IN-DEPTH ANALYSIS

Requested by the ECON committee

The next SSM term: Supervisory challenges ahead

Banking Union Scrutiny

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European banking supervision: Stock-taking and next steps

Abstract

Compared to the pre-SSM period, the European banking system today appears healthier and sounder. Capital ratios and asset quality have steadily improved. Capital ratios have become not only higher but also more comparable and reliable. Taking stock of these positive outcomes, the challenges for supervision in the future is to be able to foster financial integration and reconcile harmonisation with greater consideration of bank and country specificities. In this respect, we see an approach encouraging supervisory dialogue positively. Furthermore, supervisory requirements need to be simple, clear, and possibly stable to reduce uncertainty and the compliance costs of an overly demanding supervision. We also look forward to a model that does not let out of sight the very final goal of good supervision, that is favouring economic growth through a healthier and sounder banking system. Overall, we encourage more nuanced and less 'one-size-fits-all' supervisory decisions, supported by stronger empirical research to reduce the risk of unintended effects.

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EXECUTIVE SUMMARY

We provide a critical, although not exhaustive, review of major initiatives taken by the Single Supervisory Mechanism (SSM) since its inception five years ago. We also take stock of the current situation to reflect on steps that need to be taken to enhance banking supervision in Europe.

We assess the SSM's performance relative to the goals it was supposed to achieve, namely: (1) promote the safety and soundness of the European banking system, (2) increase financial integration, and (3) ensure consistent supervision.

Compared to the pre-SSM period, the European banking system today appears healthier and sounder. Capital ratios and asset quality have steadily improved, reflecting the actions taken to increase quality and quantity of capital and decrease risk. Higher and better quality capital has also been achieved through the supervisory review and evaluation process (SREP), under which the supervisor makes decisions on appropriate capital resources and capital plans; credit reduction has been promoted thanks to the extraordinary effort to resolve the problem of non-performing loans (NPLs). Simultaneously, capital ratios have become not only higher but also more comparable and reliable.

Supervision has become more consistent and transparent. Providing public guidelines on supervisor's expectations on a given matter (e.g., NPLs and internal rating models) has ensured a better understanding and has encouraged harmonisation of practices, to the benefit of all bank stakeholders. The three subsequent comprehensive assessments, and especially the one carried out ahead of the institution of the SSM, have played an important role in this respect. Specifically, asset quality reviews and stress tests not only have ensured a better knowledge of supervised banks; they have also promoted the adoption of uniform definitions for some critical items (e.g., NPLs) and the application of common methodology and templates (in stress test exercises). The development of a common supervisory culture has been encouraged thanks to the close cooperation between national authorities and the ECB.

Financial integration has also increased, although – perhaps – at a slower pace than expected and not along all desirable dimensions. The incomplete banking union as well as the ring fencing on the side of various national supervisors and Member States may have played a role in this respect.

Taking stock of these positive outcomes, the challenges for future supervision is to enhance transparency, reduce unnecessary complexity, and reconcile harmonisation with greater attention to bank and country specificities. We see positively an approach encouraging the supervisory dialogue if it embraces the perspective that, sometimes, "less" (rather than "more") is needed. This is important to offset the compliance costs for banks of an overly demanding supervision that absorbs increasingly more human, technological, and financial resources.

Finally, we look forward to a model that does not let out of sight the very final goal of good supervisors, i.e., favouring the economic growth through a healthier and sounder banking system. To this end, we also encourage less 'one-size-fits-all' supervisory decisions, supported by robust empirical research on the real effects of supervision.

1. INTRODUCTION

As is well known, Europe was shaken by a 10-year-long period of financial and economic difficulty that left the banking system disrupted in several manners. Credit risk rose to unprecedented levels, as an effect of growing exposures to stressed sovereigns as well as to defaulted borrowers. At the same time, financial fragmentation has increased considerably: capital flows reversed quickly from distressed to the core countries and bank-cross border exposures reduced sharply (Fiedler et al., 2016; Berenger-Gossler, Enderlein, 2016). It also became clear how fast, in a monetary union, problems in the financial sector can spread and affect people across the euro area.

The creation in November 2014 of the SSM was one of the policy response to restore confidence in the European banking system.[1] Specifically, the surveillance of systemically important institutions was placed under the common roof of the ECB with the explicit mandate to accomplish the following tasks:

1. ensure the safety and soundness of the European banking system,
2. create consistent supervision,
3. enhance financial integration.

The new supervisor took actions to address two main problems: (1) the insufficient capitalisation accompanied by distrust in risk-based regulatory capital ratios, as favoured by the extensive usage of internal rating models, (2) the excessive risk emerging from the traditional lending business, as mirrored by the high level of troubled assets held by European banks.

In the next sections, we first propose a critical view of actions taken by the SSM to address the aforementioned goals. We focus on interventions that have contributed to increase robustness of the banking industry by boosting capital ratios and enhancing asset quality. We also comment on comprehensive assessments (CAs) carried out over 2013-2018 to promote “transparency, repair, and consistent supervision”.

Second, we discuss some open issues and raise questions on the role of supervision for the future. We shed light on steps to take to enhance financial integration and strengthen transparency and accountability. We then comment on the potential negative externalities of an overly demanding regulation and supervision. For the future, we would welcome a supervision that may take into greater account bank or country specificities when needed. More disclosure on some supervisory decisions would help judge the supervisory actions under this profile, too. Moreover, we would welcome a supervision that takes into greater account the real effects of its actions, so as to combine more effectively the goals of greater financial stability with that of economic growth in the euro area.

[1] See Shoenmaker and Véron (2016) for a concise and effective description of the “new” banking supervisory framework created in the wake of the euro-area crisis.

