SPEECH

“The Prudential Regulation of Banks” – Practical Implications for European Supervision

Remarks by Claudia Buch, Chair of the Supervisory Board of the ECB, prepared on the occasion of the conference “Dewatripont Fest”, roundtable on “Banking and Finance”

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Thank you for inviting me to speak at today’s roundtable and for the opportunity to celebrate Mathias Dewatripont’s academic achievements.[1] Personally, I had the privilege of working with Mathias during his time as Executive Director of the National Bank of Belgium. To explain the influence his work has had on banking supervision in Europe, I would like to start by taking you back through history.

The economic rationale for the prudential supervision of banks

For a long while, no systematic conceptual framework existed to explain why we regulate and supervise banks. Yet banking activities date back to ancient times – temples in Babylonia acted as safe depositories and granted loans, the first professional bankers appeared in classical Greece and well-established banking practices developed in ancient Rome.

By comparison, prudential supervision, in an institutional sense, is a relatively modern development.[2] In the United States, for example, it was first established at the national level with the introduction of federal bank supervision in the 1860s. The architecture we recognise today as modern prudential regulation did not take shape until the 1930s and became international in scope only from the mid-1970s.

A conceptual framework for modern supervision did not even emerge until the mid-1990s. Building on earlier research on corporate finance, contract theory and information economics, Mathias Dewatripont and Jean Tirole published their seminal work, *The Prudential Regulation of Banks*, in 1994,[3] and I vividly remember reading their book at the time.

The arguments put forward by Dewatripont and Tirole can be summarised as follows:

- Banks are considered to be “managerial firms”. Managers take actions that outsiders cannot fully observe, thus requiring monitoring by those who bear the consequences of poor performance.

- Capital structure plays a disciplining role. When performance is good, equity holders, who benefit from upside gains, are in control. Due to limited liability, they incur losses only up to the amount of their capital contribution when performance is poor. This can encourage excessive risk-taking. When performance deteriorates, control should therefore shift to debt holders, who have stronger incentives

to limit losses. Debt can play a role in mitigating risk-taking incentives, but it requires debt holders to monitor banks effectively and act when performance deteriorates.

- Banks' debt holders are unique in the sense that banks are largely funded by small, dispersed depositors. These depositors may lack the information or expertise to monitor effectively how banks are managed, and they cannot easily act together when banks underperform. Performing monitoring functions is costly while the benefits of monitoring are accrued by all creditors. The monitoring incentives of depositors may therefore be limited as a result of a free-riding problem, or due to the presence of implicit or explicit guarantees such as deposit insurance.

- This creates a structural governance gap, whereby depositors need to be "represented" by an external authority that can intervene when necessary. Supervisors therefore monitor banks on behalf of depositors, ensuring risks are managed properly and intervening as required.

- Capital and solvency requirements serve as triggers for intervention on behalf of debt holders, prompting a shift in control from shareholders to supervisors. Continuous bank monitoring by supervisors allows intervention even before those thresholds are breached.[4]

Today, in my role as Chair of the Supervisory Board of the European Central Bank, it is our key responsibility to act on behalf of depositors who entrust their savings to the banks we supervise. Keeping banks safe and sound, and thereby contributing to financial stability, is, in fact, our mandate.[5]

The capital standards established by the Basel Committee on Banking Supervision reflect the insights of the conceptual framework sketched above. These standards define minimum levels of capital banks are expected to maintain, which jurisdictions then implement in their own regulatory frameworks. When banks fall short of these requirements, supervisors have a basis for intervention. In the European framework, this intervention can escalate through supervisory measures and, ultimately, to the withdrawal of a banking licence if a bank no longer meets the conditions for authorisation.[6]

This close link between theory and practice is reflected in Mathias' career. During his time as Executive Director of the National Bank of Belgium from 2011 to 2017, he was directly involved in building the international supervisory architecture. He served as the National Bank of Belgium's representative on the Basel Committee on Banking Supervision, on the Board of Supervisors of the European Banking Authority, and on the ECB's Supervisory Board from 2014. As one of the members of the Supervisory Board in its founding years, Mathias was part of the generation that helped turn European banking supervision from an institutional design into a working reality. I eventually met Mathias in 2015, in the context of joint work undertaken by the European Systemic Risk Board (ESRB).

Improving the prudential supervision of banks

Let me now fast-forward to some very interesting recent exchanges we had with Mathias. Two years ago, European banking supervisors benefited from Mathias' insights, intellectual integrity and sharp mind when

he spoke at our Supervisory Culture Conference here in Frankfurt.[7] Mathias returned to one of his enduring themes, namely the need to view regulation, supervision and resolution as a coherent incentive framework.

Several points he made then are particularly relevant today.

First, Mathias reminded us that prudential supervision ultimately acts as an incentive to banks by replicating the disciplining role that dispersed depositors are unable to exercise. In his words, the challenge is to ensure that, when a bank's performance deteriorates, control shifts credibly and in a timely manner from shareholders to supervisors and resolution authorities acting on behalf of debt holders – which lies at the heart of effective supervision.

