EUROPEAN BANKING NEWSLETTER

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NEWS FROM THE ECB

COVID-19 – ECB publishes speech to Economic and Monetary Affairs Committee

1 July 2021 – The Chair of the Supervisory Board of the European Central Bank (ECB), Andrea Enria, has delivered a speech at the European Parliament's Economic and Monetary Affairs Committee on the ECB's response to the COVID-19 crisis. Key takeaways include:

- credit risk continues to be a priority, as it has been since the start of the pandemic in early 2020;
- banks have proved to be resilient so far. They have robust capital positions and their profitability recovered in the second half of 2020 and the first quarter of 2021;
- there is still some uncertainty about how the pandemic will evolve. The recovery, and thus the economic impact of the pandemic, may be uneven across sectors and countries, and this could have consequences for bank balance sheets;
- while most banks' positions are fully or broadly in line with the ECB's expectations, certain banks, including some that now have fairly low levels of credit risk, need to address significant gaps in their risk control frameworks. These frameworks are the most important safeguard against a significant deterioration in asset quality in the future. The main areas for attention are the classification of loans, particularly when there is a significant increase in credit risk; adequate forbearance measures; and the timely and adequate assessment of borrowers' unlikeliness to pay;
- some banks started to reduce provisions in the first quarter of 2021 and take on more risks by increasing their leveraged lending activities. Very low credit quality leaves the market vulnerable to further shocks, including sudden asset repricing. These are areas of potential concern and the ECB is considering possible supervisory measures to ensure that banks take a prudent approach;
- in the absence of materially adverse developments, the ECB plans to repeal its recommendation on dividends as of the end of Q3 2021 and return to reviewing dividends and share buybacks as part of its normal supervisory process, based on a careful forward-looking assessment of each bank's individual capital planning (see item below in this section); and

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- as previously communicated, the ECB will allow banks to operate below Pillar 2 Guidance and the combined buffer requirement until at least the end of 2022.

The ECB has also continued to harmonise the supervisory approach at the European level in three other key areas:

- it has published a consultation on supervisory options and discretions available under EU law and how these are exercised by European supervisors;
- the ECB has launched a consultation on its draft revised guide to fit and proper assessments and the new fit and proper questionnaire; and
- the ECB is currently benchmarking banks' self-assessments against its supervisory expectations on climate-related and environmental risks. A full supervisory review, as well as a specific stress tests focusing on climate risk, will then follow in 2022.

Finally, Mr Enria stressed the importance of completing the banking union as a necessary condition for reaping the maximum benefits of a fully integrated banking market.

Speech

Climate-related risk and financial stability – ECB and ERSB publish joint report
1 July 2021 – The ECB and the European Systemic Risk Board (ESRB) have published a joint report on climate-related risk and financial stability that takes a closer look at how a broadened set of climate change drivers affects millions of global firms and thousands of financial firms in the EU.

The report maps out prospective financial stability risks and develops the analytical basis for more targeted and effective policy action. It establishes a detailed topology of physical and transition risks arising from climate change across regions, sectors and firms. It also applies a scenario analysis with long-dated financial risk horizons to capture prospective financial losses resulting from untimely and ineffective climate policies and technologies.

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Three climate scenarios drawn from the Network for Greening the Financial System are explored in the report, examining both physical and transition risk drivers as well as assumptions on climate technologies. The report's granular mapping of financial exposures to climate change drivers identifies the following forms of risk concentration:

- exposures to physical climate hazards are concentrated at the regional level. Around 30% of the euro area banking sector's credit exposures to non-financial companies are to firms subject to a combination of physical hazards such as flooding, wildfires, heat and water stress;
- exposures to emission-intensive firms are concentrated across and within economic sectors. For example, exposures to highly emitting firms represent 14% of collective euro area banking sector balance sheets; and
- exposures to climate risk drivers are concentrated in specific European financial intermediaries. Approximately 70% of banking system credit exposures are to firms subject to high, or increasing, physical risk over the coming decades and are expected to be concentrated in the portfolios of only 25 banks.

The ECB and ESRB highlight the consistent finding that credit and market risk losses for EU banks, insurers and investment funds could arise from untimely or ineffective climate transition. In addition, where there has been notable progress in measuring and modelling climate related risk, much remains to be done, particularly in relation to the adequacy of reported data. The variability of climate-related disclosures among financial institutions suggests refinements will be needed as progress is made to address data gaps and obtain more complete data. Ultimately, the transmission of risks to the financial system and its prospective timing must be better understood.

Report: Climate-related risk and financial stability
Data supplement
Press release

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Climate-related risk and financial stability – ECB presents action plan to include climate change considerations in its monetary policy strategy

8 July 2021 – The Governing Council of the ECB has decided on an all-embracing action plan, with a roadmap to systematically reflect environmental sustainability considerations in its monetary policy. The ECB will further incorporate climate change considerations into its policy framework and increase its contribution to addressing climate change by this action plan, in line with its obligations under the EU Treaties.

