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The view from the industry
Deloitte Banking Union Supervision Survey

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Deloitte's annual Banking Union Supervision Survey asks banks about their experiences of the Single Supervisory Mechanism (SSM) and the changing supervisory and regulatory landscape. The resulting insights enable banks to benchmark their strategies for responding to the SSM and understand best practice, and provide supervisors and policymakers with a clear industry perspective.

This year, the survey examined in particular how supervisory relationships have continued to evolve; the organizational impact on banks; and technical issues regarding supervisory activities and regulations, as borne out by the Supervisory Review and Evaluation Process (SREP) and on-site inspections (OSIs). The results of the survey highlight in part the continuation of trends observed last year, as supervisory processes have matured, and banks have refined their supervisory engagement strategies. At the same time much remains in development, not least because of the growing importance for banks of supervisory actions as the regulatory framework stabilizes.

This article sets out highlights from the survey and puts them in the context of broader developments—in particular, through the lens of the supervisory approach, business model analysis (BMA) and supervisory priorities for the year ahead—three topics that we keep coming back to in our conversations with clients.

For this second edition of Deloitte's Banking Union Supervision Survey, more than a third of banks directly supervised by the European Central Bank (ECB) participated.
The survey was carried out between February and May 2017.

Target banks
All directly supervised SSM banks within the Eurozone

Participating banks
45 directly supervised out of **19** Eurozone, **13** countries

• Countries that participated in the survey

Key messages from survey participants

Impact

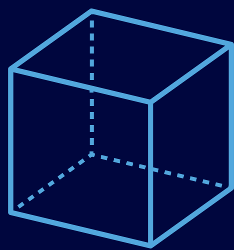
- Half of survey participants report that their supervisory spending has increased by more than 50 percent on average over the first two years of the SSM
- Supervisory priorities have driven targeted investment in operations across a number of areas, most prominently governance
- Data requests continue to be a particularly significant draw on resources and distraction for management
- Progress still needs to be made in establishing a level playing field

Relationship

- More than 60 percent of survey participants are satisfied or very satisfied with their supervisory relationship
- Coordination on messaging and policy between supervisory teams is felt to need improvement, as are the clarity and timeliness of supervisory communications

OSIs

- Most survey participants considered themselves to have been well-prepared for inspections
- From the perspective of survey participants, supervisors' planning, resourcing, and operations for OSIs could be improved
- The ECB's draft guide on OSIs and internal model investigations published after the survey was completed will help with this



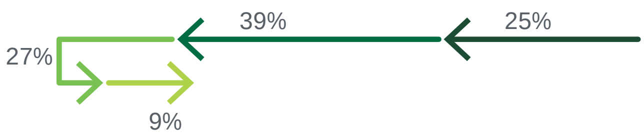
SREP

- The continued low interest rate environment is by far the most significant factor affecting banks' business models. Focusing on profitable products and increasing cost efficiency are seen as the main drivers for restoring or increasing profitability
- Despite positive developments in supervisory relationships, survey participants think there is insufficient transparency about the results of the SREP, and significant uncertainty about supervisory BMA

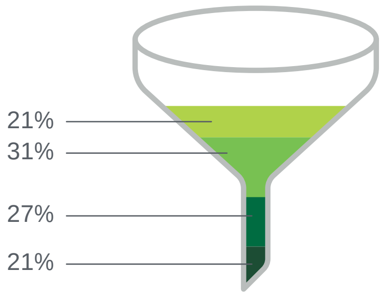
Evolution of the supervisory approach

During the 2016 SREP, conducted by the ECB, did you feel that there was sufficient transparency in terms of the methodology used and the results it produced?

Methodology



Results



● 1 fully transparent ● 2 ● 3 ● 4 not transparent at all

Two years after the ECB took control as Eurozone banking supervisor, to what extent do you think that the level playing field has been achieved?

● 1 fully achieved ● 2 ● 3 ● 4 not achieved at all

Reflecting on the evolution of supervision in the SSM over the past year, it is tempting to conclude that not much has changed. Survey participants report that the supervisory approach continues to lack transparency and consistency. That is despite relationships with supervisors—a key communications channel—having stabilized. Banks wonder if the much-heralded level playing field will ever become a reality.

Much has changed though. The reality is that the SSM is faring better against higher industry expectations. The ECB has made significant strides in clarifying its expectations on key topics—through bilateral discussions between banks and Joint Supervisory Teams (JSTs), publications, and speeches—and supervisory processes have matured. Perhaps most notably, the ECB has made changes to how it implements the SREP, against the backdrop of a broader discussion about the process at the EU level. The split of the SREP capital requirement into a Pillar 2 Requirement and Pillar 2 Guidance is intended to improve comprehensibility. Further, the ECB has worked on its qualitative approach and is consulting on its multi-year plan on SSM guides on the Internal Capital Adequacy Assessment Process (ICAAP) and Internal Liquidity Adequacy Assessment Process (ILAAP),[1] which provides details of what the ECB expects from annual submissions.

