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# The next SSM term: Supervisory challenges ahead

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IN-DEPTH ANALYSIS

Requested by the ECON committee

European Parliament

# The next SSM term: Supervisory challenges ahead

## Banking Union Scrutiny


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Economic Governance Support Unit

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ECONOMIC GOVERNANCE SUPPORT UNIT

# The next SSM term: Supervisory challenges ahead


## Abstract

In this note we first highlight different developments for banks under direct ECB supervision within the SSM that may prompt further investigation by supervisors. We find that banks that were weakly capitalised at the start of direct ECB supervision (1) still face elevated levels of non-performing loans, (2) are less cost-efficient and (3) reduced their share of subordinated debt financing over the last years. We then stress the importance of continuous and ongoing cost-benefit analysis regarding banking supervision in Europe. We also encourage processes to question existing supervisory practices to ensure a lean and efficient banking supervision. Finally, we underline the need of continuous and intensified coordination among regulatory bodies in the Banking Union since the efficacy of European bank supervision rests on its interplay with many different institutions.


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**ABOUT THE EDITOR**

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# CONTENTS

## LIST OF ABBREVIATIONS

**AQR** **Asset Quality Review**

**BRRD** **Bank Recovery and Resolution Directive**

**CET1** **Common Equity Tier 1**

**ECA** **European Court of Auditors**

**ECB** **European Central Bank**

**EDIS** **European Deposit Insurance Scheme**

**MREL** **Minimum requirements for own funds and eligible liabilities**

**NCA** **National competent authority**

**RWA** **Risk weighted assets**

**SSM** **Single Supervisory Mechanism**

**SRM** **Single Resolution Mechanism**

**TLAC** **Total Loss Absorbing Capacity**

**TRIM** **Targeted Review of Internal Models**

## LIST OF FIGURES



## LIST OF TABLES

## EXECUTIVE SUMMARY

Changing the supervisory landscape and bundling banking supervision in the Single Supervision Mechanism (SSM) shall ensure a homogenous supervisory standard across institutions in the participating member states of the Banking Union.

In this note we start by examining entities that entered direct supervision by the ECB in 2014 and analyse how three selected balance sheet items developed. We distinguish banks according to their level of capitalisation at the onset of the SSM. Institutions entered direct supervision in 2014 with different levels of capital and we focus on banks with initially weaker capital buffers. Utilizing publicly available data on balance sheet items, we find that banks with an initially weaker capital buffer do not seem to have increased their stability under direct ECB supervision. Specifically, we find banks with weaker capital buffers neither reduced their share of non-performing loans significantly nor improved their cost efficiency. Furthermore, we find that, on average, banks reduced their reliance on subordinated debt financing since 2014.

The second part of this analysis discusses two different aspects that are important for an ongoing improvement of supervisory outcomes within the SSM. In particular, we argue for establishing an improvement process for supervisory practices and urge supervisors to ensure a wider use of supervisory information and advocate (1) greater public disclosure of supervisory risk and (2) new/further feedback channels. Overall, we propose an ongoing process of streamlining the administration within the SSM, which would enhance the relative benefits of banking supervision. Finally, we discuss the need for strong and well-established interfaces of common supervision within the SSM and beyond and highlight that both the interplay of the ECB with NCAs and of the prudential supervisors (ECB and NCAs) with resolution authorities (SRB and national resolution authorities) requires close attention.

# 1. INTRODUCTION

The Financial Crisis and the European sovereign debt crisis highlighted deficiencies in the regulatory framework for the European banking sector. To harmonise regulation and strengthen the resilience of financial institutions in Europe, the European Union took various initiatives that culminated in the Banking Union, which brought about an unprecedented supranationalisation of banking regulation in the participating member states. The new regulatory architecture consists of a set of harmonised prudential rules for banks ("Single Rulebook"), the direct supervision of significant banks by the ECB within the Single Supervisory Mechanism (SSM), a homogenous framework for the resolution of failing banks within the Single Resolution Mechanism (SRM), and the impending establishment of a European Deposit Insurance Scheme (EDIS). While discussions on EDIS are still ongoing, and the Banking Union is thus still incomplete, the far reaching supranationalisation of supervisory powers in the SSM came into force on November 4th 2014 and since then more than 100 large European banks are directly supervised by the ECB.

Supervision by the SSM shall harmonise supervisory standards across institutions in the participating member states and ensure a level playing field. The 4th of November 2019 marks the fifth anniversary of banking supervision within the SSM and in this in-depth analysis we take stock of this evolution and identify future challenges that need to be addressed in the future.

We start by examining how banks that entered direct supervision by the ECB in 2014 evolved over the last years (infra 2). We focus specifically on banks that were more fragile in 2014. Because the levels of capital varied at the start of direct ECB supervision, we investigate whether the development of banks with initially weaker capital buffers differed from that of banks with a higher level of capital at the start of the SSM. Focusing on publicly available data on balance sheet items, we find heterogeneous developments in our sample and banks with an initially weaker capital buffer apparently did not increase their resilience under direct ECB supervision. In particular, our data analysis suggests that banks that entered direct supervision of the SSM with weaker capital buffers were not able to significantly reduce their share of non-performing loans or improve their cost efficiency. Furthermore, we find that on average all banks have reduced their reliance on subordinated debt financing since 2014. This development is problematic since the SRM provides a framework for resolving failing banks and thus strengthens the role of subordinated debt as a disciplining device due to the possibility of a bail-in in times of bank distress.