The recently established ECB climate change centre will coordinate the activities that are relevant for the purpose of the action plan within the ECB, in close cooperation with the Eurosystem. These activities will focus on the following areas:

- Macroeconomic modelling and assessment of implications for monetary policy transmission;
- Statistical data for climate change risk analyses;
- Disclosures as a requirement for eligibility as collateral and asset purchases;
- Enhancement of risk assessment capabilities;
- Collateral framework; and
- Corporate sector asset purchases.

The decision follows the conclusion of the 2020-21 strategy review, in which the reflections on climate change and environmental sustainability were of central importance.

Press release
Detailed roadmap of climate change-related actions

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A digital euro – The ECB decides to launch the investigation phase of a digital euro project

14 July 2021 – The Governing Council of the ECB has decided to launch the investigation phase of its digital euro project, following the publication of its report in late 2020 and input from a number of stakeholders. The investigation phase will last 24 months and aims to address key issues regarding the design and distribution of a digital euro. During the investigation phase, the Eurosystem will focus on a possible functional design that is based on users' needs and prioritise the use cases that are a matter of priority, namely a riskless, accessible and efficient form of digital central bank money. The investigation will also assess the possible impact of a digital euro on financial markets, financial stability and monetary policy and identify the design options that will ensure privacy and avoid risks for euro area citizens, intermediaries and the overall economy. Furthermore, it will define a business model for supervised intermediaries within the digital euro ecosystem.

Press release
Report on a digital euro

COVID-19 – ECB returns to a bank-by-bank assessment of capital and distribution plans

23 and 29 July 2021 – A recommendation by the ECB (ECB/2021/31) repealing its earlier recommendation (ECB/2020/35) on dividend distributions by banks during COVID-19 has been published in the Official Journal of the EU and will take effect from 30 September 2021.

In an accompanying press release, the ECB notes that the latest macroeconomic projections suggest an improvement in the reliability of banks' capital trajectories. It adds that "supervisors are well prepared to go back to the previous supervisory practice of discussing capital trajectories and dividend or share buy-back plans with each bank in the context of the normal supervisory cycle". Supervisors will take a forward-looking view in their assessment of banks' capital trajectory and distribution plans, taking into account the results of the 2021 stress test and credit risk practices. The ECB is asking banks to adopt a prudent and forward-looking approach when deciding on remuneration policies.

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The ECB has also published an updated version of its FAQs on the supervisory measures it has taken in response to the COVID-19 pandemic.

Recommendation repealing Recommendation ECB/2020/62 (ECB/2021/31)
Updated FAQs
Press release: ECB decides not to extend dividend recommendation beyond September 2021

TARGET Services – Eurosystem accepts conclusions of independent review and will implement recommendations

28 July 2021 – The ECB has published a response from the Eurosystem to an independent review of incidents affecting TARGET Services (particularly TARGET2 and TARGET2 Securities) between May and November 2020.

The ECB has also released an abridged and redacted excerpt from the independent review's report. Several weaknesses have been identified, including in relation to business continuity management, recovery testing and communication protocols in crisis situations. Based on these findings, a number of recommendations have been made.

The Eurosystem has accepted the recommendations as well as the report's general conclusions. The ECB has also published an accompanying letter to the European Parliament's Economic and Monetary Affairs Committee in which it commits to keeping the Parliament and the wider public informed about progress in the implementation of the recommendations.

Letter: Independent review of TARGET incidents in 2020 and the Eurosystem's response
Deloitte: Report on the external review of TARGET services in the context of the incidents in ECB: Response of the Eurosystem as operator of TARGET Services to the external review carried out by Deloitte on the incidents that affected TARGET Services in 2020
ECB: Response of the Eurosystem as operator of TARGET Services to the external review carried out by Deloitte on the incidents that affected TARGET Services in 2020
Press release

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EU-side stress test – EBA and ECB publish results

30 July 2021 – The European Banking Authority (EBA) and the ECB have published the results of their respective 2021 EU-wide stress tests for banks. These sought to compare and assess the resilience of EU banks and the EU banking system to shocks, and to challenge the capital position of EU banks.

The EBA, drawing on data from 50 banks from 15 EU and EEA countries, found that under a very severe scenario the EU banking sector would stay above a common equity tier 1 (CET1) ratio of 10% with a capital depletion of EUR 265 billion against a starting CET1 ratio of 15%. The stress test was characterised by an adverse scenario that assumed a prolonged COVID-19 scenario in a "lower for longer" interest rate environment

The ECB, looking at data from 38 banks in the EBA sample, and a further 51 medium-sized ECB-supervised banks, found that the average final CET1 ratio for the 89 banks under a three-year adverse scenario is 9.9%, down 5.2 percentage points from a starting point of 15.1%. From this, the ECB concludes that the supervised euro area banking system is resilient to adverse economic developments, and found that the main drivers of capital depletion are credit risk, market risk and income-generation capacity.

