Stepping Boldly into a new Decade: European Banking Supervision at Ten

Joint analysis and recommendations from the Association of German Banks (BdB) and KPMG

Introduction

2024 is a pivotal moment for Europe. After weathering a series of crisis – health, economic, geopolitical – in recent years, the EU is now turning its focus squarely to promoting economic growth and competitiveness. Newly re-appointed European Commission (EC) President Ursula von der Leyen has made a revived European economy central to her vision of a Europe that can define its future in a changing, uncertain world.[1] Drawing on the recommendations of former Italian Prime Minister and European Central Bank (ECB) President Mario Draghi,[2] von der Leyen has made promoting European prosperity and competitiveness the number one priority for her incoming Commission.

2024 also marks 10 years of the EU Single Supervisory Mechanism (SSM), created in response to the global financial crisis and the subsequent Eurozone sovereign debt crisis. In November 2014 the ECB formally took over direct supervision of the largest and most systemically important banks in the Euro area, designated as 'Significant Institutions' (SIs). This constituted the first pillar of the European Banking Union, alongside the creation of the Single Resolution Mechanism (SRM) to manage bank failures and the still-to-be-implemented European Deposit Insurance Scheme (EDIS).

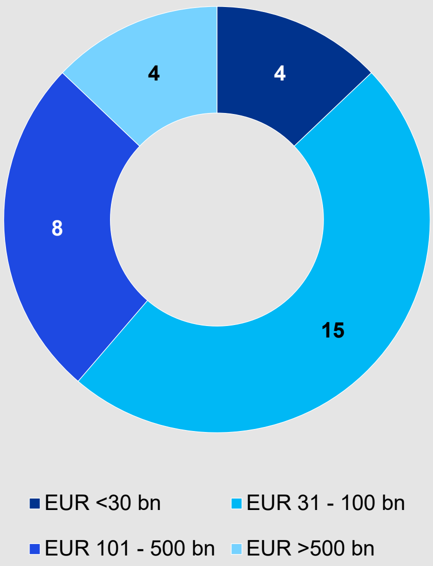
This makes 2024 a doubly appropriate moment to reflect on the SSM's achievements in its first decade, and to consider priorities for the years ahead. This paper offers a contribution to that debate. It is informed by the results of a survey of ECB-supervised banks conducted in the summer of 2024 by the Association of German Banks (BdB), KPMG and the Center for Financial Studies (CFS) at the Goethe University, Frankfurt. The survey investigated banks' assessment of SSM supervision's strengths, weaknesses and priorities for reform. This paper presents the key findings of that survey and offers recommendations for the future of SSM supervisory policy.

[1] Statement at the European Parliament Plenary by President Ursula von der Leyen, candidate for a second mandate 2024-2029, 18 July 2024. https://neighbourhood-enlargement.ec.europa.eu/news/statement-european-parliament-plenary-president-ursula-von-der-leyen-candidate-second-mandate-2024-2024-07-18_en (accessed 25 November 2024)
See also Ursula von der Leyen: Europe's Choice: Political Guidelines for the next European Commission 2024−2029, 18 July 2024. https://commission.europa.eu/document/download/e6cd4328-673c-4e7a-8683-f63ffb2cf648_en?filename=Political%20Guidelines%202024-2029_EN.pdf (accessed 25 November 2024)
[2] The future of European competitiveness: Report by Mario Draghi, 9 September 2024. https://commission.europa.eu/topics/strengthening-european-competitiveness/eu-competitiveness-looking-ahead_en (accessed 25 November 2024)

SSM Supervision Survey overview
Over 100 ECB-supervised 'Significant Institutions' (SIs) were invited to participate on a voluntary basis in the BdB-KPMG-CFS SSM Supervision survey.

