Sabine Lautenschläger: National supervision in a European system – what is the new balance?

Speech Ms Sabine Lautenschläger, Member of the Executive Board of the European Central Bank, at the Fifth FMA (Austrian financial market authority) supervisory conference, Vienna, 30 September 2014.

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Mr Ettl,

Mr Kumpfmüller,

Ladies and gentlemen,

Nine months ago to the day, the Finanzmarktaufsicht (Austrian financial market authority or FMA) issued two press releases announcing major "restructuring measures". According to the FMA, banking supervision in the euro area would be built on "new foundations" in 2014 and the year would bring new tasks and challenges.

I really like the building site metaphor. It isn't hard to imagine what the challenge of laying new foundations and constructing a new building – especially during regular operations – means.

This event today is about national supervision in a European system and where the new balance lies. The focus is therefore on the stability of the European supervisory building.

Now, there are clear rules or conditions to be complied with when constructing a building. Tasks and responsibilities must be clearly defined. Everybody needs to know what to do or to leave alone – and that goes for the Single Supervisory Mechanism (SSM), too. The European supervisory building, consisting of the ECB and 19 national supervisors, isn't a single family home, but a large building complex; a structure that should be sturdy and stable, even in stormy conditions.

Expectations of the developer

European legislators and the public, too, expect the SSM to ensure a resistant, robust banking system in the euro area. Supervision in Europe is rightly expected to be better than what 19 national supervisors could achieve with national means. The new system of supervision should be neutral and not wedded to national thinking and traditions. It should, where appropriate, produce a level playing field. It had become apparent in the financial crisis that the difficulties of large, strongly interlinked banks were not just a national problem and that difficulties can spill over into the public sector and the real economy.

The SSM is supposed to identify any risks that may endanger national financial markets or the European financial market as a whole at an early stage and take measures to counter them. It should be assertive and able to act.

If it is set up properly, the SSM can indeed meet the majority of these expectations. A European supervisory body will be able to identify risks early on and act effectively. The SSM will be in a position to provide a considerable part of what a supervisor can do for a resistant banking system. Among other things, the division of tasks between national supervisors and the ECB will ensure this. But not all the developer's wishes can be fulfilled or are feasible, as the resistance of the European banking system or the performance of a national credit institution don't just depend on the supervisor's performance and ability to act. In order to be resistant in the long term, a bank needs a sustainable business model; it needs sufficient income in order to bear the risks associated with banking. After all, it shouldn't be forgotten that the balance sheet of a bank – especially a bank with extensive corporate banking – is always a reflection of the economies in which it operates as a financial service provider.

Construction planning – dimensioning the building

But let's leave the expectations and go back to the building itself. At the beginning of every construction project is the planning. The architect has to bring the wishes and expectations of the developer into line with all kinds of existing restrictions. The final purpose of the building needs to be clearly defined.

With regard to the SSM, this means that, for practical reasons, direct supervision of all institutions in the euro area was neither feasible nor wanted right from the outset. Fully centralised supervision would've had the considerable disadvantages associated with an organisation being too large, the resultant burdens for all concerned – which would be considerable – and a loss of national and regional expertise concerning the specific characteristics of banks in the Member States. What added value would have been brought by direct ECB supervision of the many smaller institutions, which often have regional roots? What challenges would've arisen in terms of linguistics alone? After all, without having a detailed look at a large number of credit files, it isn't possible to properly supervise most of the banks which are active in private and corporate banking. National language skills are indispensable here for discussions with the Executive Board and employees, as well as for looking into the files. Furthermore, it wouldn't have been feasible to set up direct supervision of all banks in the euro area within a year.

As you can see, ladies and gentlemen, when it came to the dimensions of our building, it was once again a question of striking a balance between the advantages and disadvantages of a central or decentral solution. For supervision to function in the euro area, a balanced relationship must be achieved between centralisation and regionality. Making the building as big as possible must not, then, be an end in itself, because the foundations for this are lacking.

