The supervision of less significant institutions in the Single Supervisory Mechanism

The European Single Supervisory Mechanism (SSM), one of the central pillars of the banking union, was launched on 4 November 2014. It is intended to provide a key contribution to the safety and soundness of credit institutions and to the stability of the financial system in the European Union as well as each individual member state.

Unlike significant institutions, which generally have more than €30 billion in total assets and are supervised directly by the European Central Bank (ECB), less significant institutions (LSIs) continue to be under the direct supervision of the national competent authorities (NCAs). In Germany, this affects around 1,660 institutions which are jointly supervised by the Federal Financial Supervisory Authority (BaFin) and the Bundesbank. In this context, the responsibilities and tasks of these two institutions will remain unchanged. In particular, the Bundesbank is responsible for the ongoing supervision of institutions, and will therefore remain these institutions' local point of contact in the future.

The ECB supervises the LSIs indirectly in the sense of an oversight function. The aim is to ensure harmonised high standards of supervision and a consistent approach within the SSM. These joint supervisory standards are currently being gradually developed by the ECB in cooperation with national supervisors. In addition, the ECB can prescribe supervisory priorities or principles on how to evaluate certain issues. In exceptional cases, the ECB can take over direct supervision if this is necessary to ensure the consistent application of high supervisory standards.

As part of its oversight function, the ECB can issue regulations, guidelines or general instructions to be implemented by national supervisors as well as recommendations to supervisors. Moreover, the NCAs are obliged to disclose certain information to the ECB. The ECB can, in addition, request additional information from the NCAs. The intensity of indirect supervision by the ECB is dictated by the priority of an institution, determined based on its risk profile and its impact on the domestic financial system.

Taking stock of indirect supervision, now that the SSM has been in existence for slightly over a year, yields a generally positive picture. Quite a bit has already been achieved on the road to harmonised European supervision thanks to the close cooperation and intensive dialogue between the ECB and the NCAs. However, many challenges still remain. This year, a particular focus will be on further optimising the exchange of information and the coordination processes between the ECB and the NCAs. BaFin and the Bundesbank will work together to ensure that adequate attention is paid to the proportionality principle and the clear division of responsibilities between the ECB and the NCAs with respect to the supervision of LSIs.

Supervisory approach

Creation and scope of the SSM

SSM is one of the cornerstones of the banking union

In response to the financial and economic crisis, and given the progress being made in EU financial market integration, on 29 June 2012 the European Union heads of state or government took the decision to establish the SSM. This mechanism has centralised banking supervision at the ECB and represents one of the cornerstones of the banking union.

SSM Regulation as the legal basis

On 4 November 2014, the ECB began to discharge the tasks conferred upon it by the SSM Regulation. The legal basis for the ECB's work is the Regulation conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (SSM Regulation).[1] Although the SSM's scope is initially confined to the euro-area member states, all other EU member states may "opt in" under certain circumstances. The SSM covers all institutions which are deemed to be credit institutions pursuant to the Capital Requirements Regulation (CRR),[2] ie which take deposits and grant credit. It will also cover parent undertakings included in credit institutions' scope of prudential consolidation, including financial holding companies and mixed financial holding companies.

Direct and indirect supervision by the ECB

The SSM Regulation confers overall supervisory responsibility for all SSM institutions on the ECB. However, the ECB only directly supervises the 129 significant institutions in the euro area, 22 of which are German. This is conducted by joint supervisory teams (JSTs) composed of staff from the ECB and the national competent authorities (NCAs). Significant institutions account for over 80% of the euro-area banking sector, measured by total assets. However, if one looks at the number of institutions, it is clear that more than 96% of institutions, ie the approximately 3,460[3] less significant institutions (LSIs) in the euro area, are still supervised directly by the NCAs and only indirectly by the ECB. Germany's small and medium-sized institutions, which number approximately 1,660, are thus also still supervised directly by BaFin and the Bundesbank.

Criteria and rules for classifying an institution as significant or less significant

As a rule, whether an institution is supervised directly or indirectly by the ECB depends on whether it is classified as significant or less significant. The criteria and rules for this classification are set forth in Article 6 (4) of the SSM Regulation and Article 39 *et seq* of the SSM Framework Regulation.[4]

National responsibilities and tasks

BaFin and Bundesbank still jointly responsible for direct supervision

Even following the entry into effect of the SSM and the amended version of the German Banking Act *(Gesetz über das Kreditwesen)*, LSIs in Germany are still jointly supervised directly by BaFin and the Bundesbank. Pursuant to section 6 (1) of the Banking Act, BaFin is the national competent authority. It is responsible for supervising less significant CRR credit institutions as well as other institutions pursuant to section 1 of the Banking Act which do not fall under the scope of the SSM Regulation.