31 banks from 10 (out of 21) SSM countries participated, accounting for around 30% of total SI assets. Survey respondents include banks across the full range of business models, including universal, corporate / wholesale and retail lenders. Respondents similarly spanned a wide range of bank sizes, with the majority being mid-sized (with total assets of €30-500 bn)

Figure 1: Distribution of respondent banks by total assets



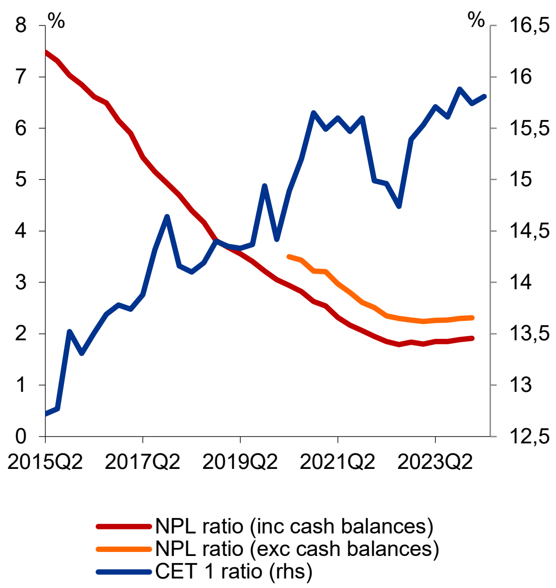
Source: BdB, KPMG in Germany, CFS, 2024

Due to the voluntary nature of banks' participation the survey sample could not be strictly representative. In particular the sample skews geographically in favour of banks located or headquartered in Germany (making up 48% (15) of all respondents, against 22% of all SIs and 29% of Euro area GDP). Nonetheless the survey results provide a useful 'pulse check' of banks' assessment of SSM supervision and points to some general conclusions and lessons for the future.

Looking Back: Reviewing the SSM's first decade

Significant success…
An assessment of the SSM's first 10 years must begin by acknowledging its real and significant successes. Created in the aftermath of the great financial crisis of 2008-09 and the subsequent Eurozone sovereign debt crisis, the SSM has overseen the stabilization and recovery of the European banking system. Particularly notable is the repair of European banks' balance sheets since the start of ECB direct supervision. Since 2015, capital ratios have increased by around 50%. Non-performing loans (NPLs), which in some Euro area countries accounting for around half of all loans at the height of the crisis, have also fallen sharply (Figure 2).

Figure 2: Eurozone bank balance sheet repair
Capital (CET 1) and Non-Performing Loan (NPL) ratios at Euro area Significant Institutions since 2015



Source: ECB

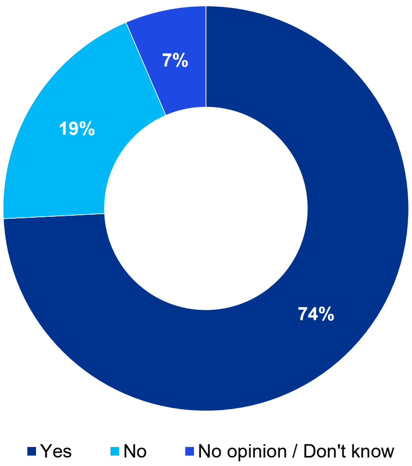
Under ECB supervision, the most significant European banks have thus successfully repaired their balance sheets, leaving them substantially safer and more resilient than a decade ago.

During this process the ECB has successfully established itself – and the SSM at whose centre it sits – as a leading global supervisor.

Reflecting this, all of the banks responding to our survey agreed that the establishment of the SSM has improved the overall quality of banking supervision in Europe. A large majority also believe that the ECB effectively identifies and focuses on the key risks and vulnerabilities of the banks it supervises (Figure 3).

Figure 3: Focus on key risks

Do you think that the SSM is sufficiently focused on key risks and vulnerabilities of the institutions under supervision?



Source: BdB, KPMG in Germany, CFS, 2024

This is consistent with the widely shared perception in the banking industry that SSM supervision is more effective – and more intrusive – than supervision by national authorities before 2014.

…but at a significant cost…

This higher quality of supervision has, however, come at a material costs to European banks. This was clearly reflected in our survey. All bank respondents said that the compliance cost of supervision had increased, and the great majority (87%) considered the cost to have significantly increased (Figure 4).

Figure 4: Evolving costs of SSM supervision

The scope and intensity of the SSM/SREP have increased over time. What impact have you experienced with regard to the bank-internal costs associated with the SREP since its inception in 2014?