Of course, there remains more to do. Banks are hoping for greater clarity around supervisory methodology and also other topics such as stress testing and risk data. Only 9 percent of survey participants think that the SREP methodology is sufficiently transparent, while only 21 percent judge the SREP results to be sufficiently transparent. The relatively more favorable response on transparency of results may reflect improvements in disclosures in SREP letters, while aspects of the underlying process remain challenging to understand. The ECB is, however, ultimately likely to be reluctant to provide more insight into its methodology, in order to not encourage banks to game the approach. However, unless banks fully understand why their capital requirements are being increased, their ability to remedy the supervisory concerns that gave rise to them will be limited.

In addition, while JSTs have stabilized and banks' meetings with them have become more frequent over the past year, banks perceive there to be some problematic differences between formal and informal communication. While banks can sometimes wait months for formal communication (e.g., the final results of OSIs or approval for model changes), informal communications can be much faster, but by definition less certain as the outcome can be changed as a result of the ECB's internal challenge process. Banks would value a more coordinated and tailored approach across the ECB, in particular between policy and supervision teams.

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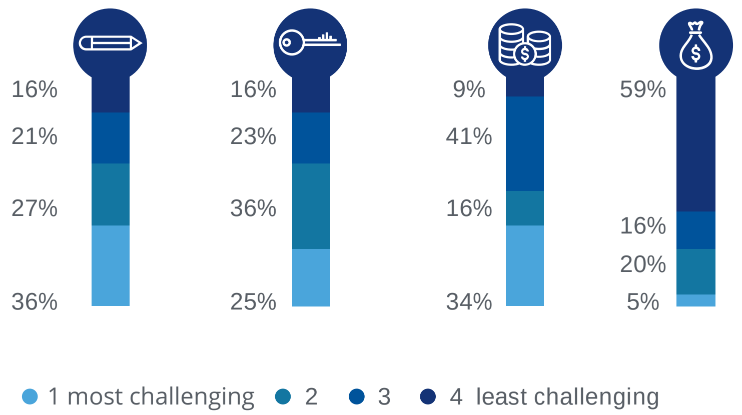
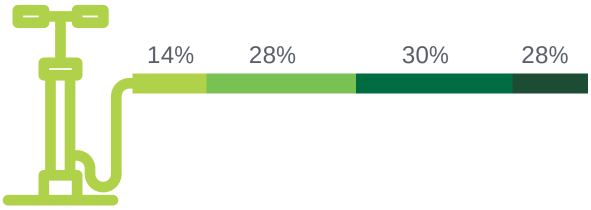
Which pillar of the SREP assessment was most challenging for your organization in terms of effort and resources (staff and management)?



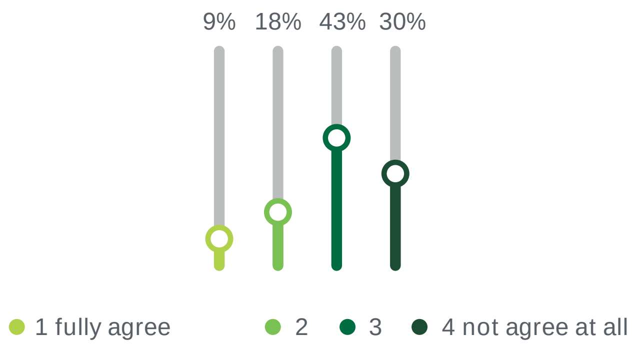
1. "Multi-year plan on SSM Guides on ICAAP and ILAAP," letter from Daniele Nouy, Chair of the Supervisory Board, ECB, February 2017, https://www.bankingsupervision.europa.eu/ecb/pub/pdf/170220letter_nouy.en.pdf

Business model analysis

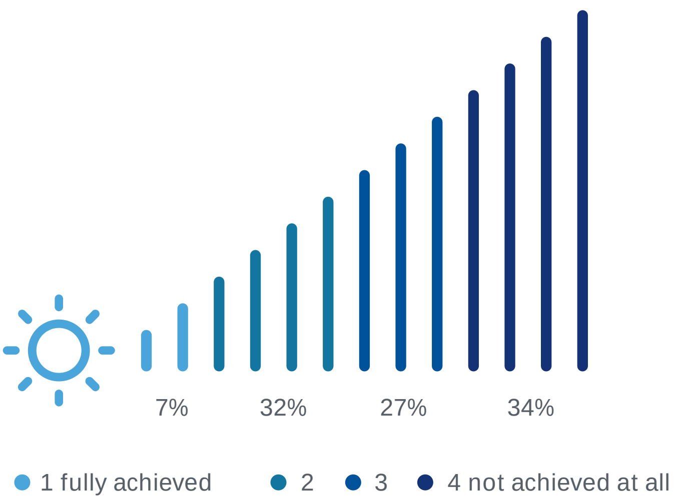
Do you think that the SSM's supervisory activities are putting you under pressure to adapt your business model beyond changes that the board would make in any case?