Cooperation and the division of tasks between BaFin and the Bundesbank are governed by section 7 of the Banking Act. The Prudential Supervisory Guideline,[5] issued by BaFin in agreement

1 Council Regulation (EU) No 1024/2013 of 15 October 2013.
2 Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 646/2012 (OJ L 176, 27 June 2013, p 1).
3 Information according to the ECB Banking Supervision B. List of less significant institutions, current as at 30 December 2015.
4 Regulation (EU) No 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (SSM Framework Regulation) (ECB/2014/17).
5 Guideline on the implementation of and quality assurance for the ongoing monitoring of credit institutions and financial services institutions by the Deutsche Bundesbank (Richtlinie zur Durchführung und Qualitätssicherung der laufenden Überwachung der Kredit- und Finanzdienstleistungsinstitute durch die Deutsche Bundesbank) of 21 May 2013.

Criteria for identifying significant institutions pursuant to Article 6 (4) of the SSM Regulation and Article 39 *et seq* of the SSM Framework Regulation

A credit institution shall be considered significant if any of the following conditions are met.
The total value of its assets exceeds €30 billion. The ratio of its total assets over the GDP of the participating member state of establishment exceeds 20%, unless the total value of its assets is below €5 billion.
Public financial assistance has been requested or received directly for the institution from the EFSF[1] or the ESM.[2]
The institution is one of the three most significant credit institutions in the participating member state.
The national competent authority has stated that it considers the institution to be significant with regard to the domestic economy, and the ECB has confirmed the assessment.
Moreover, the ECB may, on its own initiative, decide to classify a supervised group as significant if the parent undertaking has established subsidiaries, which are themselves credit institutions, in more than one participating member state and
– the total value of the group's assets exceeds €5 billion and – the ratio of its cross-border assets/liabilities to total assets/liabilities exceeds 20%.

1 European Financial Stability Facility. **2** European Stability Mechanism.
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with the Bundesbank, fleshes out the details with respect to day-to-day supervisory practice.

Bundesbank is responsible for ongoing supervision

Pursuant to section 7 (1) of the Banking Act, the Bundesbank is responsible for the ongoing supervision of institutions. This is conducted in a decentralised manner by the Bundesbank's nine Regional Offices, whereas the Bundesbank's Central Office performs a coordination function and is responsible for policy issues. The Regional Offices are therefore still the institutions' local point of contact. As part of a preventive, risk-based supervisory strategy, their primary responsibility is fact-finding, evaluating submitted documents, reports, annual accounts and on-site inspection reports and holding regular and *ad hoc* discussions with senior management. In addition, they are obliged to create, at least once a year, a comprehensive risk classification and assessment as part of the supervisory review and evaluation process (SREP) for each institution (the supervisory risk profile). On this basis, they give BaFin proposals for supervisory action, where necessary. BaFin is responsible for finalising the risk profiles and taking decisions on supervisory measures and actions. Ongoing supervision also encompasses the performance by supervisors of on-site inspections at institutions pursuant to section 44 of the Banking Act; these are likewise usually conducted by the Bundesbank's Regional Offices. The main purpose of these inspections is to assess the institutions' risk management and the internal models used to calculate capital requirements.

Scope and design of indirect supervision

Aims and major instruments

In their capacity as direct supervisors of LSIs, the NCAs are still the recipients of reports and the institutions' direct point of contact. Small and medium-sized institutions' direct contact with the ECB is thus limited to exceptional cases. The respective country's national language likewise remains the official language for communications with institutions, and national accounting standards (eg the German Commercial Code) continue to apply.

