Banking prudential regulatory bulletin

PwC Ireland

Q1 2023

Executive summary

Welcome to latest edition of the Banking prudential regulatory bulletin which covers key updates within the industry. A number of significant developments occurred in first quarter of the 2023, including the following:

- The European Central Bank (ECB) published its supervisory priorities for 2023 - 2025, which will form the basis of the ECB's supervisory activity for the next three years. The strategic priorities include strengthening resilience to immediate macro-financial and geopolitical shocks, addressing digitalisation challenges and strengthening governance capabilities, and stepping up efforts to address climate change.
- The European Banking Authority (EBA) quarterly risk dashboards show that European Union (EU) banks maintain robust capital and liquidity ratios and the non-performing loan (NPL) ratio declined slightly to just below 1.8% in the first quarter. However, banks' asset quality expectations have further deteriorated, notably for SME and consumer finance.
- A number of important public consultations have been issued, including on new market risk internal models under FRTB and supervisory reporting with respect to IRRBB.
- A 'Dear CEO Letter' was issued in March to Investment Firms, outlining the best practices and key findings identified from targeted reviews of Control Frameworks and Risk Appetite Statements (RAS). Firms should be aware that the CBI requires this letter to be discussed at the next Board meeting, and for the discussion to be recorded in the meeting minutes.
- Finally, on sustainability and climate risks, the EBA has issued an Opinion to the European Commission on the draft European Sustainability Reporting Standards and the ECB and the European Supervisory Authorities (ESAs) call for enhanced climate-related disclosure for structured finance products.

We hope you enjoy reading this quarters edition.

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Prudential regulatory developments

Capital and liquidity

EBA publishes its annual quantitative monitoring report on minimum requirement for own funds and eligible liabilities complemented by a related impact assessment

In January, the EBA published its annual quantitative report on minimum requirement for own funds and eligible liabilities (MREL) with data as of December 2021. The report is complemented by an analysis looking into the impact of the MREL framework on a number of relevant dimensions. As of 31 December 2021, the EBA estimated that 70 banks reported an MREL shortfall of €33 billion out of a sample of 245.

This is down by 42% compared to last years' quantitative report on MREL on a comparable basis. The report shows progress in closing MREL shortfalls, albeit at a lower rate for smaller banks, and concludes that the impact of MREL on banks' profitability is manageable, although heterogeneous across types of banks and Member States.

The liquidity coverage ratio of EU banks declined in the first half of 2022 but is still well above the minimum requirement

In January, the EBA published its report on liquidity measures, which monitors and evaluates the liquidity coverage requirements currently in place in the EU. The liquidity coverage ratio (LCR) declined to 166% in June 2022. The fall was due to an increase in outflows driven by higher interest rates and volatility which led to a decline in asset prices during the first half of the year. The evolution of banks' LCR levels is particularly relevant given the uncertain economic outlook with high levels of inflation and the process of normalisation of the monetary policy.

EU banks hold materially lower liquidity buffers in foreign currencies, particularly the USD, which requires enhanced monitoring by banks and supervisors to avoid excessive vulnerability to disruptions in the foreign exchange markets.

EBA Risk Dashboard shows that capital and liquidity ratios remain robust

In January, the EBA published its quarterly Risk Dashboard together with the results of the autumn edition of the Risk Assessment Questionnaire (RAQ). This dashboard highlighted that:

- Overall, banks maintain robust capital and liquidity ratios;
- The average Common Equity Tier 1 (CET1) ratio declined slightly to 14.8% from 15% in the previous quarter on a fully loaded basis;
- The average Liquidity Coverage Ratio (LCR) reached 162.5% (164.9% in Q2 2022) while the average Net Stable Funding Ratio (NSFR) remained at 126.9%;
- The non-performing loan (NPL) ratio declined slightly to just below 1.8%. However, banks' asset quality expectations have further deteriorated, notably for SME and consumer finance.

EBA updates some important Q&As in the area of own funds and eligible liabilities

In February, the EBA updated some of its existing Q&As on own funds and eligible liabilities to ensure consistency with the revised final draft Regulatory Technical Standards (RTS) on own funds and eligible liabilities to provide clarity to institutions and market participants.

