Special report

EU supervision of banks' credit risk

The ECB stepped up its efforts but more is needed to increase assurance that credit risk is properly managed and covered





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Executive summary

The European Central Bank (ECB), in close cooperation with national supervisors, directly supervises around 110 significant banks of the 21 participating member states of the Banking Union. This is known as the Single Supervisory Mechanism, set up in 2014.

Supervisors assess the risks banks face (such as credit risk, governance, liquidity and the business model) in an annual process and check that banks are equipped to manage those risks properly. The outputs of the process are a formal risk assessment and annual supervisory decisions. They impose either additional capital requirements on banks (called pillar 2 requirements) beyond the regulatory minimum (called pillar 1 requirements) to cover those risks not captured by pillar 1 or supervisory measures that ensure banks take corrective action to improve the management and control of their risks, or both.

One main source of prudential risk to banks is credit risk, in particular borrowers failing to repay their loans which then become non performing. Underprovisioning can threaten the viability of banks as shown by past crises. The ECB recently flagged that the outlook for banks is deteriorating, amid weakening economic prospects and increasing credit risk.

It is crucial for banks' viability that the ECB not only ensures a sound management and coverage of credit risks but also a timely identification of, and provisioning for, non-performing loans by banks. Considering the importance of trust in the banking sector and to inform stakeholders, we decided to carry out this audit where we assessed whether the ECB's approach to supervision of credit risks in banks and in addressing legacy non-performing loans (classified as such before April 2018) was operationally efficient. Our focus was on the ECB's action in the 2021 supervisory cycle, including a sample of 10 banks with identified challenges with non-performing loans.

V Our overall conclusion is that the ECB stepped up its efforts in supervising banks' credit risk, and in particular non-performing loans. However, more needs to be done for the ECB to gain increased assurance that credit risk is properly managed and covered.

With the exception of some shortcomings, the assessments of the **banks' credit risk level and control environment** in our sample were of good quality with proper use of benchmarking tools. However, in the context of the Supervisory Review and Evaluation Process, the ECB made inefficient use of its existing tools and supervisory powers to ensure appropriate coverage of credit risk.

The methodology, newly applied in 2021, for determining the additional capital requirements (pillar 2) to be imposed by the ECB as supervisory authority did not provide assurance that the banks' various individual risks were appropriately covered. Moreover, the ECB did not apply its methodology consistently: it did not impose proportionally higher pillar 2 requirements the higher the risks faced by a bank. The European Banking Authority has not carried out an assessment of the application of the ECB's new methodology.

The ECB also did not escalate its supervisory measures for some banks even in the presence of high and sustained credit risk and persistent control weaknesses. The supervisory cycle in 2021 took very long (13 months). The final decisions were not issued to banks until February 2022, mainly due to a lengthy dialogue and approval phase. Such a long duration implies a risk that ECB's assessments do not reflect banks' actual risk profiles.

Lastly, supervision suffered to some extent from the fact that several national supervisors fell short of their commitments to provide staff resources. The ECB also decided not to increase headcount for its supervisory function from 2023 onwards.

With regard to **legacy non-performing loans**, their overall size began to decline from 2015 and continued to do so as a result of a number of factors, amongst which the ECB's actions. The ECB did not systematically use its specific supervisory powers (the power to require a specific provisioning policy or adjustments to own funds calculations) to instruct banks to address cases where the accounting treatment was considered not prudent from a supervisory perspective. In 2018 the ECB chose to tell banks that it would give them an additional capital requirement (pillar 2 add-on) if such non-performing loans were not addressed. The focus of its approach, applied to all banks, was on timely resolution of legacy non-performing loans.

The ECB wanted to discourage many banks' "wait and see" approach and to incentivise them to act proactively, without more forceful ECB intervention (i.e. the additional pillar 2 add-on). The ECB's approach, by design, did not resolve the issue at once, as it gave banks years to comply. Moreover, not all banks acted as proactively as the ECB had expected. The approach chosen by the ECB also resulted in an unequal treatment of banks, as those with a higher share of non-performing loans were given more time than the others, and banks could choose a coverage approach that was most advantageous to them. We found that the process resulted in some inefficiency as it was resource-intensive to administer both for banks and the ECB alike.

XII To enhance operational efficiency, we recommend that the ECB should:

- Strengthen the risk assessments of banks;
- Streamline the supervisory review and evaluation process;
- Apply supervisory measures that better ensure sound coverage and management of risks by banks.

Introduction

Prudential supervision of banks by the European Central Bank

O1 Banks in the EU are supervised within the framework of the Single Supervisory Mechanism (SSM) which was set up in 2014. The SSM, one pillar of the Banking Union, comprises the European Central Bank (ECB) in its role of supervisor and the national competent authorities (NCAs) of the participating member states. These are the 20 euro area member states and Bulgaria since 2020. In September 2022, the ECB directly supervised 110 significant institutions (hereafter referred to as "banks") which hold almost 82 % of banking assets in the Banking Union¹. The SSM is mainly governed by the SSM Regulation and the SSM Framework Regulation.

O2 EU banking supervision follows a common annual process, known as Supervisory Review and Evaluation Process (SREP) and is intended to ensure that banks comply with EU prudential requirements. Guidelines issued by the European Banking Authority (EBA) specify how to carry out the SREP. In line with the "comply or explain principle"², the ECB as well as the NCAs must inform the EBA whether they comply with the guidelines and, if not, state the reasons. The requirements are to ensure the safety and soundness of the European banking system and to increase financial integration and stability. Day-to-day supervision is carried out by joint supervisory teams (JSTs). They comprise staff from both the ECB and NCAs and their work is coordinated and supported by the ECB, including by its horizontal functions. In 2021 administrative expenditure on the ECB's supervisory tasks was €577.5 million³.

O3 The SREP is used to ensure that the trust in banks is warranted. Without trust in the soundness of a banking system, banks cannot play their role of lending to the real economy as they would not have the necessary means. This role is particularly crucial in the EU where most small and medium-sized enterprises, recognised as being the backbone of the economies, do not have access to capital markets. Reassuring EU citizens that they can trust their banks was also one of the drivers of the Banking Union and the creation of the SSM.

¹ European Central Bank website, Banking Supervision.

² Regulation (EU) 1093/2010 (Art. 16).

³ ECB Annual Report on supervisory activities 2021, Section 6.1.

O4 The concept of the SREP was first introduced with the Basel II accords in 2004. The ECB carried out its first SREP in 2014 based on national approaches. Those first SREP decisions were complemented by the results of the 2014 health check carried out by the ECB known as the "comprehensive assessment". Any bank that joins the ECB's supervision has to undergo this assessment. It includes an asset quality review to enhance transparency regarding banks' exposures, including as regards the adequacy of asset and collateral valuations and related provisions, in particular as far as non-performing loans (NPLs) are concerned. The second SREP carried out in 2015, was based, for the first time, on a common approach. This constituted an important step towards achieving a level playing field within the Banking Union

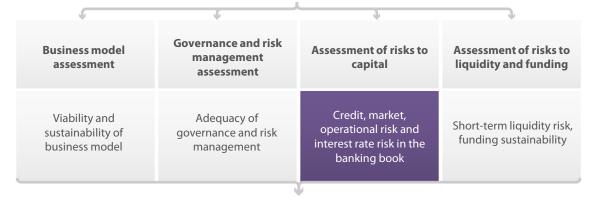
The supervisors run the SREP to verify that the risks that banks are exposed to are properly managed and covered by sufficient capital buffers in the event that these risks materialise. As part of the process, supervisors look at a bank's risk profile based on four different elements: (i) business model, (ii) governance, (iii) risks to capital and (iv) risks to liquidity. Credit risk is one of the risks that supervisors analyse as part of their assessment of risks to capital.

Of The supervisors assign scores for individual risks which are built up to an overall SREP score from 1 to 4, reflecting the supervisory assessment of the risk level and the quality of a bank's risk controls. The higher the score the bigger the assessed risk.

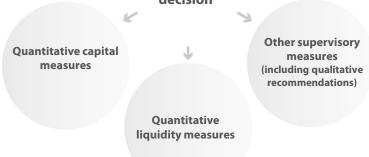
O7 The SREP results in supervisory actions decided after the assessment, including measures related to capital and/or liquidity or other types of supervisory measures (see *Figure 1*).

Figure 1 – Overall SREP assessment

Overall supervisory review and evaluation process assessment



Supervisory review and evaluation process decision



Source: ECA based on ECB.

The SSM Regulation, which applies to the ECB (as supervisor), sets out a non-exhaustive list of the possible supervisory measures which can be taken by the ECB. The ECB can for example require banks to reinforce their arrangements, processes and strategies or to hold additional capital, in particular that referred to as pillar 2 requirement (P2R), over and above regulatory minimum own funds. The latter are defined in pillar 1 of the Basel III Framework (i.e. the international regulatory framework for banks), see *Figure 2*. The Basel III Framework was transposed by the EU with the Capital Requirements Regulation⁴ and the Capital Requirements Directive⁵.

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⁴ Capital Requirements Regulation.

⁵ Directive 2013/36/EU.

There are three components of capital that are to be used to comply with the regulatory requirements (see *Figure 2*): Common Equity Tier 1 (CET 1), Additional Tier 1 and Tier 2. CET 1 is the capital of the highest quality and includes amongst others shares and retained earnings. Breaching its capital requirements implies consequences for a bank, for example it may be subject to restrictions in its possibilities for paying dividends.

Type of capital requirements To be covered by Non-binding Capital guidance recommendations Basel III - Pillar 2 CET 1 min. 1 % of total risk exposure amount Combined buffer requirements 0 % - max, currently 8.5 % of total risk exposure amount CET 1 (Art. 128 (6) and Art. 129 Capital Requirements Directive) Additional own funds requirements CET 1: 56.25 % of P2R Basel III - Pillar 2 (P2R) 0 % - max. 8 % of total risk exposure Overall amount CET 1 + Additional Tier 1: 75 % of P2R capital requirements (Art. 104 (1) Capital Requirements Total SREP Other (OCR) Directive) capital requirements (TSCR) -Binding, to be met Minimum own funds requirements CET 1: min 4.5 % of total risk exposure amount at all times min 8 % of total risk exposure CET 1 + Additional Tier 1: min 6 % of total risk amount (Art. 92 (1) Capital Requirements Other Regulation)

Figure 2 – Regulatory capital requirements

Credit risk and non-performing loans in the EU

Source: ECA.

