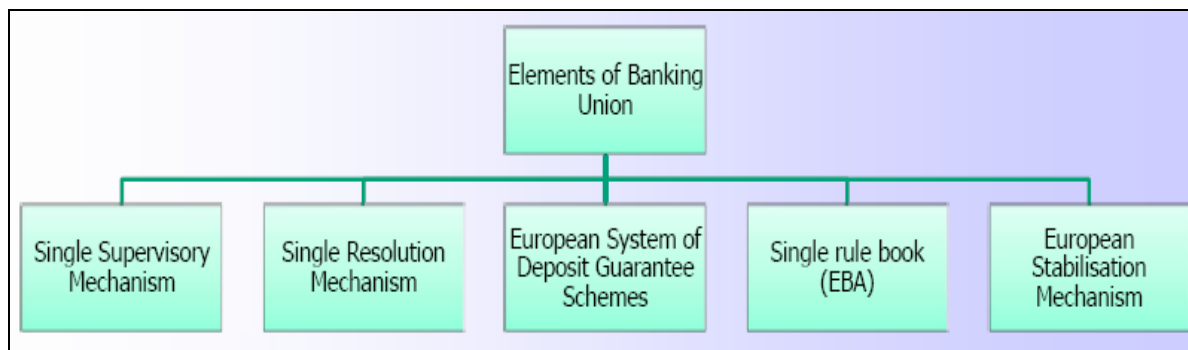


## THE SINGLE SUPERVISORY MECHANISM – A NEW AGE OF PRUDENTIAL SUPERVISION IN THE EURO AREA

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**Introduction.** Next Tuesday, at the 4th of November, the most important pillar of the European banking union is set to become a reality: the Single Supervisory Mechanism (SSM), which places the European Central Bank as the central prudential supervisor of financial institutions in the Euro area<sup>2</sup>. The second pillar of the European banking union – the Single Resolution Mechanism (SRM), which aims to ensure an orderly resolution of failing banks with minimal costs for taxpayers, will probably start in 2016. The third pillar – a joint European deposit guarantee scheme – is still on the waiting-list, at least to the year 2018. The single rulebook is the foundation of the banking union and can be regarded as the fourth element. It consists of a set of legislative texts that all financial institutions (including about 8.300 banks) in the EU must comply with. Last but not least, some authors consider the European Stabilisation Mechanism as fifth element of the banking union, because the ESM provides financial assistance to Euro area member states to safeguard the financial stability (see picture).



Source: Dietz, Thomas: Der Single Supervisory Mechanism – Aufbau und Aufgaben der supranationalen Bankaufsichtsbehörde bei der EZB, in: Roland Eller, Markus Reif u.a. (ed.): Jahrbuch Treasury und Private Banking 2014, Potsdam 2013, p. 94.

The driving force for the banking union was the Euro area crisis, in which many banks were found to be undercapitalized and short of liquidity. In many European countries private debts were transferred to sovereign debt as a result of bank bailouts. The European banking union was designed in 2012 to integrate and stabilize the banking industry in the European Union. Although, not all EU member states are participating in the SSM, since the EU treaties give the ECB only jurisdiction over banks in the Euro

<sup>1</sup> Disclaimer: Any assessments given in this speech do not necessarily represent official positions of Deutsche Bundesbank.

<sup>2</sup> For more detailed information see Deutsche Bundesbank: Progress towards a European banking union, in: Annual Report 2013, p. 21 – 38, Deutsche Bundesbank: Europe's new recovery and resolution regime for credit institutions, Monthly Report June 2014, p. 31 – 55 (see [www.bundesbank.de](http://www.bundesbank.de)) and Dietz, Thomas: On the Single Supervisory Mechanism, Journal of Risk Management in Financial Institutions, Vol. 7 (2014), No. 3, p. 221 - 225.

area. However, the SSM allows for non-Euro area states to enter into a close cooperation agreement with the ECB transferring supervisory powers for their banks.

It is certainly not an exaggeration to classify the European banking union as the most ambitious European project since the start of the Euro. It is a mission that is as necessary as it is logical, because a single monetary policy calls for integrated financial markets and integrated supervision. The SSM as a core feature of the banking union reconciles control and liability with respect to cross-border banking supervision. Moreover, the SSM minimizes non-tariff-based restrictions for the free movement of financial services in the euro area and fosters a level playing field for all financial institutions. Since the day-to-day micro-prudential supervision for “significant” (large) institutions is done by a supranational banking supervision authority within the ECB, the “home-bias” of national supervisors will be eliminated. The progress which has been achieved in the SSM is described in the following chapters.

