CEPS POLICY BRIEF

TEN YEARS OF THE SSM:

The past, present and future of banking supervision in the Banking Union

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SUMMARY

European banking supervision will have been operational for ten years come November 2024. The Single Supervisory Mechanism (SSM) has evolved from a start-up to a mature, well-established, and respected supervisor. Harmonised and transparent supervisory practices have been implemented, whilst the European banking sector has proved to be resilient with strong capital and liquidity positions. Nevertheless, whilst acknowledging the progress that has been made, Europe should not rest on its laurels.

As the global financial landscape is continuously evolving, the European framework must naturally also evolve with it. Growing geopolitical tensions, the rise of FinTech and BigTech companies, the ongoing digital transformation, and climate change not only all impact banks but they also add more complexity to the work of supervisors. This is because of the possibility for unexpected and difficult to model events, the creation of new business models, products and services, as well as the emergence of cultural, behavioural and ethical considerations that should also be taken into account.

To address these challenges, supervisors should enhance their competencies, approaches and tools (quantitative and qualitative) to stay ahead of evolving market dynamics and to remain aligned with the rapid evolution of technology and the risks that climate change poses. Equally important, ensuring thorough and efficient supervision requires fostering and strengthening collaboration and information-sharing between all relevant authorities.

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TEN YEARS OF THE SINGLE SUPERVISORY MECHANISM

Although since the 1950s, many regulations affecting commerce in the EU had been harmonised, up until 2013 and the adoption of the Single Supervisory Mechanism (SSM) Regulation, each Member State had its own banking rules, bank regulator and supervisor, and followed its own procedures when a bank within its borders failed or needed to be rescued. However, the weaknesses of such a decentralised approach were starkly revealed in the wake of the Global Financial Crisis and the subsequent sovereign debt crisis that badly hit the euro area.

To address cross-border financial challenges and crises, the EU embarked on a journey of reforms that included the design of the Single Rulebook, the enhancement of the Capital Requirements Directive (CRD) and Regulation (CRR), the introduction of the Bank Recovery and Resolution Directive (BRRD), as well as the Deposit Guarantee Schemes (DGS) Directive.

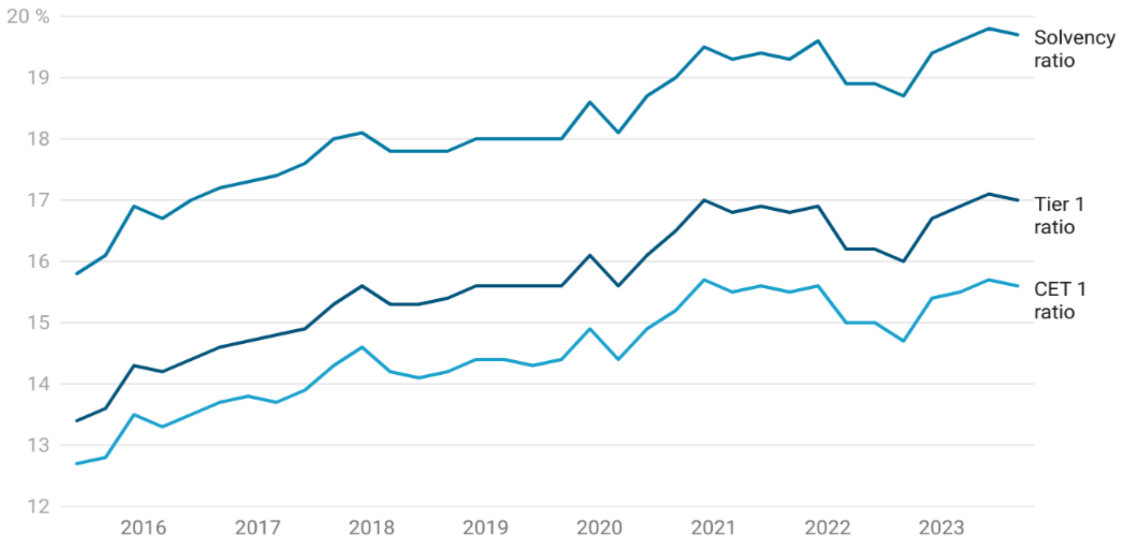
But these were not enough. Proposals for creating an EU Banking Union – to ensure the common implementation of the new banking standards in the eurozone – were brought to the table in mid-2012. It took a severe sovereign debt crisis for Member States to realise that the supervisory competencies of the most significant institutions had to be pooled. Just a couple of years before, the European Supervisory Authorities (ESAs) were created but they were only granted regulatory and not supervisory competencies (indeed, at present, supervision of securities markets and insurance and pension funds remain at national level). In 2014, the Banking Union was created and consisted of three pillars: i) the SSM, which started operating in 2014; ii) the Single Resolution Mechanism (SRM), fully up and running as of 2016; and iii) the European Deposit Insurance Scheme (EDIS), which is still pending with the European Commission's 2015 legislative proposal languishing on Member States' desks.

