SCOPE

Supervision – the overlooked strength of Europe's banking systems

Sam Theodore | November 2023

European banks are displaying strong and stable financial and business fundamentals in no small measure due to the effectiveness of the supervisory regime and practices successfully pursued since the aftermath of the global financial crisis a decade and a half ago. Supervisors are unsung heroes of the European sector in ensuring it remained trouble-free during the various convulsions of recent years: the pandemic, Russia's war on Ukraine, inflation and cost-of-living stresses, and the demise last spring of SVB, Signature, First Republic, and Credit Suisse. Each such convulsion triggered "the crisis is back" market panic about the sector. Each time, to paraphrase Mark Twain, the reports of a new crisis were greatly exaggerated.

I see bank supervision facing several growing challenges, which in relative terms should move it in new and more complex directions. Specifically, there is the need to supplement quantitative tools – like prudential metrics – with qualitative and scenario-based elements which fill in the blanks when relating to non-financial risks: cyber, digital-transformation, business model, misconduct, and fraud (including money laundering and terrorism finance), climate, etc.

The fast-evolving and increasingly complex financial ecosystem makes it evident that supervisors' reliance mostly on the classic prudential metrics – capital, leverage, liquidity, and funding – is no longer capturing the full range of banking and financial risks. There is significant systemic risk in banking even when capital and liquidity remain adequate. This is not always recognised by the markets – which focus mostly on banks being profitable and complying with prudential metrics – but supervisors are increasingly moving in this direction. More recent speeches and documents published by supervisory authorities attest to that.

Equally, supervisors are increasingly aware that new market dynamics and different sets of progressive regulations (PSD2/PSD3, FiDA, MiCAR, etc.) are unmistakeably changing the banking landscape, while prudential entry barriers into the banking sector set up by protective regulations remain high. Specifically, open banking and finance, private credit provided by specialised funds and other non-bank sources, etc., are testing the staying power of the incumbent banks and implicitly the reach of their supervisors. More in-depth cross-sector and cross-border cooperation among bank supervisors and other public authorities is required.

The increasing use of artificial intelligence should help the supervisory function improve and become more targeted. Specifically, AI could cover more routine tasks (box-ticking) that still take the lion's share of supervisors' day jobs, thus speeding the processes, minimising unnecessary overlaps, and adding more quality and meaning to the supervisory function.

Regulation vs supervision: not the same

Market observers have highlighted the effectiveness of the regulatory architecture put in place after the GFC – in essence a much-revamped prudential regime and the new resolution framework – as the foundation for the banking sector's improved financial wellbeing.

But any regulatory framework, strong and reassuring as it may be, is but a static foundation which *ipso facto* cannot guarantee banks' performance within safe and stable parameters in an ever-shifting environment. It is supervision which is the dynamic agent of change for how banks perform and behave in various circumstances. Supervision that can be effective, proactive, adaptable, and reliable; or light-touch, rigid, reactive, and unreliable – as was the case before the GFC.

When assessing banks' financial strength and performance, analysts and investors relate to wise, risk-adverse management strategies, and rightly so when it is justified. Less evident is that, to a larger extent than often assumed, supervisory guidance and steering help convince bank CEOs and their boards to limit the downside risk of implementing some of these strategies – or to engage in more material remedies if the risk taking becomes excessive. In other words, while supervisors, understandably, hardly push for banks to boost profits – that is more the market's job – they pay attention to the risk taking and risk management side of their activities.

Supervision vs. resolution: uneven equilibrium

Confident as I may be that vigorous and proactive on-the-ball supervision can help keeping a bank out of terminal troubles, I am highly sceptical that, when a bank gets closer to that cliff, resolution on its own will rescue it.

My previous *The Wide Angle* report suggested that the prompt and unconditional takeover of the financially stressed bank by a financially healthy domestic peer should be the only effective endgame of bank resolution, if resolution really must be activated – a big if, as the takeover of Credit Suisse by UBS has proven. If necessary, that would include an element of softer state support (emergency liquidity, second loss guarantees, etc.) to make the transaction more palatable to the acquirer. No other planned resolution avenue, notably not restoring the failing bank as a viable independent entity, can safely succeed without materially increasing the risk of a bank run.

This makes supervision essential in preventing bank accidents. In fact, we can consider supervision as the last reliable external line of defence against a bank failure, because if the worsening situation slides beyond the supervisory reach, all bets are off. As we have seen with Credit Suisse's demise, compliance with capital and point-in-time liquidity prudential metrics are not a guarantee against the threat of a dramatic flight of deposits or other customer funds which can impact the entire bank's business model and viability.

Good, dynamic supervision needs to go beyond prudential compliance. All available tools need to be fully used well ahead of a cliff-edge scenario. Through decisive early intervention -- including senior management changes, business-line restructuring, if necessary, going all the way to non-equity capital conversion or write-downs – supervisors can keep a bank away from failure, thus avoiding the more nebulous resolution zone.

The uneven equilibrium between supervision and resolution appears more evident in the euro area, where the supervisor, the ECB, and the resolution authority, the Single Resolution Board (SRB), both powerful, are nonetheless two institutionally separate bodies located in two different cities (Frankfurt and Brussels, respectively). While the ECB and the SRB have a history of cooperating closely are working hand in hand in supervision/resolution colleges, the slide of a failing bank from supervision to resolution may be less smooth than in the case of jurisdictions where supervision and resolution are under one umbrella – like the UK, Denmark, or Switzerland. And even in the latter case, as shown by the Credit Suisse saga, it is the national government which may decide to avoid the official resolution process when deeming that the evolving situation of a nationally important bank (in this instance a G-SIB) is beyond the reach of normal supervisory action.

SSM – a framework delivering on its promise

The Single Supervisory Mechanism (SSM), established 10 years ago, has delivered good and balanced supervision across a uniquely large and diversified banking sector despite

some initial teething problems. It is widely recognised that, by and large, EA banks have managed to stay out of trouble during difficult years. The ECB is the world's only supervisor responsible for systemically important banks covering no less than 21 national banking systems at present: it directly supervises 109 banking groups representing 82% of aggregated EA banking assets. Bringing all banks to a supervisory level playing field has been a task the ECB has been striving to achieve from the start, so far with positive results, at least for the largest groups.

In addition, I view the ECB as one of the better and more transparent supervisory authority public communicators. There are numerous reports and speeches which shed light on the ECB's supervisory thinking and acting – something that on balance is welcomed by banks and market participants.

Author

Sam Theodore

Senior Consultant
Scope Group
+44 (0)7769 321043
s.theodore@scopeinsights.com

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Scope SE & Co. KGaA

Lennéstraße 5
D-10785 Berlin
scopegroup.com

Phone: +49 30 27891-0
Fax: +49 30 27891-100
info@scopegroup.com

Bloomberg: RESP SCOP

Contact Details

scopegroup.com/contact

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