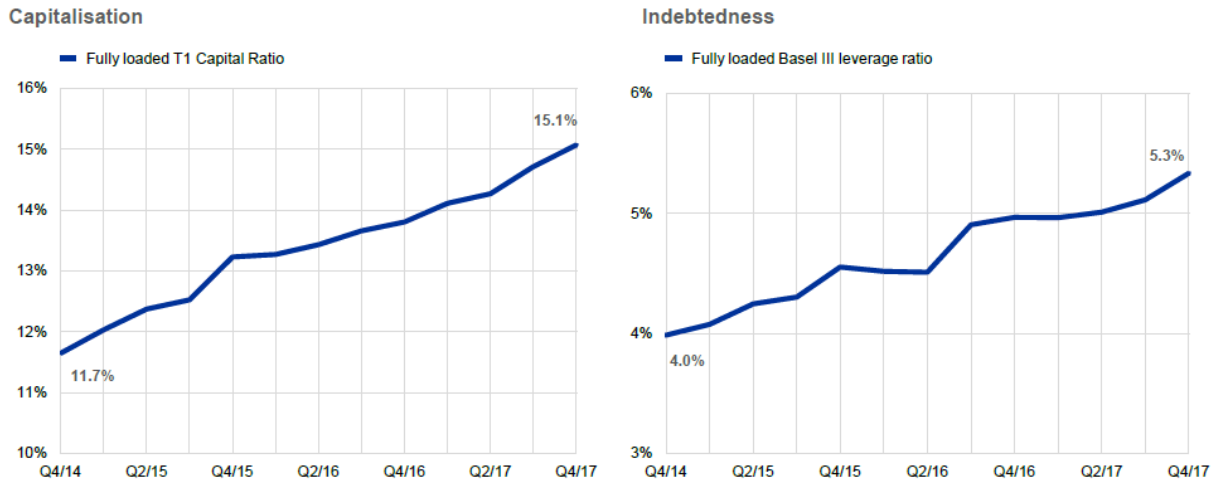
2. THE FIRST-TERM OF THE SSM: STOCKTAKING OF MAIN ACTIONS

The SSM's strategy to promote a safer and sounder banking system relied on three types of interventions. On the one hand, banks were required to improve loss-absorption capacity by raising more and better quality capital; on the other hand, they were asked to restore asset quality by resolving the NPLs issue. At the same time, to rebuild credibility in risk-based regulatory capital ratios and avoid unnecessary variation in risk weighted asset (RWA) densities (i.e., the ratio of RWA to total assets), the supervisor produced guidelines to reduce discretionary behaviour in the usage of internal rating models.

2.1 Addressing capital inadequacy

To improve loss-absorption capacity, banks were asked to raise equity capital in steps, starting with the comprehensive assessment in 2014.[2] Specifically, Figure 1 shows that banks directly supervised by the ECB have increased their Tier 1 capital ratios by 3.4 percentage points (see the left-hand panel of Figure 1). In the same time period, overall bank indebtedness fell by more than a quarter, with the average leverage ratio increasing from 4% to 5.3% (see the right-hand panel of Figure 1).

Figure 1: Evolution of capital adequacy in banks supervised by the ECB



Source: ECB (2018b)

Focusing on the highest quality component of bank capital, recent aggregate statistics show that the common equity tier 1 (CET1) ratio for the significant banks directly supervised by the ECB is now around 14% (as of mid- 2018), well above the minimum required by the Basel III rules (Angeloni, 2018a).

This outcome is confirmed by the recent stress test showing that 87 banks directly supervised by the ECB (representing nearly 90% of euro area banking assets) have become more resilient to financial shocks over the past two years. Despite a more severe adverse scenario than in the 2016 stress test, the average CET1 capital ratio of these banks after a three-year stress period was 10.1%, up from 8.8% two years ago.

[2] The 2014 CA flagged 25 banks as having a capital shortfall, meriting particular supervisory attention, among them Veneto Banca, Banca Popolare di Vicenza, and Banca Carige. In this sense, and given the subsequent developments, the CA may not be considered a fully success story.

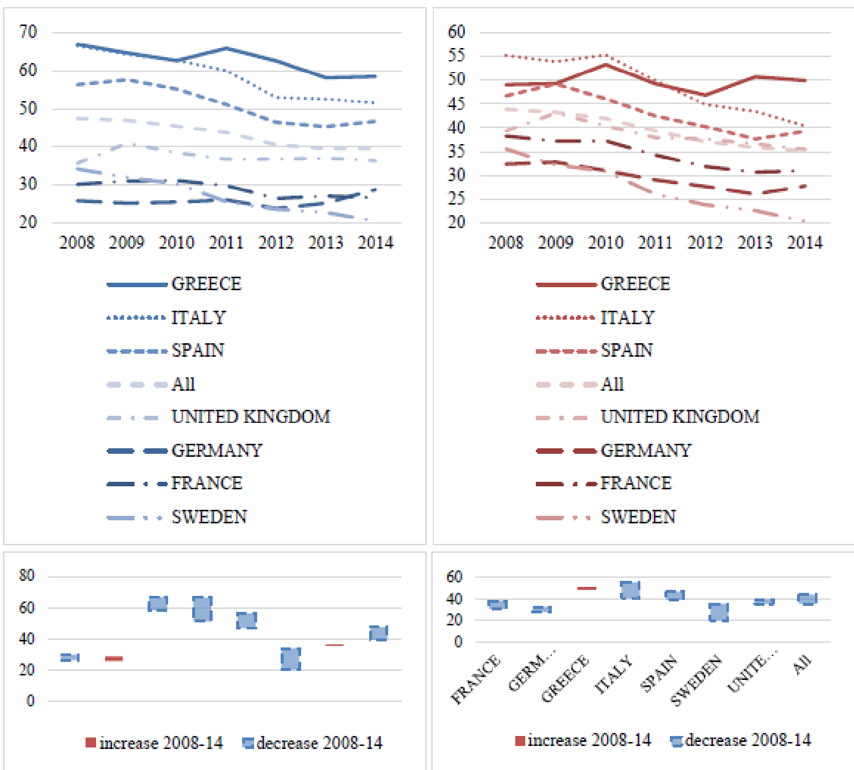
Looking at the 54 medium-sized banks tested solely by the ECB, the results show that they also have become better capitalised.[3] These 54 banks also entered the stress test with a stronger capital base (with an average CET1 ratio of 16.9%, up from 14.7% in 2016) and also exited the test with higher capital buffers than two years ago (with an average final CET1 of 11.8% at the end of the test, compared to 8.5% in 2016). Despite this, it is worth mentioning that, unlike the EBA stress tests, ECB stress tests results are only disclosed at the aggregate level, which reduces their informative value.