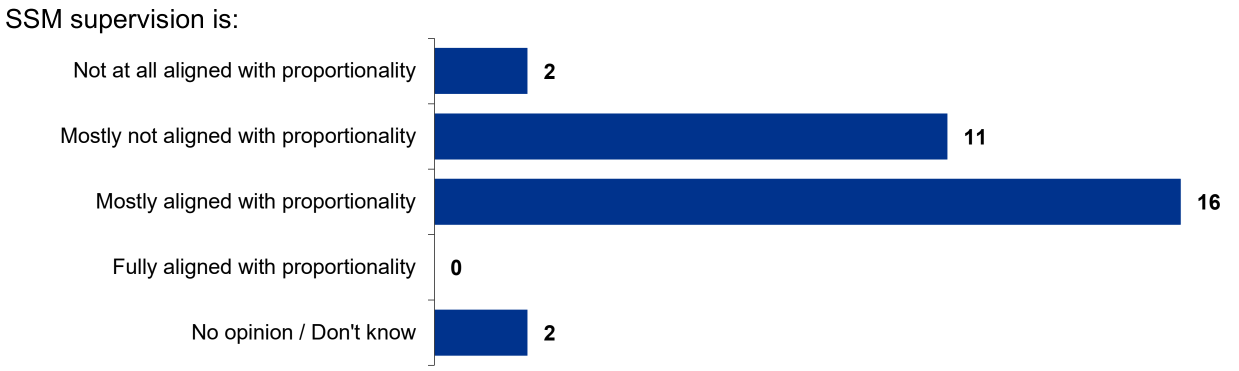
The costs have:

Source: BdB, KPMG in Germany, CFS, 2024

Meanwhile almost half of banks surveyed said that SSM supervision is not proportionate with regard to bank size, risk profile and/or business model (Figure 5).

Figure 5: Proportionality of SSM supervision

A major principle of the SSM/SREP is "proportionality" with regard to size, risk profile and business model to preserve financial stability and prudential soundness. Based on your practical experience: Is the SREP overall aligned with the principle of proportionality?



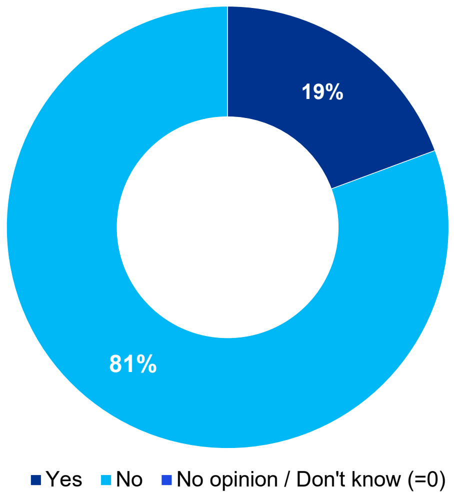
Source: BdB, KPMG in Germany, CFS, 2024

Banks generally cite three main aspects of ECB supervisory practice as driving the high and disproportionate cost of supervision. First is the imposition by supervisors of requirements that go beyond those set out in EU legislation or international standards. The ECB's approach to Leveraged Finance transactions and to provisioning under the International Financial Reporting Standard 9 (IFRS 9) accounting standard are frequently cited as examples. The ECB has also been criticized for implementing some requirements before they have been enacted in legislation (and before their final legal form is known), such as obligations concerning climate risk management and climate transition plans.

The second major driver of supervisory cost identified by banks is the high volume of data that supervisors require them to provide. Banks argue that ECB data requests often go beyond the framework set out by European Banking Authority (EBA) standards. They also cite frequent duplication between data requests from different ECB teams or from the ECB and national supervisors. As assembling and supplying the detailed information required is time- and resource-intensive, data requests represent a significant supervisory cost, in particular for smaller banks. Indeed, the overwhelming majority of respondents to our survey believed that the costs of complying with ECB data requests are not justified by the financial stability or other benefits that these exercises bring (Figure 6).

Figure 6: Costs and Benefits of data requests

The scope of SSM/SREP information requirements has significantly increased over time. Do you think that the growing data requirements are justified from a cost-benefit perspective?