In particular, the EBA updated Q&A 2017_3277 on the notion of 'sufficient certainty' which relates to when an institution has to deduct from its own funds the amounts for which it has received a prior permission from the competent authority. The EBA has amended the Q&A as follows:

"when exercising a call option contained in the terms and conditions of an instrument, sufficient certainty is deemed to exist only at the time of the announcement of the call to the holders of the instrument, and the corresponding deduction will take place only at that point in time. The revised approach has benefitted from exchanges with market participants and is deemed to bring more clarity and convergence in existing practices. In addition, the revised Q&A extends the scope of the treatment to eligible liabilities instruments."

Basel III capital ratios for largest global banks fell to pre-pandemic levels in H1 2022, latest Basel III monitoring exercise shows

In February, the Basel Committee on Banking Supervision (BCBS) published it's Basel III Monitoring Report. The report outlines that:

- The capital ratios for a sample of the largest global banks decreased from their record highs in H2 2021 to pre-pandemic levels in H1 2022, according to the latest Basel III monitoring exercise, based on 30 June 2022 data;
- The leverage ratio fell on average across all regions, after showing some volatility during the pandemic period;
- The dividend payout ratio continued its upward trend as banks no longer face restrictions in dividends that member jurisdictions introduced at the onset of the pandemic.

EBA consults on standards for supervisors assessing the new market risk internal models under the fundamental review of the trading book

In March, the EBA launched a public consultation on its draft RTS on the assessment methodology under which competent authorities verify institutions' compliance with the requirements applicable to their internal models under the FRTB rules. These RTS are part of the phase 4 deliverables of the EBA roadmap for the new market and counterparty credit risk approaches.

The consultation runs until 26 June 2023.

EBA publishes annual assessment of banks' internal approaches for the calculation of capital requirements

In March, the EBA published its reports on the annual market and credit risk benchmarking exercises conducted in 2022. These exercises aim at monitoring the consistency of risk weighted assets (RWAs) across all EU institutions authorised to use internal approaches for the calculation of capital requirements.

Regarding market risk, for the majority of participating banks, the results confirm a relatively low dispersion in the initial market valuation (IMVs) of most of the instruments, and a decrease in the dispersion in the value at risk (VaR) submissions compared to the previous exercise.

For credit risk, the variability of RWAs remained rather stable, despite the pandemic and the different banks' pace in complying with the policies set out in the EBA internal rating-based (IRB) roadmap. A particular focus has been put on analysing the impact of the pandemic and the compensating public measures on the IRB models.

Recovery and resolution

EBA asks authorities to increase transparency on their approach to bail-in in case of banking failure

In February, the EBA published its final Guidelines addressed to resolution authorities for the publication of their approach to the bail-in tool implementation. The EBA highlight that transparency and predictability are key both to the credibility of the resolution framework and to the safeguard of investors' protection.

The guidelines aim at ensuring that a minimum level of harmonised information on how authorities would effectively execute the write down and conversion of capital instruments and the use of the bail-in tool ("exchange mechanic") is made public.

SRB, EBA and ECB Banking Supervision statement on the announcement on 19 March 2023 by Swiss authorities

In March, the Single Resolution Board, the EBA and ECB Banking Supervision issued a statement welcoming the actions taken by the Swiss authorities in order to ensure financial stability.

The statement outlines that the resolution framework has established the order according to which shareholders and creditors of a troubled bank should bear losses.

In particular, common equity instruments are the first ones to absorb losses, and only after their full use would Additional Tier One be required to be written down. The statement outlines that this approach has been consistently applied in past cases and will continue to guide the actions of the SRB and ECB banking supervision in crisis interventions.

Supervisory reporting

EBA launches public consultation on the amending ITS on supervisory reporting to introduce new IRRBB reporting

In January, the EBA launched a public consultation on its draft Implementing Technical Standards (ITS) on supervisory reporting with respect to IRRBB. Proportionality is a key consideration in the proposed new reporting, in order to make reporting requirements better suited to the size and risk of the institutions.

- The consultation paper proposes new, harmonised reporting requirements for the assessment and monitoring of institutions' Interest Rate Risk in the Banking Book (IRRBB) across the EU;
- This new reporting will provide supervisors the necessary data to monitor IRRBB risks in credit institutions, taking into careful consideration the concept of proportionality.

The consultation ends on 2 May 2023.

