



Algemene Rekenkamer

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**Report of the Task Force on European Banking  
Union to the Contact Committee of Supreme Audit  
Institutions of the European Union and the  
European Court of Auditors**

*on prudential supervision of medium-sized and small  
("less significant") institutions in the European Union  
after the introduction of the Single Supervisory  
Mechanism*



ΚΥΠΡΙΑΚΗ ΔΗΜΟΚΡΑΤΙΑ

ΕΛΕΓΚΤΙΚΗ ΥΠΗΡΕΣΙΑ ΤΗΣ ΔΗΜΟΚΡΑΤΙΑΣ



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## List of Abbreviations

ACA	Austrian Court of Audit
BNAO	National Audit Office of Bulgaria
BNB	Bulgarian National Bank
BoD	Board of Directors
BoS	Bank of Slovenia
CBC	Central Bank of Cyprus
CoA	Slovenian Court of Auditors
CRD	Capital Requirements Directive
CRMS	Common Rules and Minimum Standards
CRR	Capital Requirements Regulation
Bundesbank	Deutsche Bundesbank
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht
DNB	De Nederlandse Bank (Dutch Central Bank)
EBA	European Banking Authority
ECA	European Court of Auditors
ECB	European Central Bank
EDIS	European Deposit Insurance Scheme
EIOPA	European Insurance and Occupational Pensions Authority
ESCB	European System of Central Banks
ESMA	European Securities and Markets Authority
EU	European Union
FIN-FSA	Finnish Financial Supervisory Authority
FMA	Financial Market Authority
FMABG	Financial Market Authority Act
FSAP	Financial Sector Assessment Programme
HPI	High Priority Institutions
ICAAP	Internal Capital Adequacy Assessment Process
IFRS	International Financial Reporting Standards
ILAAP	Internal Liquidity Adequacy Assessment Process
IMAS	Information Management System
IMF	International Monetary Fund
LPI	Low Priority Institutions
LSI	Less Significant Institutions

MaRisk	Minimum Requirements for Risk Management of Banks
MPI	Medium Priority Institutions
NCA	National Competent Authority
OeNB	Oesterreichische Nationalbank
RAS	Risk Assessment System
SI	Significant Institutions
SREP	Supervisory Review and Evaluation Process
SRM	Single Resolution Mechanism
SSM	Single Supervisory Mechanism
SAI	Supreme Audit Institution
TFEU	Treaty on the Functioning of the European Union

## **0 Executive summary**

### **0.1 Point of departure**

As from 2008, Europe was hit by a financial crisis and a subsequent sovereign debt crisis. Many governments supported failing financial institutions with public funds amounting to hundreds of billions of euros. In response, the countries of the euro area introduced the European Banking Union, including a Single Supervisory Mechanism. In this Mechanism, the European Central Bank is directly responsible for prudential supervision of all 'Significant Institutions'. National Competent Authorities are directly responsible for supervising the 'Less Significant Institutions', based on guidance of the European Central Bank.

### **0.2 Auditing banking supervision in the Single Supervisory Mechanism**

The Supreme Audit Institutions of Austria, Cyprus, Finland, Germany and the Netherlands carried out a parallel audit to examine banking supervision at national level. The objectives of the parallel audit were:

- 1) to gain insight into differences among EU Member States in the way supervisors have set up and carry out prudential supervision for LSIs, and
- 2) to collect evidence about possible 'audit gaps' that may have emerged as a result of the introduction of the Single Supervisory Mechanism.

### **0.3 Key finding 1: Differences in regulatory transposition, design and practice of banking supervision**

The *regulatory framework* regarding banks in the EU is characterised by complexity and has been subject to a number of changes since the outbreak of the financial crisis. We identified differences in how EU rules are transposed into national law. We found that within one common Supervisory Mechanism different national rules and regulations apply.

Furthermore we found differences in the *institutional design of prudential supervision*:

- Frequently, the National Central Bank is responsible for prudential supervision but in some countries, the prudential supervisor is set up as a separate

institution or responsibilities are shared between the Central Bank and a National Competent Authority.

- Supervisory costs are charged to the supervised entities, but to different degrees.
- Often the Ministry of Finance has a central role in supervising the supervisor, while in two countries Parliament and representatives of the regulated institutions are involved in this supervision.

We also found the following significant differences in *supervision practice*:

- Methods designed either by the European Central Bank or national approaches are used for categorizing banks according to their systemic relevance and for assessing risks.
- The proportionality of the annual assessment in the Supervisory Review and Evaluation Process for Less Significant Institutions varies.
- Substantive focus in the Supervisory Review and Evaluation Process is either on assessing risks to capital, liquidity and sustainability of funding, or on assessing banks' business models and adequacy of governance and risk management.
- Either quantitative interventions (capital add-ons) are used by the National Competent Authority, or primarily qualitative interventions.

### **Key results**

- The way banking regulation is transposed, and banking supervision is designed and conducted, varies across different EU Member States. Within the Single Supervisory Mechanism, the single rulebook has to be adhered to. Nevertheless, the set-up and conduct of supervision can be tailored to specific national situations and national rules and regulations.
- Future efforts by NCAs and the ECB are needed to strike a balance among harmonisation, proportionality and supervisory flexibility to match national specific circumstances. We encourage the European Commission and national decision makers to closely follow-up on how supervisory practice develops in the Member States.

#### **0.4 Key finding 2: Audit gaps confirmed and increasing**

The *audit mandate of the European Court of Auditors* with respect to the supervisory activities of the European Central Bank is narrowly defined as an examination of the operational efficiency of the management of the European Central Bank. At the time the Eurogroup considered the issue in December 2015, it argued that this narrow definition has its roots in primary law rather than the SSM regulation. However the resulting effects should be examined as they may give rise to differences in the depth of audit at European compared to national level in some Member States. The Special Report of the European Court of Auditors on the Single Supervisory Mechanism of November 2016 confirmed that the loss of mandate by some national SAIs after the introduction of the Single Supervisory Mechanism is not compensated by the mandate of the European Court of Auditors.

The European Commission's review of prudential supervision by the European Central Bank states that the European Court of Auditor's mandate "is indeed more limited than the mandates of certain national Supreme Audit Institutions over national banking supervisory authorities."<sup>1</sup> It encourages the European Court of Auditors and the European Central Bank to conclude an inter-institutional agreement that specifies the modalities of information exchange in view of granting the European Court of Auditors access to all information necessary for performing its audit mandate.

We agree that an inter-institutional agreement can be a first step to improve external accountability of the European Central Bank's supervisory function. However, ultimately we deem it necessary to clarify the audit mandate of the ECA, as this has a direct effect on the range of information the ECB is able to share with the ECA. The European Court of Auditors claims for itself the right to interpret the scope of its audit mandate. In our opinion, the clarification of its mandate should highlight *inter alia* that the provisions of Article 27.2 of the ESCB Statute are intended to protect the independence of monetary policy. The other ECB function – prudential supervision – needs to be subject to more stringent

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<sup>1</sup> On 11 October 2017, the European Commission published its first review of Council Regulation No. 1024/2013.

control and accountability than monetary policy. This could be achieved, for example, by giving the ECA the possibility to perform comprehensive audits of banking supervision pertaining to significant institutions as was the case in several countries including Germany and the Netherlands prior to the introduction of the SSM. The ECA's audit mandate may need to be clearly defined by means of an amendment of secondary law (Single Supervisory Mechanism Regulation) and possibly primary law to generate greater legal certainty and create a sustainable solution. In this parallel audit, we also found that *Supreme Audit Institutions with a mandate to audit the supervision of Less Significant Institutions are facing increasing difficulty accessing relevant information*. A growing number of documents pertaining to Less Significant Institutions are subject to rules and standards of the European Central Bank. As a result, information of the European Central Bank relevant to audits on Less Significant Institutions is not shared with Supreme Audit Institutions. This new 'audit gap' will increase in importance as the European Central Bank issues more harmonizing guidance and methodology regarding the prudential supervision of Less Significant Institutions in the years to come.

Ten Supreme Audit Institutions in the euro area have a *limited or no mandate to audit banking supervision of Less Significant Institutions* and/or are facing difficulties exercising this right. As a result, supervision of Less Significant Institutions in these countries is largely not subject to external audit.

### Key Recommendations

- The European Court of Auditors and the European Central Bank should conclude – as a first step – an inter-institutional agreement specifying the modalities of their information exchange. However, ultimately we deem it necessary to clarify the audit mandate of the ECA with regard to supervision of Significant Institutions, as this has a direct effect on the range of information the ECB is able to share with the ECA. It may be necessary to cement this clarification in either secondary law and, if needed in primary law, with a view to generating greater legal certainty and creating a sustainable solution.
- National Competent Authorities should authorise disclosure of information relating to prudential supervision of Less Significant Institutions to their respective Supreme Audit Institutions, in line with Art. 59 (2) of the Capital Requirements Directive (see Appendix 2).
- National governments and parliaments in the EU should examine whether their Supreme Audit Institution has been given the *de jure* and *de facto* mandate to audit banking supervision. Where necessary and feasible they should seek an extension of their audit mandates in line with Art. 59 (2) of the Capital Requirements Directive.



# 1 Introduction

## Background

Following the outbreak of the financial crisis in 2008, the functioning of financial sector supervision was closely scrutinised and a number of shortcomings were identified. In response, the European Council decided in 2012 to set up a European Banking Union consisting of three pillars:

1. The Single Supervisory Mechanism (SSM, effective in 2014), which ensures the soundness of supervision on financial institutions, by introducing a harmonised set of rules and harmonised supervision.
2. The Single Resolution Mechanism (SRM, effective in 2016), which aims to ensure the efficient resolution of failing financial institutions at minimum costs for taxpayers and the real economy.
3. A European Deposit Insurance System (EDIS, proposed in 2015, not finalised<sup>2</sup>) to replace national deposit guarantee schemes and thereby prevent potential mass withdrawal of deposits in case of bank failure.

Since the entry into force of the SSM, the European Central Bank (ECB) has been exclusively responsible for prudential supervision of the Significant Institutions (SIs) of euro area Member States, and of the countries choosing to opt into the SSM.<sup>3</sup> The SSM comprises a common banking supervision system involving both the National Competent Authorities (NCAs) as well as the ECB. In total, there are about 130 SIs<sup>4</sup>, representing approximately 80 per cent of the bank assets EU-wide.

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<sup>2</sup> In the meantime, national deposit guarantee schemes in all EU Member States have been established that guarantee a harmonised amount of 100,000 euros per deposit.

<sup>3</sup> Thus far, none of the EU Member States outside the euro area has joined the SSM.

<sup>4</sup> On the basis of the SSM regulation, a credit institution or financial holding company or mixed financial holding company shall not be considered less significant, unless justified by particular circumstances to be specified in the methodology, if any of the following three conditions is met: (I) the total value of its assets exceeds EUR 30 billion; (II) the ratio of its total assets over the GDP of the participating Member State of establishment exceeds 20 %, unless the total value of its assets is below EUR 5 billion; (III) following a notification by its national competent authority that it considers such an institution of significant relevance with regard to the domestic economy, the ECB takes a decision confirming such significance following a comprehensive assessment by the ECB, including a balance-sheet assessment, of that credit institution. The criteria for significance are determined by the ECB. See

<https://www.bankingsupervision.europa.eu/banking/list/criteria/html/index.en.html>

The medium-sized and small banks (also called “Less Significant Institutions”, LSIs) are supervised directly by the NCAs, in as far as the supervision has not been taken over by the ECB. The ECB, however, maintains final supervisory authority and ensures that supervisory requirements are consistent.

As a consequence of the SSM, audit responsibilities for banking supervision also changed:

- Audit responsibility regarding prudential banking supervision directly exercised by the ECB – i.e. of the largest banks – no longer lies within the audit scope of national Supreme Audit Institutions (SAIs), but has become part of the audit mandate of the European Court of Auditors (ECA).
- The audit responsibility regarding prudential banking supervision of LSIs directly exercised by the national supervisors remains with national SAIs.

This means that the SAIs of euro area countries that previously had a mandate to audit the supervision of all banks are no longer able to perform this role for the SIs. Survey evidence<sup>5</sup> suggests that this is the case for at least eight SAIs.<sup>6</sup> Since the audit mandate of the ECA is more limited than that of several national SAIs, concerns arose that an “audit gap” in banking supervision has emerged. At the time the Eurogroup examined the issue in December 2015, it took the view that the SSM did not create an audit gap, but that there are differences in the depth of the audit competences for banking supervision at the European level compared to national practices in some member states. It invited the European Commission to pay particular attention to such differences when reviewing the SSM regulation.

Furthermore, given the final supervisory authority of the ECB over the supervision of LSIs, questions arose concerning the extent to which the SSM affects national SAIs’ ability to perform an independent control of the NCAs’ supervisory activities. For these reasons, the Contact Committee (an autonomous, independent and non-political assembly of the heads of SAIs of EU

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<sup>5</sup> To establish the status of audit mandates within the SSM of respective SAIs, the ECA carried out a survey in 2015.

