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Banking Union: what are the priorities of the SSM to achieve trust in the banking system?

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Objectives of the session

This session discussed whether the expectations related to the SSM had been met so far. The objective of this session was also to review the priorities of the SSM and the significant challenges of how to achieve trust in the banking system of the Eurozone and make banks' business models sustainable in the current monetary, economic and regulatory environment.

Executive Summary

Benefits of a Single Supervisor

Since 2014, the Single supervisory mechanism (SSM) has been responsible for supervising the most significant banks in the Eurozone, with the aim of ensuring consistent supervisory practices and increasing the soundness and stability of the banking system. In order to treat equally all supervised banks showing the same characteristics, the ECB needs homogeneous rules and homogeneous ways of applying them. Some benefits had arisen from the moves towards an integrated framework that had taken place over the course of the past year and a half. The SSM has achieved a lot in the areas of common approaches, common supervision, and levelling differences. There had been in particular an integration of practices, and willingness to borrow from best practices that were already present across Europe.

As the SSM operational units, joint supervisory teams (JSTs) are composed of ECB and national competent authorities (NCAs)' staff. The SSM draws therefore on the expertise and resources of 19 NCAs in performing its supervisory tasks, while also benefiting from centralised processes and procedures. This set-up allows for a cross-border perspective while retaining a national perspective. The SSM is a major step towards a level playing field in banking supervision in Europe. In the future it will continue its endeavours towards full comparability and harmonisation.

The EBA's deliberations had included the important issue of how to ensure the existence of a common rulebook and practices across the European Union, beyond the boundaries of the monetary union and the SSM. The concept of dealing with a single supervisor was a very attractive one to international banks, and now that regulators in the Eurozone were gathered together, it was easier to identify the differences between regulatory approaches across Europe: for example, the differing approaches to the supervisory review and the evaluation process (SREP). Indeed there had been 19 different approaches to Supervisory Review and evaluation Process (SREP), but these were now being organised in a much more consistent and integrated way. It took some time to fully realise all those benefits in an operational sense, but there had still been some ‘major game changers’ and steps forward.

In addition, having a single representative body able to conduct meetings with the Federal Reserve or the Prudential Regulation Authority (PRA), as an equal partner in a trilateral context, had also been helpful.

Predictability, consistency and Coordination Issues

SSM was a major investment, and the result of a major crisis; it had been in place for 16 months, and had achieved some of its goals, but a lot more work needed to be done. There needed to be both operational and regulatory improvements to improve the performance of the SSM. Firstly, it would be necessary to plan the SSM’s actions better, with involved parties receiving the agendas of meetings sufficiently early to prepare for them; more transparency and feedback in relation to things like the SREP methodology and internal model validation; and clarification on how the ECB intended to integrate the stress-test results in the SREP analysis in 2016. The calendar of the SREP needed to be reformed, to reduce the amount of activity that was front loaded into the first half of the year.

Increased visibility would also be necessary in relation to the Basel Committee, SSM and EU Commission regulatory agendas. There should be clarification regarding reporting requirements, to reduce duplicated requests. Although the concept of having a single approach was being widely debated, there had been multiple perspectives prevalent during the discussion at the end of 2015 on Pillar II and MDA; there needed to be a more coherent and consistent view on these crucial issues, as this had led to instability in the market and higher volatility. More precisely, the EU legislation created notably an inconsistent treatment of AT1 instruments across Europe. Firstly, these instruments were paid, not based on group results, but on solo accounts of the company. In his institution’s case, their holding company is based in Germany, and subject to German GAAP. In order to avoid confusion of investors, the payment on AT1 instruments should be based on IFRS. Secondly, many investors do not understand that in Germany AT1 payments were not based on the Group level but on the GAAP solo account of the company. This should be based on the consolidated accounts of the group, as is the case in the US. Thirdly, uncertainty is created due to the different interpretations of the interaction between the Pillar II requirement and MDA (e.g. CRD IV vs. EBA/ECB and European Commission).

There was no more volume in the market: banks were keeping liquidity for themselves, which made banks safer but weakened the market. As such, adjustments were based on price, which created huge volatility, and made the market susceptible to shocks such as the one that had happened over Chinese New Year 2016. Inconsistency in legislation, uncertainty about supervision, and huge volatility added up to cause accidents.

