Danièle NOUY
Chair of the Supervisory Board

COURTESY TRANSLATION

Mr Marco Zanni
Member of the European Parliament
European Parliament
60, rue Wiertz
B-1047 Brussels

Frankfurt am Main, 22 March 2017

Re: Your letter (QZ017)

Honourable Member of the European Parliament, dear Mr Zanni,

Thank you for your letter on the issue of Level 3 asset supervision under the Single Supervisory Mechanism, which was passed on to me by Mr Roberto Gualtieri, Chairman of the Committee on Economic and Monetary Affairs, accompanied by a cover letter dated 1 March 2017.

Level 3 assets are financial instruments whose fair value cannot be determined directly by reference to market-observable information and therefore requires the use of other pricing techniques. Such assets can include complex (OTC) derivatives, illiquid asset-backed securities, distressed debt, commercial real estate loans and municipal bonds.

In ECB Banking Supervision, we obviously recognise and address the complexity in the valuation of Level 3 assets, including derivatives, and have adopted a supervisory approach that promotes thorough supervision and understanding of these products.

Fair value exposures, including Level 3 fair value exposures, were examined by ECB Banking Supervision in the context of the asset quality review (AQR) carried out in 2014. This review of fair value exposures – including in relation to Level 3 assets – led to much smaller adjustments to asset carrying values than did the review of credit files and collective provisioning. Out of a total adjustment to asset carrying values of €47.5 billion, only €4.6 billion resulted from the review of Level 3 fair value exposures, whereas the larger element of the adjustment, i.e. €42.9 billion, resulted from additional provisions related to the review of credit files and collective provisioning. In addition, the AQR led to an increase in stocks of non-performing exposures (NPEs) by €135.9 billion across the institutions subject to the AQR process, as NPE definitions were harmonised and made comparable.

Based on the outcome of that assessment, ECB Banking Supervision identified the area of credit risk as a supervisory priority for both 2015 and 2016 and made considerable progress during that period. Joint supervisory teams (JSTs) have ensured the effective and consistent implementation of remedial measures initiated under the AQR, reviewed banks' provisioning practices, and conducted a thematic review with a specific focus on leveraged finance. In addition, ECB Banking Supervision has published guidance aimed at supporting banks in effectively addressing non-performing loans (NPLs).

Despite this progress, a considerable amount of work remains to be done with regard to NPLs, and in the area of credit risk as a whole. As at the end of the third quarter of 2016, the stock of NPLs across a sample of 122 significant institutions stood at €921 billion[1], which is several times higher than the total stock of Level 3 assets held by euro area banks. As I have publicly emphasised on a number of occasions, resolving this issue will be a long process and will require the combined efforts of supervisors and public authorities across Europe. Against this background, ECB Banking Supervision continues to list credit risk and NPLs among its supervisory priorities for 2017, together with business models, profitability drivers and risk management.

Nevertheless, ECB Banking Supervision is also giving due supervisory attention to risks posed by Level 3 assets. The supervisory priorities are by no means an exhaustive list of supervisory activities, and a broad set of activities is carried out by JSTs and on-site inspection teams on an ongoing basis.

In cases where Level 3 assets are material for specific banks, we continue to devote significant attention to potential valuation issues through both our off-site and on-site supervisory processes. The Supervisory Review and Evaluation Process (SREP) methodology explicitly captures Level 3 assets within the scope of the assessment of market risk. Based on an institution's individual risk profile, the relevant JST investigates market risk aspects on a recurring basis and is equipped with a set of indicators allowing it to assess and address the complexity of market activities.

In addition to the activities carried out at bank-specific level, we also keep track of the larger picture. The SREP includes a broad set of horizontal analyses which compare key indicators and supervisory assessments across all banks supervised directly by ECB Banking Supervision.

These tools enable us to assess the level of risk posed by holdings of Level 3 assets, both at the bank-specific and sector-wide levels, and to react accordingly – bearing in mind that Level 3 assets also directly impact any potential G-SIB surcharge as a function of a bank's complexity. With these tools, we can also ensure that our SREP decisions are well-balanced and consistent across all banks and countries supervised at the European level.

Yours sincerely,

[signed]

Danièle Nouy

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1 See "Table T03.05.1 Asset quality: non-performing loans and advances by reference period", in European Central Bank (2016), *Supervisory Banking Statistics, third quarter 2016*, p.70, available at https://www.bankingsupervision.europa.eu/banking/statistics/html/index.en.html