# The Single Supervisory Mechanism

by Ignazio Angeloni [13]

**Abstract**

This article describes the actions undertaken by the European Union towards the establishment of a Single Supervisory Mechanism (SSM), with a special focus on its rationale, on its priorities to promote the soundness and stability of the banking system across the Euro Area. This work also discusses the need to implement an harmonised regulatory framework in the estimation of bank risk and in the calibration of prudential requirements.

The global financial crisis triggered financial reforms in all major economies, but nowhere was the change as comprehensive and radical as in the euro area. In 2008, as the crisis reached its peak in the United States, the euro area still had national banking regulatory frameworks (for supervision, regulation and crisis management), with only a mild overlay of harmonisation arrangements provided by European directives and supervisory "committees" without binding powers. At the time of writing (December 2015) a euro area-wide banking supervisor has been in charge for more than a year at the European Central Bank (ECB), with the mandate of ensuring banking soundness, stability and a level playing field in the whole euro area. A single bank resolution authority is about to take responsibility for crisis management, supported by a single resolution fund. There is a le-

13. ECB. I am grateful to Cécile Meys for excellent drafting support. The views expressed here are my own and should not be attributed to the ECB. This article draws largely on a speech held in Dublin on 27 November 2015, available at https://www.bankingsupervision.europa.eu/press/speeches/date/2015/html/se151127.en.html.

gal framework for conducting supervision, the Capital Requirements Regulation (CRR), which is directly applicable to all banks in the euro area without the need for national transposition, as well as EU-wide crisis management rules, the Bank Recovery and Resolution Directive (BRRD). The launch of a European deposit guarantee scheme is still being discussed, but in the meantime the rules guiding the operation of the national schemes have largely been harmonised.

The aim of this article is not to describe all the elements of the European Banking Union. It focuses on its supervisory arm, the Single Supervisory Mechanism (SSM). In particular, it elaborates on the establishment of the SSM and the rationale behind it, as well as its priorities during its first year of operation. Special focus is placed on what the SSM has accomplished in the area of regulatory harmonisation to give rise to an effective level playing field, and on the methods it uses to assess bank risks and calibrate the prudential requirements, namely the Supervisory Review and Evaluation Process (SREP). Finally, the article provides an overview of the priorities of the SSM for the immediate future.

## 1. Banking Union: why and how

The original design of the European monetary union, codified in the Maastricht Treaty, did not foresee that banking supervisory powers would need to be centralised at the Union level. Yet shortly after the creation of the monetary union in 1999, a number of observers and policy-makers warned that the new monetary architecture would be incomplete, and therefore fragile, without at least some coordination of supervisory policies among euro members.[14] The response to this concern was the creation of three fora, the so-called Lamfalussy committees, aimed at fostering supervisory convergence and best practices in the areas of banking, securities markets and non-bank intermediaries. The effectiveness of these committees was severely limited, however, because they had no decision-making powers and their activity was limited to exchanges of views and information among national authorities, thereby issuing non-legally binding guidance.

14. Padoa-Schioppa, T., "EMU and banking supervision", lecture at the London School of Economics, 1999, available at https://www.ecb.europa.eu/press/key/date/1999/html/sp990224.en.html and Bini Smaghi, L. and Gros, D., "Open Issues in European Central Banking", Palgrave Macmillan, 2000.

The euro crisis, from 2010 onwards, dramatically exposed the limitations of the existing arrangements. The experience of banking crises in Ireland, and subsequently in Spain, clearly showed that crises originating in national banking sectors could, in the absence of effective euro area-wide crisis management frameworks, rapidly transmit across countries through a variety of contagion channels, endangering the very confidence in the stability of the euro. A first attempt to strengthen the banking framework was made in 2011 by transforming the three committees into permanent agencies.[15] But that step immediately proved to be insufficient.