<sup>6</sup> These are Austria, Cyprus, Germany, Ireland, Lithuania, Malta, Netherlands and Spain.

Member States and the ECA) decided to make the audit of banking supervision a focal point of its next steps to take.

#### Mandate for a parallel audit by the Contact Committee

At its meeting in June 2015, the Contact Committee adopted a statement on banking supervision and the importance of fully auditable, accountable and effective banking supervision arrangements following the introduction of the SSM.<sup>7</sup> With this statement, it also set up a Task Force or organizational subgroup, in which a number of SAIs committed to work together on the subject of the Banking Union. The Task Force was mandated to start planning and conducting a collaborative audit of the supervision of individual LSIs in selected EU countries.

#### Objectives of the parallel audit

The first objective of the parallel audit was to gain insight into the state of play and possible differences among EU Member States in the regulatory framework for banking supervision after the introduction of the SSM, and the way the respective national supervisors have set up and carry out prudential supervision.

The second objective was to collect evidence about possible 'audit gaps' that may have emerged as a result of the introduction of the SSM. In particular, the audit sought to identify problems that SAIs are confronted with in auditing supervision of LSIs in their own countries.

#### Audit approach, audit questions and audit scope

The SAIs participating in the parallel audit (Austria, Cyprus, Finland, Germany and the Netherlands) were requested to carry out their audit work as outlined in a common audit plan, and sum up their findings in a country report. The joint report has been drafted based on the individual country reports, which have undergone contradictory procedures as customary in the countries concerned. The final report was adopted by the participating SAIs and approved by the Contact Committee of Heads of EU SAIs.

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<sup>7</sup> [http://www.eca.europa.eu/sites/cc/Lists/CCDocuments/CC\\_STATEMENT\\_2015/CC\\_SSM\\_statement\\_EN.pdf](http://www.eca.europa.eu/sites/cc/Lists/CCDocuments/CC_STATEMENT_2015/CC_SSM_statement_EN.pdf)

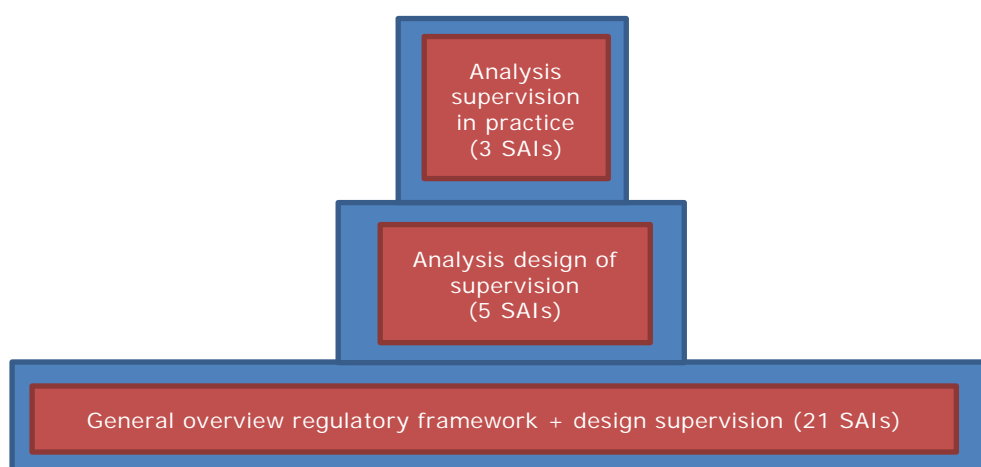
The parallel audit was based on the following audit questions:

1. *Regulatory framework*: How has the (European and) national regulatory framework changed since or as a result of introducing the SSM?
2. *Design of LSI supervision*: How has prudential supervision been designed at the NCA since the introduction of the SSM?
3. *Supervision of LSIs in practice*: How are prudential supervisory standards applied in practice?

As the audit mandates of the participating SAIs differ (see Appendix 1), not all SAIs have been able to study all three audit questions in their work.

The SAIs of Cyprus, Germany and the Netherlands carried out an audit in which all of these questions were addressed. The SAIs of Austria and Finland were able to answer the first two questions of the parallel audit. Furthermore, a group of 16 other SAIs have contributed to this audit by providing information about the banking landscape in their country, as well as general overviews of changes to the regulatory framework and the design of supervision in their country.<sup>8</sup>

Figure 1.1: Set up of audit and participating SAIs



<sup>8</sup> 16 SAIs have contributed by providing information about the banking landscape in their country, and general overviews of changes to the regulatory framework and the design of supervision in their country. These are the SAIs of Bulgaria, Croatia, Estonia, Greece, Hungary, Ireland, Latvia, Lithuania, Luxembourg, Malta, Poland, Portugal, Romania, Slovenia, Sweden and the United Kingdom.

The audit scope of this report is limited to prudential supervision of LSIs. By carrying out prudential supervision, governments ensure the safety and soundness of the banking system in their country. The NCAs monitor the banks to ensure that they comply with the relevant regulations and do not take on excessive risk.<sup>9</sup>

### Audit methodology

Each of the five SAIs involved in the parallel audit carried out audit work in accordance with its national practices. This also meant that the audit was conducted over different time periods, with the SAIs of Austria and Germany finishing earlier than the SAIs of Cyprus, Finland and the Netherlands. In all countries, the audit involved desk research of supervisory documents, exchange of information by e-mail, and meetings and interviews with officials at the relevant supervisory authority, or multiple authorities in the cases of Austria and Germany. In Austria and the Netherlands, the audit work also involved their respective Ministries of Finance.

To facilitate in-depth observations of supervision, the SAIs of Austria, Cyprus, Germany and the Netherlands requested and received access to a relevant number of supervisory files of selected LSIs. Additionally, the Netherlands Court of Audit requested and was given permission to attend the annual meeting at the Dutch supervisory authority in which decisions pertaining to the Supervisory Review and Evaluation Process (SREP) regarding LSIs were taken.

### Challenges encountered during the audit

The SAI of Finland faced the challenge of not being mandated to audit banking supervision. While the four other SAIs in the parallel audit had a full mandate to audit banking supervision in their country, they also faced limitations (in some cases of a severe nature). In most cases, this was due to the relation between the national supervisory authority and the ECB. Chapter 5 provides more details on these issues.

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<sup>9</sup> Definition adapted from Mishkin, F.S. (2001): Prudential Supervision: Why Is It Important and What Are the Issues? In: *Prudential Supervision: What Works and What Doesn't*, by Frederic S. Mishkin, ed. University of Chicago Press.

Sensitive and/or confidential information obtained during the audits

The SAIs that carried out audit work with regard to audit question 3 (practical application of supervision) obtained access to sensitive and/or confidential supervisory data. The auditors live up to the same disclosure requirements on confidentiality and professional secrecy standards as are applicable to the auditee (the NCAs). Depending on the level of confidentiality, the SAIs took appropriate measures to safeguard the information against unauthorised access and disclosure.

These confidentiality and professional secrecy standards as well as compliance measures also apply to the Task Force as a whole. Therefore the final report aggregates and compares national results, but sensitive and/or confidential information is not disclosed.

## 2 Regulatory Framework

This chapter discusses the ways in which the regulatory framework governing banks in the EU Member States participating in the parallel audit has been affected by the SSM. Two overarching findings stand out:

- Since the outbreak of the financial crisis, a few legislative changes at EU level required several adaptations of national banking acts. It has become difficult, even for experts, to stay abreast of the discrete changes.
- Even prior to the introduction of the SSM, banks faced a complex regulatory framework, consisting of international, European and national rules and regulations. The SSM has led to the transfer of certain powers to the ECB and required further adjustments to an already complex framework.

### Frequent changes of regulatory framework since the financial crisis

Following the events of the financial and sovereign debt crisis beginning in 2007/2008, the regulatory framework governing the banking sector has undergone a number of changes. These are briefly outlined below.

- |      |   |
|------|---|
| 2009 | Adaptation Basel II: As a first reaction to the financial crisis, the Basel Committee on Banking Supervision issued stricter requirements for securitization.   |
| 2011 | Launch of the European System of Financial Supervision (ESFS): The ESFS resulted in the creation of three European supervisory authorities: <ul style="list-style-type: none"> <li>• European Banking Authority (EBA),</li> <li>• European Insurance and Occupational Pensions Authority (EIOPA),</li> <li>• European Securities and Markets Authority (ESMA).</li> </ul> |
| 2014 | Introduction of Basel III, Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD IV): These introduced, among others, stricter capital and liquidity requirements for banks.  |
| 2014 | Start of the SSM: The regulation transferred responsibility for the supervision of SIs and indirectly for the supervision of LSIs to the ECB.   |

2015 Start of the SRM: A framework for the orderly resolution of banks that are failing or likely to fail was implemented.

These changes required a high number of adjustments to national rules and regulations, entailing amendments of existing rules as well as the introduction of new ones. In the period between autumn 2008 and summer 2017, the German Banking Act was amended 73 times by discrete legislative proposals.

Furthermore, at least four more changes will come into effect in 2018. Similarly, the Austrian Banking Act was amended 38 times between autumn 2008 and summer 2017 and the Dutch Financial Supervision Act was amended at least 75 times between the entry into force of said act in January 2007 and a subsequent consultation for the revision of the act that was reported in November 2016.

These amendments create the impression of a high pace of change and make it difficult – even for experts in this field – to keep up-to-date. Especially smaller LSIs incur high administrative costs in order to ensure compliance with the regulatory framework.

#### National regulatory framework prior to the introduction of the SSM

Prior to the introduction of the SSM, banks in Europe already operated in a complex regulatory environment. This complexity stemmed in part from the fact that rules and regulations had different sources of origin. In addition to national sources, the regulatory framework encompassed:

- EU regulations with direct effect in the Member States (e. g. CRR).
- EU directives that required transposition into national law (e. g. CRD IV).
- EBA guidelines.<sup>10</sup>
- the directly applicable technical standards developed by the EBA based on approximately 100 mandates set forth in the CRR and CRD IV.
- non-binding recommendations issued by the Financial Stability Board, the Basel Committee on Banking Supervision (transposed into the CRD IV regime) and EBA.

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<sup>10</sup> The EBA guidelines should be taken into account by the ECB and the NCAs under the principle of “comply or explain”.



While the European and international influences in some way contributed to creating a common regulatory basis, their non-binding character and issuance in the form of directives meant that substantive regulatory differences among the Member States remained. For example, the CRD IV does not recommend the introduction of the International Financial Reporting Standards (IFRS). In Article 87 (2) CRD IV speaks of "applicable accounting rules" and leaves it open to the respective Member State, as is the case under other EU rules. In several countries, the IFRS are in use – with assets being mostly recognised at market value. However, in Germany most banks maintained the Commercial Code, which stipulates that assets are assessed at acquisition cost.<sup>11</sup> A further example is the transposition of Art. 104 of the CRD IV, which stipulates that banking

#### **Case in Point: Transposition of Art. 104 of the CRD IV in Finland**

Article 104 of the CRD requires that banking supervisors are granted a specific range of competences to impose supervisory measures in case the CRD or the CRR are breached or a breach is likely to occur within 12 months. The competences can range from the imposition of additional or more frequent reporting up to the restriction or limitation of a bank's business.

The transposition of the CRD IV into national law resulted in different competences of the national NCAs. We note that in Finland the transposition of Article 104 CRD does not ensure that the Finnish Competent Authority, the Financial Supervisory Authority (FIN-FSA) has a possibility to impose supervisory measures on LSIs in all cases set in the CRD.

supervisors should be equipped with the powers to correct or sanction the breach of banking regulation. In Finland, this provision was transposed differently as in other Member States.

#### National regulatory framework after the introduction of the SSM

With the introduction of the Banking Union in 2014, more EU legislation was adopted, in particular the SSM Regulation and the ECB SSM Framework Regulation. These assigned banking supervisory tasks and competences to the ECB. As a consequence it became necessary in some countries to amend national regulatory frameworks in areas where the SSM Regulation transferred tasks from NCAs to the ECB. Two such prominent tasks are the granting and revoking of bank licenses and the granting of declarations of no objection for the acquisition or disposing of qualifying holdings in credit institutions. These two tasks are assigned to the ECB with regard to all institutions, both the SIs and the LSIs

<sup>11</sup> [https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ecb\\_guide\\_options\\_discretions.de.pdf](https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ecb_guide_options_discretions.de.pdf)

(common procedures). The SSM Regulation provides that the regulated SIs must submit all of their respective requests, notices and applications directly to the ECB.

Despite the fact that the two aforementioned regulations led to a transfer of supervision to the European level and therefore laid the groundwork for more uniformity in banking regulation, substantial national differences remain. This is in part due to the fact that those subject matters not included in the list of tasks to be executed by the ECB remain within the remit of national authorities. This includes, for example, the application of the rules on consumer protection or rules concerning the fight against money laundering.