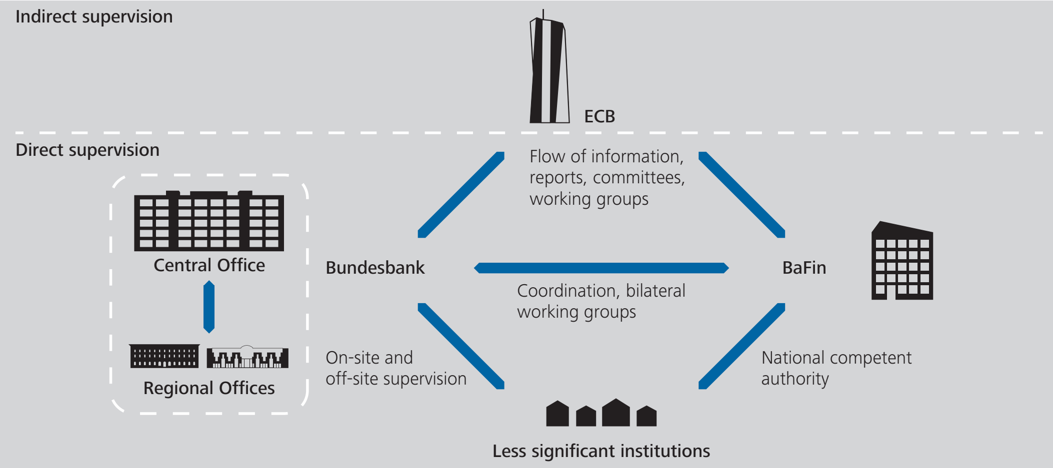
ECB oversight function

In its indirect supervision of LSIs, the ECB takes on an oversight function. The ECB not only oversees the NCAs' supervisory activities, but also has an overview of all LSIs.

Issuance of regulations, guidelines, instructions and recommendations by the ECB

The SSM Regulation gives the ECB a variety of powers over the NCAs to allow it to perform its oversight function effectively. For instance, the ECB can, under Article 6 (5) (a) of the SSM Regulation, issue regulations, guidelines or

Overview of responsibilities and tasks in Germany



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general instructions, which the NCAs are required to implement. The ECB can also issue non-binding recommendations to supervisors.

Regular and ad hoc submission of information to the ECB by national supervisors

Moreover, Article 6 (2) of the SSM Regulation subjects both the ECB and national supervisors to a duty of cooperation in good faith and an obligation to exchange information. To this end, the NCAs shall provide information to the ECB through regular reports. Where necessary, the ECB can request additional information and conduct relevant analyses. Such analyses also include thematic reviews designed to provide a targeted insight into the NCAs' supervision of predefined risk areas at the level of single entities or groups of comparable entities.

Ensuring high standards of supervision and a consistent approach within the SSM

The aim of oversight is to ensure high standards of supervision in the sense of a best-practice approach as well as a consistent procedure within the SSM. These joint supervisory standards are being gradually developed by the ECB in cooperation with the NCAs. Moreover, the ECB may also set supervisory priorities or define principles on how to evaluate certain issues. What the ECB cannot do, however, is to issue individual instructions relating to a specific LSI.

Observing the principle of proportionality

The ECB is required to observe the principle of proportionality at all times in its activities. What this means is that the ECB's oversight and analytical activities as well as its framework for harmonising supervisory practices in indirect supervision must, in terms of scope and applicability, take due account of the diversity of institutions in the SSM, their size and their business models.

Direct impact possible in individual cases

The ECB's indirect supervision can result not only in effects for NCAs; there may also be direct consequences for institutions. Last year, this was the case, for instance, for the ECB's recommendation on dividend distribution policies in order to ensure sustainable compliance with capital requirements, which BaFin, in accordance with the ECB recommendation, also addressed to LSIs in May 2015.[6]

On-site inspections of banking operations still conducted by the NCAs

Pursuant to Article 6 (6) of the SSM Regulation, the NCAs are still responsible for on-site inspections of banking operations, though the ECB is permitted to send observers.

ECB can assume direct supervision in individual cases

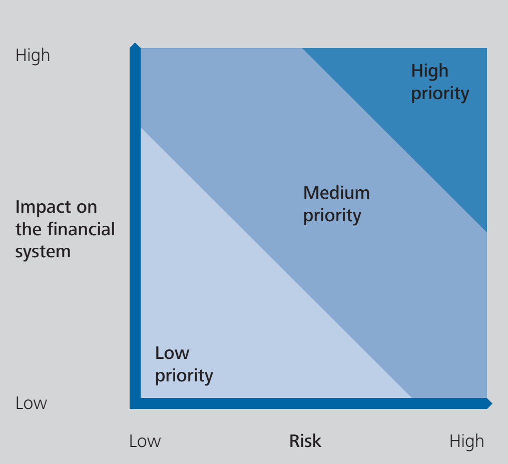
Finally, Article 6 (5) (b) of the SSM Regulation entitles the ECB, as a last resort, to assume direct supervision over an LSI should this be necessary to ensure the consistent application of high supervisory standards.