In light of our empirical findings, the second part of this analysis explores two different aspects that might further improve supervisory outcomes within the SSM. In particular, we support the successful establishment of a continuous and ongoing improvement process of supervisory practices as an integral part of the future development of the SSM. Specifically, we expect benefits for financial stability by ensuring a better use of (newly gathered) supervisory information and we advocate (1) greater public disclosures of supervisory risk evaluations from different stress test/risk exercises, and (2) establishment of new/further feedback channels from supervisors to banks. Moreover, we propose to establish an ongoing process of streamlining the SSM administration and improving the cost efficiency of banking supervision (infra 3). Furthermore, we focus on the interfaces of common supervision within the SSM and beyond and highlight that both the interplay of the ECB with NCAs and of the prudential supervisors (ECB and NCAs) with resolution authorities (SRB and national resolution authorities) requires close attention (infra 4).

# 2. DEVELOPMENT OF DIRECTLY SUPERVISED BANKS

With the aim of harmonising supervisory standards across countries of the European Banking Union, the ECB assumed its function as the supervisor of large European banks within the SSM on November 4th 2014.[1] To prepare for its role as the direct supervisory body, the ECB engaged in a comprehensive assessment of 130 banks, expected to qualify for direct supervision by the ECB, in 2014. This comprehensive assessment consisted of (1) a review of participating banks' assets (asset quality review (AQR)) and (2) a stress test. The AQR was a point-in-time assessment of these banks' assets while the forward-looking nature of the stress test should identify deficiencies in these banks' capital adequacy. To ensure equal treatment and consistency across institutions, ECB teams performed independent quality assurance on the work of the banks and national regulators. The findings of the AQR highlighted heterogeneous treatment of (1) accrual accounted assets and (2) stocks of non-performing exposures across the participating institutions, which resulted in an aggregate adjustment of 47.5 billion EUR to participating banks' asset carrying values as of 31 December 2013 (ECB, 2014). The identified capital shortfall and the outcome of the stress test indicated considerable heterogeneity in European banks' capital buffers and hence their resilience, underlining the need for harmonised supervision and a level playing field.

To provide insights into whether banks under the direct supervision of the SSM have indeed become more resilient since the start of the SSM, we assess here the evolution of selected balance sheet items of directly supervised entities. We start in 2014 and use information on reported adjusted capital ratios by the AQR as the AQR ensured that capital ratios at directly supervised institutions are computed using a homogenous approach. Specifically, we group banks into three categories depending on reported (adjusted) CET1 ratios. Since bank capital serves as a buffer against unexpected losses, a lower capitalisation ratio thus indicates greater bank fragility. For our analysis, we group banks as follows: weakly capitalised banks, i.e. banks with a reported CET1 ratio below 8 percent, medium capitalised banks, i.e. banks with a CET1 ratio between 8 and 12 percent, and strong capitalised banks, i.e. banks with a CET1-ratio above 12 percent. Due to lower capital buffers, weakly capitalised banks tend to be riskier and we expect that supervisors will focus on these banks to ensure that they become more resilient and improve their position. To shed some light on this, we use balance sheet information for the fiscal years 2014 and 2017,[2] provided by SNL Financial, and present the evolution of banks' (1) asset quality (share of non-performing loans), (2) cost efficiency (cost-to-income ratio) and (3) subordinated debt financing (share of subordinated debt financing in total RWA). For the aforementioned groups based on banks' CET1-ratios we examine how average asset quality (non-performing loans), cost efficiency (cost-to-income ratio) and subordinated debt financing evolved over the first three years of direct ECB supervision.[3]

## 2.1 Asset quality

Banks devise risk management practices to account for expected losses due to credit defaults. Elevated levels of non-performing loans may reduce bank resilience and be indicative of inferior lending

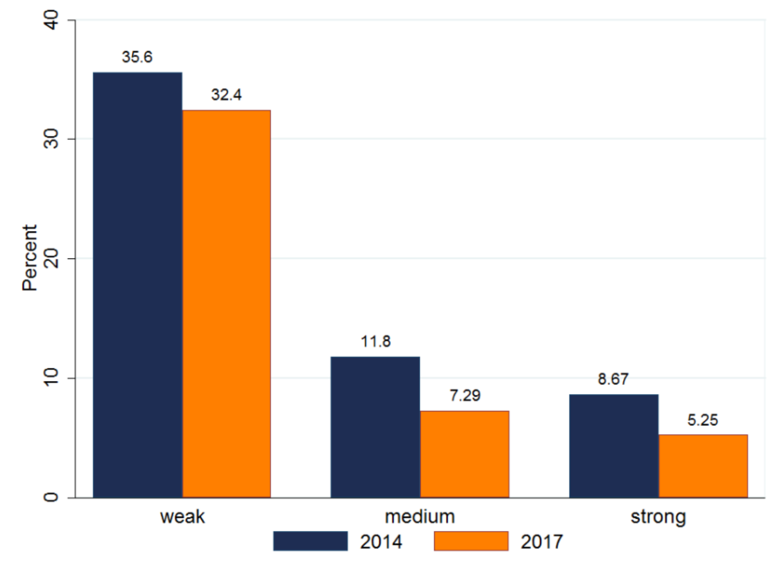
[1] The ECB directly oversees all significant banks in the participating countries where the criteria for determining whether the SSM Regulation and the SSM Framework regulation stipulates criteria applied to determine whether a bank is significant, or not. As of January 2nd 2019, the ECB directly oversees 117 significant entities.