## 3 Design of LSI Supervision

### 3.1 Organizational design

In this chapter, we present the set-up of the supervisory systems in the respective countries. We discuss the institutional framework and a number of organizational aspects such as the budget for banking supervision, the allocation of resources within NCAs and quality assurance. While the audits encompassed a number of aspects including the supervisors' internal checks and balances, we chose to focus here on the results we consider significant.

We note that in most of the countries, the Central Bank is responsible for prudential supervision. In all five countries, supervisory costs are (partially) charged to the supervised institutions, SIs and LSIs, but result in very different costs per institution. These can largely be explained by the banking landscape in the countries concerned, which shows considerable variety.

By the end of 2016, there were about 6,600 banking institutions in the EU. The total assets held by those institutions amounted to 43.2 trillion euros.<sup>12</sup> This is about three times the total EU economy.<sup>13</sup> Especially Germany, followed at some distance by Poland and Austria, has a large number of banks in absolute terms.

#### 3.1.1 The institutional set-up of supervisory authorities and the scope of their tasks

Results of the questionnaire and the parallel audit show that the institutional arrangements for banking supervision differ among countries. An overview is given below in Table 3.1.

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<sup>12</sup> European Banking Sector Facts & Figures 2016, European Banking Federation, [http://www.ebf.eu/facts\\_and\\_figures/](http://www.ebf.eu/facts_and_figures/) retrieved on 27 July 2017. Figures as at 31 December 2016.

<sup>13</sup> EU GDP for 2016: 14.8 trillion euros, Eurostat, <http://ec.europa.eu/eurostat/tgm/refreshTableAction.do?tab=table&plugin=1&pcode=tec0001&language=en>

Table 3.1: Institutional arrangements for banking supervision

Institutional Arrangement	Countries
Supervisor in Central Bank	12 (BG, CY, EL, HR, HU, IE, LT, NL, PT, RO, SI, UK)
Supervisor as separate institution	6 (EE, FI, LV, MT, PL, SE)
Supervisor shares competence with Central Bank	3 (A, DE, LU)

In a majority of 12 countries, supervision is carried out by the respective Central Bank. From an organizational perspective, this appears logical, as Central Banks interact with banks on an ongoing basis and are therefore well prepared to also conduct supervisory functions. Six countries opted for a solution where prudential supervision is conducted by a separate institution other than the Central Bank. In three countries, supervision is split between two authorities. For example in Germany and Austria, the Central Banks are responsible for conducting the audit field work, whilst a separate institution takes supervisory decisions. The split of tasks among two institutions can be explained by constitutional concerns about Central Bank independence and accountability, based on the prerequisite that, as the Central Bank is by law independent but supervisory decisions should be subject to democratic accountability, the intervention authority in those countries cannot be one and the same institution as the Central Bank.

Further information on the split of tasks among supervisors and their responsibilities can be found in Table 3.2 below.

Table 3.2: Supervisory Tasks by Country

	Austria		Cyprus	Finland	Germany		The Netherlands
NCA	Oesterreichische Nationalbank (OeNB)	Financial Market Authority (FMA)	Central Bank of Cyprus (CBC)	Finnish Financial Supervisory Authority (FIN-FSA)	Deutsche Bundesbank (Bundesbank)	Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)	Dutch Central Bank (DNB)
Banking Supervision	Field-work	Decisions	Field-work <b>and</b> Decisions	Field-work <b>and</b> Decisions	Field-work	Decisions	Field-work <b>and</b> Decisions
Insurance and Pension Supervision	no	yes	no <sup>14</sup>	yes	no	yes	yes
Securities Supervision	no	yes	no <sup>15</sup>	yes	no	yes	no <sup>16</sup>

Table 3.2 shows, for example, that the range of sectors being supervised varies across the five countries. In Cyprus, the supervisory authority is responsible for supervision of banks only. The Netherlands entrusted their authority with supervision of banks, insurance companies and pension funds, whereby each sector is placed in a separate entity. Fully integrated supervision of banking, insurance, pension companies and securities was implemented in Austria, Germany and Finland. Banking supervisors in the countries participating in the parallel audit are responsible for supervising different numbers and types of institutions.

<sup>14</sup> For insurance supervision in Cyprus, the Superintendent of Insurance is responsible; for pension supervision, the Registrar of Funds for Occupational Retirement Benefits is responsible.

<sup>15</sup> Cyprus Securities and Exchange Commission is responsible.

<sup>16</sup> Authority for the Financial Markets – AFM – is responsible.

As illustrated in Table 3.3 below, more than 30 per cent of all euro area institutions (credit institutions and foreign branches) are located in Germany and Austria. Many of them have been originally established as smaller municipal self-help institutions (savings banks), or cooperative self-help organizations (Volksbanken und Raiffeisenbanken). Cyprus, Finland and the Netherlands, on the other hand, have fewer institutions in absolute terms and an above-average share of branches of foreign institutions. Essentially the same branches of foreign institutions exist across all five countries. This may cause specific complexity for the NCA: Foreign banks may stand for institutions operating globally and maintaining branches in a number of countries. A branch shares services within its group, e.g. on cash management, management of risk bearing capacity or on IT-Systems. If several branches of one group – or the head company – get into distress, official interventions by several NCAs may become necessary. The intervention of various authorities in the various legally independent companies of the Group can endanger the maintenance of system-relevant functions of the Group.<sup>17</sup> Hence NCAs facing branches have to provide for branch-specific consequences of intervention.

Table 3.3: Number of credit institutions and foreign branches

Number of credit institutions and foreign-controlled branches	Number of credit institutions		Number of foreign controlled branches	
	Year 2014	Year 2015	Year 2014	Year 2015
Austria	677	648	30	30
Cyprus	32	32	24	24
Finland	262	248	30	32
Germany	1 698	1 666	105	108
The Netherlands	177	161	39	42
EU	7 352	7 110	986	982

Source: ECB 2016, Report on financial structures, Annex, table 5.

<sup>17</sup> <https://www.bundestag.de/blob/333188/2466b19bce1a95b29b00f6c8f63f5289/09---prof--hellwig-data.pdf>, p.3 f.

As illustrated in Table 3.4 below, the German and Dutch institutions own more than 37 per cent of the euro area's assets. The assets held by foreign subsidiaries and branches in Finland are almost twice the assets held by the domestic banking groups.

Table 3.4: Total assets of domestic banking groups and foreign-controlled subsidiaries and branches

Total assets of domestic banking groups and foreign-controlled subsidiaries and branches	Domestic banking groups (Bill. euros)		Foreign-controlled subsidiaries and branches (Bill. euros)	
	Year 2014	Year 2015	Year 2014	Year 2015
Austria	751	720	328	337
Cyprus	49	59	27	14
Finland	163	178	410	369
Germany	6 750	6 649	312	306
The Netherlands	2 359	2 346	169	182
Euro area	24 265	24 067	3 831	3 677

Source: ECB 2016, Report on financial structures, Annex, table 6.

### 3.1.2 Funding of Supervisory Authorities

There are different ways in which NCAs fund their budgets. All in all, we can distinguish between funding obtained from public funds (e.g. state budget), own funding<sup>18</sup> and funding obtained by charging the supervised banks directly (e.g. fees<sup>19</sup> or levies<sup>20</sup> charged to banks).

Table 3.5 illustrates that the share of NCAs' supervision costs charged to banks differs among the five countries covered by this audit.

- In Cyprus, Finland and the Netherlands, NCAs' supervision costs are largely covered by fees charged to banks.

<sup>18</sup> In the case of own funding, the income of an NCA from non-banking operations is used to cover bank supervision costs. One can also speak of cross-subsidization.

<sup>19</sup> In the case of a user fee, the costs of an institution are distributed after the use of benefits. E. g. in Finland the supervision fee is collected as either a fixed fee, as a proportional fee based on last adopted financial statements or as a combination of these. [http://www.finanssivalvonta.fi/en/About\\_us/Powers\\_funding/Funding/Supervision\\_fees/Pages/Default.aspx](http://www.finanssivalvonta.fi/en/About_us/Powers_funding/Funding/Supervision_fees/Pages/Default.aspx)

<sup>20</sup> In the case of levy, the cost of an institution is not distributed according to the use of services, but according to other criteria (for example, according to the user's balance sheet).

- In Austria and Germany, supervision costs incurred by the intervention authorities – the Financial Market Authority (FMA) and the Bundesanstalt für Finanzdienstleistungsaufsicht (Federal Financial Supervisory Authority/BaFin) – are essentially covered by imposing levies on banks. The Central Banks have to finance their supervision budgets largely from their own funds.

Table 3.5: 2015 Key Indicators for banking supervision

Key Indicator Institution	Budget (million euros)	Funding by state budget	Funding by fees (million euros)	Funding by levy	Own funding	Staff (FTE)
Austria: OeNB	34.74 <sup>21</sup>	0	0	8.00	26.74	154.10
Austria: FMA	31.12 <sup>22</sup>	1.78	0.51	28.83	0	74.10
Cyprus: CBC <sup>23</sup>	1.90	0	1.90	0	0	6.00
Finland: FIN-FSA	25.90	0	23.10	0	2.80	121.00
Germany: Bundesbank	114.50	0	13.20	0	101.30	1216.00
Germany: BaFin	71.70	0	1.00	76.40	0	488.00
The Netherlands: DNB	144.00	0	144.00	0	0	603.00

Note: The figures reported in column 2 (budget) and column 7 (staff) may include different elements per country and therefore cannot be directly compared without caveats.

Source: Respective National Competent Authorities

In our analysis, we decided to look at the supervisory budgets per bank and per supervisory staff (FTE<sup>24</sup>). This was possible only to a limited extent because the figures are reported by the participating SAIs, sometimes without information about what is included (e.g. Anti-Money Laundering, Regulation etc.). Bearing this caveat in mind, Table 3.6 below shows that these two statistics differ

<sup>21</sup> The Austrian figure indicates the institution's total costs of banking supervision.

<sup>22</sup> The Austrian figure indicates the institution's total costs of banking supervision.

<sup>23</sup> The CBC did not provide its total cost of banking supervision and instead provided to its national SAI only the LSI figures. The CBC holds the view that disclosure of CBC's supervision costs for SIs would be warranted only, if audit work on the operational effectiveness of ECB's supervisory functions were to be undertaken.

<sup>24</sup> FTE: Full Time Equivalents.



markedly among the five countries audited. The highest supervisory budget per bank is reported for the Netherlands. The highest staff per bank is also reported for the Netherlands, where approximately 3.7 FTE work on the supervision of a bank compared to approximately 0.5 FTE in Austria and Finland. This can be explained, *inter alia*, by the fact that the Dutch NCA carries out most of its audit work itself as well as by the high number of large banks and foreign branches supervised by the Dutch authorities.

Table 3.6: Key Figures 2015 for banking supervision

Key Figures Institution	Budget (thousand euros)	Staff (FTE)	Number of credit institutions	Budget/credit institution (thousand euros)	Staff/credit institution (FTE)
Austria <sup>25</sup>	65 860	228.2	648	102	0.4
Cyprus <sup>26</sup>	1837	6.0	5	367	1.2
Finland	25 900	121.0	248	104	0.5
Germany	186 200	1 704.0	1 666	112	1.0
The Netherlands	144 000	603.0	161	894	3.7

Note: The figures reported in column 2 (budget) and column 3 (staff) may include different elements per country and therefore cannot be directly compared without caveats.

Source: Respective National Competent Authorities

### 3.1.3 Budgeting of NCAs

An NCA's annual budget is usually drawn up by the Executive Board. In most cases, it is approved internally by the Supervisory Board. It is sometimes also approved by an external authority, such as the Ministry of Finance or Parliament. The results for the five countries audited can be found in table 3.7 below.

<sup>25</sup> The Austrian figure indicates the institution's total costs of banking supervision.

<sup>26</sup> The figures for Cyprus cover LSI-supervision only.

Table 3.7: Budgeting

	Austria		Cyprus	Finland	Germany		The Netherlands
	FMA	OeNB	CBC	FIN-FSA	BaFin	Bundesbank	DNB
Budget drafting	Executive Board	Governing Board	Board of Directors	Director General	Executive Board	Board of Bundesbank	Governing Board
Internal Budget approval	Supervisory Board	General Council	Board of Directors		Administrative Council	Board of Bundesbank	Supervisory Board
External Budget approval				Board of the Bank of Finland			Ministry of Finance and Ministry of Social Affairs and Employment

In the Netherlands, the budget is drafted by the supervisor's Governing Board. Approval is obtained by the Supervisory Board of the Central Bank and externally from the Ministry of Finance (and the Ministry of Social Affairs and Employment, as far as supervision of pension funds is concerned). In its Financial Sector Assessment Report (FSAP) published on 13 April 2017, the International Monetary Fund (IMF) recommended strengthening the operational independence of the national prudential supervisor DNB with regard to setting budgets and wages. In Finland, the Central Bank confirms the budget of FIN-FSA and parliament performs an ex-post review on an annual basis. In Austria, Cyprus and Germany, the National Central Banks (NCBs) decide on their budget autonomously. This is further elaborated in section 3.1.5, Table 3.9.