EBA: Report: 2021 EU-wide stress test
Press release
Summary
FAQs
ECB: SSM-wide stress test
Press release
FAQs
Data

NEWS FOR THE SINGLE SUPERVISORY MECHANISM (SSM)

[No relevant items].

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NEWS FOR THE SINGLE RESOLUTION MECHANISM (SRM)

CRR – SRB publishes guidance on approach to permissions for reduction of eligible liabilities

28 July 2021 – The Single Resolution Board (SRB) has published guidance on its approach to prior permissions for eligible liabilities under the Capital Requirements Regulation (575/2013/EU) (CRR). The SRB has, to date, applied a provisional procedure to assess and approve banks' applications for the redemption of eligible liabilities. It intends to amend that process in line with the relevant draft RTS, published by the EBA on 26 May 2021, for all permissions effective as of 1 January 2022 (that being the deadline for firms to comply with the intermediate minimum requirement for own funds and eligible liabilities (MREL) targets set under the Single Resolution Mechanism Regulation (806/2014/EU) (SRM Regulation)).

An additional communication on the new regime will be published in early September. The European Commission will finalise the draft RTS by adopting them in the form of a delegated regulation in due course, although for procedural reasons this is unlikely to be achieved by January 2022.

Guidance: Information requirements for applications for permission in line with the draft RTS on own funds and eligible liabilities, Section 2 Subsection 2 – 'Permission for reducing eligible liabilities instruments'
Webpage
Press release

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MREL – SRB publishes its MREL dashboard covering the reporting period Q1.2021

26 July 2021 – The Single Resolution Board (SRB) has published its minimum requirement for own funds and eligible liabilities (MREL) dashboard which covers the reporting period of the first quarter of 2021.

The main findings of the dashboard were:

- In percentage of the total risk exposure amount (TREA), the average BRRD2 MREL target including the combined buffer requirement (CBR) stood at 26.1% of the TREA;
- The average MREL shortfall, including the CBR, reached 0.60% TREA which equals EUR 42.2 billion. It remained stable with respect to the fourth quarter of 2020 (+0.01% TREA), while it increased in absolute values by EUR 2.2 billion;
- In the first quarter of 2021, the MREL issuances amounted to EUR 76.3 billion, which is equal to 1.1% TREA, increasing by EUR 31.8 billion with respect to the previous quarter. However, it remains 17% below the level registered over the same period of the previous year; and
- In the second quarter of 2021, the funding costs remained stable around pre-pandemic levels.

Press release
MREL Dashboard – Q1.2021

European Commission v Landesbank Baden-Württemberg (Joined Cases C-584/20 P and C-621/20 P) (EU:C:2021:601)

Single Resolution Fund – 2017 ex-ante contributions – authentication of a decision of the Single Resolution Board – obligation to state reasons – confidential data - The European Court of Justice (ECJ) has considered an appeal brought by the European Commission and the SRB against a decision of the General Court concerning the calculation of the 2017 ex-ante contributions to the Single Resolution Fund (SRF), and the legality of provisions in Commission Delegated Regulation (EU) 2015/63.

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Landesbank Baden-Württemberg, a German credit institution, brought an action to annul the SRB's decision concerning these contributions. In September 2020, the General Court annulled the SRB's decision, concluding that provisions in Articles 4 to 7 and 9 and in Annex I of the Commission Delegated Regulation were illegal, on the grounds that the method of calculation specified in them meant that the SRB was not in a position to give verifiable and reviewable reasons for the individual burdens imposed on an institution.

The ECJ has set aside the General Court's judgment. It has annulled the SRB's decision on the ground that the SRB's statement of reasons was inadequate, although it has taken a different approach from that of the General Court concerning the scope of the requirement to state the reasons for the decision. It has concluded that the obligation to state reasons is fulfilled where the institution concerned by a decision fixing ex ante contributions to the SRF has been provided with: (i) the method of calculation used by the SRB; and (ii) sufficient information to understand, in essence, how their individual situation has been taken into account for the purposes of the calculation. That is the case even if the institution has not been provided with confidential data relied on by the SRB in making the calculation.

However, the ECJ has not upheld the General Court's finding on the illegality of the provisions in the Commission Delegated Regulation. Instead, it has concluded that the provisions do not prevent the SRB from disclosing, in collective and anonymised form, sufficient information to enable an institution to understand how its individual situation has been taken into account in making the calculation.

Commission v Landesbank Baden-Württemberg and Single Resolution Board, Judgment of the Court (C-584/20 P and C-621/20 P)
Press release

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We have unrivalled coverage of regulatory developments in the EU, which enables us to provide pure regulatory advice on the interpretation and application of EU directives and regulations. We also have strong connections with the best financial institutions lawyers in the United States, Asia and South America.

Our many years of experience of advising a diverse range of major financial institutions allows us to offer the most incisive advice available.

If you would like to discuss any of the developments in this update, or any other financial regulatory matter, please contact one of the following or your usual EFIG contact.

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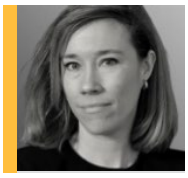

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