2.2 Rebuilding confidence in regulatory capital ratios

At the same time, the ECB took actions to reduce inconsistency in internal models. To motivate this initiative, it is important to recall that the crisis had shown not only that bank capitalisation was inadequate but also that risk-weighted capital ratios were questionable indicators of bank soundness. Figure 2 shows changes in risk weighted asset densities, proxied by the ratio of RWA over total assets (left-hand panel) and over exposure at default (right-hand panel), in a sample of banks from different European countries over 2008-2014. Two striking facts emerge: the discrepancy across banks as for the level of the ratios, and the generalised decreasing trend in a period featured by great financial and economic uncertainty.

Figure 2: Changes in RWA / TA and RWA / EAD in 2008-2014.

Results are reported only for countries having at least 3 banks in the sample



Source: Bruno et al. (2017a)

Specifically, it became clear that the large variability of risk weighted asset densities among banks and countries was partly unmotivated, i.e., unrelated to different business models or accounting practices.

[3] In addition to the EBA sample (33 banks), which covers around 70% of euro area banking assets, they represent a further 9% of banking assets in the euro area.

Inconsistency could derive from more or less lenient practices of the various national supervisors involved in the validation process (see Bruno et al., 2017a); banks themselves could have taken advantages of the flexibility and complexity of internal models to game the system and arbitrarily reduce RWAs (Behn et al., 2016; Mariathasen and Merrouche, 2014).

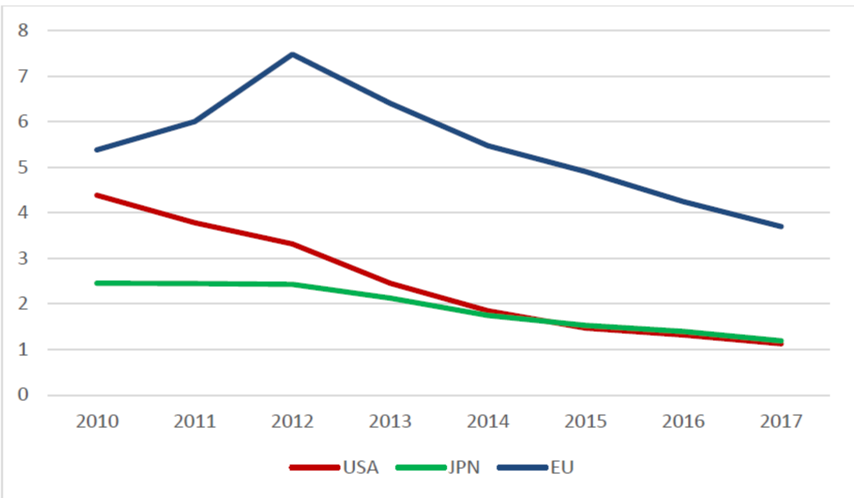
The European banking supervisor responded with a multi-year project (2016-2019), denominated TRIM (targeted review of internal models), aiming to assess whether banks' internal models comply with the regulation and whether the risk estimates are reliable and comparable. In March 2018, the ECB published a guide to ensure a uniform understanding of the general (i.e. non-model specific) topics, in particular for the internal rating based (IRB) approach, the main goal being that of ensuring a common and consistent approach to matters related to internal model, to the benefit of different stakeholders, including supervisors.[4]

2.3 Resolving NPLs

Requiring banks to hold more capital came hand in hand with instructions to have more clean and more transparent balance sheets. This resulted into actions to address the NPLs issue.

As is well known, NPLs came to the attention of macroprudential authorities in Europe because of the magnitude of the problem and their potential negative externalities (ESRB, 2019). NPLs in European banks skyrocketed to unprecedented levels in the wake of the global financial crisis, making them more vulnerable than US or Japanese institutions to the repercussions of poor asset quality (Magnus et al., 2018) (Figure 3).

Figure 3: International comparison of NPLs ratios (in %)



Source: World Bank data on NPLs

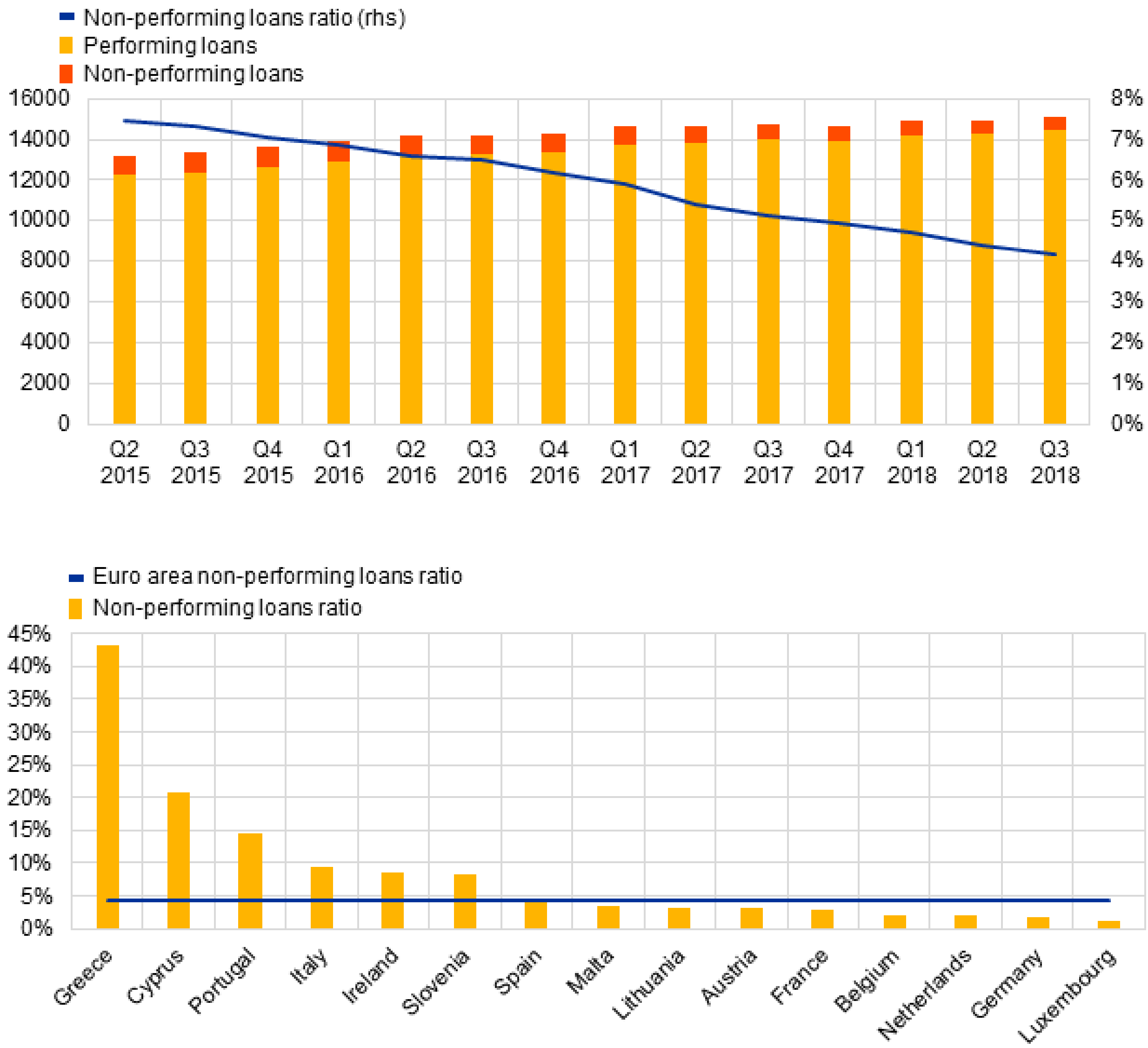
The European supervisors have reacted fiercely to resolve the problem of legacy assets. To summarise the main initiatives, in March 2017, the ECB published a guidance providing an effective toolkit for banks when tackling NPLs. As part of the guidance, high NPL banks were required to agree strategies to address NPL stocks. In March 2018, the ECB realised an addendum to this guidance setting out supervisory expectations for the provisioning of new NPLs. More recently (July 2018), the ECB

