EUROPEAN CENTRAL BANK
BANKING SUPERVISION

27 March 2023

ECB's comments to

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"

Executive summary

Paragraph VI

While it would have been possible to use existing tools and powers in a different way, the ECB considers that the approach chosen is the most efficient and effective, as shown by the reduction in non-performing loans (NPLs) and the increase in coverage since the publication of that approach. See also the comments on paragraph 91.

Paragraph VII

The ECB is of the view that its current methodology for determining additional capital requirements (Pillar 2 capital requirements – P2Rs) ensures that all material risks to which an institution is exposed are appropriately covered:

I) The ECB maintains that its P2R methodology is in line with the European Banking Authority (EBA) guidelines on the Supervisory Review and Evaluation Process (SREP) that were published in March 2022. There are currently no outstanding recommendations from the EBA regarding the ECB's SREP and P2R methodologies.

II) The ECB is of the view that its methodology enables all available information – including data from institutions' internal capital adequacy assessment processes (ICAAPs), along with other relevant key risk indicators and the outcomes of prudential assessments performed by the ECB as part of ongoing supervision – to be used efficiently to determine P2Rs. The ECB's aim in this regard is to ensure that all of the potential overall impact of institutions' material risks is appropriately covered by either Pillar 1 or Pillar 2 capital requirements.

III) The ECB makes constant improvements to its P2R methodology on the basis of the lessons learned from each SREP cycle or following further assessment of the impact that specific risk drivers have on P2Rs. In addition, the ECB will soon undertake a more structural review of the effectiveness and efficiency of its P2R methodology.

The ECB applies its methodology consistently. Since 2022, an independent supervisory risk function (the Directorate Supervisory Strategy and Risk) has helped to ensure this by acting as a second line of defence, performing benchmarking and horizontal analysis of SREP scores, as well as implementing quantitative and qualitative measures. Finally, the ECB notes that constant proportionate increases in P2Rs across all levels of overall risk scores may not always be appropriate and justified, particularly since other qualitative supervisory measures are also imposed, which may be more effective means of addressing the relevant risks or other supervisory concerns.

Paragraph VIII

The ECB acknowledges the length of the SREP cycle and is considering ways to reduce it. At the same time, the ECB believes that the risk referred to in the last sentence is largely mitigated, since the Joint Supervisory Teams (JST) should consider all relevant events occurring after the cut-off date which could have an impact on the SREP assessment (reorganisation within the group, other corporate events, last-minute reductions in non-performing exposures (NPEs), etc.), so that the SREP decision is as up to date as possible.

Paragraph XI

The ECB considers that its approach to NPLs (both asking high-NPL banks for specific NPL reduction strategies and the application of coverage expectations to all banks) has successfully addressed the "wait and see" approaches observed in the past. In particular, the announcement of NPE coverage expectations played an important role in accelerating NPL reduction. It should also be noted that the resolution of NPLs takes time and cannot be carried out overnight without significant adverse consequences for the overall economy. By the time the ECB began addressing uncovered credit risk using supervisory measures, most banks had proactively reduced NPLs (particularly the more aged ones) and covered the remaining risk, which is confirmed by the small number of banks to which P2R add-ons were applied and the low levels of those add-ons.

The approach chosen by the ECB ensures that banks in the same situation are treated equally. Supervisory measures are tailored to the individual situation of each bank. They are calibrated to make sure that they are proportionate by considering bank-specific circumstances. In other words, differences in banks' situations justify differences in treatment. However, the ECB ensures that banks in similar situations are treated consistently.

The ECB expects all banks to consider its expectations, and it analyses whether the treatment of NPLs is prudent on a case-by-case basis, bearing in mind its publicly communicated expectations. Where such treatment is not considered to be prudent, the ECB applies supervisory measures in the form of Pillar 2 add-ons.

The ECB does not believe that the process was resource or time-intensive, particularly in the context of its first year of implementation and given the objectives to be achieved (see the comments on paragraph 104 for details).

Paragraph XII

See the comments on the individual recommendations. The ECB accepts recommendations 1(a), 1(b)(ii), 2, 3(a)(ii), 3(b) and 3(c). The ECB partially accepts recommendations 3(a)(i) and 3(a)(iii). The ECB rejects recommendation 1(b)(i).

Paragraph 14

The ECB's mandate relates to risk identification and provisioning from a prudential perspective.

Paragraph 43

First bullet point

The ECB currently provides around 7% of all Single Supervisory Mechanism (SSM) staffing for on-site activities. The ECB was not able to secure SSM staffing for 10% of the prioritised investigations in 2021.

Second bullet point

In 2021, the ECB was not able to secure SSM staffing for 26% of the prioritised investigations.