EBA consults on the amending ITS on supervisory disclosures

In February, the EBA launched a public consultation on its draft ITS on supervisory disclosures. The amended draft ITS incorporate the changes to the EU legal framework, in particular those related to supervisory reporting and investment firms.

The draft amending ITS aim at specifying the format, structure, contents list and annual publication date of the supervisory information to be disclosed by competent authorities.

The deadline for the submission of comments was 9 March 2023.

EBA publishes Handbook on data submission for supervisory benchmarking

In March, the EBA published a Handbook on supervisory benchmarking of internal models. The Handbook is an online tool that provides guidance and links to relevant documents and information for the supervisory benchmarking to facilitate their accessibility.

In particular, the Handbook includes overviews for all applicable Q&As relevant to credit risk, market risk and IFRS 9 benchmarking. More detailed information is also provided for the key credit risk elements of the data submission. The Handbook will be regularly updated.

EBA consults on amendments to the reporting on the Fundamental Review of the Trading Book

In March, the EBA launched a public consultation on its draft ITS amending the ITS on specific reporting requirements on market risks (FRTB reporting), aiming at providing supervisors with the necessary tools to monitor these risks.

- The consultation paper expands the reporting on the FRTB approaches to the calculation of own funds requirements for market risks;
- The expanded reporting will provide supervisors with the necessary data to monitor institutions' compliance with the prudential rules.

The consultation runs until 21 June 2023.

EBA issues revised list of validation rules

In March, the EBA issued a revised list of validation rules for its reporting standards ITS, RTS and Guidelines), highlighting those which have been deactivated either for incorrectness or for triggering IT problems.

Competent Authorities throughout the EU are informed that data submitted in accordance with these reporting standards should not be formally validated against the set of deactivated rules.

ESG

EBA issues Opinion to the European Commission on the draft European Sustainability Reporting Standards

In January, the EBA published an Opinion on the draft European Sustainability Reporting Standards (ESRS) developed by the European Financial Reporting Advisory Group (EFRAG).

In this Opinion the EBA acknowledges that the draft ESRS are consistent with international standards and any other relevant EU Regulation and welcomes the level of alignment with the Pillar 3 disclosure requirements.

The EBA believes that the draft standards are a good basis for the implementation of the Corporate Sustainability Reporting Directive (CSRD), although a few aspects should deserve further consideration.

Interoperability of the draft standards with the EBA Pillar 3 disclosures, together with the data that credit institutions need from a risk management perspective, are central considerations of the Opinion.

EBA seeks input from credit institutions on green loans and mortgages

In February, the EBA launched an industry survey to receive input from credit institutions on their green loans and mortgages as well as market practices related to these loans. The purpose of the survey is to collect both quantitative and qualitative information the EBA can use to advise the European Commission. The work is part of the Commission’s Strategy for financing transition to a sustainable economy.

The deadline for the call for input ended on 19 April 2023.

Basel Committee to review recent market developments, advances work on climate-related financial risks, and reviews Basel Core Principles

In March, the BCBS met to take stock of recent market developments and risks to the global banking system and related vulnerabilities, and to discuss a range of policy and supervisory initiatives. The main topics of discuss were:

- Basel Committee to review recent bank and market developments;
- Progresses work on developing a potential bank disclosure framework for climate-related financial risks;
- Advances review of Core principles for effective banking supervision.

ECB and the ESAs call for enhanced climate-related disclosure for structured finance products

In March, the ESAs, together with the ECB, published a Joint Statement on climate-related disclosure for structured finance products. The Statement encourages the development of disclosure standards for securitised assets through harmonised climate-related data requirements.

The statement highlights that there is currently a lack of climate-related data on the assets underlying structured finance products. This poses an obstacle for the classification of products and services under the EU Taxonomy Regulation and Sustainable Finance Disclosure Regulation (SFDR) and hinders the proper assessment and management of climate-related risks.

The Statement sets out the joint efforts of the ECB and the ESAs to facilitate access to climate-related data with a view to improving sustainability-related transparency in securitisations and to promoting consistent and harmonised requirements for similar instruments.

Investment firms

Dear CEO letter on targeted reviews on control frameworks and RAS

On 29 March 2023, the CBI issued a Dear CEO Letter to all MiFID Investment Firms and Market Operators. The purpose of the Dear CEO letter was to outline the best practices and key findings identified during a series of targeted reviews of Control Frameworks and RASs across a sample of MiFID Investment Firms.

