Article published in the
Federal Ministry of Finance's Monthly Report
January 2018

The Single Supervisory Mechanism: Lessons learned after the first three years

- The Single Supervisory Mechanism (SSM) commenced operations on 4 November 2014.
- The SSM is one of the central components of the European banking union established in response to the global financial crisis and the subsequent sovereign debt crisis. Its aim is to unify and improve banking supervision in Europe.
- The legal bases for cooperation between supervisory authorities within the SSM framework are laid down in "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" (SSM Regulation) and "Regulation (EU) No 468/2014 of the European Central Bank of 16 April 2014 establishing the framework for cooperation within the Single Supervisory Mechanism between the European Central Bank and national competent authorities and with national designated authorities (SSM Framework Regulation)".

Introduction

As part of the EU's efforts to overcome the financial crisis, the European banking union was set up for the purpose of enhancing the stability of the financial system and advancing financial market integration. The banking union is based on a common set of rules (called the Single Rule Book) that cover, in particular, banking supervision, the resolution of banks, and deposit guarantee schemes. The SSM is one of the three pillars of the banking union alongside the Single Resolution Mechanism and the further harmonisation of national deposit guarantee schemes. It provides a European-level perspective on banking supervision, a perspective that is necessary due to Europe's tightly interlinked banking sector. The objective is to ensure consistent supervisory practices by EU member states and to break the dangerous nexus between bank debt and government debt that exacerbated recent crises in certain member states.

Structure and functioning of the SSM

As early as 29 June 2012, euro area heads of state and government reached a general agreement that a single supervisory mechanism for euro area banks should be established at the European Central Bank (ECB). On 3 November 2013, the Regulation "conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions" (the SSM Regulation) entered into force. One year later, the SSM was up and running. The SSM Regulation was supplemented by the SSM Framework Regulation, which was issued by the ECB on 16 April 2014 and which lays down the general rules for cooperation between supervisory authorities within the framework of the SSM. The ECB's role as banking supervisor currently covers only those member states that belong to the euro area. Non-euro area member states may choose to join the SSM if they wish, but so far no countries have exercised this "opt-in" option.

Distribution of tasks within the SSM

The SSM is an aggregation of banking supervisors that encompasses the ECB and the national supervisory authorities of the member states (which are referred to as National Competent Authorities or NCAs). The ECB is tasked with the direct supervision of "significant institutions" in the euro area. A credit institution's significance is gauged on the basis of various criteria: the decisive criteria include the total value of a credit institution's assets (i.e. whether or not these exceed €30 billion), the ratio of the credit institution's assets to the GDP of the member state where it is domiciled (i.e. whether or not this ratio exceeds 20%), and whether or not the institution has received direct financial assistance from the European Stability Mechanism (ESM). In any case, the three largest credit institutions in each member state are subject to direct supervision by the ECB. In addition, the ECB has ultimate decision-making powers over what are referred to as "common procedures" that apply to significant institutions and to those that are designated "less significant institutions"; these procedures include the issuance and withdrawal of banking licences and the review of acquisitions of qualifying holdings (i.e. holdings that exceed 10%). NCAs provide the necessary input for these ECB decisions. In addition, NCAs retain direct supervisory powers over less significant institutions. Germany's NCA is the Federal Financial Supervisory Authority (BaFin), which exercises its powers in cooperation with the Deutsche Bundesbank.

