EUROPEAN CENTRAL BANK

EUROSYSTEM

ECB-PUBLIC

Feedback on the input provided by the European Parliament as part of its resolution on the ECB Annual Report 2014

The ECB's Annual Report is presented to the European Parliament each year, in a dedicated session of the Economic and Monetary Affairs Committee. Following this presentation, given by the Vice-President, the President of the ECB attends a plenary debate on the Annual Report. This year, for the first time, the ECB has also decided to publish its feedback on the input provided by the European Parliament as part of its resolution on the previous year's Annual Report[1] (hereinafter "the resolution"). This decision was taken in response to a suggestion made in the resolution[2] and provides a further example of the ECB's commitment to accountability, which goes beyond fulfilling the requirements of the Treaty.

1. Monetary policy

1.1. The ECB's contribution to the general economic policies in the Union

The European Parliament states in its resolution that it "e*xpects the ECB to contribute to the general economic policies in the Union and to the achievement of their objectives, pursuant to Article 282 TFEU, provided its main task of price stability is not put in jeopardy*".

The Treaty, which establishes a clear hierarchy of objectives for the Eurosystem, underlines that ensuring price stability is the most important contribution that monetary policy can make to achieving a favourable economic environment and a high level of employment.[3]

While the Treaty thus clearly lays down the ECB's primary objective, it does not, however, give a precise definition of what is meant by price stability. In 2003, the ECB's Governing Council announced a quantitative definition of price stability, as it is to be understood in the context of the ECB's monetary policy: "Price stability is defined as a year-on-year increase in the Harmonised Index of Consumer Prices (HICP) for the euro area of below 2%."

It is worth briefly recalling the reasons for price stability being defined in this way. First, inflation rates of below, but close to, 2% are low enough to allow the economy to fully reap the benefits of price stability. Second, the definition also reflects the ECB's commitment to: i) provide an adequate margin to avoid the

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1 The text of the resolution as adopted is available at http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//NONSGML+TA+P8-TA-2016-0063+0+DOC+PDF+V0//EN.

2 Paragraph 23 of the resolution.

3 See the section of the ECB's website "Objective of monetary policy" available at https://www.ecb.europa.eu/mopo/intro/objective/html/index.en.html.

risks of deflation; ii) take into account the possibility of HICP inflation slightly overstating true inflation (as a result of the small but positive bias incurred when measuring price-level changes using the HICP) and; iii) provide a sufficient margin to address the implications of inflation differentials in the euro area. Moreover, the definition of price stability adopted by the Governing Council is symmetric and reflects quantitative evidence that deflation or excessively low inflation is as dangerous as high inflation.

A quantitative definition of price stability has several benefits. First, it makes the ECB's monetary policy more transparent. Second, it helps the public to form expectations of future price developments. And third, it provides a clear and measurable yardstick against which the European citizens can measure the ECB's performance, thus making it more accountable as an institution.

Since June 2014, the ECB has introduced a series of decisive policy measures to forestall risks that inflation may settle around levels not sufficiently close to 2% in the medium term. These measures have made a notable contribution to the economic recovery and to employment growth, which are a precondition for inflation to firm and return to levels close to 2%. In particular, the comprehensive package adopted in March 2016 was designed to exploit the synergies between different instruments and was calibrated to further ease financing conditions and stimulate new credit provision, and thereby give increased momentum to the euro area's economic recovery. By facilitating access to credit for businesses across Europe, and helping to boost investment, create jobs and thus support overall economic growth, the ECB, while pursuing its primary objective of price stability, is at the same time contributing to the general economic policies of the Union.

1.2. Effectiveness of the ECB's monetary policy measures

With regard to the ECB's monetary policy, and in particular its effectiveness, the resolution *"concludes that the programme for purchasing public and private debt securities in secondary markets could be more effective"*.

There is strong evidence that the monetary policy measures referred to here have been highly effective, and that they have had an impact comparable to that of similar programmes carried out in other economies. The expanded asset purchase programme (APP), together with the other monetary policy measures (such as the negative interest rate policy and the targeted longer-term refinancing operations (TLTRO)), has significantly eased financing conditions in all euro area countries. As a result, the fragmentation in financial markets has been reduced considerably, although it has not yet been entirely overcome.