To what extent do SSM requirements and requests play a role in driving adjustments to your business model?



Are SSM business model expectations communicated in a clear and understandable manner?



Supervisory BMA has been a priority for the ECB since the beginning of the SSM. Three years on, we often hear about an increase in the intensity of supervisory scrutiny of business models and it is a topic currently mentioned regularly in speeches by the ECB Supervisory Board. Supervisors are exploring, in particular, banks' ability to generate their cost of capital, against the backdrop of protracted low/negative interest rates and disruption from new technologies, and the challenge of responding to the UK's withdrawal from the EU. There is a stated expectation that the Eurozone banking sector needs to consolidate,[2] although the mechanism for making this happen remains unclear.

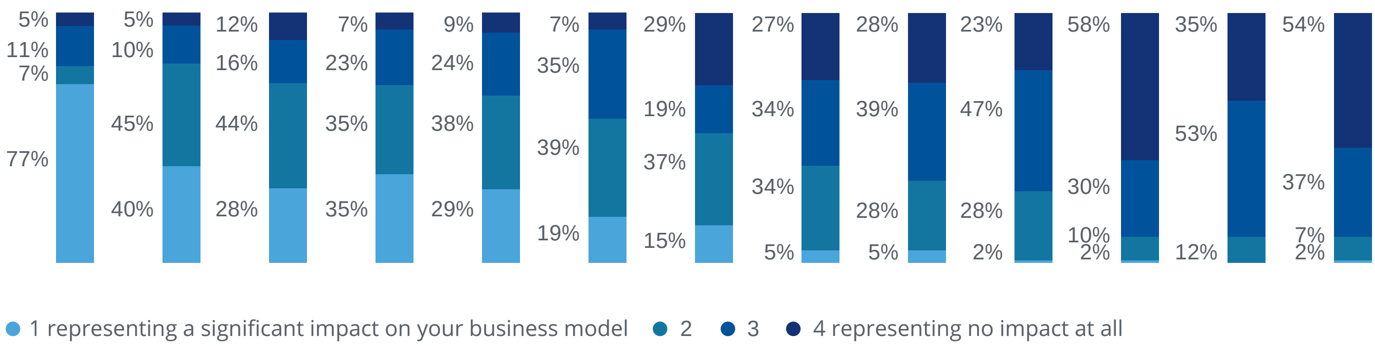
That level of activity suggests banks should be very focused on understanding their business through the lens of supervisory BMA, in particular whether or not they are outliers in the quantitative horizontal analysis. However, any concern that supervisors will try to intervene and tell banks how to run their business is probably unfounded. In fact, the SSM approach has remained rather quantitative, and as a result banks are asking themselves if and when BMA will become more influential in the supervisory process. The majority of survey participants (61 percent) find expectations on BMA unclear or difficult to understand. Overall, banks do not report much pressure to change their business strategy or their approach to managing their business model in response to supervisory activities. Only 14 percent of survey participants are definitely planning such changes, while 28 percent are considering them. The perceived lack of potency of BMA as a "lever" for supervisors may be addressed, in particular as follow-up discussions with supervisors become more frequent.

2. "Interview with Mannheimer Morgen", Sabine Lautenschläger, Member of the Executive Board and Vice-Chair of the Supervisory Board, ECB, July 2017, https://www.bankingsupervision.europa.eu/press/interviews/date/2017/html/ssm.in170729.en.html

That is not to say that banks are not themselves focused on challenges to their business model. The impact of the low interest rate environment is considered to be the key driver of any change to business models. Survey respondents, however, ranked both competition from outside the banking market and Brexit at the lower end, with only 2 percent considering each to have a significant impact on their business model. Meanwhile, 28 percent ranked new competition from outside the banking sector second and another 12 percent ranked new competition from the banking sector second. The fact that the perception—or prioritization—of issues appears to diverge between banks and supervisors reflects differing perspectives. That banks' and supervisors' perceptions differ so much when it comes to the priority topics may prove problematic and aligning these different perspectives may have to become a priority in its own right.