10 When banks grant loans they inevitably face the risk that borrowers become unable to repay their loans. The goal of credit risk management is to limit this risk by carefully assessing the creditworthiness of potential borrowers and by collecting interest that is sufficiently high to cover the risks to the bank that their borrowers default. When a borrower is unlikely to pay or in default because scheduled payments are more than 90 days past due, a loan is non performing. Accounting standards require banks to book provisions for such NPLs in the amount of the entire outstanding loan minus any payments they can, based on previous experience, reasonably expect to obtain from (i) the defaulted borrower or (ii) the recovery of collateral.

- 11 A high share of such NPLs to overall loans (the NPL ratio) can weigh on a bank's performance, i.e. its profitability, and may even render the bank unviable, particularly if it cannot afford to adequately provision for them. A bank must have sound risk management (including strong lending standards, lending margins that are sufficiently high to cover the cost of losses, and stress testing) as it is key in helping prevent or alleviate the build-up of NPLs. In fact, in case of deteriorating economic conditions or when there is a sudden fall in house prices after they have become unsustainable, a soundly managed bank is in a better position to mitigate the generally unavoidable hit of soaring NPL levels.
- 12 Among the legacies of the 2008 financial crisis were the high levels of NPLs that weighed on some banks of the Banking Union: by late 2015 the average NPL ratio was still high at over 7 % (see *Figure 3*), with five of 20 member states (see paragraph *01*) having banking systems with NPL ratios over 10 % (see *Figure 4*).

Figure 3 – NPL ratio for the 21 Banking Union members



Source: ECB Supervisory banking statistics (Q1 2022, NPL ratio for SSM countries).



Figure 4 – Evolution of NPLs (in EUR and as a ratio to all assets for SSM banks)

Note: Comparable data not available for EE, SK. Start-point data for 2015Q4 (LU), 2016Q2 (MT), 2016Q1 (SI); end point data for 2021Q3 (LV).

Source: ECB supervisory banking statistics.

Tackling NPLs became a policy priority within the EU and on 11 July 2017 the Council issued conclusions on an Action Plan to address high levels of NPLs. It highlighted the need for action as regards bank supervision, the reform of insolvency and debt recovery frameworks, the development of secondary markets for NPLs and the restructuring of the banking industry. One of the main steps to progress the third pillar of the Banking Union, a European Deposit Insurance System, is addressing the problem of high NPLs. Completing the Banking Union aims at reducing fragmentation of the banking sector in the EU and ensuring a fair competitive landscape for banks.

14 The ECB is a crucial player in these efforts. To avoid that banks fail due to credit risk not being properly managed and covered, it should ensure that banks address their shortcomings in a timely manner with regard to credit risk management (such as poor lending standards) and related accounting policies (identification of and provisioning for NPLs).

15 By the third quarter of 2022, the NPL ratio had fallen to 1.8 % in the Banking Union. This represents a marked drop compared to 2015. The dispersion across member states (while still high) has fallen considerably. The downward trend is in part due to (i) reductions in NPLs due to improved economic circumstances; (ii) loans under public support measures expiring or due to expire; and (iii) sales and securitisations (transfers to new owners) of legacy NPLs. New NPLs may arise as COVID-19-related support measures come to an end and economic challenges from the war in Ukraine and high inflation merge. Indeed, the ECB has recently flagged that there is an increase in credit risk and that a fall in banks' share prices points to a deterioration in the outlook for them.

Audit scope and approach

16 Given that NPLs can be an important threat to a bank's viability, and with a view to safeguarding financial stability, it is crucial, and increasingly so with the current challenging economic conditions, that supervisors efficiently use their supervisory powers. With regard to credit risk in particular, the supervisors should ensure a sound management and coverage of credit risks including the timely identification and provisioning of new NPLs by banks through a thorough and intrusive SREP.

17 Credit risk has indeed been a supervisory priority of the ECB since the set-up of the SSM. Therefore, we decided to carry out this audit to shed light on the ECB's supervision of credit risk in general and non-performing loans in particular.

18 This report complements the reports we published on the ECB's supervisory activities in 2016⁶ and 2018⁷. The follow-up of the 2016 special report is set out in *Annex I*. Our mandate to audit the operational efficiency of the management of the ECB is outlined in the relevant legal text⁸. In 2019, the ECA and the ECB signed a memorandum of understanding which specified the practical arrangements for document and information exchange. We obtained full access to the documents we requested and full cooperation from ECB staff throughout the process.

19 Our work benefitted from the open and constructive dialogue that we had with the ECB and its staff. The ECB's publications on supervision show that it has been moving towards more transparency (for example in 2020 publishing for the first time the pillar 2 requirements for each bank). This enhances market discipline, the third pillar of the Basel framework for supervision as well as its own accountability.

Special report 29/2016: "Single Supervisory Mechanism – Good start but further improvements needed".

Special report 02/2018: "The operational efficiency of the ECB's crisis management for banks".

Article 27.2 of the Protocol (No 4) on the Statute of the European System of Central Banks and of the ECB and Article 20(7) of the SSM Regulation.

- 20 Specifically, the audit examined whether the ECB's approach to supervision of credit risk in banks and in addressing legacy NPLs (defined as those which date from before 2018) was operationally efficient. To this end, we assessed the relationship between resources employed (i.e. staff, tools and processes) and outputs with regard to the following questions:
- Was the ECB's approach to supervising credit risk efficient in ensuring a sound coverage and management of such risk by banks?
- Was the ECB efficient in addressing prudential concerns in relation to legacy NPLs (i.e. those dating before 2018)?
- 21 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. We audited the activities of horizontal ECB directorates with responsibility for supervisory methodology and on-site inspections, as well as the directorates with direct responsibility for the supervision of specific banks.
- We interviewed staff from multiple JSTs (which included both ECB and NCA staff) and the ECB's horizontal functions. We examined relevant documentation on ECB systems and carried out analysis on the full population of banks. To answer both audit questions, we also examined the supervisory files of a sample of 10 banks with high levels of NPLs. In this bank sample we aimed to include banks with different business models, from small to large, and across a number of member states. In order to have insight from a range of stakeholders we interviewed an industry group and an EU supervisor from outside the Banking Union.

Observations

The ECB's assessments of credit risk are of good quality, but it does not efficiently use its tools for ensuring sound management and coverage of credit risk

23 The annual SREP is a core activity of the supervisor. The assessments of the risks of each bank under supervision (see *Figure 1*) are carried out off-site, as well as on-site if deemed necessary. They are based on a wide range of information of a quantitative and qualitative nature. To ensure a consistent assessment across banks, the JSTs should, according to relevant standards (see paragraphs *01-02*), compare each bank with other banks (benchmarking) and take into account relevant context in making their credit risk assessments.

24 The assessment for a bank in a given year is summarised in the SREP decision, which the supervisor sends to the bank (see paragraph 07). The decision generally includes measures that banks are required to take to address specific weaknesses identified. With specific regard to credit risk, the measures can require banks to hold additional capital to cover risks and/or to remedy or mitigate deficiencies in credit risk controls and/or credit risk management.

25 In this section we assess the efficiency of the ECB's implementation of this process for credit risk, i.e. the relation between resources employed and outputs delivered in terms of quantity, quality, and timing. Specifically, we assessed whether:

- (a) the ECB's assessment of banks' credit risk was comprehensive;
- (b) the staff resources allocated were aligned with identified risks;
- (c) the process to take SREP decisions was timely;
- (d) the ECB ensured that risks it identified were covered by capital; and
- (e) the ECB made efficient use of its tools to address identified weaknesses at bank level.

The ECB's supervisory assessments of banks' credit risk have some shortcomings but are generally of good quality

The credit risk assessment carried out by the JST consists of an assessment (resulting in a score) of both the credit risk level facing a bank as well as how the bank controls this risk e.g. through governance arrangements (see *Figure 5*). The risk level assessment starts after the data gathering with automated scores for each bank based on risk indicators. JSTs can deviate from these automated scores to a certain extent as they can downgrade the score by two notches or upgrade by one notch to take into account the specificity and complexity of an institution. This is referred to as constrained judgement and takes place in phase 3.

Figure 5 – The SREP assessment phase



Source: ECA based on ECB SREP Manual.

27 The risk control assessments are based on checklists with which JSTs examine banks' compliance with legal requirements (phase 2), supplemented by a more detailed assessment (phase 3). This is meant to allow them to take into account the specificity and complexity of a bank while also ensuring consistency across supervisory judgements within the SSM.

- We examined credit risk assessments by reference to our sample of 10 banks (see paragraph 22). We analysed whether:
- the ECB converted the external standards (the 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 (including banks' management of NPLs);
- JSTs correctly applied the guidance;
- o the ECB made good use of benchmarking tools for banks.
- 29 In general, we found that the ECB converted the external standards into operational guidance for JSTs, mainly through its SREP Manual. The latter includes specific instructions for what assessments have to be carried out for banks for all of the SREP elements. We note that supervisory assessments are driven by automated scores, adjusted by JSTs where necessary. However, the ECB did not define objective criteria for the exercise of constrained judgement by JSTs (see paragraph 26). In fact, it limited itself to listing factors which JSTs may take into account but did not give instructions on how to do this so as to ensure consistency across the JSTs.
- 30 The majority of the requirements stemming from the relevant standards were carried out by the JSTs in our bank sample in completing their SREP assessments. Nonetheless we identified certain shortcomings in the implementation of the SREP which are set out in the following paragraphs.
- 31 For the assessment of the **credit risk level** (phase 3), we found that for all 10 banks in our sample the ECB did not assess or did not fully assess certain elements in line with the relevant EBA guidelines (see paragraph 28). These include for example for some banks a non-assessment or an incomplete assessment of the quality of performing loans and the materiality of non-performing loans per portfolio. While half of the sampled banks concerned had received the worst possible risk level score of four anyway, incomplete assessments imply nevertheless that a sound management and coverage of risks cannot be fully ensured.