6 See Recommendation of the European Central Bank of 28 January 2015 on dividend distribution policies (ECB/2015/2).

Common procedures: authorisation of credit institutions, withdrawal of authorisations and acquisition of qualifying holdings

Irrespective of whether an institution is classified as significant or less significant, there are three areas in which common procedures are conducted, ie the ECB and the NCAs cooperate, though the decisions are taken by the ECB (Article 73 *et seq* of the SSM Framework Regulation). These include the decision on approving applications for authorisation to take up the business of a credit institution and withdrawing such authorisation (Article 14 of the SSM Regulation) as well as on the acquisition of a qualifying holding in a credit institution (Article 15 of the SSM Regulation).

Prioritisation of less significant institutions (schematic view)



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Prioritisation of LSIs

The LSIs in the SSM are highly diverse in terms of size, risks and structure, as well as in the nature, scope and complexity of their business activities. In order to do justice to this heterogeneous structure, the principle of proportionality represents a guiding principle of the ECB's indirect supervision, much as in the supervisory approach in use at present in Germany.

Implementing the principle of proportionality by prioritising institutions

The ECB has been pursuing a graduated approach, one that centres on prioritising institutions, as a way of implementing the principle of proportionality. It assigns one of three priority ranks (high, medium, or low priority) to institutions. The prioritisation process is conducted annually. Whereas the 2015 review was still conducted on the basis of relatively rough, simplified criteria, the ECB has now, in cooperation with the NCAs, developed a comprehensive prioritisation methodology, which was already used for the prioritisation for 2016.

Priority determined on the basis of institutions' intrinsic riskiness and impact on domestic financial system

The methodology is initially aimed at a quantitative analysis of an institution's priority. It looks not only at the institution's intrinsic riskiness based on the SREP assessment and/or risk profile, but also at the impact an institution has on its domestic financial system as criteria for classification.

Moreover, the methodology defines certain catch-all provisions. Thus, institutions whose total assets are relatively close to the significance threshold pursuant to Article 6 (4) of the SSM Regulation are also ranked as high-priority. This is intended to ensure that the ECB has sufficient information on those institutions that could potentially become significant in the future and would therefore fall under its direct supervision, irrespective of their specific riskiness. By contrast, institutions with a relatively small impact on the domestic financial system are generally ranked only medium-priority or low-priority.

Prioritisation is finalised after a dialogue between the ECB and the NCAs on the respective institutions, which incorporates qualitative assessments from the NCAs and takes into account any new developments.

Prioritisation influences intensity of indirect supervision

An institution's ranking in the various categories affects the intensity with which the ECB exercises indirect supervision. For instance, the priority determines the extent and frequency of NCAs' reporting requirements or the ECB's requests for additional information. It also guides the NCAs' internal processes and activities.

Requirements for reporting information to the ECB

ECB needs information from NCAs in order to perform indirect supervision

Under the division of tasks in the SSM between the NCAs, which supervise LSIs directly, and the ECB, which supervises LSIs indirectly, the NCAs are required to submit certain information to the ECB. Article 6 (2) of the SSM Regulation stipulates that the NCAs must provide the ECB with all the information the latter needs to carry out the tasks conferred upon it. Another purpose of the reporting requirements is to keep the ECB apprised of major developments, information which it can use as the basis for its own analyses of sectors or important single entities.

Reporting requirements directed exclusively at the NCAs

The reporting requirements are directed exclusively at the NCAs and not the institutions. The supervisors shall compile the requisite information in the course of their normal supervisory activities and communicate it to the ECB in the form of standardised notifications. Moreover, the ECB regularly receives all data reported to the NCAs as part of the regular supervisory reporting system pursuant to the provisions of the CRR and the European Commission's implementing regulation laying down implementing technical standards with regard to supervisory reporting of institutions,[7] which is based on the CRR.

Breakdown into ex ante notification, ex post reporting and other notifications

Articles 96 to 100 of the SSM Framework Regulation define the procedures, including the applicable deadlines. They classify notification requirements into the following categories: *ex ante* notifications, *ex post* notifications and other notifications.

Ex ante notifications

Generally restricted to high-priority institutions

Pursuant to Articles 97 and 98 of the SSM Framework Regulation, the NCAs are required to communicate material supervisory procedures and material draft supervisory decisions to the ECB. These reporting requirements apply only to high-priority institutions.