Government bond yields, for example, have fallen on average by around 120 basis points since early June 2014. Analysis carried out by Eurosystem staff concludes that more than 100 basis points of this overall observed adjustment are a result of the combination of monetary policy measures that have been taken since then. The impact on long-term interest rates of the Eurosystem's purchases has, on average, been greater than that of the three rounds of large-scale asset purchases conducted by the Federal Reserve after 2009, taking into account the smaller scale of the Eurosystem's purchases so far. As a consequence of these interest rate adjustments, bank lending rates for euro area non-financial corporations (NFCs) have also fallen by around 80 basis points since June 2014, which has triggered a noticeable increase in the supply of and demand for bank credit to an extent that the volume of such credit to both households and firms is also recovering. Small and medium-size enterprises in particular have benefited from banks increasingly passing on policy rates since the announcement of the credit easing package in June 2014. Bank lending rates for loans to euro area NFCs have declined more for very small loans than for large amounts, a pattern that is particularly noticeable in the vulnerable euro area countries.

The analysis carried out by Eurosystem staff also shows the policy measures to have had a considerable impact on euro area inflation and gross domestic product (GDP). In the absence of the APP, inflation would have been negative in 2015. Moreover, the monetary policy measures implemented to date are forecasted to contribute to raising euro area GDP by around 1.5% in the period 2015-18.

While external shocks in the second half of last year have weakened inflation and the recovery in the euro area relative to staff projections from a year ago, the package of measures adopted in March 2016 will help to offset these new shocks and accelerate the return of inflation to levels below, but close to, 2% over the medium term.

1.3. Possible risks associated with the ECB's monetary policy measures

In discussing the APP, the resolution "*asks the ECB to carefully monitor the risks associated with its purchase programmes*".

The ECB is aware of the possible risks associated with its purchase programmes. It closely monitors the possible risks relating to its balance sheet, the possible unintended effects of the programmes on financial stability, and the risks linked to the eventual ending of the current unconventional monetary policy measures.

In particular, the ECB closely monitors financial risks to its balance sheet resulting from the APP and continuously reviews all APP transactions to ensure compliance with the risk control framework defined and communicated for the programme[4]. It employs a range of methods to analyse the various risks associated with the APP exposures, as well as the risks resulting from other monetary policy instruments. The results of this analysis are reported to the ECB's Executive Board and Governing Council on a

[4] More information on the risk control measures is available on the ECB's website at: https://www.ecb.europa.eu/paym/coll/risk/riskcontrol/html/index.en.html.

monthly basis, thus providing them with a full, detailed and up-to-date picture of the risks incurred as a consequence of the ECB's monetary policy in general and the APP in particular. This allows them to take action quickly to implement any risk-mitigating measures that may be deemed necessary.

The ECB also closely monitors the potential build-up of vulnerabilities in the euro area financial sector which might occur as an unintended consequence of the APP. While supporting the financial cycle and reviving lending is one of the intended effects of the purchase programme, developments in credit indicators should be closely monitored, in order to identify any potential signs of overheating. ECB staff analysis shows that measures of the credit gap (i.e. the deviation of the credit to GDP ratio from its underlying trend), which are considered good early warning signs for financial crises and are used as benchmark indicators for setting counter-cyclical capital buffers, have remained in negative territory in the euro area.

An additional concern associated with the APP is the effect of low yields on banks' profitability. While the profitability of euro area banks is currently low, ECB staff analysis shows that net interest income has been broadly stable since the end of 2014. Although low interest rates have compressed the interest income earned on loans, this has, to date, been more than compensated for by lower funding costs and increased lending. ECB staff calculate that the overall effect on bank profitability of the low interest rate environment (again, taking into account all aspects, not only negative interest rates) will, on average, be positive, although very small, over the period until 2017. Furthermore, the time profile of the impact on profitability is expected to follow a u-shaped curve: an initial positive impact is followed by a negative transitory effect, with profitability then recovering again towards the end of the projection period. In the medium term, positive macroeconomic effects are shown to more than compensate for the negative effect of the compression of term premia: savings made on provisions as a result of higher credit quality materialise at a slower pace, but are more persistent. The immediate effect of the low interest rate environment on banks' net interest income is positive, as liabilities are re-priced faster than assets. The effect then becomes negative as the interest rates on (longer-term) assets are compressed more than those on (shorter-term) liabilities. The low rate environment also, however, leads to an increase in intermediation amounts, which mitigates the negative effect of the compression of unit margins and, in the later period, is expected to outweigh it. In light of the impact of the prevailing low interest rate environment, banks might want to adjust their business models. There have not yet, however, been any significant signs of change in the main components of banks' operating profits.