The SSM marked a major advance in the EU integration process by shifting from highly fragmented national banking supervision systems to a unified European approach. The main objectives of European banking supervision are to ensure the safety and soundness of the European banking system, enhance financial integration and stability, and ensure consistent supervision. Following the creation of the SSM, the European Central Bank (ECB) was entrusted with extensive and direct micro-prudential supervisory powers over the most significant banks in the euro area . At the same time, the ECB was also granted substantial powers to guide and coordinate the prudential supervision of less significant institutions (LSIs) that remained at national level .

Ten years down the line, the European banking sector is strong, banks are safer and sounder, whilst supervision is more uniform and applied in a consistent way, thus ensuring a level playing field, transparency and accountability. The Common Equity Tier

1 (CET1) ratio of significant institutions has increased from 12.7 % in Q2 2015 to 15.6 % in Q3 2023 (see *Figure 1*) and the current liquidity coverage ratio (159 % in Q3 2023) is well above the minimum requirement (100 %).

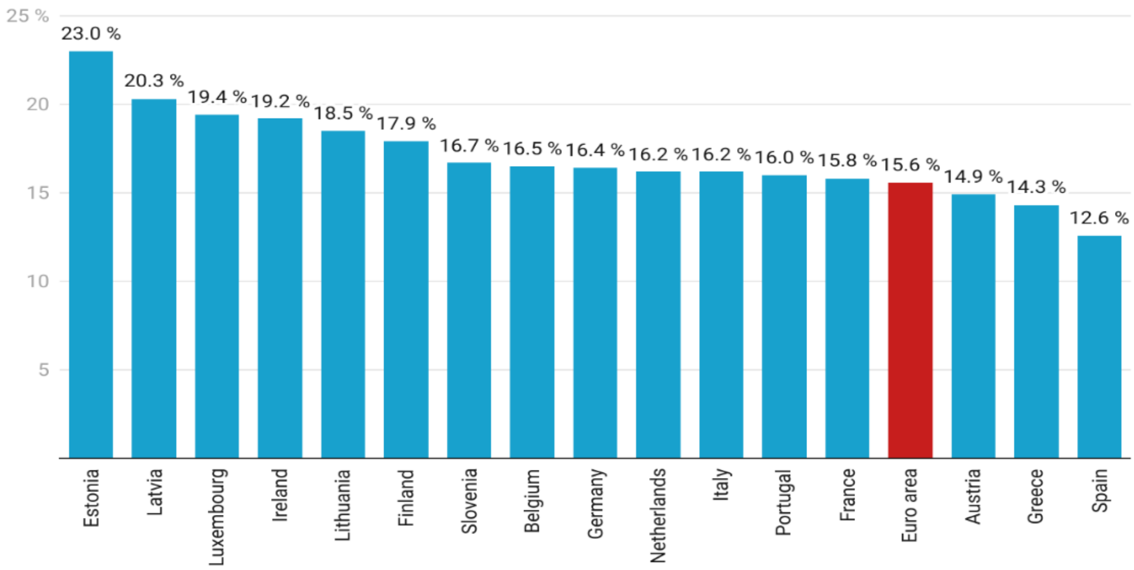
Figure 1. Evolution of significant institutions' solvency ratios between Q2 2015 and Q3 2023



Source: Authors' elaboration based on ECB data. Created with Datawrapper.