The question of MREL and TLAC, and the respective role of SRM and SSM, needed to be considered, along with the problem of Basel IV and the consequences for the IRB. There also ought to be more guidance and transparency in the area of internal models. Although the direction of Basel on this issue was not necessarily welcomed by the industry, banks would still want to know what was impending.

Banks needed to become accustomed to the fact that the macro environment, technology and regulation were the three key factors that were structuring and lowering prospective profitability, and the enhanced perspective of organic capital generation. The SSM should also become familiar with these issues, in the sense that capital needed to increase generally, and would also need to develop a fruitful relationship with other supervisors. It would be helpful, as well, for the SSM to unify its practices and to be seen as banks' main interlocutor, rather than just another partner; to become better known outside of the Eurozone; and to build up its relationship with US regulators.

International groups were calling for the banking union to be treated as in a single jurisdiction and not face local requirements (capital, liquidity); some progress had been made towards this goal, such as having waivers for solo rules in individual countries, but these moves had been too cautious. Best practices from individual countries were currently being brought to bear in the supervisory approach of the SSM; Dutch bankers had introduced a bankers' oath, and the SSM had also taken an interest in countries that paid more attention to details, file reviews, and data analysis. These two approaches were complementary and enriching.

A lot more could be done in relation to the SRB and the SRM. Regarding the former, the focus was always on when a bank was failing or likely to fail, and when control moved over to the resolution authorities: it had become clear that it was usually not difficult to determine that a bank was failing, but it was more difficult to determine what form the bank should take after the resolution weekend, and what supervisory requirements would need to be imposed on it. This topic needed to further looked at.

Progress on conduct had been slower. Conduct regulation and supervision had been kept within the scope of national authorities; this was a very important issue, and now that prudential aspects had been dealt with, it was the next thing to look at.

SSM Evolution in Countries with Large Foreign Banking Sectors

Representatives of national banks in countries where large percentages of the banks were foreign banks differed regarding the impact that SSM had had. One stated that the SSM environment meant that co-ordination had to take place at the higher SSM banking union level, or Eurozone level, which had significant impacts on their regulatory and supervision cultures. The other stated that national organisations had worked well with their counterparts in different countries in the past; they had had joint memoranda of understanding, and he did not perceive a significant difference between the pre SSM and post SSM situation. Improvements could be made: the supervisory review process timelines could be better aligned, and there should be a clearer policy stance on stress testing approaches for subsidiaries, although the panel member acknowledged that more time was needed.

Achieving Trust, Reforming Banks' Business Models and improving profitability

One banking representative stated that profitability would inevitably be lower in the future taking into account the monetary, economic, technological and regulatory environment; to manage this, it was vital to have notably clarity and guidance on the forthcoming regulations. The instability of legislation has not helped to restore confidence in the EU banking sector and had had major consequences for the profitability of banks. For instance, specialised lending could lead to a threefold or fourfold increase in capital requirements. Investors wanted opportunities to discuss Basel with European banks, and when they did so, it was important for banks to be able to speak about them in detail. Due to the uncertainty on the forthcoming global (Basel IV) regulations, banks had not been in a position to do so and this could create volatility in European financial stocks, which was something that definitely needed to be avoided in the current, already volatile context.

Non performing loans in the banking system in Europe, and levels of certainty business models, also needed to be considered. Non performing loans having recurred as a source of concern was surprising, because a very comprehensive assessment had taken place at the end of 2014, with provisions increasing to the necessary level. However, investors did not accept this when banks had non performing loan percentages of 20% or higher; this would need to be addressed via the SSM.

Regarding NPL, this was an important indicator, but from a supervisory capital and equities calculation perspective, prudent and concrete asset value was more important. Ultimately, capital adequacy was the most important ratio, and if the value of assets was correct, differences in NPL ratios did not distort the analysis and comparability of the banks.

