

## **Andreas Dombret: A success story? Reflecting on one year of European banking supervision**

Dinner speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the SUERF-Deutsche Bundesbank-IMFS Conference on “SSM at 1”, Frankfurt am Main, 3 February 2016.

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### **1. Introduction**

Ladies and gentlemen

Thank you for the opportunity to speak at the joint conference of the SUERF Colloquium, the Deutsche Bundesbank and the Foundation Geld und Währung. It is a pleasure to be here this evening, and I hope that your discussions today have been fruitful and informative.

Henry Ford once said: “Coming together is a beginning, keeping together is progress, working together is success.” And that’s exactly what I would like to talk about tonight: Working together in European banking supervision, and the question of whether, and under what circumstances, the Single Supervisory Mechanism, or SSM for short, can write a success story of its own.

### **2. Coming together: the first year of European banking supervision**

European supervisors came together over a year ago to put the first pillar of the European banking union in place. The SSM became operational on 4 November 2014. That was the date on which the ECB assumed responsibility for supervising the most significant banks in the euro area. These banks, which number roughly 120 in all, account for more than 85% of the aggregate balance sheet of the euro area’s banking sector, making the European Central Bank one of the biggest banking supervisors in the world.

But besides being one of the largest banking supervisory authorities worldwide, there’s something else that makes the ECB one of a kind – it is the only supranational supervisor in the world. Never before have sovereign nation-states come together and surrendered their powers in the field of banking supervision to an independent authority.

### **3. Keeping together: where do we stand?**

The SSM has been up and running for nearly a year and a half – and now is a good time to reflect on how it has fared so far. And I must say that our experience has been quite positive. But at the same time, it would be dishonest of me to say there weren’t any challenges still facing European supranational supervision.

There are two particular challenges currently facing the SSM that I would like to discuss this evening: first, that of striking a balance between harmonisation and proportionality, and second, institutional challenges.

Since November 2014, banks in the euro area have been supervised according to a set of harmonised standards. This is an important step for creating a level playing field and improving supervisory effectiveness. Yet at the same time, we need to meet the challenge of implementing supervisory practices that are proportionate to the specific characteristics of individual institutions.

In practical terms, this means, for example, that supervisory expectations and requirements should be proportionate to the size, significance and riskiness of the supervised institution. We have to emphasise the role of proportionality in guiding the way we supervise differently sized banks.

Things are somewhat different for the less significant institutions, or LSIs for short. There are around 3,500 institutions in the euro area, of which 1,600 are German LSIs. Although the LSI sector as a whole is overseen by the ECB in matters of risk concentration, the individual institutions continue to be directly supervised by the national competent authorities. The ECB and the national supervisors are currently in the process of developing joint standards for the supervision of these smaller banks. Here, too, harmonising standards up to a certain degree is a necessary and welcome measure.

That said, it is particularly important – as far as LSIs are concerned – to give national supervisors sufficient leeway to allow for the particular characteristics of individual institutions. Supervising LSIs is, and should be, a matter for national supervisors. That conforms to the principle of subsidiarity and represents the most effective and efficient solution.

Another topic in this regard is debate on options and national discretions. Today, European supervisory legislation offers around 150 options to choose from. Because these options may be exercised in many different ways at the national level, they are sometimes regarded as obstacles for creating a regulatory level-playing field. To be sure, sometimes it is reasonable to interpret rules against the backdrop of specific national circumstances, but sometimes it is not. So we need to analyse all the options and discretionary scope provided at the national level very carefully. The ECB and the national supervisors have just kick-started this evaluation process and until now, a number of national options have been harmonised.

The second challenge I would like to discuss is somewhat different because it is rooted in the existing legal framework, so it's not exactly a matter that's still taking shape.

Since the ECB is responsible for European banking supervision, so it follows that the Governing Council, as its supreme decision-making body, is accountable not just for monetary policy issues but also for matters of banking supervision. These two areas of responsibility overlap at the bank level. This, of course, gives rise to conflicts of interest, because after all, banks are not just a crucial element in the monetary policy transmission process; they are also subject to banking supervision. Thus, the ECB has to deal with the conflict of interest of being a banking supervisor with access to central bank liquidity and the other way round a central bank that decides about banks that are important in the monetary policy transmission process.

In an effort to minimise such conflicts of interest, a governance structure has been put in place to limit the Governing Council's involvement in supervisory decisions. Speaking personally, I have my doubts whether this set-up will truly help to prevent a clash between the ECB's monetary policy mandate and its role as a banking supervisor. You will most likely have explored this issue in much greater depth early on today.

As I mentioned earlier, the SSM is only the first pillar of the European banking union. The second is the European Single Resolution Mechanism which will deal with future bank failures. This mechanism has been operational since 1 January 2016. Its task is to realign incentives and make the entire banking system more stable. In cases where a bank is no longer viable, its shareholders and creditors will be first in line to bear the resulting losses – the taxpayer will only be asked to contribute as a very last resort. This is an urgently needed step in the right direction.