32 For the **credit risk control** assessment we found that:

- the ECB guidance to JSTs on which questions (the checklist for phase 2 as outlined in *Figure 5*) had to be answered was inconsistent. Clear instructions as to whether important questions (for example on whether NPL classification policies and procedures were aligned to the legal requirements) had to be answered or not were only given to JSTs covering 22 specific banks out of the 110 covered by the SREP in 2021, of which two were in our sample. This meant that the consistency of the assessment process across the population of supervised banks was weakened;
- o in 2021, questions for the regular phase 3 risk assessment were made mostly optional for JSTs. Instead, the ECB expected the banks to carry out a self-assessment of their credit risk control frameworks. They were assessed by the JSTs and the information was used for the credit risk assessments. However, certain questions from the regular phase 3 risk assessment were not covered in the banks' self-assessments. Moreover, the optional nature of the regular phase 3 checklist meant that the ECB could not verify the consistency of the assessments.
- We found that JSTs assigned three banks (out of our sample of 10) risk control scores of 2 or 3 (better than the worst score of 4) although their assessments of the risk control environment were incomplete (see paragraph 32). A positive risk control score can have a downstream impact on the supervisory measures (see paragraph 07).
- 34 In order to ensure that banks are **benchmarked** appropriately, the ECB maintains a comprehensive range of visualisation and comparison tools. This allows JSTs to see how their bank compares to other banks for a wide range of key risk indicators. In the SREP assessments we examined for our bank sample we found that, in general, JSTs made good use of these benchmarking tools.
- 35 However, there are some shortcomings with how the benchmarking tools are calibrated. In particular, the phase 2 risk level automated score (see paragraph 26) is calibrated on thresholds which are out of date, and create a positive bias even according to ECB internal analysis. We found that this led to systematic adjustments by JSTs to compensate for the bias by downgrading the scores in the constrained judgement phase.

36 The benchmarking tools are mainly standalone. They are not well integrated with the expectations for JSTs outlined in the SREP Manual, nor with the IT tool used by JSTs for the qualitative SREP assessment. This makes the work of the JSTs more burdensome due to the need for manual cross-checking.

Staff allocations aligned with identified risks but shortfalls not yet addressed

- 37 We set out to examine if the ECB allocated resources efficiently to JSTs and to onsite supervision to ensure that supervisory effort is aligned with the relevant risks.
- We found that the ECB has a technique (the cluster model) for allocating its resources to JSTs based on size, complexity and risk of the banks. The cluster model is also used to determine the intensity of supervision with which JSTs supervise banks on a recurrent basis. However, a significant share of activities (42 %) are unplanned such as asset sales or mergers which JSTs need to assess.
- 39 We found in our bank sample that unplanned work (such as the assessment of a loan sale or securitisation) can have an impact on planned SREP work. In two of our sampled banks the JSTs' analysis of the banks' own self-assessment (see paragraph 32, second bullet point) was delayed due to other unplanned but pressing tasks, although the work was caught up later in the SREP cycle. The ECB has a process to fill temporary resource needs, but JSTs found it cumbersome to fill positions in time to meet the demands of the job.
- **40** Moreover, due to a change in process in 2021, the ECB no longer assesses whether allocated resources were sufficient to carry out specific tasks to its own required standards. This means that the ECB is less able to link needs with resources.
- **41** We also looked at staffing for on-site activity, i.e. on-site inspections and internal model investigations:
- JSTs may consider it necessary to ask for an on-site inspection to provide for example an in-depth analysis of various risks or of internal control systems. Onsite inspections are carried out by dedicated inspection teams;
- the ECB carries out investigations of banks' internal models used to determine capital requirements, which need approval by the ECB.

42 The establishment of the SSM saw the ECB given the responsibility for conducting on-site inspections with the assistance of the NCAs. In April 2022 the responsible ECB directorate general for on-site activities was operating below its approved staffing level: it had vacant posts representing 10 % of the total assigned staff resources of 149. A staffing shortfall was highlighted already in our 2016 report on the SSM set-up⁹ and it reduces the ECB's ability to carry out on-site activities.

43 We found that in 2021, not all prioritised inspections could be carried out:

- o although the ECB assesses the requests for on-site inspections from JSTs and decides on a priority list, it was not able to staff 10 % of the prioritised on-site inspections in 2021;
- the gap between requests and capacity was much higher for internal model investigations. For 2021, the ECB was not able to staff 26 % of the prioritised investigations. With regard to the lack of resources for internal model investigation, the responsible ECB directorate general issued a warning to the Supervisory Board in early 2022 pointing at substantial reputational risk. The Supervisory Board has taken no action yet in response to this warning.

44 The ECB has formal budgetary separation between its central banking and supervisory tasks which is intended to ensure that both tasks can be carried out without prejudice to and separately from each other. The expenditure for carrying out the ECB's supervisory tasks is met by levying annual supervisory fees on supervised institutions. This is consistent with the relevant standard (Basel Core Principle 2)¹⁰ which requires that a supervisor is financed in a manner that does not undermine its autonomy or operational independence.

45 However, the ECB Governing Council decided not to increase further headcount starting from 2023 for both the central banking arm and supervisory arm.

Nevertheless, the ECB's supervisory arm (through the Chair and Vice Chair of the Supervisory Board) may request additional resources if new or expanded tasks are granted or specific needs due to supervisory choices emerge. In that respect we note that, after the end of our audit work, the ECB approved additional posts to reduce its dependency on external resources for the performance of on-site inspections and

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Special report 29/2016: "Single Supervisory Mechanism – Good start but further improvements needed", see paragraph 160.

Basel Committee on Banking Supervision: "Core Principles for Effective Banking Supervision", see Principle 2.

internal model investigations. The above means that resource allocation is being influenced by budgetary considerations emanating from the ECB in its role as a central bank, as being heard in the decision-taking process (the Chair and Vice Chair of the SSM Supervisory Board are consulted¹¹) is not the same as taking the decision over the supervisory budget independently. This is not in line with the relevant standard (see paragraph *44*) which requires that supervisory resources be set independently. We highlighted this issue also in our 2016 report on the SSM set-up¹².

46 Under the legal framework, NCAs have to provide staff for the ECB's off-site and on-site supervisory activities. For example, around 90 % of the on-site inspectors and about two thirds of JST staff are coming from NCAs. The latest ECB staffing survey shows that nine out of 22 NCAs are short of their commitments, amounting to 32 FTEs or 4 % of overall staffing commitments. The gap was greatest for JSTs for the largest and most complex banks.

47 There is an escalation process for when NCAs do not live up to their staffing commitments, the final step being a formal letter sent by the ECB to the NCA. In 2021, although a senior-level meeting took place between the ECB and two NCAs, no formal letter was sent to any NCA by the ECB at the time of our audit. No additional resources were provided by the end of 2021.

ECB's consultation and approval processes are thorough but impede timely notification of the SREP decision to banks

48 Supervisors should seek to ensure that banks receive supervisory direction in a timely manner while ensuring that assessments and measures are consistent for all banks. We set out to examine whether the ECB's process to do so was timely.

The SSM is represented with one person on the ECB Governing Council consisting in total of 26 members.

Special report 29/2016: "Single Supervisory Mechanism – Good start but further improvements needed", see paragraphs 47-52, 186.

- 49 The ECB's process for arriving at SREP decisions the SREP cycle consists of four main phases:
- assessment by the JSTs;
- benchmarking and review by the ECB horizontal units;
- consultation with the banks concerned (dialogue phase);
- approval process.

The assessment phase of the 2021 SREP cycle began in mid-March after banks submitted data and the draft SREP decisions were finalised by early July (see *Figure 6*). Thereafter, the supervisory dialogue began during which banks were informed of the quantitative and qualitative measures and recommendations that the ECB intended to impose as well as the main reasons underlying them. The supervisory dialogue ended in mid-September and the following five months were taken up with formal steps such as legal review, the formal right-to-be-heard process, internal approvals and eventual approval by the Supervisory Board and Governing Council. The formal right-to-be-heard process was based on a draft SREP decision, i.e. including the quantitative and qualitative supervisory measures. Banks could make formal comments on this draft SREP decision.

Figure 6 – SREP 2021 timetable



Source: ECA based on ECB data.

51 While this overall process is thorough, it lacks efficiency due to the fact that the tail end (i.e. dialogue and approval phases) takes up a lot of time: approximately twice the length of the assessment and benchmarking phases. For our sample of 10 banks we examined the extent to which supervisory measures changed between the supervisory dialogue in July 2021 and the final SREP decision in February 2022. We found that despite the time taken, and the two procedures in place (supervisory dialogue and right-to-be-heard), the measures did not change substantively in content or number, with only some changes to the deadlines given for implementing the measures. The exception was the specific additional pillar 2 requirement for a

coverage shortfall for non-performing loans which was novel in 2021 (for details on this add-on, see paragraphs 77-104).

The end result was that for the 2021 SREP cycle the final SREP decisions were not issued to banks until February 2022, 13 months after the reference date of end-December 2020. This was as long as for the 2018 cycle but longer than for previous cycles such as 2017, 2019, and 2020 where decisions had issued before year end. The 13-months period was also appreciably longer than for example the time taken by the Swedish prudential supervisor for a similar task (nine months). In terms of impact, the overall length of the process means that banks under ECB supervision do not receive the formal, legal result of the process in a timely manner. In fact, a bank's risks (such as the level of NPLs and provisioning) can change during the lengthy dialogue and approval phases. This increases the risk that a SREP decision is out of date by the time it is formally issued.

The ECB does not efficiently use its tools to ensure that credit risk is fully covered by additional capital

At the end of the SREP, the supervisor may impose additional own fund requirements, known as pillar 2 requirement (see paragraph *08*). This is the case when the supervisor determines that the own funds held by the bank do not provide a sound coverage of risks to capital to which the bank is or might be exposed, provided such risks are assessed as material to the bank¹³. In line with the EBA SREP Guidelines¹⁴, the pillar 2 requirement should be determined on a **risk-by-risk basis** and should cover¹⁵:

- the risk of unexpected losses, and of expected losses insufficiently covered by provisions, over a 12-month period (except where otherwise specified in the Capital Requirements Regulation), known as "unexpected losses";
- the risk of underestimation of risk due to deficiencies in banks' internal models (i.e. statistical models, which can be used by banks to determine how much capital they need based on their risks);

¹³ EBA SREP Guidelines of 2018, point 342; EBA SREP Guidelines of 2022, point 360.

¹⁴ The ECB notified compliance with the SREP Guidelines on 15/02/2019.

¹⁵ EBA SREP Guidelines of 2018, points 348 and 349; EBA SREP Guidelines of 2022, points 368 and 371.