[2] We use information from 2017, as balance sheet information for the fiscal year 2018 was not available for most of the institutions yet.

[3] To keep the sample of banks in our analysis consistent, we exclude banks with missing values on the balance sheet items. We provide a list of banks, split into the respective groups in the appendix.

decisions or risk management practices. Moreover, high levels of non-performing loans tend to have negative ramifications for the real economy and empirical work finds that a reduction of bad loans in the banking sector benefits the economy in the medium term (Balgova, et al., 2016). Figure 1 shows the average level of non-performing loans in a bank's loan portfolio for the aforementioned groups.

**Figure 1: Share of non-performing loans in loan portfolio (2014 and 2017)**




Source: Own calculation, S&L Financial

While, on average, banks reduced their share of bad loans over the period 2014 to 2017, Figure 1 suggests considerable heterogeneity across banks here. Banks that came under direct supervision by the SSM in 2014 with relatively low levels of capitalisation had a large share of bad loans in 2014 (35 percent) and still have a relatively high level of non-performing loans in their loan portfolio in 2017 (32 percent). Although recent discussions raise doubts regarding the detrimental link between non-performing loans and bank credit (Angelini, 2018), the elevated level of non-performing loans nevertheless presents a threat to bank stability. This is all the more troubling as particularly banks with low levels of capital buffers continue to be afflicted with elevated levels of non-performing loans. Regarding the statement of its priorities, the SSM stressed its focus on supervising credit risk over the last years, and put particular emphasis on the need to reduce the level of non-performing loans (ECB, 2016, 2017, 2018). Hence, the relatively high levels of non-performing loans that have hardly changed over time, especially for banks that entered direct supervision by the SSM with a weaker capital buffer, is surprising and warrants some further examination.

## 2.2 Cost efficiency

Expansionary monetary policies over the last years and the zero-lower bound have reduced lending margins for European banks. Weak bank profits may pose a threat for financial stability (ECB, 2015).[4] To assess whether banks have increased their cost efficiency to counter these perils, we now turn to the cost-to-income ratio for banks in the aforementioned different groups for the years 2014 and 2017.[5]

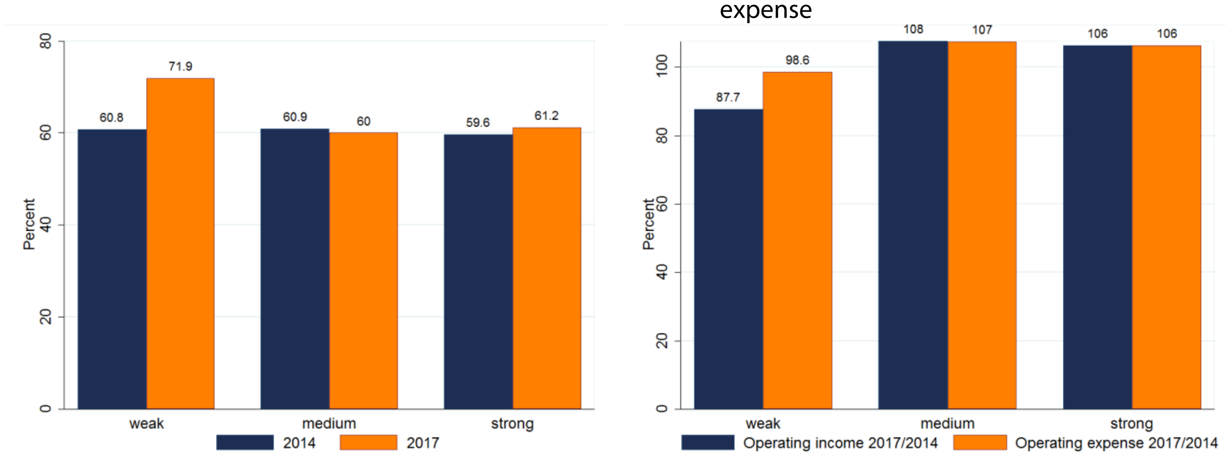
[4] While an easing of monetary policy reduces net interest income, Peydro et al. (2017) argue that the bank profitability does not necessarily decrease, since banks also experience lower loan losses and higher noninterest income during periods of monetary easing. Heider and Saidi (2019) find that negative interest rates prompt European banks, however, to increase their risk taking.

[5] We follow the definition provided by SNL and use the ratio of operating expenses to operating income here.

Since operating expenses as well as operating income affect a bank's overall cost efficiency, we also present changes in income and expenses here (Figure 2).

**Figure 2: Cost efficiency ratio and components (2014 and 2017)**

a) Operating Income / Operating Expenses    b) Change in Operating income/Operating expense




Source: Own calculation, S&L Financial

Figure 2(a) shows that banks with a weak initial capital ratio became more inefficient and display lower cost efficiency compared to 2014. While the cost-to-income ratio for banks with medium and high capitalisation virtually remained constant since 2014, banks in the lowest group show an increase in their cost-to-income ratio of about 11 percentage points. Figure 2(b) examines this further and presents the average ratio of operating income / operating expenses in 2017 to its level in 2014. This figure shows that banks with a medium and high level of capitalisation increased their income but also operate with higher expenses, albeit without any significant change in their level of cost efficiency. Banks with a weak capitalisation, on the other hand, became less cost-efficient as their income fell by about 12 percent while their expenses decreased only by about 1 percent. This loss of cost efficiency due to the small change in operating expenses for weakly capitalised banks is particularly worrisome as empirical evidence suggests that - in addition to cyclical factors - structural factors, such as a high level of non-performing loans (see Figure 1), tend to have a detrimental effect on European banks' profitability (ECB, 2018). A further deterioration in cost efficiency may therefore happen if underlying structural factors are not addressed. Aside from ensuring that banks are cost-efficient in order to improve bank stability, a particular focus should also lie in supervising banks' lending behaviour as banks may increase their risk taking in the current environment of low interest rates (Heider and Saidi, 2019). Understanding why banks that were less capitalised than their peers in 2014 became also less cost-efficient is important to gauge potential effects for financial (in)stability.