But in its final form, the European banking union will be made up of three pillars, the final one being a common deposit guarantee scheme. Let's make one thing clear – a single deposit guarantee arrangement is certainly the logical next step in terms of financial integration, but it is altogether premature at the present time because it would disequilibrate liability and control. Why do I say that? Well, we first need to achieve deeper integration before an integrated deposit guarantee scheme can work effectively. A single European banking supervision set-up has been put in place – that much is true – but national economic policy decisions still have a huge bearing on the economic wellbeing of domestic banks. The same holds true for the legal framework – just take insolvency law, which is still very much rooted

in the national domain. The existence of different rules has a direct impact on banks' risk situations. That's why Europe would have to be given stronger rights to intervene in national economic policies, and a harmonised set of rules would be needed, before a European deposit guarantee scheme can be set up. That path means ceding certain rights to control national budgets to the European level, and it is one that ultimately leads to what is known as a fiscal union. For sure, such a step would require euro-area countries to surrender a degree of national sovereignty to Europe.

A move of that kind would necessitate wide-ranging changes to both national and European legislation. And to be honest, I don't see much willingness to go down that path right now. Bearing that in mind, I strongly advise against taking the second step before the first. To be honest, I do not really see a reason for being in hurry in this issue. In 2014, we introduced largely harmonised rules for deposit insurances, ensuring that deposits up to 100.000 Euro are secured in case of a bank's insolvency. The risk of this insurance, today, lies with the respective Member State the defaulting bank is located in. I am convinced that as long as banks' well-being is still so much affected by national legislation, this is an appropriate setting and there is no justification for pan-European risk sharing without fundamental adjustments to the current framework.

#### **4. Working together: the road to success**

The creation of the banking union has significantly bolstered the financial supervisory architecture in Europe. If we define "success" as "maintaining financial stability", then focusing our efforts solely on banking supervision would be like making the road to success a narrow, single-lane highway. Supervisors can only be as effective as the rules and regulations they apply. What we need to do, then, is add a second lane to that road – a sound regulatory framework for the banking system – for that was an area in which the financial crisis laid bare a number of shortcomings.

Significant progress has been made in the regulatory space in the more than seven years that have elapsed since Lehman Brothers went under. The most important measure was the Basel III framework in 2010, which introduced stricter capital requirements and new liquidity rules. When Basel III is fully implemented in 2019, regulatory capital requirements will be significantly higher and tougher than under Basel II, and I firmly believe that the financial system today is already more stable than before.

The Basel Committee has forged ahead along this path over the past few months – one of the items on its "to do" list for 2016 is to finalise the Basel III reform package before the end of the year. And things are moving along swiftly – the fundamental review of the trading book (FRTB) was endorsed by the central bank governors in January, which means that the new market risk framework will take effect in 2019. Work is also ongoing to address the problem of excessive variability in risk-weighted assets by the end of 2016. The Basel Committee has set its sights on two outcomes: removing internal model approaches for certain risk types, and placing constraints on the use of internal model approaches for credit risk, in particular through the use of floors. In parallel, the standardised approaches for credit and operational risk are reviewed. Another issue the committee is currently working on is the final design and calibration of the leverage ratio, so that it can be implemented as a Pillar 1 measure by 1 January 2018.

To make one thing clear: The regulatory projects mentioned do not target on imposing further burdens on the banks – which would mean first and foremost higher capital requirements. In that regard, I highly appreciate the overall impact study the Basel Committee will conduct this spring, which will give us precious hints on how all the regulatory measures interact and should be calibrated. I think the Basel Committee is on the right track, and finalising the Basel III reform package in 2016 is my regulatory priority in 2016.

While we may rightly expect much of the Basel III framework, it is no secret that higher capital standards and new liquidity requirements are not the only toolkit available when financial stability is at stake.

That's why the Basel III regime has been flanked by a host of other regulatory projects that have been launched in response to the financial crisis: the "too big to fail" issue, sovereign exposures and the shadow banking system are just three regulatory projects I could name.

This is neither the time nor the place to explore these regulatory projects in any great detail, of course. But there is one point I really would like to stress. All the regulatory projects I mentioned just now call for international cooperation – and not just on the Basel Committee for Banking Supervision or the Financial Stability Board, where it works very well. If we as national regulators do not coordinate our approaches to regulation, we will create a fragmented financial system that opens up vast opportunities for regulatory arbitrage. So working together – as regulators and supervisors; at the national, the European and the global level – would be a huge step towards successfully safeguarding financial stability.

## **5. Conclusion**

The first one-and-a-half years of the SSM have been hailed as a success – and rightly so, in my eyes. Coming back to Henry Ford, whom I quoted at the beginning of my speech, European supervisors have come together successfully in the shape of the SSM. Time will tell whether this project will prove to be a lasting success. Don't get me wrong: I certainly believe it will be, and I have good reason for saying that: the SSM has got off to a flying start – which is all the more impressive, given the short space of time in which it was created – and its day-to-day supervisory activities are gradually taking shape.

A number of challenges do remain, however, though that it is hardly surprising for such a new set-up. I discussed two of them today. But I am quite optimistic that these challenges will be met. Once the Basel III rules have been finalised during the course of this year, day-to-day supervisory activities will be based upon a sound, and hopefully coherent, framework.

At the end of the day, the work of the SSM will be measured in terms of its long-term success in maintaining a stable financial system. Successful European supervision needs more than just institutional structures and a sound regulatory framework – it also depends on employees who work together in a manner described by Winston Churchill when he said: "It is no use saying 'We are doing our best'. You have got to succeed in doing what is necessary."

I wish you a pleasant evening here at the premises of the Bundesbank. Thank you for your attention.