- the risk arising from deficiencies in internal governance, including internal control arrangements and other deficiencies.
- For the 2021 SREP cycle, the ECB chose to implement a new approach for the generation of the pillar 2 requirement, which is still being fine-tuned. This was in response to an EBA review which found that the previous approach needed improvement. This new approach involves a four-step process:
- o the starting point is an overall risk score in Step 1, which is derived from the SREP assessment phase. The score is automatically calculated by applying predetermined weights to the various risk elements (those mentioned in *Figure 1*, except liquidity). Based on this overall risk score, JSTs select an initial add-on (expressed in percent of risk-weighted assets). In fact, for each overall risk score (going from 1 (lowest risk) to 4 (highest risk)) a specific add-on range (minimum to maximum) was pre-defined by the ECB. JSTs may adjust the automated overall risk score within certain limits to take account of the specificities of banks' risk profiles;
- in Step 2 the selected initial add-on is broken down by formula into up to seven individual add-ons for different risks (such as credit risk, operational risk, market risk, etc.). The formula uses inputs from a bank's own internal capital adequacy assessment process (ICAAP), i.e. a bank's quantification of how its risks are covered by its pillar 1 capital (see paragraph 09);
- JSTs then re-assess the individual risk-by-risk add-ons in Step 3 (also by reference to peer benchmarks and other standards);
- o in Step 4 the pillar 2 requirement is re-built by adding up the individual risk-byrisk add-ons. The final Step 4 add-ons can be higher or lower than the one chosen in Step 2. For an illustration of this process, see *Figure 7*.

Interest rate risk score (risk level + risk control) Credit risk score (risk level + risk score risk control) Internal governance & risk management score **Business** Market Ranges model score risk score (risk level + % credit risk risk control) risk % market risk 0,00 % x₄% x₁ % Breakdown formula % ... % operational risk Add-on % % interest rate risk x₉ % x₁₂ % Overall risk score % business model % internal governance & risk management x₆ %

Figure 7 – Process leading from initial overall add-on to add-ons by specific risks

Source: ECA based on the ECB.

While in recent years the ECB has taken steps towards increasing transparency (see paragraph 19), it has not yet published the full SREP methodology. We do not disclose the information on weights or the ranges used in the ECB's pillar 2 methodology as the ECB considers it confidential.

We assessed the efficiency of how the ECB applied the EBA SREP Guidelines for the pillar 2 requirement generation. In particular, this includes how the ECB's supervisory methodology and its implementation ensure that identified risks are sufficiently covered by capital.

The EBA guidelines applicable for the 2021 SREP cycle (see also paragraph *53*) required that "the ICAAP calculations, where deemed reliable or partially reliable, should be the starting point for the determination" of the pillar 2 requirement ¹⁶. Where the ICAAP was not deemed reliable the outcome of the supervisory benchmarks should be the starting point. However, the ECB chose not to use the ICAAP

¹⁶ EBA SREP Guidelines of 2018, point 350.

as the starting point. We noted that ICAAP reliability is low even after seven years of SSM supervision with less than half of banks' ICAAPs being assessed as reliable by the ECB in 2021. The EBA has not carried out an assessment of the application of the ECB's new methodology used for the first time in the 2021 SREP cycle.

In fact, rather than using the ICAAP as a starting point, the overall risk score was based on weights for each risk (as mentioned in paragraph 54). The weights were applied to the scores resulting from the supervisory assessment for each risk. For the 2021 cycle subject to our audit, the weights were equal for all banks, hence not reflecting their specific situation. We note that the weights were changed for the 2022 cycle and vary by business model of the bank. JSTs may adjust the automated overall risk score within certain limits.

As the paragraphs above show, the ECB's current methodology for the calculation of additional capital requirements **does not follow a risk-by-risk approach** as required by the EBA guidelines (see paragraph *53*). The overall risk score is built from a supervisory assessment of risk levels as well as model and other internal control weaknesses, hence from bundling of the risk scores,

- which means that there is no way to directly link individual risk drivers with the risk-by-risk add-ons;
- o nor did we find evidence that the ECB quantified these risks for each bank. In fact, a pre-existing tool for doing such quantifications was not in use for the 2021 cycle and is no longer available for the 2022 cycle. As an example, instead of having quantified a specific risk¹⁷, there is a score for all risks that may or may not

the SREP Guidelines of 2018, point 342: "Competent authorities should determine through the SREP capital assessment whether the own funds held by the institution provide sound coverage of risks to capital to which the institution is or might be exposed, if such risks are assessed as material to the institution" and 343: "Competent authorities should do this by determining and setting the quantity (amount) and composition (quality) of additional own funds the institution is required to hold to cover elements of risks and risks not covered by Article 1 of Regulation (EU) 575/2013 ('additional own funds requirements'), including, where necessary, own funds requirements to cover the risk posed by model, control, governance or other deficiencies"; EBA SREP Guidelines of 2022, point 368: "For the purpose of the previous paragraph, competent authorities should determine on a risk-by-risk basis, the amounts of capital considered adequate, by identifying, assessing and quantifying the risks to which the institution is exposed and they should take into account the full risk profile of an institution".

- include this specific risk and control weaknesses that may or may not be related; and
- there is neither an explicit distinction in the methodology nor a risk mapping in its application between (i) specific risks (specifically those not covered by pillar 1 capital requirements, risks not appropriately covered, and risks not covered at all) and (ii) the pillar 2 requirement.
- As the ECB is not in a position to break down the capital add-on for a bank into individual risk drivers, this means that it has **no assurance that the calculated pillar 2 requirements ensure a sound coverage of risks** that need to be covered nor that model deficiencies and control weaknesses are appropriately addressed (see paragraph *53*).
- The pre-defined ranges from which the initial add-on is chosen have not been updated since 2017 and the ECB has not carried out any analysis yet to verify whether the ranges accurately reflect the relevant risks at bank level. We note, based on public data, that the pillar 2 requirements given to the banks supervised by the ECB as a result of the 2019, 2020 and 2021 SREP cycles ranged from 0.75 % to 3.90 %. The predefined ranges also overlap to a large extent (see *Figure 7*), meaning that a bank with a lower overall risk score can receive a higher pillar 2 requirement add-on than a bank with a higher overall risk score.
- We examined whether the ICAAP played a role when it came to make a choice within a given range. In particular, where the ECB assesses an ICAAP as unreliable, the ECB's SREP manual expects the JST to pick from the upper end of the range. For the 2021 SREP cycle, we found that this internal guidance was often not followed:
- JSTs chose initial add-ons equal to or lower than the mid-point of the ranges in two thirds of the cases where the ECB found the bank had an unreliable ICAAP. More than half of banks had an unreliable ICAAP (see paragraph 57);
- o there were three banks in the SSM population in 2021 with the worst possible overall risk score (4) and an unreliable ICAAP. These three banks received pillar 2 requirements at the very lower end of the suggested range.
- We also examined the extent to which the ECB used the pre-defined ranges for the **years 2017 to 2021** and ensured consistency in how the pillar 2 requirements were imposed. We found that the use of the pre-defined ranges was not consistent between banks with lower and higher identified risks.

The ECB's methodology provides for higher pillar 2 requirements as overall risk scores increase. Accordingly, as set out in *Figure 8*, the theoretical minimum pillar 2 requirements (i.e. the minimum of the pre-defined ranges, see paragraph *54*) increase in a linear way and the theoretical median pillar 2 requirements grow proportionally faster because rising risks levels and control weaknesses point to a greater risk of bank failure. In practice, however, worse overall risk scores did not result in proportionally higher pillar 2 requirements. We found that the pillar 2 requirements for banks with a SREP score of 4 were indeed higher than those for banks with a SREP score of 2+ (2+ was the best score applied by the ECB). However, there is a clear trend:

- the worse the SREP score, the smaller the incremental increase in the pillar 2 requirement;
- o the worse the SREP score, the closer the actual pillar 2 requirement to the theoretical minimum, and the wider the gap to the theoretical median.

SREP scores and P2Rs Overall risk scores (ORSs) and (pooled 2017-2019) P2Rs (2021 only) — Median P2R imposed Median P2R imposed Range minimum Range minimum Range mid-point Range mid-point 3+ 3-3+ 3-SREP Category **ORS Category**

Figure 8 – SREP scores and pillar 2 requirements for 2017 to 2021

Note: for 2020 a full SREP cycle was not run due to the COVID-19 pandemic, and for the 2021 SREP cycle the SREP score was replaced by the overall risk score (ORS).

Source: ECA based on ECB data.

- 65 In particular (see also *Figure 8*), we found that:
- o for banks with lower identified risks (SREP scores of 1, 2+, 2, 2-), the ECB chose an average pillar 2 requirement above the mid-point of the pre-defined range;
- o for banks with higher identified risks (SREP scores of 3+, 3, 3-, 4), the ECB chose pillar 2 requirements below the mid-point of the pre-defined range, in fact closer or even below the minimum of the range;
- for the banks with a SREP score of 4, the ECB had not imposed a pillar 2 requirement higher than 3.90 % in any year. In three cases SREP 4 banks received pillar 2 requirements below the suggested minimum of the range.
- Our own analysis of banks' ICAAPs for our sample of 10 banks showed that the pillar 2 requirements as determined by the ECB were in four cases significantly lower and in two cases significantly higher than the uncovered risks determined by these banks through their ICAAPs. Moreover, had the banks' ICAAPs been taken into account (irrespective of their reliability), this would in general have resulted in much more heterogeneous pillar 2 requirements. An assessment the ECB had performed in the context of the developments of its pillar 2 requirement methodology had yielded similar results. This together with the other points mentioned above (see paragraphs 59-61) means that the ECB has no assurance that the pre-defined ranges actually reflect the relevant risks at bank level.
- By comparison, we note that while for the 2021 cycle the ECB imposed pillar 2 requirements ranging from 0.75 % to 3.90 %, another EU supervisor imposed pillar 2 requirements ranging from 0.78 % to 76.10 % which is significantly above the ECB's highest applied one.
- 68 Lastly, the limited variation in the pre-defined ranges and the systematic choice of pillar 2 requirements at the lower end of the ranges for the weakest banks help those banks which would not have sufficient capital (headroom) to comply with higher requirements.

We also examined the extent to which the ECB attempts to measure **consistency** over time in the pillar 2 requirements it imposes. As part of its quality assurance process, we found that the ECB does an ex-post review of the developments in risk indicators, SREP scores, and pillar 2 requirements for the banks under its supervision. These reviews mainly focus on comparison with other banks during the same year, and the same bank the previous year. There is little focus by the ECB on developments over longer periods which can see large changes in underlying risk levels.

