Bank Supervisory Priorities and Risk Assessment for 2023 to 2025, available at https://www.bankingsupervision.europa.eu/banking/priorities/html/ssm.supervisory_priorities202212~3a1e609cf8.en.html.



Vishwas Khanna, Partner

Vishwas has international financial services consulting and risk management experience across Europe, US, Middle East and SE Asia, leading a multitude of risk transformations and change programmes.

Vishwas is a trusted advisor to the C-Suite across a number of financial institutions with strong working relationships with industry associations and academia and is a speaker at industry events and forums.

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Rohan Wilson, Senior Manager

Rohan Wilson is a highly experienced financial services professional with a strong background in supporting CROs, CEOs, COOs and other ExCo members in banks across the UK and Europe. He has a proven track record as an SME in risk management and regulatory change, as well as a regulatory change project and programme manager.

Rohan has a demonstrated history of successfully delivering Regulatory and Business transformation programs, drawing on his expertise in risk management and regulation, programme & project management, as well as his former experience as a derivatives trader. In over 15 years in financial services, he has successfully executed mission-critical programs in the UK, Germany, Belgium, Luxembourg and Malta, covering a diverse range of firms and cultures.

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Brain Momoh, Senior Manager

Brain Momoh has over 15 years of expertise in risk, regulation, and transformation projects within the global financial industry. He has a deep and practical understanding of financial markets and products, which has contributed to his success in driving diverse risk, regulatory, technology, and compliance initiatives.

Throughout his career, Brain has undertaken several assignments with Tier 1 institutions, such as Barclays, BNP Paribas, Bank of America, and Royal Bank of Scotland (RBS), as well as engaging with regulators like the PRA. His assignments have covered a wide range of areas, including finance transformation, risk management in structured / project finance, third-party risk control frameworks, IBOR transition, stress test data frameworks, and plausibility assessments for data submissions.

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Kavisha Sharma, Consultant

Kavisha is a lawyer with proven experience in regulatory interpretations, high-quality documentation production and strategic consulting.

She joined Advantage Reply after graduating from the London School of Economics with a Masters in Law (Banking Law and Financial Regulation). She has over 3 years of financial services experience, including as a Singapore-qualified lawyer who worked as a legal counsel in a MAS-licensed asset and wealth management firm. At Advantage, her feedback from clients and internal colleagues on various programmes has been exceptional.

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