Irrespective of an institution's priority, Article 97 (4) and Article 98 (3) of the SSM Framework Regulation stipulate that the NCAs must notify the ECB of those procedures or draft decisions which they deem material, which could negatively affect the stability or reputation of the SSM, or on which the ECB's views are sought. The purpose behind all these notifications is to give the ECB the opportunity to pass comment prior to the NCA's final decision, without having any binding effect on the NCA.

Ex post reporting

Concerns all institutions; frequency dependent on priority

Pursuant to Article 99 of the SSM Framework Regulation, NCAs shall regularly forward institution-specific information to the ECB. This reporting requirement covers all LSIs, though the frequency of the reports depends on the priority ranking.

Article 100 of the SSM Framework Regulation states that NCAs must report annually on their activities in the supervision of LSIs. The report shall contain quantitative and qualitative information on the national banking sector, the supervisory process, and organisational aspects.

Other notifications

Especially in the event of a rapid and significant deterioration in an institution's financial situation

There are various other reporting requirements in addition to *ex ante* notifications and *ex post* reporting. One particular example is that, pursuant to Article 96 of the SSM Framework Regulation, the ECB is to be notified whenever an institution's financial situation deteriorates rapidly and significantly.

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7 Commission Implementing Regulation (EU) No 680/2014 of 16 April 2014 laying down implementing technical standards with regard to supervisory reporting of institutions according to Regulation (EU) No 575/2013 of the European Parliament and of the Council.

Requirements for reporting information to the ECB

Information trigger	Type of information	Frequency
Ex ante notification (Articles 97 and 98 of the SSM Framework Regulation)	Material supervisory procedures and material draft supervisory decisions	*Ad hoc* basis
Ex post reporting (Articles 99 and 100 of the SSM Framework Regulation)	Institution-specific information and annual report	Regularly
Other notifications		
Deterioration of the financial situation (Article 96 of the SSM Framework Regulation)	Institution-specific information	*Ad hoc* basis
Ad hoc assessment of significance (Article 52 *et seq* of the SSM Framework Regulation)	Result of assessment of significance	*Ad hoc* basis
Ad hoc changes to the list of less significant institutions (Article 49 of the SSM Framework Regulation)	Changes in the supervised institutions	*Ad hoc* basis
Administrative penalties (Article 135 of the SSM Framework Regulation)	List of administrative penalties	Regularly

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Projects in the SSM

SREP for less significant institutions

Background

Components of the supervisory review process: ICAAP and SREP

The supervisory review process (second pillar of the Basel Framework) is designed to ensure a comprehensive analysis of an institution's risks and the capital available to cover them, taking into account individual circumstances. The two components of the second pillar are the creation of an internal capital adequacy assessment process (ICAAP) and the supervisory review and evaluation process (SREP).

Under the SREP, supervisors review the arrangements, strategies, processes and mechanisms implemented by an institution to comply with the prudential requirements. The risks faced by an institution, as well as its capital and liquidity adequacy, are also evaluated. The objective is to determine whether an institution has ensured adequate and effective risk management as well as sufficient risk coverage. The results of the SREP form the central basis for the annual institution-specific operational supervisory planning and for determining supervisory measures.

At the European level, the SREP requirements are anchored in Article 97 of CRD IV,[8] while their transposition into German law is set out in section 6b of the German Banking Act. BaFin and the Bundesbank are responsible for performing the SREP for German LSIs.

Future design of the SREP

The European Banking Authority (EBA) published guidelines on the SREP on 19 December 2014.[9] The guidelines are addressed to the competent authorities of the EU member states, who must apply them from 2016 onwards. They constitute a comprehensive overall framework for the structure of the SREP.

Development of a harmonised SREP methodology for LSIs

As part of its indirect supervision function, the ECB is currently developing a harmonised SREP methodology for LSIs in cooperation with BaFin, the Bundesbank and the other NCAs. The work looks likely to extend into 2017, which means that the results will only material-

8 Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (Capital Requirements Directive IV).
9 EBA Guidelines on common procedures and methodologies for the supervisory review and evaluation process (EBA/GL/2014/13) dated 19 December 2014.

ise fully at a later date. The methodology is essentially being developed in line with both the EBA's SREP guidelines and the SSM's SREP methodology for significant institutions, which has been in use since 2015. It will define minimum requirements on which NCAs will base SREP performance in future. Responsibility for the actual application of the SREP in Germany nonetheless remains with BaFin and the Bundesbank.