An overview of the SSM preparations

Much has been done in the last 12 months to prepare the start of the Single Supervisory Mechanism on the 4th of November. The biggest workload was caused by the comprehensive assessment, in which a total of 128 European banks was subject to a thorough “health check” in order to provide maximum transparency and strengthen confidence among market players. The comprehensive assessment is based on balance sheet data from December 2013 and consists of two important components:<sup>3</sup>

1 The *asset quality review* (AQR). Using a medical analogy, the AQR can be compared with an X-ray image – it allows supervisors to find unpleasant surprises that might be hiding on bank balance sheets. The on-site-inspections of the AQR focused on credit and market exposures, collateral valuations, classifications of non-performing loans and provisioning, looking both at individual exposures and aggregate portfolios. The resulting data were used to find out whether there is any need for valuation adjustments and consequently depreciations.

2 The *stress test*. This exercise is rather looking like a “cardiac stress test” for banks. It tries to give a prediction for the patient’s health in the future by assessing the ability of a bank’s shock-absorption capacity under external shocks. In the stress test – which was conducted in collaboration with the European Banking Authority – institutions need to simulate two macroeconomic scenarios: a baseline scenario, which is largely consistent with the European Commission’s 2014 winter forecast and an adverse scenario simulating a severe economic downturn. The adverse scenario assumes a recession with GDP shrinking by 0.7% in 2014 and by 1.4% in 2015, followed by zero growth in 2016, accompanied by rising unemployment, falling prices in the financial and real estate markets, an increase in general interest rate levels as well as growing European sovereign bond spreads.

The last step of the comprehensive assessment combined the AQR with the stress test results. The final outcome of the comprehensive assessment was publicised only some days ago at the ECB website. Banks facing a capital shortfall are required to submit recapitalization plans within two weeks. Capital shortfalls should be covered within 6 month for those identified in the AQR or the baseline stress test scenario, and within 9 months for those identified in the adverse stress test scenario. The most important sources for additional funding are the shareholders of the bank. If private funding is not able to refill the identified capital shortfalls, it is up to the home state of a bank to provide support. As a last option the government can recapitalise banks, issue guarantees or mitigate risks. However, for an evaluation of the published capital shortfalls calculated on the basis of balance sheet information from Dec. 2013, it is necessary to pay attention to the capital measures which have been taken in 2014, since several banks have already strengthened their capital base in recent months.

### **The new age of prudential supervision after the 4th of November**

Under the SSM the ECB will take on direct responsibility for supervising the 120 most significant euro-area banks. The main tasks of the SSM are

- Granting and revoking licenses for conducting financial services
- Information gathering and on-site inspections
- Supervisory measures (fines, etc) against institutions and its managers
- Approving of qualified holdings (exceeding 10 % of its capital or voting rights)
- Conducting day-to-day supervision with the help of joint supervisory teams

