A year of the SSM – résumé and outlook

Speech by Danièle Nouy, Chair of the Supervisory Board of the Single Supervisory Mechanism, at the ESE (European Supervisor Education Initiative) Conference 2015 "Financial supervision in Europe - on the right track?" hosted by Czech National Bank, Prague, 1 October 2015

Ladies and Gentlemen,

Thank you very much for the introduction, and thank you for inviting me to speak at this distinguished event.

The topic of our session here is “The banking union – a first résumé”. As you know, the Single Supervisory Mechanism (SSM) became operational last November. This was only three years after the so-called “Four Presidents’ report” was published, which paved the way for the decision to establish a banking union in the euro area. The banking union is one of Europe’s responses to the lessons learned during the financial crisis and a further step towards deepening Europe’s single market. The SSM constitutes the first key pillar underpinning the banking union, along with the Single Resolution Mechanism and the increasing coordination of the national deposit guarantee schemes.

Next month will mark the first anniversary of the SSM. In our first year, we have taken a giant leap towards ensuring consistent banking supervision in the euro area. In my speech, I will start by highlighting some concrete evidence of the added value of ECB banking supervision. I will then expand on our priorities for the near future.

A comprehensive start

Before we even became fully operational in November, the ECB was tasked with conducting a comprehensive assessment of the banks that were likely to fall under its direct supervision. This in itself was an exercise of unprecedented magnitude. It consisted of an asset quality review and a stress test, and required the close involvement of the ECB, the national supervisory authorities, the European Banking Authority and the private sector.

In conducting the rigorous balance sheet review in combination with a stress test, we substantially enriched our knowledge of the actual financial situation of the banks that we now supervise, and gained valuable and detailed insights into the trends affecting the European banking system. Most importantly, the comprehensive assessment was one of the key building blocks in renewing market confidence in the euro area banking sector. This gave us a head start in getting to know very well most of the banks that we subsequently began supervising. Also, it was the first step towards establishing a European supervision culture of thoroughly and prudently monitoring, challenging and assessing banks. By checking that banks are adequately capitalised and have proper governance and risk management in place, we contribute to financial stability. The banks, in turn, can contribute to sustainable growth.

Under one roof

After the comprehensive assessment, we jumped straight into supervision. It helped immensely that the SSM was part of an established institution: the ECB. We all agree that supervisory tasks should be carried out in full separation from monetary policy to avoid conflicts of interest and to ensure that each function is executed in accordance with its objectives. The legal framework designed by European legislators in October 2013 is very clear on this point in that it guarantees the separation and independence of the functions within the ECB and also shields the SSM from undue external influence. To underline this, ECB supervision is held accountable in its own right: the Supervisory Board submits an account of its meetings to the European Parliament, we regularly report to the relevant European parliamentary committee – separately from monetary policy operations – as well as to the Eurogroup, and we publish a separate annual report on supervisory activities, which is presented to the European Parliament and the Eurogroup.

At the same time, the ECB was the natural home for meeting all of the challenges of establishing the SSM. No other institution could have offered a sounder basis for the creation of the SSM and I would argue that no other institution could have absorbed these new functions and so many new staff as efficiently as the ECB. For a new European supervisory authority starting its work, the ECB's long established services and its credibility as an institution are invaluable assets. Our supervision also benefits from a link with the central bank: in the SSM we ensure that micro-prudential supervision is complemented by a macro-prudential perspective. Our mandate includes both micro- and macro-prudential competences and this was an important lesson from the crisis. So, while the division of competences and the separate responsibility of the ECB supervision are firmly anchored in European law, being under one roof ensures that no relevant macro-level information gets lost between the supervisory authority and the monetary policy-maker.

Of course, we also work very closely with the national supervisory authorities. In addition to around 800 supervisors in Frankfurt, we draw on another 2,000 supervisory staff in the 19 euro area countries. On top of being involved in the Joint Supervisory Teams (JSTs) which are in charge of the supervision of the 123 most significant banks, national supervisors directly supervise the remaining 3,500 euro area banks and implement the supervisory guidance and best practices that we agree to at the European level. We benefit from the national experience and expertise of the local supervisors; at the same time, the fact that supervisory policy decisions are made at the European level guarantees the absence of political influence and national capture. And additional measures safeguard this neutrality. For example, the coordinators of JSTs are not nationals from the home countries of the banks supervised. We have combined all these strengths to create a unique form of cooperation, which could inspire other current and future European bodies.

One of the major assets of the SSM is the capacity to compare banks' situations across countries through benchmarking, peer reviews and horizontal functions. We are dedicated to tough supervision; we strive to be fair and even-handed in our actions, while avoiding a one-size-fits-all supervision approach. By balancing uniform supervisory anchor points with constrained supervisory judgement, we ensure both consistency across institutions and supervision tailored to banks' specific circumstances. With this approach we also accommodate banking diversity which I consider very desirable from a financial stability perspective.

