Cyril Roux: Working with the Single Supervisory Mechanism regime

Address by Mr Cyril Roux, Deputy Governor (Financial Regulation) of the Central Bank of Ireland, at the Banking and Payments Federation Ireland (BPFI Banking) Conference, Dublin, 27 November 2015.

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Introduction

Ladies and gentlemen

It is my pleasure to take part in today's BPFI conference on the Banking Union and speak after Ignazio Angeloni, my fellow member at the ECB Supervisory Board, and before Elke König, the Chair of the Single Resolution Board.

I would like to offer a second insight into the workings of the Single Supervisory Mechanism (SSM) from the perspective of the national head of financial regulation in one of the Eurozone countries.

The SSM is an unprecedented experiment. For the first time, prudential banking supervision is conducted at supra-national level. The financial crisis has been a catalyst for the decision to do so, but it is no surprise that the European Union Treaty had already provided for the possibility to conduct banking supervision at the same level as the conduct of monetary policy, well before the financial crisis of the past decade.

Indeed, I would agree that banking supervision is best conducted by the institution which is the lender of last resort. The provision of emergency liquidity assistance, which is sometimes necessary, is dependent upon the medium term prospect of solvency. A conversation between separate arms of a central bank on these issues, adjudicated by a single body, appears to me a happy medium between necessary separation of duties and useful proximity of knowledge and effective decision making.

That being said, only time will test the governance and effectiveness of the SSM. Monetary economists would be familiar with the debate around optimal currency areas, and the history of international currency unions. The large and diverse Eurozone is the first real-life case study of an international banking supervisory area. In the course of this speech I will underline some of the strengths and challenges of supra-national supervision, based on the first year of operation of the SSM.

The SSM in operation

As you know, the SSM is both a legal framework and a supervisory approach embedded in an operational architecture.

The legal framework is made of the SSM Regulation and the SSM Framework regulation. These regulations designate the ECB as the competent authority for supervising Eurozone banks against their prudential requirements. The largest banking groups of the Eurozone, and the top three in any country, the so called Significant Institutions – or SIs-, are supervised directly by the ECB; all the other ones, named Less Significant Institutions – or LSIs – are supervised by the national competent authority – in Ireland, this is the Central Bank .

For the LSIs, the decision-making authority, except for acquiring transactions, and all supervisory staff have stayed within the Central Bank, so the changes may not be manifest, although the ECB mandates the approach and methodology for supervision and exercises oversight.

For every significant institution, on the other hand, decision-making has shifted to Frankfurt and the daily supervision has been attributed to an international team headed in Frankfurt but mostly made of local supervisors – this team is what we call in our lingo the joint supervisory team or JST. The functioning of the SSM is thus based on the co-operation between the 19 national competent authorities, including the Central Bank of Ireland, and the ECB. In practical terms, the establishment of these Joint Supervisory Teams means that SIs will now have worked for a year with their Frankfurt-based JST Coordinators, along with some Frankfurt based supervisors.

Notwithstanding this, the vast majority of JST members continue to be those based in Dublin, who have likely been in your supervisory team before the SSM, and who you continue to interact with throughout the year. In addition, a number of Central Bank Inspection and Analysis staff support the JSTs through dedicated on-site activity, cross-sectoral and specialised expertise. All in all, the vast majority of the supervisory work is and will continue be conducted in Dublin for the Irish SIs.

Banking supervision can thus benefit from the varied perspectives and judgment brought by an international team of supervisors, and the strength brought by the critical mass of knowledge of combined national competent authorities and the ECB. On the other hand, the functioning of the JSTs faces the combined management challenges of international public institutions, matrix structures, and the tensions brought by the transfer of powers and responsibilities. Familiar in other contexts, these management challenges are specific to the conduct of supervision at a new supra-national level. Delivering consistent, timely and effective supervision, including the issuance and follow-up of remediation programs, is proving challenging for issues that go beyond capital requirements. So too is keeping staff motivated throughout this complex network of national authorities and the ECB. It is a credit to the SSM that it acknowledges these teething problems and is determined to address them.

Notwithstanding these hurdles, there have been numerous speeches to mark the first anniversary of the SSM which have recognized its many achievements. These successes have been well documented and Ignazio Angeloni has reminded us of them. Let me add to this chorus that one of the critical success factors of the SSM has been the ECB's success in attracting high quality staff. Many of them are experienced banking supervisors coming straight from the national banking authorities, including the Central Bank of Ireland. They have been attracted by the exciting challenge of working abroad, in helping establish the SSM, and the much better financial terms and employment conditions offered to them. A second wave of supervisors is expected to leave the Central Bank and other national competent authorities next year, as the ECB will be increasing its SSM headcount by 25%. Combined with the familiar constraint of FEMPI, this will bring further stresses to the bench strength of banking supervision in the Central Bank, and to the challenge of replenishing once more our ranks.

