Andreas Dombret: Moving together – one year of European banking supervision

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the ESE Conference 2015 "Financial supervision in Europe – on the right track?", Prague, 2 October 2015.

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1. A courageous mission

Ladies and gentlemen

Ever since the idea of an integrated Europe first arose, political convergence has been accompanied by scepticism and even by fears. How could nations and cultures with various languages, mentalities and histories develop a common understanding of government and administration? Without a blueprint solution, Europeans adopted a best-practice approach that is nicely captured by a quote from Shakespeare: "Wisely and slow. They stumble that run fast."

Against this backdrop, the mission of a unified banking supervision network must have appeared almost illusionary. Nevertheless, on 4 November 2014 it became a reality, and the ECB was designated as its leading authority, thereby becoming directly responsible for what turned out to be 85% of banking balance sheets in the euro area. Such a transition naturally involves acquiring skills and expertise: with that in mind, human resources equating to roughly 1,100 full-time equivalents were newly appointed by the ECB. And it also meant developing administration systems and procedures from scratch.

Admittedly, Europe has by now witnessed quite a few very influential developments on a European scale. But while the European Union developed over decades and the euro was implemented as a common currency over a period of approximately ten years, the Single Supervisory Mechanism, or SSM for short, became a fully fledged and operational organisation after around only two years of preparations.

Such a courageous mission could only be ratified under very specific circumstances. In fact, I believe that it was only realisable in the face of the financial and sovereign debt crises and the vulnerability of the common currency area that was revealed as a result. We experienced banks that were "too big to fail" and needed to be rescued. We also experienced banks that were caught in a vicious cycle together with their governments due to debt amalgamation.

As a consequence, national supervisors were overburdened. Good rules for the financial sector are not enough – they also need to be enforceable under bad circumstances. Rules are worth little if you do not ensure that banks abide by them. Therefore, one of the SSM's primary goals was, and still is, to promote a trusted financial regime by protecting the common currency area from banks' exploitative potential.

In addition, the SSM was designed to harmonise supervision, eliminate home biases, alleviate cross-border supervision and get an early and reliable overview of emerging risks – in short, to enhance the path towards a fully integrated financial sector in Europe.

The SSM was doomed to be successful because it had to be a key servant of financial stability as soon as it came into being. It also attracted attention because it had potential to serve as a compass for Europe. Moving together – is it working? After one year of the SSM, it is about time for a review.

2. Components of the SSM's success

One year after its establishment, I can confirm that the launch of the SSM has been a success. But its success goes beyond a mere change of supervisory responsibilities.

Harmonisation and quality enhancement got underway beforehand with a comprehensive assessment that made sure that banks were well-capitalised from the outset.

Take a look at German banks – we witnessed recapitalisation even before the comprehensive assessment was carried out in 2014. In other countries, an overall € 25 billion capital shortfall had to be straightened out as a result of the comprehensive assessment. Corrections to banks' assets worth € 48 billion and harmonisation of the definition of non-performing loans (leading to corrections of € 136 billion) also made clear that the need for harmonisation was truly significant and that the new supervisory player was recognised as a serious authority from the beginning.

Putting such "hard facts" to one side, we are also seeing the benefits of the new regime in our daily business. There are 123 joint supervisory teams – or JSTs for short – for those banks that are directly supervised by the ECB. Bundesbank supervisors are participating in 22 JSTs for German banks as well as in 12 host JSTs for foreign banks. This multinational interaction noticeably helps preclude home bias. However, we cannot rule out the continued existence of some preconceptions because they may be unintentionally masked by habits and different attitudes towards supervision. But a cross-national dialogue is probably the most productive way to discover and discuss partial supervisory routines.

Furthermore, a level playing field and cross-border supervision are facilitated within the SSM area. Of course, the European Single Rulebook and the European Banking Authority have their part to play in this development. But when it comes to the cross-border supervision of a banking group, institutional exchanges within JSTs have proved rewarding. In addition, the ECB has already harmonised its use of roughly 100 regulatory options and discretions that were meant for specific national situations but led to an inconsistent framework in the SSM area.

Overall, banks are said to mark their new supervisory counterpart as tough but fair. In today's difficult financial environment, I am inclined to read this feedback as a compliment for the SSM as a whole because we seem to manage two roles at once: the role of a referee to ensure fair play and a level playing field and the role of a diligent doctor to ensure that our patients remain sound and healthy – prescribing a bitter pill when necessary.

3. European supervision – a continuing everyday challenge

Improving processes and cultural learning take time. And there is no doubt that it will be an ongoing challenge to ensure steady and high supervision quality that reflects both banks' individual risks and their changing environment.

Let me emphasise a few challenges the SSM faces with direct relation to supervisory quality. My first example deals with our own impact on the sector's diversity, which is reflected in the differentiation between 120 significant institutions that are directly supervised by the ECB and about 3,500 less significant institutions that are supervised by national authorities.