Paragraph 45

Following a proposal by the Executive Board, the Governing Council has decided that all three pillars of the ECB – central banking, banking supervision and shared services – should be subject to stabilisation. In 2016 the Governing Council decided, in response to a proposal by the Executive Board, that the headcount and total costs of the central banking and shared services functions should be stabilised by 2019 at the latest.

The Medium-Term Stabilisation Plan for the SSM function was adopted by the Governing Council in 2019 following a proposal by the Chair and the Vice-Chair of the Supervisory Board. That included the approval of additional resources for 2020, 2021 and 2022, and the application of the stabilisation commitment as of 2023. Thus, the cost stabilisation commitment applies across the whole of the ECB as of 2023.

In line with the definition of cost stabilisation adopted, the Chair and the Vice-Chair of the Supervisory Board may suggest that the Executive Board makes a headcount request to the Governing Council in the event of a new mandate or new or expanded tasks. At the same time, the SSM's Medium-Term Stabilisation Plan does itself detail several areas where headcount requests can be considered in the event of changes or refinements to supervisory choices beyond 2022. For example, the Governing Council has approved, in the context of the ECB's 2023 budget and headcount, 43 new permanent full-time equivalents (FTEs) in 2023 (plus an additional 6 FTEs in 2024, as well as 16 FTEs from the ESCB and international organisations (IOs) in 2025) in order to internalise consultancy relating to on-site banking supervision and internal model investigation tasks in the SSM pillar, reducing the ECB's dependence on external resources and improving its capacity to perform on-site inspections, in line with ECA recommendations (made in previous special reports). This will be achieved while being budget-neutral in terms of supervisory fees.

As regards governance, the budget of the ECB is based on Article 12.3 of the Statute of the ESCB and of the ECB, which tasks the Governing Council with adopting the ECB's Rules of Procedure, which govern the ECB's internal organisation and its decision-making bodies. The first sentence of Article 15.1 of the Rules of Procedure establishes the budgetary procedure at the ECB, stipulating that, before the end of each financial year, the Governing Council, acting on a proposal from the Executive Board in accordance with any principles laid down by the former, must adopt the ECB's budget for the subsequent financial year. Under Article 29(1) of the SSM Regulation, expenditure on supervisory tasks must be identified separately within the budget of the ECB. The second sentence of Article 15.1 stipulates that the Chair and Vice-Chair of the Supervisory Board must be consulted on this separately identifiable expenditure. At the same time, the Vice-Chair of the Supervisory Board is a member of the Executive Board and the Governing Council, thereby ensuring that the SSM function is represented when decisions are made about the ECB's budget. With the Chair and the Vice-Chair being tasked with providing their views on supervisory matters and the Governing Council having a mandate to decide on financial matters across all functions of the ECB, we are firmly of the view that there is no breach of the SSM's independence.

Paragraph 47

The ECB wishes to clarify that the escalation process described refers specifically to the JSTs. A letter is also sent if the national competent authority (NCA) and the ECB agree that it is helpful to ensure transparency regarding the specific national budgeting process that an NCA is subject to.

Paragraph 53

Second bullet point

The ECB notes that, as a rule, it addresses deficiencies in the internal models that a bank uses to compute its capital requirements via specific supervisory measures based on dedicated investigations conducted outside the SREP, which are separate from the P2R and other requirements established by the SREP decision.

Paragraph 54

Fourth bullet point

The ECB wishes to emphasise that, since risk-by-risk add-ons can be adjusted by JSTs in Step 4, the final P2R that results from the aggregation of those add-ons can be different from the initial overall add-on chosen in Step 1 (and can even end up lying outside the range of P2R values associated with the relevant overall risk score).

Paragraph 57

The EBA's SREP guidelines were reviewed in 2021, mainly in order to implement changes introduced by Capital Requirements Directive V (CRD V).

According to the revised SREP guidelines published by the EBA in March 2022, the ICAAP is a key input when determining the P2R (see paragraph 371: "*The determination of the amount of capital considered adequate and additional own funds requirements on a risk-by-risk basis should take into account the ICAAP calculations if deemed reliable or partially reliable, as well as the outcomes of supervisory benchmarking and other relevant inputs as appropriate, including the supervisory judgement.*"), but not necessarily the "starting point" for the computation of the P2R. As a result, the ECB expanded its methodology in 2021 with a view to enabling efficient use of all available information when determining P2Rs (including data from institutions' ICAAPs, along with other relevant key risk indicators and the outcomes of prudential assessments performed by the ECB as part of ongoing supervision). This seeks to ensure that all of the potential overall impact of institutions' material risks is appropriately covered by either Pillar 1 or Pillar 2 capital requirements.

Against this backdrop, the ECB maintains that its P2R methodology is in line with the EBA SREP guidelines published in March 2022. There are no outstanding recommendations from the EBA regarding the ECB's SREP and P2R methodologies.

Paragraph 59

See the comments on paragraph 57.

First bullet point

See the comments on the second bullet point.