First achievements: SREP, options and national discretions

One year down the road, I can assure you that we have already gained a lot of experience in the field of European banking supervision. Allow me to highlight two concrete examples where we have proven to be a game changer.

I will start with our first full round of annual supervisory assessments of the banks, the so-called "Supervisory Review and Evaluation Process" or SREP. It results in the determination of individual capital levels to be met by banks. Because we were only about two months into operations, the first assessment round performed by the ECB in 2014 was still mostly based on the methodology formerly applied by the national supervisors. But I am pleased to say that the 2015 round is being done under a unified methodology that was developed by us at the ECB in close cooperation with the 19 national supervisors. This exercise is already showing the impact of a more harmonised approach to banking supervision: consistency has been improved with regard to the level of capital requirements. In the long run, the unified methodology will enhance the effectiveness of supervision, as a common language between supervisors and banks is developed, and supervisory actions and capital trajectories are better anticipated.

Of course, we did not start from scratch, and we are not reinventing the wheel regarding supervision. For example, on the supervisory methodology we identified common denominators and existing divergences and pinpointed best practices on which we then modelled our final outcome. And we employ this approach for many of the issues we are facing to achieve our ultimate objective of a level playing field for banking across Europe.

As you can see we are very busy establishing common methodologies, a joint culture and a shared reputation, which will ensure that we have the right instruments and incentives to effectively carry out our supervisory tasks. This foundation has already been successfully tested, as the comprehensive assessment shows. This brings me to the second strand of work to which I would like to draw your attention. We quickly found out that supervisory practices cannot be harmonised in the SSM without harmonising the interpretation of regulations. The comprehensive assessment shed light on parts of the European prudential regulation (the CRDIV/CRR package), where some discretion remains for supervisors or national governments to decide on its concrete implementation.

We have counted over 150 such provisions, ranging from the progressive phase-in of new standards and definitions to more permanent exemptions from the general rule. Regulators usually refer to these as “options” and “national discretions”.

It is important to distinguish them from uniform provisions introduced to accommodate specific features of the European economy, including, for instance, the preferential treatment of exposures to small and medium-sized enterprises. Contrary to this type of support measure, where all banks in Europe are treated equally, options and national discretions create significant discrepancies in the way the Single Rule Book is implemented nationally.

These options and national discretions are often the result of long negotiations in the Council and Parliament concerning how to take account of different market structures and legal environments. But many of them have significant material effects on the level of prudence of the framework and on the comparability of capital ratios which make it hard for investors to price capital and funding for the banks. They also add an additional layer of complexity as well as a source of regulatory arbitrage. They create competitive disadvantages for banks in euro area countries that have chosen the most virtuous standard and can thus pose a risk to the financial sector. Last, but not least, they make our job as supervisors much more difficult, as we need to take this uneven playing field into account in daily supervision.

Harmonised banking supervision requires a harmonised approach and that is why it is necessary to develop a single SSM-treatment of all options and national discretions.

We have undertaken tremendous work to make a difference on this front and have proposed solutions to those national options that fall under the discretion of the national supervisors; and I'm pleased to say that, in the SSM, we have agreed on a single implementation of these national options for the whole euro area. In a few cases harmonisation was not possible with the level of rigour that I would have liked to see, unfortunately, so the dialogue with legislators is ongoing. Nevertheless, this is a unique and necessary achievement, which could not have been reached in any other European forum.

Of course, harmonisation cannot be a goal in its own right. Exactly the same is true for national exceptions: if they contribute to a more stable banking system, we will be eager to preserve or even promote them. But if they are only the reflection of unquestioned traditions, pure national interest and regulatory capture, they should be removed. We expect the positive outcomes in terms of the prudence, consistency and stability of the framework to far outweigh the adjustment costs that each national banking system will face when converging to the high standards.

In promoting the rigorous harmonisation of the SSM regulatory framework, we are aligning it with global standards or, when there is no such standard, adopting the most conservative approach. This is what the SSM is about: progressing towards more consistency, more comparability and, eventually, more trust in the European banking system. In this respect, we are a game changer: in a lot of cases, we can from now on speak of options and discretions, and leave out the “national”.

Among the achievements of this year I would also like to mention the work conducted on business models and profitability. Following up on the findings of the comprehensive assessment, JSTs engaged in firm discussions with banks' senior management to set a high level of SSM expectation and challenge the viability of business models and profitability drivers. An SSM business model classification was developed to categorise significant institutions, which is a major step forward for conducting credible peer analyses, supporting JSTs' assessments and challenging business models of credit institutions. The work around the analysis of profitability drivers is intended to be deepened throughout 2016.