It goes without saying that a broad information base is vital for the purpose of financial stability. Banks themselves ultimately profit from insights into financial cycles and threats to the financial sector. But I fear that our data requests require resources in banks that are more easily provided by large institutions. We should assess in an open-minded manner whether the costs and benefits of our supervisory curiosity are always aligned with respect to many small banks. What is more, sector diversity also requires that factors other than size be taken into account: these include business models, the changing regulatory and financial environment and even societal trends such as digitalisation.

It should be in our interest to safeguard a level playing field, not only with respect to special national treatment but also with respect to risk-adequate supervision. Protecting variety in banking is one way to enhance sector stability. Therefore, I appreciate efforts from the ECB to widen the perspective of banking supervision beyond the level and quality of capital towards proportionality.

There are other challenges that concern the supervisory quality and long-term functioning of the SSM. I am thinking especially of our most valuable resource, namely well-trained and motivated staff. Therefore, I strongly support initiatives such as the ESE initiative that support cross-border learning and knowledge sharing.

Staff motivation is a core asset. Anyone working for the SSM should be able to make a difference. That requires processes to be transparent and unbiased as to the result. We have to reconsider processes that are overly pre-structured, which will make the mechanism more productive as a whole. There are promising examples of expert groups in which national supervisors share and develop their knowledge.

Another area to examine should be decision-making processes themselves: any effective and timely involvement in a decision requires that it can make a difference. That should help staff of national supervisory authorities, in particular, feel like they are part of the SSM − the SSM as a network that makes accurate, high-quality decisions and delivers best-practice supervision.

There are still incidents of mismatched working cultures in our daily supervisory operations, one example being on-site inspections. We should ensure that there is no rivalry between national dogmas but rather a cooperative search for proper solutions. Additionally, language is obviously an enduring challenge in a European context. The ECB promotes English as a working language, but institutions often prefer their local language to avoid legal uncertainties. Language barriers will continue to accompany the SSM.

Lastly, allow me to turn to a fundamental flaw that the SSM still has to overcome in its construction. Let me restate one of the initial reasons for the mission of a transnational banking supervision network that I mentioned earlier: it should serve to decouple bank risks from nation state risks. This, however, should not be substituted for a coupling of bank risks and central bank risks.

The ECB plays different roles in our monetary union: the role of a microprudential supervisor as well as that of a responsible authority for monetary policy. So the ECB works with banks as both a business partner and their supervisor. While there are certainly synergies between both tasks with respect to financial stability, unintended symbioses are possible as well – and I believe that they could become more dangerous. It is especially with respect to institutions that are likely to fail that I fear political incentives could go astray. In the long run, I therefore call for a strict line between supervisory powers and monetary decisions.

4. Unifying national and European perspectives

Where should the SSM go from here? It seems like a natural response to internal frictions to cultivate SSM processes and enhance centralisation. This might be interpreted as a blueprint to overcome frictions with national cultures. One is inclined to question the network character of European banking supervision at large: wouldn't a single authority do a more efficient job? I want to iterate two essential arguments against this reasoning. Instead of a steady path towards more centralised supervision, I am arguing for a balanced mix of centralised stringency and national diversity.

First – and well known to most in the business – good supervision requires us to be close to banks. This is not only a matter of physical proximity. Language, business environment, culture and many other accompanying characteristics of the banking business have local roots. The generally slow process of European integration aside, we cannot expect regional diversity to ever become extinct. While the ECB has indeed done a remarkable job of steering the SSM through its first year, this does not imply that it is bound to solve any organisational difficulty in a top-down manner. Instead, we should take advantage of bottom-up engagement whenever it is feasible.

Second, we should keep in mind the need for self-control. We have to assure our internal balance of powers. Again, this is not meant as a subtle reach for national privileges but instead as a call for institutional diversity. This is not to be confused with harmonised supervision, which remains ever paramount. Importantly, institutional diversity can only be maintained if national supervisory authorities have a meaningful voice in the process. Diversity cannot be maintained by itself. It needs to be actively promoted via the SSM governance culture.

5. Conclusion

The SSM has gained a reputation as a tough but fair supervisor. I have argued for the preservation of its network character. In order to retain a power balance, we have to allow for multi-level governance. We should aim for an open-minded leadership that governs the SSM according to supreme aims.

Let me reiterate three important aims and implications.

- Risk-adequate supervision implies that we should allow for flexible supervisory requirements when applicable.
- Efficient processes require us to use our human resources in areas of the SSM where they will be most useful.
- Maintaining diversity and subsidiarity within the SSM network requires us to actively promote the involvement of national supervisory authorities.

European integration essentially involves learning to manage diversity. In this respect, the ECB has proved itself to be a prototype for self-awareness and openness. Recent SSM-internal analyses of strengths and weaknesses and organisational changes show that it is not resting on its laurels but rather aiming for long-term success.