Second bullet point

The ECB is of the view that there are **different ways of determining Pillar 2 capital requirements on a risk-by-risk basis.** It is not necessary to precisely quantify every individual risk to which an institution is exposed; indeed, that may not necessarily constitute best practice, as it could create a false sense of precision regarding P2Rs and the related supervisory dialogue with institutions, which could potentially hamper the efficiency and effectiveness of supervisory action in this area. The ECB took this into account when it expanded its P2R methodology in 2021 by looking more closely at individual risks. The ECB's methodology enables all available information – including data on institutions' ICAAPs, along with other relevant key risk indicators and the outcomes of prudential assessments performed by the ECB as part of ongoing supervision – to be used efficiently to determine P2Rs. This seeks to ensure that all of the potential overall impact of institutions' material risks is appropriately covered by either Pillar 1 or Pillar 2 capital requirements.

The ECB makes constant improvements to its P2R methodology on the basis of the lessons learned from each SREP cycle or following further assessment of the impact that specific risk drivers have on P2Rs. In addition, the ECB will soon undertake a more structural review of the effectiveness and efficiency of its P2R methodology.

Finally, the ECB wishes to emphasise that the impact of specific risk drivers is considered in different parts of its P2R methodology: in Step 1 via the scores assigned to the risk categories to which those specific risks belong; in Step 2, to the extent that those risks are addressed in the bank's ICAAP; and in Steps 3 and 4 as factors to be considered when making further adjustments to the risk-by-risk components of the final P2R.

Paragraph 60

See the comments on paragraph 57.

Paragraph 70

The introduction of the SREP Executive Letter in 2021 has further improved communication with institutions in relation to the main outcomes of the SREP and the main drivers of Pillar 2 requirements. Nevertheless, the ECB believes that there is potential to further enhance transparency towards banks when communicating the main drivers of P2Rs.

The ECB is of the view that its P2R methodology is in line with the EBA SREP guidelines published in March 2022.

There are currently no outstanding recommendations from the EBA regarding the ECB's SREP and P2R methodologies, or regarding the question of how Pillar 2 requirements are communicated and justified to institutions in SREP decisions.

Paragraph 80

The ECB's guidance to banks on NPLs also explains that "*the guidance is 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*". In this regard, the guidance makes the ECB's understanding of Articles 74 and 79(b) and (c) of Directive 2013/36/EU (CRD IV) transparent. Supervisory measures can be triggered by a failure to comply with those legislative provisions, as transposed into national law and read in the light of the ECB's guidance.

Paragraph 82

A bank's annual financial statements and related provisions are signed off by the bank's statutory external auditor.

Within its prudential mandate, the ECB's main tasks as regards accounting are:

1) to assess whether banks have policies and procedures that ensure provisions are adequate and timely;
2) to check the adequacy of provisions using a range of different tools (such as benchmarking) and request detailed information that can be used to challenge banks if need be.

The ECB's methodology envisages that concerns will be discussed with external auditors, both at the level of individual banks and at horizontal level.

Finally, the power conferred by Article 16(2)(d) of the SSM Regulation does not enable the ECB to ask banks to book additional provisions. That power to require banks to apply a specific provisioning policy only allows the ECB to influence the provisioning policy of a bank within the limits of accounting standards – for instance, where such a framework allows for flexibility in the selection of policies or

requires subjective estimates, and the specific implementation choices of the institution are not adequate or sufficiently prudent from a supervisory point of view.

Paragraph 85

The ECB would like to clarify that the reference to provision coverage in the addendum to its guidance to banks on NPLs relates to the prudential provisioning concept, rather than the accounting concept.

Paragraph 86

Within the ECB's overall approach to NPLs, coverage expectations play a forward-looking role by incentivising timely resolution of NPLs and preventing excessive build-up of uncovered NPLs in the future. Consequently, those expectations are relevant to *all* banks – not just those which currently have high levels of NPLs.

The ECB only considers imposing a supervisory measure under the Pillar 2 framework if, after giving due consideration to the specific circumstances presented by a bank, the ECB is of the view that its prudential provisions do not adequately cover the expected credit risk.

Paragraph 90

The reason for the delayed application, the phasing-in and the differentiation of the three groups relates to the main objectives of the ECB's approach – i.e. reducing the level of NPLs, addressing the lack of timely resolution and ensuring coverage of the risk posed by aged NPLs remaining in banks' balance sheets. The delayed application of supervisory measures and the phasing-in both act as incentives, allowing banks – including by spreading the financial burden over time – to resolve NPLs before the ECB applies its supervisory measures. This is confirmed by the 48% reduction in NPL volumes that was seen between Q1 2017 (when the ECB's guidance on NPLs was published) and Q4 2020 (when banks had to report coverage expectations for the first time).

The delayed application is also related to the fact that, for loans classified as NPEs before April 2018, the coverage expectations had not been published at the time of the recognition of default.

