Helmut Ettl

CEO Financial Market Authority

New Frameworks Require New Perspectives: Realizing Common European Banking Supervision

The establishment of the Single Supervisory Mechanism (SSM) signifies a fundamental and radical change in the framework for supervising banks by all banking supervisors in the euro area. It necessitates a change in the legal framework, a change in institutional settings, and a change in the distribution of responsibilities. These changes, however, will not instantly lead to a total change in our thinking and behavior. Realistically, we will see a lag between changes in structures and the changes in hearts and minds that will have to follow. Hence, for the SSM to be successful from the beginning, it will be essential to start thinking as a Single Mechanism from today and start acting as a Single Mechanism from the first day.

To establish a successful new and common approach to banking supervision right from the beginning – as is intended – the following three conditions will have to be met: First, a new supervisory perspective, with the euro area's aggregate economic strength as the point of reference, needs to be adopted. Second, this new perspective will need to translate into taking common decisions in the interest of the European Union as a whole. Thus, a European approach to banking supervision will have to be formed, an approach that will be shaped significantly by the SSM Supervisory Board as the central body for decision making. Third, when decisions are taken, temporary shortcomings and unintended effects such as a possible increase in bank concentration will have to be considered. The following sections will explore the three conditions in more detail.

1 Adopting a New Supervisory Perspective

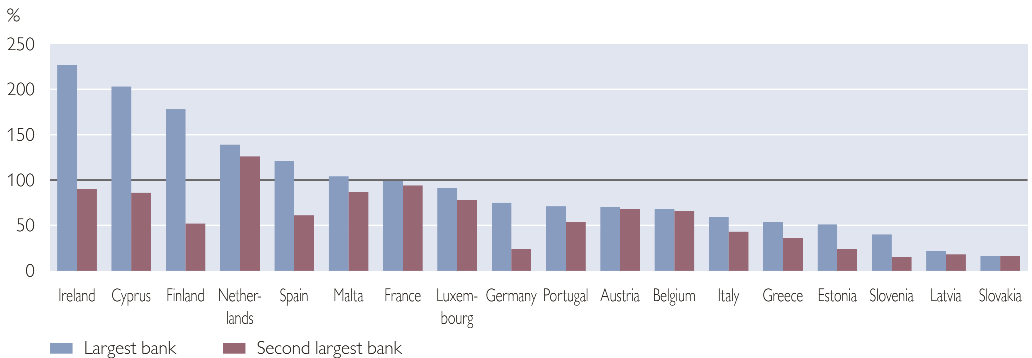
In the era before the SSM, supervisory measures and actions were significantly limited by each member state's capacity to absorb the negative effects of a bank failure or to rescue a bank deemed "too big to fail". The economic strength of the respective member state was the point of reference for supervisory agencies.

The importance of this point becomes most apparent when relating the balance sheets of the largest banks in an economy to its GDP. According to data from 2012, the total assets of the largest banks were outweighing national GDP in 6 out of 18 economies (chart 1). Ireland and Cyprus represent extreme cases, where in each case the ratio of one bank's total assets to GDP exceeded 200%.[1] As a consequence, Irish and Cypriot banks are "too big to fail", and perhaps also "too big to res-

[1] *In Austria, for instance, the largest bank's balance sheet amounts to 70% of Austria's GDP.*

Chart 1

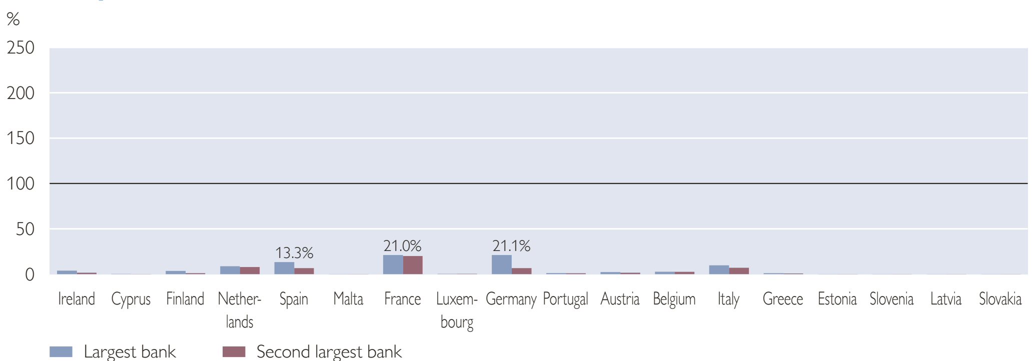
Total Assets of the Two Largest Banks as a Share of the Home/Host Country's GDP by Member State by End-2012



Source: FMA database (2014).