According to a central banker, with the present low interest rates they had not yet significantly damaged the interest income of banks but, eventually, they would do so, and there was also concern about how banks would develop their business models. To address these kinds of concerns, it would be necessary to enhance synergies, and to produce more realistic assessments at both the local and group levels and at the SSM level. Risk assessment methodology was vital: uniform terminology, uniform assessment of scoring indicators, and uniform reporting needed to be in place; otherwise, different requirements would be in place for the same risk level in different banks and groups, which would cause competitive disadvantages. A panel member from a smaller European country noted that there was a need to consider the pressure that all of these demands placed on administrative capacities and on staff.

In such a context, for stable profits to be achievable in the future, regulatory stability was essential. The finalisation of Basel III needed to be completed within a reasonable timeframe and calibration for stability’s sake, although there were good reasons why time had been taken over this. Other challenges to banks’ business models included competition, technological innovation and market developments; instability was not only arising from regulatory concerns.

A Central Banker summarised the job of supervisors as containing three aspects: promoting a stable regulatory environment while completing the banking union project in the appropriate way; promoting consistency and a level playing field, both within the SSM and globally with peers; and to militate against the huge amount of pressure that was placed on institutions to be profitable, which created a risk of them acting in ill advised ways. Supervisors should identify weak practices reaching for yield, inappropriate risk return, and short term type behaviour.

Detailed Summary

1. Benefits of a Single Supervisor

Since 2014, the Single supervisory mechanism (SSM) has been responsible for supervising the most significant banks in the Eurozone, with the aim of ensuring consistent supervisory practices and increasing the soundness and stability of the banking system.

A representative of a large cross border banking group stated that he had seen some benefits over the past year and that in terms of integration the glass was half full. There had been an integration of practices, and clear strategic willingness to borrow from best practices that were already present in the supervisory landscape across Europe and the relevance of Pillar II for the Nordic countries, as well as certain approaches to site analysis in other countries. This brought about an integrated framework which was clearly challenging, yet fair and transparent. He stated that all of the BRRD related topics for the SSM perimeter of competence were now moving towards a much more integrated approach than had been the case in the past, which was a positive development, as was the willingness to adopt a single group recovery plan.

A representative of the public authorities observed that SSM was a major investment, and the result of a major crisis. It had been established 16 months ago, and although there were reasons to be optimistic, a lot more work needed to be done. Prior to the SSM, 19 countries had been coordinating their activities through a college; now, these were subsumed into a joint supervisory team, coordinated and led by the ECB and benefiting from the input of the different member states. This allowed for a cross-border perspective, while retaining a national perspective as well. The SSM had also run a comprehensive assessment and had concluded that, because of options and national discretions, it was not possible to fully compare capital ratios: these differences could result in 1% to 2% capital ratio differences. The other goal that needed to be pursued, therefore, was comparability and a level playing field.

He specified that the SSM had achieved a lot in the areas of common approaches, common supervision, and levelling differences. A large number of areas remained beyond their control: certain differences were embedded in legislation, and some member states were actually trying to embed more of these, in order to maintain certain practices. These were areas in which legislative solutions may be necessary. The SSM would use their powers to the maximum extent possible, and benefits were already being seen in a number of areas. Liquidity was an area in which it will be possible to have more transferability of liquidity than had been the case in the past while also reflecting prudential concerns about the distribution of liquidity in a group.

There had been 19 different approaches to Supervisory Review and evaluation Process (SREP), but these were now being organised in a much more consistent and integrated way. Having a single representative body able to conduct meetings with the Federal Reserve or the Prudential Regulation Authority (PRA), as an equal partner in a trilateral context had also been helpful. The ECB was working on addressing a number of the issues mentioned, including developing more consistent ways to review models in an environment heavily affected by Basel. Some very good dialogues were taking place with the industry, regarding how to make our supervisory programme more transparent, including on-site inspections, which was a controversial area.

A Central Banker noted that one important strand within the organisation’s deliberations had been how to ensure the existence of a common rulebook and practices across the European Union, beyond the boundaries of the monetary union and the SSM. A representative of the industry stated that, although banking union had not yet been achieved, a significant amount of work had taken place. The concept of dealing with a single supervisor was a very attractive one to international banks; it would allow them, in principle, not to have to deal with lots of different authorities but with a single one. Given that the institution was quite new, a huge amount of work that had been done, and banks appreciated this.