Paragraph 91

When the ECB's guidance was published in Q1 2017, NPLs totalled €866 billion. It was necessary to strike a balance between (i) addressing the problem posed by NPLs and (ii) the potential impact on the broader economy of moving too fast before banks had taken the preparatory steps necessary for ambitious NPL resolution. Consequently, the ECB believes that its gradual approach was appropriate.

The ECB believes that its approach is working and did give banks sufficient incentives to proactively reduce their NPLs before supervisory measures related to coverage expectations were applied. In fact, banks reduced their NPLs by 13% in the period of time between the establishment of the SSM and the publication of the ECB's guidance on NPLs in Q1 2017, by 48% between the publication of the ECB's guidance and the first reporting of banks' coverage expectations in Q4 2020, and by 34% between the publication of the ECB's coverage expectations and banks' first reporting of coverage expectations. As a result of this reduction in the level of NPLs, the aggregate coverage expectations shortfall was only 20 basis points of risk-weighted assets in Q4 2020.

Paragraph 92

While it is true that banks with higher levels of uncovered NPLs were given more time to resolve risks stemming from NPLs, this was related to the objective of the policy (reducing NPLs and addressing the lack of timely resolution) and its backstop function – not to any desire to give advantages to banks that were in a worse situation. The ECB wanted to give those banks sufficient space to reduce their NPLs before it started to apply supervisory measures.

Supervisory measures were calibrated to address the individual situation of each bank, making sure that they were proportionate. In other words, banks in different situations were treated differently, while banks in the same situation were treated equally.

Paragraph 93

The ECB expects all banks to consider its expectations, and it analyses whether the treatment of NPLs is prudent on a case-by-case basis, bearing in mind its publicly communicated expectations. Where such treatment is not considered to be prudent, the ECB applies supervisory measures in the form of Pillar 2 add-ons.

Paragraph 94

While the Pillar 2 add-on leaves the available capital untouched, it impacts the MDA and capital headroom. It also impacts MREL requirements and market sentiment.

With that in mind, the majority of banks opted to reduce their shortfalls to zero via post-reference date adjustments in order to avoid P2R add-ons, despite the fact that such add-ons have a lower cost if only the capital perspective is considered.

Paragraph 95

Since the ECB does not have regulatory powers, it needs to address banks' risks via supervisory measures following case-by-case assessments. With this in mind, the ECB assesses whether banks' coverage of risk is sufficiently prudent on the basis of its publicly communicated NPE coverage expectations. Such supervisory measures need to be imposed at the time of the SREP decision, so there will always be a time lag between the detection of uncovered credit risk and the supervisory measure that is used to address it.

Owing to the time lag between the end-2020 reference date and issuance of the final SREP decision, there is a need to ensure that any changes are reflected in the final decision, so that the add-on is consistent with the risk at that point in time. While this may lead to some differences in treatment, those differences are not significant, and the benefits in terms of the incentives that banks have to continue reducing their shortfalls compensate for any downsides the approach might have.

Paragraph 102

Owing to the time lag between the end-2020 reference date and issuance of the final SREP decision, the ECB needs to ensure that any changes in uncovered risk are reflected in the final decision, so that the add-on is consistent with the risk at that point in time (i.e. it is not excessive relative to the uncovered risk). Moreover, the post-reference date adjustment framework also provides an incentive for active reduction of shortfalls and NPLs overall.

Paragraph 104

The ECB does not believe that this process was particularly resource and time-intensive (especially in the context of its first year of implementation): (i) fewer than half of all banks asked that their specific circumstances be taken into account; and (ii) the supporting tool provided to JSTs allowed them to quickly assess the majority of cases, focusing only on those where follow-up with banks might be needed. The process has since been enhanced for the 2022 cycle, with improvements to the tool and additional training.

As regards the number of resubmissions, this was a consequence of it being the first year. It was no different from other newly introduced reporting processes in that regard.

Paragraph 108

Under the cost stabilisation commitment approved by the Governing Council, a headcount request may be submitted to the Governing Council in the event of substantially new or expanded tasks of strategic importance or new mandates. That applies across the whole of the ECB (central banking, banking supervision and shared services). The Governing Council approved such headcount requests for the supervisory function in the ECB's budgets for 2022 and 2023.

Moreover, the SSM's Medium-Term Stabilisation Plan, which has been approved by the Governing Council, indicates a number of areas where headcount requests can be considered beyond 2022. As part of the ECB's yearly operational and resource planning, the various needs and available resources are reviewed, with flexible resource pools available to management if resources need to be reprioritised in response to strategic gaps in resourcing or changes to priorities.

See also the comments on paragraph 45.

Recommendation 1 – Strengthen the risk assessments of banks

Point (a)

The ECB accepts this sub-recommendation.