The 2021 SREP cycle was the first one for which the ECB communicated the key drivers of the pillar 2 requirement to banks in qualitative terms. The pillar 2 requirement as such was communicated in the SREP decision and the key drivers were communicated in an accompanying "executive letter". We did not assess the legality of the statement of reasons, i.e. whether it adheres to the standards required by Union law¹⁸. Nevertheless, we found that banks did not receive the add-ons (percentages) specific to each of the individual risks. By comparison, another EU supervisor provides more detail on the components of the pillar 2 requirement to banks. In fact, by design, the ECB's methodology does not allow for the provision of detailed information on (i) which uncovered risks contributed to what extent to the pillar 2 requirements, or (ii) what was driving year-to-year changes, if any. However, the EBA guidelines¹⁹ (see paragraph 57) require supervisors to clearly justify to banks any additional own funds requirements on a risk-by-risk basis, which is not possible with the current approach.

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¹⁸ Treaty on the Functioning of the European Union (Article 296) and related case law (for example Judgement of the General Court in Case T-411/17).

EBA SREP Guidelines of 2018, point 354: "Competent authorities should ensure that the additional own funds requirements set for each risk ensure sound coverage of the risk. To this end, competent authorities should: (a) **clearly justify** any additional own funds requirements that differ significantly from the outcomes of reliable ICAAP calculations or the benchmark calculations [...]; EBA SREP Guidelines of 2022, point 363: "When setting the additional own funds requirements and, where relevant, guidance, competent authorities should: [...] b. **clearly justify all elements** of additional own funds requirements for P2R" and section 7.6.

The ECB does not efficiently use its supervisory powers to instruct banks to better manage credit risk

71 The ECB has the supervisory powers and tools to instruct banks to take corrective actions. Qualitative supervisory measures (see *Figure 1*) have the purpose of requiring the bank to reduce the level of inherent risk or to strengthen management and control arrangements. These measures, usually set out in the SREP decision, can consist of requirements and recommendations. Qualitative requirements are usually used for escalation in the case of non-compliance with recommendations. In extreme cases, the ECB can even require the dismissal of board members or withdraw a license where a bank's internal controls are not in line with legal requirements. We assessed by reference to the full population of supervised banks whether the ECB used these measures efficiently in response to the risks which it had identified.

72 We found that the ECB's SREP Manual as well as other guidance documents do not provide comprehensive guidance on how JSTs should respond to material deficiencies related to credit risk, leaving JSTs considerable discretion. In practice, the ECB relies more heavily on recommendations than requirements to banks.

73 In our sample, we observed several banks with repetitive recommendations and/or material credit risk related deficiencies over the period 2019-2021 where (i) the credit risk control score and the pillar 2 requirements remained unchanged over the same period and (ii) there was no escalation in the measures. This is despite the ECB's ability to use qualitative requirements in case of non-implementation (see paragraph 71).

74 We also looked at the overall pattern for banks with the weakest scores for credit risk control (i.e. score 4) over the 2017-2021 period. In the whole supervised population there were six such cases. As shown in *Table 1*, we found that in five cases ECB supervision did not remediate persistent weaknesses in banks' credit risk management as the score remained weak. In fact, supervisory measures were taken with delay and did not yet result in the intended improvements. Moreover, for half of these six banks, the pillar 2 requirement remained stable or even decreased.

Table 1 – Banks with credit risk control score of four and presence of supervisory measures (SM) (2017-2021)

Bank	2017	2018	2019		2020	2021	
Α	4	4	4	4	(SM)	4	
В	4	4	4	4		3	
С	3	3	4	4	(SM)	4	
D	3	3	4	4	(SM)	4	(SM)
E	2	2	3	3	(SM)	4	(SM)
F	3	3	3	3	(SM)	4	(SM)

Notes:

- (1) Improvement of the score is highlighted in green.
- (2) Worsening of the score is highlighted in orange.

Source: ECA based on ECB data.

In a similar vein, where a bank fails to comply with the legal requirement to have a sound and effective ICAAP, the ECB may make full use of its supervisory powers (see paragraph 71). Nevertheless, as mentioned in paragraph 57, seven years after the establishment of the SSM, the majority of directly supervised banks still do not have reliable ICAAPs.

76 This points to shortcomings in the ECB's efficiency in instructing banks on how to address the deficiencies that it has identified, meaning that it cannot ensure that the identified risks are being timely remedied and hence appropriately managed at bank level.

The ECB has stepped up its efforts for addressing prudential concerns relating to legacy NPLs but does not make the best use of its tools

The internationally accepted standards, the Basel Core Principles (specifically Core Principle 18), require supervisors to determine that banks have adequate policies and processes for the early identification and management of problem assets (which include NPLs), and the maintenance of adequate provisions and reserves. Addressing asset quality issues has been one of the key priorities for the ECB since the set-up of the SSM in 2014. It has highlighted credit risk as well as heightened levels of non-performing loans as key risks facing euro area banks. The ECB has also observed

"varying approaches by banks to the identification, measurement, management and write-off of NPLs"20.

We assessed the operational efficiency of the ECB's implementation of the above standards and respective EU law. Our audit focused on **loans classified as non-performing before April 2018**, also referred to as **legacy NPLs**. Accordingly, we assessed whether the ECB:

- (a) provided a timely remedy to prudential concerns related to legacy NPLs;
- (b) ensured an equal treatment; and
- (c) made an efficient use of the supervisory tools.

79 On 20 March 2017, the ECB published its NPL Guidance as "a supervisory tool with the aim of clarifying the supervisory expectations regarding NPL identification, management, measurement and write-offs in areas where existing regulations, directives or guidelines are silent or lack specificity". Therein, the ECB describes:

- o in detail what it expects from banks with regard to the implementation of accounting standards, in particular how to provision for NPLs, how to value the collateral linked to an NPL, how to estimate losses for secured and unsecured loans and gives guidance for write-offs of NPLs. The NPL Guidance further states that provisioning plays a crucial role in ensuring the safety and strength of the banking system and that supervisors need to make decisions on the adequacy and timeliness of provisions;
- the details to be included in an **NPL reduction strategy**, which **banks with high levels of NPLs** are expected to provide to the ECB. Banks have to define targets
 for the reduction of NPLs over a realistic but sufficiently ambitious horizon (NPL
 reduction targets). There were 39 banks treated as "high-NPL" by the ECB in
 the 2021 SREP cycle.

The ECB stated that the Guidance is taken into consideration in the SREP and is "non-binding in nature". We note that the ECB nevertheless expected banks to "explain and substantiate any deviations upon supervisory request", and "non-compliance may trigger supervisory measures". Therefore, while not binding *de jure*, it *de facto* imposed new obligations.

²⁰ ECB, Guidance to banks on non-performing loans, 2017, p. 5.

81 The EU regulatory framework grants the ECB, in line with its mandate of microprudential supervision, the power²¹ to require a specific (i) provisioning policy or (ii) treatment of assets. The latter means that the ECB can require credit institutions to apply specific adjustments (deductions, filters or similar measures) to own funds calculations where the accounting treatment applied by a bank is considered not prudent from a supervisory perspective. In the Commission's view as expressed in its 2017 SSM review, the use of this power is particularly important for tackling the NPL problem. This view was reiterated by EU lawmakers when, in April 2019, they adopted²² a "prudential backstop" applicable to loans that originated after 26 April 2019 and explicitly excluded legacy NPLs.

The ECB's SREP Manual does not specifically mention this specific power, although it does highlight at various occasions that JSTs are responsible for determining that banks' provisions are adequate and timely. Accounting standards require provisions to be booked in the amount of the full expected lifetime loss²³. The expected lifetime loss should be based on a realistic estimate of future payments (such as collateral recovery) that a bank may still receive. Under certain conditions, this power also allows for the mitigation of prudential concerns where accounting standards do not ensure a full coverage of risks, for example, where banks heavily rely on collateral that is rarely realised. However, we found no evidence that the ECB had seriously considered using this specific power in a systematic way for supervised banks, where needed.

With regard to the JSTs' task to ensure (i) timely and adequate provisioning for NPLs, (ii) banks' adherence to accounting standards as well as (iii) the soundness of banks' credit management (incl. lending standards, pricing, arrears management, risk management), refer to paragraphs 71-76 on the use of supervisory measures. In particular, we found that, by reference to the sample of banks, in practice **the ECB did not** (i) give supervisory measures that requested banks to book additional provisions or (ii) impose CET 1 deductions (see paragraph 09).

The ECB's supervisory powers are set out in Article 16 (2) (d) of the SSM Regulation.

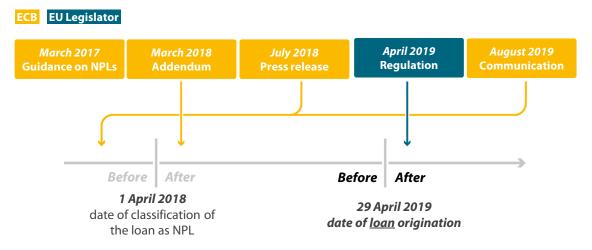
International Financial Reporting Standard 9 Financial Instruments (IFRS 9), Section 5.5 Impairment.

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²² Regulation (EU) 2019/630, Recital (6).

- The 2017 Guidance announced that as a next step, the ECB "plans to place a stronger focus on enhancing the timeliness of provisions and write-offs". Indeed, in 2018 and 2019, it complemented this Guidance by so-called coverage expectations (the sequence of events can be seen in *Figure 9*):
- In March 2018 the ECB adopted an Addendum applicable to **new NPLs** only (those **classified as such from 1 April 2018 onwards**). For loans that originate **after 26 April 2019** and related NPLs, in April 2019, the EU legislators adopted a "**prudential backstop**" in the form of CET 1 deductions where NPLs are not sufficiently covered by provisions or other adjustments (see paragraph **81**);
- on 11 July 2018, it communicated by a press release that the coverage expectations were also applicable to legacy NPLs (loans classified as non-performing before April 2018). Details on the approach were provided in a Communication of August 2019.

Figure 9 – Chronology of rules applying to NPLs



Source: ECA based on ECB publications and legislation.

The coverage expectations were meant to address prudential risks related to the heightened level of NPLs identified by the ECB (see paragraph 77). We acknowledge the policy choice of the ECB. We did not assess its rationale or legitimacy. Instead, our audit focused on the implementation and impact of the policy. The stated objectives²⁴ of the policy were:

- "to help banks resolve their NPLs";
- "to avoid an excessive build-up of non-covered aged NPLs on banks' balance sheets in the future";
- "to ensure that banks do not build up aged NPLs with insufficient provision coverage".