### 3.1.4 Allocation of resources within NCA

The resources of the NCAs (funds, staff, IT capacity) are allocated to their constituent units on an annual basis:

Table 3.8: Allocation of resources

	Austria	Cyprus	Germany	The Netherlands
Unit	Task	Department	Department	Task
Methods	Investment and staff plan	Departmental budget	Staff plan and IT overall planning	No specific method
Criteria	Supervisory tasks	Experience/ qualifications of supervisory staff	<ul style="list-style-type: none"> <li>For staff: Staff is allocated to supervise a specific bank</li> <li>For IT: In general, each unit receives the same IT capacity as in the previous year to handle current projects</li> </ul>	No specific criteria

Table 3.8 shows the differences which can be gathered from the information available for four of the countries. In the Netherlands, staff assignments to supervision give a noteworthy room for *ad hoc* decisions. The allocation of resources appears to be need-based in all cases.

### 3.1.5 Supervision of supervisors

The ECB is responsible for supervising the NCAs' supervisory activities with a view to ensuring an adequate and harmonised conduct of LSI supervision.<sup>27</sup> Moreover, in the various countries banking supervision is monitored either by the Ministry of Finance, by Parliament or the Central Bank. Representatives of the banking industry are often involved. Various monitoring models are used, as illustrated in Table 3.9 below.

<sup>27</sup> <https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssmguidebankingsupervision201411.en.pdf> p. 41.

Table 3.9: Role of Ministry of Finance, Parliament and representatives of regulated institutions in supervising the supervisor

	Austria	Cyprus	Finland	Germany	The Netherlands
NCA (Central Bank)	<p>OeNB: <b>Ministry of Finance:</b></p> <ul style="list-style-type: none"> <li>• Shareholder-rights</li> <li>• Right to obtain information on direct costs of on-site activities and off-site analysis</li> </ul>	<p>CBC: Parliament and <b>Ministry of Finance:</b></p> <p>Right to obtain information on budget</p>	<p>Bank of Finland: Not taking part in banking supervision</p>	<p>Bundesbank: <b>Parliament:</b> Right to obtain information on</p> <ul style="list-style-type: none"> <li>• financial statements</li> <li>• external auditor's report</li> <li>• Federal Court of Auditors' report</li> </ul>	<p>DNB: <b>Ministry of Finance:</b> Ministry of Finance approves annual budget</p>
NCA (not Central Bank)	<p>FMA: Supervisory board has six voting and two coopted members:</p> <ul style="list-style-type: none"> <li>• <b>three from Ministry of Finance</b></li> <li>• three from OeNB</li> <li>• <b>two co-opted from Austrian Economic Chamber sends members</b></li> </ul> <p>Role of <b>Ministry of Finance:</b> supervise, that FMA fulfils its legal tasks, respects the laws and regulations in questions and do not exceed its remits.</p>	N. a.	<p>FIN-FSA: <b>Parliament</b> decides on membership to Parliamentary Supervisory Council which examines efficiency and effectiveness of banking supervision.</p>	<p>BaFin: administrative council has 17 voting members:</p> <ul style="list-style-type: none"> <li>• six from Federal <b>Ministries</b></li> <li>• five members of <b>Parliament</b></li> <li>• <b>six with professional experience</b></li> </ul> <p>Role of <b>Ministry of Finance:</b> legal and supervisory control.</p>	N. a.

As illustrated above, the supervision of the supervisor varies among the five countries.

- In Austria, the Central Bank (OeNB) has the legislative duty to inform the NCA (FMA) and – to some extent – the Ministry of Finance about the costs of its supervisory activities. The FMA is supervised by the Ministry of Finance; three members of the Central Bank join FMA's supervisory board.
- In Cyprus, the Parliament and the Ministry of Finance are only informed about the Central Bank's budget.
- In Finland, the Parliamentary Supervisory Council examines the efficiency and effectiveness of banking supervision.

- In Germany, the supervision differs between the two institutions: the German Parliament has restricted information rights at the Bundesbank. The Federal Ministry of Finance has limited supervising rights at BaFin. Furthermore, BaFin's administrative council is involved in supervision.
- In the Netherlands, supervision is carried out as part of the budget approval function residing with the Ministry of Finance.

### 3.1.6 Quality assurance and control

The main goal of quality assurance and control is to identify improvement potential for methodologies, standards and supervisory policies.<sup>28</sup> Quality assurance on banking supervision is performed at two levels, at ECB level and at NCA level.

The ECB is responsible for quality assurance of the NCAs' supervision of LSIs (Directorate General Micro-Prudential Supervision III). From its point of view, the aim of quality assurance is to assess the consistent application of the common methodological framework and to ensure compliance. Furthermore, quality assurance monitors the quality of supervisory practices.

The NCAs perform quality assurance and control in various ways. We structure the information available in this context following a three-lines-of-defence model:

- The first line of defence provides for internal controls within the original processes which are performed by the operative units.
- The second line of defence aims at quality management and a continuous quality improvement.
- The third line of defence ensures quality assurance by internal revision.

The findings per country are illustrated in Table 3.10 below<sup>29</sup>. They show that all banking supervisory authorities pursue measures of quality control.

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<sup>28</sup> <https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssmguidebankingsupervision201411.en.pdf> p. 42.

<sup>29</sup> Not applicable in the case of Finland as the Finnish SAI does not have audit rights concerning the NCA (FIN-FSA).

In Austria, Cyprus, Germany and the Netherlands, the NCAs indicated measures that can be depicted in a process-oriented three-lines-of-defence model. This means that the actual processes are tested with regard to compliance with the requirements.

Table 3.10: Quality assurance

	Austria		Cyprus	Germany		The Netherlands
	OeNB	FMA	CBC	Bundesbank	BaFin	DNB
<b>First Line of Defence</b>	Observing the SSM Supervisory Manual and internal process descriptions.	Observing the SSM Supervisory Manual and internal process descriptions.	Observing the SSM Supervisory Manual.	Observing the organisational process descriptions.	Observing the organisational process descriptions.	Observing the SSM supervisory Manual and organisational process descriptions.
<b>Second Line of Defence</b>	Quality assurance specifications of the SSM Supervisory Manual as well as internal approval procedures and documentation guidelines.	Quality assurance specifications of the SSM Supervisory Manual as well as internal approval procedures and documentation guidelines.	No quality assurance programmes of their own yet.  Participation in the ECB Supervisory Quality Assurance network of the SSM.	Amongst others quality assurance is involved in the preparation of the service instructions and the training of the employees.	Quality management and the purpose of a continuous quality improvement, is currently under construction.	Department of Risk management and Strategy conducts independent audits of supervisory activities.
<b>Third Line of Defence</b>	Audits by general audit departments of the NCB as well as by the Joint Task Force, consisting of internal auditors of the NCA and the NCB.	Audits by general audit department of the NCA as well as by the Joint Task Force, consisting of internal auditors of the NCA and the NCB.	Audits by internal audit department of the CBC.	The quality assurance carries out reviews of the ongoing supervision.	Audits by internal revision.	In theory audits by internal audit department of DNB. In practice no internal audits of supervision on LSIs.

### 3.2 Description of supervisory process for LSIs

We found that the design of the supervisory process is typically described in manuals. All five participating SAIs indicated that their NCAs follow the SSM supervisory manual to some extent (see also Chapter 4).

Table 3.11: Description of supervisory process of LSI's

	Austria	Cyprus	Germany	The Netherlands
LSI	SSM Supervisory Manual with complementary own Austrian methodology for LSI	SSM Supervisory Manual like for SI	SSM Supervisory Manual with complementary own German methodology for LSI	SSM Supervisory Manual like for SI

The Netherlands apply the ECB provisions originally designed for SI supervision to the supervision of LSIs. Cyprus uses a similar procedure while applying the principle of proportionality. In Germany and Austria, the methodology of the SSM is supplemented by own methods tailored to the supervision of LSIs.

In the course of conducting the audit work, we noted that access to the SSM Supervisory Manual was not granted in most of the cases. This problem is further explained in Chapter 5.

## 4 Supervision of LSIs in practice

In this chapter, we assess the three main steps involved in the exercise of prudential supervision of LSIs in Cyprus,<sup>30</sup> Germany and the Netherlands:

- **Risk analysis** – all in all, we find that the NCAs of Cyprus and the Netherlands follow the ECB methods for SIs when categorising and analysing the risks of their LSIs, whereas the German banking supervisors follow their own national method for LSIs.
- **SREP** – the Supervisory Review and Evaluation Process was audited by three SAIs, is carried out by the respective NCAs on an annual basis and with notable differences in detail.
- **Intervention and follow-up** – the three Member States' SREPs audited have a follow-up system in place but do not assess the extent to which its supervision has been effective on an individual LSI-basis.

### 4.1 Risk analysis

The risk analysis performed by NCAs serves 1) to categorize LSIs according to their systemic relevance as required in the SSM, and 2) to provide the first step for the annual SREP.

#### Categorisation of LSIs according to their systemic relevance

In the categorization of institutions according to their systemic relevance, first a distinction is made between SIs and LSIs. As described earlier, only the LSIs are subject to 'national' supervision by their NCA. On the basis of a risk analysis, the LSIs are further categorised by the NCAs according to their systemic relevance. This is done in different ways in different countries and forms the basis for deciding, for example, how often a full analysis needs to be carried out.

In Cyprus and the Netherlands, the NCAs use the ECB's method of categorizing LSIs according to their systemic relevance: High Priority Institution (HPI), Medium Priority Institution (MPI) and Low Priority Institution (LPI). Important

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<sup>30</sup> The SAI of Cyprus has indicated that, due to insufficient cooperation from the CBC, it has in many cases not received written evidence of the answers provided to them verbally by the CBC.



elements in the assessment are the size of the LSIs, its impact on the national economy and its intrinsic risk. To measure the intrinsic risk, the NCA of the Netherlands uses the quantitative risk assessment model that is part of its ongoing supervisory activity in the SREP.

In Cyprus, three LSIs are classified as high priority institutions. Neither institution has total assets of more than 5 billion euros, which is the primary criterion for classifying an LSI as high priority according to the SSM rules, but they are the largest LSIs in terms of total assets. The remaining five LSIs are classified as medium/low priority institutions, as the CBC found no rationale in the SSM rules to make a clear distinction between medium and low priority institutions.

In Germany, a national model is used to categorise LSIs according to their systemic relevance. The Bundesbank and BaFin together prepare a risk profile for each institution that is updated on an ongoing basis. On the basis of these risk profiles, BaFin carries out a risk classification of the institutions according to their quality and systemic importance. The *quality* criterion is used to assess the extent and complexity of the risks and, as additional factors, whether an institution's organisation and risk management systems are structured appropriately. By evaluating the *systemic importance*, BaFin estimates the effect that a hypothetical failure of the institution could have on the financial sector as a whole. The factors assessed in making this estimation are size, the intensity of interbank relationships and the extent of business interconnectedness with foreign countries.

#### Setting the baseline for the SREP

The second function of the risk analysis is to provide a basis for the SREP.

Table 4.1 illustrates our main findings with regard to the Risk Assessment System (RAS) that is used by the NCAs in Cyprus, Germany and the Netherlands. The ECB has developed a *RAS/Risk Control-model* in which risks can be scored

from 1 (low risk) to 4 (high risk).<sup>31</sup> Scores in separate risk areas are combined in one overall score. The way in which partial scores cumulate in an overall score is laid down in the SSM Manual of the ECB, which is confidential and to which we were not granted access.