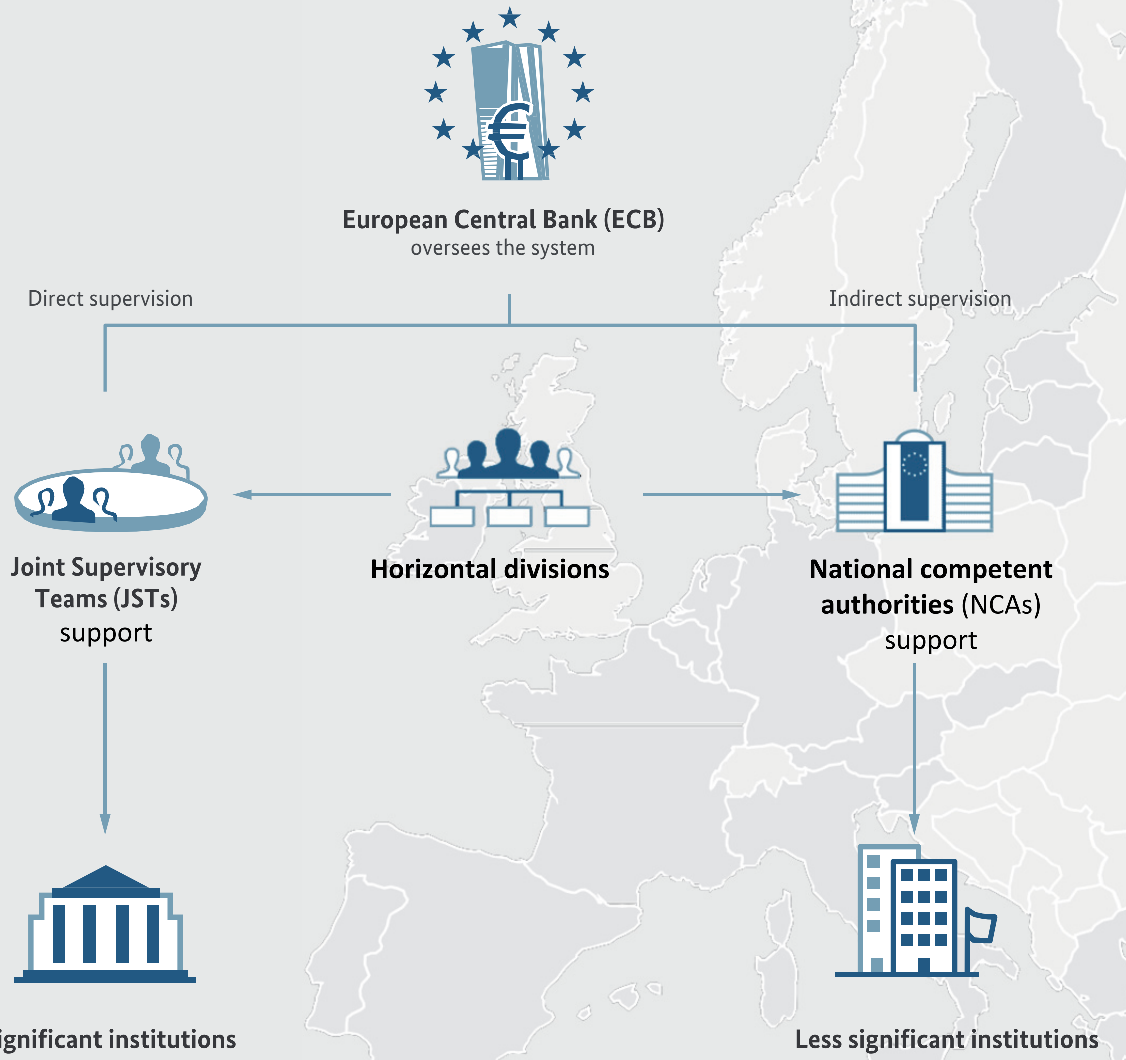
In all, the ECB exercises direct supervision over 119 significant institutions and banking groups in the euro area. 21 of these have their headquarters in Germany. As of the close of 2017, 1,457 German credit institutions are classified as less significant and are subject to direct supervision by BaFin in cooperation with the Deutsche Bundesbank.

Cooperation within the SSM

The ECB and the NCAs work together closely in performing the tasks they are charged with. The NCAs provide the ECB with all the information it needs to complete the tasks assigned to it by the SSM Regulation, and they assist the ECB in carrying out such functions as on-site bank inspections. The supervision of individual significant institutions is conducted by Joint Supervisory Teams (JSTs) that are composed of staff from both the ECB and the NCA of the country where the institution in question is established. The specific composition of a JST is based on the significance, complexity, business model and risk profile of the supervised credit institution as well as the scale of the institution's business activities in individual SSM member states. The ECB may also require NCAs to provide notification of (a) the material supervisory procedures conducted and (b) the material supervisory decisions taken in connection with less significant institutions. In doing so, the ECB is exercising the powers that have been conferred upon it to ensure the application of high supervisory standards and consistent supervisory outcomes (indirect supervision). The ECB also has the option of assuming full supervisory powers over less significant institutions. In addition, it may issue regulations, guidelines or general instructions to NCAs in order to ensure the implementation of consistent, high standards throughout the euro area.

Distribution of tasks within the SSM

Figure 1



Source: ECB

The SSM's first three years: a positive track record

The SSM has built a positive track record in its first three years of operation. Europe's single banking supervisor was created under tremendous time pressure as the first component of the banking union. It now plays an important role in safeguarding long-term financial stability and advancing financial market integration. The SSM has made it possible to harmonise supervisory practices, which not only helps to unify bank regulatory policy on an EU-wide basis but also significantly enhances the stability of the banking sector. This same conclusion was reached by the European Commission in its report to the European Parliament and the Council dated 11 October 2017. As a result, the Commission finds it unnecessary to amend the SSM Regulation at this time.

During the past three years, the further harmonisation of supervisory practices under the SSM has brought Europe closer to its objective of using consistent, high standards to supervise euro area banks. For example, bank supervisors have a variety of options and discretions at their disposal, and in 2016, the ECB and the NCAs agreed to harmonise how these options and discretions are exercised throughout the entire euro area. Another key instrument for harmonising supervisory practices is the Supervisory Review and Evaluation Process (SREP), which ensures that all euro area banks are supervised on the basis of the same methods and standards. As part of the SREP, supervisory authorities review whether credit institutions (a) conduct adequate internal evaluations of risks and (b) manage these risks properly. To the extent necessary, individual banks may be subjected to additional capital and liquidity requirements. The European Banking Authority's guidelines on SREP already contain harmonised European specifications, which the ECB used as a basis for setting up a supervisory review and evaluation process for all significant institutions. The ECB is currently working together with the NCAs to develop an SREP methodology that will be used for less significant institutions.