Another Central Banker stated that, now that regulators in the Eurozone were gathered together, it was easier to identify the differences between regulatory approaches across Europe: for example, the differing approaches to the supervisory review and the evaluation process. This had now been co-ordinated, and there was a single approach, which he expected would continue to develop. This speaker added that international groups were impatient to be treated as a single jurisdiction; some progress had been made towards this goal, such as having waivers for being subject to solo rules in individual countries, but these moves had been cautious. Even with a single SSM, a balance was struck between pursuing financial integration and the need for prudence. Regarding the interaction between the national supervisors and the ECB, it appeared that best practices from individual countries were being brought to bear in the supervisory approach of the SSM: for instance, his nation was quite advanced in terms of behavioural finance, and in understanding the impact of behaviour and culture on the governance of institutions. His country's bankers had introduced a bankers' oath. The SSM had also taken an interest in other countries, which paid much more attention to details, file reviews, and delving into the data. The two approaches were complementary and enriching.

2. Predictability and coordination Issues: there should be improvements, both from an operational perspective and from a regulatory one

A banker stated that not all the conditions were yet in place to allow the Eurozone to benefit fully from single supervision. Improvements need to be made, both from an operational perspective and from a regulatory one. Regarding the former, it would be necessary to have better planning of the SSM actions and have more transparency in the calendar for thematic reviews and enquiries. Banks needed to receive the meetings' agendas sufficiently early on to prepare for them; in addition, more transparency and feedback on the SREP methodology and internal model validation were necessary; and clarification on how the SSM intended to integrate the stress-test results in the SREP analysis in 2016 was needed. With regards to internal models, it was extremely important to have a clear framework regarding the approval process and the timing. Any change in this respect would lead to considerable delays in the update of the existing internal models, and so this was a clear operational problem.

Another banking representative also insisted on the need for **more guidance and transparency in the area of internal models**. This was an issue regarding which banks had invested significantly over the past years, including IT, resources and money, and banks perceived a natural tendency to 'front-load' the upcoming regulation. He added that having more clarity on some key methodological issues would be key, including SREP transparency in terms of results and of the MDA. Banks needed to know how things would work, or it would be difficult to engage investors in the market and give them clear guidance on the expected prudential requirements. According to this industry representative, the calendar of the SREP needs to be improved: there would be an 'intense concentration of activity' between the end of January and June, and in 2016, the stress test would take place and a couple of thematic reviews would begin. This puts large amounts of stress on the structures and the people within banks, which also had other tasks to fulfil during this period. This calendar should be improved in future, probably by moving the thematic reviews closer to the end of the year when the SREP was concluded, in order to put a smoother process in place.

The previous speaker stated that **clarification regarding reporting requirements was necessary**: there had been a significant increase in the volume and frequency of data reporting, with duplications of requests. For the leverage ratio, for instance, there were three different reports with slightly different calculation methods: the Quantitative Risk Assessment (QRA) for systemically important banks, the SREP and CRR delegated acts. Regarding reporting to the ECB and concentration risk, 90% of this data was already reported for large exposure purposes: there was therefore duplication, which was a problem. Operational losses were reported three times – in the short-term exercise, in SREP and in QRA, using slightly different methods and definitions. It would therefore be helpful to speak with banks regarding the content and format of forthcoming new data requests.

Another representative of the industry stated that the challenges for the SSM remained the same as they had been in the past. There had been previous mention of a recent confrontation between the SSM and the industry; clearly, there was willingness to co-operate and improve on this. From a more structural perspective, banks needed to become accustomed to the fact that the macro environment, technology and regulation were the three key factors that were structuring and lowering prospective profitability, and the enhanced perspective of organic capital generation. The SSM should also become familiar with these issues, in the sense that capital needed to increase generally. However, his organisation recognised that this recognition would take some time, provided that there were no specific idiosyncratic crises, which were difficult to predict.

According to him, the SSM would also need to **create a fruitful relationship with other supervisors**. Although the banking representative was not an expert on the relationship with the US, it was clear that one less desirable by-product of having the SSM as a 'strong player' in the European supervisory framework was that it had created defensiveness on the other side of the relationship. The relationship within a college of supervisors had previously been a relationship between peers; now, this had changed, and on issues such as MDA, there were some disputes between the SSM and other supervisors which would need to be addressed. Going forward, the SSM would become more powerful and able to steer the debate and the supervisory framework across Europe.

