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Chair of the Appropriations Committee
of Federal Parliament
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Report pursuant to Art. 88, para 2 of the German Federal Budget Code on a limitation of the audit mandate of the German SAI in the field of banking supervision and financial institutions

Annex: 1

Dear Chair,

In our report as of 20 January 2016 (III 5 – 20 51 03), we reported to the Appropriations Committee of Federal Parliament (Appropriations Committee) about the German SAI's limited audit mandate in the field of banking supervision and financial institutions.

Until 3 November 2014, the supervision of German credit institutions fell into the exclusive remit of the German Federal Financial Supervisory Authority and the German Central Bank. Since the introduction of the Single Supervisory Mechanism (SSM) on 4 November 2014, the European Central Bank (ECB) has been responsible for the central and common supervision of all significant credit institutions of the euro area within the meaning of Regulation 1024/2013 as of

15 October 2013. Until 3 November 2014, the German SAI's mandate to audit the Federal Financial Supervisory Authority and the German Central Bank and to access audit evidence with regard to banking supervision was unlimited – irrespective of size and significance of the relevant banking institution. With the introduction of the SSM, the responsibility for auditing the supervisory function of the ECB was transferred to the European Court of Auditors (ECA).

As a result, the German SAI's audit mandate was replaced by the ECA's audit mandate. Pursuant to Article 27.2 of the ECB statute, the ECA is responsible for examining the "efficiency of the management of the ECB", also as regards its supervisory tasks (cf. Article 20 of the SSM Regulation). The undefined legal concept of "efficiency of the management" refers to an audit of how efficient management functions have been performed. Thus audit work does not cover the efficiency and regularity of banking supervision. This results in an audit gap which did not exist when the German SAI audited supervisory bodies. Moreover, the ECA does not have the right vis-à-vis the ECB – as compared to the German SAI pursuant to Art. 95 of the German Federal Budget Code – to decide on its own accord which documents are relevant to the audit and should therefore be inspected or accessed. As a result, the ECA is dependent on the ECB's willingness to cooperate.

At its 73th meeting on 27 April 2016, the Appropriations Committee took note of the German SAI's report issued on 20 January 2016 and requested the Federal Government to speak up for an audit and control standard at EU level comparable to the high national standard and to thus ensure a comprehensive external audit of banking supervision.

As at 18 November 2016, the ECA published its first audit report with regard to the ECB's supervisory function.¹ "We became aware, however, of an important obstacle in all areas of our intended audit – namely, the emergence of disagreement with the ECB over the exact terms of our mandate and right to access documents. Arguing that they lay outside our remit, the ECB was not willing to share a number of documents that we needed to complete our work. As a result we were only partly able to assess whether the ECB is managing the SSM efficiently in the areas

¹ Special report no. 29/2016 (pursuant to Article 287 (4) subsection 2 TFEU). The Single Supervisory Mechanism – Good start but further improvements needed, together with the answers submitted by the ECB, Annex 2. Source: <https://www.eca.europa.eu/en/Pages/DocItem.aspx?did=39744>

of governance, off-site supervision and on-site inspections.”² The audit results underline our concerns expressed in our report as of 20 January 2016 that a considerable audit gap has emerged.

The Supervisory Review and Evaluation Process (SREP) is the key element of the banking supervisory function. It includes the following steps:

- a) establishing the facts by analysing incoming data and information that is to be obtained (e.g. financial statements, audit reports),
- b) summarising and analysing the information obtained and assessing the impact of a given fact on current and potential risks of an institution and the fact’s significance for banking supervision,
- c) summarising and assessing all information with a view to the future as to
 - whether the risks to which the institutions are exposed are matched by such regulations, strategies, procedures and mechanisms that ensure a robust risk management and a comprehensive risk coverage and
 - whether the institution has ensured that the risks to which it is exposed are matched by sufficient capital and liquidity resources,
- d) deciding on supervisory measures and their implementation (e.g. warnings, dismissal of managers, imposing of fines and additional capital requirements, and revocation of license),
- e) risk-oriented supervision planning in which the audit intensity is to be determined per institution. The level of audit intensity needs to be higher, the larger the impact of an institution’s activity on the financial stability and the higher such institution’s risk exposure.