The shortcomings of the financial framework were in fact exacerbated by the very existence of the euro, as a result of the strong interdependencies among national economies and banking sectors generated by the single currency. An important manifestation of this was the adverse feedback loop between banks and public finances at the national level; banking sector weaknesses rapidly transmitted to public budgets, via the backstop that states provided to the bank safety nets, and conversely, weak public finances eroded the market confidence in banks, notably due to the large exposure of banks to domestic sovereigns (the so-called "home bias" in bank portfolio holdings). Addressing this shortcoming, and the need for a strong crisis management and prevention framework, were the key arguments for the creation of the Banking Union. The proposal to create an integrated banking framework was first mentioned in the June 2012 report by the President of the European Council, prepared in close collaboration with the European Commission, the Eurogroup and the European Central Bank.[16] At almost the same time, euro area political leaders decided at the summit held at the end of June 2012 to ask the Commission to prepare the blueprint of a single supervisory authority within the ECB.

The Banking Union consists of three pillars. The first pillar is the establishment of a single supervisory authority in the ECB, the SSM, responsible for banking supervision. The main aim of this mechanism is to ensure the safety and soundness of European banks, both individually and as a system, in order to increase financial integration and stability and to ensure consistent super-

15. For more detail, see Angeloni, I. and Beretti, T., "Harmonising banking rules in the Single Supervisory Mechanism", *Law and Economics Yearly Review*, Vol.4, Part 1, October 2015.

16. "Towards a genuine Economic and Monetary Union", available at https://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/134069.pdf

vision. As such, the SSM possesses both microprudential and macroprudential powers, the latter being shared with the Member States. In particular, the ECB is responsible for the effective and consistent functioning of the SSM and exercises oversight over the functioning of the system, based on the distribution of responsibilities between the ECB and the national supervisory authorities, as stipulated by the SSM Regulation.[17]

Based on the differentiation that the SSM Regulation makes between banks that are deemed "significant" and those that are deemed "less significant", the ECB directly supervises banks of significant relevance, according to their size, importance for the economy and cross-border activities, as well as any bank which receives assistance directly from the European Stability Mechanism. At present, the SSM directly supervises 122 banking groups, whose balance sheets account for €25 trillion in assets (over 80% of euro area banks' assets). Subject to the oversight of the ECB, the national competent authorities (NCAs) continue to directly supervise less significant institutions, of which there are around 3,500.

The second pillar of the Banking Union is the establishment of the Single Resolution Board (SRB). Its mission is to ensure an orderly resolution of failing banks with minimum impact on the real economy and public finances of the participating Member States. It will also be in charge of the Single Resolution Fund, which is financed by banking sector contributions to ensure that funding support is available during the restructuring of a bank. The SRB has been operational since 1 January 2015 and will be fully operational, with a complete set of resolution powers, as of January 2016.

The third pillar is the establishment of a European Deposit Insurance Scheme, which is yet to be created. On 24 November 2015, the European Commission made a proposal for a European Deposit Insurance Scheme (EDIS). The EDIS would be built on the existing system of national deposit guarantee schemes and introduced gradually. It would start with a re-insurance approach which would last for three years, until 2020. Afterwards, the EDIS would progressively become a mutualised system. Once the EDIS assumes 100% risk, the EDIS will fully insure national DGS. This should be in 2024, at the same time when the Single Resolution Fund and the requirements of the DGS Directive

17. Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63).

will be fully phased in.[18] However, it should be underlined that the EDIS is an essential component of the Banking Union, as the establishment of a common safety net for deposit protection will underpin confidence, stabilise the banking system by preventing deposit outflows and contribute to a level playing field. Only the same level of confidence in deposit protection across the Banking Union will lead to a truly single banking framework.

## 2. The setting-up of the SSM (2012-2014)

Following the decision taken in June 2012 to launch the SSM, the European Commission prepared a draft regulation, which was in effect the "charter" of the new supervisory authority. After intensive consultation and revisions in the European Council and the European Parliament, the SSM Regulation was finally adopted in October 2013. The regulation stipulated that the SSM should assume its supervisory powers and responsibilities in November 2014.

