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How to Change the World (of European Banking) by Implementing the SSM? Implications for and Demands on Banks and Regulators

“Inneregy is doing the right thing, even when no one is watching.”
(C. S. Lewis, 1898–1963)

As early as in the fall of 2008, it became obvious that the existing regulatory and supervisory framework was not able to prevent one of the biggest global financial crises since the 1930s. Equally important, the crisis revealed also quite a significant amount of “misbehaviour” in financial markets in addition to institutional shortcomings, calling for a fundamental change in the governance of financial behaviour. The G20 – in particular at their London Summit in 2009 – as well as the European Commission called for and designed an encompassing set of initiatives to cover all these areas, ranging from capital requirements to financial incentives.1

As one consequence of the many avenues followed in this context by 4 November 2014 the ECB will assume responsibility for banking supervision in the euro area, making a major institutional reform in Europe to become operational. This reflects that from its very beginning in 2012 the Single Supervisory Mechanism (SSM) has been driven by the lessons learned from the recent financial crisis: The focus of the Single Supervisory Mechanism has thus been explicitly geared towards achieving a new framework that would be able to induce shift in behaviour, both on the side of supervisors as well as on the side of market participants to improve the situation towards a fundamentally improved governance structure for European banking.

Shortcomings in Supervision and in Banking Revealed by the Crisis

Before addressing some of the shortcomings in supervision revealed by the crisis, a brief account of structural change in the European financial system during the past two decades might be helpful as a starting point. The international expansion of the financial sector starting from about the mid-1990s was one of the biggest processes of financial globalization in modern financial history.2 This process — amplified by the creation of European Monetary Union — has also substantially changed the financial landscape of Europe, reflecting the efforts and needs

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for intensified European financial integration at the same time. Cross-border mergers in banking became a characteristic feature of this development during this time as well as a marked increase in foreign ownership, most pronounced in the CESEE region. The result of these merger waves was a relatively small number of countries holding high market shares in cross-border banking in Europe. At the same time, the financial institutions dominating cross-border banking activities not only expanded rapidly in balance sheet size but set up extremely complex organisational structures including huge numbers of (foreign) subsidiaries.

The creation of big cross-border institutions through mergers and acquisitions was a very visible but by far not the only significant structural change that contributed to the creation of crisis prone European financial structures. At least as important, and in contrast to traditional and more localized (commercial) banking models, which relied strongly on deposit funding, these new institutions to a much larger degree used short term debt (wholesale funding) and international capital markets to fund their activities. Thereby, a significant substitution in the liability structure of banks from non-bank customer deposits towards more short-term and volatile funding took place. This made banks very vulnerable to funding problems. Liquidity crises transmitted through international financial markets and it increased the interconnectedness and the systemic nature of European banking at the same time. Moreover, it led to complex and opaque intermediation chains that in turn created hidden maturity transformation, liquidity risks, credit risks and distorted incentives. These complex chains of intermediation with their origin in a model of financial intermediation depending on short term funding from international capital markets have been pointed out and discussed in detail by Shin (2010).

The increasing cross-border nature of banking in Europe together with its considerable dependence on international markets for short-term debt was not matched by an appropriate regulatory and supervisory development at the supranational level. This was one of the important structural shortcomings revealed by the financial crisis of 2007 and 2008. Despite a certain harmonization process of regulatory frameworks, supervision remaining organised along the traditional boundaries of nation states had a very difficult task to uncover the risks hidden in complex cross-border chains of financial intermediation, starting with the access to appropriate information.

As pointed out for example by Hellwig (2014), the crisis has revealed another critical aspect of supervisory shortcomings resulting directly from the organisation of supervision along national borders. In the course of any banking crisis, issues of insolvency had to be dealt with by regulators and poli-

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ticians, which are particular complicated in the case of big banks. First of all, insolvency problems must be identified as early and as correctly as possible. The standard criterion to identify an insolvent banks is when the value of its assets falls short of the threshold of its regulatory capital. When such a situation occurs, it is inferred that at some point the bank will not be able to cover its liabilities. In practice, especially when markets freeze and market prices are often unreliable during a crisis, the valuation of assets and liabilities becomes very difficult and contains a considerable amount of judgement. At this stage, if supervision is organised at the level of nation states, attempts that would force banks to reveal their losses, to recapitalize or cut back their activities might be postponed. This situation is likely to be reinforced by fiscal concerns, especially since the fiscal authorities that might start operating are also confined to national borders and coordination might be difficult and the willingness for burden sharing limited. If the recapitalization or closure of insolvent banks implies a large fiscal burden for particular countries, supervisors are likely to be challenged between their individual supervisory mandate and general macrostability concerns in a situation like this. In a cross-border institutional design like the SSM, supervisors, by definition, are in a much stronger position to address the relevant issues.4