There are considerable cross-country differences, however (see *Figure 2*). Estonian and Lithuanian banks have CET ratios well above the euro area average, whilst Greek and Spanish banks have significantly lower ratios. But these discrepancies should be analysed in greater depth, as the aggregate data conceal important details, such as potential differences between large cooperative groups – which are very dominant in some countries – and listed banks.

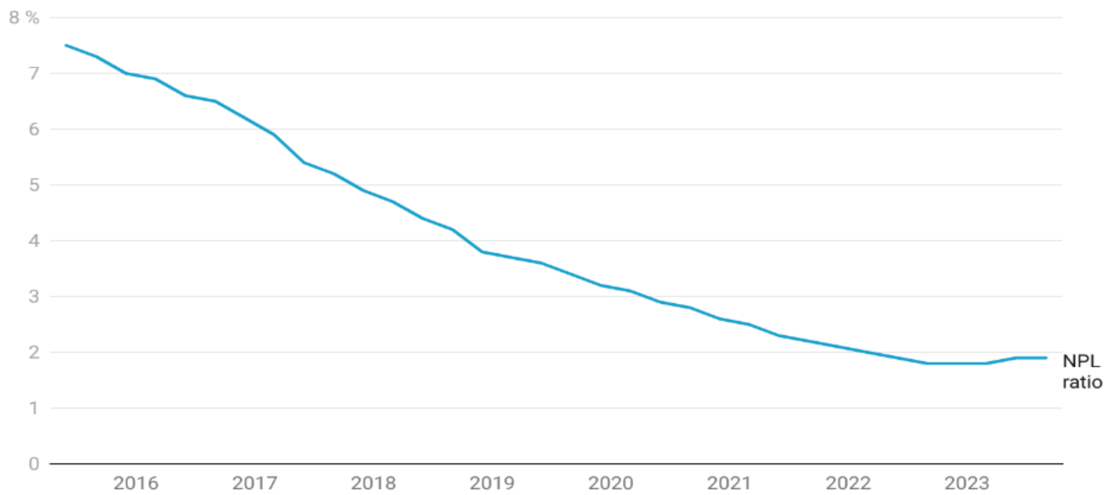
Figure 2. CET 1 ratios by Member States in Q3 2023



Note: Some countries participating in European banking supervision are not included in this chart, either for confidentiality reasons or because there are no significant institutions at the highest level of consolidation in that country.
Source: Authors' elaboration based on ECB data. Created with Datawrapper.

Non-performing loan (NPLs) ratios (i.e. NPLs as a share of gross loans) have significantly decreased, moving from 7.5 % in Q3 2015 to 1.8 % in Q3 2023 (see *Figure 3*). Moreover, with net interest margins being the main profitability driver, significant institutions' return on equity (ROE) stood at 10 % in Q3 2023 (up from 7.6 % one year earlier). This is very close to the 2007 peak of 10.6 %.