At the ECB, the work to set up the SSM lasted 28 months, from July 2012 to October 2014. The preparatory phase was divided, broadly speaking, into three strands of work.

The first strand was the establishment of the SSM governance framework and the methodologies to be used by the SSM. The establishment of a governance framework consisted of the creation of its governing bodies: the Supervisory Board and its steering committee, the Administrative Board of Review, and the Mediation Panel.

The Supervisory Board is the core of the SSM decision-making process. It is composed of a chair and vice-chair, representatives of each NCA, as well as four ECB representatives. The Supervisory Board prepares and approves complete draft supervisory decisions, which are subsequently sent to the Governing Council – the sole final decision-maker of the ECB, according to the EU Treaties – for final approval via a non-objection procedure. Such a procedure means that draft decisions prepared by the Supervisory Board are deemed adopted unless the Governing Council opposes them, normally within a two-week period. In the case of emergencies this period can be shortened.

18. See http://europa.eu/rapid/press-release_IP-15-6152_en.html.

Supervisory Board meetings are prepared by a steering committee, whose participation is limited to eight members of the Supervisory Board and five of the NCA representatives on the Supervisory Board. The national participation follows a rotation scheme. Another important body is the Administrative Board of Review, which carries out internal administrative reviews of the decisions taken by the ECB. It consists of five regular and two alternate members who are academics and former policy-makers with expertise in legal and supervisory matters. Finally, a Mediation Panel was established to resolve differences of views in the event of an objection by the Governing Council to a draft decision prepared by the Supervisory Board. Its members are chosen from among the members of the Governing Council and the Supervisory Board, one per Member State.

In addition to establishing the governance framework, the preparatory work also included drafting internal arrangements for the functioning of the SSM, including the functioning of the governing bodies, the relationship with the "central banking wing" of the ECB and the relationship between the ECB and the national supervisory authorities. These rules are enshrined in the SSM Framework Regulation and the Rules of Procedure of the Supervisory Board of the ECB.[19] In addition, a Supervisory Manual was drafted to guide the supervisory teams in the conduct of day-to-day supervision. The Supervisory Manual is an internal document that describes the processes and methodology for the supervision of credit institutions, as well as the procedures for cooperation within the SSM and with authorities outside the SSM.

The second strand consisted of setting up and organising the supervisory structures and recruiting staff. More than 1,000 new ECB staff members were recruited, representing a mix of nationalities, ages and gender, as well as different professional backgrounds. The majority (around 800) are supervisors, with the rest, including statisticians, lawyers and IT experts, providing support services. The supervisory staff are organised into four large departments, plus a secretariat assisting the Supervisory Board. Two of these departments directly supervise the significant banking groups, the third is responsible for coordinating the NCAs which supervise the less significant institutions, and the fourth

19. The main documents describing the legal framework of the SSM are available on the ECB's website at https://www.bankingsupervision.europa.eu/legalframework/ecblegal/framework/html/index.en.html.

offers technical expertise to the other areas and provides the methodological standards which guarantee the singleness of the supervisory approach and its horizontal consistency. Supervisors from the first two departments, supported by staff from the national supervisory authorities, contribute to specialised teams, known as Joint Supervisory Teams. Each team, headed by a coordinator from the ECB, is responsible for the supervision of a single banking group.

The third strand was the comprehensive assessment, which provided a health check of the banks for which the ECB would become directly responsible. This assessment was conducted for 130 banking groups, covering about 85% of the euro area banking sector in total. It consisted of two components. First, an asset quality review (AQR) that provided a risk-based analysis of the main components of the banks' assets, and second, a stress test which calculated the sensitivity of the banks' balance sheets to two macroeconomic scenarios, a consensus scenario and an adverse scenario. These components were then brought together to produce a measure of the capital required to satisfy certain prudential criteria.

