EUROPEAN CENTRAL BANK

BANKING SUPERVISION

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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, 8 May 2018

Re: Your letter (QZ-029)

Honourable Member of the European Parliament, dear Mr Zanni,

Thank you for your letter on non-performing loans (NPLs), 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 26 March 2018.

High levels of NPLs weigh on banks' performance and profitability and ultimately have a negative impact on banks' lending to the economy. To address the problem of NPLs, the European Central Bank (ECB) set out a number of best practices in its Guidance to banks[1] published in March 2017. As explained in my recent letter of reply to MEP Carthy[2], the ECB has not imposed specific reduction targets and has not expressed a preference for certain NPL reduction tools, such as the sale of NPLs, over others.

Regarding the ECB's NPL Addendum[3], the aim is to avoid the accumulation of new NPLs by fostering timely provisioning practices. It is important to note that the Addendum indicates, for the sake of transparency, what the ECB expects from banks when they assess their risk exposures; and it serves as a starting point for our supervisory dialogue with the banks on whether they have made adequate and timely prudential provisions for NPLs.

Any assessment of the potential impact of the Addendum on individual banks would require making assumptions on a number of highly uncertain parameters regarding the future NPL inflows, the efficiency of future workout and legal procedures, the revision of banks' credit underwriting criteria, also taking into account the evolution of the economic context.

Concerning your question on quantitative supervisory expectations with regard to illiquid securities and derivatives, it must first be highlighted that the relative importance of fair value assets and liabilities (for level

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1 See "Guidance to banks on non-performing loans" available on the ECB Banking Supervision website: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/guidance_on_npl.en.pdf

2 Available on the ECB Banking Supervision website: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.mepletter180321_Carthy.en.pdf

3 See "Addendum to the ECB Guidance to banks on non-performing loans: supervisory expectations for prudential provisioning of non-performing exposures" available on the ECB Banking Supervision website: https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.npl_addendum_201803.en.pdf

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1, 2 and 3 combined) has decreased markedly for significant institutions over the last three years, from more than 30% of total assets (and 20% of liabilities) to around 23% of total assets (and 14% of liabilities). In particular, Level 3 assets decreased from €188 billion to €132 billion (significantly less than 1% of total assets). Level 3 liabilities remained stable, although they represent a lower share of the balance sheet than Level 3 assets.

While Level 2 and Level 3 exposures may give rise to valuation uncertainties, the nature of the related risks is different from those of NPLs. Level 2 and Level 3 exposures are performing, and their classification as Level 2 or Level 3 is not an indication of poor quality.

The Single Supervisory Mechanism (SSM) has been assessing the robustness of banks' valuation practices with a view to promoting awareness of the inherent risks and the application of prudent valuation and risk management approaches, thereby applying the full set of our supervisory instruments. The SSM has thus dedicated significant resources to this issue since its inception, beginning with the asset quality review as part of the 2014 comprehensive assessment. That assessment was the starting point for identifying potential issues with banks' valuation and classification approaches and prompted a first set of targeted remedial action plans. We have subsequently increased our efforts, not least through a combination of enhanced monitoring, "deep dives" and on-site inspections. Those inspections evaluate the soundness and effectiveness of the valuation framework and the controls over the pricing models that are used to produce fair values. The missions have a particular emphasis on the correct assignment of the positions to the fair value hierarchy and include the testing of specific transactions. (Namely, sample analyses of specific transactions are performed, with the aim to review the concrete implementation of the institutions' policies and procedures, assess the observability of market data sources and hence the adequate assignment of the positions measured at fair value).

In scope are banks with major trading operations, but also other institutions that exhibit elevated fair value exposures relative to their size and given their specific business models. This concerns in particular equity investments and debt instruments outside the derivative space, where Level 3 positions can also be significant.

Moreover, level 2 and Level 3 positions consist, to a large degree, of hedging and client-related transactions providing financial services to the real economy and satisfying a demand from various economic agents. Our supervisory objective is to ensure that banks focus their activities on structuring and delivering instruments that produce value-added for clients, and that the resulting positions are valued, managed and controlled in an appropriate manner. In this sense, our attention will continue to focus on the effectiveness and reliability of banks' control processes, such as classification under the fair value hierarchy in compliance with relevant regulations, and the correctness of the concomitant profit and loss recognition, in particular but not exclusively at inception of those transactions, as well as on related governance structures, such as well-functioning new product approval procedures.

Yours sincerely,

[signed]

Danièle Nouy