Feedback on the input provided by the European Parliament as part of its resolution on the ECB Annual Report for 2015

The ECB's Annual Report for 2015 was presented by the ECB's Vice-President on 7 April 2016 in a dedicated session of the Economic and Monetary Affairs Committee of the European Parliament.[1] Later in the year, on 21 November, the President of the ECB attended the Parliament's plenary debate on the Annual Report.[2] The following day, the plenary adopted its resolution on the ECB Annual Report for 2015 (hereinafter "the resolution").[3]

On the occasion of the transmission of the ECB Annual Report for 2016 to the European Parliament, the ECB is providing its feedback on the input provided by the European Parliament as part of its resolution.[4] This feedback is made public in line with the practice started last year in response to a request from the European Parliament.[5] This provides a further example of the ECB's commitment to accountability, going beyond the requirements of the Treaty.

1 The ECB's monetary policy

1.1 The effectiveness of the ECB's measures

The resolution discusses the effectiveness of the ECB's monetary policy measures and their impact on financing conditions in the euro area in several articles, for example in paragraphs 11, 12, 13, 15 and 17.

The ECB considers that the financial conditions faced by companies and households in the euro area have improved since the launch of the asset

1 See https://www.ecb.europa.eu/press/key/date/2016/html/sp160407_1.en.html

2 See https://www.ecb.europa.eu/press/key/date/2016/html/sp161121_1.en.html

3 The text of the resolution as adopted is available on the European Parliament's website at http://www.europarl.europa.eu/sides/getDoc.do?type=TA&reference=P8-TA-2016-0433&language=EN&ring=A8-2016-0302

4 This feedback does not cover the issues raised in the European Parliament's resolution related to ECB Banking Supervision and the Single Supervisory Mechanism. For a discussion on these matters, see the ECB Annual Report on supervisory activities (available at https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssmar2016.en.pdf) and the feedback accompanying the transmission letter (available at https://www.bankingsupervision.europa.eu/ecb/pub/pdf/170317_coverletter_ecb_ar_on_supervisory_activities_2016en.pdf).

5 See paragraph 23 of the European Parliament resolution of 25 February 2016 on the European Central Bank Annual Report for 2014 available at http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+P8-TA-2016-0063+0+DOC+PDF+V0//EN

purchase programme (APP)[6] **and the targeted longer-term refinancing operations (TLTROs).**[7] This improvement has been significant and has promoted a sizeable recovery in lending to firms and households in the euro area at steeply falling borrowing costs. The costs of bank borrowing for non-financial corporations (NFCs) declined by around 115 basis points between May 2014 and February 2017, while the dispersion of these costs across the euro area decreased significantly.[8] These improving lending conditions are crucial in supporting additional spending plans of households and firms given the predominantly bank-based financial structure of the entire euro area.

As regards the resolution's emphasis on financial conditions for small and medium-sized enterprises (SMEs), it should be noted that SMEs seem to have particularly benefited from the increasing pass-through of policy rates since the credit easing package of June 2014. From that date until February 2017, bank lending rates on very small loans (those of below €250,000, which are to be taken as a proxy for SME loans) declined by around 180 basis points, whereas bank lending rates on all NFC loans declined by around 115 basis points (and those on large loans, i.e. of above €1 million, to NFCs declined by around 90 basis points).[9] However, structural differences, for example owing to different risk profiles and asymmetric information, imply higher lending rates for SMEs than for large firms.

The ECB does not share the resolution's concerns regarding the distortive effects of the corporate sector purchase programme (CSPP) for SMEs. In order to be as inclusive as possible for euro area incorporated companies, the CSPP eligibility criteria have been drafted in a broad manner (e.g. no minimum issuance amount, eligibility of short-dated debt instruments). Moreover, buoyant bond market conditions for large companies owing to the CSPP make it attractive for these companies to obtain more funding from bond markets, incentivising banks to use the increased space on their balance sheets to provide loans to SMEs.