The basic structure of the SREP is shown in the chart on page 59. The SREP is built around four main elements:

- Business model analysis
- Assessment of governance and risk management
- Assessment of capital risks and capital adequacy
- Assessment of liquidity risks and liquidity adequacy

Common to all four elements is the fact that they are subject to an ongoing risk assessment in the form of a risk assessment system (RAS), similar to the previous supervisory risk profile. The development and implementation of the RAS is a current focus of SSM work.

Calculation of automatic ratings as starting point for further evaluation

Under the future RAS, the individual elements will be assigned rating scores on a scale of one to four – as has so far been the case – and a detailed verbal assessment will be made of each element. The evaluation is therefore based on both quantitative and qualitative criteria. The quantitative risk evaluation is based on selected indicators taken from supervisory reporting and other data sources. With the objective of introducing a harmonised procedure throughout the SSM, the automatic ratings created in the RAS will make this assessment process more standardised. These ratings will serve as the starting point for more in-depth, institution-specific analysis, which in turn lies at the heart of the RAS. The provisional automatic ratings are comprehensively validated and supplemented with additional information, before a final score is given for each specific area. Finally, the scores are condensed to produce an overall score, which serves as a measure of an institution's viability.

Supervisory assessment of capital and liquidity adequacy required

In addition to the RAS, NCAs performing the SREP have to make their own assessment of the adequacy of each institution's capital and liquidity, and make a decision on capital and liquidity requirements. The formulation of the capital requirements should take into account the RAS results, the institution's ICAAP, and supervisory and internal stress tests. Risk-reducing diversification effects between individual risk types will not be taken into account, however. Discussions concerning the details of how to determine the capital and liquidity requirements have not yet been finalised.

Determination of supervisory measures at end of SREP, including capital add-on

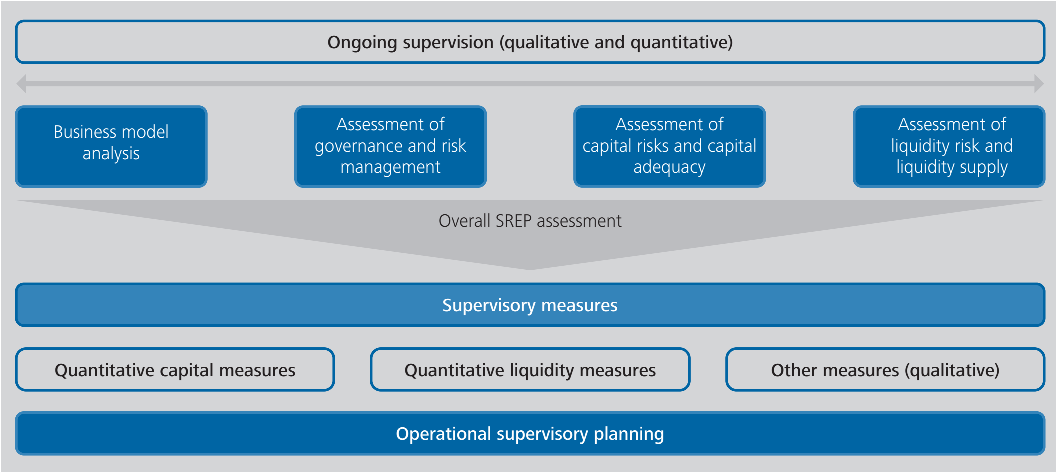
At the end of the SREP, quantitative and qualitative supervisory measures should be determined based on an overall assessment. This will normally also involve setting a capital add-on, which will be a component of the SREP decision and will generally have to be covered by capital recognised for supervisory purposes.

In addition to the in-depth assessment of the various SREP elements, selected financial and non-financial key risk indicators are monitored on a quarterly basis; these are derived from the regular supervisory reporting system for each institution. The objective is to identify any changes in the financial situation and risk profile of the supervised institution at an early stage.