[4] The guide is also intended as a document for the internal use of the different supervisory teams. More generally, the guide claims that "all internal models should be documented to enable a qualified third party to independently understand the methodology, assumptions, limitations and use of the model and to replicate its development and implementation". ECB (2018a)

announced the decision to address the stock of NPLs by setting bank-specific supervisory expectations for the provisioning of NPLs as part of the supervisory dialogue. The aim is to achieve same coverage of NPL stock and flow over the medium term through bank-specific expectations that are guided by individual banks' current NPL ratio and their main financial features in a consistent way across comparable banks.

As a result of these actions, the NPLs ratio of significant institutions have decreased from 8% as of mid-2015 to nearly 4% as of the third quarter of 2018 (top panel of Figure 4); nevertheless, discrepancies across banks and countries still persist (bottom panel of Figure 4) and the aggregate level of NPLs in euro area banks remains far too high, compared to international peers.

Figure 4: NPLs in banks supervised by the ECB by reference period and by country.



Source: ECB, Supervisory banking statistics, 3rd quarter 2018

2.4 The multiple roles of comprehensive assessment

These specific actions have either been anticipated or complemented by asset quality reviews and stress tests, the two components of the comprehensive assessments that European supervisors carried out in 2013-2018 to promote "transparency of the banks' balance sheets, consistency of supervisory practices, and repair".

The first CA that started in 2013 right ahead of the SSM inception was an important instrument to take stock of the health condition of the euro area banking system. It included the first wide asset quality review (AQR), a key step to promote transparency and comparability across very diverse banks. For example, the banks under assessment were asked to apply, for the very first time, a stricter and uniform definition of NPLs, followed by a detailed asset level scrutiny. The AQR outcome was the recognition of new NPLs by nearly 140 billion euro.

The stress test is the second component of the CA; the 2014 stress test was the last exercise with a pass/fail threshold and the explicit goal of identifying capital shortfall. In 2016, with no hurdle rate to overcome, the stress test became a more important component of the wider supervisory assessment as the test results became inputs to SREP.[5]

The 2018 stress test made progress on previous exercises, becoming more demanding.[6] Greater data granularity, common templates, simpler assumptions and clarifications, helped to enhance internal consistency and data comparability.

More recently, the ECB has made further progress by widening the risk coverage in stress test. One of the criticisms emerged from previous test was, in fact, the limited risk coverage, being the stress test primarily a solvency assessment. In 2017, the ECB conducted the sensitivity analysis of interest rate risk in the banking book. In February 2019, the ECB launched a sensitivity analysis to assess banks' ability to handle idiosyncratic liquidity shocks; the exercise will run over May/June 2019 and the results will feed into the ongoing supervisory assessments of banks' liquidity risk management frameworks, including the SREP. [7]

Another advantage associated with CAs is that they have entailed intense cooperation between the ECB and national authorities; this has been important to exploit synergies among authorities and to build a common supervisory culture.

Overall, CAs have proved to be an important and multitasker supervisory tool. They have fostered comparability and transparency by enhancing quantity and quality of information available on banks. Harmonised definitions and procedures and greater cooperation between the ECB and national supervisors have promoted more consistent supervision. The wider risk coverage insured by sensitivity analyses will contribute to a better understanding of supervised banks, which is a key prerequisite to identify and implement necessary corrective actions through the SREP.

2.5 Enhancing financial integration (what has been done)

There are several reasons why financial integration is a desirable objective, the main of which is to facilitate the intermediation functions carried out by the financial system, with better risk sharing and

[5] Through SREP, supervisors also assess the credibility of the actions that the bank would put in place for mitigating the effect of the shock (Enria, 2018).

[6] Although more demanding than previous exercises under several respects, there are still areas requiring improvements (see Bruno and Carletti, 2018). For example, current stress tests show elements of the adverse scenario that have become outdated and may need to be revised based on more recent market development (Enria, 2018).

[7] Art. 100 CRDIV requires that competent authorities conduct at least annually supervisory stress tests on the supervised institutions as an input to the SREP. EU-wide stress tests are conducted biennially, with the next one being scheduled for 2020. In between, the ECB carries out stress tests focussed on topical issues, namely interest rate risk in the banking book (in 2017) and liquidity risk (in 2019).

diversification (ECB, 2018b). As such, financial integration may translate into reduced intermediation costs, easier access to financial markets, more efficient resource allocation, and increased portfolio diversification. Through all these channels, a higher degree of financial integration implies more financial development and, therefore, economic growth.

Unfortunately, after the positive trend that followed the introduction of the euro, financial integration in Europe decreased considerably in the wake of the global financial crisis and, above all, the euro debt crisis. Especially the latter was a disruptive trigger of financial fragmentation, as the close link between sovereigns and banks created the risk of breakup of the currency union.