Source: BdB, KPMG in Germany, CFS, 2024

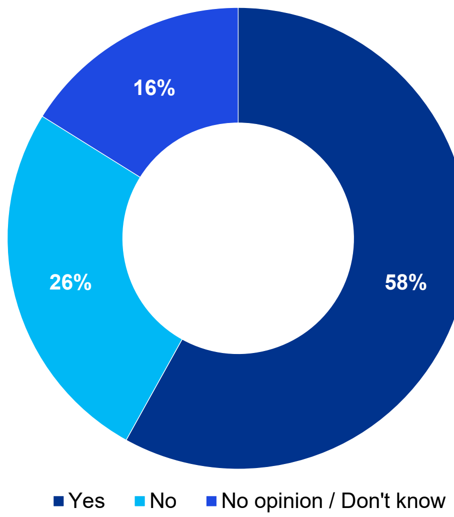
Third, banks note the large number of supervisory investigations (on- and off-site inspections, deep dives and thematic or targeted reviews). These examinations often run for several weeks and can occupy dozens of bank staff full-time in preparing for and responding to supervisors' extensive and detailed requests for information. They thus constitute a substantial and costly supervisory burden even where no or only limited remedial actions are subsequently required. Similarly to data requests, banks question whether the high volume of supervisory examinations (in 2023 the ECB conducted 178 on-site inspections, 83 internal model inspections and an undisclosed number of off-site inspections, together resulting in the imposition of 5,465 supervisory measures)[3] is justified, and whether inspection programmes are sufficiently sensitive to differences in firm size and risk profile. They also cite several instances of multiple overlapping investigations initiated simultaneously by different parts of the ECB, with Joint Supervisory Teams (JSTs) and horizontal teams investigating similar issues without apparent coordination.

…with implications for European growth and competitiveness

The high cost of European banking supervision matters because it could limit banks' ability to finance the wider economy, their core social function. The Draghi report highlighted the strong relationship between banks' profitability and their capacity to provide risk capital. All else equal, more costly supervision diverts resources (human and financial) away from lending. This could weigh on the dynamism and competitiveness of the European economy. Indeed, a majority (58%) of respondents to our survey affirmed that the creation of the SSM had created a competitive disadvantage for Eurozone banks (Figure 7).

Figure 7: Impact on Competitiveness

Do you think that the SSM puts European banks covered by the SSM at a competitive disadvantage to banks outside the scope of the SSM?



Source: BdB, KPMG in Germany, CFS, 2024

[3] ECB Annual Report on supervisory activities 2023, 21 March 2024. https://www.bankingsupervision.europa.eu/press/publications/annual-report/html/ssm.ar2023~2def923d71.en.html (accessed 25 November 2024)

Looking Forward: Priorities for the next decade

The tenth anniversary of the SSM is an opportune moment to reflect on its record so far, and to draw out the key lessons for the drive to continuously improve the quality and effectiveness of European banking supervision. On the basis of our analysis and the results of our survey, we identify two overarching objectives. In our view, the SSM must:

- continue to **safeguard financial stability**, preserving the successes of its first decade; and
- strive to **reduce compliance burdens** on banks, enabling them to thrive in the longer term.

Recommendations for reform

To achieve these goals we offer three key recommendations for the SSM in the years ahead:

1. Growth Objective
2. Risk-Based Proportionality
3. Effective Communication

Recommendation 1: Growth Objective

European leaders have made promoting economic growth their highest policy priority. As EC President von der Leyen has said, "there is wide consensus that [growth and competitiveness] must be at the top of our agenda, and at the heart of our action."[4] As ECB leaders have recognized in other contexts, the EU Treaties require all EU institutions, and the ECB specifically, to support the wider economic policies of the EU.[5]

ECB banking supervision should therefore **formally include the promotion of European economic growth in its formal objectives**, alongside ensuring the safety and soundness of European banks.

ECB Supervisory Board Chair Claudia Buch has rightly noted that financial stability is a necessary condition for sustainable growth.[6] On this basis she and other ECB leaders have argued against relaxing regulatory or supervisory standards. A growth objective would not do this. Rather, it would enshrine the requirement that supervisors fully consider the impact of their policies and actions on banks and their ability to continue financing the wider economy. This would ensure that proposed new supervisory requirements or interventions are rigorously tested to ensure that their benefits in terms of financial stability are sufficient to justify the cost they impose.

Recommendation 2: Risk-Based Proportionality

Rigorous testing of the costs and benefits would reinforce the principle of proportionality, by taking account of the different impact of a particular policy on banks of different size and business model. Some supervisory interventions – such as detailed data requests or inspections on a given topic – may be entirely appropriate for a large systemic or universal bank but yield little benefit (while imposing substantial costs) for firms that are smaller or whose business models pose lower risks to financial stability.

The ECB should therefore commit to **greater risk-based proportionality** in its supervision, and adapt its supervisory activities according to banks' size and business model.