These expectations **apply to all banks** supervised by the ECB. Although labelled as "non-binding" (see paragraph *80*), where banks do not meet the ECB's coverage expectations, they are subject to an additional pillar 2 requirement (called pillar 2 addon), **irrespective of whether these banks had high levels of NPLs or not** (see paragraph *79*, second bullet point).

87 The coverage expectations introduced for the first time the concept of **gradual** (calendar) provisioning at EU level. The schedules (calendar) for achieving full prudential provisioning were based on an ECB assessment that considered potential impacts for each individual bank and as a result created three groups of banks based on their respective NPL ratios at the end of 2017. For each of the three groups it defined different schedules: the end of 2024 to 2026 for secured loans and the end of 2023 to 2025 for unsecured loans. With its chosen approach, the ECB attempted to strike a balance between achieving full coverage and spreading the financial burden on the banks over time.

Pushing for a gradual increase of prudential provisions over several years, until full coverage has been achieved, was meant to discourage banks' "wait and see" approaches observed in the past, and to act as an enabler for the main objective of resolving NPLs.

²⁴ These are set out in the 2018 Addendum and the 2019 Communication.

- The coverage expectations were based on the observation that the longer a loan has been non-performing, the higher the risk that expected future cashflows do not materialise and the lower the recovery value. Even though addressing cases where banks' reliance on collateral and a lack of regular payments constitute a prudential risk, i.e. concern about the level of provisioning, was not the ECB's primary objective, banks were encouraged to book the maximum level of provisions possible under the applicable accounting standard, i.e. based on a realistic estimate of the expected lifetime loss (see paragraph 82) or to adjust their (regulatory) capital on their own initiative (voluntary CET 1 deductions). International accounting standards require full provisioning of the expected lifetime losses immediately once a loan becomes non-performing (and adjustments whenever economic conditions change).
- 90 While the ECB aimed at discouraging a "wait and see" approach and at pushing for timely resolution (see paragraph 88), it gave banks years to comply with its expectations (see paragraph 87). It also considered it necessary to provide banks with both a delayed starting date (i.e. 2020) and a phase-in path. This was despite the fact that over half of the legacy NPLs had already been non-performing for five years or more when eventually subjected to the ECB's coverage expectations. For example, a secured loan could have been non-performing already for seven years or more in March 2018 but full prudential coverage would not be required until 2026.
- 91 The delayed starting date was, inter alia, meant to be an incentive for banks to resolve their NPLs proactively without the ECB having to impose a supervisory measure. However, it did not work as expected as many banks only reacted with the prospect of a pillar 2 add-on being applied for the first time in the 2021 SREP cycle. A more systematic use of the ECB's supervisory powers (see paragraph 81), starting in 2017, and targeted at those banks identified as having insufficiently covered NPLs could have yielded quicker results where banks were indeed underprovisioned, be it from an accounting or a prudential perspective. The ECB's approach, by design, did not resolve the issue at once but provided for a gradual path.
- Moreover, the approach led to **banks not being treated equally**. First, the effect was that banks with a higher amount of NPLs that were inadequately covered got even more time (up to two years) compared to those with a higher initial coverage (see paragraph *87*).
- 93 Second, the ECB's approach allows banks to choose what is most advantageous for them. In fact, there are different ways to achieve coverage of NPLs as described in *Table 2*.

Table 2 – Ways to achieve coverage and related impact

How?	What does it mean? (non-exhaustive description)
Provisions	Expense that lowers a bank's profits or increases its losses, generally reducing retained earnings (balance sheet).
	Retained earnings are a component of the regulatory CET 1 capital (see paragraph <i>09</i>)
CET 1 deduction (pillar 1)	It reduces the regulatory CET 1 capital that is available to meet the capital requirements.
	A capital requirement which has to be partially met by:
P2R (pillar 2) add-on	 the regulatory CET 1 capital (56.25 %) and
	 other capital components. See Figure 2.

Source: ECA analysis.

94 A pillar 2 add-on leaves the available capital untouched; it only increases the capital requirement. Moreover, the pillar 2 add-on needs to be covered by CET 1 capital only by 56.25 % (see *Table 2*). CET 1 capital is the regulatory capital of the highest quality²⁵. Hence, a pillar 2 add-on is often less costly compared to the other instruments, i.e. CET 1 deductions and provisions. The latter two both have a direct and higher negative impact on the CET 1 capital that is available to cover regulatory capital requirements.

95 Third, we found that the pillar 2 requirement approach by design leads to differences between those banks that proactively made deductions or booked provisions before the reference date (31 December of the preceding year, e.g. December 2020 for the SREP 2021 cycle) and those which had not taken action. This is because the pillar 2 add-on becomes effective only with the SREP decision, normally about one year after the reference date. This holds true also in cases where a bank, to avoid the imposition of a pillar 2 add-on, reduces an initial shortfall by taking actions (mostly provisions) in the following year. In fact, the ECB takes such additional provisions into account before determining the final pillar 2 add-on, thus giving these banks also an extra year.

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The CET 1 capital ratio, i.e. the ratio between "core" capital and risk-weighted assets of a bank, matters the most as it reflects the overall financial strength of the bank.

96 In terms of success of the coverage expectations, it can only be assessed when they have been fully implemented by the end of 2026, i.e. nine years after the issuance of the NPL Guidance. Although we have assessed neither the causal relationship between the ECB's actions and the decrease in NPLs nor the impact of other factors (see paragraph 15), it stands to reason that the ECB's actions contributed to the continued reduction over the last five years (see Figure 4).

97 Instead, one focus of our audit was the process for the implementation of the coverage expectations in 2021 where the ECB used pillar 2 add-ons for the first time. In the 2021 SREP cycle (based on 2020 year-end data, see paragraph 91) it imposed a pillar 2 add-on for a coverage shortfall on 22 out of 110 banks. In fact, the majority of banks had met the ECB's supervisory coverage expectations by booking provisions by the end of 2020. Half of the banks that finally received a pillar 2 add-on reduced their coverage shortfalls significantly, mostly by booking provisions or making CET 1 deductions over the course of 2021. In the end, provisioning was the most widely used tool to cover the expectations.

98 In general, the pillar 2 add-ons for legacy NPLs for individual banks ranged from 0.01 % to 0.30 %. They were:

- a very small component of banks' overall capital requirements. The latter stood at 13.50 % on average after the 2021 SREP;
- o very small also in comparison with the "regular" pillar 2 add-ons: their average was 2.24 % across the SSM population and the maximum imposed was 3.90 % (see paragraph 61). Overall the pillar 2 requirements rose by 0.20 percentage points compared to the previous year, mostly driven by the imposition of the pillar 2 add-on for the ECB's coverage expectations.
- 99 The process for the calculation of the pillar 2 add-on involves a number of steps:
- (1) The calculation of the shortfall before exemptions (= coverage expectations minus the available coverage (e.g. provisions));
- (2) The identification and analysis of potential exemptions;
- (3) The calculation of the shortfall after exemptions;
- (4) Post reference date adjustments (such as further provisions or NPL disposals);
- (5) The calculation and imposition of the final pillar 2 add-on.

- 100 In addition to their regular reporting obligations, banks had to submit specific data for the determination of the coverage expectations and the available capital supply for prudential provisioning purposes. Banks also could identify cases where the application of the coverage expectations would result in more than a 100 % coverage. In addition, banks could ask for exemptions, e.g. excluding those NPLs for which regular payments of principal and interest leading to full repayment were being made.
- 101 The ECB had to check the plausibility of the banks' reporting in line with the ECB's standard procedures. Potential exemptions were assessed via a mix of automated and case-by-case analysis to ensure that the supervisory expectations were appropriate in all cases, in particular whether the criteria for an exemption were met. In the end, only 18 % of exemptions requested by banks were accepted by the ECB, accounting for approximately 12.3 % of the reduction in the (initial) shortfall.
- 102 In addition, the ECB applied post reference date adjustments to the shortfalls after exemptions, prior to the imposition of the pillar 2 add-on through the SREP decision. These adjustments allowed banks to take material increases in provisions (see paragraph 95), capital deductions, full write-offs or NPL disposals made after 31 December 2020 into account, accounting for 46.1 % of the reduction in the shortfall achieved.
- 103 For banks, which received a pillar 2 add-on, the process was sometimes not complete even after the adoption of the final SREP decision (see *Figure 6* for the timeline). Using a separate reporting template, they could apply for further adjustments over the course of the year.
- 104 Although the ECB has specific IT tools to analyse the submitted templates and which help to focus on those cases which need to be followed up with banks, the entire process, in particular the assessment of exemptions, was resource and time-intensive. In fact, we found that there were a total of 55 resubmissions of the reporting templates from 33 banks and the number of resubmissions since 1 May 2021 continues to be high.

Conclusions and recommendations

105 Overall, we conclude that the ECB stepped up its efforts in supervising banks' credit risk, and in particular non-performing loans (NPLs). However, more needs to be done for the ECB to gain increased assurance that credit risk is properly managed and covered. This is important as poor credit risk controls and a lack of coverage by banks can undermine their viability and that of the financial system.

106 A comprehensive Supervisory Review and Evaluation Process (SREP) assessment is the foundation of efficient supervision of banks. The ECB in general converted the external standards into guidance for use by supervisors, but some guidance (in particular for credit risk control assessments) led to an inconsistent approach to assessments by joint supervisory teams. When it came to the actual credit risk assessments of banks, we found some shortcomings in how they were carried out but that they were mostly compliant with relevant standards (see paragraphs 26-33).

107 The ECB's benchmarking tools are well designed and are used by joint supervisory teams to put bank-specific findings into perspective. However, we found that certain tools use out-of-date thresholds and are insufficiently integrated with other systems used to carry out and document their SREP assessments which made the work of the joint supervisory teams more burdensome (see paragraphs 34-36).

108 The relevant standard requires that supervisory resources should be set independently in a manner that does not undermine the autonomy or operational independence of supervisors. However, the ECB decided not to increase headcount, starting from 2023, for both its central banking arm and its supervisory arm. Nevertheless, the Chair and Vice Chair of the Supervisory Board may request additional resources in specific circumstances but the final decision remains with the ECB's Governing Council. Moreover, as the ECB no longer measures the relationship between needs and resources, it has no assurance that planned tasks are being completed to its own standards (see paragraphs 37-40 and 44-45).