Table 4.1: Overview of main findings of risk analysis

Audit topic	Cyprus	Germany	The Netherlands
<b>NCA's performance of risk analysis</b>	Ongoing process, as part of the annual SREP, based on SSM Manual.	Ongoing process, including review and analysis of regulatory reporting and other financial information, assessment of business model, horizontal peer reviews and internal stress tests of LSIs.	Ongoing quarterly assessment, integrated in annual SREP, based on SSM Manual.
<b>Methodology for risk analysis</b>	Off-site monitoring and evaluation of reports and on-site inspections. Based on the above, the bank's ICAAP is evaluated during the SREP and a RAS score is assigned by CBC staff (i.e. expert judgement).	Capital adequacy assessment process (ICAAP) model, aimed especially at ensuring establishment of appropriate internal governance structure by MaRisk, <sup>32</sup> is used.	RAS score assigned using quantitative tool based on ECB-model, with additional expert judgement.
<b>Risk categories evaluated</b>	<ul style="list-style-type: none"> <li>- Business model &amp; profitability</li> <li>- Governance and risk management</li> <li>- Risk to capital</li> <li>- Risk to liquidity and funding</li> </ul>	<ul style="list-style-type: none"> <li>- Risk in the lending business</li> <li>- market price risks</li> <li>- Counterpart risks</li> <li>- Liquidity risks</li> <li>- Operational risks</li> </ul>	<ul style="list-style-type: none"> <li>- Credit risk</li> <li>- Operational risk</li> <li>- Market risk</li> <li>- Interest rate risk in the banking book (IRRBB)</li> <li>- Short term liquidity risk</li> <li>- Funding sustainability and business risk</li> </ul>
<b>Risk analysis performed alone or with ECB</b>	Primarily alone (partly with ECB).	alone	alone

As illustrated in Table 4.1, at each NCA, the risk analysis is performed as an ongoing process. The risk analysis process is either integrated in, or part of, the annual SREP process. The methodology used to carry out the risk analysis differs, and in fact each of the three NCAs assessed uses a different approach: The NCAs of Cyprus and the Netherlands assign SSM-based RAS scores, however: whereas the SAI of Cyprus does this on the basis of qualitative expert judgement, the Dutch NCA combines quantitative and qualitative elements. The

<sup>31</sup> ECB (2016): SSM SREP Methodology Booklet, Sheet 16.

<sup>32</sup> Nationally defined minimum requirements for risk management (Mindestanforderungen an das Risikomanagement - MaRisk).

German NCA uses its own model, based on the reports of institutions' need to deliver regularly on their capital position as well as the Internal Capital Adequacy Assessment Process (ICAAP). The risk categories evaluated in the process by the NCAs are closely related to each other but not fully identical. In the case of Cyprus, a limited number of risk analyses were performed with the ECB. In Germany and the Netherlands, the ECB was not involved in the performance of risk analyses.

## 4.2 Supervisory Review and Evaluation Process

The central element of prudential supervision of LSI is the SREP.

### What is the Supervisory Review and Evaluation Process (SREP)?

The Supervisory Review and Evaluation Process requires the NCA to annually carry out the following actions for each institution:

- a) collecting the facts ("feeds into the Supervisory Examination Programme").
- b) future-oriented overall assessment with respect to:
  - viability and sustainability of the business model of a bank.
  - adequacy of governance and risk management of a bank.
  - risks to capital.
  - risks to liquidity and funding.
- c) taking the SREP decision on supervisory measures.

Supervisors have already used similar procedures for some time. In December 2014, the EBA issued guidelines for common procedures and methodologies for the SREP to competent authorities.<sup>33</sup>

- For supervision of SIs, the ECB has drawn up an SSM Manual. It contains provisions as to how European NCAs in the euro area are to carry out the SREP Process. The SSM Manual has to comply with the EBA-guidelines.
- For the supervision of LSIs, some NCAs use the ECB provisions laid down in the SSM Manual which have originally been designed for SI-supervision (NL, CY). As from 2018 a common methodology will be in place.<sup>34</sup>

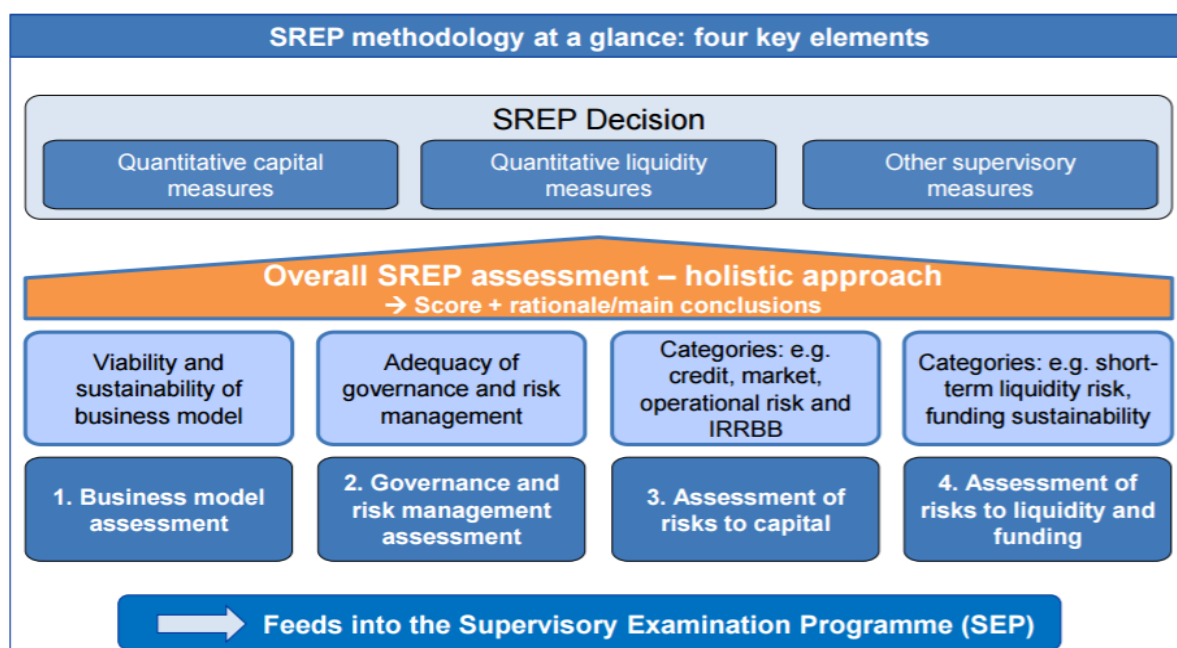
Since 2016, the NCAs have to comply with this harmonised SREP or, in case they do not, give reasons for non-compliance. The SREP can be visualised by a flowchart as follows:

<sup>33</sup> EBA/GL/2014/13.

<sup>34</sup> See homepage ECB: A consistent SREP methodology for LSIs.

Figure 4.1: SREP elements to be carried out by supervisor as proposed by the ECB/SSM

### Building block approach in line with EBA Guidelines



Source: ECB (2016): SSM SREP Methodology Booklet – 2016 edition – Level playing field – High standards of supervision – Sound risk assessment.

The key purpose of the SREP is to ensure that institutions have in place adequate arrangements, strategies, processes and mechanisms, as well as capital and liquidity, to ensure a sound management and coverage of their risks. This includes those risks revealed by stress testing and the risks an institution may pose to the financial system.<sup>35</sup>

Financial institutions need to comply with legal requirements that define the minimum amount of capital they need to hold (pillar I capital<sup>36</sup>). By means of a SREP decision, institutions may be required to hold additional capital (pillar II

<sup>35</sup> <https://www.eba.europa.eu/regulation-and-policy/supervisory-review-and-evaluation-srep-and-pillar-2/-/activity-list/NRWsAs5hcSDu/more>

<sup>36</sup> Minimum Capital Requirements.

capital<sup>37</sup>) in order to cover specific (additional) risks. As part of the SREP, NCAs are expected to collect information from institutions regarding their capital position and their liquidity position.<sup>38</sup>

Table 4.2 below provides an overview of the way the SREP is carried out by the NCAs of the countries participating in the parallel audit.

Table 4.2: Main findings regarding the SREP

Audit topic	Cyprus	Germany	The Netherlands
<b>Frequency of LSI -evaluation in SREP</b>	<p>Most LSIs are subject to an annual SREP by the CBC.</p> <p>All LSI-reports are assessed once received also taking into account other factors that the CBC sees relevant (e.g. results of current and previous on-site inspections, external auditors' and internal auditors' reports, the bank's annual ICAAP/ILAAP reports and macro-prudential information).</p>	<p>All LSIs are subject to an annual SREP decision by BaFin. In the SREP three types of inputs are considered:</p> <ol style="list-style-type: none"> <li>1. Annual expanded audit of financial statements including a comprehensive assessment especially of appropriateness and effectiveness of the risk management and the regularity of the business organization by the external auditor.<sup>39</sup></li> <li>2. Annual input of data from the banks.</li> <li>3. Special audits by NCA whose frequency depends on the risk classification and systemic relevance of the LSI concerned.<sup>40</sup></li> </ol>	<p>All LSIs are subject to an annual SREP, in which all LSI-reports are assessed together with other factors DNB sees as relevant for the SREP, such as results of on site investigations or macro-prudential information.</p>
<b>Assessment of:</b> <ul style="list-style-type: none"> <li>- business model</li> <li>- governance &amp; risk management</li> <li>- risk to liquidity</li> <li>- risk to capital</li> </ul>	<p>The CBC assesses all elements of the annual SREP and assigns a RAS score based on its assessment.</p> <p>There is no internal methodology for an exact CBC-approach, but the CBC indicates that the SREP process for LSIs is in</p>	<p>MaRisk is used for the assessment of business model and governance.</p> <p>BaFin / Bundesbank have implemented the SREP approach in line with EBA-guidelines.</p> <p>Risk to capital is assessed with</p>	<p>DNB assesses all elements in the annual SREP cycle that is (according to DNB) based on the ECB SSM Manual.</p> <p>Included are RAS-scores calculated with a tool based on ECB-model, ICAAP, ILAAP, stress tests, results from on-site</p>

<sup>37</sup> Additional capital requirements determined for the individual institution within the framework of the SREP.

<sup>38</sup> Banks are expected to regularly hand in reports concerning their position on capital as part of the internal capital adequacy assessment process (ICAAP) and liquidity as part of the internal liquidity adequacy assessment process (ILAAP).

<sup>39</sup> Other issues are the IT systems, the interest rate risk, credit risk compliance with the obligations arising from derivatives transactions, reorganization planning, the determination of own funds, capital resources, capital buffer, liquidity situation and correction of shortcomings. The external auditor has to inform the NCA without delay in certain cases. E.g. detection of a threatening institutional failure. The scope of the audit is set out in the German Audit Report Regulation. BaFin can also issue test focus points. [https://www.gesetze-im-internet.de/pr\\_fbv\\_2015/BJNR093000015.html](https://www.gesetze-im-internet.de/pr_fbv_2015/BJNR093000015.html)

<sup>40</sup> An LSI of low systemic relevance and an overall low risk may only be subject to a special audit by the NCA every 12 years.

Audit topic	Cyprus	Germany	The Netherlands
	accordance with EBA guidelines and the SSM Manual.	risk profile and result of the ICAAP in accordance with the EU legislation.  Liquidity risk assessed using ILAAP, in accordance with the EU legislation.	investigations, macro-prudential information.
<b>Types of decisions in SREP</b>	Identification of weaknesses and imposition of Pillar II capital add-ons.	By year-end 2015, mainly informal measures to combat organizational deficiencies.  In an escalation procedure, formal measures can be imposed if no improvement is made within a certain period of time.  Since 2016 identification of weaknesses, general prudential decision on capital and liquidity, imposition of Pillar II capital add-ons, and imposition of additional liquidity requirements.	Identification of weaknesses, general prudential decision on capital and liquidity, imposition of Pillar II capital add-ons, and imposition of additional liquidity requirements.
<b>Types of problems detected</b>	Not reported. <sup>41</sup>	Among other things: - Deficiencies in design of risk management system - Shortcomings in business organization - Unsatisfactory yield and equity - High operational risk - Accumulated credit risk - Interest rate risks - Shortcomings in the IT control and internal auditing.	Among other things: - Reputational risk - Business model risk - Uncertainty about data quality - Asset encumbrance - Insufficient recovery plan - No identifiable risk culture and a clear search for yield - Operational risk in anticipation of unknown or unforeseen risks.
<b>Structured SREP process applicable to all LSIs in NCA?</b>	According to CBC, the reporting phase is largely harmonised for all LSIs.  The SREP report for all LSIs includes assessment of all four risk elements described in the SSM Manual, on the basis of a RAS score. However there are no internal procedures for ensuring this.	The SREP of the German Banking Supervisory Authority essentially complies with EBA requirements.	The SREP of DNB is harmonised for all LSIs. It is based on ECB methodology for SIs and is compliant with the EBA rules for SIs and EC regulations.

On the basis of Table 4.2, we find there are no significant differences in the frequency of the application of the SREP in Cyprus, Germany and the Netherlands. In all the three countries, nearly all LSIs are subject to a SREP assessment and decision each year.

<sup>41</sup> Confidential - No permission by the CBC to disclose this information.

In Germany and the Netherlands, the SREP is harmonised for all LSIs. However, there are differences concerning the information basis of the SREP. In Germany, the SREP assessment considers three types of inputs:

- the annual audit by the external auditor, which includes an expanded qualitative assessment and a financial statement analysis ,
- the annual input of data from the banks, and
- the results of “special audits” the frequency of which depends on the risk classification and systemic relevance of the bank in question. For instance, a LSI of low systemic relevance and an overall low risk may only be subject to a special audit by the NCA every 12 years.

In the Netherlands, all LSIs, including those with low systemic risk, are subject to a full annual SREP assessment of capital and liquidity, on the basis of annual input of data from the banks. The methodology used by DNB is based on the ECB SSM Manual. In Cyprus, the SREP is harmonised for all LSIs and is based on the ECB methodology for SIs.