The banking union project was one of the policy responses to halt financial fragmentation in the European banking system. As such, the establishment of the first pillar of the banking union, i.e., the SSM, has played an important, although partial, role to alleviate financial fragmentation. The banking union is incomplete[8] and the capital market union (CMU) has not yet established. In a sense, the single supervisor has been the prevalent mechanism available so far to promote deeper integration.

Of course, a common bank surveillance with its common practices and harmonised rules represents, almost by definition, a way to overcome a fragmented regulatory environment. Beyond that, the main channel through which the European banking supervision has promoted financial integration is by weakening the sovereign-bank vicious circle. This mainly occurred through actions taken to enhance banks' soundness. Sounder and healthier banks are, in fact, less exposed to sovereign risk and have less need for government bailouts; stronger balance sheets also reduce the risk of bank-induced sovereign distress (Dell'Ariccia et al., 2018).

[8] The single resolution fund will be fully activated only in 2023 and the European deposit insurance system has not yet been created.

3. SUPERVISORY CHALLENGES AHEAD

The sections above have illustrated the main actions taken by the SSM during the first term of its activity. The assessment so far has been positive. On average, banks are now better capitalised and less risky, having reduced their legacy assets in a remarkable way. Supervisory convergence has been fostered by more coordinated and harmonised actions. These initiatives have proven beneficial also in terms of financial integration, despite the fact that the banking union is still incomplete and the capital market union has not yet been established.

In the next sections, we will discuss potential areas of improvements and aspects that may require a more fundamental thinking of the role of the European banking supervision in the years to come.

3.1 Enhancing financial integration (what can be done)

We have illustrated the advantages of greater financial integration and the improvements already made toward this direction. Clearly, completing the banking union and starting the capital market union are fundamental steps to promote deeper integration. Nevertheless, we want to expand on two areas of interventions that the SSM could explore as of now: (1) to weaken the bank-sovereign nexus; and (2) to reduce fragmentation, thus eventually leading to more cross-border consolidation.

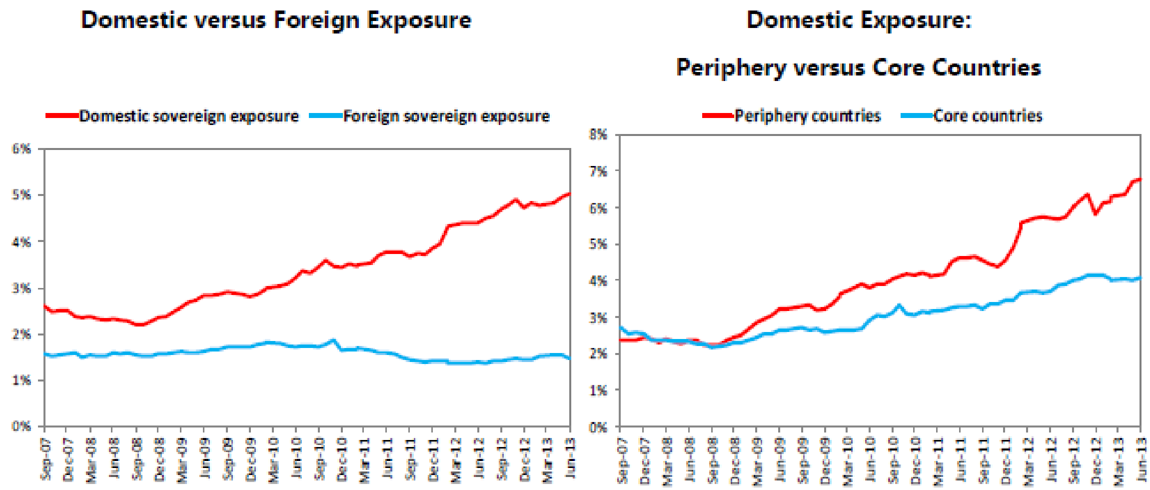
As previously said, risk reduction on the bank, and therefore national, level is important to weaken the bank-sovereign nexus and doing that is important to reduce financial fragmentation. The bank-sovereign diabolic loop is, however, not yet broken and sovereign risk re-emerges periodically.

One reason for the revival of the sovereign-bank loop are the recent political events in fiscally weak members states (e.g., the Italian elections in March 2018 and the advent of a populist-led coalition government). These have led to abrupt sovereign spread increases, thus triggering, in a nearly mechanical way, higher funding costs for banks domiciled in these countries, independently of their individual characteristics (Angeloni, 2018b).[9]

These latest happenings point once again to the importance of weakening the vicious nexus between banks and sovereigns. One way of doing this is to introduce some form of regulation for banks' sovereign bond holdings. Figure 5 shows the change in euro area banks' sovereign exposures in the years prior to and post the euro sovereign debt crisis. It emerges that, in the wake of the sovereign crisis, euro area banks increased their domestic government exposures more strongly than foreign sovereign bonds, resulting in a home bias that was more accentuated for banks from fiscally weak countries.

[9] Following the general election in March, a populist-led coalition government took shape in May 2018 igniting a tug of war with the EU over the country's budget. The increased uncertainty put Italian debt under severe strain and the spread between Italian and German 10-year government bond yields widened to the highest level since the height of the Eurozone crisis. As a response, major rating agencies either downgraded Italy's rating or downgraded the outlook to negative. See "Charts of the year: have Italy's old demons returned?", Financial Times December 12, 2018.

Figure 5: Home-bias and sovereign exposure in euro area banks



Sources: Bankscope; and European Central Bank, Individual MFI Balance Sheet Statistics.

Note: The sample comprises 247 banks from euro area countries. Periphery countries include Greece, Ireland, Italy, Portugal, and Spain. Core countries include Austria, Belgium, Finland, France, Germany, Luxembourg, and the Netherlands. Sovereign exposures are expressed in percent of total bank assets.

Source: Dell'Ariccia et al. (2018)

These issues have been largely debated (see Altavilla et al., 2017 and Dell'Ariccia et al., 2018, among others). Policy responses include the European Commission's legislative proposal (as of May 2018) to enable the development of a market of new, synthetic safe assets denominated sovereign bond backed securities (SBBS).[10] The proposal is still under discussion and thus, no conclusion can yet be drawn.[11] Also, it is not yet clear whether SBBS can be considered the response to the debated regulatory treatment of sovereign bonds, or whether these securities should be seen simply as a way to favour the creation of safe assets in Europe.

