EUROPEAN CENTRAL BANK
BANKING SUPERVISION

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, 11 May 2020

Re: Your letter (QZ025)

Honourable Member of the European Parliament, dear Mr Zanni,

Thank you for your letter asking questions about Level 2 and Level 3 assets, 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 6 April 2020.

In your letter, you refer to a loss incurred by ABN AMRO Clearing as a consequence of the market distress that has followed the outbreak of the coronavirus (COVID-19) and ask several questions about European banks' exposures to Level 2 and Level 3 assets and the impact that the COVID-19 crisis has had on the value of those assets.

As indicated in ABN AMRO's press release of 26 March 2020,[1] the reported loss was a consequence of the bank's decision to close out the position of a US client that had failed to meet the margin requirements of a major central clearing counterparty (CCP) following extreme stress and dislocation in US markets. It is worth noting that the main driver of that loss was the unsuccessful trading strategy pursued by the bank's client, rather than uncertainty regarding the valuation of the underlying instruments. In the case of trades cleared via a CCP, valuations tend to be fairly standardised and not particularly difficult to assess.

As regards Level 2 and Level 3 assets, the ECB has (as I explained in my letter to you dated 14 April 2020) devoted considerable resources to the supervisory assessment of complex instruments measured at fair value, carrying out a series of coordinated initiatives, both off-site and on-site (some of which are still ongoing).

With regard to your first question on bank holdings of Level 2 and Level 3 assets per euro area country, our supervisory statistics, which are regularly published on the ECB Banking Supervision website, provide

[1] https://www.abnamro.com/en/newsroom/press-releases/2020/abn-amro-records-incidental-net-loss-of-usd-200-million.html

granular information on this subject.[2] As you can see from the most recent set of data, banks in Portugal (2.81%), Belgium (1.60%) and Germany (1.57%) had the most Level 3 assets as a percentage of total assets on 31 December 2019, while banks in Germany (20.74%), France (17.35%) and Ireland (11.11%) had the most Level 2 assets as a share of total assets. It is worth noting that these aggregate ratios of Level 2 and Level 3 assets to total assets are just one way of assessing a banking system's exposure to such assets.

In a recent data collection exercise looking at the regulatory trading books of 13 major SSM banks, the majority of trading activities (around 87%) involved assets classified in Level 2, which mainly consisted of short-dated standard derivative contracts (such as interest rate swaps) with limited uncertainty surrounding valuations. Level 3 positions in the trading book only accounted for around 2% of the total and were concentrated in a few banks, with around 82% of those Level 3 positions being held by the three largest SSM banks.[3]

As regards your second question on the impact that the COVID-19 crisis has had on the value of Level 2 and Level 3 assets and liabilities, the ECB is closely monitoring the effect that the market distress has had on banks' balance sheets, CET1 capital levels and requirements. As part of that monitoring process, we are carefully assessing the adequacy of the valuation adjustments that have been carried out for fair value assets in order to account for the increase in uncertainty.

Furthermore, as part of our market risk campaign, several on-site inspections covering banks with significant trading activities were completed before on-site fieldwork was suspended because of the COVID-19 pandemic.

Turning to your last question, I do not, as things stand, see any need to impose restrictions on Level 2 and Level 3 exposures. It is important to emphasise that Level 2 and Level 3 positions largely consist of hedging and client-related transactions providing financial services to the real economy and satisfying a demand from various economic agents. Nevertheless, some of those instruments do give rise to specific market and valuation risks, and a sufficiently robust framework is needed in order to identify, assess and monitor those risks. In this context, our aforementioned supervisory activities – and the on-site inspection campaign more specifically – seek to ensure that institutions have rigorous and consistent processes for assessing valuation uncertainty and determining valuation adjustments and, ultimately, that all instruments measured at fair value are assessed appropriately.

Yours sincerely,

[signed]

Andrea Enria

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[2] See https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.supervisorybankingstatistics_fourth_quarter_2019_202004~4848fcfef2.en.pdf (page 80).

[3] For more information on Level 2 and Level 3 assets and liabilities, please refer to the recent ESRB report entitled "Macroprudential implications of financial instruments in Levels 2 and 3 for accounting purposes" (https://www.esrb.europa.eu/pub/pdf/reports/esrb.200225_macroprudentialimplicationsfinancialinstrumentslvl2and3~6570e40b64.en.pdf?5961598e804245f73cf4ca5891ef2e36).