An additional important point in this respect is the widespread lack of appropriate resolution instruments (in Europe). Authorities and supervisors might feel that anything other than forbearance and playing for time might be worse; this is to say risking a disorganised wind down of financial institutions with complicated cross-border coordination and burden sharing issues down the road. As a consequence this will have an impact on bank behaviour and supervision ex ante, resulting in excessive risk taking by banks and probably a soft and light touch approach in supervision and regulation.

How Will the SSM Change the Behaviour of Supervisors?

The SSM will change the supervisory framework in Europe significantly. For the first time in the history of the European Union there will be a banking supervisor with a European mandate that is based on a common set of rules developed by the European Banking Authority. The new framework enables supervisors to look at cross-border banks beyond a viewpoint shaped mainly by national borders already in non-crisis periods. If supervisors actively use this opportunity, this will become a strong force against market fragmentation and financial disintegration. This fragmentation was fostered during the crisis by the spiral of weak banking systems impairing the sovereign states that had to provide fiscal backstops, which in turn affected the banking systems themselves. This negative feedback loop contributed strongly to a further fragmentation and disintegration of financial markets, complicating the effectiveness of monetary policy as well as putting a burden on cyclical development at the same time.

Within the SSM the ECB will be responsible for the direct supervision of about 130 banking groups, which together represent about 85% of all banking assets in the euro area. Overall, this comprises about 1,200 credit institutions. The centralized supervision and the key role of the ECB in the

4 For a clear and detailed discussion of these issues see Hellwig (2014).
process shall have a strong impact in ameliorating two of the weak spots identified in the previously existing framework: Information flows will be centralized and no longer fragmented according to national institutional arrangements. This setting shall make it much easier to detect risks as early as possible that were hidden in the complex interconnectedness of cross-border financial institutions. The centralization of supervisory responsibility at the level of the ECB should also shield supervisors from a certain home bias and from unequal treatment of financial market participants that may have played some role in a purely decentralized setting.

How Will the SSM Change the Behaviour of Market Participants?

At the level of financial institutions and financial market participants the implementation of the SSM removes many opportunities to exploit the regulatory and supervisory fragmentation of markets that was previously existing. Dealing with a central supervisor will in the short run create a number of practical challenges for individual institutions. Banks will have to deal with a new supervisor who is remote from domestic peculiarities and politics. They will have to ensure compliance with the new uniform guidelines and standards. They will have to cope with new issues in data collection and the provision of information. Banks will have to decide whether they need to expand (cross-border) or if they can deal with the new situation by restricting themselves to “domestic markets”. These are all major challenges that are likely to consume lots of organisational capacity in the short run.

In the medium term the new framework will force banks to think much more in terms of a common European market and a single set of rules. Whether this will lead to a material change in behaviour is of course crucially dependent on how the new supervisory framework is backed up by a credible set of resolution rules. Only if these rules are clear and credible the balance of power can be readjusted in the right direction.

As it has been demonstrated by the evolution of the recent crisis, strategic behaviour of market participants, implying self-interestedness, does not mix well with shared or common interests, such as European integration in general and financial and economic integration in particular. Despite rules and norms in place before the crisis, encouraged by innovation in financial products and enormous profits and gains, financial market behaviour got out of control and restrictions on risk taking or approaches of (self-) regulation functioned less and less effectively (Groenleer et al., 2014).

Will the SSM Change the Role of the ECB?

The integration of supervisory functions with central banking has always been controversial and triggered extensive discussions over decades. Over time, many countries have gained experiences with various models and with a switch between different models. Some countries had integrated supervisory functions into the central bank for a long time, based on the central bank’s role in stabilizing the financial system, its role as a lender of last resort as well as because of its role as a producer of the relevant data. Other countries had

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kept the two functions separate from the beginning, in many cases in the institutional form of an independent financial markets authority. With the SSM it has now been decided that the ECB, as the monetary policy authority for the euro area, will also be in charge of the SSM.