The ECB's policy measures have contributed to a significant improvement in banks' funding conditions. This has happened mainly through two channels. First, bank funding instruments were among the asset classes that saw a substantial compression of medium-to-long-term yields. This was supported by portfolio

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6 The APP includes all programmes under which private sector and public sector securities are purchased to address the risks of a too prolonged period of low inflation. It consists of: i) the third covered bond purchase programme (CBPP3); ii) the asset-backed securities purchase programme (ABSPP); iii) the public sector purchase programme (PSPP); and iv) the corporate sector purchase programme (CSPP). Monthly net purchases of public and private sector securities amount to €80 billion on average (from March 2015 until March 2016 this average monthly figure was €60 billion). From April 2017 they will amount to €60 billion on average. For more information, see https://www.ecb.europa.eu/mopo/implement/omt/html/index.en.html

7 TLTROs are one of the ECB's non-standard monetary policy tools. Through TLTROs the ECB provides long-term loans to banks and offers them an incentive to increase their lending to businesses and consumers in the euro area. For more information, see https://www.ecb.europa.eu/explainers/tell-me/html/tltro.en.html

8 For direct access to the summary statistics, see https://www.euro-area-statistics.org/

9 See footnote 8.

rebalancing effects from Eurosystem asset purchases[10] and by scarcity effects owing to lower bond issuance by banks, which could fund themselves under the TLTROs. Second, banks continued to replace more expensive, short-term market funding with TLTRO funding (and, in addition, used the option to roll over TLTRO-I with the cheaper TLTRO-II). The improvement in banks' funding conditions has influenced broader financial conditions and, eventually, economic growth and inflation.

The ECB takes note of the issue raised in the resolution that it is also important to examine the potential impact of banking characteristics on the transmission mechanism. The ECB has provided analysis on this specific aspect of the bank lending channel, in particular on fragmentation.[11] While the monetary transmission mechanism, which consists of various channels[12], was significantly hampered and had almost ceased to function in a number of countries at the height of the crisis, the ECB's non-standard measures have contributed to unblocking the pass-through across a large set of countries and across different banking characteristics. The pass-through from policy rates to the lending rates of households and enterprises has now become more even, after showing significant differences during the first few years of the financial crisis.

1.2 Monetary policy implementation

Paragraph 4 of the resolution highlights the incentive structure of TLTRO-II and questions its effectiveness.

The change in the incentive structure in TLTRO-II (compared with the first series of TLTROs) is intended to incentivise banks to pass on to ultimate borrowers the accommodative funding conditions it offers. The mandatory repayment requirement has been removed and a price incentive mechanism has been added instead. As in the first series of TLTROs, the new series distinguishes between banks that are on a deleveraging path and those that have been increasing their loan books. For the former group, lending benchmarks are indeed negative (to accommodate the deleveraging imperatives that these banks are facing), but imply that banks need to cut the rate of their deleveraging by half in order to meet their benchmark. They thus need to demonstrate a marked improvement in their lending

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10 The ECB purchases private and public sector assets from investors such as pension funds, banks and households. These investors may choose to take the funds they receive in exchange for assets sold to the ECB and invest them in other assets. By increasing demand for assets more broadly, this mechanism of portfolio rebalancing pushes prices up and yields down, even for assets that are not directly targeted by the APP. For more information, see https://www.ecb.europa.eu/explainers/tell-me-more/html/app.en.html

11 See Altavilla, C., Canova, F. and Ciccarelli, M., "Mending the broken link: heterogeneous bank lending and monetary policy pass-through", Working Paper Series, No 1978, ECB, November 2016; Holton, S. and Rodriguez d'Acri, C, "Jagged cliffs and stumbling blocks: interest rate pass-through fragmentation during the euro area crisis", *Working Paper Series*, No 1850, ECB, September 2015; Durré, A., Maddaloni, A. and Mongelli, F.P., "The ECB's experience of monetary policy in a financially fragmented euro area", *Comparative Economic Studies*, Vol. 56, pp. 296-423, 2014.

12 For a description and a schematic illustration of the main transmission channels of monetary policy decisions, see https://www.ecb.europa.eu/mopo/intro/transmission/html/index.en.html

patterns compared with their previous track record. This is fully in line with the targeted nature of the instrument.[13]

Concerns are also expressed in paragraph 16 of the resolution in relation to the non-marketable assets and asset-backed securities (ABSs) put forward as collateral to the Eurosystem in the framework of its refinancing operations.

The ECB takes note of the issue raised in the resolution and the request to disclose which central banks have accepted ABSs and credit claims, as well as to disclose valuation methods regarding such assets. Generally speaking, the ECB continuously aims to improve transparency with regard to its monetary policy implementation. In that vein, in 2016 the ECB made available on its website historical snapshots of the eligible assets database, for example.[14] However, as a matter of principle, it does not provide any data on monetary policy operations at country level. This policy mainly aims to ensure the confidentiality of counterparties' data, which is particularly relevant for countries with only a few counterparties, where country-based information could allow conclusions to be drawn on the recourse to monetary policy operations of single counterparties. Furthermore, disclosing which central banks have accepted ABSs and credit claims would not allow any conclusions with regard to the effectiveness of the Eurosystem's monetary policy implementation. Nor would it allow any conclusions with regard to the level of risks taken on by the respective national central banks (NCBs) within the risk-sharing framework in place. It is recalled that the Eurosystem applies homogeneous eligibility, valuation and risk control rules across all euro area counterparties.