Significant institutions

The architects of the SSM thus decided that only the largest banking groups with cross-border activities in the euro area should be directly supervised by the ECB. The national supervisory authorities in the euro area countries will thus continue to be the main contact for the remaining banks.

So the SSM will directly supervise what are known as significant institutions. This category consists of 120 banking groups with around 1,200 individual institutions, which hold more than 80% of the total banking assets in the euro area. If things were to get difficult, these banks could have a significant impact on the stability of the financial system in the euro area. Eight of these banking groups are Austrian.

Less significant institutions

All 3,500 other institutions will be indirectly supervised by the ECB. The decisive point is that the national supervisor remains the direct contact for the credit institutions and generally takes the associated supervisory decisions. But there will also be some changes in terms of the supervision of less significant institutions, because the SSM will influence the supervisory approach of the national supervisors. Through rules, guidelines and recommendations, the SSM will steer the national supervision of less significant institutions. The aim of this is not to make everything the same; it is rather to ensure that a uniformly high level of supervision is achieved in the euro area. The sole aim must be to ensure a level playing field for all and to prevent blind spots on the supervisory map.

The term less significant institutions is, in fact, misleading. There are certainly countries where individual institutions are not in themselves systemically relevant, but where the same cannot be said for these institutions taken together. In addition, the less significant institutions do not all look alike. They have balance sheets ranging from a few million euro to almost 30 billion. Some less significant institutions operate on a purely regional level, with business models that are sometimes very simple, but sometimes very specific, while others are cross-border institutions with very complex business models. The range is huge. The same is true of their characteristics and distribution in the euro area. Owing to their numerous cooperative banks and savings banks, Germany (with 48.2% of such institutions) and Austria (with 564 banks, accounting for 16% of such institutions and 8% of banking assets in the euro area) are home to the majority of less significant institutions. This makes Austria our second largest "customer", after Germany, in the area of indirect supervision. At the same time, there are countries that have very few such institutions: Cyprus, for example, will have seven such institutions in the SSM.

What does indirect supervision mean?

Let me say a few words on what indirect supervision actually means. Indirect supervision by the ECB consists of two elements, macro-prudential supervision and supervision of institutions and sectors. Macro-prudential supervision aims to identify and address deficits, in particular by comparing or benchmarking the various supervisory systems and approaches, and to spread and enforce best practice approaches. Institutional and sectoral supervision are about the institutions prioritising their levels of risk and the possible effects accordingly, thereby defining the intensity of the indirect supervision. Depending on which "class" of intensity the bank is in, the content of the reports will change in agreement with the various national supervisors. For example, we're currently working on the draft of a reporting guide for national supervisors. This guide should provide an overview of the information the ECB requires. After all, indirect supervision isn't possible without information, unfortunately. The reporting guide will be an expression of the multi-stage supervisory approach. The reporting requirements are differentiated according to the prioritisation of the institution, the type of information to be provided and the reporting interval.

For example, we will put into a high "intensity class" those institutions that may have considerable adverse effects on the financial system of their Member State in the event of a crisis. For these banks, we will supervise the activity of the national supervisory authority more intensively. This way, the SSM can ensure high-quality supervision that follows uniform standards, even in individual cases, without subjecting each institution to an equally high intensity of supervision. This applies first to those institutions that, as a first step, were classified by national supervisory authorities as institutions that require particularly intensive supervision. In the not-too-distant future, however, there will be additional criteria, which will allow granular differentiation. I'm thinking here, for example, of institutions for which early warning indicators are sounding or banks that are growing large enough naturally to be regarded as significant banks through balance sheet growth or increasing interconnectedness.