109 Furthermore, nine out of 22 national supervisors (national competent authorities) continue to fall short of providing staffing to joint supervisory teams in line with commitments given and the ECB's escalation attempts have not resulted in additional resources from the national competent authorities. Several of them also do not provide adequate staffing for on-site inspections which has resulted in activity below the ECB's own level of assessed need (see paragraphs 41-43 and 46-47).

Recommendation 1 – Strengthen the risk assessments of banks

The ECB should improve the efficiency of the supervisory assessment process by:

- (a) Improving guidance and benchmarking processes for supervisors (in particular for credit risk control assessments) and putting in place a quality assurance process to ensure that credit risk assessments are complete;
- (b) Safeguarding the operational independence of the ECB as a supervisor by:
 - (i) Setting and putting in place ECB supervisory staffing levels based on needs, independent of the ECB central banking staffing strategy;
 - (ii) Urging national supervisors to comply with their commitments to provide staff by making rigorous use of existing escalation procedures.

Target implementation date: for sub-recommendation (a) Q4 2023 (for the 2024 SREP cycle); for sub-recommendation (b) Q2 2024

110 In 2021 final SREP decisions were issued 13 months after the reference date, longer than in previous years and compared to other supervisors. Such a long timeline implies that the final decision was based on a risk assessment which was not up to date (see paragraphs 50 and 52) and that risks were not being managed in a timely way or sufficiently covered.

111 The dialogue and approval phases of the SREP cycle led to inefficiencies in the process. Together these took twice the length of the assessment and benchmarking phases. The processes for consulting banks (the supervisory dialogue and the right-to-be-heard period) were procedural rather than substantive and very few changes were made to what the ECB had communicated to banks informally half a year before issuance of the final SREP decision (see paragraph *51*).

Recommendation 2 – Streamline the supervisory review and evaluation process

The ECB should improve the efficiency of the supervisory cycle by shortening the dialogue and approval phases and issue final decisions within 10 months of the reference date.

Target implementation date: Q4 2023 (for the 2024 SREP cycle)

- 112 The ECB applied a new methodology in 2021 for determining the amount of capital a bank must hold (the pillar 2 requirement or P2R), beyond the regulatory minimum, to cover identified risks. This methodology and its application mean that individual risks (including credit risk) are not being clearly linked to the pillar 2 requirement imposed, and we did not find evidence that the ECB quantified these risks for each bank (see paragraphs 53-60 and 70). Therefore, the ECB has no assurance that risks are fully covered.
- 113 The ECB has pre-defined ranges per risk score from which supervisors are expected to select a pillar 2 requirement. These pre-defined ranges do not have a specific link to the risks and the ranges overlap considerably, meaning that a lower-risk bank can receive a higher pillar 2 requirement than a higher-risk bank. For the highest risk banks, the ECB consistently selected pillar 2 requirements at the very bottom of the pre-defined ranges (see paragraphs 61 and 63-68). This helped banks which would not have had sufficient capital to comply with higher requirements.
- 114 A sound capital assessment process at bank level is essential for risk management. We found that the ECB did not systematically adjust the pillar 2 requirements upwards in response to when it found that banks' own assessments of capital adequacy (the ICAAP) were unreliable and internal guidance was not followed (see paragraph 62).
- 115 The ECB also gives qualitative measures to banks. These are instructions to banks to take specific actions to deal with identified risks. In the population of supervised banks we saw a pattern of the ECB failing to sufficiently escalate supervisory measures when credit risk is high and sustained (see paragraphs 71-76) meaning that it did not ensure that risks were well managed by the banks.
- 116 In recent years, the ECB put pressure on banks in the EU banking system to address legacy NPLs. NPLs have decreased for years and have continued to decrease since 2017. Although we have not assessed the causal relationship between the ECB's policy (in particular its coverage expectations) and the decrease in NPLs, it stands to reason that the ECB's actions were one of several factors contributing to this decrease. Whether the policy was eventually a success can only be assessed when it has been fully implemented by the end of 2026, i.e. nine years after the issuance of the NPL Guidance (see paragraphs 15, 84 and 96).

- 117 The ECB has supervisory powers to address banks' provisioning policies where banks do not have sound processes and data for the identification and measurement of NPLs. Amongst others, pursuant to Art. 16 (2) (d) of the SSM Regulation, the ECB can require banks to apply specific adjustments (such as deductions) to own funds calculations where the accounting treatment applied by a bank is considered not prudent from a supervisory perspective, for example, where banks heavily rely on collateral that is rarely realised. This is particularly important in the context of tackling NPLs, as highlighted by the Commission in its 2017 SSM review. We observed that the ECB has not used this power systematically for this purpose (see paragraphs 79-83).
- 118 The ECB has devised and implemented a broader policy applicable to all banks: to focus on the timely resolution of legacy NPLs, to get them off banks' balance sheets and to prevent their future build-up. To this end, the ECB relied in particular on so-called coverage expectations. This approach involved the imposition of a pillar 2 add-on where banks do not resolve legacy NPLs over time or achieve coverage through other means (additional (accounting) provisions, prudential CET 1 deductions, or write-offs and NPL disposals) to serve as an enabler. The objective was to discourage many banks' "wait and see" approach and to incentivise them to act proactively, without more forceful ECB intervention. The policy goal was to not impose such pillar 2 add-ons per se (see paragraphs 84-86 and 88).
- 119 However, the ECB's approach did not work as expected as it led to banks reacting only with the prospect of the pillar 2 add-on, applied for the first time during the SREP 2021 cycle. An earlier and more systematic use of the ECB's supervisory powers, starting in 2017, could have yielded quicker results where banks were indeed underprovisioned, be it from an accounting or a prudential perspective. The ECB's approach, by design, did not resolve the issue at once but provided for a gradual path (see paragraphs 87 and 89-91).
- 120 The design of the ECB's approach requiring pillar 2 add-ons results in unequal treatment of banks. First, the ECB's provisioning expectations are most lenient on banks that have the highest stock of NPLs, granting them the most time to comply, up to nine years after the issuance of the NPL Guidance. Second, compared to banks that proactively cover potential provisioning shortfalls, the ECB grants banks that continue to face a shortfall after the reference date 13 additional months to close it. Third, the ECB's approach allows banks to act in a way which is most advantageous for them (i.e. either booking provisions, or reducing CET 1 capital or accepting a pillar 2 add-on) (see paragraphs 92-95).

121 The ECB's chosen approach involved additional reporting by all banks, including those with a low level of NPLs. The process for imposing pillar 2 add-ons (run for the first time in 2021) was complex and resource-intensive for supervisors and banks and resulted in some inefficiency. Most banks (around 80 %) met the ECB's coverage expectations through accounting provisioning prior to the SREP cycle, or further adjustments in the course of the following year. The pillar 2 add-ons were ultimately imposed on a limited share of banks and their size was small compared to the overall capital requirements (see paragraphs 97-104).

Recommendation 3 – Apply supervisory measures that better ensure sound coverage and management of risks by banks

The ECB should improve the efficiency and transparency of the supervisory process by:

- (a) Amending its methodology for the calculation of pillar 2 requirements to give assurance that all relevant risks are sufficiently covered, including:
 - identifying and quantifying each individual risk as required by the EBA guidelines;
 - (ii) imposing capital requirements that ensure adequate coverage of these individual risks, in particular where risks are high and persistent;
 - (iii) providing reasons in the SREP decisions that clearly justify the pillar 2 requirements on a risk-by-risk basis to ensure full transparency towards banks.
- (b) Using the **full** range of its supervisory powers where required, when a bank does not effectively address persistent risk control weaknesses (including relating to provisioning).
- (c) Publishing its methodology for generating pillar 2 requirements.

Target implementation date: Q4 2024

This report was adopted by Chamber IV, headed by Mr Mihails Kozlovs, Member of the European Court of Auditors, in Luxembourg at its meeting of 18 April 2023.

For the Court of Auditors

Tony Murphy
President

Annex

Annex I – Follow-up of Special Report 29/2016 Single Supervisory Mechanism – Good start but further improvements needed

Level of timeliness: timely; delayed; deadline not passed; no follow-up action as recommendation rejected by the ECB; no deadline for implementation set; ECB's choice not to implement after further analysis.

Reco	ommendation	Fully implemented	In most respects	In some respects	Not implemented	Remarks	Timeliness
1	Delegation certain decisions to lower levels; further guidance in form of checklists, templates and flowcharts for each decision.	X				The ECB made a comprehensive analysis for the delegation framework including consideration of national powers. It also developed a comprehensive list of documents for decision-making and related templates.	®
2 (i)	Assessment of the risks entailed with shared services, implement necessary safeguards and compliance monitoring and		X			The ECB made a comprehensive risk analysis and some safeguards (e. g. separate reporting lines for some services) were put in place. In the context of the analysis, some DGs (e. g. Directorate General	@

Recommendation	Fully implemented	In most respects	In some respects	Not implemented	Remarks	Timeliness
ensure that the needs of the supervisory functions are reflected in full					MacroPrudential Policy & Financial Stability, Directorate General Economics) were not classified as shared services by the ECB but wholly allocated to the central banking (i. e. monetary policy) function only, while they also provide input to the supervisory side in the context of stress-testing. This is not per se incompatible with the separation principle. Yet, a risk analysis, consideration of safeguards and compliance monitoring was not carried out for these (e.g. if sharing of credit risk benchmarks used for macroprudential purposes could affect policy choices in banking supervision). There are no distinct organisational instructions for how to monitor or document such monitoring, and report upon risks arising from shared services with regard to the separation	

Rec	ommendation	Fully implemented	In most respects	In some respects	Not implemented	Remarks	Timeliness
						principle set out in article 25 (2) of the SSM Regulation.	
2 (ii)	Separate reporting lines are in place where specific supervisory resources are concerned.				х	The recommendation was rejected at the time and no further work was done on it.	⊗
2 (iii)	Stronger involvement in the budgetary and related decision- making process of the supervisory board				х	The recommendation was rejected at the time and no further work was done on it.	⊗
3	Assignment of sufficient resources for the internal audit capability to allow coverage of high and medium risk areas		Х			Internal audit of supervisory topics became more intrusive and the resource situation improved. Time recording was discontinued. The ECB estimates that on average roughly 10 full-time equivalents are used on SSM-related tasks and three for planning, risk monitoring and possibly administrative inquiries. Following an individual risk analysis, only	@