The Eurosystem has always accepted a wide range of collateral for its credit operations for historical and structural reasons. In order to cater for the inherent (credit, market and liquidity) risks of each of these asset types, the Eurosystem requires a number of detailed eligibility criteria, including minimum credit quality standards and graduated valuation haircuts which take into account risks associated with different assets as a function of their type (haircut category), residual maturity and credit quality. The Eurosystem regularly reviews the risk control framework and in this context updated the haircut schedule in January 2017, introducing in particular more granular valuation haircuts for ABSs.[15] As regards credit claims, the Eurosystem ensures sufficient risk mitigation, applying higher haircuts to account for the fact that these are applied to nominal amounts due to the absence of observable market prices.

In paragraph 20, the resolution also addresses the cases of liquidity provision to Greek and Cypriot banks and the framework governing the provision of emergency liquidity assistance (ELA).

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[13] For more information on the pricing mechanism of TLTRO-II, graphical illustrations of its functioning and stylised examples of TLTRO-II benchmarks, see https://www.ecb.europa.eu/pub/pdf/other/eb201603_focus03.en.pdf

[14] See https://www.ecb.europa.eu/paym/coll/assets/html/index.en.html

[15] The haircut category of an asset is determined by the combination of asset type and issuer group. The haircut category assignments are regularly reviewed from a risk perspective. The values valid as of 1 January 2017, as specified in the general framework, are available at https://www.ecb.europa.eu/paym/coll/risk/liquidity/html/index.en.html.

With respect to the provision of central bank liquidity, the ECB recalls that it established harmonised criteria for accessing the various facilities. In this context, it is worth distinguishing between the provision of central bank liquidity in the form of regular Eurosystem monetary policy operations and the provision of central bank liquidity in the form of ELA. For the purpose of regular Eurosystem monetary policy operations, credit institutions need to be financially sound. In order to assess the financial soundness of an institution, the ECB takes into account information on capital, leverage and liquidity ratios as reported in accordance with supervisory requirements.[16] As far as ELA is concerned, current procedures foresee that ELA may be provided to solvent financial institutions that are facing temporary liquidity problems, without such operation being part of the single monetary policy. For this purpose, the prudential supervisor provides an assessment of the solvency of the institution receiving the ELA, including the criteria used to come to a positive conclusion with respect to solvency. Responsibility for the provision of ELA lies with the NCB(s) concerned. This means that any costs of, and the risks arising from, the provision of ELA are incurred by the relevant NCB. [17]

Paragraph 7 of the resolution discusses the possibility of increasing the share of European Investment Bank (EIB) bonds purchased by the ECB, particularly those related to large-scale infrastructure projects in the sectors of transport and energy .

In the context of the ECB's public sector purchase programme (PSPP), the ECB purchases government bonds regardless of the issuers' funding intention, as long as all eligibility criteria are fulfilled. At the same time, the Eurosystem is prohibited from buying bonds issued by public sector entities in the primary market by Article 123 of the Treaty on the Functioning of the European Union. Thus, EIB bonds can only be purchased in the secondary market in the context of the PSPP and subject to the applicable eligibility criteria, including issue and issuer limits. It should be noted that the benefits from the APP are not limited to the securities bought but also spread to other assets (through the portfolio rebalancing effect discussed above).

Finally, the resolution discusses TARGET2 balances in paragraph 31.

The increase in TARGET2 balances since late 2014 is distinct from that observed during the sovereign debt crisis. During the sovereign debt crisis, liquidity provision was predominantly demand-driven and the rise in TARGET2 balances coincided with mounting stress and fragmentation, as evidenced in a range of other indicators, such as interest rate differentials, credit spreads and financial market volatility measures. Severe stress and fragmentation led to a drying-up of market-based funding. Banks turned to the Eurosystem to fulfil their liquidity needs, which were fully accommodated through fixed-rate full allotment lending operations against eligible collateral. As the funds borrowed by banks in vulnerable countries flowed to less vulnerable countries to substitute for lost market funding, TARGET2 balances increased.