The results of the comprehensive assessment are described in detail in a public report.[20] To mention only a few key numbers, the overall impact of the exercise on the banks' aggregate Common Equity Tier 1 (CET1) capital, i.e. its high-quality capital, was equal to €262.7 billion. The AQR resulted in an upward adjustment in the estimated amount of non-performing exposures in the euro area as a whole of €136 billion, or 18%. Overall, relative to the pre-set minimum benchmarks (capital ratios equal to 8.5% for the AQR and base scenario of the stress test, and 5.5% for the adverse scenario of the stress test) a total shortfall of €24.6 billion was identified across 25 banks. As several banks had already covered the shortfalls before the end of the exercise, in the end 13 banks were asked to additionally replenish their capital by a total amount of €9.5 billion.

By providing a wealth of information on all significant banks, not just those whose balance sheets needed strengthening, the assessment provided a stimulus and a starting point for further supervisory actions that were undertaken during the SSM's first year of operation.

20. The report is available at https://www.bankingsupervision.europa.eu/banking/comprehensive/html/index.en.html. For a summary, see Angeloni, I., "Countdown to the start of the SSM", speech held in Madrid on 31 October 2014, available at https://www.bankingsupervision.europa.eu/press/speeches/date/2014/html/se141031.en.html.

## 3. The first year of operation (2014-2015)

Following the comprehensive assessment, one of first priorities was to ensure the recapitalisation of the banks that were identified as having a shortfall. More broadly, the comprehensive assessment demonstrated that there were major differences in the quantity and quality of capital across all supervised banks, not systemically related to the nature or extent of the underlying risks. This led to the launch an important work stream, described in more detail in Section 3.1, whose aim was to harmonise the options and discretions contained in the regulation.

Another priority during 2015 was to ensure that banks have proper management control, as only then can the risk management of a bank be effective. With a focus on banks' management and risk management framework, the SSM assessed banks' business models, profitability drivers, governance, risk-taking behaviour, capital adequacy and credit risk.

A further important strand of work has aimed at developing common methodologies. These methodologies are included in the Supervisory Manual and ensure that the same procedures are followed when performing a supervisory assessment. The methodologies build on previous experience and best practices, treating all banks consistently while taking into account differences in business models. These methodologies cover all supervisory areas, ranging from remuneration practices to an assessment of the issuance of a Tier 2 instrument by a bank. Section 3.2 describes in more detail the common methodology developed for the SREP.

### *3.1 Harmonising the legal framework*

As mentioned above, an important finding of the comprehensive assessment was the existence of unjustified major discrepancies across the supervised banks in terms of capital requirements. Many of these discrepancies, which impede fair competition and the existence of a level playing field, are based on the manner in which the EU's legal framework – composed of the Capital Requirements Directive (CRD IV) and the Capital Requirements Regulation (CRR) – is applied across countries. Discrepancies originate partly from the transposition of the Directive into national law and partly from diverging application of the many flexible provisions (the options and discretions) contained in the legislation. “Option” means that there are alternative ways to apply a given provision and “discretion” means that the possibility exists to apply or not to apply a given provision. Before the SSM, those decisions were made by the national authorities. As a new competent authority, the SSM now needs a single coherent framework on how to apply those provisions.

The Supervisory Board identified around 120 options and discretions which can be exercised by the ECB, for which a single approach has been agreed. That package covers important areas such as capital, liquidity, large exposure requirements for cross-border groups, the phasing-out of capital components not included in the Basel framework and the prudential treatment of insurance participations. In conducting this work, the guiding principle was to promote harmonisation with prudence and with the appropriate degree of gradualism considering the legitimate expectations generated by previous treatment by the national authorities. An impact assessment was conducted to measure the likely effect of the policy.

This gave rise to two legal instruments: a regulation (a legally binding instrument) laying down the legal obligations for the significant banks related to the prudential treatment of options and discretions that are of a general nature, and a guide (a non-legally binding instrument) that provides guidance to supervisory teams on how to treat individual cases. The guide contains case-by-case provisions, whose application is bank-specific. Both documents were submitted to a public consultation and are expected to enter into force in spring 2016.

