Andrea ENRIA
Chair of the Supervisory Board

COURTESY TRANSLATION

Mr Marco Zanni
Member of the European Parliament
European Parliament
60, rue Wiertz
B-1047 Brussels

Frankfurt am Main, 14 April 2020

Re: Your letter (QZ006)

Honourable Member of the European Parliament, dear Mr Zanni,

Thank you for your letter, 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 9 March 2020.

As regards the actions that ECB Banking Supervision is taking to address valuation risks posed by Level 2 and Level 3 assets, it is important to note that most Level 2 assets consist of standard derivative contracts, such as interest rate swaps, with limited valuation uncertainties.

The ECB has devoted considerable resources to the supervisory assessment of complex fair-valued instruments, including, but not limited to, Level 3 assets. This work is becoming more intense with trading risk and asset valuation being identified as supervisory priorities for 2019 and 2020 and possibly beyond. In this context, we performed an advanced data gathering exercise on valuation risk in 2019 and before the suspension of on-site activities we had already concluded a significant part of our inspection campaign that targeted several Significant Institutions (SIs) focusing on valuation risk, looking into the impact both on banks' accounting measures and on their regulatory capital.

These activities are targeted at significant institutions with material exposures to complex assets. The purpose is to check that similar instruments are treated in a similar manner, to verify that the valuation of financial instruments adequately reflects uncertainty, and to assess how banks are applying the prudential valuation framework. These objectives are all in line with the recent European Systemic Risk Board (ESRB) recommendations on the subject. In addition, and also in line with ESRB recommendations, ECB Banking Supervision is working intensively on banks' implementation of the new market risk framework, the Fundamental Review of the Trading Book (FRTB). The FRTB will improve the way in which market risk, including of Level 2 and Level 3 assets, is taken into account in the prudential framework.

Although the European Banking Authority (EBA) recently decided to postpone the 2020 EU-wide stress test to 2021, I would like to reassure you that risks related to Level 2 and Level 3 assets are taken into account in the stress test methodology and quality assurance. Concerning your question as to whether the ECB intends to prioritise a deeper analysis of risks related to the presence of Level 2 and 3 assets in forthcoming stress tests, it should be noted that the methodology for the EU-wide stress test is provided by the EBA. The ECB also applies the EBA stress test methodology in its own Supervisory Review and Evaluation Process (SREP) stress test, which is conducted for SIs that are not included in the sample of the EU-wide stress test. Indeed, the EBA already introduced more explicit treatment of Level 2 and Level 3 assets under stress in its EU-wide stress test methodology for the 2018 exercise. The EBA market risk scenario includes, for all instruments measured at fair value, a severe and sudden decrease in market liquidity and an increase in market price uncertainty, as has been observed in past crises. In the stress test, banks have to incorporate into their projections the impact of these shocks on their prudential and accounting reserves. The higher complexity and lower liquidity of products such as Level 2 and Level 3 assets are reflected in a higher stress impact in the EBA market risk scenario. The ECB’s quality assurance of banks’ stress test results ensures that this methodology is correctly applied.

Yours sincerely,

[signed]

Andrea Enria