[16] See Article 55a of ECB Guideline 2015/1938 of 27 August 2015 (ECB/2015/27) available at https://www.ecb.europa.eu/ecb/legal/pdf/oj_jol_2015_282_r_0010_en_txt.pdf

[17] For more information, see https://www.ecb.europa.eu/mopo/ela/html/index.en.html

The current increase in TARGET2 balances reflects the sizeable liquidity injections through the APP. Today, central bank liquidity provision is mainly supply-driven and is due to the APP. When implementing the APP, NCBs purchase bonds from a set of eligible counterparties, which can sell securities on their own behalf or act as intermediaries for the underlying sellers (i.e. the owners) of the bonds. Whenever these purchases entail a cross-border payment by the NCB, TARGET2 balances are potentially affected. Around 80% of bonds purchased by NCBs under the APP were sold by counterparties that are not resident in the same country as the purchasing NCB, and roughly half of the purchases were from counterparties located outside the euro area. Reflecting the financial structure of the euro area, a significant number of large APP counterparties are domiciled in financial centres located in a few countries, while most of the non-euro area counterparties access the TARGET2 payment system via the Deutsche Bundesbank. As a result, very large net cross-border flows of central bank money to accounts held at the Deutsche Bundesbank occur during the implementation of the APP, leading to changes in TARGET2 balances.[18]

Looking beyond the implementation of the APP, TARGET2 balances remain elevated owing to portfolio rebalancing and the financial structure of the euro area. As the underlying sellers make other forms of investment or purchase other securities, including non-domestic securities, additional liquidity flows occur, which can keep TARGET2 balances elevated. For the euro area as a whole, there has been a rebalancing towards non-euro area debt securities, in line with the euro area's persistently negative interest rate differentials vis-à-vis other advanced economies. The purchases of other securities by the underlying sellers can also entail cross-border settlement and lead to payment flows to financial centres. Furthermore, the banks with business models that attract more liquidity holdings are typically located in a small number of financial centres.

Although TARGET2 balances are increasing, evidence provided by a range of financial market and banking statistics does not indicate a general increase in stress. This reflects the fact that TARGET2 balances are not necessarily in themselves an indicator of stress. Furthermore, current account balances in euro area countries with large current account deficits before the global financial crisis have undergone a significant correction over recent years and, in most cases, have turned into surpluses. The current increase in TARGET2 balances therefore differs from the dynamics observed during previous episodes of rising balances. The ECB continues to closely monitor TARGET2 balances as well as developments in a range of indicators that provide direct information about levels of market stress.

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[18] The impact of the settlement of asset purchases on TARGET2 balances is explained in more detail in the ECB's Economic Bulletin and in the Bundesbank's Monthly Report. See the box entitled "TARGET balances and the asset purchase programme", *Economic Bulletin*, Issue 7, ECB, 2016 (https://www.ecb.europa.eu/pub/pdf/other/eb201607_box02.en.pdf) and the box entitled "The impact of Eurosystem securities purchases on the TARGET2 balances", *Monthly Report*, Vol. 68, No 3, Deutsche Bundesbank, March 2016.

2 Financial stability outlook

Paragraphs 14, 15 and 18 of the resolution focus on the possible side effects of the ECB's current monetary policy measures and their impact on the financial stability outlook for the euro area.

The ECB acknowledges the challenges that euro area banks, insurers and pension funds are facing, but also emphasises that these go well beyond the broader impact of its monetary policy. Investor concerns regarding profitability prospects are reflected in the volatility of euro area financial institutions' stock prices in 2016 and early 2017. Macroeconomic prospects have been at the heart of cyclical profitability challenges facing banks as they dampened loan demand and affected borrower credit quality. Euro area insurers and pension funds faced headwinds from the low growth environment. By supporting the economic recovery and price stability, therefore, accommodative monetary policy is making an important contribution to strengthening the operating environment for all these institutions. The recovery in bank lending indicates a progressive strengthening of the banking sector, as also reflected in the improvement in the responses to the euro area bank lending survey. However, structural challenges continue to play a significant role. For banks, these include stocks of non-performing loans, cost inefficiencies and/or overcapacity, which prevail in some regions and continue to dampen credit supply. For insurers and pension funds, the environment creates a need for adjustments to the traditional life insurance business model in particular.