The question of breaking the loop remains open. Other proposals entail the introduction of concentration limits or non-zero risk weights on banks' sovereign bond holdings. Diversification should be the first priority and the possibility to reduce risk concentration should be seriously taken into consideration. Although these initiatives fall into the competence of regulators rather than the SSM, the latter may play an important role in fostering the implementation of future regulatory initiatives, for example, through the use of guidelines. [12]

However, a regulatory intervention aiming at limiting banks' exposure to their domestic sovereign must also be accompanied by the completion of the banking union and in particular the creation of a fiscal backstop that reduces the other side of the bank-sovereign nexus, namely the reliance of banks on their own sovereign in distressed situations.

[10] The proposal aims to level the playing field by removing unjustified regulatory impediments and granting SBBS the same regulatory treatment as national euro-area sovereign bonds (in terms, for example, of capital requirements, eligibility for liquidity coverage and collateral, etc.). For a description of the new securities, see Brunnermeier et al. (2017).

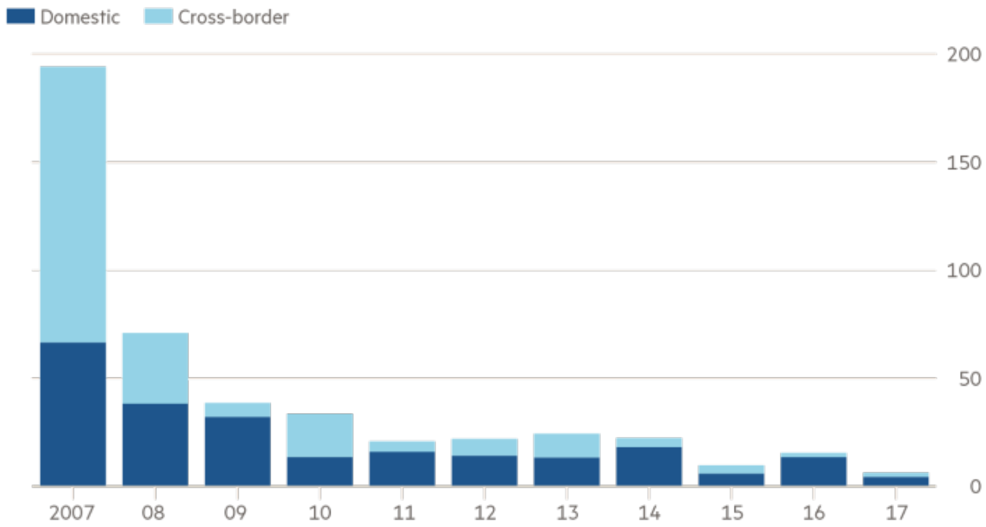
[11] For example, it is hard to say a priori whether SBBS will be, in fact, issued or widely accepted . In this last respect, see Dermine (2019) who casts doubts on a demand-led approach to developing a market of SSBS.

[12] It is worth noticing that setting concentration limits may have several repercussions on banks' behavior, e.g., as for liquidity management decisions. This is why any such decision should be calibrated carefully in order to consider benefits and costs of smaller holdings (Dell'Ariccia et al., 2018).

A second way to foster financial integration is by promoting cross-border consolidation. The euro area remains significantly 'overbanked', with an insufficiently efficient banking sector and insufficiently developed capital markets (ESRB, 2014). European banking supervision should try to take more decisive actions to counter fragmentation and possibly encourage further consolidation, having in mind, of course, of not creating further problems in terms of too-big-to fail.

The general impression is that, contrary to expectations, common supervision has not taken sufficient measures – or it does not have adequate tools – to counter fragmentation and has not done enough to reduce obstacles to cross-border bank consolidation. Stylised facts show that after the global financial crisis, banks in the EU deleveraged by cutting cross-border assets and sheltering domestic assets (Schmitz and Tirpák, 2017; Fiedler et al., 2016; ECB, 2018); similarly, cross-border mergers and acquisitions have dropped dramatically (Figure 6).

Figure 6: European bank mergers and acquisitions in 2007-2017 (deal value, USD billion)



Source: Dealogic / Financial Times, https://www.ft.com/content/810e4256-e73e-11e7-8b99-0191e45377ec

It is therefore worth investigating the reasons behind the existing fragmentation, by examining whether and to what extent European banking supervision has restrained (or not sufficiently promoted) the consolidation process that in certain markets may be the most feasible way to achieve higher integration (ECB, 2018b). [13]

Empirical evidence on the impact of prudential policies on cross-border banking is ambiguous (Schmitz and Tirpák, 2017 and literature therein). Anecdotal evidence and qualitative research is instead more conclusive and report that some aspects of the current supervisory approach could create unnecessary obstacles to the emergence of pan-European banks (Shoenmaker and Véron, 2016). [14]

For example, some banks argue that national supervisors are still often unprepared to let their 'national champions' go.[15] This, together with the tendency of national authorities to keep introducing local

[13] According to the ECB, cross-border consolidation seems the most realistic way of achieving a higher degree of integration in retail banking markets; nevertheless, the number of cross-border branches and subsidiaries of foreign banks remained low in the euro area on aggregate, as did their share of assets and loans (ECB, 2018).

[14] Shoenmaker and Véron (2016) argue that stress tests tend to favour scenarios of correlated downturns in all euro-area countries (and beyond), thus negating the stability benefits of geographical diversification (see in particular the country chapter on Spain).

[15] The ECB has the final say on approving changes of control and acquisitions of/by all supervised banks, but the national authorities receive the applications from banks, have a role in the preparation of decisions, and may exert substantial powers of "moral suasion" through levers over which they retain full control, such as conduct standards.

requirements and limitations does not help reducing fragmentation.[16] Moreover, domestic enforcement of liquidity and capital requirements tend to create considerable discretion and variation. In this respect, European banking supervision seems far from being integrated.

Overall, the impression is that banks may refrain from undertaking cross-border aggregation due to the uncertainty and the length of the authorisation process, or because they are afraid that the process will lead to excessive capital raises or to inefficient liquidity management, thus reducing the potential savings of consolidation. This calls for a more efficient authorisation process, well-motivated decisions in terms of requirements, and the removal of impediments in the application of cross-border capital or liquidity waivers, when these are not justified by prudential considerations.[17]

3.2 Strengthening transparency and accountability

Enhancing supervisory disclosure is important because transparency goes hand in hand with accountability. Greater openness and disclosure also fosters financial integration and is relevant for enhancing predictability of supervisory actions, for the benefit of all bank stakeholders. Communication and transparency in the supervisory process are important because shortcomings in these areas might increase uncertainty on the part of market participants and erode market discipline (Shoenmaker and Véron, 2016). Clarity and certainty are also relevant for banks to adapt strategies and settle into sustainable business models.