The low-yield environment may also induce financial intermediaries to engage in a "search for yield" in order to boost profits. One way of identifying increased risk-taking is to analyse information on asset holdings. ECB staff analysis shows there has been a shift in asset allocation in the investment fund sector from higher- to lower-rated debt securities.[5] A similar shift has also been observed in the insurance sector, although the change is less pronounced here, with the proportion of debt holdings rated “below credit quality” declining. Banks’ portfolios, meanwhile, have shifted towards higher-rated debt securities.

Another area being closely monitored by the ECB at present is real estate markets. Developments in residential real estate markets show significant variation between countries. In the euro area as a whole, prices are increasing slightly on average, and there are no indications of excessive valuations. Only in a few countries are various price, credit and indebtedness indicators pointing to potential emerging risks. The macroprudential policy stance, however, appears broadly appropriate, given the risks identified.

When considering the potential risks associated with the future ending of the current purchase programmes, it is worth examining the exit from the previous purchase programmes undertaken by the ECB. The first two covered bond purchase programmes (CBPP1 and CPBB2) were concluded as scheduled, in an orderly manner, and there were no adverse effects on market functioning. The Securities Markets Programme was terminated when the Outright Monetary Transactions were introduced. Around this time, improvements were being seen in market functioning and risk premia on euro area government bond markets were declining.

Moreover, for the individual purchase programmes included under the APP, there are various features designed to mitigate potential risks related to the ending of these programmes. First, the Governing Council will continue to conduct the purchases until it sees a sustained adjustment in the path of inflation that is consistent with its aim of achieving inflation rates below, but close to, 2% over the medium term. Second, the principal payments on securities held under the APP will be reinvested after the end of the APP net purchases, for as long as is necessary, i.e. the APP purchases will not be ended too abruptly. Third, the maturity structure of the bonds purchased is such that there is a natural, smooth exit strategy embedded in the APP after the end of the purchases and reinvestments, as the bonds progressively mature over time.

1.4. Eligibility requirements for the APP

The resolution “*asks the ECB, where possible, to apply the APP to all Member States without discrimination while respecting the rules the ECB is bound by*”.

The APP is, in principle, open to all assets fulfilling its eligibility requirements, which include credit quality assessments. All countries are therefore treated according to the same rules. For bonds to be eligible for APP purchases, they need to meet strict criteria. First, they must, as a rule, be eligible as collateral for

[5] Funds have also increased the average residual maturities of debt securities holdings and continued to expand their exposure to emerging markets. See the November 2015 edition of the ECB’s Financial Stability Review.

monetary policy operations, as specified in Guideline ECB/2014/60.[6] Second, they need to satisfy a series of additional requirements, specific to the particular asset purchase programme in question. These eligibility requirements, in particular with regard to credit quality, are designed to ensure that the financial risks to the Eurosystem remain limited.

1.5. Output gap estimates

In its resolution, the European Parliament "*considers that it would be useful if, alongside its assessment of monetary and financial conditions, the ECB could provide, in its statement following the monthly meeting of its Council of Governors, its assessment of the extent of output gaps across the euro area".*

The output gap is not an observable variable, and any estimates of it are therefore subject to a considerable level of uncertainty. This stems from the choices of the specific methodology followed to calculate the variable, and the assumptions, parameters and data series used in the computation. The ECB does not therefore rely on a single estimate, but instead uses a range of estimates based on various methodologies, taking into account the dispersion of the different measures.

Moreover, as the ECB does not publish any other summary indicator of the position of the euro area economy in the economic cycle, there is a risk that publishing a point estimate for the output gap may lead market participants to focus solely on this one specific figure, ignoring the uncertainty associated with it. The variety of methodologies available also means that publishing a range of estimates would not necessarily provide instructive information. Furthermore, it could lead to incorrect inferences being drawn as to the processes behind monetary policy decisions.

2. Institutional issues

2.1. Independence of the ECB

The resolution "*takes note of the ECJ judgment of 16 June 2015 in Case C-62/14, and calls on the ECB to take it into consideration in its actions; urges the ECB to reassess and, if necessary, reinforce its independence from political decisions"*.