Emphasis on proportionality principle in methodology development

Implementation of the proportionality principle is closely bound up with the development of the SREP methodology for LSIs. German supervisors are advocating the proportional design and application of the SREP, and hence risk-oriented supervision, in order to take due account of the heterogeneous banking landscape in Germany with its multitude of small and medium-sized institutions. In particular, the SREP approach must comply with the requirements outlined in the EBA's SREP guidelines, as

Structure of the supervisory review and evaluation process (SREP)



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well as being consistent with the SSM's SREP methodology for significant institutions. In keeping with this, the proportional design of the SREP is based on an institution's priority, amongst other things. Additional criteria are also to be used in order to adequately take into account the specifics of the institution in question. This is demonstrated by the following proportionality dimensions: frequency, scope and intensity of supervisory engagement as well as supervisory requirements for the institution's risk management, for instance.

Between continuity and change

Many of the future SREP requirements are already incorporated into the current German SREP approach, which means that there will certainly be a degree of continuity, especially with respect to supervisory requirements. At the same time, at least some change will come, chiefly in terms of supervisory practice. This change will, however, also have an indirect impact on the supervised institutions, particularly in the form of capital add-ons.

In future, greater weight will be given to business model analysis than thus far

Business model analysis is a frequent topic of discussion in this connection. Thus far, the business model has been analysed and evaluated at several different points in the supervisory assessment process. In future, business model analysis will be more rigidly structured, and the relevant information will be compiled systematically. For example, future analyses will explicitly assess the viability of a business model over the next 12 months and its sustainability in the coming three years. The analysis will be based on both quantitative data, such as the cost/income ratio and the return on equity, and qualitative assessments. However, supervisors are expressly advised not to prescribe a specific business model, nor are business models to be harmonised. Instead, institutions will retain responsibility for their business models. Nonetheless, supervisors will, in the interests of forward-looking analysis, take a closer look at the institution's business environment, priorities, and strategy and financial planning as well as the underlying assumptions. The aim will be to ascertain whether the business model is a potential source of excessive risk to an institution. Moreover, vulnerabilities that could lead to the failure of the institution are to be identified.

ICAAP and institutions' internal procedures as basis for supervisory assessment

A significant new feature in the SREP is the dedicated quantitative calculation of the institutions' capital and liquidity requirements to be performed by supervisors, which can regularly result in a capital add-on being set. The exact procedure for calculating the liquidity requirements is still in the early stages of development. The ICAAP as well as the institutions' internal procedures and methods will be the initial starting points for calculating the capital and liquidity requirements in future. This approach ensures that institutions' individual circumstances are adequately taken into account. Consequently, the ICAAP can remain the key instrument for internal governance alongside the provisions of section 25a (1) of the German Banking Act and the BaFin Circular on the Minimum Requirements for Risk Management. German supervisors are endeavouring to support the ongoing development and enhancement of the ICAAP and keep supervisory intervention in internal governance to a minimum.

Institutions in Germany already have sound capital base at present

At present, the vast majority of LSIs in Germany already have sound levels of capital and liquidity. Capital add-ons are already an option in Germany, in order to account for risks or deficiencies in proper business organisation that were not, or only insufficiently, covered, for example. In this respect, the future supervisory calculation of capital and liquidity levels represents an evolution of the current approach.

Qualitative assessments by the NCA will remain part of the SREP

The future supervisory approach, which will have a significantly more quantitative focus, allows better comparisons and more harmonised assessments to be made concerning institutions in the SSM. This is contingent on the availability of a harmonised database. However, this must not result in a purely mechanistic derivation of the SREP results. Instead, qualitative assessments by the competent authority will continue to form a key component of the SREP.

Extensive field tests to be conducted and national interim solution for 2016

The ECB's SREP methodology for LSIs and the underlying criteria and indicators are initially to be the subject of extensive field tests. As the collaborative work between the ECB and the NCAs is no longer expected to be finalised in 2016, but the EBA's SREP guidelines have to be applied from 2016, German supervisors are currently working intensively on a suitable interim solution for 2016.

Besides the risks already covered in Pillar 1, interest rate risk, in particular – as one of the most significant bank-specific risks – will have to be accounted for in the capital quantification. If required, additional material risks are to be included in the calculation when analysing an individual institution. The main objective must be to develop a practicable and comparable approach for the institutions, for example by using standardised indicators such as the Basel interest rate shock as a measure of interest rate risk in the banking book.

Supervisory priorities for 2016

Background

Supervisory priorities as key component of annual supervisory planning

Each year, the ECB and the NCAs set supervisory priorities that are derived from the aggregate of the individual institutions' assessments, but also from the macro perspective. These priorities determine the supervisory activities for the following 12 to 18 months. They constitute a key component of annual supervisory planning and support the coordination of supervisory activities across various institutions. They thus help to create a level playing field and enhance the effectiveness of supervisory actions.