Firms should be aware that the CBI requires this letter to be discussed at the next Board meeting, and for the discussion to be recorded in the meeting minutes.

The ‘Dear CEO’ letter includes two appendices,the first of which describes good practices observed during the course of the CBI’s reviews and the second outlining the key findings from the review.

Other updates

ECB published SSM Supervisory Priorities for 2023-2025

In January, the ECB published its supervisory priorities for 2023 - 2025, based on an assessment of the main risks and vulnerabilities for supervised banks, the progress made on the priorities endorsed last year and the outcome of the 2022 Supervisory Review and Evaluation Process (SREP).

The publication includes three strategic priorities that will form the basis of the ECB's supervisory activity for the next three years, as follows:

- Strengthening resilience to immediate macro-financial and geopolitical shocks;
- Addressing digitalisation challenges and strengthening governance capabilities;
- Stepping up efforts in addressing climate change.

The EBA observed a significant increase in the number of high earners across EU banks in 2021

In January, the EBA published its Report on high earners for 2021. The analysis shows a significant increase of the number of individuals working for EU banks and investment firms who received a remuneration of more than €1 million. This increase is linked to the overall good performance of institutions, in particular in the area of investment banking and trading and sales, continuing relocations of staff from the UK to the EU and a general increase in salaries.

EBA publishes final revised Guidelines on methods for calculating contributions to deposit guarantee schemes

In February, the EBA published its final revised Guidelines on deposit guarantee schemes (DGS) contributions. The revised Guidelines further strengthen the link between the riskiness of a credit institution and how much it needs to contribute to the DGS funds that will be used to reimburse depositors in case their bank fails.

EBA launches 2023 EU-wide stress test

In January, the EBA launched the 2023 EU-wide stress test and released the macroeconomic scenarios. The EU-wide stress test will be conducted on a much larger sample compared to previous years, covering 70 EU banks and 75% of total banking assets in the EU.

The adverse scenario is based on a narrative of hypothetical heightened geopolitical tensions, with high inflation and higher interest rates having strong adverse effects on private consumption and investments, both domestically and globally. In terms of GDP decline, the 2023 adverse scenario is the most severe used in the EU wide stress up to now.

The severe nature of the adverse scenario reflects a deliberate choice and reflects the purpose of the stress test exercise, which is to assess the resilience of the European banking system to a hypothetical severely deteriorated macro-environment. The EBA expects to publish the results of the exercise at the end of July 2023.

European Supervisory Authorities identify good practices for financial education initiatives on scams, fraud and cyber security

In January, the three ESAs published a joint thematic Report on national financial education initiatives on digitalisation, with a focus on cybersecurity, scams, and fraud. The report identifies good practices that national competent authorities and other public entities can follow when designing and implementing their financial education initiatives.