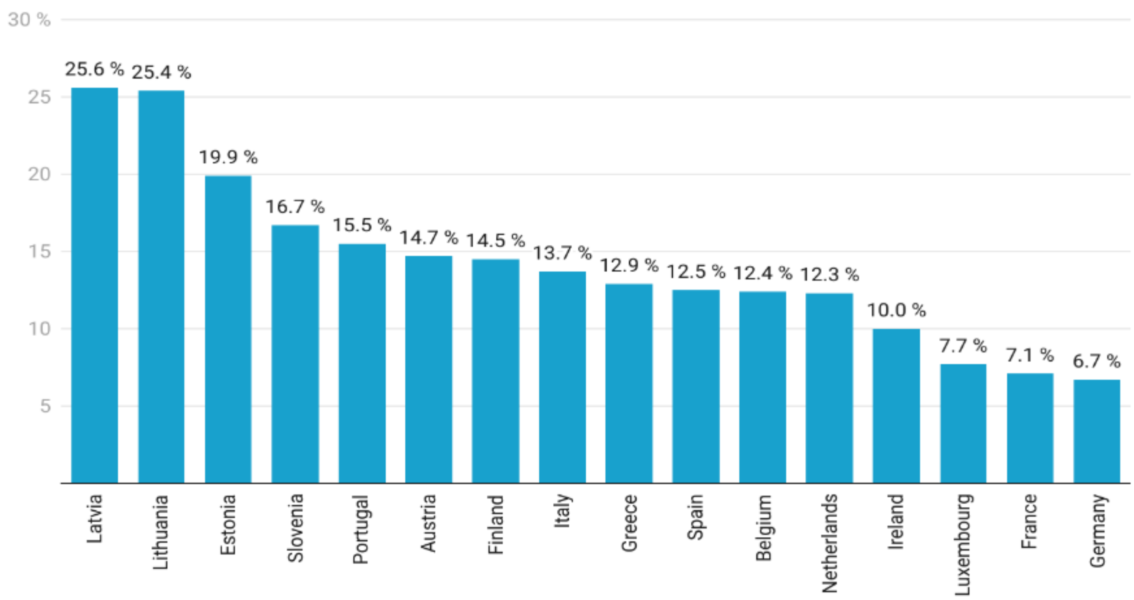
Figure 3. Significant institutions' non-performing loans ratio between Q2 2015 and Q3 2023



Note: NPLs ratio includes cash balances at central banks and other demand deposits.
Source: Authors' elaboration based on ECB data. Created with Datawrapper.

Across Member States there are significant differences (see *Figure 4*). Banks in countries like Latvia and Lithuania have ROE in excess of 25 %, whilst those in Luxembourg, France and Germany having a single-digit ROE. The difference between the highest (Latvia) and lowest (Germany) was about 19 percentage points at the end of the third quarter of 2023 (higher than the 15.3 in 2021, but far from the 101.6 recorded in 2013). Still, as highlighted in the SSM's Annual Report for 2023, supervisors remain cautious about the sustainability of this surge in banks' profitability.

Figure 4. Return on equity of significant institutions by Member State in Q3 2023



Note: Some countries participating in European banking supervision are not included in this chart, either for confidentiality reasons or because there are no significant institutions at the highest level of consolidation in that country.
Source: Authors' elaboration based on ECB data. Created with Datawrapper.

More proof of the sector's resilience comes from the latest stress test conducted by the European Banking Authority (EBA), which yields some interesting results. First, EU banks are in a better starting position than in 2021, with higher levels of income, profitability and asset quality and lower doubtful assets ratios. Second, banks have sufficient capital to cope with the adverse scenario. Indeed, in the adverse scenario, the average CET1 in 2025 would be 10.4 %, almost 200 basis points above the minimum requirement of 8.5 %. Third, in both the baseline and the adverse scenarios, the positive effect of the increase in net interest income stands out, which could be mainly explained by the increase in lending rates[1].

[1] On the negative side, in both scenarios, reference should be made to the increase in operating expenses with an impact of almost 1 000 basis points (i.e. 10 %) in terms of capital consumption.

Fourth, and considering the banking sector was in dire straits in several southern European Member States 10 years ago, their situation has since significantly improved. Results show that banks in Greece and Spain, although with lower capital levels as shown in Figure 2, would cope best with the adverse scenario, with capital consumption reduction figures that are almost half the EU average. This contrasts with French and German banks, which are above the European average. But also compared to the 2021 results, capital consumption of Cypriot, Greek and Italian banks (and to a lesser extent, Portuguese and Spanish ones) has halved in the two-year period 2023.

Finally, compared to the US Fed stress test results, the capital consumption coming out of the European tests is higher (4.8 % in the EU versus 2.3 % in the US). However, this does not imply that the European banking sector is in a less resilient position compared to the US[2]. In fact, March 2023's financial turbulence is good proof of this, illustrating that the European sector can withstand major systemic risks affecting other jurisdictions. For example, this can be reflected in the performance of European banks compared to US ones (see *Figure 5*).