National Competent Authority

From an National Authority perspective, the establishment of the SSM for banking supervision has led to a thorough change in how supervisors within the Central Bank work. There is the complex multi-location JST relationship to manage with an even greater emphasis on analysis, "constrained judgment", quantitative assessments (including of risk and control frameworks) and, a particularly large change for the Central Bank, a move to formalised end-to-end on-site inspections.

The approach to supervision developed by the ECB, with our input and influence, gives the Central Bank, and banking supervision, the opportunity to build on the significant developments and achievements that have already taken place in the post-crisis and Programme years. These include the roll-out of risk-based supervision, the development of leading stress testing approaches and data analytics. This has been combined with instilling an assertive culture amongst our supervisors, as well as using our powers under a credible threat of enforcement. These hard-earned achievements contributed to the delivery of large tracts of the financial sector reform programme but also mean that Irish banking supervision staff are well-placed to demonstrate tier-one supervisory capabilities and to operate with excellence in the SSM.

With this in mind, Banking Supervision in the Central Bank has been restructured last year with three Divisions: namely: Supervision, Analysis and Inspections in order to:

1. Create a very clear distinction between off-site supervision, on-site inspections, and specialist expertise;
2. Establish strong relationships, organisational workflows and seniority of engagement between the Central Bank and the ECB.

In working within the SSM, the Central Bank has sought to impact and influence the nature, approach and outcome of supervision to ensure that we have safe banks and increased financial stability at home and abroad. We have done this by helping extensively in the formative stages of the SSM; guiding the development of the Comprehensive Assessment methodology; facilitating the development of the SSM's supervisory IT system though the provision of PRISM to the ECB; supporting significant numbers of secondees to the ECB ; and providing leadership on those areas where we have well-founded expertise. An example of this is Sharon Donnery's – the Central Bank's Director of Credit Institutions Supervision – appointment as chair of the SSM High Level Group on Non-Performing Loans. Ireland has learned the hard way to deal with the problem of NPLs and we can offer our insights in leading this work, and in our membership of numerous other working groups.

The Supervisory Board

The governance of the SSM rests on its Governing Council and its Supervisory Board. Both are comprised of six ECB members and 19 national members. For the Supervisory Board, the national member is the deputy governor in charge of banking supervision or his equivalent in each of the 19 Eurozone countries.

The Supervisory Board is the highest body of the ECB where, in practice, substantial debates take place on supervisory decisions. Proposals are brought to the Board by the JSTs and debated with a view to issue draft decisions. The Governing Council, as a rule, adopts these decisions, although it can object to any; this exceptional circumstance would then trigger the convening of a Mediation panel. This has not happened so far.

The composition of the Supervisory Board brings unique strengths and challenges to its task. All its members are senior and experienced supervisors or central bankers or both. The aggregate wealth of knowledge and experience of the Board is formidable, and further supported by the staff of the ECB and the national competent authorities. I can say, as Ireland's member of the Supervisory Board, that all decisions are approached with rigour and integrity and that the Board brings thorough challenge to supervisory proposals tabled to its meeting.

However, it is fair to say that the Central Bank would not accept from a regulated entity to have such a numerous Board, and it proves indeed unwieldy at times. Furthermore, the best national supervisory boards have a mix of supervisors, magistrates and members with a long banking industry experience. Although the members of the Supervisory Board of the ECB have a variety of skills, including in business management, law, accounting and risk, and although the six members chosen by the ECB have been carefully chosen to bring as much diversity as possible, the institutional set-up leaves the Supervisory Board with less first-hand banking experience than perhaps desirable.

The Supervisory Board plays an extraordinary central role in the SSM because all supervisory decisions requiring approval under the prudential legislation for all significant institutions must be approved by it and subsequently by the Governing Council. The SSM is hampered by the EU Treaty which limits decision making authority at the ECB to the Governing Council and the Executive Board. Ireland has learned from the previous modus operandi of its Financial Regulator the pitfalls of overly centralised decision-making and of a two tier decision making body. As a result, supervision in the Central Bank has been highly devolved since the beginning of the decade, and very few decisions are deemed so important that they need to be taken by a Director or the Deputy Governor. In a stark contrast, the SSM has operated since day one at the extreme end of centralisation. Not a single decision, even the most routine and least consequential one, has been delegated. Electronic mailboxes of Supervisory Board members and Governors are clogged with a daily shower of insignificant written procedures, and unproblematic fitness and probity applications can take months to be processed. Legal impediments need to be lifted to make delegation possible and bureaucracy reduced. The governance and decision making structure are yet to be truly tested as admittedly the SSM has yet to face its first open crisis.

