ECB single supervisor's relations with national authorities still in flux

Six months after the European Central Bank took charge of bank supervision in the eurozone, its division of powers with national authorities and international organisations is still being defined.

By Philip Alexander

Danièle Nouy, chair of the single supervisory mechanism (SSM) at the European Central Bank (ECB), has made clear the ambitious agenda for harmonisation that the SSM will pursue, and the difficulties of achieving it. In a letter to members of the European Parliament in May 2015, Ms Nouy said the "application of the different national laws is hampering the achievement of a level-playing field and further integration in the banking sector," which is a key objective of the eurozone banking union.

EU directives can be interpreted at the national level based on each country's legal system. Ms Nouy said this unavoidably led to "divergences" in the way rules such as the Capital Requirements Directive had been implemented.

"These are differences relating to both detail and scope. Furthermore there are cases where it is not clear whether certain national provisions implement or complement the directive, which gives rise to legal uncertainty whether, having regard to the provisions of the SSM regulation, the ECB is competent to exercise the power directly or instruct the national competent authority to decide," said Ms Nouy.

Since November 2014, the SSM has been responsible for directly carrying out prudential supervision at the eurozone's largest banks – currently 123 in number – and for indirectly overseeing smaller banks through the national authorities. For directly supervised banks, on-site supervision is now carried out by multinational joint supervisory teams (JSTs) based in Frankfurt.

"The ECB is moving rapidly to harmonise supervisory techniques. The JSTs are almost a revolution, because the head of the team will never be from the bank's home country, which is an important cultural change. One of the main challenges for the new supervisor will be how to prioritise its actions and react swiftly to the questions from the banks to have a smooth relationship," says Marie-Anne Barbat-Layani, chief executive officer of the French Banking Federation.

At present, directly supervised banks are still sometimes receiving information requests from local supervisors, and it is not always clear if this is on their own initiative or at the behest of the ECB. On the flip side, the ECB may also stray into areas that are theoretically still in the hands of national authorities.

"The ECB does not have a mandate on consumer protection, anti-money laundering or payments. But there have been some grey areas where the directly supervised banks have asked for clarification. In particular, the ECB has sometimes made direct enquiries on the payments system and security issues, even though banks are meant to be reporting to the local supervisor for this information," says Reima Letto, head of banking prudential regulation at the Federation of Finnish Financial Services.

Josef Christl
"The complex organisational structure could be a major impediment to taking quick, difficult decisions"

National discretion

Alongside the three directorates general consisting of JSTs, the SSM also has a fourth directorate general (DG4) under the former head of group risk at Germany's Commerzbank, Korbinian Ibel. This has responsibility for providing specialised services across the whole SSM, including quality assurance, assessing banks' internal capital models and developing new standards and policies. DG4 will be crucial to the harmonisation process within the banking union.

The SSM has already issued guidance on payout ratios for dividends, and to what extent banks can include interim profits in their Tier 1 capital. The regulator has indicated that its next priorities include national discretions on the definition of capital, especially the inclusion of deferred tax assets or goodwill, and the review of internal models.

"This is the first sign of evidence that the SSM wants to move quickly, and to ensure a level playing field; objectives that we totally support," says Bertrand Lussigny, director of bank supervision at the French Banking Federation, and a former prudential regulator at the Banque de France.

The ECB has identified 154 national discretions that it is examining, and it calculated in the comprehensive assessment that these add up to a total of €126bn in capital – with the inclusion of deferred tax assets in the capital base a major contributor to this figure. Consultancy Deloitte has produced a six-month report card on the progress made by the SSM, which notes that three countries – Germany, Spain and Italy – account for half the sum.

"The concern is that higher capital needs could affect economic growth, but the response from SSM executives is that more credible definitions of capital will help boost confidence and bring down funding costs, so banks will not lose out overall," says Clifford Smout, a partner in Deloitte's centre for regulatory strategy in London.

Proportionate burden

This does not mean all national discretions will be removed. If the SSM believes there are grounds to take a proportionate approach, then some discretions could be retained. But to ensure a level playing field, Mr Smout says they would need to be open to all 19 members of the banking union. The question of proportionality also feeds into the wider discussion about how the arrival of the SSM will affect the thousands of smaller indirectly supervised banks.

"We would not expect the examination of the financial position of indirectly supervised banks to be as intensive as the comprehensive assessment. But the ECB remains ultimately responsible for the supervision of these smaller banks, and they will not want to adopt an approach that is transparently inconsistent with what they do with the larger banks. Any differences will have to be justified in terms of proportionality," says Mr Smout.