Despite this positive track record, there is still room for improvement in certain areas. In particular, the SSM framework should ensure that significant institutions remain subject to a full and complete public auditing process. When supervisory powers over significant credit institutions domiciled in Germany were transferred to the ECB, this meant that the European Court of Auditors – not the Bundesrechnungshof – is now in charge of the public auditing of these institutions. To further improve the European Court of Auditors' public auditing practices, a cooperation agreement should be concluded between the Court and the ECB.

Enhancing governance

In addition to its supervisory capacities, the ECB is also in charge of euro area monetary policy. These two tasks that have been conferred upon the ECB pursue different objectives – regulatory compliance and the stability of the banking sector on the one hand, and price stability in the euro area on the other – that can conflict with each other in certain cases. For this reason, when the SSM was established, a priority was placed on maintaining a strict separation between the ECB's monetary policy functions and its supervisory tasks. A specially created Supervisory Board prepares all supervisory decisions, although these decisions must be taken by the ECB's decision-making body, the Governing Council, which is also responsible for making decisions on monetary policy.

A clear separation between monetary policy and banking supervision would require giving the Supervisory Board ultimate decision-making power over supervisory matters. But this would mean that the EU treaties would have to be amended, a step that requires political unanimity among all EU member states. Until such a step is feasible, the existing arrangements inside the ECB aim to ensure a clear organisational separation between these two areas of responsibility, including separate reporting lines and secrecy requirements.

Separation of monetary policy and supervisory functions

The EU treaties stipulate that, within the ECB, only the ECB Governing Council has the power to take decisions that have an external impact. This is a provision of primary law that could not be modified by a provision of secondary law in the SSM Regulation. For this reason, supervisory decisions must be made by the Governing Council, which is also responsible for making decisions relating to monetary policy. Decisions in the area of banking supervision are made on the basis of what is called the "non-objection procedure": under this procedure, the Supervisory Board submits draft decisions to the Governing Council that are deemed adopted if the Governing Council does not object within a specified period of time. In addition, a mediation panel was set up for the purpose of resolving differences of opinion between affected member states and the Governing Council.

Centralised decision-making structures cultivate a common understanding of bank supervisory rules and standards throughout the euro area, thereby helping to ensure a level playing field for all banks. However, the push towards harmonisation should not lose sight of the fact that banking supervision must function effectively. Every year, the Supervisory Board and Governing Council must make thousands of decisions, and these decisions are prepared using a complex coordination procedure that incorporates input from national supervisory authorities and central banks. The decisions that need to be made vary widely in terms of complexity and importance and do not always require the involvement of the Supervisory Board and Governing Council. In the interest of greater efficiency, the ECB's proposal to delegate (a) routine decisions and (b) decisions with minor implications to the working level is a welcome idea. This would allow the Supervisory Board and the Governing Council to focus their resources on major decisions.

Ensuring proportionality

The SSM puts structures in place to ensure (a) the uniform application of high supervisory standards throughout the euro area and (b) the cross-border monitoring of Europe's closely interlinked banking sector. It is crucial, however, that both supervisory and regulatory practices strike a proper balance between harmonisation and proportionality. Regional, non-complex institutions should not have to satisfy the same requirements that apply to large international banks. This does not mean less supervision but rather supervision that is suitably tailored to a bank's size and complexity ("small banking box"/more proportionality in banking regulation).

Small banking box/more proportionality in banking regulation

Germany has proposed to the other EU member states that an alternative regulatory regime be put in place for small and non-complex credit institutions. As a first step, during the process of revising the Capital Requirements Regulation (CRR) and the Capital Requirements Directive (CRD IV), the German government pressed for substantial simplifications to be made within the existing legislative framework. Germany's objective is not to weaken regulation but rather to ensure a level of regulation that is well-suited to small, non-complex institutions. Unnecessary bureaucratic requirements – reporting obligations, for example – should be eased for small, non-complex banks, but fundamental capital, liquidity and risk management requirements should remain in place.

The principle of proportionality should also be taken sufficiently into account in other processes such as the Supervisory Review and Evaluation Process. A bank's internal risk measurement and risk management procedures must be in line with its business model, size and risk level. These objectives should be taken into account in the SSM's SREP methodology for less significant institutions.

Summary remarks

Three years after its launch, the SSM has proven itself to be a supervisory network that functions smoothly and effectively and that has helped to make the European banking system more stable and resilient overall. Europe's single supervisory mechanism is headed in the right direction, but certain areas require further improvement.