A Central banker stated that his country's perspective was that it was necessary to enhance synergies, and produce a more realistic assessment at the local and group levels and the SSM level. Risk assessment methodology was key: there needed to be uniform terminology, uniform assessment of scoring indicators, and uniform reporting. If this was not in place, different assessments would be created, which would mean having different requirements for the same risk level in different banks and groups. This would, in turn, cause competitive disadvantages: not only among SSM banks, but also between SSM and other jurisdictions like Asia and the US. His country expected improved co operation between EBA and the Basel Committee and better implementation in all these jurisdictions; otherwise, other banks are likely to lose in competitiveness. The panel member added that there was a more technical issue to consider: all of these demands placed pressure on administrative capacities and on staff.

A banking representative stated the SSM, being a new organisation, needed to get to 'know itself'. Many people within her firm working on regulatory issues thought the introduction of the SSM would mean the bank would only have to be in contact with a single authority. In reality, it problems the old regulators still want to be actively involved. One of the challenges for the SSM will be to unify supervisory practices over time, and become banks' main interlocutor, rather than just an additional partner. The SSM also needs to become known outside of the Eurozone. Indeed, the SSM is now the largest supervisor in the world and other supervisors will need to acknowledge it. The relationship between the SSM and the US regulators is very important for instance, especially for banks that are also present in the US and currently struggling to implement their intermediate holding company. The representative was confident that this relationship will be strengthened step by step.

Secondly, commenting on the scope of the SSM's competences, the representative reminded the audience that the SSM is in charge of the prudential framework. Although this is fine, there is a lot of regulation outside of this scope that is also very important and that is the conduct rules.

Conduct matters is been kept within the scope of national authorities' competences. Now that prudential aspects have been largely dealt with, it will be important to make sure that payments are processed safely, that everything that is going through banks' pipelines is acceptable from an anti money laundering perspective, and that customers are looked after. This is difficult to achieve with various authorities being in charge of conduct matters. Therefore, a harmonisation or integration of conduct supervision should be a priority for policy-makers in the coming years.

A representative of a central bank noted that **a lot more could be done in relation to the Single Resolution Board and the Single Resolution Mechanism**. On single resolution, the work that was done was always focused on when a bank was failing or likely to fail, and when control moved over to the resolution authorities. The lesson had been learned from the countries that were dealing with resolution that it was usually not difficult to determine that a bank was failing; it was more difficult to determine what form it should take after the resolution weekend, and what supervisory requirements would need to be imposed on that particular bank when it was emerging. This topic had not yet been developed to a significant extent.

The issue of having two institutions dealing with a business was absolutely contiguous with this kind of delicate relationship; when the relationship was called into question, it was a very difficult moment for a bank. Bank resolution in Europe and worldwide was a largely new issue, and had to be made to work well.

Another Central Banker on the panel noted that, from a more technical perspective, there needed to be more co-ordination between the Single Resolution Board, the supervisory authorities, and the SSM. His institution was a central bank, with both mandates: responsible for supervision, and also a single resolution authority. They needed more common procedures, which would decrease the administrative burden on the banks. More co-operation in this area would be welcomed by the industry.

3. The lack of consistency on Pillar II and MDA had led to instability in the market

A representative of a bank stated that, although there was discussion of a single approach, there were still ‘multiple heads’ in existence, along with unstable legislation. There had been multiple perspectives prevalent during the discussion at the end of 2015 on Pillar II and Maximum Distributable Amount (MDA); there needed to be a more coherent and consistent view on these crucial issues, as this had led to instability in the market and high volatility. Banks needed certainty, consistency and a global vision, both from the public and the private sector, and to understand how these things interacted dynamically within the current macro-economic environment, which was one of no growth and a zero interest rate.

One illustrative example was what had happened during mid-February in the market with regards to Additional Tier 1 (AT1) instruments; this clearly showed a lack of certainty, a lack of consistency, and a lack of global vision.