Chart 2

Total Assets of the Two Largest Banks as Share of Euro Area GDP by Member State by End-2012



Source: FMA database (2014).

cue", in relation to the domestic economies. Moreover, as demonstrated in the recent crisis, even the rescue of a bank that is much smaller relative to GDP can create a massive burden on the budget and the tax payer.

The establishment of the SSM does not necessarily affect the size of banks. Rather, it matches the level of governance integration to the degree of market integration. With that, the euro area as a whole will be the new point of reference for banking supervisors. By comparing bank total assets to the euro area GDP (chart 2), we get a very different picture: The majority of significant banks have balance sheets of less than 10% of euro area GDP. Banks with total assets exceeding 10% of GDP can be found in only three countries (Germany, France and Spain), and no bank in the euro area has total-assets-to-GDP ratios exceeding 21% of euro area GDP.[2] The relation between the supervisory jurisdiction and the largest banks is reduced remarkably.

With the euro area as the new point of reference, the figures of the largest

[2] *The largest banks of the euro area such as Deutsche Bank, BNP Paribas and Groupe Crédit Agricole each has assets equivalent to about 20% of GDP.*

European banks are now – in terms of economic weight – comparable to those of the U.S.A.. For example, the largest U.S. bank (JP Morgan) has assets 15% of U.S. GDP (or 23% on an IFRS-equivalent basis).[3]

Thus, from the SSM perspective the weight and importance of each individual euro area institution is reduced to a fraction of its national weight.[4] Therefore, a new economic relationship between the supervised entities, its supervisors, and the European economy will emerge, and have important effects. As a large majority of banks will be far from being "too big to fail", their bargaining power will be reduced, and more pressure can be exerted on them by regulators to act prudentially. A healthier and more balanced relationship will be the consequence. It will be the foundation for a new sustainable supervisory culture.

2 Institutionalizing Decision-Making in the Interest of the European Union As a Whole

Until now, the change of regime exists largely on paper. It needs to be translated into common decision-making processes, formally and informally. Formally, such a translation has been effected through the establishment of the Single Supervisory Board which had its initial meeting in February and has operated since then. Even more importantly, however, a change of regime necessitates a change in mindset. Without adjusting our ways of thinking to the European mandate, we will not be able to establish a level playing field with all its benefits. Thus, the question is how the newly established organizational structures can be transformed into common decision-making processes with the interest of the European Union as their focal point.

Every individual National Competent Authority (NCA) needs to actively contribute to the creation of a European supervisory institution that aims

for the common good and that ultimately acts in the interest of the European citizen. While the Joint Supervisory Teams (JSTs) will be the central fora in which supervisors from different countries join to find a common understanding and way of supervision, the Supervisory Board of the SSM will be the place to substantially shape the common supervisory approach.[5]

The Supervisory Board's central position in the supervisory framework is based on its particular features. Formally, the Board's members are the executive directors of the NCAs[6] plus a Chair and a Vice-Chair, and four repre-

[3] *ESRB. 2014. Is Europe Overbanked? Reports of the Advisory Scientific Committee, 4.*

[4] *To give an example: Erste Bank Group, presently the largest bank in Austria, has total assets amounting to only 2% of euro area GDP.*

[5] *Joint Supervisory Teams are composed of staff from National Competent Authorities and are led by an ECB JST Coordinator. Every significant banking institution will be supervised by a full JST.*

[6] *If the National Competent Authority is not the national central bank, a representative of the national central bank may attend the meeting. The voting right is to be exercised by the representative of the National Competent Authority.*

sentatives of the ECB. Its main responsibility is to adopt decisions on the microprudential level concerning any of the – currently around 130 – banks that are deemed to be "significant" and thus fall under direct ECB oversight.[7] These supervisory decisions will be made by the collegial board by simple majority. Most importantly, the Supervisory Board is obliged to act in the interest of the European Union as a whole, as stipulated in the SSM Regulation. This means that the common good of the European Union, not national interests is to guide the actions and decisions in the SSM.