## 2.3 Subordinated debt financing

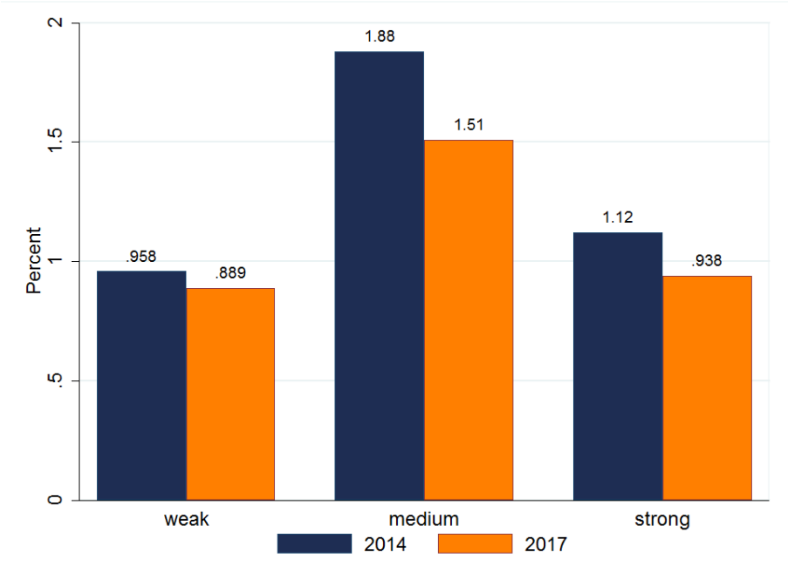
Harmonising banking supervision by directly supervising financial entities through the SSM is one pillar of the European Banking Union. The Single Resolution Mechanism (SRM), designed to ensure a common framework for resolving failing institutions, is the second pillar of the Banking Union.[6] In conjunction with the SSM, the SRM shall thus address prior deficiencies in the regulatory framework for failing European banks. Especially the ability to bail-in debtholders during times of bank distress via the

[6] The European Deposit Insurance Scheme is the third pillar of the European Banking Union.

bail-in tool, as laid out in the Bank Recovery and Resolution Directive (BRRD), should foster market discipline by investors of bail-in able debt and thus contribute to financial stability (Götz, et al., 2017).

To ensure, however, that the bail-in of debtholders is not only a theoretical option when banks become distressed, banks need to have a sufficient amount of bail-in able debt. Unfortunately, detailed information regarding the level of pre-designated bail-in able bank debt, prescribed in resolution planning, is not publicly available. Bank balance sheets, however, provide information about one important component of banks' bail-in able liabilities: subordinated debt. Figure 3 presents that evolution of banks' subordinated debt financing as a percentage of their total RWA.

**Figure 3: Share of subordinated debt in RWA (2014 and 2017)**




Source: Own calculation, S&L Financial

Compared to 2014, banks' share of subordinated debt financing decreased by 2017. This general trend gives rise to concerns as the ability to bail-in debtholders in case of banking distress is important for the proper resolution of failing banks.[7] Aside from facilitating a bail-in of debtholders in times of distress, an increase in the trading and availability of subordinated bank debt in financial markets is desirable for another reason as well. Due to the looming risk of a bail-in, one can expect that the financial market risk premium for subordinated bank debt also better reflects bank risk. This contributes further to financial stability. Thus, given the importance of subordinated bank debt for financial stability, it is worthwhile to understand whether (or why) banks are reluctant in their use of (public) subordinated debt financing.

[7] Note, however, that a detailed analysis regarding the total level of bail-in able debt at the bank-level requires granular data, which are not publicly available.

# 3. ENABLING A PROCESS OF CONTINUOUS IMPROVEMENT OF SUPERVISORY PRACTICES

Banking supervision today requires and absorbs much more resources as compared to the pre-crisis period. Both the SSM and the NCAs have enlarged the scale and scope of supervisory activities. As a result, it becomes more important to monitor costs and benefits of the associated activities and to improve supervisory practices wherever possible. This is particularly important as many newly introduced supervisory practices may have been implemented under time pressure and without a thorough cost-benefit analysis. While the implementation of new regulations and supervisory practices may have slowed down, the supervisory framework is still in a learning phase where continuous adjustments may be necessary to improve the whole system substantially. In our view, the successful establishment of an ongoing improvement process is one of the most important tasks for the future development of the SSM. Specifically, we expect opportunities for improvements in primarily two areas (1) improving the use of (huge) amounts of information collected by supervisory authorities and (2) streamlining the administrative processes thereby enhancing the cost efficiency of banking supervision.