The consequence of the risk-oriented approach of institutional supervision is that the majority of the banks that, owing to their level of risk and their size, are classified as "low" or "medium" priority are subject to only very light supervision by the ECB. This applies, for example, to the majority of cooperative banks and smaller savings banks. For the new European system of supervision, however, a sectoral view will be added, which we will develop further in the next few years. We want to identify institutions that together represent a concentration risk for the financial system and could therefore be systemically relevant as a group in the event of a crisis. We describe these virtual groups as sectors. We will be paying particular attention to this group.

Resources of indirect supervision

To conclude the topic of dimensioning, I'd now like to say a few more words on the resources for indirect supervision in the SSM. On the basis of uniform requirements, operational supervision for the 3,500 less significant banks has quite consciously been left to the national supervisory authorities. The distribution of staff in the new European supervisory body also takes account of this basic idea: while around 400 supervisors will take care of the 120 significant banking groups at the ECB, operational national supervision of the 3,500 less significant institutions will be accompanied by approximately 80 members of staff at the ECB. We are therefore quite consciously relying on the thousands of employees in the national supervisory authorities who, with their knowledge of specific regional characteristics, take care of this large group of banks on a daily basis.

Structural soundness

The construction plans are in place. What regulations now need to be observed to ensure that the building is stable?

I believe that four fundamental technical requirements need to be fulfilled:

(1) First of all, a European supervisor needs a single legal basis which does not just determine the rules to be followed by the European banking sector, but also allows the supervisors scope for action. Only then will we be able to create a level playing field within the SSM area.

The conditions for a single legal framework for banks and supervisors were put in place at the European level when the Capital Requirements Regulation (CRR) and the Capital Requirements Directive IV (CRD IV) entered into force on 1 January 2014. In addition, the European Banking Authority (EBA) in London is working on a single rulebook, a single interpretation of the legal basis for European banking supervision. This will take the form of binding technical standards on a variety of topics.

The European Regulation and Directive contain a number of national options and individual solutions in order to cater for specific national features. If the European legislator has left it up to the national legislator to transpose these options – as is the case in around 20 instances – and the national legislator has done so in the form of a law, the SSM must respect this. We have to apply national law, even if this might impair the level playing field.

The situation is different when the European legislator has left the exercise of national options to the discretion of the supervisor, as has been done in around 80 cases. Over the past few months, we have made a list of all the national options and will come to a decision as soon as possible as to where we stand on every single one them, whether we will exercise them and if so, how. The national supervisors will play an important role in this respect, as they are the ones that will have to explain the national features and the related risks to us. They are the ones who should complement our knowledge of national markets and market structures, of national legal systems and risk trends. And we know, as supervisors, that some of these options are the result not of specific market structures, but of the continued existence of old traditions and popular habits.

(2) Good supervision in Europe requires knowledge and experience of individual national as well as European markets and market structures; it requires knowledge and experience of national and European legal systems. Knowledge should be consolidated and decisions taken centrally at the European level so that attention is focused on the European interest instead of on the solely national interest. The division of tasks within the SSM provides for just that. As I said, the ECB will take complete responsibility for the direct supervision of significant institutions. But national supervisors will bring their knowledge and experience to the supervisory teams and support the ECB in its supervision, and they will do so in line with a single supervisory approach. It is our aim at the ECB to have detailed knowledge of the business model and risk profile of each of the 120 directly supervised institutions. We want to be able to assess, at any time, the risk-bearing capacity, the internal control systems and the governance of banks, and to intervene at an early stage when we see danger. In short, we intend to supervise intensively. I have already spoken in detail about the division of labour with regard to the less significant institutions. In both areas, then, knowledge of national and

European markets will be brought together with a single evaluation system, a single supervisory approach and a central, European decision-maker.

(3) The third precondition for successful supervision in Europe is that macro-prudential oversight dovetails with micro-prudential supervision.

This is a case of complementing the supervision of credit institutions, which is very much concerned with individual circumstances, with important, well-prepared information that can only be obtained from the perspective of the euro area as a whole, or the global financial system. It is not just in the supervision of internationally active banks that it is important for the supervisor to know what risks are emerging in the financial markets. And looking at it from the other side, national supervisors can carry out the important task of identifying national incentive systems and channels of contagion. Such information makes it possible to intervene preventively and at a much earlier stage.

