Andreas Dombret: The Single Supervisory Mechanism – from European supervisor to European supervision

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at the Handelsblatt Annual Conference "New developments in banking supervision", Frankfurt am Main, 11 November 2015.

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1. Introduction

Ladies and gentlemen

It gives me great pleasure to speak to you here today at the Handelsblatt Annual Conference on the topic of new developments in banking supervision. Carnival season begins today, 11 November at 11.11 am – but to those of you who are hoping for a traditional, witty Carnival speech at this point, I'm afraid I'm about to let you down. Besides, 11 o'clock is still a good couple of hours away.

Nonetheless, I think we should begin on a light-hearted note. Have you heard the one about the German, the Frenchman and the Englishman who are sentenced to death but granted one final request? The Frenchman chooses a six-course meal with red wine. The German asks to give one last, long speech. And the Englishman's final request? "I want you to shoot me before the German starts speaking."

Ladies and gentlemen, I hope that none of us will have to make such a final request any time soon, and I promise to keep my speech short. In any case, the topic I have chosen is still fairly new – the Single Supervisory Mechanism, or SSM.

2. One year of European banking supervision: initial successes ...

Just as today marks a new season for those who celebrate Carnival, we banking supervisors entered a new era just over a year ago – the era of European banking supervision.

On 4 November 2014, we established the first pillar of the European banking union in the form of the Single Supervisory Mechanism (SSM). On that day, the European Central Bank (ECB) assumed responsibility for directly supervising the approximately 120 largest banks in the euro area. It therefore now supervises over 85% of the euro-area banking sector, measured by total assets.

To make one thing clear from the start, it is obvious how much has been achieved over the past year. The SSM, which is staffed by personnel from the ECB and each euro-area country's national competent authorities, has got off to a flying start, which is mainly down to the excellent teamwork between these two groups of supervisors. The joint supervisory teams, or JSTs, show us on a daily basis how diverse supervisory cultures are growing ever closer to one another.

A year ago, a new age also began for the banks we supervise. The supervisory approach has taken on a significantly more quantitative slant, for example, and day-to-day supervisory practices are now mainly being conducted in English. All in all, it appears to me that banks have adapted well to the new supervisory setting.

The SSM represents the creation of the first ever European supervisory regime. However, it is crucial that the SSM also establish a consistent basis for banking supervision across Europe.

Only then will we be able to tackle the weaknesses exposed by the recent financial crisis. One such weakness was the tendency of national supervisors to train their sights primarily on the institutions based in their own jurisdiction, meaning that risk that spilled over to other countries sometimes went undetected until it was too late. The SSM can address this problem by taking an explicitly European approach and comparing banks from different countries, for example.

Another aim of the SSM is to prevent banks in different countries from being supervised with varying degrees of strictness because, for instance, national supervisory regimes are too heavily influenced by national interests. To reduce this risk, the JSTs are headed by coordinators who are not usually from the country in which the supervised bank is located.

The upcoming EU-wide stress test also demonstrates the need to apply a European perspective. Last Thursday, the ECB announced which euro-area banks will participate in the EU-wide stress test, to be conducted next year by the London-based European Banking Authority (EBA). For the first time, the sample has been defined from an SSM-wide rather than a national perspective. The 19 euro-area countries will be treated as a whole when calculating asset coverage, instead of taking a country-by-country approach. Making the stress tests more European marks another important step towards creating a level playing field.

Yet it is not just the supervisors – supervisory standards also have to become European, which is why the ECB is constantly striving to harmonise the prudential standards of the individual euro-area countries. The situation at present is that national supervisors can, in some cases, choose between various options under European supervisory law and are able to decide autonomously on the concrete application of the law. The outcome is that banks in the euro area are still subject to completely different rules.

For example, discussions are underway concerning the treatment of deferred tax assets. In a number of countries, these assets are recognised as equity when, under the CRR – an EU Regulation governing supervisory requirements – they generally have to be deducted from equity capital. One option allows for a longer transitional period, during which the new deduction requirements are introduced step by step. In my opinion, however, this results in disparate competitive conditions among EU banks. Other options that are currently being discussed include, for instance, the treatment of intragroup loans in the light of the large exposure limit and the exemption from liquidity requirements for single entities that are part of a group.

I take a positive view of the SSM’s current efforts to limit these national options. And today marks the beginning of a consultation on the possible harmonisation of these options. If we can bring in a reasonable limit here, this will help us harmonise supervision in the individual countries and restrict the influence of national interests. Nonetheless, any effort at harmonisation needs to be accompanied by a sense of proportion; I will return to this point later.

Ladies and gentlemen, like Carnival today, the SSM was kicked off one year ago – and, I believe, successfully. But there is no question that such a new structure has to be further consolidated and is faced with challenges so soon after its launch.