The focus of the SREP also varies across the three countries. Up until 2015, the German supervisors put major emphasis on the assessment of an LSI’s business model, governance and risk management (first two mostly qualitative elements of SREP). Since then the German supervisors, like their Dutch counterpart, place focus in the SREP on the assessment of a bank’s risks to capital, liquidity and funding (last two mostly quantitative elements of the SREP). In line with this, the Dutch NCA tends to impose additional capital requirements from the start and for each individual LSI, whereas the German supervisors (up until 2015) only imposed additional quantitative capital requirements, if qualitative measures recommended earlier in the process were not complied with. The Cypriot supervisor focuses more on the assessment of the bank’s governance and risk management arrangements and the risks to capital. The Cypriot NCA generally tends to impose additional capital requirements based on its assessment of the risks to capital and less frequently based on the assessment of the other qualitative elements of the SREP.

### 4.3 Intervention and follow-up

As a third step of the supervisory cycle, the NCA can design interventions and/or take measures to address detected shortcomings. In Table 4.3 below, we give an overview of the possible NCA interventions, how the follow-up of interventions is monitored, how supervisory decisions are reported, and how the NCA assesses the effectiveness of supervision.

Table 4.3: Main findings – intervention and follow-up

Audit topic	Cyprus	Germany	The Netherlands
<b>Range of possible NCA interventions</b>	<p>Among other things:</p> <ul style="list-style-type: none"> <li>- Require an LSI to take action deemed necessary by CBC to rectify problems</li> <li>- Impose specific conditions such as treatment of assets in terms of capital requirements or to use profits by LSI to strengthen funds, and to assume control of the business of the LSI for so long as the CBC considers necessary</li> </ul>	<p>The range of possible interventions for BaFin is broad. In practice, BaFin mainly requests removal of business deficiencies within a reasonable period.</p> <p>Until the end of 2015, it only imposed additional capital requirements in individual cases, if a LSI did not comply with BaFin's earlier intervention requirements in a timely manner.</p> <p>Since 2016, BaFin has implemented the EBA SREP guidelines and formalises to some extent an approach that requires a decision on Pillar 2 capital add-ons.</p>	<p>DNB can use a wide range of possible intervention instruments, but, in practice, mainly focuses on requiring LSIs to hold own funds in excess of the requirements, and to impose a liquidity requirement (LCR) with a longer survival period than minimally needed.</p> <p>Moreover, until the end of 2016, DNB required all LSIs to maintain their entire amount of additional capital in Capital Equity Tier 1 (CET1), i.e. highest quality capital.</p>
<b>Reporting of supervisory decisions to banks and the public</b>	<p>Supervisory decisions are reported to the LSIs via a confidential letter.</p> <p>Decisions are not made public.</p>	<p>Communicated back to LSIs depending on severity: by letter or formal decision.</p> <p>BaFin publishes certain imposed measures on institutions or senior managers of institutions on its website.</p>	<p>Supervisory decisions are reported to the LSIs via a confidential letter.</p> <p>Decisions are not made public.</p>
<b>NCA monitoring of follow-up by institutions</b>	<p>CBC monitors actions taken by LSIs after SREP (e.g. based on the LSIs' response letter).</p>	<p>Deficiencies are tracked by ongoing supervision until they are eliminated. This can take years.</p>	<p>DNB follows up on actions by LSIs in subsequent SREP years.</p>
<b>Assessment by NCA of effectiveness supervision</b>	<p>No</p>	<p>No</p>	<p>Not for each LSI individually. In the annual "State of Supervision", DNB reports on degree to which its medium-term objectives have been achieved.</p>



Table 4.3 shows that:

- All NCAs have a broad range of possible intervention instruments that they may use. Depending on how these instruments are used, different practices come to light. Up until 2015, the German supervisor put a major focus on imposing qualitative decisions, requiring LSIs to improve for example their business model. In the past, the NCA has only imposed additional quantitative capital requirements, if the earlier decisions had not been followed up on. Since 2016, this practice has changed in line with the EBA SREP Guideline. In contrast, in the Netherlands, the NCA's main instrument of choice is to impose additional capital requirements; in Cyprus, additional capital is imposed generally on assessment of risks to capital and less frequently on the assessment of other qualitative elements of the SREP.
- Only in Germany, the NCA sometimes publishes certain decisions that are part of the SREP.<sup>42</sup> In Cyprus and the Netherlands, the SREP decision is only shared with the LSI concerned on a confidential basis.
- Each of the NCAs assessed has a system in place to monitor the follow-up of its SREP decisions. However, the NCAs do not assess the extent to which its supervision has been effective with regard to the individual LSIs.

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<sup>42</sup> [https://www.bafin.de/DE/Aufsicht/BankenFinanzdienstleister/Massnahmen/Mitteilungen/mitteilungen\\_node.html](https://www.bafin.de/DE/Aufsicht/BankenFinanzdienstleister/Massnahmen/Mitteilungen/mitteilungen_node.html)

## 5 Audit Gaps

### 5.1 Supervision of SIs

With the introduction of the SSM, the responsibility of audit banking supervision of SIs was transferred from national SAIs to the ECA. The ECA's audit mandate with respect to the ECB is, however, narrowly defined as an examination of the operational efficiency of the management of the ECB in line with Art. 27 (2) of the Statute of the ESCB.<sup>43</sup> The SSM Regulation extends this mandate to the ECB's supervisory activities.

In a statement dated June 2015, the Contact Committee drew attention to the fact that "an audit gap has emerged in those euro area countries where previous audit mandates of national SAIs over national banking supervisors are not being replaced by a similar level of audit by the ECA over the ECB's supervisory activities."<sup>44</sup> It encouraged the European Parliament, the Council of the EU, the European Council and the European Commission to consider a strengthening of the ECA's mandate concerning the audit of the ECB's SSM.

On 16 December 2015 the president of the Eurogroup stated in a letter to the acting chair of the CC, that the establishment of the SSM per se did not create an audit gap. After all, the ECA's audit rights vis-à-vis the ECB were established in the ESCB/ECB statutes and were merely extended to banking supervision. However the Eurogroup acknowledged that there are differences in the depth of the audit competences for banking supervision at the European level compared to national practices in some member states. It invited the European Commission to pay particular attention to such differences when reviewing the SSM regulation and to explore the legal feasibility of a possible framework agreement between ECA and the ECB.

This call for action was followed up in a joint letter by the presidents of the SAIs of Germany and the Netherlands in their capacity as chairs of the CC Task Force

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<sup>43</sup> Council Regulation 1024/2013 (SSM Regulation) explicitly requires the ECA to take into account the supervisory tasks conferred on the ECB when examining the operational efficiency of the management of the ECB.

<sup>44</sup> [http://www.eca.europa.eu/sites/cc/Lists/CCDocuments/CC\\_STATEMENT\\_2015/CC\\_SSM\\_statement\\_EN.pdf](http://www.eca.europa.eu/sites/cc/Lists/CCDocuments/CC_STATEMENT_2015/CC_SSM_statement_EN.pdf)

on Banking Union to the European Commission in July 2016. In the letter, the Task Force drew special attention to the Eurogroup's suggestion made in its statement from 16 December 2015 to explore the legal feasibility of a possible framework agreement between the ECA and the ECB.

In November 2016, the ECA published its Special Report No 29/2016 on the SSM. In the audit, the ECA looked at the new mechanism's governance structure, the organisation and resourcing of banking supervision teams and the on-site inspection procedure. In the process, disagreement emerged with the ECB over the ECA's precise terms of its mandate and the right to access documents. In appendix 2 of the ECA's special report, it lists evidence that was not provided by the ECB although the ECA would have needed to perform its audit, including bank files. As a result, some important areas of the SSM's activities could not be covered.<sup>45</sup> These include the SREP.

In its response to the report, the ECB stated that it had not "imposed" a restriction on access to documents. "Access to documents by the ECA should be in line with its mandate as stipulated by Article 27 (2) of the ESCB Statute and Article 20 (7) of the SSM Regulation." According to the ECB, the ECA's mandate to audit the operational efficiency of the management of the ECB does not extend to such documents as minutes of the Supervisory Board of individual supervisory decisions. Therefore, in its view, there is no lack of cooperation, but a different interpretation of the audit scope.

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<sup>45</sup> European Court of Auditors (2016), „Special Report No. 2016/29 Single Supervisory Mechanism – Good start but further improvements needed“: <http://www.eca.europa.eu/en/Pages/DocItem.aspx?did=39744>. Pg. 45, No. 87.

At a Symposium on Building the Financial System of the 21st Century in Frankfurt on 30 March 2017, Yves Mersch, Member of the Executive Board of the ECB, gave a keynote address entitled “Central bank independence revisited.” He concluded that the additional mandates and functions conferred on the ECB after the financial crisis with regard to micro and macro prudential supervision and crisis management are not covered by the very high level of independence provided to the ECB under Art. 130 of the Treaty. Instead, they are subject to stricter accountability and democratic control requirements compared to the ECB’s traditional functions – especially monetary policy.

**Case in Point: Extract from the SSM Review on ECA**

“This review also looked at the effectiveness of the external audit applicable to the ECB, considering that the scope of ECA’s audit mandate over the ECB should be looked at in the context of the overall accountability arrangements applicable to the ECB in its supervisory capacity and in light of the fact that the mandates of national audit bodies over NCAs are very divergent. At the same time it should be highlighted that in accordance with the TFEU, the ECB is subject to an obligation to provide the ECA with any document or information necessary for the ECA to carry out the task corresponding to its legal mandate. It would be welcomed if the ECB and the ECA conclude an inter-institutional agreement to specify the modalities of information exchange in view of permitting the ECA access to all information necessary for performing its audit mandate.”

On 11 October 2017, the European Commission published its first review of Council Regulation No. 1024/2013 conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions. Art. 32(e) of the SSM regulation states that the review is to be published by 31 December 2015. Among other things, the review states that the accountability arrangements applicable to the ECB are overall effective. As to administrative accountability, the ECB is subject to extensive complementary reviews by various administrative bodies in the EU, including the ECA. While the Commission acknowledges that the ECA’s mandate to audit the operational efficiency of the ECB’s management “is indeed more limited than the mandates of certain national SAIs over national banking supervisory authorities”, the ECB’s accountability should be assessed “holistically in light of all accountability arrangements to which it is subject.” Art. 27 of the SSM regulation, as well as Art. 56-57 of the CRD IV in conjunction with Article 287 (3) second subparagraph of the Treaty on the Functioning of the European Union (TFEU) make clear that the ECB is required to provide any document or piece of information to the ECA that is necessary for the ECA to carry out its task, within the limits of its mandate. The

Commission encourages the ECA and the ECB to conclude an interinstitutional agreement that specifies the modalities of information exchange in view of granting the ECA access to all information necessary for performing its audit mandate.

### *Conclusions*

The ECA's Special Report No 29/2016 on the SSM confirms earlier concerns raised by the Contact Committee of EU SAIs in 2015 that the ECA is unable to comprehensively audit the ECB's supervisory activities. The main reasons for this are differences between the ECA and the ECB in understanding the ECA's audit mandate as laid down in Art. 27 (2) of the ESCB Statute and Art 20 (7) of the SSM Regulation. The ECB has so far held the view that the accountability provisions in primary and secondary law do not permit the ECA audit the conduct of the SREP.

The keynote address by Yves Mersch, Member of the Executive Board of the ECB, however, implies that prudential supervision is subject to more accountability and democratic control than monetary policy. Taking all arguments into account, we conclude that the ECA's mandate concerning banking supervision has to be defined more broadly than has been the case up to now. In our opinion, the definition should reflect that the provisions of Art. 27 (2) of the ESCB Statute are meant to protect the independence of monetary policy. The other ECB function – prudential supervision – needs to be subject to more stringent control and accountability than monetary policy. Prior to the implementation of the SSM, the German and Dutch SAI, for example, had the right to audit the entire process of supervising SIs and LSIs. We now face a situation where the ECA's mandate, as it is currently exercised in practice, falls short of the mandates several national SAIs, including those of Germany and the Netherlands, had prior to the introduction of the SSM.

## **5.2 Supervision of LSIs**

NCAs continue to supervise LSIs, however, on behalf of the ECB. In Art. 59 (2), the CRD offers Member States the possibility to authorize the disclosure of certain information relating to the prudential supervision to SAIs in their Member

State. A necessary precondition is that SAIs have a specific mandate under national law to investigate or scrutinise the actions of authorities responsible for the supervision of institutions or for laws governing such supervision.

#### 5.2.1 Supervision of LSIs in countries with audit mandates

At least eight SAIs have a mandate under national law to audit banking supervision of LSIs, out of which four participated in the full parallel audit of the Task Force on the European Banking Union. Their audit scopes are outlined in Appendix 1. In general, banking supervisory institutions are set up as public law entities in these countries and SAIs are authorised in their respective national primary or secondary law to audit such entities. Subject to the limitations imposed by Central Bank independence, the same rights to audit and to access information apply as regards government controlled entities.