## 3.1 Leveraging supervisory information for the benefit of banks and market discipline

The financial crisis has led to a substantial increase in knowledge and expertise of banking supervisors. Anecdotal evidence suggests that limited information and knowledge of innovative financial instruments as well as banks' risk management techniques contributed to the development and severity of the financial crisis (Levine et al., 2012). This has changed dramatically in the last decade and supervisors have substantially improved their supervisory practices and access to detailed bank level data. As a result, banking supervision has the potential to increase its benefits to society by expanding supervisory disclosure to the public and by engaging in supervisory feedback with individual banks

### 3.1.1 Fostering market discipline by enhanced supervisory disclosures

Two examples from Europe and the US illustrate the potential of enhanced supervisory disclosures for financial stability and market discipline.

- Pillar 2 supervisory disclosures in Sweden. Contrary to the disclosure practices of the ECB, financial supervisory authority of Sweden discloses detailed information on a bank's capital requirements and, in particular, details about the outcomes of its own Supervisory Review and Evaluation Process (SREP). [8] This disclosure provides capital markets with detailed insights, allowing a bank level comparison of specific banks' risks such as pension risks, banking book interest rate risks and credit concentration risks. Since these risks are evaluated by the supervisor via standardized methods a cross-bank comparison is internally consistent and makes it easier for capital market participants to compare risk profiles of different banks. Compared to disclosure requirements imposed on individual banks, supervisory disclosure adds an important piece of information by aggregating bank level data with a common model that allows consistent comparisons among banks.
- US stress testing exercise. Different from European stress testing, US stress testing is based more on a "top-down" approach, implying that stress test results are primarily derived from

[8] See, for instance, "Capital requirements for the Swedish banks", published by the Swedish supervisory authorities. Available at: https://www.fi.se/contentassets/cfc8eb3b18fd4409868479f9af279ce9/kapitalkrav-sv-banker-kv3-2018-eng.pdf

common supervisory models and thus less dependent on bank specific modelling practices (Haselmann and Wahrenburg, 2018). A consistent top-down approach approach is widely regarded as a means to improve the information content and comparability of individual bank's stress test results and helps to increase market discipline. Further, it reduces the stress test burden for each bank as it shifts a larger part of the process to supervisory authorities.

### 3.1.2 Fostering market discipline by enhanced supervisory disclosures

Financial institutions argue that communication with supervisors tends to be a one-way-street with supervisors raising questions and data requests and banks responding without tremendous ongoing feedback in return. Acknowledging that supervisors have a lot to offer – but are naturally reluctant to provide feedback to supervised institutions – we encourage supervisors to engage in a (new) culture of enhanced communication.

Examples of such improvements in communication may be supervisory benchmarking surveys in areas such as the evaluation of cyber risks or the evaluation of anti-money laundering practices. Supervisors spend a considerable amount of time analysing and comparing the respective capabilities of individual banks. Nonetheless, feedback of their insights is usually restricted to the publication of highly aggregated results. We believe that, supervisors could improve the risk management practices of banks by providing banks with appropriate detailed information regarding their individual strength and weaknesses.

Another area of potentially fruitful feedback communication is the expansion of supervisory research. A lot of research conducted by supervisory authorities uses bank-level supervisory data and explores policy relevant questions such as the effect of a strong recession on the capital adequacy of individual banks. Outcomes from these supervisory research efforts may be of great use for a bank's management and supervisors should explore areas where conveying specific insights to banks may enable a better understanding of their risk and improve their risk taking decisions.

A third area concerns supervisory information regarding banks' internal risk models. Banks use internal models in many areas such as market risk, credit risk and operational risk. The current ECB's Targeted Review of Internal Models (TRIM) exercise reviews these models and potentially results in supervisory decisions forcing some banks to change their modelling approaches to ensure consistency and comparability of modelling practices. The TRIM exercise imposes substantial costs on financial institutions and thus raises questions regarding avenues for the improvements of its cost-benefit-ratio. The exchange of information about details of internal models is clearly restricted by the desire (1) to maintain a level of model heterogeneity (to prevent systemic risks) and (2) to protect confidentiality (as models are a source of banks' competitive advantage). Notwithstanding these restrictions, we believe that improved exchange and communication between supervisors and banks may support banks in their risk management practices and may improve the benefits of supervisory initiatives for involved banks.[9]

The character of the ongoing dialogue as a means for continuously achieving small improvements makes it unlikely that banks with a public listing would have to publicly disclose the information in

[9] The banking industry routinely conducts benchmarking projects to support the development of industry best practices where independent consultants benchmark each bank's individual approach. By adding features of these benchmarking projects to the TRIM exercise, for instance, the benefits of this exercise for participating banks may be substantially improved

accordance with art. 17 para. 1 of the Market Abuse Regulation.[10] Typically, the information on possible relative improvements will not pass the materiality threshold of MAR, art. 7(1)(a), because its disclosure would not have a "significant effect on prices" of the bank's securities. If more serious deficits with potentially negative effects on prices were uncovered in the dialogue, MAR art. 17(5) would exempt listed banks from the ad hoc-disclosure duty if the publication of the pertinent information would undermine financial stability.

## 3.2 Streamlining of administration and improving the cost efficiency of banking supervision

Public bureaucracies display a tendency to expand over time and banking supervision is prone to over-bureaucratization. An ongoing process should identify supervisory activities that are no longer needed or that should be scaled back in order to continuously streamline administrative procedures. This process can only be successful if it is supported by a suitable governance structure. Requiring supervisors to regularly analyse and demonstrate the effectiveness of their own activities is not sufficient. Only an independent and knowledgeable institution with proper incentives and suitable resources can fulfil this task.