(4) The last and fourth condition for successful European supervision has to do with the SSM using the advantages of its size to the greatest advantage. With powers of direct supervision over around 120 banks, the SSM has a broad knowledge base with which to identify risks at an early stage through cross-sectional analyses and comparisons. For this reason the SSM will be able to rely on a strong horizontal function, which, together with the supervisors of the institutions, evaluates business and risk management practices at the banks and if need be formulates standards and establishes best practices.

Preparation for further extensions

A clever builder considers, even in the planning phase, whether it will be possible in future to meet requests to extend the building. In the construction of the SSM European lawmakers have set clear rules on how EU Member States that are not part of the euro area can nonetheless become part of the SSM. The rules for this close cooperation are there; so extensions are not out of the question! And to this I am very open, well disposed, as long as they meet certain conditions.

The strict rules governing the construction of the main building must also be applied to extensions. For this reason, close cooperation is not designed as an agreement between the ECB and the country in question, but as the result of an application that has been accepted. If an EU Member State that does not use the euro wishes to participate in the SSM, it must create the legal basis enabling the SSM to issue instructions and guidelines to its national supervisory authority. This is particularly important because, in non-euro area countries, the SSM cannot act directly vis-à-vis a credit institution but implements its decisions indirectly, via the national supervisory authority. The banking system of a country that enters into close cooperation must of course undergo an extensive health check before the SSM takes on supervision – just as happens at present in the euro area.

Conclusion

Ladies and Gentlemen, let me draw your attention one final time to our vast construction project. It is almost finished.

Countless experts from the euro area have worked together on this project. And here I am also talking in particular about my colleagues at the national supervisory authorities, from the Oesterreichische Nationalbank and the Finanzmarktaufsicht.

With incomparable effort, they have helped to shape the project at all levels by means of expert knowledge, years of experience and manpower: from many, many working groups to the numerous staff who have come to prepare the day-to-day running of the building and make sure it can function over the medium term. They have all made an essential contribution to ensuring that, from the plans to the operational phase, it has always been possible to maintain the balance between the necessary ultimate responsibility at the central level and the legitimate interests of the euro area countries in both planning and implementation. This will continue to be so in the future, as the 18 (soon 19) member countries with their national supervisory authorities will also be prominently represented in the Supervisory Board.

I have no doubt that our European supervisory project will be ready on time. There are exactly 35 days to go till the start date, 4 November. In Frankfurt we are currently working very hard on the start of regular supervisory operations at the ECB, as the responsibility for the supervision of around 4,700 credit institutions in the euro area will from that day on lie with us.

The staff of the SSM has largely been recruited. A few interviews are still being held. The way supervision will be carried out has been defined. The division of labour between the national supervisory authorities and the ECB has been laid down. Internal procedures have been set out in the Supervisory Manual.

The part of the construction project covering significant credit institutions is virtually complete. The Joint Supervisory Teams, which will supervise the 120 significant banking groups, have already formed and are getting up to speed on their banks.

In the part covering less significant institutions, our colleagues are currently gathering detailed information on the banking supervision systems and the population of other banks and their features in the euro area. This part will also be ready to operate on 4 November.

Ladies and Gentlemen, I am convinced that only by working closely together and ensuring a clear division of labour between national supervisors and the ECB will we be able to fulfil our mandate to make the banking system of the euro area more robust.

The foundations of the SSM will in future surely be exposed sometimes to uneven stress in one place or another. This is completely normal for a building that stands for many years.

As long as we do not forget the principles applied by the architects of the SSM, it will always be possible for the ECB and the national supervisory authorities to together regain the right balance. This is the prerequisite for ensuring that the primary aim of the SSM, high-quality banking supervision in the euro area, is met in the long term.

Thank you for your attention.