For some other options and discretions, which are exercised directly by Member States and not by supervisory authorities, adjustments in national legislation will be necessary. This follow-up work is scheduled to start after the current work is concluded in 2016.

### *3.2 Setting the prudential requirements*

A second important strand of work has been the development of an SSM-specific methodology for assessing and measuring the risks relevant to each bank, and for setting the prudential requirements. In 2015 the SSM conducted this process – the SREP – using a unified methodology for the first time. This methodology combines quantitative and qualitative elements and treats all banks consistently, while accounting for different business models.

The SREP methodology of the SSM follows banks' internal strategies and decision-making processes and is structured along four components: business model assessment, internal governance and risk management, risks to capital, and risks to liquidity and funding. Each component is assessed both quantitatively and qualitatively. The quantitative assessment is based on a broad range of data covering, among other things, own funds, financial reporting, large exposures, and credit and operational risk. The data, which are provided by the banks on the basis of harmonised standards, give rise to numerical risk scores.

The qualitative component involves supervisory judgements regarding factors such as risk controls, risk culture and governance. It is important to form an articulate opinion on how these risks develop and on what impact they may have within each specific institution. This analysis requires internal knowledge and relies to some extent on the subjective judgement and experience of the supervisor. Within the SSM, the Joint Supervisory Teams, possessing this knowledge and experience, are responsible for providing the qualitative input. The judgement cannot be mechanical, but it can and should be reasoned.

In order to ensure consistency across banks, certain principles are followed. One of these is "constrained judgement", meaning that the subjective element can only influence the quantitative result to a certain extent. Another key principle is proportionality, which means that the level of supervisory engagement (i.e. its frequency or intensity) should be linked to the complexity and systemic relevance of the bank's activities.

Following the 2015 SREP, the Pillar 2 requirements for the major institutions directly supervised by the ECB increased on average by 30 basis points relative to the previous year. Including the phasing in of the macroprudential buffers, the average increase totals around 50 basis points. This moderate increase is adequate from both a micro and a macroprudential perspective, allowing a gradual transition towards the "fully loaded" Basel III requirements – that is, the requirements set by the Basel III framework after the completion of the transitional phase.

### *3.3 Communication issues*

One aspect deserving attention is the communication strategy surrounding the SREP. Different considerations come into play here. On the one hand, enhancing public information about supervised entities, part of which is of a proprietary nature, can have undesired effects. One line of thought maintains that in order to preserve an open and productive dialogue between the supervisory authority and the bank, all information exchanged should remain confidential. The possibility of proprietary information being released, especially to competitors, may discourage openness and deprive the supervisor of critical information. In some cases, supervisory judgements placed in the public domain without proper caution may increase the uncertainty surrounding individual (weaker) institutions, with risks to financial stability.

These arguments carry weight but must be compared to the advantages of transparent communication. Ultimately, the SREP aims to ensure that banks have adequate prudential safeguards in relation to their level of risk. Investors' decisions need to be supported by adequate information on the returns and risks involved. Some knowledge of supervisory requirements can help in this respect. First, the SREP provides information on future capital plans, which in turn influence future returns on capital instruments. Second, it acts as a benchmark, indicating whether a bank is judged to be "safe and sound" by the supervisor. This helps with the calculation of risk. Therefore, an appropriate degree of disclosure may enhance market confidence and encourage investment decisions, actually reducing uncertainty. This was, in fact, the rationale behind the very high degree of transparency that characterised the ECB's comprehensive assessment in 2014.

When thinking about communication regarding the SREP, it is important to distinguish between the transparency of the process and the disclosure of the outcomes. The former relates to public knowledge of the methodology employed and the latter relates to public communication of the results. A transparent process helps to ensure that results are properly internalised by supervised banks and prevents misunderstandings. In the SSM, the Joint Supervisory Teams, which engage in a continuous dialogue with the banks, are the appropriate channel to convey this type of information. It should remain clear at all times that the SREP is not a mechanical process: a degree of reasoned discretion must always be preserved. Nevertheless, the dialogue between the Joint Supervisory Team and the bank limits the risk of "unpleasant surprises" at the end of the process, which facilitates proper public disclosure of the outcome. Such disclosure should, in any event, always be agreeable to the bank concerned.