The ECB takes note of the ECJ judgment of 16 June 2015 in Case C-62/14. The ECJ found Outright Monetary Transaction (OMTs) to be compatible with European Union law. The ECJ followed the arguments put forward by the ECB and confirmed that OMTs, in view of their objectives and the instruments provided for achieving them, fall within the area of monetary policy and therefore within the

[6] The document is available on the ECB's website at: https://www.ecb.europa.eu/ecb/legal/pdf/en_ecb_2014_60_f_sign.pdf.

powers of the Eurosystem. The ECJ underlined that the ECB takes its decision on the activation of OMTs in full independence.

2.2. Relations with the European Systemic Risk Board

The resolution "*stresses the importance of the organisational independence of the European Systemic Risk Board, and calls on the ECB to consider ways of enhancing this board's independence"*.

The ECB considers that, at present, no far-reaching changes are needed to the legal framework of the European Systemic Risk Board (ERSB). Some technical adjustments to its operational framework could, however, improve its efficiency and allow it to make a stronger contribution to preventing and mitigating the systemic risks to financial stability that arise from developments within the financial system. These adjustments should be considered by the European Parliament, the Council and the Commission when assessing the need for concrete legislative proposals. As stated in its Opinion on the review of the mission and organisation of the European Systemic Risk Board[7], the ECB supports, in principle, the proposal to appoint a full-time ESRB Managing Director, provided that the ECB President would continue to act as ex officio chair of the ESRB General Board on a permanent basis.

The ESRB has also benefited from the strong analytical, logistical and statistical support provided by the ECB, and has thus been able to build on the ECB's reputation and expertise. While it is important that the ESRB's identity be strengthened and enhanced, existing synergies should nonetheless be preserved.

2.3. AnaCredit

The resolution "*calls on the ECB to completely rework the proposal to set up a comprehensive Analytical Credit Dataset (AnaCredit)"*.

The ECB is currently carefully reviewing the comments it received, both via email and during the meetings held at the European Parliament, following the publication of the draft AnaCredit Regulation in December 2015. These comments will be given due consideration by the Governing Council before a final decision on the Regulation is made. At the same time, the need to preserve the essential benefits of the Regulation for credit analyses and policymaking will also be taken into account.

In designing its proposal for the AnaCredit Regulation, the ECB has, from the outset, conducted detailed assessments of the impact of the Regulation, with a view to ensuring its policy relevance and operational usefulness while limiting costs. Through continuous contacts with national central banks at all stages, and via them with reporting agents and their associations, as part of the Merits and Costs Procedure[8], the

[7] See ECB Opinion of 4 February 2015 on the review of the mission and organisation of the European Systemic Risk Board (CON/2015/4) https://www.ecb.europa.eu/ecb/legal/pdf/en_con_2015_4__f_sign.pdf

[8] For further details, see the quality assurance procedures available at https://www.ecb.europa.eu/stats/html/sqf.en.html.

ECB ensured that the reporting burden for banks would be contained and that the data would be collected and compiled in a cost-effective way. The draft AnaCredit Regulation, published on the ECB's website on 4 December 2015, had already been significantly streamlined in comparison with earlier drafts, in particular in order to take into account the proportionality principle. It in particular excluded information that had originally been foreseen for later Stages, namely information reported on a consolidated basis, data from foreign subsidiaries outside the euro area, information on derivatives and groups of connected clients, loans to households and data from non-credit institutions.

In line with the principle of proportionality, Article 17 of the draft AnaCredit Regulation provides for the possibility of national central banks granting derogations to small credit institutions. This common practice allows the reporting burden on small institutions to be reduced (and was used previously in, e.g. Regulation ECB/2013/33 concerning the balance sheet of the monetary financial institutions sector and Regulation ECB/2012/24 concerning statistics on holdings of securities).

When considering the cost of AnaCredit for small and medium-sized banks in particular, it should be noted that many of these banks use shared IT centres and have standardised IT processes. As a group, they are bigger than the large banks in many credit market segments and equally if not more cost-effective. The fact of having shared IT systems, which automate data management, means that the collection and processing of credit data required is the same, irrespective of whether a credit is provided by a smaller or larger credit institution within the same association. Moreover, the industry acknowledges that it is more cost-effective for the IT centres, which support small and medium-sized credit institutions, and therefore for the institutions themselves, not to introduce artificial reporting thresholds that discriminate between participating credit institutions, and this to different degrees over time. As the IT centres are typically financed by all participating banks, irrespective of whether their data are transmitted to the Eurosystem or not, the cost for an individual small or medium-sized bank of a regulation such as the AnaCredit Regulation being introduced is not dependent on whether the data of that specific bank have to be reported or not.