During the post-crisis area, a large number of new regulatory and supervisory activities and measures have been introduced where some of these measures were initially only intended as temporary short term fixes. Consider for example, banking stress tests, introduced as a temporary measure to restore confidence until the new Basel regulations are implemented. Ten years after the financial crisis and close to the full implementation of new capital regulations, it is time to reconsider the benefits and costs of this activity. This seems consistent with developments in the United States, where major changes to stress testing were already introduced. Following these changes, only very large banks in the United States are still subject to stress testing. Moreover, their stress tests will be less burdensome because a qualitative assessment of the risk management capabilities of large US banks has been removed. While some observers interpret this as evidence of a reinvigorated banking lobby, others argue that stress testing has experienced diminishing benefits after years of repeated execution.

Since the banking industry operates in a changing environment, it is obvious that new and enhanced supervisory activities need to be introduced frequently and on a regular basis. It is less obvious that this process should be accompanied by abandoning activities that are no longer needed. Periodic cost benefit analysis of different supervisory activities may not be sufficient to determine if a certain type of bureaucracy is no longer needed due to path dependency. A more promising strategy may be the introduction of a "One-In-One-Out-Rule", which specifies that a new administrative burden can only be introduced when simultaneously an effective compensation by abandoning another administrative burden is implemented.

[10] Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (market abuse regulation) and repealing Directive 2003/6/EC of the European Parliament and of the Council and Commission Directives 2003/124/EC, 2003/125/EC and 2004/72/EC, 2014 O.J. (L 173) 1.

# 4. MAKING THE INTERFACES WITHIN THE SSM AND BEYOND WORK

The SSM is the first pillar of the still incomplete Banking Union.[11] The catchword characterizes the political agenda agreed upon at the height of the European sovereign debt crisis in 2012 that aims at supranationalising key regulatory standards for banks and their uniform and impartial implementation in the participating member states. However, the SSM Regulation[12], due to (perceived) legal restrictions under the so-called *Meroni*-doctrine[13], does not task one designated European institution with the prudential oversight of the banking sectors in the participating member states. Instead, it promulgates an institutional architecture that sees the ECB as the hub at the centre of the supervisory network but also assigns important supervisory functions to the NCAs as spokes. The effective functioning of the SSM therefore hinges critically on making the interfaces within the SSM work smoothly, which requires continuous efforts also in the next term (infra 4.1). Moreover, common supervision is only one element of the Banking Union and interacts substantially with resolution. Hence, also the exchange of information and cooperation with the SRB and national resolution authorities demands continuous attention (infra 4.2).

## 4.1 Interplay with National Competent Authorities

The SSM is not a supranational institution but a mechanism that requires extensive information sharing and cooperation between the ECB and NCAs in prudential bank supervision (for a detailed description of the division of labour between the ECB and the NCAs in the SSM see Tröger, 2014). While the ECB directly supervises the largest banks licensed in the participating member states, NCAs share the competence to oversee less significant banks with the ECB.[14]

The significant responsibilities conferred on the ECB require that much of the supervisory legwork is indeed performed 'close to the ground'. The supervisory architecture seeks to integrate NCAs in order to capitalise on their knowledge of national, regional and local banking markets, their longstanding expertise particularly with regard to the interpretation and application of (harmonised) national banking regulation, and their advantages with regard to location and language skills. In line with SSM Regulation, Art. 6 para. 7 the ECB devised a general 'framework to organise the practical modalities' of the interplay between itself and the NCAs, with regard not only to the supervision of less significant institutions, but also to that of the euro area's biggest banks that fall under its direct oversight.[15] NCAs

[11] On the three main (common supervision, resolution and deposit insurance) and two adjacent (common prudential regulation and lender of last resort function) building blocks of the banking union see Tröger (2014).

[12] Council Regulation 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, 2013 O.J. *(*L 287) 63 [hereinafter: SSM Regulation].

[13] In its Judgement of 13 June 1958, *Meroni v. High Authority*, C-9/56, EU:C:1958:7 the ECJ held – very broadly – that any delegation of discretionary powers to an institution that is not foreseen in the founding treaties was impermissible. Later case law arguably qualified the ECJ's rigorous approach significantly, see Judgement of 22 January 2014, *UK v. European Parliament and Council of the European Union*, C-270/12, EU:C:2014:18 which upheld the conferral of powers on ESMA to ban short selling under certain preconditions. For a discussion of the doctrine in the context of the SSM see for instance Ferran and Babis (2013); Wymeersch (2012).

[14] SSM Regulation, art. 6 para. 4 lays out the criteria for distinguishing between significant and less significant banks. For a detailed delineation see Lackhoff (2013); Lo Schiavo (2014).

[15] European Central Bank Regulation 468/2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities [hereinafter: SSM Framework Regulation], 2014 *O.J.* (L 141) 1. For an overview, see Lackhoff (2014).

are indeed tightly involved in the supervision of significant institutions, starting with uncovering the factual basis for various ad hoc or ongoing supervisory measures (e.g., on site verifications, evaluation of internal risk models), up to and including drafting decisions for the ECB, SSM Regulation, art. 6 para. 7 lit. b). Moreover, the ECB will have to rely on NCAs when it comes to enforcing prudential regulation. It can impose administrative sanctions autonomously only if banks breach directly applicable EU law; apart from that, the ECB needs to require NCAs to open proceedings if banks violate (harmonised) national law,[16] thereby coercing reluctant NCAs into quasi-representative actions (for a detailed description of the sanctioning regime in the SSM see Götz and Tröger, 2017; Witte, 2014; Schneider, 2014).