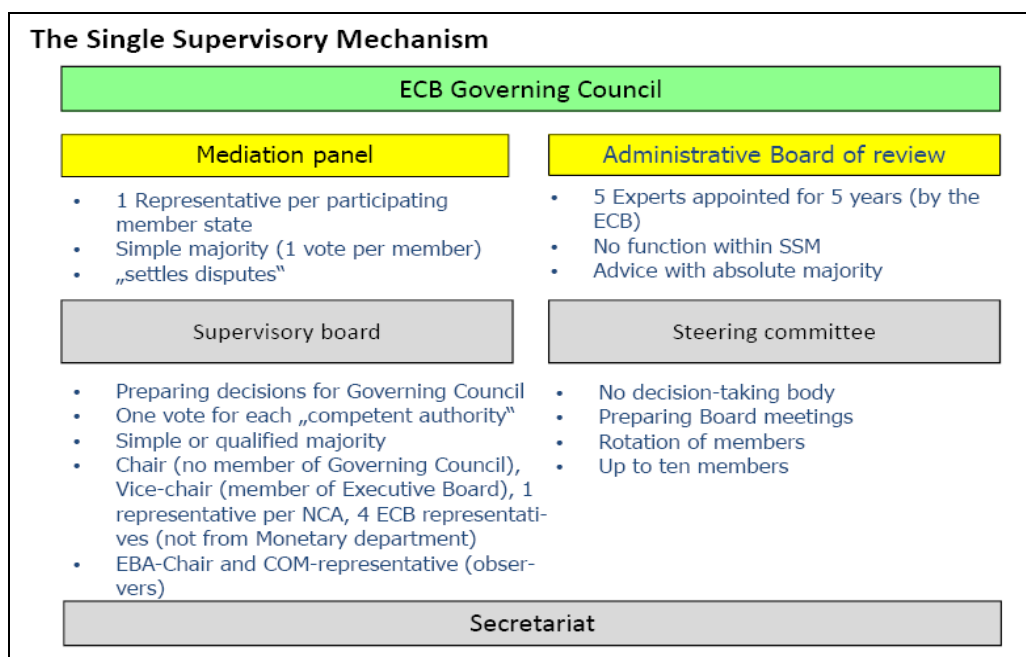
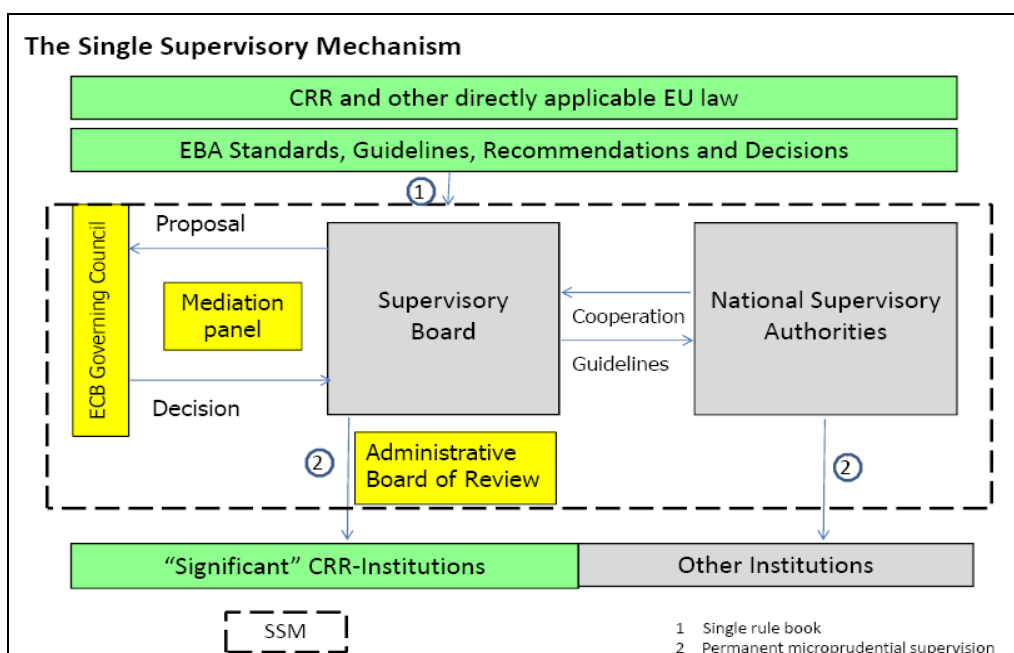
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<sup>3</sup> For more details see Nouy, Danièle: State of play of the Comprehensive Assessment and the overall SSM preparations, Bundesbank Symposium, 9 July 2014, p. 4 – 8 (AQR) and 9 – 14 (stress test) at [www.bundesbank.de](http://www.bundesbank.de) and ECB: SSM Quarterly Report 2014/2, p. 19 – 23 (publicized at [www.ecb.europa.eu](http://www.ecb.europa.eu)).

What does the SSM mean for the responsibilities of the national supervisory authorities? A closer look to the tasks of the German supervisors, BaFin and Bundesbank, under the SSM may exemplify the new situation:

1. They will continue to directly supervise around 2,000 smaller German banks.
2. The direct supervisory responsibility for the 21 German SSM banks will be handed over to the ECB, while BaFin and Bundesbank will continue to provide the ECB with ongoing supervision.
3. BaFin and Bundesbank will be involved in supervising the 99 foreign SSM banks.

How will the SSM work in practice? The ECB plans to employ around 770 persons in the new supervisory body and another 200 in support functions. The on-going supervision of the SSM banks will pass to joint supervisory teams, headed by an ECB coordinator which should not come from the country in which the supervised bank is headquartered. The joint teams are largely staffed by the national authorities. As a result, BaFin and Bundesbank employees will continue to supervise German SSM banks and ensure that national supervisors' expertise is not lost. The following two pictures illustrate the tasks of the ECB and the national supervisors under the SSM<sup>4</sup>.



<sup>4</sup> See Dombret, Andreas: European banking union: Where do we stand? Press briefing, Frankfurt/M., 23 July 2014.

Source: Dietz, Thomas: Der Single Supervisory Mechanism – Aufbau und Aufgaben der supranationalen Bankaufsichtsbehörde bei der EZB, in: Roland Eller, Markus Reif u.a. (ed.): Jahrbuch Treasury und Private Banking 2014, Potsdam 2013, p. 96, 103.

### **Conclusion**

The Single Supervisory Mechanism, a central pillar of the European banking union, aims to strengthen the stability of the financial system. The banking union and the start of the SSM on the 4<sup>th</sup> of November is a major step towards this objective. However, there is still a lot of work to be done until the Single Resolution Mechanism, another cornerstone of the European banking union, will come into force in 2016.