Figure 5. Performance of European and US banks during the March 2023 events

Notes: The EURO STOXX Banks Index tracks the performance of European banks. The KBW Nasdaq Bank Index tracks the performance of the leading banks and thrifts that are publicly traded in the US. The Index includes 24 banking stocks representing the large US national money centres, regional banks and thrift institutions.
Source: Authors' elaboration. Created with Datawrapper.

[2] These results should be treated cautiously, as they are not directly comparable. To begin with, the methodology used is very different, with the Fed using a 'top down' approach as opposed to the European 'bottom up' approach. Furthermore, the Fed's stress test only focused on the 23 largest banks, whilst in Europe the exercise covers 98 banks. The largest banks that disappeared as a result of the financial turmoil in March 2023 (i.e. First Republic Bank and Silicon Valley Bank (SVB), the 15th and 17th largest US banks in terms of assets at the end of 2022) were not part of the US stress test.

Nevertheless, this fruitful supervision comes at a (increasing) cost for the banking sector, since fees are levied to cover the SSM's expenditure (see *Table 1*). This is expected to be above EUR 660 million in 2024, with significant institutions covering the bulk of the cost.

Table 1. Expenditure on ECB supervisory tasks (EUR million)

	2022	2023	2024 (est.)
Fees for significant supervised entities or groups	566.8	626.3	633.4
Fees for less significant supervised entities or groups	27.0	27.2	27.6
Total expenditure on ECB supervisory tasks	593.8	653.5	661.0

Source: Authors' elaboration based on ECB data.

HOW DOES EU BANKING SUPERVISION COMPARE TO THE US?

Whilst the main aim of banking supervision is to ensure the safety, soundness and stability of the banking sector, as well as to facilitate common minimum standards[3], there are significant differences on how this is applied across jurisdictions. For example, though the EU emphasises harmonisation and centralised supervision – especially within the eurozone – the US features a more decentralised and complex regulatory framework with multiple regulators. This is like Switzerland, which maintains a dual banking system with a mix of federal and cantonal authorities overseeing banks[4].

Institutional framework and supervisory practices

As described above, the EU's banking supervision is part of the SSM. The ECB directly oversees significant banks, whilst less significant banks are supervised by NCAs in close cooperation with the ECB. The SSM's objective is to establish uniform oversight practices throughout its Member States. The ECB conducts regular Supervisory Review and Evaluation Processes (SREP) to assess the risks banks face and determine the adequacy of capital and liquidity. The ECB's approach is to apply a single supervisory policy across all significant banks it directly supervises.

In the US, as mentioned above, the banking supervision system is characterised by its complexity and multiple regulators. The Fed, the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) are the primary

[3] The Core Principles for Effective Banking Supervision were issued in 1997 by the Basel Committee on Banking Supervision. The Principles have since been revised in 2006 and 2012. Currently, following the consultation launched by the Basel Committee on Banking Supervision in July 2023, they are once again in the process of being reviewed.

[4] Cantonal banks are supervised by their respective cantonal authorities, whilst federal authorities, including the Swiss Financial Market Supervisory Authority, oversee other banks.

federal regulators, each with specific mandates. Additionally, state-level banking regulators play a crucial role, as they oversee state-chartered banks. This dual banking system allows banks to choose between a federal or state charter, determining which regulator oversees them. Supervisory practices include regular examinations, stress testing (especially for large, systemically important banks), and compliance checks with federal and state laws. The Comprehensive Capital Analysis and Review (CCAR) is a notable stress testing exercise conducted by the Fed.

Following the financial turbulence of March 2023, several reports[5] have been published by US public authorities. When it comes to the work of US supervisors, the reports point out that supervisors were not quick enough in escalating their supervisory actions to tackle the identified vulnerabilities, nor were they strong enough to require the banks to respond more prudently. The reports strongly emphasised the lack of an escalation process to force banks into taking their recommendations into account.

Regulatory approach

The regulatory approach in the EU is more harmonised, particularly within the euro area, with regulations and directives such as the CRR and the CRD IV which implement the Basel III standards and extends it beyond G-SIBs. The aim is to ensure a level playing field across all Member States and promote financial stability through uniform rules.