The literature and practical experience show that supervisors have diverging interests when the discharge of supervisory duties affects economies asymmetrically. This may be the case when the affiliates of a cross-border banking group are of diverging importance for the respective national financial markets in which they operate (see for instance Holthausen and Rønde, 2004; Bolton and Oehmke, 2016). In a Banking Union, the observation translates into a suboptimal information sharing and cooperation between the supranational hub (ECB) and the national spokes (NCAs) (see particularly Carletti, Dell'Ariccia and Marquez, 2016). In light of this incentive structure, it is therefore of utmost importance that beyond the legal framework with its extensive obligations to share information and cooperate, the ECB organizes, continuously monitors and amends the interaction within the SSM in a way that truly integrates NCAs in the pan-European supervisory endeavor. An important question therefore is which measures the ECB has taken and/or intends to take beyond the SSM Framework Regulation to induce NCAs to engage optimally within the SSM.

## 4.2 Coordination with resolution authorities

While many jurisdictions task the prudential supervisor also with resolution powers that apply when a bank fails,[17] supervisory and resolution functions are strictly separated in the Banking Union. Such an arrangement creates many interfaces where supervisory and resolution authorities need to interact in a smooth and consistent manner in order to achieve optimal results and establish reliable practices to shape desirable market expectations.

The most prominent need for continuous coordination exists in the area of resolution planning, in particular with regard to the prescription of capital subject to bail in. The minimum requirements for own funds and eligible liabilities (MREL) shall ensure that a failing bank can be resolved at all times without resort to tax payer money and without perils to financial stability (for a clear statement of the policy objectives, see FSB, 2015, item 1). Recital 79 of the BRRD[18] states: "To avoid institutions structuring their liabilities in a manner that impedes the effectiveness of the bail-in tool it is appropriate to establish that the institutions meet at all times a minimum requirement for own funds and eligible

[16] SSM-Reg., art. 18 para. 1 and para. 5.

[17] The prime example is the Federal Deposit Insurance Corporation (FDIC) which today has resolution powers even with regard to the largest U.S. bank holding companies under Title II of the Dodd Franck Wall Street Reform and Consumer Protection Act (12 U.S.C. §§ 5381 et seq.); for a description with a comparative view to the European regime in the banking union see Gordon and Ringe (2015).

[18] Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council, 2014 O.J. L173/190.

liabilities". Quite importantly, the constant and time-consistent prescription of loss-bearing capital is also of critical importance to establish market discipline (debt governance). Only if investors in potentially loss bearing bank capital are able to anticipate with reasonable certainty who else will be liable besides themselves once the bank fails, will they be able to price the risk accordingly and render the financing conditions for banks sensitive to the institutions risk taking behavior (see Tröger, 2018; Tröger, 2019). After the implementation of the FSB TLAC standard,[19] MREL for the euro area's largest banks will comprise of a fixed minimum set by the prudential supervisor (ECB for significant banks and NCAs for less significant banks) and a potential institution specific add-on set by the SRB. In addition, the SRB will also have the power to request an additional layer of high-quality bail-in capital needed in off-standard resolution scenarios (MREL guidance). As a consequence, the institution specific MREL – just like the own funds requirements of banks under the reformed CRR/CRD IV rules – will consist of two building blocks: a standard layer adjusted to regular resolution planning and a buffer for exceptional circumstances. The latter component is strongly linked to regulatory capital prescriptions supervised by the ECB. In particular, MREL guidance may only be set if the competent authority after stress testing has issued capital guidance for additional own funds to cover exceptional losses (pillar 2 guidance). With a view to the policy objective of instilling market discipline, ideally, the necessary coordination between the ECB and the SRB should be as time-consistent and predictable as possible.

In a similar vein, coordination between the ECB as prudential supervisor and the SRB is also required with regard to resolution triggers in order to shape market expectations crucial for banks' refinancing conditions (debt governance).

Investors will base their risk assessment on authorities' administrative practice. The accuracy of any prediction of anticipated loss bearing thus hinges on understanding who makes the final call under which circumstances. Regrettably, the BRRD and SRM-Regulation[20] establish a multipolar decision making structure that potentially impedes predictability. Under the BRRD supervisory authorities (ECB for significant banks and NCAs for less significant banks) determine whether an institution is failing or likely to fail and should therefore be put in resolution,[21] because they possess the necessary information as a result of their ongoing oversight, supervisory exams etc. Within the SRM, the SRB has the ultimate decision making power.[22] However, still, a protracting ping-pong between regulators with diverging preferences for resolution[23] may ensue (for a critique see Pagano, 2015). Given that the loss given default investors face hinges critically on when resolution is triggered, efficient pricing will depend pivotally on a transparent and predictable practice observed by all authorities involved (see also the recommendation of the ECA to provide more guidance on the failing or likely to fail-assessment, ECA, 2018) .

Given the negative policy implications of inefficient interagency cooperation, it is of critical importance that the ECB proactively seeks to coordinate with resolution authorities and aligns regulatory practices

[19] FSB (2015).