The audit findings confirmed that three out of the four participating SAIs (Austria, Germany, the Netherlands) were able to gain access to national supervisory documentation. This includes LSI bank files needed to perform a comprehensive audit of the set-up and functioning of banking supervision in line with their respective mandate. The SAI of Austria also included SIs in its national audit and was given access to relevant documentation. The SAI of Cyprus, on the other hand, was limited in its ability to audit supervisory activities with regard to LSIs due to a narrow interpretation of its audit mandate by the NCA.<sup>46</sup>

However, at the same time, the audit also showed that all four participating SAIs encounter difficulties when attempting to access ECB documents relevant to LSI supervision. These include but are not limited to the below:

a) *The "SSM Supervisory Manual – Processes, Procedures and Methodology for the Supervision of Significant and Less Significant Institutions" (SSM Manual) issued by the ECB.*

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<sup>46</sup> Only SREP reports were provided on the grounds that Art. 28A of the Banking Business Law permits disclosure of supervisory information in summary form only (transposition of Art. 53 CRD).

Access to the manual is pertinent as some NCAs use the SSM methodology for SIs even for LSI supervision (Netherlands, Cyprus). Out of the four participating SAIs, only the SAI of Austria was able to obtain the SSM Manual (as applicable in December 2015) because it was used by the Austrian supervisory institutions as a reference model. However, the SAI of Austria was not entitled to evaluate the ECB's Manual as its audit mandate (based on the Austrian Federal Constitution) did not cover the ECB and documents issued by the ECB. The SAI of Cyprus was given hard copies of some sections of the SSM Manual at the start of the audit but was later requested to return these due to confidentiality requirements. The SAI of the Netherlands explicitly requested access to the SSM Supervisory Manual but was denied access with the exception of certain pages not relevant to the audit. The German SAI has also not been granted access to the SSM Manual.

b) *Documents concerning LSIs submitted to the ECB's Information Management System (IMAS)*

ECB's confidentiality requirements prevent SAIs from accessing supervisory information submitted to the ECB's IMAS, despite the fact that the information is about LSIs and should therefore be auditable by Member State SAIs. The SAI of the Netherlands, for example, was denied access to IMAS on the grounds that it included supervisory information on SIs. At the same time, the Dutch NCA already loaded onto IMAS supervisory information on all LSIs, although this has not yet been required.<sup>47</sup> Once the process of uploading is complete, the Dutch SAI will no longer be able to access supervisory information on LSIs despite the fact that it has a legal mandate to audit the supervision of said institutions. The SAI of Cyprus was not granted access to any internal systems of the Central Bank's Bank Supervision and Regulation department, including IMAS

**Case in point: IMAS in Germany and the Netherlands**

BAFIN and Bundesbank are currently using their own national information management system called BAKIS. However, along with other NCAs they participate in a test phase of IMAS for LSIs, which is expected to be completed in 2018.

The Dutch NCA also uses its own national information management system and has, at the same time, started using IMAS for all LSIs. Once IMAS is fully operational for LSIs, the Dutch supervisor will most likely cease using its own national system.

<sup>47</sup> It is expected that the ECB will require NCAs to archive their supervisory information on LSIs in IMAS from 2019/2020 onwards.

and the intranet. The SAI of Austria reported that it was able to observe SI actions of the Austrian Central Bank in IMAS. The SAI of Germany does not have any audit experience concerning documents submitted to IMAS, as IMAS is just being tested by its national banking supervisors.

*c) ECB's Annual report on the SSM supervision of LSIs.*

The ECB has prepared this document since 2016 using qualitative and quantitative information supplied by NCAs concerning the previous calendar year. To that end, NCAs are asked by the ECB to complete templates and questionnaires. Access to the annual report has not been provided to most of the participating SAIs on the grounds of ECB confidentiality. The SAI of Cyprus asked its NCA to provide the questionnaire/templates submitted to the ECB and/or the part of the Annual Report relating exclusively to the supervision of Cypriot LSIs. However, access was not granted.

The aforementioned documents (SSM Supervisory Manual, national supervisory documents submitted to IMAS, ECB's Annual report on the SSM supervision of LSIs) have been classified as ECB-restricted or higher as defined in the Common Rules and Minimum Standards (CRMS). The CRMS are to ensure that, within the entire Euro-system, sensitive ESCB and SSM information is treated

**Case in point: Access to documents by the Cypriot and Dutch SAIs**

Following instructions received by the ECB, the Cypriot NCA asked the SAI of Cyprus, before providing access to documents, to provide a written confirmation that confidential information would be protected appropriately and to agree in writing that certain local information provided to the Cyprus SAI would not be shared with any other institution.

The SAI of Cyprus believed that setting such pre-conditions before providing access to information constituted a very different interpretation of its audit mandate by the CBC<sup>48</sup> and went beyond the provisions of applicable national and EU legislation. Nevertheless, the head of the Cypriot SAI provided the NCA with a written confirmation that he fully respects the provisions of applicable national and EU legislation.<sup>49</sup> Nevertheless, no access was granted to a number of ECB-restricted documents as well as other internal CBC documents such as the annual budget. In addition, the Cypriot SAI had to await the completion of a lengthy consultation process with the ECB before getting access to the documents and information requested.

The SAI of the Netherlands directly made contact with the ECB regarding access to some ECB information, as the NCA instructed it to do so. However, the ECB did not answer to this request.

<sup>48</sup> See Appendix 1.

<sup>49</sup> The same wording was used when the NCA granted access to ECB-restricted information to the SAI of Cyprus in a previous audit.



with appropriate care. Based on the CRMS, the local management may share with third parties ECB-restricted information or information classified with a similar level of protection by national authorities so long as this is justified on business grounds. Furthermore, Guideline (EU) 2015/856 of the ECB laying down the principles of an Ethics Framework for the SSM permits members of the ECB and the NCAs to disclose inside information to other persons provided that such disclosure is made in the course of carrying out professional duties on a need-to-know basis.

In practice, however, some national banking supervisors require SAIs to go through lengthy approval processes before sharing ECB-restricted information. In other cases, they fully refuse to provide the requested information.

### *Conclusions*

The audit findings confirm that even in the area of supervision of LSIs – an area where national SAIs are meant to have full competence – SAIs are currently faced with restrictions (in some cases of a severe nature). The reason for this is that an increasing number of documents concerning LSIs are subject to the ECB's Common Rules and Minimum Standards. These specify that sensitive ESCB/SSM information must not be shared with persons outside the ESCB/SSM without express prior authorization. The stringency of the restrictions depends on the level of classification applied, ranging from ECB-restricted to ECB-secret. It is expected that this 'new' audit gap is likely to increase in importance as the ECB issues more guidance and methodology regarding the prudential supervision of LSIs (e.g. ECB Common Standards for Supervising LSIs).

#### 5.2.2 Supervision of LSIs in countries without audit mandates

An ECA survey suggests that at least ten SAIs have a limited mandate or no mandate to audit the supervision of LSIs. This can have a number of reasons, including that the SAI does not have the capacities to perform such audits on banking supervision. As a result, banking supervision of LSIs in these countries is not subject to an independent, external audit.

The lack of mandate can stem from the absence of a *de jure* audit right by the SAI over banking supervision, as in Finland.

#### **Case in point: Finland**

The Financial Supervisory Authority FIN-FSA (Finanssivalvonta in Finnish) is responsible for the supervision of Finland's financial and insurance sectors. Prudential supervision is one of the key tasks of the FIN-FSA. The FIN-FSA is also the NCA in Finland and it participates in the SSM. FIN-FSA conducts supervision in cooperation with the ECB's banking supervision arm.

From an administrative point of view, the FIN-FSA operates in cooperation with the Bank of Finland (the Central Bank of Finland). In line with the Constitution of Finland (731/1999, § 90), the Bank of Finland operates under the guarantee and supervision of Parliament. According to the Act on the National Audit Office (676/2000, § 1), the National Audit Office's tasks shall not include auditing the Bank of Finland. Hence, the National Audit Office of Finland has no mandate to audit the FIN-FSA.

In other countries, SAIs may have a *de jure* mandate - ranging from comprehensive to more limited - but are unable to exercise this right in practice. One case in point is Slovenia as illustrated below.

#### **Case in point: Slovenia**

In Slovenia, credit institutions are supervised by its Central Bank, the Bank of Slovenia (BoS). At present, the Slovenian Court of Auditors (CoA) does not have an explicit mandate to audit the supervision performed by BoS. While the Act on the Court of Auditors permits the CoA to audit any legal entity of public law (Art. 20 (5)) and establishes that the BoS is a legal entity governed by public law (Art. 1 (2)), the CoA has, in practice, faced resistance when attempting to audit the BoS. The main reason provided for this restriction is Central Bank independence. This is why a legislative process has been initiated to amend Art. 52 of the BoS Act, giving the CoA an explicit mandate to conduct regularity and efficiency audits of BoS operations as defined by the CoA Act. The amended BoS Act addresses issues raised by the ECB in its opinions CON/2014/25 and CON/2015/8 and has come into effect on 21 October 2017. At the end of October 2017 BoS informed CoA that it has requested the Constitutional Court of the Republic of Slovenia to find the amended law to be unconstitutional as it interferes with Central Bank independence and is retroactive.

In Slovenia, the Court of Auditors sought to address this situation by making its mandate more explicit in the relevant legislation.

In the course of this audit, we also came across an example where Parliament decided to give an explicit mandate to the SAI to audit banking supervision performed by the NCA. This solution may, however, no longer be open to euro area countries.

### Case in point: Bulgaria

The Bulgarian National Audit Office (BNAO) has a *de jure* mandate to audit the budget expenditures of the Bulgarian National Bank (BNB), the reports on the budget outlays of the BNB and the enactment of the Public Procurement Law. On 29 April 2015, the 43<sup>rd</sup> National Assembly adopted Decision No 45, assigning the BNAO the task of auditing the BNB's banking supervision. The audit scope included important areas for identifying key issues concerning the legal framework of the banking supervision, planning of the supervisory function, performing and reporting the distant supervision and checks on the spot. The results of the audit have been published:

<http://www.bulnao.government.bg/en/articles/the-bulgarian-national-audit-office-carried-out-performance-audit-on-the-effectiveness-of-banking-supervision-1584>.

Note: Bulgaria is not a member of the euro area and therefore not automatically part of the SSM. However, it has the option to participate in the SSM; in this case, its national supervisor enters into "close cooperation" with the ECB.

### Conclusions

The fact that at least ten SAIs in the euro area have a limited or no mandate to audit banking supervision of LSIs and/or are facing difficulties exercising this right in practice is a matter of concern. An independent and professional SAI is an important actor in a country's accountability chain.<sup>51</sup> Decisions made by the European Parliament, the European Commission, national parliaments and national governments with regard to banking supervision should not solely be based on the self-assessment of the Central Banks concerned but also on verified information, provided that the respective SAI has the capacities to audit this. This chain is interrupted or cut short where SAIs are not given the opportunity to advise parliament on the efficiency and effectiveness of banking supervision of LSIs. In a policy area where trillions of euros are at stake, accountability and democratic control should not be compromised.

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<sup>51</sup> OECD on SAIs : <http://www.oecd.org/gov/external-audit-supreme-audit-institutions.htm>

## **6 Overall conclusions**

This audit was conducted in parallel in five EU Member States (Austria, Cyprus, Finland, Germany and the Netherlands) with two objectives in mind:

1. To gain insight into the regulatory framework governing LSIs after the SSM came into effect and the way in which banking supervision is set up and carried out in practice.
2. To collect evidence about possible 'audit gaps' that may have emerged as a result of the introduction of the SSM. In particular, the audit sought to identify problems that SAIs have been confronted with in auditing supervision of LSIs in their own countries.

### **Part 1 – Review of Regulatory Framework and Banking Supervision**

#### Regulatory Framework (Chapter 2)

The regulatory framework regarding banks in the EU is complex and has undergone a number of changes in recent years. In particular, national banking acts had to be amended several times to ensure compliance with the SSM as well as other rules, such as the CRR and CRD IV. Differences in how EU directives are transposed and other non-binding standards are applied have resulted in a regulatory system that is diverse. As a result, LSIs face different regulatory requirements in different countries and this affects the way in which supervision is performed.

#### Design of Supervision (Chapter 3)

There are a number of differences in the design of prudential supervision. They mainly concern the question as to whether the national prudential supervisor is an institution separate from the National Central Bank, and its relation to the Central Bank. In most of the countries, prudential supervision falls within the remit of the National Central Bank. This arrangement can have the advantage of protecting supervisory decision making from political interference, but may reduce democratic control and oversight on the other hand. In the Netherlands, the Dutch Central Bank is the sole prudential supervisor of LSIs, and the Ministry of Finance is involved in establishing the Central Bank's supervisory budget.