Issues of substance

Let me move now to some issues of substance. It remains the case that many banking systems in the Eurozone, including Ireland's, are largely nationally focused. Allied to this are the deeply different business models, legal environment, ways of banking, and economic outlooks and as a result the SSM has to strike a balance between consistency and taking due account of national realities.

As Ignazio Angeloni has reminded us, the ECB has launched a consultation on the 'Options & National Discretions' in an attempt to facilitate the application of the Capital Requirement Directive and Regulation across the Eurozone. This is an important initiative consistent with the SSM mandate, but it is clear that certain national discrepancies will continue to apply, if only because they are beyond the reach of this consultation. For instance, the European text recognises as CET1 instruments deferred tax credits and in some instances the shares of cooperatives banks held by their clients, notwithstanding the fact that these shares are repayable when the clients terminate their banking arrangements. Competitive differences will thus continue to apply within the Eurozone, and even more within the EU. That is, however, primarily an issue for co-legislators, and competitions authorities, rather than the mandate of the prudential supervisor.

Ignazio Angeloni has also delineated how the SSM has been conducting the first round of the common Supervisory Review and Evaluation Process (SREP) in 2015, with a view to determine the so-called pillar 2 capital requirements. The SREP decisions will be finalised in the coming weeks but it has already been publicly said that the Pillar2 capital requirements envisaged for the SSM significant institutions in 2016 are slightly higher than in 2015. Pillar 2 capital is held to account for those risks not fully captured in the standard Pillar 1 requirement, such as concentrations of exposures, and must be held at all times, just like pillar 1. So I will add my voice to Ignazio Angeloni's and acknowledge that the amount of both pillar one and pillar two capital requirements are material for investors in securities issued by credit institutions. The prudential supervisor is right in willing to preserve a space for a private dialogue and engagement with the banks on the way it assesses them, and the detailed appraisal of their risk profiles need not be disclosed. But the sum of all capital requirements of a bank, including macroprudential buffers, can hardly be held secret to those who own it or to those who are asked to provide it credit.

A final issue of substance that I wish to address is that of enforcement. It is the Central Bank's strongly held view that enforcement is critical to supervision, including to prudential supervision. Here also, the unfortunate experience of the Irish Financial Regulator of the previous decade has convinced us that the credible use of enforcement must be deployed to be an effective supervisor. The SSM so far has not yet concluded nor managed to significantly progress enforcement cases and in some cases found legal difficulties in national competent authorities bringing to a close their own cases. Even though the SSM supervisory powers only extend to taking sanctions against banks, whereas local supervisors can take actions against individuals, breaches of the prudential regulation must be enforceable in practice and the SSM has to find its feet as an enforcer as it enters its second year of operation.

Beyond the SSM

The SSM has very broad remit but not an exclusive one. The Central Bank's position as the national macro-prudential authority, national resolution authority, institution in charge of anti-money laundering in the financial sector and the national consumer protection authority for financial institutions places us at the centre of many regulations that apply to banks prudentially regulated by the SSM. In all these guises, the Central Bank's role remains to safeguard stability and protect consumers. We bring all these perspectives when debating prudential decisions within the SSM.

Furthermore, the creation and imminent commencement of the Single Resolution Board (SRB) and the second pillar of Banking Union will add a new dimension to the supervision of banks. As Resolution authorities will go to the banks and draw up their resolution plans, they will need to undertake both desk-based and on-site work similar to that of the SSM. The European legislators have chosen to give to Resolution authorities, as well as the supervisory authorities, the ability to determine that banks are failing or likely to fail. This overlap of responsibility will also mean that Resolution authorities will need to be able to know banks well enough to make that determination, through work of their own and sharing of information with supervisory authorities, including the SSM. I trust Elke König, Chair of the SRB, will in a moment delineate how she sees this operating in practice.

Conclusion

I will conclude by looking to the future and the challenges ahead. We recognise that banks face continued headwind on profitability, the on-going drag of non-performing loans, new and emerging risks such as cyber threats and the implementation and full application of regulatory reform from Basel III and the second pillar of Banking Union, the Single Resolution Mechanism.

The cumulative impact on banks' balance sheets of the Minimum Required Eligible Liabilities allied to the increased capital and liquidity requirements arising from the Capital Requirements Directive is yet to be felt. Business model viability and sustainable profitability assessments will drive much of the supervisory engagement in the coming period as well as the operational risk issues such as IT and cyber risk. The SSM is also conscious of the potential impact of International Financial Reporting Standard (IFRS) 9 and will seek to engage with the banks on these issues in 2016.

Working well within the Single Supervisory Mechanism and the Single Resolution Mechanism is critical to conducting efficiently this programme of work. I hope I have given some insight into this new regime, some of the successes and some of the issues that will need to be resolved in the coming years in the pursuit of harmonised supervision reflective of national circumstances.