The ECA intended to examine the efficiency of the SREP implementation. The ECB did not submit any documents that describe the application of this process to a particular institution and would thus allow its examination. The ECA’s audit was rather limited to details concerning the efficiency of the ECB’s management (e.g. budgeting, sourcing of staff). We attached an excerpt from the ECA’s audit report dealing with the ECB’s refusal to grant access to documents (cf. Annex 1).

As a result, the ECA was unable to fully audit supervisory activities – as it was possible for the German SAI in the past. In their joint letter as of July 2016, the President of the German SAI and the President of the Dutch SAI informed the

² Special report no. 29/2016 (pursuant to Article 287 (4) subsection 2 TFEU). The Single Supervisory Mechanism – Good start but further improvements needed, together with the answers submitted by the ECB, p. 10

European Commission about this audit gap. They requested the Commission to also focus on this audit gap in the announced SSM review report. On 28 November 2016, Valdis Dombrowski, the Vice-President of the European Commission, sent a response letter confirming that

- national SAIs actually have no access to ECB documents (e.g. manuals). In other words, national SAIs are faced with limitations even in areas in which they are granted full audit rights and
- the ECA's audit mandate is limited to the "efficiency of the ECB management". This means that the ECA's mandate to perform compliance audits, performance audits and financial audits is limited accordingly.

The Vice-President of the European Commission informed the Eurogroup that the European Commission intended to describe the audit gap in its upcoming report on the SSM Regulation. He further informed the Eurogroup that he was examining all legal options to close the audit gap within the framework of existing treaties by concluding an agreement between the ECA and ECB.

According to the German SAI, the Federal Government should consider all options to close the audit gap. The Federal Government should not only support the conclusion of an agreement between the ECA and ECB. The Federal Government should also consider amending the SSM Regulation or the extending audit access outlined in the EU Financial Regulation (Article 161) to also cover banking supervision functions.

The German Federal Ministry of Finance strongly supports the plan to ensure an external audit of "significant institutions" without any audit gaps. Any uncertainties regarding audit matter and audit scope of the ECA relative to the ECB's supervisory function should be resolved. The Ministry is of the opinion that modifying the audit mandate laid down in the SSM Regulation or the audit access outlined in the EU Financial Regulation would violate the provisions of Article 27 (2) of the ESCB and ECB statutes and thus higher-ranking rules of primary EU law (cf. a protocol to EU Treaties). The aim should therefore be the conclusion of an agreement.

In a statement, the ECA thanked the German SAI for its commitment. The ECA confirmed to have limited access to relevant documents without outlining the legal circumstances.

The German SAI is of the opinion that banking supervision is not a component of the ECB's central banking functions which for the most part are not covered by the ECA's audit mandate. The banking supervisory function is rather a separate function. Therefore, banking supervision is not necessarily subject to the audit limitations laid down in Article 27 (2) of the ECB statute. In order to close the audit gap, the provisions of the SSM Regulation and/or the EU Financial Regulation are to be substantiated. Experience has shown that the ECB's interest in concluding an effective audit agreement with the ECA will be limited.

The German SAI therefore recommends that the Appropriations Committee renew its efforts to encourage the Federal Government to support the amendment of the SSM Regulation and/or the EU Financial Regulation in order to finally extend the ECA's audit mandate.

We have copied this letter to the Public Accounts Committee's Chair and to the Federal Ministry of Finance.

