CONTRIBUTION

Bank resilience and sustainable growth: two sides of the same coin

Contribution by Claudia Buch, Chair of the Supervisory Board of the ECB, at the Bruegel Annual Meetings panel on “Future-proofing European banking”

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Almost 20 years after the onset of the global financial crisis, and more than a decade after the creation of the European banking union, there is an intense debate about the future of European banking.

Over the past decade, Europe’s banking sector has become much more resilient. This benefits the economy and society: financial services can be provided more reliably, and the probability and severity of potential crises are lower.

But further reforms are needed to make the European banking sector future-proof, to sustain the progress made and to tackle structural weaknesses. In Europe, growth and innovation are being held back by geopolitical tensions, a fragmented Single Market and a complex institutional framework.

Safeguarding banks’ resilience is equally important in light of heightened financial and operational risks. Geopolitical risks have already materialised, but their effects on banks’ balance sheets unfold only over time. The digitalisation of financial services provides new opportunities to adapt banks’ business models but introduces new risks. Cyber risks can pose a threat to banks’ operations, requiring investment in IT and cybersecurity.

Resilience is thus needed – to keep deposits safe, payments systems functioning and credit flowing, including in times of stress.

There is a way to avoid undesirable trade-offs between promoting growth and preserving resilience. Sustainable growth and resilience are, in fact, two sides of the same coin. The European Commission’s report on the competitiveness of the EU banking sector provides an opportunity to advance both.[1]

A balanced reform package needs to enhance market integration, complete the banking union and remove undue complexities.

Enhancing market integration and completing the banking union

The main gains for growth and resilience come from further market integration.

Recent work at the International Monetary Fund (IMF) illustrates the potential gains from greater banking market integration.[2] Reducing barriers to cross-border banking could make it easier to form cross-border lending relationships and ultimately deliver higher growth. Because the Single Rulebook harmonises banking regulation, these barriers must be identified elsewhere. In fact, many differences in national rules relevant for banks persist in the form of differences in insolvency regimes, consumer protection rules or mortgage market regulation.[3]

Greater harmonisation of national rules would contribute to both simplification and integration. It would make the regulatory framework less complex and allow banks to scale up and develop pan-European business models.

Completing the banking union would be a key accelerator for integration. Deposit insurance remains fragmented along national borders, and risk sharing is inefficient. Less than 2% of household deposits are held across borders.[4] A European deposit insurance scheme would reassure savers that they were equally protected across Europe. It would ease the cross-border provision of services and thereby promote integration. As it wouldn't matter which national deposit guarantee fund covered risks, the bank-sovereign nexus would be weakened further.[5]

Removing the barriers that prevent banking groups from moving liquidity and capital efficiently across borders can further support a more integrated, more competitive market. This would not mean less scrutiny by supervisors and resolution authorities. On the contrary, safeguards in periods of stress would be retained.

Together, these reforms can promote growth through greater integration and competition, while strengthening resilience.

Two pitfalls must be avoided as this agenda is being implemented.

The first would be a lack of political consensus to move the banking union forward and harmonise national rules. This would be a missed opportunity to strengthen European banks in a challenging environment. A key structural weakness – market fragmentation – would remain.

The second would be to mistake weaker capital requirements for a growth strategy. Well-capitalised banks are needed to finance the economy and take risks. In an uncertain environment, the leverage ratio and the output floor act as safeguards against underestimating risks. Weakening standards in the hope of “freeing up” capital is unlikely to boost lending and growth.

At the current juncture, bank capital is not a binding constraint on credit supply. Distributions to shareholders in the form of dividends and share buybacks have even increased in recent years, and capital buffers remain ample. On aggregate, banks directly supervised by the ECB have a Common Equity Tier 1 level of capitalisation of around 16%, well above minimum requirements. Weaker standards could lead to higher shareholder payouts rather than to more lending or the investment that banks need, for example in IT.

Lowering safeguards would make the system more fragile without addressing the structural factors holding back growth. It could be seen as weakening Europe's commitment to international cooperation. Internationally agreed Basel standards provide a common baseline for bank resilience and support a level playing field across jurisdictions. They should be implemented faithfully, in a strictly risk and evidence-based manner.