The European banking supervisor can take a step ahead in this direction by disclosing the way the stress test results inform the SREP. In fact, there is not a clear and direct link between these results and supervisory actions: first, stress rest results and pillar 2 guidance are not released at the same time; second, disclosure of supervisory measures is still debated and there is no common approach as the decision on pillar 2 disclosure is left to banks (Enria, 2018). Moreover, as for the stress test analysis that the ECB carries out directly, the European supervisor should ensure the same degree of disclosure as the EBA.

A second step towards greater supervisory openness and accountability refers to the role played by the ECB in the resolution mechanism. According to the Bank Recovery and Resolution Directive framework, the European banking supervisor is in charge of the decision to declare a bank "failing or likely to fail". The criteria behind this decision are not transparent and decisions are not made public.[18] This may leave excessive discretion on the side of the supervisor and lead to uncertainty both for banks and the market, thus inhibiting investors' ability to exert market discipline and potentially increasing the likelihood of panic runs by depositors. The lack of EU harmonised liquidation regimes worsen the problem, making the task of taking consistent resolution decisions even more complicated.

3.3 Reducing unnecessary costs and complexity of banking supervision

Increased transparency and more consistent supervision required an effort that in some cases translated into greater complexity and higher burden for supervised institutions.

[16] "… banks' bosses say that regulators need to do more to harmonize the fragmentation of European banking regulation before cross-border deals will become attractive, such as by agreeing to a common deposit guarantee scheme or lifting national capital restrictions". FT, Europe banks' bosses see need for consolidation in sector, 2 January 2018.

[17] Cross-border waivers can be overruled by member states exercising their own option. To foster harmonisation in the euro area, the ECB should encourage the removal of this option that should instead be assigned to the supervisor (ECB, 2018b).

[18] For example, the liquidation of Veneto Banca and Banca Popolare di Vicenza was particularly lengthy and controversial. After negotiations lasting several months, the ECB stated that a precautionary recapitalisation procedure was not applicable and the two banks were declared "failing or likely to fail" (Micossi, 2019). Interestingly, resolution tools were not applicable as the single resolution board deemed Veneto banks not systemically important enough. Nevertheless, the Italian government decided that the ordinary procedure (i.e., the forced administrative liquidation) would be likely to have negative externalities in the local area and opted for a public measures in support of an orderly liquidation of these banks.

European banks face multiple layers of regulation and supervision with multiple authorities being responsible of the entire process such as the SSM, SRB, Basel Committee, EBA, the European Commission and their local supervisors. For the benefit of clarity and to avoid an unnecessary burden, overlapping tasks should be reduced and different approaches on the same matter should be reconciled, even when entailing different legislative levels.[19]

We also welcome that the matter is the object of debate among supervisors. Angeloni (2018a) criticises the complexity of the current supervisory and legal infrastructure.[20] Enria (2018) emphasises the need for reducing uncoordinated actions between supervisory authorities as well as undue data requests. The ECB recognizes that synergies arising from the ECB's and the EBA's mandates needs to be maximised.[21]

Looking ahead, one significant challenge is on how to contain compliance costs by simplifying the multiplicity of overlapping regulators and any other competent authorities. One way of achieving this is to foster greater coordination among the different authorities, both at level 1 and 2 of the regulatory and supervisory process, and to minimise national discretion.

3.4 A more general concern: how to make a stricter supervisor a good one

In the long run, increasingly demanding regulation and supervision certainly has positive effects; in the short run, it may produce negative externalities, if entailing excessive requirements. It may incentivise regulatory arbitrage and the shift of activities to non-regulated sectors (thus, favouring the re-emergence of shadow banking), or it may lead banks to become overly risk-averse, thus dampening credit supply.[22]

We aim to expand on the second concern.

Indeed, the ultimate goal of a sounder banking system should be the promotion of economic growth, thanks to a more efficient allocation of financial resources. Understanding whether, and the extent to which, stricter rules translate into greater economic growth is a relevant and not trivial question that deserves further investigation.

Specifically, ever-increasing capital requirements may come at the risk of undermining banks' lending capacity, at least in the short term if higher capital requirements are achieved mainly by deleveraging and reducing risk-weighted assets, rather than by issuing new capital.[23]

Some initiatives taken in view of the most desirable goal of reducing legacy assets may also have unclear or unintended effects. Guidelines on NPLs solicit banks to reduce legacy assets and, *pari passu*, increase coverage ratios. Although not binding, these are supervisory expectations that banks will be strongly encouraged to follow. The point is that NPLs are an aggregate, comprising contracts with different intrinsic quality. Banks might have little incentives to provide funds to "unlikely to pay" borrowers, as new funds would mechanically increase the stock of NPLs, even if providing fresh

[19] An example in this respect is the different approach on bank provisioning in the ECB final addendum relative to the EC's proposal, both released as of March 2018 that raised concerns and created confusions among banks.

[20] The current legal basis of single supervision in Europe is a three-tiered system that includes European norms directly applicable to banks; provisions established by European directives that need to be transposed into national law; and provisions that are purely national. This setup leaves ample room for national variations and rulings, which create an uneven playing field across jurisdictions. Important areas where harmonisation is lacking include bank authorisation and licence withdrawals, fit and proper assessments, and the imposition of a moratorium for banks in crisis (Angeloni, 2018).

[21] To this end, "the duplication or inappropriate allocation of tasks should be avoided, since this could blur the responsibilities of the respective authorities, thereby rendering the system less effective as a whole" (ECB 2018b).

[22] Interestingly, in mapping the key risk drivers affecting the euro area banking system over the next two-three years, the SSM has included the risk of reaction to regulation. Specifically, the ECB recognises that tighter regulation in the short term can excessively challenge banks' profitability and impose risks on the banking sector, such as banks failing adapt on time or postponing strategic decisions. ECB (2019).