However, Mr Letto says the SSM is already having an impact on indirectly supervised banks, because it has assumed responsibility for their licence approvals from the local supervisor. He says this has become very time-consuming, with large numbers of applications queuing up at the ECB even for mergers between small, highly capitalised Finnish co-operative or savings banks that have no cross-border operations.

"The local supervisor also seems to be willing to extend decisions addressed to directly supervised banks in a copy-and-paste manner to the indirectly supervised institutions, such as how far interim profits can be included in the core Tier 1 capital ratio," says Mr Letto.

Business model scrutiny

Another potentially far-reaching innovation from the SSM is the adoption of business model analysis. This tool is already used by UK supervisors, but it represents a significant innovation in some eurozone jurisdictions. It may have strategic implications for certain banks.

"There are initial indications that the ECB may have reservations about certain business models, although the methodology has not settled down yet and we do not know how it will feed through to Pillar 2 capital add-ons. The SSM is very clear that it is not for them to mandate business models, but rather to discover what the potential weaknesses are," says Mr Smout.

The analysis of business model weaknesses is particularly complicated. For instance, reliance on wholesale funding could make a bank more susceptible to failure or it could be the symptom of rapid balance sheet growth that is itself the source of vulnerability. Nonetheless, the need to ask such questions is clear, following the poor performance of Italy's popolare co-operative banking sector during the comprehensive assessment. The Italian government has now introduced legislation to allow restructuring and changes to the popolare ownership system to ease recapitalisation of these banks.

"The ECB's business model analysis will feed into the shake-up that is already happening. In Austria for instance, federal guarantees are being removed from the hypotheken banks, which will need to rebuild. Hypo Alpe Adria is being broken up, and the banks that have a central and eastern European focus are reconsidering their geographic footprints. We can also see that the Raiffeisen organisational structure is making it more difficult to raise additional capital," says Josef Christl, an independent consultant who was previously head of bank supervision at the Austrian National Bank.

Marie-Anne Barbat-Layani
"The joint supervisory teams are almost a revolution"

International sphere

One vital question on which the SSM regulation is largely silent is the role it will play in international regulatory discussions, in particular at the Financial Stability Board (FSB) and Basel Committee on Banking Supervision (BCBS). Ms Barbat-Layani says the SSM is powerful because it represents 19 different countries without being tied to one particular national authority. She believes its credibility has been further enhanced by the success of the comprehensive assessment exercise in 2014.

"We have had the unsettling episode of the EU introducing the bank resolution and recovery directive, and then just a few months later the [total loss absorbing capacity] initiative was launched by the FSB. These things need to be more coherent, and one of the ways that can be done is for the ECB to play an important role in putting forward the interests and specific characteristics of the eurozone in global discussions on banking supervision. French banks support the banking union as this corresponds to their criteria of rigorous risk management," she says.

Mr Smout says the ECB is also in a strong position to influence the discussions on the consistency of risk-weighted asset calculations. It has direct access to a larger sample of banks than the BCBS, and as a supervisor rather than a coordinating body it can also make deeper enquiries to get behind the numbers.

Daniel Trinder, global head of regulatory policy at Deutsche Bank, says studies by the BCBS suggested that about 75% of risk-weighted asset (RWA) variation was due to actual differences in risk, with a significant portion of the remaining 25% down to differing supervisory interpretations in each jurisdiction. He believes DG4 will play a central role in addressing these variations.

"The Bank of England and Federal Reserve both have a large number of global banks to benchmark and compare against. Most individual eurozone regulators never had that before. The SSM now permits peer review supervision. It has a division with a specific remit for peer and horizontal review, to ask searching questions about RWA consistency and other supervisory issues across the whole banking union," says Mr Trinder.

A more immediate concern will be the SSM's relationship with the other pillar of the banking union itself. The single resolution board (SRB) is already recruiting its staff, which will ultimately number 270. It will begin full operations from January 2016, based at the European Commission in Brussels, rather than with the ECB in Frankfurt.

The SSM has its own crisis management team and Mr Smout says there is the potential for this team and the SRB to require different information from banks on resolution planning. Mr Christl believes the real acid test of the whole banking union concept will be the ability of the two different boards in different cities to handle a crisis management situation.

"It is still too soon to judge the long-term success of banking union. The day-to-day supervision seems to be working well so far and supervisory standards in general are improving, but the complex organisational structure could be a major impediment to taking quick, difficult decisions," says Mr Christl. GRR