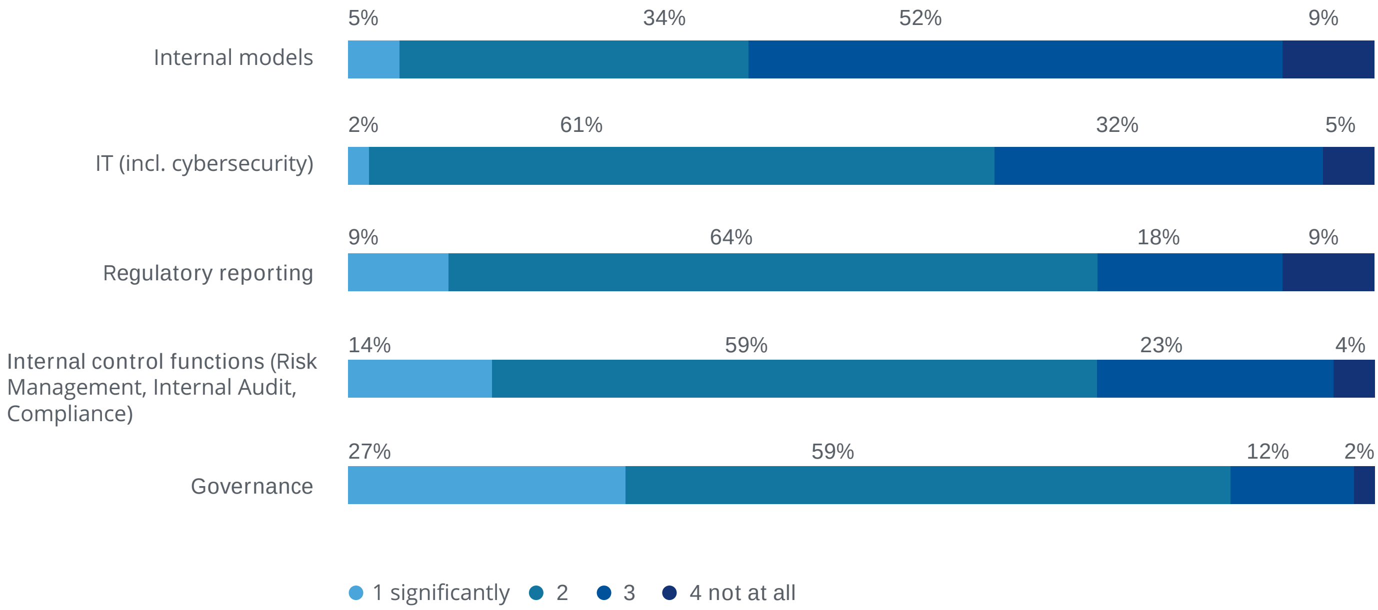
The impact of the low interest rate environment is considered to be the key driver of any change to business models.

To what extent do the following factors affect your business model?



Business model analysis

To what extent do you think that your bank has improved/the operations of your bank have improved in the following areas over the last year?



At the start of 2017, the ECB set out its supervisory priorities: business models and profitability drivers; credit risk, with a focus on non-performing loans (NPLs) and concentrations; and risk management. Survey participants report that they have made significant investments over the past year in operations aligned to areas of supervisory scrutiny. Most notable is the extent of investment in governance, which ranked second highest in terms of number of inspections as reported by the ECB in its latest annual report on the SSM. It also could be interpreted as a response to the ECB's thematic review on risk governance. Banks seem to be reactive rather than proactive in that sense. Given the amount of new regulation they have to implement, this is a pragmatic approach. The danger, though, that this will backfire some day in terms of banks falling short of supervisory expectations in a particular area remains.

Looking forward, these topics are likely to remain important, but the aspects that supervisors focus on will evolve. Most importantly, work on business models will focus on Brexit preparedness. The ECB is closely monitoring planning by banks with operations in the UK, as well as banks relocating operations to the Eurozone. The ECB has to ensure that the banks it currently supervises have adequate plans in place to be able to continue operations without major disruption. For banks moving to the Eurozone, the ECB needs to handle more authorizations, and the number of banks to be supervised will increase. Given the attention on Brexit and the resources required, it remains to be seen how far the ECB will be able to pursue other efforts (even with its stated intention to increase resources). Brexit will stretch its resources and the ECB will potentially need to be more selective as to which initiatives to push forward, as well as reconsidering timelines.

The Targeted Review of Internal Models (TRIM) program has picked up and the in-depth on-site review cycle has started. The program is up and running for all risk types in scope with the key objectives being to reduce the variability of risk-weighted assets (RWAs) stemming from internal models, to improve consistency across banks' methodologies, and to restore the credibility and adequacy of capital requirements. The work on NPLs, IFRS 9 implementation, and risk governance is also proceeding. Elsewhere in the banking union, the resolution cases during 2017 have provided important lessons for the SSM and Single Resolution Mechanism, and will drive changes to supervisory and resolution approaches over the coming months.

We also expect to see more work on topics such as cyber risk and outsourcing. Both have become more prominent on the EU supervisory agenda.