In the five Member States that participated in the parallel audit, the budgets for supervision available to the NCAs vary significantly, with the supervisory budget per credit institution in the Netherlands being eight times as high as the budget per credit institution of the Austrian, Finnish or German supervisory authority. However, these comparisons have the drawback that the underlying data on budgets and staff does not directly lend itself to a meaningful comparison.

The resources allocated to the supervisors differ among the countries. In some SAIs, resources – such as staff, IT and budget – are allocated on the basis of supervisory tasks, whereas in other SAIs the allocation is made on a departmental basis following different methods and criteria. We have not gained any evidence to suggest that one approach is to be preferred over another.

Supervision of supervisors lies within the general responsibility of the ECB, but is also performed at national level in all the five countries. We note that in three out of five participating countries the Ministry of Finance bears a central role in supervision of the supervisor (Austria, Germany, the Netherlands). Also Parliament and representatives of the regulated institutions (Austria, Germany) participate in this scrutiny.

#### Supervision of LSIs in Practice (Chapter 4)

There are three steps involved in the prudential supervision of LSIs: risk analysis, supervisory review and evaluation, intervention and follow-up on decisions taken.

As part of the risk analysis, the systemic relevance of LSIs is, as a first step, established by the banking supervisors of the participating countries using different methods. Whereas the NCAs of Cyprus and the Netherlands (partially) use the ECB's SI-method to categorise LSIs, the German NCAs (BaFin and Bundesbank) follow their own method of categorizing LSIs according to their quality and systemic importance. The methods used for performing risk analysis also differ: The NCAs of Cyprus and the Netherlands assign SSM-based RAS scores; however, whereas the SAI of Cyprus does this on the basis of qualitative expert judgement, the Dutch NCA combines quantitative tools with additional

qualitative expert judgement. On the other hand, the German supervisors focus on ICAAP.

In the annual SREP, four main elements are assessed: the viability and sustainability of the business model of a bank, the adequacy of governance and risk management of a bank, the risks to capital and the risks to liquidity and funding. The parallel audit revealed that NCAs differ in their focus on these elements. Until 2015, the German supervisors focused mainly on the first two (mostly qualitative) elements. Since then, the German supervisors, like their Dutch counterparts, have focused mainly on the quantitative capital and liquidity assessment of LSIs. The Cypriot supervisor focuses more on the assessment of the bank's governance and risk management arrangements and the risks to capital.

We identified a difference in the information basis of the SREP. In the Netherlands, all LSIs, including those with a low systemic risk, are subject to a full SREP assessment of capital and liquidity, namely on the basis of annual input of data from the banks. In Germany, an annual SREP is performed that is based on:

- annual audit by an external auditor which includes a qualitative assessment and financial statement analysis,
- annual input of data from the banks
- the results of special audits the frequency of which depends on the risk classification and systemic relevance of the bank in question. Special audits are not carried out on an annual basis for every LSI.

In Germany and in the Netherlands, the SREP is harmonised for all LSIs. In Germany, the national SREP complies with Guidelines from the EBA on common procedures and methodologies for the Review and Evaluation Process. In the Netherlands, the Review and Evaluation Process is based on the ECB methodology for SIs.

Finally, we found that different practices exist concerning the intervention instruments that NCAs use towards the LSIs they supervise and the way these

interventions are followed up. Although this practice is now subject to change, until year-end 2015, the German NCA has, only imposed additional quantitative capital requirements if qualitative measures recommended earlier in the process were not followed up. In contrast, the Dutch NCA tends to impose additional capital requirements from the start and for each individual LSI. The Cypriot NCA generally tends to impose additional capital based on its assessment of the risks to capital and less frequently based on other qualitative elements of the SREP. In Germany, the NCAs sometimes publish certain decisions that are part of the SREP. In Cyprus and the Netherlands, the decision is only shared with the LSI concerned on a confidential basis. While each of the fully audited countries' NCAs has a system in place to monitor the follow-up of its SREP decisions, none of the NCAs evaluates the extent to which its supervision has been effective on an individual LSI-basis.

### Key results

- The way banking regulation is transposed, as well as banking supervision is designed and conducted, varies across different EU Member States. Within the Single Supervisory Mechanism, the single rulebook has to be adhered to. Nevertheless, the set-up and conduct of supervision can be tailored to meet the requirements of specific national situations and national rules and regulations.
- Future efforts by NCAs and the ECB are needed to strike a balance among harmonisation, proportionality and supervisory flexibility to match national specific circumstances. We encourage the European Commission and national decision-makers to closely follow up on how supervisory practice will develop in the Member States.

## Part 2 – Gaps in auditing the supervision of banks

### Limited audit mandate of the ECA to audit the supervision of SIs

The audit mandate of the ECA with respect to the (monetary activities of) ECB is narrowly defined as an examination of the operational efficiency of the management of the ECB. The SSM Regulation extends this mandate to the ECB's supervisory activities.<sup>52</sup> The ECA's Special Report on the SSM was published in November 2016 and confirms earlier concerns that the ECA is unable to comprehensively audit the ECB's supervisory activities.<sup>50</sup> In practice, this means

<sup>52</sup> Art. 27 (2) of the Statute of the European System of Central Banks. Council Regulation 1024/2013 (SSM Regulation) explicitly requires the ECA to take into account the supervisory tasks conferred on the ECB when examining the operational efficiency of the management of the ECB.

<sup>50</sup> Special report No 29/2016.

that the loss of mandate encountered by some national SAIs after the introduction of the SSM, is not compensated by the ECA. Prior to the SSM, at least eight SAIs had the *de jure* mandate to perform comprehensive audits of banking supervision with regard to SIs.

#### SAIs face limitations in exercising their audit mandate

Furthermore, some national SAIs with a mandate to audit the supervision of LSIs, are facing increasing difficulty accessing relevant documents. This is because an increasing number of documents on LSIs are subject to the ECB's Common Rules and Minimum Standards (CRMS). According to the standards, ECB confidential information cannot be shared with persons outside the system of Central Banks without express prior authorization. As a result, SAIs are unable to access documents needed to perform audits on LSIs in line with their mandate. These audit gaps are expected to increase in importance as the ECB issues more harmonizing guidance and methodology regarding the prudential supervision of LSIs in the years to come. For example, in the period starting 2019/2020, all information on LSIs will be integrated in IMAS (Information Management System) of the ECB. This means that as from that moment, SAIs will no longer be able to fulfil their legal duty to audit the supervision of LSIs.

#### Some national SAIs have no audit mandate

At least ten SAIs in the euro area have a limited or no mandate to audit banking supervision of LSIs and/or are facing difficulties exercising this right in practice. The lack of mandate can stem from the absence of a *de jure* audit right with regard to banking supervision, as for example in Finland. Some SAIs do not at present have the capacities to audit banking supervision. As a result, banking supervision of LSIs in these countries is largely not subject to an independent, external audit by the SAI.



### Key Recommendations

- The ECA and the ECB should conclude – as a first step – an inter-institutional agreement specifying the modalities of their information exchange. However, we ultimately deem it necessary to clarify the audit mandate of the ECA with regard to the supervision of SIs, as this has a direct effect on the range of information the ECB is able to share with the ECA. It may be necessary to cement this clarification in secondary law and, if needed in primary law, with a view to generating greater legal certainty and creating a sustainable solution.
- NCAs should authorize disclosure of information relating to prudential supervision of LSIs to their respective SAIs, in line with in Art. 59 (2) of the Capital Requirements Directive.
- National governments and parliaments in the EU should examine whether their SAI has been given the *de jure* and *de facto* mandate to audit banking supervision. Where necessary and feasible they should seek an extension of their audit mandates in line with Art. 59 (2) of the Capital Requirements Directive.

## Appendix 1

Country	Relevant Laws and Regulations	Main Content of Laws
Germany	<p>Art. 111 (1) Federal Budget Code</p> <p>Art. 1 (1) Financial Services and Integration Act</p> <p>Art. 2 (1) Bundesbank Act</p>	<p>Art 111 para. 1 of the Federal Budget Code states that the Bundesrechnungshof shall examine the financial management of federal public law bodies.</p> <p>Articles 89 through 99, 102 and 103 of Federal Budget Code apply to the Bundesrechnungshof's audit of BAFIN and Bundesbank accordingly. Art. 95 of the Federal Budget Code specifies that documents which the Bundesrechnungshof deems necessary for carrying out its functions must, on request, be sent to it within a set period or presented to its authorised officers. The Bundesrechnungshof and its authorised officers shall have access to any information they require.</p> <p>The Federal Financial Supervisory Authority (BaFin) and the Bundesbank are entrusted with national banking supervision. Both institutions have the status of federal public law bodies (Article 1, paragraph 1 of the Financial Services and Integration Act and Article 2 Sentence 1 of the Bundesbank Act).</p>
The Netherlands	<p>Art. 91 Government Accounts Act</p> <p>Art. 1:93d Financial Supervision Act</p>	<p>Art. 91 of the Government Accounts Act outlines the audit powers of the Netherlands Court of Audit.</p> <p>In the case of the Dutch Central Bank (DNB) – which is responsible for prudential supervision – it is specified that the Netherlands Court of Audit can audit DNB except for the activities it undertakes with respect to TFEU, i.e. the monetary tasks of the DNB.</p> <p>Furthermore, following Art.59 (4) of the CRD, the Dutch Financial Supervision Act was adapted to explicitly state that the Netherlands Court of Audit has access to confidential data (article 1:93d). This was added in 2014 after the NCA experienced limitations in its access to prudential supervision data.</p>
Austria	<p>Art. 126b (1)-(2) Austrian Federal Constitution</p> <p>Art. 1 Financial Market Authority Act (FMABG)</p> <p>Art. 9 Federal Act on the Austrian Central Bank</p>	<p>The audit mandate granted by the Austrian constitution provides audit rights to the Austrian Court of Audit (ACA) which cover the Austrian Central Bank (OeNB) as well as the FMA.</p> <p>The ACA is entitled to audit federal institutions as well as enterprises where the Federation holds at least 50 per cent of the share, stock, or equity capital (Art. 126b para. 1-2 Austrian Federal Constitution).</p> <p>Art. 1 Financial Market Authority Act (FMABG) established the FMA as an institution under public law. The ACA's mandate is based on Art. 126b para. 1 Austrian Federal Constitution.</p> <p>The "Bund" (Federation) is the sole shareholder of the OeNB (Art. 9 Federal Act on the Austrian Central Bank); i.e. the Federation holds at least 50 per cent of the share, stock, or equity capital (Art 126b para. 2 Austrian Federal Constitution) which grants an audit mandate to the ACA.</p>

Country	Relevant Laws and Regulations	Main Content of Laws
Cyprus	Art. 60 of the Central Bank of Cyprus Laws of 2002-2007	<p>The Auditor General of the Republic has a legal mandate to audit the operational effectiveness of the supervision activities of the CBC which are not related to its tasks and competences derived from the ESCB. Article 60 of the CBC Laws of 2002 – 2007 (unofficial translation by Audit Office) reads as follows:</p> <p>“(b) Without prejudice to Article 38 of the Statute, the Auditor General of the Republic may carry out financial and performance audit of the activities of the Bank, that are not related to its tasks and competences [of the Bank] derived from the ESCBs, and under the condition that his reports and audit activities do not touch upon the Bank’s independence.</p> <p>In order for the Auditor General to carry out the abovementioned task, the Bank provides to him all the necessary information, books and other records.</p> <p>For the purposes of this paragraph performance audit shall mean the audit of the operational effectiveness of the activities of the Bank that are not related to its tasks and competences [of the Bank] derived from the ESCB and which does not touch upon its independence.”</p> <p>Based on the above information, the Auditor General has a legal mandate to audit the operational effectiveness of the supervision activities of the CBC for LSIs, since this competence does not derive from the CBC’s participation in the ESCB.</p>
Finland		The National Audit Office of Finland does not have the right to audit FIN-FSA.

## Appendix 2

Article 59 paragraph 2 of Directive 2013/36/EU of the European Parliament and the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC

"Member States may authorise the disclosure of certain information relating to the prudential supervision of institutions to parliamentary enquiry committees in their Member State, courts of auditors in their Member State and other entities in charge of enquiries in their Member State, under the following conditions:

- (a) that the entities have a precise mandate under national law to investigate or scrutinise the actions of authorities responsible for the supervision of institutions or for laws on such supervision;
- (b) that the information is strictly necessary for fulfilling the mandate referred to in point (a);
- (c) the persons with access to the information are subject to professional secrecy requirements under national law at least equivalent to those referred to in Article 53(1);
- (d) where the information originates in another Member State that it is not disclosed without the express agreement of the competent authorities which have disclosed it and, solely for the purposes for which those authorities gave their agreement.

To the extent that the disclosure of information relating to prudential supervision involves processing of personal data, any processing by the entities referred to in the first subparagraph shall comply with the applicable national laws transposing Directive 95/46/EC."