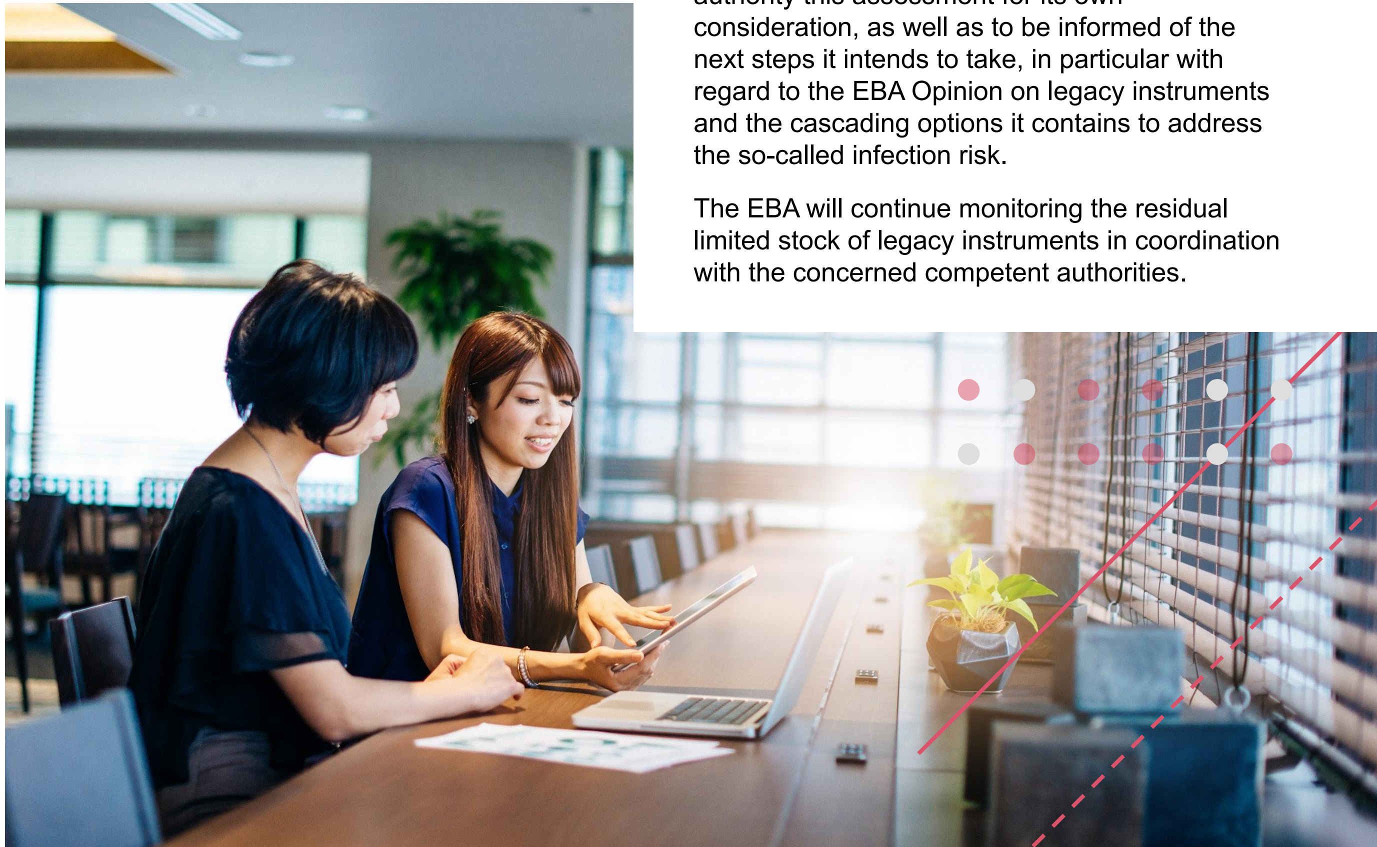
The ESAs highlight the fact that a lack of financial literacy and unfamiliarity with digital technologies can increasingly lead to financial vulnerability and exclusion of consumers. Without appropriate digital financial skills and the ability to ensure their cybersecurity, consumers are more at risk of becoming victims of scams and fraud.

To address this issue, the ESAs have identified 12 good practices that can help national competent authorities (NCAs) and other public entities increase the reach and effectiveness of their financial education initiatives and thereby help improve consumers' digital financial literacy.

EBA publishes final draft technical standards defining the homogeneity of the underlying exposures in STS securitization

In February, the EBA published its final draft RTS setting out the conditions for the assessment of the homogeneity of the underlying exposures in a pool of a Simple Transparent and Standardised (STS) on-balance-sheet securitisation.

Homogeneity is one of the key simplicity requirements enabling originators and investors to properly assess the underlying risks while facilitating investors due diligence.



The EBA responds to law firm on the prudential treatment of legacy instruments held by DNB Bank ASA

In January, the EBA published a response to the letters received from a law firm on 23 June and 3 October 2022, regarding the case of the prudential classification as Tier 2 instruments of legacy perpetual bonds (so-called 'Discos') of an institution established in Norway (DNB Bank ASA). After careful consideration of the concerns raised the EBA assessed that the Discos cannot count as fully eligible Tier 2 instruments of DNB Bank ASA.

The EBA shared with the relevant competent authority this assessment for its own consideration, as well as to be informed of the next steps it intends to take, in particular with regard to the EBA Opinion on legacy instruments and the cascading options it contains to address the so-called infection risk.

The EBA will continue monitoring the residual limited stock of legacy instruments in coordination with the concerned competent authorities.

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