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KPMG's European Central Bank Quarterly Update

May 2017

Welcome to our early summer edition of the ECB Update. The opening months of 2017 have seen a number of initiatives by the ECB and national supervisors - closely monitored and analysed by KPMG's ECB Office.

As always, this newsletter aims to highlight coming changes. Just as importantly, it identifies their potential effects on financial institutions' strategies and operations. In this edition we take a close look at five areas:

- The ECB's push to harmonize the supervision of less significant institutions;
- The ECB's potentially far-reaching adoption of cultural and behavioural supervision;
- The questions that Brexit poses for the supervision of Euro-denominated financial markets;
- The ECB's proposed new guidance on banks' approach to the ICAAP and ILAAP processes and
- The ECB published the final guidance to banks on leveraged transaction.

We have also recently published a detailed report on a perennial topic of interest to the ECB: Non-performing loans in Europe: what are the solutions? So why have NPLs remained stubbornly high in some banks and some countries? In this paper we highlight four key impediments for this, click here to view the paper.

On May 11, 2017 The European Banking Authority (EBA) issued the final Guidelines on ICT Risk Assessment that aim to promote common procedures and methodologies for information and communication risk assessments as part of the annual SREP process. The guidelines will apply from 1 January 2018 and we expect the ECB to apply them in the 2018 SREP process. Click here to read the final report.

On May 15, 2017 European Central Banking Authority (ECB) published the final guide to fit and proper assessments. The guide clarifies criteria and process for determining suitability of banks' board members and helps banks to comply with ECB Banking Supervision's policies. Click here to read the guide.

On 16 May 2017 the ECB has published its guidance to banks on leveraged transactions. The final definition of leveraged transactions according to ECB is now: The credit institution is expected to consider as a leveraged transaction any transaction that meets at least one of the conditions below:

1. All types of loan or credit exposure where the borrower's post-financing level of leverage exceeds a Total Debt to EBITDA ratio of 4.0 times
2. All types of loan or credit exposures where the borrower is owned by one or more financial sponsors. For more details and the exclusions please refer to our article.

Excluded from this definitions are, amongst others, only transactions below EUR 5m, loans to SMEs, loans to investment-grade borrowers and certain exposure types. We believe that in particular global banks with significant corporate loan portfolios will struggle to implement the new guidance.

The European regulatory landscape is constantly evolving. We hope this Update will help readers to stay on top of ongoing changes and to identify what's around the corner.

LSIs: Fast becoming significant

National approaches to the supervision of less significant institutions (LSIs) have remained uneven during the SSM's first two years. While retaining its focus on proportionality, the ECB is pushing for more harmonized supervision of significant and less significant institutions. This is a fast evolving area, pushed and further complicated by Brexit. LSIs need to be aware of the potential effects of this supervisory convergence and factor them into their strategic planning.

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Culture shock: A new approach to supervision

The ECB is planning a new aspect of supervision, focused on organisational behaviour. This is expected to build on DNB's approach, which emphasises the importance of an ethical, effective culture. Supervisors and banks alike face a steep learning curve. Banks may find the new approach unsettling, but those that embrace the process have nothing to fear - and could reap significant value.

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Brexit: Is banking only the start?

The debate over Brexit is focusing on 'new' EU-27 banking subsidiaries that will require supervision. However, London's strength in Euro trading means that financial market supervision could be a greater challenge. There is no single EU financial market supervisor to ensure a level EU-27 playing field – and limited political appetite to address the challenge. In our view, a compromise solution between the EU-27 and UK is the most likely outcome.

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ICAAP + ILAAP = ICLAAP?

The ECB is developing new guidance aimed at harmonising European banks' approaches to their ICAAP and ILAAP processes. The new guidance is based on seven key principles and is expected to enter full force within two years. It will have a varying impact on different banks, but all are likely to require significant changes to their internal processes and reporting requirements. Management boards will also be expected to take full responsibility. Given the short timeframe, banks need start planning their responses now.

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Leveraged Finance – Final ECB guidance

On 16 May 2017, the ECB has published its guidance to banks on leveraged transactions. In comparison to the draft guidance (click here to view), the guidance makes some amendments to definitions. SME, sovereign and investment grade lending are now excluded from leveraged transactions. Even so, it makes few other concessions to banks' concerns. For example, the € 5 million threshold remained unchanged. Significant Institutions now have a limited window to implement the guidance and report back to supervisors. Banks need to address these new requirements sooner rather than later.

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Further insights

Non-performing loans in Europe: What are the solutions?

Many banks across Europe suffer from high levels of non-performing loans (NPLs), in particular in Cyprus, Greece, Portugal, Ireland, Italy and some Central and Eastern European countries. NPLs across the euro area peaked at eight percent of total loans in 2013 and have fallen only gradually in some countries since then. NPLs consume capital, management time and attention. They decrease profitability and leave some banks in a weak position from which to provide finance to support growth and jobs – which in turn may limit the effectiveness of monetary policy. They may even undermine the viability and sustainability of a bank. So why have NPLs remained stubbornly high in some banks and some countries? In this paper we highlight four key impediments for this: banks' lack of preparedness, structural impediments, investor pricing, and limitations on government assistance. Find the report here.

The nexus between regulation and technology innovation

The FS Regulatory Centre of Excellence (CoE) are pleased to launch the first in a series of papers from our Global RegTech leaders – The nexus between regulation and technology innovation – which helps firms to understand where and how they can maximise the benefits and value of RegTech. Find the report here.

Useful Links

- Non-performing loans in Europe: what are the solutions?
- The nexus between regulation and technology innovation
- Contact the ECB Office: de-ECB-Office@kpmg.com
- Visit KPMG's ECB Office online

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