Removing undue complexities

At the same time, meaningful regulatory reforms can make the institutional framework within which banks operate less complex. Some supervisory and reporting complexities can even be removed without changing regulations.[6]

Generally speaking, removing undue complexities leads to a more efficient provision of financial services, thereby supporting growth. It strengthens the focus placed on relevant risks.

We are already streamlining procedures that could divert attention away from sound risk management and governance. We have a clear philosophy here: to be efficient, effective and risk-based in our supervision. We do not have to assess every risk for every bank with the same intensity every year. But if we have relevant findings, we need to ensure that banks remediate them and that we escalate our supervisory action if necessary.

Let me give you a few examples.[7]

- We have conducted a thorough review of our supervisory guidance. Out of more than 100 guidance documents, around 40 will be discontinued because they are no longer relevant. And we once again make it clear that our supervisory guidance communicates our expectations and good practices, but that it is non-binding. It does not create new legal obligations beyond those laid down in EU and national law.

- Key supervisory processes have become more targeted, allowing low-risk cases to be handled more quickly and greater attention to be devoted to higher-risk cases. Assessments of straightforward capital transactions can now be handled through a fast-track procedure and completed in about a week. Authorisation procedures are more risk-based. Fit-and-proper re-assessments do not require documents to be submitted again if there have been no material changes.

- Stress tests and reporting requirements are becoming leaner. As part of the next EU-wide exercise, which we will conduct jointly with the European Banking Authority, we have agreed to halve the number of data points banks need to report. This complements a reduction in supervisory reporting as part of our assessment of individual banks by around 20%.

- As regards the approval of internal models, banks can opt for a new, early implementation approach for material changes to models, subject to prudential safeguards. This allows us to direct supervisory resources towards higher-risk areas such as models showing outlier behaviour or subject to macro-financial vulnerabilities.

- On-site investigations are becoming more risk-based, which is already reflected in more targeted reports and a shorter average duration of missions.

- The follow-up to supervisory findings is becoming more proportionate. In our supervision, we prioritise issues that have the highest materiality and the greatest risk implications. We inform banks about findings that are of more limited prudential relevance but leave the follow-up mainly to their internal procedures.

- This year, our focus is on increasing proportionality by more closely linking supervision and reporting for small and non-complex institutions to their risk profiles.

These reforms make supervisory engagement more predictable and reduce unnecessary administrative effort, with broad-based benefits:

- banks benefit from faster decisions, clearer communication and more time to focus on managing material risks;
- supervisors benefit from freed-up capacity to address complex cases, evolving risks and serious weaknesses in governance and risk management;
- the public benefits from more effective supervision, which contributes to financial stability.

We are not lowering our guard on resilience. Prudential standards and rigour remain unchanged. But we will move faster when risks are contained and apply closer scrutiny when vulnerabilities are material.

Let me be more specific about our approach to setting capital requirements and the potential for regulatory simplification.

This year, we are applying a new, more predictable and more transparent methodology for setting microprudential capital requirements.[8]

In setting Pillar 2 capital requirements, we avoid the double counting of risks. The purpose of Pillar 2 capital requirements is to capture risks which are not, or not sufficiently, covered by minimum requirements. The new methodology equips supervisors with better tools to identify and address potential "overlaps" in risk coverage. At the same time, we maintain our ability to capture risks not covered by minimum capital requirements and exercise supervisory judgement.

In addition, our Pillar 2 guidance addresses bank-specific exposure to future macro-financial risks.

Beyond that, there are currently several macroprudential capital buffers in the European framework that capture risks to the stability of the overall system, not just individual banks. These buffers are set by national authorities. Together with different methodologies that are applied, this can make the buffer framework complex. Macroprudential requirements can therefore be simplified by regulatory changes that consolidate capital buffers and harmonise the methods used to set them.[9]

Summing-up

Together, improvements in supervision and in regulations ensure that banks can lend and take risks in a sustainable manner and have strong balance sheets to absorb shocks if risks materialise.

A well-balanced reform agenda benefits society by removing inefficiencies that constrain growth, integration and risk sharing. Europe should seize this opportunity to promote growth without sacrificing resilience. European banking supervision stands ready to support this reform agenda, bringing our expertise to the table and being fully accountable to the public.

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