2.4. Human resources

The resolution "c*alls on the Member States, the Council and the ECB to make every effort to ensure gender balance within the ECB's decision-making bodies".*

In response to this comment, reference should first be made to the process laid down for appointing the members of the ECB's Executive Board. Candidates are nominated by agreement between the Heads of State or Government of the euro area countries; the European Parliament then conducts a hearing of the candidates; and the European Council elects the members by qualified majority. During this process, the ECB gives its opinion on the professional experience and qualifications of the nominated candidates, as required by the Treaty on the Functioning of the European Union. The governors of the national central banks, who, together with the members of the Executive Board, form the ECB's Governing Council, are appointed via broadly similar processes carried out at national level, in accordance with national regulations.

The appointment of the members of its decision-making bodies is therefore outside the ECB's control. The ECB, nonetheless, considers the topic of gender diversity to be of paramount importance and has made it one of its strategic business priorities. In particular in view of the underrepresentation of women in its staff, most notably at management level, the ECB has increased its efforts in the area of gender diversity. It is doing more to attract women to careers at the ECB and support their career development, to provide flexible working arrangements and to increase accountability and commitment to gender diversity throughout the organisation. In order to achieve these aims, the ECB has introduced a wide range of specific measures. These include the introduction of "diversity ambassadors" in each Directorate General or Directorate, the creation of a mentoring programme and a "women in leadership" training programme, and the extension of teleworking options. Through these measures, the organisation aims to reach its self-imposed targets for the proportion of women in management by the end of 2019 (35% women in management level positions (currently 24%), and 28% women in senior management level positions (currently 19%)).

2.5. Transparency

The resolution "*looks forward to the announcement of further steps to improve the transparency of its communication channels; considers that further progress could still be made, especially with regard to the SSM".*

<u>Monetary policy</u>

The ECB considers transparency to be crucial to its work and attaches great importance to communicating effectively with the public. Transparency helps the public to understand the ECB's monetary policy, and better public understanding, in turn, makes the ECB's monetary policy more credible and effective.

Over recent years, the ECB has made continual improvements to its transparency. It has started publishing accounts of its monetary policy meetings and has made more information publicly available, including on monetary policy portfolios, Target2 balances and forward guidance. It has also published detailed information on the ECB's "reaction function", so as to guide market expectations of possible ECB policies.

In addition to communicating with the public to explain the institution's role and set out its policy goals clearly, the ECB has also made available documents relating to specific events. In particular, it published the “Irish letters” that were part of correspondence between the ECB and the Irish authorities in the run-up to the official application of Ireland for support under an EU/IMF adjustment programme and more recently it also made the Agreement on Net Financial Assets (the ANFA agreement) available in the public domain. In February this year, it began publishing the calendars of its Executive Board members.

Banking supervision

Transparency initiatives in the area of banking supervision are mainly discussed in the ECB Annual Report on supervisory activities. It is worth mentioning, nevertheless, that the nature of the work of supervisors means that they are in close communication and dialogue with a number of counterparts: first and foremost individual banks, but also other key stakeholders involved in banking supervision, such as banking associations and auditors, parliaments and the general public. Particular attention has been given recently to improving transparency in relation to the methods and concepts of European banking supervision, including the Supervisory Review and Evaluation Process (SREP). Since the beginning of 2015, the ECB has held regular meetings with banking associations, which it uses as an opportunity to answer their questions and explain its modus operandi. In February 2016, the ECB published a booklet giving more information on the SREP. The booklet also presented the aggregate outcome of the 2015 SREP exercise. In addition, the ECB has organised workshops with MEPs and banks, and has provided information to analysts and to the press.

At the same time, ECB Banking Supervision has also engaged with the general public. It has conducted public consultations even when this was not required by the SSM Regulation (Council Regulation (EU) No 1024/2013). Public consultations were held, for example, on the ECB regulation on reporting of supervisory financial information and in respect of how options and national discretions can be harmonised; a consultation on institutional protection schemes was launched in late February 2016. Moreover, the SSM Framework Regulation, which sets the parameters for the working relationship between the national competent authorities and the ECB, and the Guide to Banking Supervision are both publicly available. Lastly, the Chair and Vice-Chair of the Supervisory Board began publishing their calendars in 2016 as a way of contributing to greater transparency.