Second, he expressed broad support for European banking supervision's move towards a more risk-focused supervisory culture, while cautioning that the devil lies in the detail. He noted that risk sensitivity can easily become overly complex. We take this advice very seriously. Indeed, we are streamlining our assessment of the internal models banks use to calculate risk weights so that we have more capacity to focus on relevant risks.[8]

More generally, an SSM supervisory culture initiative forms a key part of the comprehensive reforms we are implementing to make European banking supervision more efficient, effective and risk-based.[9] This helps ensure that the reforms are embedded in the day-to-day practices of supervisors across the ECB and the national competent authorities.

Third, drawing lessons from the March 2023 banking turmoil in the United States and Switzerland, Mathias emphasised the progress made since the global financial crisis and the need to remain vigilant. He suggested that while the resilience of the euro area banking sector reflects, in part, the consistent application of Basel III, it should not make us complacent. I cannot stress this point enough. Yes, the banking sector has become resilient. But resilience is a forward-looking concept. Banks need to remain vigilant and address evolving risks and vulnerabilities. This is especially important in the current environment of elevated geopolitical risks and given the reduced capacity of fiscal policy to buffer shocks compared with the past.[10]

Lastly, Mathias indicated areas where supervisory attention should remain sharp. These are the credibility of intervention, the risks embedded in complex business models, and the importance of governance and incentive structures within banks.

His messages resonate strongly with our approach to supervision. In our annual reviews of banks' safety and soundness, we focus on capital and liquidity, just as we assess the soundness of governance and risk management. If we identify deficiencies, we escalate supervisory measures in a timely manner.[11]

Summing up

We are here today to bid farewell to Mathias in his role as professor at Université Libre de Bruxelles. But I very much hope that we will have many more opportunities to engage with him in the future, and to benefit

from his ideas and experience. Being challenged in our work and encouraged to reflect upon it is invaluable if we are to remain focused on our overarching objective of contributing to the public good of financial stability. In the broader policy debates now underway, it remains essential to keep a clear vision of why good regulation and supervision enhance welfare rather than pursuing short-term objectives that may ultimately weaken growth *and* resilience.

The examples I have mentioned above show that we have taken on board and acted on the advice and insights Mathias has given us. For these insights and decades of public service, we are very grateful. His work will continue to shape our thinking about why we regulate and supervise banks, what has been achieved, and how these achievements can be sustained in a volatile world.

1.

I am grateful to Agnese Leonello and John Roche for their comments and support in preparing these remarks. Any errors and inaccuracies are my own.

2.

For a recently published account of the evolution of banking supervision in the United States, see Conti-Brown, P. and Vanatta, S.H. (2025), *Private Finance, Public Power: A History of Bank Supervision in America*, Princeton University Press.

3.

This research includes Diamond, D. W. and Dybvig, P. H. (1983), “Bank Runs, Deposit Insurance, and Liquidity”, *Journal of Political Economy*, Vol. 91, No 3, June; Jensen, M. C. and Meckling, W. H. (1976), “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure”, *Journal of Financial Economics*, Vol. 3, Issue 4, October; Dewatripont, M. and Tirole, J. (1994), *The Prudential Regulation of Banks*, MIT Press.

4.

In a different framework, Diamond and Dybvig (1983) show how coordination failures among small and dispersed depositors may trigger a bank’s failure due to illiquidity. Supervisors play an important role in these instances as well by helping to distinguish temporary liquidity problems from solvency problems.

5.

Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions, Article 1. The Regulation confers supervisory tasks on the ECB “with a view to contributing to the safety and soundness of credit institutions and the stability of the financial system”.

6.

See ECB Banking Supervision, “Authorisations”. Under the European banking supervision framework, the ECB is the authority in charge of banking authorisations; both the ECB and the relevant national supervisor may initiate withdrawal of a banking licence, and a licence may be withdrawn where a credit institution no longer meets the established requirements. See also Elderson, Frank (2023) “Powers, ability and willingness to act – the mainstay of effective banking supervision”, Speech, House of the Euro, Brussels, 7 December

7.

Dewatripont, M. (2024), “Organisational culture in banking supervision”, speech at the SSM Supervisory Culture Conference, ECB, Frankfurt, 17 September.

8.

See “ECB streamlines how it supervises banks’ internal models”, Press release, 30 March 2026

9.

For more information on the SSM supervisory culture initiative, see Chapter 4 in ECB (2025), “Streamlining supervision, safeguarding resilience The ECB’s agenda for more effective, efficient and risk-based European banking supervision”, December.

10.

See Buch, C. (2025) “Global banking, global risks: how banks and supervisors can navigate a complex environment” Keynote speech, ECB Forum on Banking Supervision, 13 November

11.

European Central Bank (2025), “Supervisory priorities 2026-28”, December.

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