Yours sincerely,



April



Schreiner

Limits on access to information

Areas not satisfactorily audited due to the ECB's non-provision of documents requested	Evidence not provided
<p><u>Comprehensive Assessment</u></p> <ul style="list-style-type: none"> • Stress testing • Asset Quality Review 	<ul style="list-style-type: none"> • Inter alia, guidelines on collateral valuation, process for selecting risk-prone assets, FAQs, minutes and correspondence of meetings with EBA, ERSB, ECB, assessment of impact of tax credits and related guidelines, and some project-related documents¹
<p><u>Decision-making process</u></p> <ul style="list-style-type: none"> • Compliance with timelines set • Level and timing of decisions considering the severity of the issue • Whether and how the various parties in the decision-making process add value and whether there is overlap or redundancy based on concrete cases • We could not cross-check comments made by commercial banks in the context of our survey on the decision-making process with actual decisions. 	<ul style="list-style-type: none"> • Supervisory Board decisions • Bank files • Underlying documentation of procedural steps followed in the decision making process • Supervisory Board minutes

¹ In April 2016, the ECB provided us with a DGMS IV quality assurance report dated April 2015. Though the report covered a number of areas, we were not able to perform our audit procedures using the available source documents. The report focused on procedural rather than methodological issues. We were also provided with a number of procedural documents such as engagement letters to auditors, and proposed resourcing requirements for the loan book review. We were given insufficient access to auditors' working documents and were not able to draw our own conclusions on other aspects based on the information available.

<p><u>Operational efficiency of on-site inspections</u></p> <ul style="list-style-type: none"> • Major parts of the planning methodology • Actual efficiency of on-site inspections • Consistent and efficient application of the methodology across the SSM (e.g. undue delays, lack of focus, inefficient performance of audits) • Coherent reporting of on-site inspections • Efficient consistency checks • We could not cross-check comments made by commercial banks in the context of our survey on the on-site inspection process with actual on-site reports or working papers. • Concreteness and time horizon of IMAS improvement • Quality assurance of on-site inspections 	<ul style="list-style-type: none"> • List of planned inspections not carried out • Annexes to Supervisory Manual Chapter 6 concerning the methodology for on-site supervision (Chapter 6 (60 pages) was provided but not the annexes (reportedly 1 000 pages)) • Planning of specific on-site inspections (list of on-site inspections with resource request) • List of thematic reviews and list of ad hoc requests • Underlying details of the NCA survey to assess the skills of the available on-site inspectors • Plan for the go-live of IMAS releases • Supervisory Board decisions e.g. on the planning of on-site inspections • Working papers (including planning documentation) of inspectors • Bank-specific consistency check reports • Bank files/ sampling of concrete cases • Involvement of on-site auditors and relevant reports on the Greece AQR 2015 exercise
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Operational efficiency of planning of off-site supervision

- Underlying data and calculations used in initial clustering exercise and related resource allocation
- Efficiency of supervisory activities planning
- Appropriateness of supervisory activities planning
- Efficient / appropriate use of thematic reviews in supervisory activities planning
- Operational efficiency of conduct of off-site supervision
- Efficiency of execution of supervisory activities
- Appropriateness of execution of supervisory activities
- Coherent and appropriate SREP analysis and reporting
- Appropriate / efficient use of ID cards
- Appropriateness of RAS model
- Efficient use of RAS model in supervisory process
- Efficient and targeted follow-up of supervisory decisions by the JSTs
- We could not cross-check comments made by commercial banks in the context of our survey regarding off-site supervision.

- Supervisory Manual (with the exception of approximately 25 pages on JSTs plus 17 pages on crisis management out of an overall of 346)
- Methodological annexes to the Supervisory Manual
- Detailed methodologies and models for SREP process
- Detailed methodologies of the RAS model
- Thematic reports
- Supervisory Board decisions
- SEP proposals, approved SEPs
- Actual ID cards (only a sanitised version was provided), as well as the FINREP data set used
- SREP reports
- RAS scores and model output, supporting documentation, details, overrides
- Recovery plans submitted to ECB, analysis and follow-up by JSTs
- Supervisory decisions, follow-up and implementation by the JSTs
- Clustering methodology – no provision of model, inputs (bank details, data), calculations, details on output (including overrides)
- Bank files/ sampling of concrete cases