[20] Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) No 1093/2010, 2014 O.J. (L225) 1.

[21] BRRD, arts. 32 para. 1 lit. a), 2 para. 1 no. 21.

[22] See SRM-Reg art. 18 para. 1 sentence 2.

[23] Failure can be regarded as a sign for deficiencies in the ongoing prudential supervision of banks. In this scenario supervisors have an incentive to delay resolution to camouflage their own shortcomings, see eg Jean Pisani-Ferri et al. (2012) Goyal et al. (2013).

in a transparent and time consistent manner. It can be asked therefore, which measures the ECB has taken and/or intends to take to achieve this goal.

## 5. PROPOSED QUESTIONS FOR THE Q&A SESSION

The SSM may increase its benefits to society by disclosing more relevant information to the public and/or by supplying banks with useful information. Do you agree?

Which processes are applied within the SSM in order to contain bureaucracy and in order to abandon administrative processes that no longer have a positive cost-benefit-ratio?

What does the ECB do and/or plan to optimize the interaction with NCAs and resolution authorities?

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# 7. APPENDIX

Table 1: Included banks for the analysis

| Name | CET1 (AQR) | Group |
|---|---|---|
| Banca Carige SpA - Cassa di Risparmio di Genova e Imperia | 3.88% | Weak capitalisation |
| Hellenic Bank Public Company Ltd. | 5.22% | |
| Münchener Hypothekenbank eG | 6.87% | |
| Bank of Cyprus Public Company Ltd. | 7.28% | |
| National Bank of Greece SA | 7.52% | |
| Eurobank Ergasias SA | 7.81% | |
| Liberbank, SA | 7.82% | |
| Mediobanca - Banca di Credito Finanziario SpA | 8.40% | Medium capitalisation |
| DZ BANK AG Deutsche Zentral-Genossenschaftsbank | 8.99% | |
| UniCredit SpA | 9.58% | |
| Piraeus Bank SA | 9.98% | |
| Hamburg Commercial Bank AG | 10.00% | |
| Erste Group Bank AG | 10.00% | |
| La Banque Postale, SA | 10.02% | |
| Groupe BPCE | 10.04% | |
| ING Bank NV | 10.09% | |
| NORD/LB Norddeutsche Landesbank Girozentrale | 10.13% | |
| Banco Comercial Português, SA | 10.26% | |
| Banco de Sabadell, SA | 10.26% | |
| Raiffeisenlandesbank Oberösterreich AG | 10.30% | |
| Banco Santander, SA | 10.34% | |
| Caixa Geral de Depósitos, SA | 10.41% | |
| Banco Bilbao Vizcaya Argentaria, SA | 10.54% | |
| Société Générale SA | 10.67% | |
| Bank of Valletta Plc | 10.71% | |
| Commerzbank AG | 10.84% | |
| Credito Emiliano SpA | 10.86% | |
| Unicaja Banco, SA | 10.88% | |
| Ulster Bank Ltd. | 11.55% | |
| Bankinter, SA | 11.67% | |
| RCI Banque SA | 11.67% | |
| Governor and Company of the Bank of Ireland | 11.82% | |
| Kutxabank, SA | 12.03% | Strong capitalisation |
| Landesbank Hessen-Thüringen Girozentrale | 12.23% | |
| HSBC France, SA | 12.59% | |
| KBC Group NV | 12.68% | |
| Bayerische Landesbank AöR | 13.19% | |
| Deutsche Bank AG | 13.33% | |
| Landesbank Baden-Württemberg | 13.47% | |
| Landeskreditbank Baden-Württemberg – Förderbank | 13.49% | |

| | | |
|---|---|---|
| Belfius Banque SA | 13.50% | |
| Nordea Bank Abp | 13.73% | |
| Crédit Mutuel Group | 13.76% | |
| DekaBank Deutsche Girozentrale | 14.03% | |
| Alpha Bank AE | 14.05% | |
| Bank für Arbeit und Wirtschaft und Österreichische Postsparkasse AG | 14.30% | |
| Nova Ljubljanska banka d.d., Ljubljana | 14.57% | |
| AIB Group Plc | 14.64% | |
| AXA Bank Belgium SA | 14.67% | |
| Tatra banka, a.s. | 14.88% | |
| Nova Kreditna banka Maribor d.d. | 15.66% | |
| Všeobecná úverová banka, a.s. | 15.76% | |
| Aareal Bank AG | 16.29% | |
| Deutsche Apotheker- und Ärztebank eG | 16.40% | |
| Banque et Caisse d'Epargne de l'Etat, Luxembourg | 17.04% | |
| Slovenská sporitelna, a.s. | 19.49% | |
| Nederlandse Waterschapsbank NV | 72.51% | |

Source: ECB AQR (2014)

In this note we first highlight different developments for banks under direct ECB supervision within the SSM that may prompt further investigation by supervisors. We find that banks that were weakly capitalised at the start of direct ECB supervision (1) still face elevated levels of non-performing loans, (2) are less cost-efficient and (3) reduced their share of subordinated debt financing over the last years. We then stress the importance of continuous and ongoing cost-benefit analysis regarding banking supervision in Europe. We also encourage processes to question existing supervisory practices to ensure a lean and efficient banking supervision. Finally, we underline the need of continuous and intensified coordination among regulatory bodies in the Banking Union since the efficacy of European bank supervision rests on its interplay with many different institutions. This document was provided by the Economic Governance Support Unit at the request of the ECON Committee.



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