More risk-based proportionate supervision will allow supervisors to focus their efforts and resources more on the areas of greatest risk. This would strengthen financial stability, while reducing unnecessary burdens. Delivering greater risk-based proportionality will likely require more discretion for Joint Supervisory Teams (JSTs) to tailor their examination and review programmes, and greater coordination between JSTs and horizontal policy teams over industry-wide data requests or thematic investigations.

Recommendation 3: Effective Communication

Supervisors and banks have a common goal of ensuring that banks remain safe, sound and compliant with regulatory requirements. Clear, effective and trustful communication between them is essential to achieving that goal. Yet many of the ECB's internal standards for assessing banks and methods for determining requirements remain opaque. In particular how the ECB scores firms under the Supervisory Review and Evaluation

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[4] Statement by President von der Leyen at the joint press conference with Mario Draghi on the report on the future of EU competitiveness, 9 September 2024. https://ec.europa.eu/commission/presscorner/detail/en/STATEMENT_24_4601 (accessed 25 November 2024)

[5] 'Nature-related risk: legal implications for central banks, supervisors and financial institutions', speech by Frank Elderson, Member of the ECB Executive Board and Vice-Chair of the ECB Supervisory Board, 6 September 2024. https://www.ecb.europa.eu/press/key/date/2024/html/ecb.sp240906~54436f6891.en.html (accessed 25 November 2024)

[6] 'Building a resilient future: how Europe's financial stability fosters growth and competitiveness', speech by Claudia Buch, Chair of the ECB Supervisory Board, 12 September 2024. https://www.bankingsupervision.europa.eu/press/speeches/date/2024/html/ssm.sp240912~72bbc94da5.en.html (accessed 25 November 2024)

Process (SREP) – which in turn drives supervisory decisions on Pillar 2 requirements and guidance (P2R and P2G) for capital and liquidity buffers – is unclear. This makes it harder for banks to understand what they need to do to meet supervisory expectations.

In addition, banks undergoing supervisory examinations often have little opportunity to explain the particularities of their businesses and the rationale for their existing practices to supervisors. As a result firms frequently find themselves receiving supervisory findings that they believe do not reflect a full understanding of their business or take account of all the specific circumstances.

The ECB should therefore **improve communication with banks**, by both disclosing more details of its assessment standards and processes, and by engaging in more extensive bilateral dialogue with banks at all stages of supervisory review.

Supervisory enforcement measures, including capital add-ons and financial penalties, are a necessary tool to deter willful noncompliance. As excessive use of sanctions can undermine cooperation, however, they should always be treated as a last resort.

Banks' priorities for reform

These recommendations are also borne out by responses to our survey, in which banks identified revisiting the costs and benefits of supervisory activities, more flexible supervision and enhanced communication as the most important priorities for improving supervision (Figure 8).

Implementing these recommendations, we believe, will allow European banking supervision to become more efficient, more effective and more supportive of economic growth in Europe.

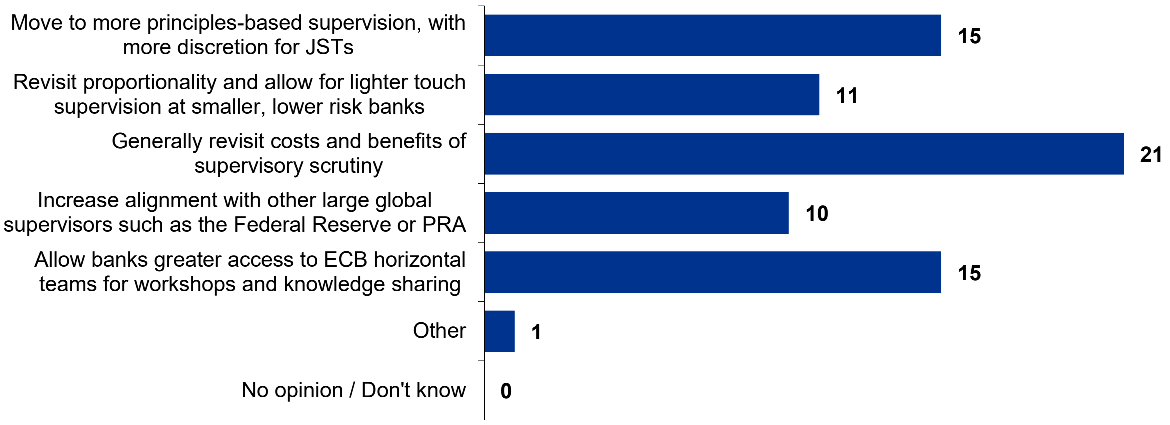
ECB SREP Reforms

To its credit, the ECB has recognized the scope and need for further improvement in its supervision. In May 2024, Supervisory Board Chair Buch unveiled a package of reforms to the Supervisory Review and Evaluation Process (SREP) that included a more risk-based approach, greater integration of supervisory activities and enhanced communications with banks.[7]