As regards macroprudential recommendations, it should be noted that cyclical systemic risks remain contained in most of the countries covered by ECB Banking Supervision and in the euro area as a whole. Consequently, and in line with decisions that have been taken by national authorities, the Governing Council considers that a broadly based increase in countercyclical capital buffers across the euro area is not warranted.

On the possible risks of housing bubbles, the ECB considers these risks to be limited for the euro area as a whole, but additional targeted macroprudential measures should be deployed. In some countries which were the subject of an ESRB warning in November, i.e. Austria, Belgium, Finland, Luxembourg and the Netherlands, relatively buoyant real estate dynamics or high household debt levels in other countries signal the risk of increasing imbalances.[19] To counter the risks related to real estate sector imbalances, the ECB considers that additional targeted macroprudential measures should be deployed and calls for the implementation of legislative frameworks for borrower-based measures in all euro area countries. Together with the national competent and designated authorities, the ECB continues to constantly monitor factors which could potentially result in risks emerging in the residential real estate sector. It has established procedures to enhance the exchange of information, thereby improving risk assessment and fostering the discussion of potential policy actions.

[19] See the ESRB's published set of country-specific warnings on medium-term vulnerabilities in the residential real estate sector at https://www.esrb.europa.eu/news/pr/date/2016/html/pr161128.en.html

3 Other issues raised in the resolution

Paragraphs 29 and 30 of the resolution touch upon the ECB Regulation on the collection of granular credit and credit risk data (AnaCredit).[20]

The concerns expressed in the resolution have already been addressed by the ECB. On 4 October 2016 the Governing Council approved principles to increase transparency in the development of ECB regulations on European statistics.[21] The principles take into account the transparency practices of the European Parliament, the Council of the European Union and the European Commission. As a result, the ECB will in future carry out public consultations when developing new draft ECB regulations on European statistics. Moreover, in the context of the AnaCredit project, the proportionality principle is applied through derogations, in full or in part, and the possibility to reduce the reporting frequency (from monthly to quarterly) for smaller credit institutions. The ECB, in liaison with the NCBs and the banking industry, has developed a manual on the harmonised implementation of the requirements foreseen in the AnaCredit Regulation. The first two parts of the manual have been published on the ECB's website, and the third part will be published by mid-2017, around one year and half before reporting begins.[22] In addition, the ECB is working with, and supporting, reporting agents (banks) on the Banks Integrated Reporting Dictionary initiative. The aim of this initiative is to support reporting agents in analysing reporting requirements and defining the data processing rules required to meet them – a task which would otherwise need to be completed by every single reporting bank. This, in turn, helps to ensure that data reported by banks to authorities are comparable and consistent, and it will contribute to minimising the reporting burden for banks.[23]

Paragraph 25 of the resolution raises the issue of the ECB's labour recruitment policy.

As regards the call for the ECB's labour recruitment policy to comply with best practice, the ECB believes that it has a good and competitive HR framework in place and will make continued efforts to steadily improve it. The ECB's views on the strengths of its HR framework, as well as on possible ways of further improving it, were presented to the European Parliament in a dedicated exchange of views with the ECB's Chief Services Officer and the Director General of Human Resources on 26 October 2016. Referring to its recruitment policy, it can be stated that the ECB attaches great importance to comparing the merits of candidates with the requirements of a position and to appointing individuals with the highest levels of

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[20] AnaCredit is a project to set up a dataset containing detailed information on individual bank loans in the euro area, harmonised across all Member States. "AnaCredit" stands for analytical credit datasets. The project was initiated in 2011 and data collection is scheduled to start in September 2018. For more information, see https://www.ecb.europa.eu/stats/money_credit_banking/anacredit/html/index.en.html

[21] For more information, see https://www.ecb.europa.eu/stats/ecb_statistics/governance_and_quality_framework/html/transparency_for_ecb_regulations_on_european_statistics.en.html

[22] For more information, see https://www.ecb.europa.eu/stats/money_credit_banking/anacredit/html/index.en.html

[23] For more information see https://www.ecb.europa.eu/stats/ecb_statistics/reporting/html/index.en.html

ability, efficiency and integrity. For this reason, the ECB specifies transparently in its vacancy notices the technical and behavioural competencies against which candidates will be assessed, distinguishing between minimum requirements that all candidates have to meet and additional requirements in terms of knowledge or competence.[24] Vacancy notices also state that the recruitment procedure may include pre-screening exercises, a written exercise, a presentation and interviews.

[24] Further information on how the ECB hires and the different pre-screening tools are provided on the ECB's careers pages http://www.ecb.europa.eu/careers/html/index.en.html