The consequences of ECB supervision – a challenge in at least three dimensions

As of the 4th of November 2014, the European Central Bank 'ECB' assumes responsibility for supervision of all European credit institutions. We are convinced that the Comprehensive Assessment as well as ECB's supervisory approach will serve as game-changers for Europe's banks, influencing strategy and business models, data and IT-infrastructure, processing and risk modeling.

Subsequently, we have brought together a strong team of experts in Frankfurt – KPMG's ECB Office. The ECB Office combines skills in all those topics as well as the different national experiences, copying the multinational approach of ECB's JSTs. Our Frankfurt-based ECB Office is backed by the KPMG's world-wide network and experience.

Supervision by ECB is a game-changer in at least interconnected three dimensions.

Firstly, the international structure of the supervisory teams is shaped by the different nationalities, languages and histories. While the 'melting pot' of nationalities and histories of the new supervisory teams undoubtedly creates uncertainty for banks, the first fundamental question of language is – at the time this is being writing – still unresolved in many institutions: Banks, directly supervised by the ECB have to deal directly with the aforementioned international supervisory teams. The question is, in which language supervisors and bankers will communicate in future?

Secondly, the impact of the supervisory model as the "focal point" in which the various national supervisory approaches concentrate cannot be underestimated. Banking supervision, previously open to varying national interpretations, will now operate not only under a single rule book, but will also be applied by a single authority. The initial signs of this new culture emerged over the summer during the Comprehensive Assessment, where many banks were challenged by the move towards the centrally established requirements. However, this was just a taste of things to come. The "Pillar 2 supervision", or Supervisory Review and Evaluation Process (SREP), is at the very heart of the single supervisory approach and deserves a deeper analysis. Pillar 2 supervision was introduced by Basel II in 2006. As of today, it still has not been harmonized within the EU but transposed via different national laws. However, the ECB, as Europe's new single supervisor, needs a harmonized SREP approach from 2015 onwards. The EBA draft guideline - published in July 2014 – aims to meet this need for harmonization and provide useful insights into ECB's future behaviour. Two of the most important new elements of the new SREP are a comprehensive review of a bank's business model and supervisory challenger models of a bank's capital and liquidity adequacy.

Thirdly, the on-going supervision of a credit institution is embedded into the horizontal functions – i.e. analysis across all banks – by the ECB. One horizontal function is the supervisory planning process, which defines a concrete supervisory examination schedule. While it is too early to say with certainty, KPMG expects a comprehensive review of risk weighted assets (RWA) to be high on the agenda of the ECB's next year supervisory schedule. This exercise would be a good complement to the Asset Quality Review (AQR) and it fits perfectly into the supervisory attitude of the European Banking Authority (EBA) and Basel Committee on Banking Supervision (BCBS), questioning the outcome of internal models. →

→ The second horizontal function is a rigorous risk analysis complementing the bank oriented bottom-up analysis, for instance, assessing systemic or sector-specific risks. We believe this element will lead to an increasing demand for flexible data delivery by banks. The ECB has the possibility and the infrastructure in place to perform horizontal analysis and to implement a truly forward-looking supervision. The requests during AQR and stress tests had been only the beginning of data demands.

The consequences of failure to adapt

The regulation establishing the ECB as the European Union's banking supervisor transfers not only the responsibility for day-to-day supervision to the ECB, but also a wide range of supervisory actions and sanctions.

Banks which fail to adapt quickly to the aforementioned challenges run the risk of earning low supervisory "scores" which in turn may lead to supervisory actions, such as capital, or liquidity add-ons. Furthermore, the ECB has the right to use "structural measures", derived from bank-recovery regulations. These measures allow the ECB to intervene in a bank's organization or business model.

The immediate implications

First of all, we recommend that all credit institutions under the supervision of the ECB perform a rigorous self-assessment of the different SREP-analysis steps, accompanied by a proper documentation.

Secondly, and to be in the position to service the increasing data demands of the ECB, a bank needs a technical infrastructure which is both flexible enough to allow for changing requests, but is well-enough embedded in the compliance infrastructure to facilitate periodic exercises such as supervisory stress tests.

Last but not least, KPMG recommends that all banks become familiar with the new supervisory culture as soon as possible. This implies a two-tier strategy of communication: First, to the "old" national supervisory authority, and second towards the new central supervisor in Frankfurt. Especially during the transition period, banks should be prepared to explain the use of the historic discretionary decisions in the supervisory rulebook they have developed in liaison with the national supervisor. A logbook, listing the decisions and the correspondence with the national supervisor, may facilitate such discussions.

The consequences in the medium term

Firstly, we have a new Pillar 2 supervision leading to a holistic supervisory view, backed by rigorous quantitative analysis. Secondly, we see a strong horizontal function – strong from an intellectual as well as from a technical point of view – with the capabilities to analyse Big Data. Thirdly, we recognize a demand for data which requests loan-by-loan, security-by-security, line-item-by-line-item information, thus changing the information of the supervisor fundamentally.

This supervisory set-up – together with the capability and willingness of the ECB to use its supervisory powers – leads us to the conclusion that supervision by the ECB will influence the whole value chain of banks: It will influence the business model, the technical infrastructure, the processes as well as the risk strategy of banks.

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