Rec	ommendation	Fully implemented	In most respects	In some respects	Not implemented	Remarks	Timeliness
						selected topics on the highrisk areas are covered (e. g. only failing or likely to fail in crisis management). While the choice from a preliminary assessment is reasonable, the resource situation needs further close monitoring to assess that within the high-and medium risk areas there is reasonable coverage.	
4	Cooperation with the Court of auditors	X				The audit of the ECB's crisis management took place before the Memorandum of Understanding between the Court of auditors and the ECB concluded in October 2019. For audits that took place after the conclusion of the Memorandum of Understanding, the ECB has provided the information necessary for the Court to perform the audits.	@
5	Formalisation of arrangements to measure and publicly disclose			х		The disclosure of information and indicators in the ECB's annual report on banking supervision	@

Re	commendation	Fully implemented	In most respects	In some respects	Not implemented	Remarks	Timeliness
	information on supervisory performance and use of surveys.					(including the supervisory priorities and risks) explain supervisory activity and provide bank-related information to provide an overall picture to allow for an assessment of supervisory performance. Still more focus on comparing supervisory priorities/ objectives against performance as well as on outcomes is necessary. Several workstreams including a pilot to measure effectiveness of the supervision of less significant institutions have been started. Although a framework for an industry survey was adopted by the Supervisory Board in December 2018, no survey has taken place yet.	
6	Amending the SSM framework regulation in order to formalize NCA commitments and to ensure that all NCAs participate			х		The ECB considered in 2017 that an amendment to the SSM Framework Regulation may not be necessary. No amendments have been made by the co-legislators. In fact, it considers that the	C

Rec	ommendation	Fully implemented	In most respects	In some respects	Not implemented	Remarks	Timeliness
	fully and proportionately in the JST work.					SSM should work based on a principle of cooperation in good faith. Details on resources provided for onsite activity are set out in paragraphs 41-43 and for NCA provision of resources in paragraphs 46-47. See also Recommendation 1 (b) (ii) for the ECB to urge national supervisors to comply with their commitments by making rigorous use of existing escalation procedures.	
7	Development of role and team profiles and methods for assessing the suitability of staff supplied by NCAs and their subsequent performance			X		A comprehensive role profile (including 15 specialisations) was developed. No role profiles for director and head of division were developed. Team profiles have been developed but are not yet formally approved while they are de facto used by the ECB. There is still no process to assess the performance of individual non-ECB JST members — just feedback to the NCA JST sub-coordinator on the	©

Reco	ommendation	Fully implemented	In most respects	In some respects	Not implemented	Remarks	Timeliness
						team performance. Thus the feedback has no impact on the individual performance appraisal at NCA level. There is no process to reject suggested JST members. Overall the ECB is reliant on the NCA's willingness and ability to cooperate in good faith.	
8	Establish and maintain a centralised, standardised and comprehensive database of skills, experience of JST employees (both NCA and ECB)			X		A stocktake of existing NCA solutions was made. While from a legal point of view, a database would have been possible, NCAs rejected the idea. For ECB and NCA staff a knowledge-sharing platform called SSMnet has been launched in June 2021. It comes with a user profile functionality which includes contact details, job-titles and on a voluntary basis further information (expertise, past experience, education). This initiative constitutes a good starting point in the given circumstances although at the moment it is not a comprehensive database of	C)

Reco	ommendation	Fully implemented	In most respects	In some respects	Not implemented	Remarks	Timeliness
						skills and experience. Furthermore, take-up of SSMnet profile functionality by the NCAs and ECB staff will be necessary in order for the platform to be useful as for talent identification.	
9	Implementing a training curriculum for banking supervision. Ensuring mandatory participation is commensurate with business needs and consideration of a certification programme.		X			A well-designed training programme was developed including content-oriented trainings. The increasing amount of participation in recent years is a major achievement. At present, none of the training is compulsory. However, the SSM training team has been working on revising the current SSM induction programme since December 2021 and started working in February 2023 on a new SSM Fundamental Qualification Programme which includes mandatory trainings with "opt out" options depending on staff profiles as well as existing qualifications.	

Rec	ommendation	Fully implemented	In most respects	In some respects	Not implemented	Remarks	Timeliness
10	Development and implementation of a risk-based methodology to determine the target number of staff and skill composition ensuring resources are commensurate with size, complexity and risk profile of the supervised institution.			X		The ECB has defined target staffing per bank cluster and used these until 2019 as benchmarks to flag potential staffing shortages. While targets have not been formally backtested, their appropriateness has been assessed qualitatively on the basis of the JST staffing survey. Details on the ECB's separation between monetary policy and banking supervision are set out in paragraph 45. Details on the NCA provision of resources are set out in paragraphs 46-47. Overall, NCA participation in JSTs is within the desired corridor (i.e. between at least 25 % - 80 % of the person's activity is dedicated to the JST work, the rest to NCA work). In 2021, a qualitative dimension was added to the staff survey.	

Rec	ommendation	Fully implemented	In most respects	In some respects	Not implemented	Remarks	Timeliness
						According to the ECB, in some NCAs, the low participation rate of JST members is driven by the prominence of host banks. In these cases, NCA staff drawn are in to participate in the supervision of a bank at group level and to supervise the subsidiary in their country on a solo-level.	
11	Review and update of the clustering model.	Х				The clustering model is risk- based and updated frequently. There was only a slight delay in implementation compared to the target implementation date.	@
12	Substantially strengthening ECB presence in on-site inspections. Increase of on-site inspections led by a non-home or non-host supervisor NCA.			Х		With the creation of a distinct directorate general for on-site and internal model inspections (DG OMI) on-site inspection capacity was enhanced within the ECB. However, the ECB's staff contribution to on-site inspections fell between 2016 and 2022. On the other hand, the number of ECB-led inspections	Q

Rec	ommendation	Fully implemented	In most respects	In some respects	Not implemented	Remarks	Timeliness
						increased substantially. Considerable improvements regarding cross-border missions occurred, but public health restrictions related to the COVID-19 pandemic led to a reduction in on-site visits in the years 2020 and 2021. Details of the combined capacity of the ECB and NCAs is set out in paragraph 46 (including the December 2022 decision to increase the ECB's resources), with the consequences for on-site activity in paragraph 43.	
13	Follow-up on weaknesses in the IT system for onsite inspections. Pursue efforts to increase the skills and qualifications of on-site inspectors.	X				The new IT features address the weaknesses identified. The new training regime for on-site inspectors is appropriate.	

Source: ECA.

Abbreviations

CET 1: Common equity tier 1

EBA: European Banking Authority

ECB: European Central Bank

ICAAP: Internal capital adequacy assessment process

JST: Joint supervisory team

NCA: National competent authority

NPL: Non-performing loan

ORS: Overall risk score

P2R: Pillar 2 requirement

SREP: Supervisory review and evaluation process

SSM: Single Supervisory Mechanism

Glossary

Accounting standards: Common set of principles and requirements that provide the basis for accounting policies and practices.

Capital headroom: The difference between (i) a bank's overall capital requirements and (ii) its capital ratio.

Capital ratio: A bank's capital in proportion to its risk-weighted assets.

Capital requirement: Required minimum amount of capital a bank must hold in proportion to its risk-weighted assets ('Pillar 1'), plus an additional amount calculated on the basis of the bank's risk profile ('Pillar 2').

Collateral: An asset taken as insurance or security for giving a loan, to be kept in the event of a default.

Common Equity Tier 1: Capital of the highest quality (i.e. least liable to be redeemed), which financial institutions must have available for unrestricted and immediate use to cover risks or losses as soon as they occur.

Components of regulatory capital: These are Tier 1 capital (comprising common equity tier 1 capital and additional Tier 1) and Tier 2 capital.

Deduction from Common Equity Tier 1 capital: Correction of regulatory capital, as a result of the application of supervisory powers, to reflect economic realities that have not been accounted for.

Expected credit losses: They reflect a bank's expectations of shortfalls in the collection of contractual cash flows.

Micro-prudential supervision: Banking supervision focusing on individual financial institutions as component parts of a financial system.

Non-performing loan: Receivable that is more than 90 days overdue, unlikely to be paid, or impaired.

Pillar 2 add-on: An additional pillar 2 requirement for banks that were assessed by the ECB as having inadequate provisions from a prudential perspective.

Pillar 2 requirement: The pillar 2 requirement is a bank-specific capital requirement covering risks, which are underestimated or not covered by the minimum capital requirements (the latter are known as pillar 1).

Provisions: An accounting term for the best estimate of a likely future liability of uncertain timing or amount, recorded on the balance sheet.

Regulatory capital: The minimum amount of capital a bank or other financial institution must hold by law.

Tier 2: Supplementary, more easily redeemable capital, which financial institutions must hold to cover losses in the event of their failure.

European Central Bank's replies

https://www.eca.europa.eu/en/publications/sr-2023-12

Timeline

https://www.eca.europa.eu/en/publications/sr-2023-12

Audit team

The ECA's special reports set out the results of its audits of EU policies and programmes, or of management-related topics from specific budgetary areas. The ECA selects and designs these audit tasks to be of maximum impact by considering the risks to performance or compliance, the level of income or spending involved, forthcoming developments and political and public interest.

This performance audit was carried out by Audit Chamber IV Regulation of markets and competitive economy, headed by ECA Member Mihails Kozlovs. The audit was led by ECA Member Mihails Kozlovs, supported by Edite Dzalbe, Head of Private Office, and Laura Graudina, Private Office Attaché; Marion Colonerus, Principal Manager; Shane Enright, Head of Task; Joerg Genner, Mirko Gottmann, Helmut Kern, Anna Ludwikowska, Ioannis Sterpis, Nadiya Sultan and Giorgos Tsikkos, Auditors.



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The European Central Bank (ECB) supervises large banks in the Banking Union, assessing their prudential risks. This includes credit risk, which is when loans become non performing and threaten the viability of banks and sometimes the whole financial system.

We found that while the ECB has stepped up its efforts, more needs to be done for the ECB to gain increased assurance that credit risk is properly managed and covered by banks. Its new methodology for determining additional capital requirements (pillar 2) does not provide assurance that individual risks are fully covered, and has been inconsistently applied: higher-risk banks did not receive proportionally higher capital requirements. The ECB made inefficient use of its existing tools and supervisory powers to ensure appropriate coverage of banks' credit risk.

We recommend strengthening risk assessments, streamlining the supervisory review and evaluation process, and applying better supervisory measures to manage risks effectively.

ECA special report pursuant to Article 287(4), second subparagraph, TFEU.



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