These are all very important prerequisites for a common European way

of supervision. However, bridging the gap between national supervisory habits and a common way of European supervision in the interest of the European Union is not straightforward. It will be crucial to ensure that decisions are not made on the basis of hard bargaining as particular national interests are played out against each other. Such an outcome would be far from desirable from the viewpoint of the European citizen. To some degree the risk of national interest-based bargaining can be avoided by protecting the votes of individual Supervisory Board Member by not making them publicly available. Studies in the field of public choice (e.g. Stasavage, 2004[8]) have shown that overly-extensive transparency in political negotiations may have detrimental effects on consensus finding and the provision of public goods because national representatives are then incentivized to take positions that are close to national interest and potentially less beneficial for the entire community. As in arrangements applied to the ECB's Council, the internal rules of the Supervisory Board restrict the public disclosure of the views of individual members and protect their individual deliberations, proposes, and vote record at Board Meetings.

Essentially, the Board will live by the individual experience and knowledge of its members at the table. Ideally, the Supervisory Board shall be a forum of discussion based on each member's individual (and largely national) experience, which acts upon this collective knowledge in the interest of the European citizen. We need to "raise our hands, not our flags". This will be the key factor in the process of successfully creating a common European supervisory mechanism.

3 Anticipating Shortcomings and Avoiding Unintended Effects of the SSM

We need to consider also possible shortcomings and unintended effects of the SSM that can, especially during the first phase of the SSM, counteract su-

[7] *This means that we will co-decide on banks located either in Austria or in other euro area member states such as Spain and Germany.*

[8] *See Stasavage, D. 2004. Open-door or closed-door? Transparency in domestic and international bargaining. In: International organization 58. 667–704.*

pervisory goals and complicate regulatory tasks.

In this regard, it is worth remembering that the SSM can be fully effective only from 2016, when all components of the banking union are operational. For instance, the complete range of bail-in instruments will not be active before 2016, and the Single Resolution Fund will be fully funded after a transition period of another eight years. During this transition period, we need to anticipate possible situations in which decisions are taken at the European level and risk is still be borne at the national level, because neither the formal mechanisms nor the framework for a common resolution scheme will be fully operational, and so individual member states and tax payers will have to pay in full the eventual bill for a failing bank. This asymmetry during the transition period requires the Supervisory Board to consider more carefully and consistently national particularities when deciding, for example, on capital and liquidity adequacy requirements for supervised banks, or on corrective measures. Therefore, a more complete shift from a national to a European perspective will be feasible and desirable only in the medium term.

We should be aware also of other possible unintended effects of the SSM. Common regulatory standards and a common supervisory mechanism could favor another wave of consolidation in the European banking industry, following the consolidation wave set off by the establishment of the EU's Single Financial Market. While, given the paradigmatic shift in banking supervision, a certain degree of consolidation may be natural and may strengthen the competitiveness and profitability of banks, consolidation should be avoided where it increases systemic risks and oligopolistic tendencies. Also, consolidation can lead to attenuated competition and reduced availability of financial services in some regions, and hyper-competition and low margins in other regions.

4 Conclusion

We have already come a long way to reach the present state of the Single Supervisory Mechanism. Much has been done so far to draft the legal framework, determine the basic institutional settings, and design the new way of European banking supervision. Yet, while the formal implementation of the SSM has made good progress, transforming the formal provisions into a real change of regime requires our minds and habits to change as well. For this reason, it is worthwhile taking a step back and considering the metamorphoses we have to undergo to create a real European Single Supervisory Mechanism. First and foremost, we need to adopt a new supervisory perspective with the euro area as the new point of reference. Second, this new perspective has to be translated into decision-making for the benefit of the European citizen, while making use of diverse national experience. Overcoming national habits and constraints will be a key factor in establishing a real level playing field with the industry. Third, we need to be aware of temporary shortcomings of the SSM during the transition phase before all components of the banking union are operational. Thus, unintended effects, such as a further increase in bank concentration, need to be considered even more carefully when taking supervisory decisions in the first phase of the SSM. We need to implement the Single Supervisory Mechanism in national legislation and formal national procedures, but most importantly, and ultimately, we need to adopt a European perspective for a truly common and single supervisory mechanism.