In 2022 the ECB reviewed its methodology for assessing credit risk levels within the SREP. That review sought to improve proportionality and achieve a more effective risk-based focus and prioritisation, while enabling more in-depth assessment of the material drivers of institutions' credit risk. In addition, the review made the methodology more comprehensive by (i) improving the focus points communicated to supervisory teams in order to help ensure consistency and (ii) expanding the underlying information basis and improving the quantity, granularity and quality of the key risk indicators available for the assessment, including the tools used to disseminate and compare information available to the supervisory teams. All in all, the review is expected to further improve the methodological support provided to supervisory teams for the assessment of institutions' credit risk levels – also in relation to the benchmarking processes and capabilities available to supervisors in this regard – as of the 2023 SREP.

The SREP methodology for assessing credit risk controls will be reviewed in the course of 2023, with a view to implementing it (in combination with the updated assessment methodology for credit risk levels) in the 2024 SREP.

Finally, since 2022 an independent supervisory risk function (the Directorate Supervisory Strategy and Risk) has performed benchmarking of SREP scores and quantitative/qualitative measures, acting as a second line of defence. As part of this organisational change, the benchmarking of SREP scores was strengthened (e.g. by including a framework for dealing with any dissenting views). In addition to the strengthening of the organisational framework, the benchmarking of risk controls was enhanced across all risk types (by comparing risk control scores with open findings and measures). More

generally, the introduction of a second line of defence aims to ensure consistency in the application of supervisory methodologies and judgement. The use of supervisory judgement is a key element of the SSM, and horizontal guidance processes and other tools supporting proper exercise of supervisory judgement have been strengthened continuously in recent years in order to ensure a level playing field in the supervision of the different types of institution covered by the ECB.

Point (b)(i)

The ECB rejects this sub-recommendation.

The stabilisation commitment applies to the whole of the ECB as of 2023. However, headcount requests can still be submitted to the Governing Council in the event of a new mandate or substantial new and expanded tasks that are of strategic importance. The stabilisation commitment is an important guiding principle with a view to encouraging continuous and rigorous prioritisation in the institution, ensuring the efficient and effective deployment of existing resources in order to make optimal use of the fees paid by supervised banks.

The resource needs of the supervisory function are governed by an established budgetary process that includes consultation with the Chair and the Vice-Chair of the Supervisory Board regarding the budget proposal. Independence is also ensured by separately defined expenditure for supervisory tasks in the overall budget, which the Chair and the Vice-Chair of the Supervisory Board are consulted on. It should be noted that costs incurred by the supervisory function are charged to supervised credit institutions on a yearly basis. The ECB's internal budgetary process involves all business areas prioritising their various budgetary demands in line with the agreed strategy, ensuring efficient use of resources.

The ECB maintains that, within the limits defined by the legal framework, the Chair and the Vice-Chair are strongly involved in the process of drawing up the budget. They are consulted, as required by the Rules of Procedure. The SSM Regulation stipulates that the Vice-Chair must be a member not only of the Executive Board, but also of the Governing Council – the ECB's ultimate decision-making body. This ensures that the views of the supervisory function are properly presented, as well as guaranteeing a high degree of influence and transparency (see also the comments on paragraphs 45 and 108). The ECB sets supervisory staffing levels in response to the relevant needs, assessing all requests independently of the central banking function on the basis of established principles and governance arrangements for the institution as a whole.

The ECB will continue to assess and support the resource needs of the supervisory function within the existing budgetary governance procedures.

Point (b)(ii)

The ECB accepts this sub-recommendation.

As regards on-site inspections and internal model investigations, the ECB has already increased transparency since 2021 in relation to the provision of resources on an individual basis via well-established reporting and dialogue with NCAs (including regular stocktakes of human resources and an annual review of data) with the aim of identifying potential deviations from staffing commitments (or negative changes over time), understanding the root causes and agreeing remedial actions. The ECB is committed to conducting a review by mid-2024 in order to see whether more formal escalation processes are necessary. This review will also encompass JST resources, as well as the escalation tools described in paragraph 47 (and the ECB's comments on that paragraph).

The ECB wishes to emphasise that it has no formal powers to compel NCAs to respect staffing commitments.

Paragraph 110

The ECB acknowledges the length of the SREP cycle and is considering ways to reduce it. At the same time, the ECB believes that the risk referred to in the last sentence is largely mitigated, since the JST should consider all relevant events occurring after the cut-off date which could have an impact on the SREP assessment (reorganisation within the group, other corporate events, last-minute NPE reductions, etc.), so that the SREP decision is as up to date as possible.

Recommendation 2 – Streamline the supervisory review and evaluation process

The ECB accepts this recommendation.