<p><u>Supervisory Board meetings</u></p> <ul style="list-style-type: none"> • Efficiency of meetings • Adherence with principle of independence for NCA representatives to the Supervisory Board 	<ul style="list-style-type: none"> • Minutes of the Board
<p><u>Accountability</u></p> <ul style="list-style-type: none"> • Comprehensive and efficient reporting to the EP • Efficient and comprehensive exchange of information as required by Article 32 of the SSM Regulation – we had to rely on third-party information in this regard 	<ul style="list-style-type: none"> • Written documentation on the ad-hoc exchange of views between the European Parliament and the Chair of the Supervisory Board • A record of proceedings of the Supervisory Board, as provided to the Parliament’s competent committee with an annotated list of decisions • The actual documentation requested by the European Commission for its Article 32 report and the correspondence, with dates, relating to the information request

Source: European Court of Auditors.

Examples of how this affected our audit are set out below.

I. Governance

Issue: In reply to the questionnaire we sent to commercial banks, three institutions stated that they had not been granted the right to be heard. However, we were not given access to bank files or decisions.

Consequence: We could not verify this assertion.

Issue: We requested samples of cases for different types of decisions (emergency situations, ordinary cases, SREP decisions, and authorisations), including the entire underlying documentation flow with the dates for every step, from the initiation stage until the final decision is reached. However we were only provided with tables indicating the dates of procedural steps, with no access to underlying documentation.

Consequence: We were unable to determine whether delays in decision-making were due to imperfections in the procedure or to the complexity of the subject matter. We were unable to address specific shortcomings in the decision-making process, identify any unnecessary layers or verify that the documents provided allowed for a well-informed decision. Any analysis of the efficiency of decision-making must therefore remain rather abstract.

Issue: We requested the minutes of the SB in order to assess whether the Chair ensures efficient but effective discussions at the SB, with regular attendance and full discussions by all members in the interest of the EU as a whole. However we were denied any access to minutes of the Supervisory Board.

Consequence: We could not express an opinion on the efficiency of the SB meetings.

II. Joint supervisory teams

Issue: In reply to our questionnaire, one commercial bank informed us that the ECB had asked for a disproportionate quantity of documentation ('hundreds of files') for its 'fit and proper' assessments, although most cases concerned the renewal of directors.

Consequence: 'Fit and proper' decisions accounted for almost half of the decisions taken by the ECB. A report by the quality assurance division emphasised that such decisions could have an impact on resources. We were unable to assess whether the procedures for fit and proper decisions were proportionate (i.e. all procedures and information requests were necessary) or had a negative impact on resource allocation. We were therefore unable to express an informed view on the need for additional staff or the more efficient organisation of tasks.

Issue: We had intended to examine risk modelling as a component of the SREP and whether data provided by supervised banks were used effectively in an appropriate risk model. We were not given any details about the impact of the data submitted by supervised banks on the RAS score. In reply to our questionnaire, many commercial banks stated that the reporting requirements placed on them were disproportionate.

Consequence: We were unable to verify whether and how reported data is used to determine the SREP score, and whether reporting requirements could be designed more efficiently to emphasise major risks.

III. On-site inspections

Issue: We were not sent the methodological annex to the supervisory manual or the underlying on-site inspection files. In some cases, commercial banks made negative assertions about the performance of on-site inspections.

Consequence: We were unable to assess any stage of the inspection cycle – selection of a bank, drafting of the pre-inspection note, conduct of and reporting on the inspection visit, ex-post consistency checks – or whether the underlying methodology addressed the key risks and resources were used appropriately and efficiently. However, an unsuitable on-site inspection approach would have huge implications for the assessment of resource allocation and efficiency of the work actually performed. An incomplete or misguided methodology would affect the efficiency of all inspections of significant banks, whether performed by the ECB or by the NCAs.