Similarly, the US approach to banking supervision also incorporates the Basel III standards, but it adapts them to the US context. The US has a more segmented regulatory structure, with different types of banks (e.g. community banks, national banks, state banks) facing different regulatory expectations and oversight intensity. The Dodd-Frank Act of 2010 also introduced significant reforms to reduce systemic risk and protect consumers. Still, the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) in 2018 amended key aspects of the Dodd-Frank Act, namely raising the thresholds for enhanced prudential standards from USD 50 billion to USD 250 billion, which in practice meant that a number of regional banks were exempt from stricter requirements. This is another reason for the March 20023 financial turmoil highlighted in the reports mentioned above.

Crisis management and resolution

In terms of crisis management and resolution, the EU has established the Single Resolution Mechanism (SRM) for managing bank failures, aiming for a standardised and efficient resolution process across Member States. Two central components to this

[5] See for example those of the Federal Reserve System on its supervision and regulation of Silicon Valley Bank, the Federal Deposit Insurance Corporation on its supervision of Signature Bank, and the US Government Accountability Office on its preliminary review of federal agency actions related to the March 2023 bank failures.

mechanism are the Single Resolution Board (SRB) – the central resolution authority within the Banking Union – and the Single Resolution Fund (SRF) – the emergency fund that is available during times of crisis.

In the US, bank failures are managed by FDIC, which not only insures deposits but also possesses the authority to handle the resolution of failed banks. On top of this, the Dodd-Frank Act also introduced the Orderly Liquidation Authority (OLA), granting FDIC the authority to wind down or liquidate large, systemically important financial institutions (SIFIs) in an orderly manner that minimises the impact on the broader financial system.

GOVERNANCE, BEHAVIOUR AND CULTURE

One of the lessons learnt from major financial sector crises and incidents is that governance, behaviour and culture can have a major impact on an institution's soundness, risk profile and integrity. A bank's internal governance entails how it is organised (e.g. business objectives, risk appetite, internal controls, roles and responsibilities, reporting processes) and the efficacy of its management bodies in conducting business and managing risk. Although governance structures are essential, it's equally important to ensure that board and management behaviour is aligned with these structures. After all, given that banks are driven by the sum of their human interactions and decisions, it's people who determine its performance. Even when a bank is well capitalised and its liquidity buffers are in order, risks related to behaviour may already be visible and get the bank into trouble.

Behaviour, which is tangible and visible, is usually fuelled by an intangible and invisible culture. Culture encompasses the collective mindset and the shared set of values that shape the everyday behaviour of a bank's employees. There are several examples in banking where culture can affect the performance of a certain institution and consequently the entire financial system (e.g. the collapse of Lehman Brothers, the LIBOR scandal, the ING money laundering scandal, the collapse of Silicon Valley Bank (SVB) and Credit Suisse). The natural question that arises is whether supervisors are equipped to assess behaviour and culture in banks. And the answer is yes.

As the SSM has evolved over the last ten years, so has banking supervision. It shifted from mainly a backward-looking approach – focusing on financial risks, systems and controls – towards a forward-looking one – focusing on a more complete assessment of risks, not only financial but also non-financial risks. Greater attention has been given to business models, board effectiveness, behaviour and culture, whilst different methods have been incorporated into supervision, such as benchmarking, risk culture assessments, in-depth thematic reviews, interviews, surveys and questionnaires.

The role of the credit risk officer (CRO) was also empowered after the global financial crisis. Nowadays, almost every bank has a CRO, most boards have established board risk committees, and the CRO is often a member of the board. However, there's still long way to go. In a sample of 72 publicly listed European banks, only 21 % of the CROs are board members[6].

Regarding the board's composition, supervisors don't only focus on the individual suitability of its members (in the case of the SVB, only one member of the board had a career in investment banking), but also on other elements, such as collective suitability, diversity and the effective functioning of the board. Between them, board members must have a good range of skills and experience, as well as a clear picture and a good understanding of the risks banks face and be ready and able to mitigate them.