Paragraph 112

The ECB is of the view that there are **different ways of determining Pillar 2 capital requirements on a risk-by-risk basis.** It is not necessary to precisely quantify every individual risk to which an institution is exposed; indeed, that may not necessarily constitute best practice, as it could create a false sense of precision regarding P2Rs and the related supervisory dialogue with institutions, which could potentially hamper the efficiency and effectiveness of supervisory action in this area. The ECB took this into account when it expanded its P2R methodology in 2021 by looking more closely at individual risks. The ECB's methodology enables all available information – including data on institutions' ICAAPs, along with other relevant key risk indicators and the outcomes of prudential assessments performed by the ECB as part of ongoing supervision – to be used efficiently to determine P2Rs. This seeks to ensure that all of the potential overall impact of institutions' material risks is appropriately covered by either Pillar 1 or Pillar 2 capital requirements.

The ECB makes constant improvements to its P2R methodology on the basis of the lessons learned from each SREP cycle or following further assessment of the impact that specific risk drivers have on P2Rs.

Paragraph 116

In line with the overall objectives of its approach to NPLs, the ECB puts pressure on banks to reduce the level of NPLs, address the lack of timely resolution and ensure coverage of remaining risks. The increase in NPE coverage works both as an incentive and as an enabler in that regard. The delayed application and phasing-in of NPE coverage expectations act as an incentive, allowing banks to resolve NPLs before the coverage expectations reach 100%. Thus, they are consistent with the overall objective of the ECB's approach to NPLs.

The ECB believes that its approach is working and did give banks sufficient incentives to proactively reduce their NPLs before supervisory measures related to coverage expectations were applied. See the comments on paragraph 91 for more details regarding the reduction of NPLs.

Paragraph 117

As regards systematic use of the powers available to the ECB under Article 16(2)(d) of the SSM Regulation, it should be noted that these powers need to be applied on a case-by-case basis and must be subject to a proportionality assessment.

Paragraph 119

The reason for the delayed application, the phasing-in and the differentiation of the three groups relates to the main objectives of the ECB's approach – i.e. reducing the level of NPLs, addressing the lack of timely resolution and ensuring coverage of the risk posed by aged NPLs remaining in banks' balance sheets. The delayed application of supervisory measures and the phasing-in both act as incentives, allowing banks – including by spreading the financial burden over time – to resolve NPLs before the ECB applies its supervisory measures. When the ECB's guidance on NPLs was published in Q1 2017, NPLs totalled €866 billion. It was necessary to strike a balance between (i) addressing the problem posed by NPLs and (ii) the potential impact on the broader economy of moving too fast before banks had taken the preparatory steps necessary for ambitious NPL resolution. Consequently, the ECB believes that its gradual approach was appropriate. The ECB believes that its approach is working and did give banks sufficient incentives to proactively reduce their NPLs before supervisory measures related to coverage expectations were applied. See the comments on paragraph 91 for more details regarding the reduction of NPLs.

Paragraph 120

The ECB does not share the conclusion that its approach results in unequal treatment of banks. Rather, its approach allows banks to be treated differently in response to differences in their specific circumstances.

First, giving banks with higher initial levels of uncovered NPLs more time to fully cover their risks was fully consistent with the overall objective of the ECB's approach to NPLs. It gave those banks scope to embark on more ambitious NPL reduction, incentivised by the fact that if they did not, the ECB would apply supervisory measures. In this context, it is important to note that the ECB's objective is not to increase coverage per se, but to reduce NPLs; increased coverage both incentivises and enables the resolution of NPLs. Thus, a supervisory measure adopted on account of uncovered credit risk in the context of coverage expectations is only a backstop in case the risk is not reduced.

Second, as regards post-reference date adjustments, the time lag between the end-2020 reference date and issuance of the final SREP decision means that the ECB needs to ensure that any changes to uncovered risk are reflected in the final decision, so that the add-on is consistent with the risk at that point in time (i.e. it is not excessive relative to the uncovered risk). Moreover, the post-reference date adjustment framework also provides an incentive for active reduction of shortfalls and NPLs overall, thereby making banks more resilient and contributing to the ECB's primary objective – i.e. the reduction of NPL levels.

Third, the ECB expects all banks to consider its expectations, and it analyses whether the treatment of NPLs is prudent on a case-by-case basis, bearing in mind its publicly communicated expectations. Where such treatment is not considered to be prudent, the ECB applies supervisory measures in the form of Pillar 2 add-ons.

Paragraph 121

The ECB considers that the process and the use of resources were efficient, given the impact that was achieved in terms of the reduction in NPLs and the increase in coverage.

First, it should be noted that, within the ECB's overall approach to NPLs, coverage expectations play a forward-looking role by incentivising timely resolution of NPLs and preventing excessive build-up of uncovered NPLs in the future. Consequently, those expectations are relevant to *all* banks – not just those which currently have high levels of NPLs. Reporting on NPE coverage is at an aggregate level and almost identical to reporting for the NPE backstop under the Capital Requirements Regulation. Moreover, the reporting of possible exemptions is optional and of benefit to banks.