Governance has a huge impact on risk-profiles and business model sustainability. In connection with the above-mentioned work, we are conducting a thematic review on “Risk governance and appetite” in all significant institutions. The performance of this thematic review has already allowed JSTs to identify follow-up supervisory actions for

2016, as well as areas for future on-site inspections. It will be concluded with the issuance of follow-up letters for every significant institution.

Supervisory priorities

Looking at the priorities for the year ahead of us, I think it is safe to say that the economic environment in which banks operate remains challenging. While indications of financial stress have generally declined in recent months, global financial conditions remain volatile in some respects. This has its effects on everybody – banks, governments and citizens.

For banks, the economic climate in the euro area poses challenges to their profitability. Banks are facing a seeming paradox: while prices of financial assets are rising, real investments in the euro area remain relatively low. If we also factor in the persistent low interest rate environment, it becomes clear that banks will have to review their business models in order to stay profitable. This viability of business models and profit drivers will likely still be a priority for us in 2016.

We know that some of the banks within the euro area still face significant credit risk; this is therefore likely to remain a key priority with a focus on non-performing exposures and concentrations of exposures in areas like real estate. We will, of course, identify other more micro-level risks as focal points for our supervisory activities next year. New technological developments expose banks to new IT and cybercrime risks and I think we as a supervisor should be aware of this.

In addition, we will engage in supervisory activities together with other European and international authorities. In the first semester of 2016, we will participate in the EU-wide stress test that will be coordinated by the European Banking Authority. On a global level, the strategic review of the Basel capital framework will continue. I think it is important that the ECB contributes to this review, that should achieve an adequate balancing of the simplicity, comparability and risk sensitivity of the Basel framework.

Lastly, there are also important regulatory developments that will have a significant impact on the banks we supervise. For example, the requirements for total loss-absorbing capacity (or TLAC) as developed by the Financial Stability Board. This will enable us to deal with the “too-big-to-fail” issues we have with global systemically important banks. The TLAC requirements will mean that the biggest banks will have to comply with an additional set of requirements. It will be our job to ensure a smooth introduction of TLAC.

Within Europe, the Bank Recovery and Resolution Directive will come into force on the first of January 2016. This Directive not only provides the European and national resolution authorities with effective tools to do their job, but imposes a new minimum requirement for own funds and eligible liabilities of banks. I would also like to say a few words about Greece. From early on, we have been involved in the events in Greece. As the supervisory authority, we share the responsibility with the Bank of Greece to ensure a stable banking system that citizens can trust. This is what we have been working on from the start of ECB supervision and it is what we will be working on in the years to come. As you know, a recapitalisation of the banks is part of the political accord that was concluded in the Eurogroup just before the summer. The SSM will play its part in ensuring that this recapitalisation is completed on time. It is important that we achieve this, because a functioning banking system is a prerequisite for economic recovery. I am confident that in this case too we will demonstrate that European banking supervision helps ensure the soundness of banks, prevent crises and support economic stability.

What I have given you now is just a quick overview of the developments that I consider will be relevant in 2016. It is far from exhaustive, but it is already quite a list. In the coming months, we will make the final selection of our supervisory priorities. We will publish this selection in early 2016, in our Annual Report. These priorities will be the subject of our on-site inspections and horizontal thematic reviews. They also help us ensure accountability: at the end of the year we will be able to assess to what degree we have reached the goals formulated in our priorities. It makes us more transparent, accountable and thus more effective.

Concluding remarks

I have provided you with an overview of where we stand with the SSM and have given you some insights into what we are planning to do next year. Also, I hope I have given you two good examples of the added value of ECB banking supervision. My main message here is that, on a European level and in one single mechanism, banking supervision is more adequate and effective. Together with the national authorities, the ECB is doing everything in its power to restore economic conditions that foster sustainable growth and economic development. For ECB banking supervision, this means implementing harmonised supervisory practices to the highest standards in the euro area. Only when banks are prudently and responsibly managed with the right incentives can the financial sector provide citizens, small and medium-sized enterprises and corporations with credit and financial services at all phases of the economic cycle. We as the SSM take a medium to long-term perspective on this, resisting those who argue for short-term relief. Ensuring that banks are adequately capitalised will help weather economic downturns, spur economic growth and generate the high-quality jobs that we all are interested in seeing in Europe. For this reason, I consider our firm determination to deliver adequate, effective and truly single European banking supervision to be our most significant contribution to the European project.

Source:

European Central Bank *Directorate General Communications*
Sonnemannstrasse 20, 60314 Frankfurt am Main, Germany
Tel.: +49 69 1344 7455, e-mail: media@ecb.europa.eu, website:
www.bankingsupervision.europa.eu