Recent international experience is informative in this regard. While somewhat diverse, supervisory practices have evolved towards more transparency in recent years. The Comprehensive Capital Analysis and Review (CCAR) in the

United States and the SREP processes in some non-euro area EU countries provide examples of this kind of development.

In the United States, the Federal Reserve publishes its annual assessment of the capital planning processes and capital adequacy of the largest bank holding companies. It does not publish its stress test methodology in order to avoid herding behaviour in risk model building and prevent activities being shifted to areas not captured by the stress testing models, but it does disclose its qualitative assessment of banks' capital plans.

In Europe, the CRD IV requires supervisors to publish the general criteria and methodologies used in the SREP. The Prudential Regulation Authority (PRA) in the United Kingdom publishes the methodology for its "Pillar 2A" capital requirements. The Danish FSA also publishes methodologies, including the benchmarks for assessing risk in several areas. Thus far, the SSM has provided a broad description of the common methodology for the SREP in its Guide to Banking Supervision. As the SREP methodology becomes more established, steps towards greater methodological transparency will be possible.

The detail in the disclosure of the outcome differs across Member States. As regards Pillar 2 requirements, under the CRD IV the decision to publish is left to the supervisory authorities. The Danish FSA publishes SREP capital add-ons for all banks, plus summaries of on-site supervisory examinations. Sweden's Finansinspektionen has published plans for a detailed supervisory methodology and discloses SREP capital add-ons. A general tendency towards greater transparency is also underway in this area. The United Kingdom has adopted a practice of allowing capital requirements to be disclosed after the competent authority has been notified. Following the introduction of this practice, a number of firms have voluntarily disclosed their capital requirements after notifying the PRA.

## 4. Conclusion: the priorities ahead

Business models and profitability drivers will continue to be key priority in the foreseeable future. In 2015 business model classification tools for conducting peer group analysis were developed and a survey of banks' profitability forecasts was conducted. Building on this work, the drivers of banks' profitability at firm level and across business models will be reviewed in depth in 2016. One area of interest is how banks are coping with the protracted low interest rate environment and incoming new regulations.

A further priority is credit risk, because of the persistently high level of non-performing loans. In this context, a taskforce has been established to develop a consistent approach to banks with high levels of non-performing loans. High levels of non-performing loans dampen banks' ability to lend and fuel concerns regarding forbearance and under-provisioning. The SSM will also conduct work on excessive concentrations of risk, as well as on exposure to sovereigns and to commercial and residential real estate.

A major multi-year project presently ongoing aims at fostering comparability and quality of internal models. Given the large number and wide diversity of internal models and specific expertise required, this is a challenging task. A targeted review of internal models will be carried out to ensure that they comply with regulatory standards and in order to foster consistency across institutions.

Another important area is capital adequacy. Of particular relevance in this regard is banks' internal capital adequacy assessment process (ICAAP), i.e. their internal processes for assessing capital adequacy, and their internal stress testing capabilities. With a view to the implementation of the new "gone concern" loss-absorbing requirements,[21] banks' preparations for resolution scenarios will be scrutinised, as will the measures that they are undertaking in order to comply with those requirements.

Finally, banks' governance and risk appetite will remain a priority. The financial crisis clearly showed that banks' governing boards often lacked all the information needed to make good business decisions. In 2015 the organisation and composition of banks' management have been reviewed, focusing on the profiles of board members so as to ensure that the relevant expertise is available at board level. A task force on behaviour and culture has been created. Building on this information, scrutiny of this key aspect of banks' corporate governance will be enhanced.

21. These are the total loss-absorbing capital (TLAC) requirements, for which guidelines have recently been issued by the Financial Stability Board and its European counterparts, and the minimum requirement for own funds and eligible liabilities (MREL).