While full details of these reforms have not been made public, they appear broadly consistent with the recommendations we set out in this paper. It remains to be seen, however, how far they will lead to real change in supervisors' priorities and day-to-day interactions with banks. We therefore urge the ECB to be bold in taking forward reform of the SREP, in line with our recommendations.

Figure 8: Priorities for improving SSM supervision

To improve supervision in the future, which of the following areas should be the highest priority for the SSM?



NB Respondents could choose multiple answers.

Source: BdB, KPMG in Germany, CFS, 2024

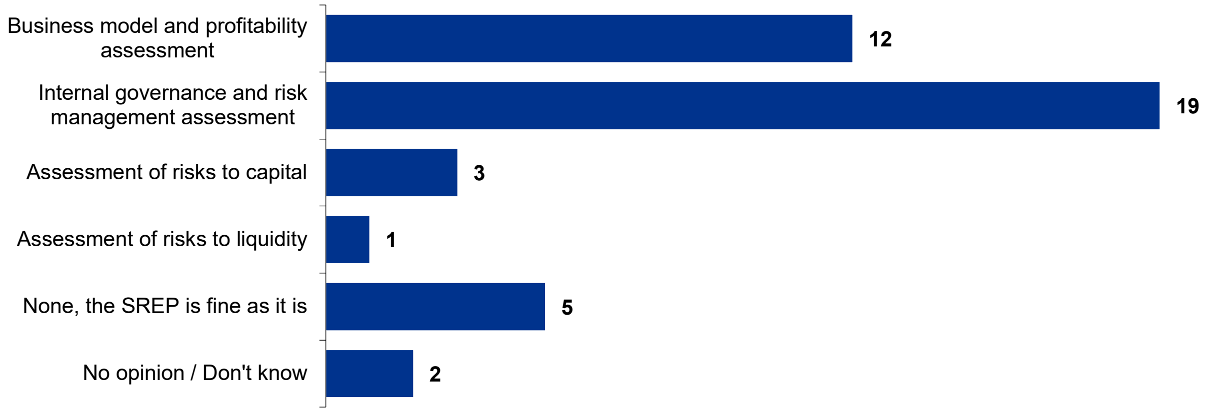
[7] 'Reforming the SREP: an important milestone towards more efficient and effective supervision in a new risk environment', ECB Supervision Blog post by Claudia Buch, 28 May 2024. https://www.bankingsupervision.europa.eu/press/blog/2024/html/ssm.blog240528~6f5a4f76c5.en.html (accessed 25 November 2024)

In particular we note that in response to our survey banks highlighted the Business Model and Internal Governance and Risk Management elements of the SREP as most in need of improvement (Figure 9).

These are the SREP elements where banks perceive a tendency for supervisors to seek to 'micro-manage' their businesses, and where ECB expectations can be least clear. We urge the ECB to take account of these concerns as it works to reform and improve the SREP.

Figure 9: Priorities for SREP Reform

Which element of the SREP do you think stands most in need of reform?



NB Respondents could choose multiple answers

Source: BdB, KPMG in Germany, CFS, 2024

Conclusion

European banking supervision embarks on its second decade from a position of strength. Since its beginning in 2014 the SSM has materially improved the quality of supervision and has successfully overseen the stabilisation and repair of the European banking system. In doing so the ECB, set at the centre of the SSM, has established itself as a leading global supervisor.

The ECB should build on that achievement in the years ahead. By enhancing its supervisory practices – and adopting the recommendations set out in this paper – the ECB can continue to maintain financial stability in Europe while also supporting European banks' ongoing viability and enabling them to continue financing investment and innovation in Europe. In this way the ECB can make a significant contribution to the new EU drive to promote European growth and prosperity.

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