The board should also be diverse, not only in terms of gender, but also with regards to diversity policies, employment, practices, earnings, leave and work arrangements, as well as childcare and other benefits. Between 2020 and 2022, more than 84 % of the CEO appointments made at significant institutions (SIs) directly supervised by the ECB were men. Over the same period, only 36 % of newly appointed board members in SIs were women. Furthermore, and as the economic environment and the skills required to navigate the banking business keep evolving, the board should be well-versed in climate and environmental risks, as well as IT infrastructure and digitalisation strategies.

CLIMATE RISKS

Climate change and environmental degradation affect banks through both physical risks (e.g. extreme weather events) and transition risks (e.g. a rising carbon price). That's why it's the SSM's duty, as a microprudential supervisor, to contribute to the safety and soundness of the banking sector by ensuring the industry has adequately prepared to manage climate-related risk. As such, several steps have been taken in the last few years, which have materialised in the following four outcomes: a guide on supervisory expectations relating to climate-related and environmental risks management and disclosure; the results of the bottom-up climate stress test; as well as the results of the thematic review on climate-related and environmental risks, accompanied by a code of good practices for climate-related and environmental risk management.

The stress test revealed that under a short-term – a three-year disorderly transition risk scenario and two physical risk scenarios (flood risk and drought, and heat risk) – the combined credit and market risk losses would amount to approximately EUR 70 billion. However, this figure should be treated cautiously as it may represent an understatement given that the scenarios are non-adverse, the data are based on projections, and the

[6] Looking at central banks, the proportion with a CRO fell from 55 % to 45 % according to the Risk Management Benchmarks 2023. Central banks in advanced economies are the least likely to have a CRO. However, and whilst the percentage of institutions saying they had a CRO fell, the number of institutions with a risk management committee rose from 83 % to 85 %.

sample or participating banks is limited (i.e. 41 of the 113 current supervised banks). On the other hand, under the 30-year transition scenarios, losses are projected to be notably lower, and dependent on the phasing-in approach to sustainable climate policies.

As for the thematic review, perhaps the most worrying fact is that 96 % of the assessed banks have blind spots in identifying climate and environmental risks. Moreover, 60 % of these were significantly important. However, on a positive note, several good practices were identified. For example, some banks are embedding climate and environmental risks into their due diligence and lending policies, whilst others are using transition planning tools to enhance the longer-term resilience of their business models.

DIGITAL TRANSFORMATION AND OPERATIONAL RESILIENCE

For many decades, microprudential supervisors have focused on financial soundness. This explains the large number of capital and liquidity legal requirements and the strict compliance control by public authorities. Nevertheless, increasing digitalisation trends, reliance on third party providers, and a challenging geopolitical landscape (with a growing number of cyber-attacks) have caused the regulatory and supervisory alarms to sound. According to the latest data, financial services rank as the third most targeted industry within the Europe, Middle East, and Africa (EMEA) region. Cyber-attacks on these firms have seen an increase by 119 % between Q2 2022 and Q2 2023.

To make further progress in the digital transformation, the ECB is taking specific measures to limit potential risks stemming from new business practices and technologies. One such measure is an IT risk questionnaire, where banks rate their own IT risk level and the maturity of their IT risk controls, forming the basis for a horizontal analysis. The results of the latest IT questionnaire for 2022, showed that: i) IT outsourcing expenses remained stable at about EUR 30 billion, with cloud expenses increasing by 56 % to EUR 2 billion; ii) data quality management remains the least mature IT risk control function; iii) the root cause behind critical services downtime was IT changes, with software issues identified by 86 % of the responded institutions; iv) institutions where management bodies have sufficient IT expertise report a greater awareness of IT risks (13 % of significant institutions still report that none of their board members have specific IT expertise).

Another measure that the ECB applies is on-site inspections at banks' premises, which provide more in-depth information on banks' IT risk management. Between 2020 and 2023, ECB Banking Supervision conducted inspections of 22 banks across 11 Member States. The main shortcomings detected were: i) failure to identify potential cybersecurity risks to systems, data and assets; ii) weak perimeter security systems, network segregation and security patch management; iii) inadequate implementation of security incident and event monitoring, as well as the inconsistent implementation of IT security reviews and tests; iv) incomplete and outdated crisis management and communication plans for cybersecurity incidents; v) misalignment between business continuity requirements and the capabilities of IT services.