[23] Angeloni (2018) claims that bank capital was raised mainly through "genuine capital increase" rather than deleverage and credit crunch. Empirical evidence points to opposite conclusions (see Gropp et al. 2017; Eber and Minoiu 2016 among others).

resources might be the proper strategy to favour the recovery of the troubled borrowers. To keep the coverage ratio unchanged, the newly originated loan would entail a cost of credit in terms of provisions. A potential effect could be that of refraining banks to make new loans to borrowers that, on the contrary, may be worth financing.

Similarly, requiring higher coverage ratio, while desirable *per se*, may place an excessive burden (especially on less capitalised or less profitable banks) that may result in reduced credit supply. [24] There may be also country specificities that can explain, and even justify, discrepancies of coverage ratios across banks, over and beyond bank (or loan) specific characteristics (see Bruno and Carletti, 2017).

How to enhance supervision without undermining bank lending?

One way of doing it is to recognize more explicitly the potential limits of the "one-size-fits-all" approach in order not to impose excessively restrictive requirements. Pillar 2 requirements have the objective of taking into account bank specificities in terms, for example, of business models. However, the lack of clarity on these assessments and the lack of disclosure of their results makes it difficult to judge the appropriateness of the supervisory decisions.

The request of more bank specific supervisory requirements does not contradict the goal of having more harmonised supervision. We welcome a unified supervisory approach and we appreciate that some level of supervisory discretion is inevitable. What we strive for is more transparency and thus, greater accountability of the supervisory process, so as to improve the predictability of the outcomes and reduce uncertainty. This would also facilitate more robust empirical research aimed at informing regulators and supervisors on the effects of their actions.

[24] Moreover, there is not so clear-cut evidence that NPLs impede lending or that higher coverage ratios shield bank lending at the point that high coverage ratio banks make more loans than less covered banks. See Bruno and Marino (2018) in this respect.

4. CONCLUSIONS AND EXEMPLARY QUESTIONS

The SSM has been one of the main policy responses to the disruption in the European economic and financial system in the aftermath of the global financial and the euro sovereign debt crisis. After five years since its inception, the assessment of the European single supervisor's activity is overall positive: supervised banks are better capitalised and have cleaner and more transparent balance sheets; the financial system is less fragmented and the banking supervision appears more consistent.

Yet, we have provided a critical view of some supervisory actions, with particular emphasis on measures meant to (1) improve capitalisation and rebuild trust in risk based regulatory capital ratios; (2) resolve NPLs, a supervisory priority due to the large amount of legacy assets held by European banks. We have also outlined the relevance of asset quality reviews and stress tests as multitasker tools to achieve a wide range of desirable objectives.

We have also discussed next steps to take in order to enhance the supervisory framework. Specifically, we identify the need for more determined and decisive actions in the following areas:

- Financial integration: the European supervisor could take into greater consideration the objective of promoting financial integration. There are various ways to achieve this. First, the supervisor may promote more incisive measures to loosen the sovereign-bank vicious circle. Enhancing banks' robustness through larger capital buffers and better asset quality is indeed a way to alleviate one of the channels giving rise to the nexus. In addition, the supervisor may take measures to facilitate more intense cross-border consolidation as a further way to help reduce financial fragmentation. In this respect, the European supervisor may promote the removal of unmotivated obstacles raised by national authorities.
- Transparency and accountability: the European banking supervisor should ensure consistent disclosure of SREP results and clarify how stress test results inform SREP. In line with EBA's practices, ECB stress test results at the bank level should be also disclosed. The process behind the decision of declaring a bank "failing or likely to fail" also requires greater openness, to the benefit of all market participants (including banks' depositors). Overall, more disclosure on supervisory decisions can help bank stakeholders to assess supervisory actions and favour more robust empirical research to better inform supervisory actions.
- The costs of a complex and demanding supervisory infrastructure: a major challenge for the future is to limit unnecessary complexity and burden for the supervised entities. The most important cost of regulation/supervision is to comply with it: tighter regulation may challenge banks' profitability and limit banks' business developments. The consequences of excessive supervisory costs may range from transferring activities to shadow banking entities and encouraging regulatory arbitrage to promoting excessively prudent banks. Supervisory decisions that take into greater consideration bank or country specific risks may reduce the drawbacks of an overly demanding supervision.
- The very goal of banking supervision. The first term of the single supervisor has been characterised by initiatives to restore trust in the aftermath of the financial and euro debt crises by rebuilding stronger and more resilient institutions. Greater harmonisation has also favoured a more level playing field. Another important challenge for the future is placing more emphasis on the real effects of supervisory actions, so as to reduce the risk that banks react to stricter regulation by contracting lending.

In light of the above considerations, exemplary questions to raise in the Q&A part of the hearing are the following:

(1) How to credibly contain the cost of an overly demanding and complex supervisory infrastructure, also having in mind that banks in Europe are not as competitive and profitable

as their international peers? Is the supervisory dialogue enough to help reduce excessive requirements and compliance costs, in particular for healthier banks?

(2) To what extent can a more intense cross border consolidation help mitigate the problems of overcapacity and low margins in the European banking industry? What type of cross-border consolidation should be promoted, also having in mind that both "too big to fail" and "too small to succeed" banks are not desirable?

(3) What is the rationale behind the decision of not disclosing bank-level ECB stress test and SREP results? Related to this, are there ways to create a better link (and disclose it) between the results of the stress tests and following supervisory actions, as, for example, as done in the US?

(4) Which are the supervisory tools currently available to limit the bank-sovereign loop, beyond requiring banks to become more resilient through higher capitalisation and better asset quality?

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Compared to the pre-SSM period, the European banking system today appears healthier and sounder. Capital ratios and asset quality have steadily improved. Capital ratios have become not only higher but also more comparable and reliable. Taking stock of these positive outcomes, the challenges for supervision in the future is to be able to foster financial integration and reconcile harmonisation with greater consideration of bank and country specificities. In this respect, we see an approach encouraging supervisory dialogue positively. Furthermore, supervisory requirements need to be simple, clear, and possibly stable to reduce uncertainty and the compliance costs of an overly demanding supervision. We also look forward to a model that does not let out of sight the very final goal of good supervision, that is favouring economic growth through a healthier and sounder banking system. Overall, we encourage more nuanced and less 'one-size-fits-all' supervisory decisions, supported by stronger empirical research to reduce the risk of unintended effects.This document was provided by the Economic Governance Support Unit at the request of the ECON Committee.

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