3. ...but challenges remain

Today I will address two current challenges facing European supervisors at the moment: first, the balance of harmonisation, subsidiarity and proportionality, and second, institutional challenges.

I have already mentioned the necessity of harmonised supervisory standards. However, it must also be clear when striving to harmonise that harmonisation has its limits, because what is important is a sustainable balance between harmonisation and proportionality. It should go without saying that, for example, a smaller bank running a low-risk business model is not supervised as intensively as a larger one engaged in riskier transactions.

Of course, the principle of proportionality is apparent even in the structure of the SSM itself. Only the 123 most significant institutions are supervised directly by the ECB; the ongoing supervision of the approximately 3,500 less significant banks remains the task of the national supervisors. These banks communicate directly with the ECB only in exceptional circumstances – for instance, if they require authorisations or wish to acquire qualifying holdings. The ECB is informed about each less significant institution in an annual report drawn up by the national supervisors. In close consultation with the national competent authorities, it has additionally defined a group of institutions on which it wishes to receive more frequent and more detailed reports.

I consider this approach to be sensible and correct, as it upholds the principle of subsidiarity. For instance, most smaller banks apply regional, relatively low-risk business models that do not require harmonised European supervision. National supervisors will be able to appropriately supervise and classify the special features of these banks in future, too.

Nonetheless, these less significant banks are also affected by the SSM. In future, these institutions are to be supervised under harmonised European standards as well. In order to ensure such consistent supervision, the ECB can give national supervisors guidance on how to design the supervision of smaller institutions. For instance, it can set supervisory focal points or define principles for the assessment of certain issues. In individual cases, however, the ECB does not have the power to order national supervisors to take specific supervisory actions or to issue specific decisions.

The ECB and the national supervisors are currently setting the relevant guidelines and revising the SSM Supervisory Manual. The challenge they face is to strike the right balance between harmonising supervisory practice, which is quite rightly an objective, and the principles of subsidiarity and proportionality. We must prevent a situation in which inherently different matters are supervised according to the same standards.

After all, the size of a bank is indeed relevant when it comes to risk. Of course, small banks are also capable of entering into bad deals, making bad decisions and failing. However, the implications for the financial system are much less severe than if a bigger bank fails and are, for the most part, likely to be contained at the national or even regional level. Small banks are not "too big to fail" and therefore have, from the outset, less incentive to take particularly high risks. Supervisors should address these differences in their requirements. It is essential that the principle of proportionality be upheld.

This principle should be considered in the current review of national options that I have already mentioned. As sensible as harmonisation is, it sometimes makes just as much sense to interpret rules in the light of national special features. We therefore have to review all national options very carefully and keep only those options that truly reflect the peculiarities of various markets and banks. It is my firm conviction that all other options should, sooner or later, be phased out.

Last but not least, a European supervisory regime needs a sounds institutional framework. In this context, thought must also be given to the SSM's decision-making structures and processes. Now that the ECB is responsible for banking supervision, the ECB Governing Council is the supreme decision-making body for supervisory decisions in addition to monetary policy ones. These two decision-making powers are relevant in that banks are, on the one hand, an essential part of the monetary policy transmission mechanism but, on the other hand, are also subject to the scrutiny of the banking supervisor. It would be wrong to claim that conflicts of interest could never arise here.

Of course, these potential conflicts of interest were discussed back when the SSM was established, and the institutional framework that restricts the role of the ECB Governing Council in supervisory decisions is meant to address this. This framework has worked thus far, but I am not sure whether it will work in all circumstances. It therefore can't do any harm to think of ways to improve it.

Alongside the institutional structures, I also see further need for improvement with regard to the decision-making structures and processes. Specifically, I mean that the SSM's senior management levels must – due to requirements laid down in the ECB Statute – also deal with many routine tasks which, purely in terms of their content, could also be carried out at other levels of the organisation. The "fit and proper" assessments of future members of the supervised banks' management bodies with executive and supervisory functions are an apt example here. This year alone, the Supervisory Board, followed by the Governing Council, has made more than 1,000 such fit and proper decisions. The ECB recognises these problems and is currently working on a solution that will hopefully soon be found.

4. Conclusion

A European supervisor for the largest banks in the euro area has now been in place for one year. From my perspective, this first year has been satisfactory and shown great promise. Nevertheless, we still have some way to go before a genuine European supervisory regime is established.

We will only reach this destination if, when harmonising supervisory standards and supervisory options, we strike a balance that makes sense from a supervisory and economic perspective and fits the structures and circumstances of the European banking market. This challenge can certainly be overcome, and it is with this in mind that I look forward to the SSM's second year.

Thank you for your attention.