In terms of information sharing this can be seen as a significant improvement compared to the previous arrangements, where monetary policy, in particular liquidity provision, was supranational and banking supervision was national. The challenge for the ECB in the new setting is how to keep the decision making processes separate but efficient within the new arrangement. Beside this difficult challenge of developing appropriate institutional arrangements and procedures in this respect, there are also several immediate practical challenges for the ECB. The most immediate one will be the successful completion of the balance sheet assessment for the European banking system (asset quality review + stress testing exercise). The successful completion of this exercise will be crucial for the reputation of the SSM and define the starting point for the SSM to operational normality.

Beyond that several other urgent issues need to be addressed, including the cooperation between the various involved European and national institutions and the application of a coherent supervisory model across all the different members of the banking union. Another area concerns the collection and analysis of banking data across the banking union. This is a challenge, both in technology as well as in analytical capacity. It is a technological challenge because of the heterogeneity and diversity of systems in which these data are currently stored as well as to bring in line the collected data with the cross-border perspective to be implemented.

Finally, on the side of the regulator there will be the challenge of attracting staff with the right expertise. There will be competition between the ECB and national authorities for qualified staff and there will be a need to train a substantial number of new employees to cope with all the qualifications needed for the new complex supervisory regime.

**Will the SSM Achieve the Desired Results in Practice?**

One important lesson drawn from the Lehmann experience during the financial crisis in September 2008 is that in a crisis even the best supervisor will be helpless if there exist no practical procedures and arrangements that allow the authorities to deal with problem banks effectively. Much of the success of the SSM will thus depend on the functionality and effectiveness of the European resolution regime to be established in parallel to the creation of the SSM (Veron, 2012).

Most relevant in this respect, the Bank Recovery and Resolution Direc-
The BRRD and the Single Resolution Mechanism (SRM) are intended and designed to provide an adequate framework for dealing with troubled banks in an operationally predefined way. Thinking about the quite far reaching consequences of this it comes as no surprise that among commentators as well as within the financial industry this part of the new framework has stirred most of the controversy. Not at least because the outcome of the recent asset quality review and stress testing exercise is directly linked to this issue.

The sceptical arguments that have been put forward are that a multi-entry resolution with different national procedures will not be viable. In particular, because first, the SRM has no facilities to provide funding during a systemic crisis when market funding disappears and second, the fiscal backstops in place are still in the domain of the member states and seem too weak to be able to provide assurance to investors during a crisis. Moreover, as has been pointed out by many critical commentators on the banking union and the SSM in general, the existing European fragmentation of fiscal policy makes the central bank as a backstop less effective than it would be in a situation with some stronger form of fiscal responsibility for banks at the European level as currently envisaged (Dullien, 2014).

While it is too early to draw any final conclusion, it is clear that for the effectiveness of the SSM to trigger material changes in behaviour of supervisors and banks the resolution regime seems to play a decisive role. The BRRD and the SRM are important steps in the right direction but ought to be enhanced in order to conclude the project sustainably in the long-term.

On the Road Back to Integrity in Financial Markets

The SSM constitutes a significant institutional reform in the European Union which was triggered by the lessons learned from the crisis and should change (and stabilize) the European landscape of banking for the future. Information fragmentation as well as coordination issues of a fragmented banking supervision system in Europe had created an environment where supervision and regulation were not as effective as it could and should have been to mitigate at least the propagation of the crisis. Misconduct of financial institutions that were not disciplined to a sufficient extent was one of the crucial determinants of the amplification of crisis effects.

Many of the (old) problems had their roots in fragmentation of supervision in a world of cross-border banking, which will be overcome in the new framework. Nevertheless, the centralization of supervision is only a first step to have a material impact and to produce a considerable improvement. Complementary, an operationally effective resolution structure together with a European deposit insurance mechanism are key. While the European authorities have clearly recognized this and therefore initiated the BRRD and the SRM, this crucial add-on elements to the new framework will remain ex-
tremely controversial in the public discussion for some time.

Overall, regulatory stability is needed as a necessary precondition first, while at the same time much more focus than in the past has to be put on reinforcing the importance of “high quality financial market governance” as well as “financial market culture” and “good behaviour” to counteract a general attitude of de-responsabilisation that led to the current crisis. It has to be recognised that the lasting success of the fundamentally new institutional structure of European banking depends heavily on substantial changes in financial behaviour on the side of the banking industry and financial market participants as well as changes in the conduct of banking supervision and resolution. Only if these changes in the direction of a “more prudent behaviour” of financial market participants will really take place on both sides, a better and more resilient European banking system will emerge.

References