Second, the process proved to be manageable for JSTs and banks, and it is worth noting that it was the first year of implementation.

While the majority of JSTs' efforts went into the assessment of exemptions, it should be noted that (i) fewer than half of all banks asked for their specific circumstances to be taken into account and (ii) supporting tools were provided to JSTs, facilitating their work. Moreover, it is already clear that JSTs' workload has been reduced in the second year of implementation as a result of lessons learnt and improvements to tools and training.

Third, the small number of banks receiving a P2R add-on actually shows that the ECB's overall approach to NPLs has been a success, increasing the resilience of the euro area banking system. This means that many institutions have eliminated uncovered risks by reducing NPLs and increasing supply elements for prudential provisioning purposes. A P2R add-on is only imposed as a supervisory measure in the event of uncovered credit risk, which is assessed on the basis of coverage expectations and bank-specific circumstances.

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

Point (a)(i)

The ECB partially accepts this sub-recommendation.

The ECB is of the view that its P2R methodology is in line with the EBA SREP guidelines published in March 2022 and that there are **different ways of determining Pillar 2 capital requirements on a risk-by-risk basis.** It is not necessary to precisely quantify every individual risk to which an institution is exposed; indeed, that may not necessarily constitute best practice, as it could create a false sense of precision regarding P2Rs and the related supervisory dialogue with institutions, which could potentially hamper the efficiency and effectiveness of supervisory action in this area. The ECB took this into account when it expanded its P2R methodology in 2021 by looking more closely at individual risks. The ECB's methodology enables all available information – including data on institutions' ICAAPs, along with other relevant key risk indicators and the outcomes of prudential assessments performed by the ECB as part of ongoing supervision – to be used efficiently to determine P2Rs. This seeks to ensure that all of the potential overall impact of institutions' material risks is appropriately covered by either Pillar 1 or Pillar 2 capital requirements.

The ECB makes constant improvements to its P2R methodology on the basis of the lessons learned from each SREP cycle or following further assessment of the impact that specific risk drivers have on P2Rs. In addition, the ECB will soon undertake a more structural review of the effectiveness and efficiency of its P2R methodology.

Point (a)(ii)

The ECB accepts this sub-recommendation.

Point (a)(iii)

The ECB partially accepts this sub-recommendation.

The ECB already ensures that every measure imposed by a SREP decision is clearly and adequately justified by the findings set out in that decision, as required by law.

The ECB works constantly to improve the accuracy, quality, and overall clarity of its communication with banks on the main risk drivers behind Pillar 2 requirements. Indeed, that was the reason for the introduction of the SREP Executive Letter in 2021. The ECB can see that there is potential for further increases in transparency towards banks when communicating the main drivers of P2Rs.

Point (b)

The ECB accepts this sub-recommendation.

The ECB is already using a wide range of supervisory measures to address weaknesses identified in the area of risk controls. However, the ECB acknowledges that its approach – which ensures that qualitative and quantitative supervisory measures mitigate risks in an effective and timely manner – could potentially be enhanced further. The ECB aims to ensure that its use of measures and powers is tailored to the specific situation in question and will continue to improve the way that it applies supervisory measures on a case-by-case basis, including when it comes to addressing weaknesses in banks' provisioning practices.

Point (c)

The ECB accepts this sub-recommendation.

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

Recommendation 2(i)

The organisational structure of ECB business areas is not dependent on risk analysis, with DG/E and DG/MF belonging to the ECB's central banking function on account of their mandates and roles.

In terms of the separation principle, DG/MF and DG/E are allocated to the central banking function. Inputs that are used by the banking supervision function, but produced independently outside of that function, be it within the ECB (as in the case of DG/MF or DG/E inputs for stress tests) or outside the ECB (as in the case of European Commission inputs for stress tests), do not fall within the scope of the separation principle, given the independent manner in which those inputs are prepared. It is not necessary to perform risk analysis to ensure that banking supervision policy choices are not affected because (i) the inputs provided by DG/MF and DG/E are independent and (ii) the very purpose of stress testing, along with other supervisory tools and processes, is to influence policy.

As regards the monitoring and reporting of non-financial risk, this is regulated by the ORM umbrella framework, which is applicable at a bank-wide level, thus also covering any risks that arise from shared services in relation to the separation principle.

Recommendation 3

The ECA's acknowledgement of progress in the area of internal audit is welcome.

A key additional task of the three FTEs mentioned is following-up on open SSM recommendations.

As the capacity of the internal audit function has increased, overall coverage of the SSM audit universe (including ECB audit work performed under the auspices of the ESCB/SSM Internal Auditors Committee) has improved significantly. It is important to note, in this regard, that some high-risk audit subjects have not yet been covered owing to relatively limited sample sizes. For example, an audit of end-to-end banking crisis management was performed in 2022 once the potential sample for substantive testing was sufficiently large to allow any trends to be identified.