In 2024, the ECB will conduct its first-ever cyber resilience stress test. This will assess how banks respond to and recover from a cyberattack, rather than their ability to prevent it. Under the stress test scenario, the cyberattack will succeed in disrupting the bank's daily business operations. Banks will then test their response and recovery measures. This exercise will be of a qualitative nature and will thus not have a direct impact on capital through Pillar 2 guidance. Supervisory practices will become more complex – once the Digital Operational Resilience Act (DORA) starts to apply as of 17 January 2025, the ESAs will have direct supervisory powers over technology providers that qualify as critical to the European financial sector. Needless to say, this creates the need for traditional financial supervisors to hire sufficient staff with IT expertise.

Finally, the SSM is also leveraging the benefits of digital technologies and is heavily investing in a portfolio of supervisory technologies (SupTech). Currently, there are at least 14 SupTech tools available in the SSM. The SSM is developing a new digital agenda for the period 2024-28, aiming to build a unified supervision cockpit that bundles together the most requested data, news, IT applications and systems.

THE FUTURE OF THE SSM – THE NEXT TEN YEARS

Over the last ten years, the SSM has proved itself to be – perhaps – the most advanced and most successful experiment of shared administration in the EU. More importantly, European banks are strong, safer and sounder as a result, whilst supervision is more uniform and applied in a consistent way, thus ensuring a level playing field, transparency and accountability. This was also confirmed by an independent external evaluation that the ECB commissioned in September 2022. The results confirmed that since 2014 the ECB has successfully established itself as an effective and respected supervisor, particularly given the many differences between national supervisory processes. Moreover, organisation is now sufficiently robust and mature to streamline processes and improve risk-based prioritisation.

However, and as we move forward, more needs to be done. The SSM's supervisory priorities for 2024-26 refer to a banking sector that is resilient to immediate macro-financial and geopolitical shocks, effective at addressing governance shortcomings, able to manage climate-related and environmental risks, fully embracing the digital transformation, and have robust operational resilience frameworks in place. To achieve these priorities, **supervisors need to move away from the current approach, which is overly mechanical, time-consuming, quantitative and capital-centric, to an approach that is more efficient, with more room for supervisory judgement and a more holistic view of the risk set.**

As indicated in the independent external evaluation report, **three broad areas where future work should be focused are: i) supervisory culture, ii) supervisory review and evaluation process (SREP) scores and capital requirements, and iii) qualitative measures:**

- **On supervisory culture, there's a need to move from a more rigid approach towards a risk-based one**, increase the efficiency of the SREP process, better integrate the results of other supervisory activities into the SREP analysis, as well as provide clearer supervisory expectations to banks[7].
- Regarding **SREP scores**, a process that has been seen as excessively mechanical, it **should follow a risk-by-risk approach** and limit the use of the internal capital adequacy assessment processes.
- Regarding **qualitative measures**, their **importance should be increased and linked to the SREP scores.**

The increasing relevance of operational risk prevention will have an impact on the entire EU banking sector. Banks and financial institutions will face increased regulatory scrutiny coupled with more rigorous scrutiny of their IT and cybersecurity practices. This will also require **continuous investment in security technologies, staff training and incident response capabilities. IT expertise will also be necessary both at the management level and within the operational team.**

All in all, the EU banking sector is much more solid than it was 10 years ago, even if differences persist between Member States. The SSM is the best functioning element of the Banking Union and it's also a model global supervisor considering 2023's financial turbulence. Successfully integrating very different supervisory practices and cultures is frankly a remarkable achievement.

But we shouldn't rest on our laurels – the independent evaluation's recommendations should be implemented. Moreover, **building on the lessons learnt from the US and Switzerland, supervisory actions should follow an escalation ladder and become more intrusive if banks fail to take appropriate action. The SSM should also build as much as possible on the benefits that the digital transformation can (and will) bring. And finally, this should be done in the most efficient possible way, keeping costs to the minimum.**

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[7] Particularly on the qualitative measures required to improve the outcome of the supervisory risk assessment.

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