EUROPEAN CENTRAL BANK

BANKING SUPERVISION

Andrea Enria
Chair of the Supervisory Board

Mr Sven Giegold
Member of the European Parliament
European Parliament
60, rue Wiertz
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Frankfurt am Main, 23 June 2020

Re: Your letters (QZ020 and QZ011)

Honourable Member of the European Parliament, dear Mr Giegold,

Thank you for your letter on the solvency criterion (QZ020), which was passed on to me by Ms Irene Tinagli, Chair of the Committee on Economic and Monetary Affairs, accompanied by a cover letter dated 27 March 2020. I will also address some of the questions you posed in your letter to the ECB President (QZ011), which was passed on by Ms Tinagli accompanied by a cover letter dated 20 March 2020. The President forwarded your letter to me as this topic is also related to banking supervision.

With regard to your first point (in both letters) on precautionary recapitalisation, let me first recall that this procedure is an exception to the determination that a bank is failing or likely to fail (FOLTF) in cases where extraordinary public financial support is necessary to remedy a serious disturbance in the economy of a Member State and preserve financial stability. A bank may request precautionary capitalisation to address a capital shortfall established in the national, Union or SSM-wide stress tests, asset quality reviews or equivalent exercises conducted by the European Central Bank (ECB), the European Banking Authority (EBA) or national authorities, where applicable, confirmed by the competent authority. Other conditions set out in the applicable legal framework must also be met, including the requirement that the bank requesting precautionary recapitalisation be solvent.

In the event that a bank under the ECB's direct supervision applies for precautionary recapitalisation within the scope of Article 18(4)(d)(iii) of the Single Resolution Mechanism Regulation (SRMR)[1], the ECB assesses the bank's solvency.

[1] Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010, (OJ L 225, 30.7.2014, p. 1).

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Initially, the ECB had adopted an internal methodology for the assessment of solvency which was based on the bank's compliance with the minimum capital requirements pursuant to Article 92 of the Capital Requirements Regulation[2] (i.e. Pillar 1 requirements). This methodology was published on the ECB Banking Supervision website. The reference to this internal methodology was subsequently deleted as it was revisited in 2018 to incorporate a forward-looking assessment based on Pillar 1 and Pillar 2 capital requirements, also ensuring alignment with the FOLTF assessment.

More in details the new internal methodology follows a two steps approach.

As first step a forward looking assessment is performed based on Pillar 1 requirements (i.e. 4.5% CET1 and 8% total capital), taking into account certain and highly probable net losses and/or decrease of capital ratios in the next 12 months as well as remedial actions which have been confirmed and adequately substantiated with proof by the bank. Only if the bank fulfils Pillar 1 requirements throughout that interval is the first step requirement considered to be met.

As a second step, after the first step requirement is met, solvency should be confirmed if the Supervisory Board judges that it is unlikely that the bank will have sustained breaches of Pillar 2 requirements over the next 12 months after cleaning Pillar 2 requirements of any double counting.

Against this background, and linked to your second question, compliance with Pillar 2 requirements is considered in the new internal methodology for precautionary recapitalisation, which is also in line with the approach taken in the context of authorisation of credit institutions[3].

While this approach reflects the limited experience so far, in future the ECB might have to adjust the internal methodologies. For instance, in systemic crises the degree of uncertainty on future developments could make the forward looking assessment more problematic.

For the sake of completeness, and linked to your second question to President Lagarde in letter QZ011 on the FOLTF assessment, a bank is deemed to be FOLTF if it meets, or is likely to meet in the near future, one or more of the conditions set out in Article 18(4) of the SRMR. These conditions are that a bank: (i) infringes requirements for continuing authorisation in a way that would justify the withdrawal of the authorisation; (ii) has more liabilities than assets ("(likely) over-indebtedness"); (iii) is unable to pay its debts as they fall due ("(likely) illiquidity"); or (iv) requires extraordinary financial public support (with certain exceptions, including precautionary recapitalisation as mentioned above). In line with the EBA Guidelines on FOLTF, the determination whether a bank is FOLTF is an expert judgement based on a comprehensive assessment of both qualitative and quantitative objective elements, taking into account all other circumstances and information relevant to the bank.

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[2] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012 (OJ L176, 27.06.2013, p. 1).

[3] See also ECB Guide to assessments of license applications, available at https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.201901_guide_assessment_credit_inst_licensing_appl.en.pdf

With regard to your last question relating to the definition of solvency for the purposes of emergency liquidity assistance (ELA), we use a definition which is based on point-in-time compliance with the minimum capital requirements (Pillar 1 requirements). This different definition can be explained by the different nature of ELA and Precautionary Recapitalisation. While ELA is a collateralised liquidity assistance, the precautionary recapitalisation framework does not foresee any form of collateral. Still, discussions are under way to consider the possible need to align the two definitions of solvency.

Yours sincerely,

[signed]

Andrea Enria