Priorities build on an assessment of key risks

The supervisory priorities build on an assessment of the key risks banks are facing and take into account economic, regulatory and supervisory frameworks and developments. The supervisory priorities, which apply to the entire SSM, are passed by the Supervisory Board. Based on these priorities, the NCAs set out priorities with respect to their specific banking sectors.

Priorities at the SSM level

The ECB, in cooperation with the NCAs, identified the key risks to the SSM institutions in 2016. Among the risks identified, those of greatest significance are business model and profitability risk, followed by further key risks with varying levels of importance depending on the specific SSM country.

Based on these key risks, the SSM has defined five supervisory priorities for 2016:[10]

- Business models and profitability drivers
- Credit risk
- Capital adequacy
- Risk governance and data quality
- Liquidity

Priorities at the national level

Supervisory priorities as fleshing out of or extract from the supervisory strategy

German supervisors previously adopted a supervisory strategy each year, defining the key risks in the banking sector and the instruments available to tackle them. The supervisory priorities at the national level thus constitute a fleshing out of or extract from the supervisory strategy.

Against the backdrop of the persistent low-interest-rate environment, business model and profitability risk is a particular focus at the national level, too. Increasing competition and cost pressure as well as changing technical conditions, such as advancing digitalisation, are further intensifying the pressure on profitability. This assessment was also confirmed by the survey conducted by BaFin and the Bundesbank in summer 2015 on the profitability and resilience of German credit institutions in the low-interest-rate setting, which questioned around 1,500 small and medium-sized German banks. The survey showed that the persistently low interest rates weighed significantly on German credit institutions in all survey scenarios over a five-year period. If the low-interest-rate environment continues, a clear decrease in earnings can be expected. Given the existing surplus capital and available hidden reserves, most institutions are still able to withstand the strains caused by the low-interest-rate setting.[11] Nonetheless, the viability and sustainability of business models as well as the profitability drivers of the institutions will be supervisory priorities at the national level in 2016.

The possible further consequences of a persistent low-interest-rate setting are closely linked to this topic. German supervisors will keep a watchful eye on whether institutions loosen their lending standards or enter into a greater volume of speculative transactions. The impact of a sudden interest rate rise must also be analysed carefully.

This is not the only area where there is overlap between the supervisory priorities at the national and SSM levels. German supervisors, too, will focus on deficits in institutions' risk management as well as the adequacy and security of their IT systems in 2016, for instance.

Conclusion and outlook

Responsibility for the direct supervision of LSIs remains with the NCAs, which in Germany means BaFin and the Bundesbank. Therefore, the direct effects on LSIs of the ECB's indirect supervision are, in principle, limited. Furthermore, the ECB must take into account the proportionality principle when exercising indirect supervision.

Nonetheless, various individual aspects are likely, over time, to result in indirect effects on the institutions, at the very least. This relates in particular to the joint supervisory standards currently being developed. Once they have been adopted, these will be applied by the NCAs, which will affect the way in which institutions are supervised.

Indirect effects also stem from the specification of supervisory priorities as an integral part of a supervisory strategy. The key priority for 2016 at the SSM and national levels will be the viability and sustainability of business models as well as the institutions' profitability drivers.

10 See ECB Banking Supervision publishes priorities for 2016, ECB press release dated 6 January 2016.
11 See the Bundesbank press release concerning the results of the survey on the low-interest-rate setting dated 18 September 2015.

The general finding is that the creation of the SSM has made the supervisory approach more quantitative; equally, more emphasis has been placed on peer comparisons between institutions. This approach allows for better comparability and harmonised assessment of institutions across national borders, thus tackling the weak points revealed by the financial and economic crisis.

Thanks to the close cooperation and intensive dialogue between the ECB and the NCAs at various levels, the experience thus far with SSM supervision of LSIs can be viewed as positive overall.

Irrespective of this, some challenges remain. This year, a particular focus will be on further optimising the exchange of information and the coordination processes between the ECB and NCAs. It will also be important to pay sufficient attention to the proportionality principle and the clear division of responsibilities between the ECB and the NCAs when further harmonising supervisory processes and practices. BaFin and the Bundesbank will work together to ensure this. Under these conditions, the SSM is an opportunity to achieve better and more effective supervision throughout the European banking sector, making a key contribution to the stability of the financial system in the euro area.