Recommendation 5

A revised supervisory planning process was launched early in 2022, which aims to improve the monitoring and reporting of activities relating to supervisory priorities and increase the effectiveness with which strategic objectives set out in those priorities are achieved. In 2022, the focus was on ensuring that our process was fit for purpose, from priorities right through to operations. In the second year of this endeavour, new reports will be produced, linking outputs and outcomes of the ECB's banking supervision work with the implementation of priorities. The ECB is also exploring ways of extracting supervisory performance from observable outcomes. These data will improve reporting in the ECB's annual report on banking supervision.

As regards the industry survey, the ECB has used alternative means (e.g. high-level conferences and fora, and the Banking Supervision Market Contact Group) which, in our view, fully serve the purpose of this recommendation. The supervisory effectiveness pilot for less significant institutions has been completed (see the Supervisory Board's decision of December 2022), and regular follow-up is planned.

Recommendation 6

Article 6(3) of the SSM Regulation clearly specifies that NCAs are obliged to assist the ECB in the performance of its tasks. Moreover, NCAs have a duty to cooperate in good faith in accordance with Article 6(2) of the SSM Regulation. Articles 3 et seq. of the SSM Framework Regulation clearly specify that NCAs have a duty to make NCA staff available to JSTs, while Article 4(5) of the SSM Framework Regulation provides that the ECB and the NCAs must consult each other and agree on the use of NCA resources with regard to JSTs.

ECB analysis shows that the shortfall in NCA staff relative to commitments has declined since 2016. However, there is still a 4% shortfall relative to 2019 commitments. The ECB continues to tackle shortfalls through discussions between JST coordinators and local coordinators, as well as escalation meetings with NCAs at higher levels. This may prove difficult in practice, since local legislation may set limits which are not commensurate with banks' risk profiles. The ECB's belief that there is no need to amend the SSM Framework Regulation stems from the fact that the SSM is based on a principle of cooperation in good faith.

Recommendation 7

Targets for team profiles are agreed by the leadership of each JST as part of a centrally steered annual exercise. The outcome of this exercise is reported to the Supervisory Board on an annual basis.

Recommendation 8

Users' profiles include contact information, job titles and details of JST membership. Users also have the option, on a voluntary basis, of adding details of their expertise, languages spoken and membership of expert groups or networks (with all fields based on defined taxonomies). Users can provide biographical information using a template, which includes details of past experience, education, etc.

SSMnet is used by 6,500 active users (at the ECB and NCAs), but most of those users have not yet set up a profile.

There is an ongoing communication campaign aimed at increasing the use of SSMnet profiles among ECB and NCA staff. In the future (medium term), an HR internal talent marketplace platform will be established in order to improve the documentation and management of skills and experience (for ECB staff working in JSTs).

Recommendation 9

In January 2023 work began on the design and development of a key qualification. This will be a modular programme, with opt-outs based on staff profiles, and it will result in certification. The first cohort are expected to complete the programme in 2024.

In parallel, comprehensive modular training paths for supervisors on traditional risks, as well as emerging risks which are SSM priority areas (namely IT and cyber risks, digital transformation, and climate-related and environmental risks), will start to be developed in 2023, reviewing existing SSM training opportunities, identifying gaps and sourcing/developing new training where relevant.

Finally, the SSM induction has been redesigned as a three-day residential programme with the primary aim of facilitating navigation of the institution for newcomers and giving them the tools they need to excel in their new environment. It involves sessions on the fundamentals of supervision and SSM tools and organisation, as well as social activities. The first of these three-day inductions will take place in June 2023.

Recommendation 10

The annual JST staffing survey collects information on the tasks allocated to JST staff on the basis of the SREP risk map. In the light of discussions between JST coordinators and local coordinators, task allocation targets are set and the targets are combined. The results of this exercise are presented to the Supervisory Board and revisited on an annual basis.

Recommendation 12

The COVID-19 pandemic made on-site activities very difficult in 2020 and 2021 (and some of 2022 as well). Consequently, any data comparing the number of cross-border missions in these years with the situation pre-pandemic should be treated with caution. In December 2022 the ECB approved an initiative aimed at significantly strengthening the ECB's on-site resources by the end of 2025. This will be achieved by creating new ECB positions in exchange for a commensurate reduction in the budget for external consultants. A total of 65 new SSM positions will be created, including 49 new ECB positions (representing a 34% increase in DG/OMI's headcount) plus 16 additional ESCB/IO positions, in exchange for a commensurate reduction in the budget for external consultants (who are used to complete inspection teams). The full implementation of this initiative will be monitored closely by the Supervisory Board and the Executive Board. This internalisation will help to increase the operational independence of the ECB, enabling it to lead more inspections. Similar efforts are being made with a view to increasing numbers of cross-border missions, with NCAs being set more ambitious targets for cross-border engagement, for example.