The legislation created an inconsistent treatment of AT1 instruments across Europe: Firstly, these instruments were paid, not based on group results, but on solo accounts of the company. In his institution’s case, their holding company is based in Germany, and subject to German GAAP. In order to avoid confusion of investors, the payment on AT1 instruments should be based on IFRS. Secondly, many investors do not understand that in Germany AT1 payments were not based on the Group level but on the GAAP solo account of the company. This should be based on the consolidated accounts of the group, as is the case in the US. Thirdly, uncertainty is created due to the different interpretations of the interaction between the Pillar II requirement and MDA (e.g. CRD IV vs. EBA/ECB and European Commission).

There was no more volume, because banks kept their liquidity for themselves, and as such, although the banks were safer, the market was weaker. Adjustments were based on price, which created huge volatility. During February, in the week of the Chinese New Year, one third of the world had not been trading, which increased volatility. Inconsistency in legislation, uncertainty about supervision, and huge volatility – due to of a lack of liquidity in markets – could cause accidents, and Gary Cohn had expressed these concerns the previous day of the Eurofi conference. It is important to address these issues and ensure that there is certainty, consistency, and a global vision.

4. SSM Evolution in Countries with Large Foreign Banking Sectors

A Central Banker stated that more than 90% of his nation's banks were subsidiaries or branches of foreign banks, mostly based in Austria, Italy and Belgium. This legal and cultural environment had been complicated, because a cross-border bank had changed their subsidiary to a branch, but this branch was a subsidiary of the Czech Republic, which was not part of SSM. This was a complication that needed to be solved at the SSM level: this bank was the fourth biggest bank in his country. Although one might start at the group level, the SSM environment meant that co-ordination had to take place at the higher SSM banking union level or Eurozone level. This was a very important issue in his country; it completely changed the country's regulatory and supervision culture.

A representative of a different central bank stated that his country's experience was a unique one: around 90% of the country's banking sector was owned by subsidiaries of non-SSM countries like Sweden and Norway. The three biggest banks were Scandinavian banks, which meant that there was a need for a high standard of co ordination between his nation's supervisors and Scandinavian authorities. These organisations had always had a very good understanding of each other, with memoranda of understanding between them, and he did not perceive a significant difference between the pre SSM and post SSM situation. Some aspects should be improved; for instance, the supervisory review process timelines could be aligned, and there should be a clearer policy stance on stress testing approaches for subsidiaries. However, these were aspects of daily business, and with the SSM being a unique and new project, more time was needed to achieve this level of co-ordination.

5. Achieving Trust and Increasing profitability are very challenging in the current monetary, economic and regulatory context.

The instability of legislation and the lack of visibility on the forthcoming global and EU legislations have not helped restore confidence and have impeded the consolidation of the EU banking sector

According to a representative of the industry, the question of MREL and TLAC, and the respective role of SRM and SSM, needed to be considered, along with the problem of Basel IV and the consequences for the IRB. Instability in legislation has not helped restore confidence. Ever since the beginning of 2016, there had been very high volatility; the risk premium on bank capital was very high; and, despite low interest rates, the cost of capital had not decreased. A significant part of this risk premium was connected to unpredictable legislation. The piling up of regulatory constraints has a cost. For example, a large part of the cost reductions achieved by SSM banks that have engaged in a cost reduction plan have been absorbed by their contributions to the Deposit

Guarantee Schemes and the Single Resolution Fund. They were also aware of the fact that Basel IV might significantly change the European environment.

Banks' restructuration could be a way to manage compliance costs but restructuration requires an accurate assessment of the profitability of the different business units and asset prices which is based on capital requirements. However, there was no visibility on the value of the assets, and no visibility on the profitability of the different businesses, because it was not clear what the capital requirement would be in the future in the context of Basel IV and TLAC/MREL. Specialised lending, for instance, could lead to a fourfold increase in capital requirements, and if this were to be the case, it would not be possible to restructure this sector, to sell activities, or to concentrate on or buy these activities. This was a major problem for the industry at the present time: it was extremely difficult to reduce costs and improve banks' profitability in Europe.

A representative of a Central bank stated that the need for regulatory stability was important, as those who worked in European standard setting bodies were already aware. The finalisation of Basel III needed to be completed within a reasonable timeframe, and needed to create some stability. Basel III was a significant endeavour, responding to a major crisis, and could therefore not be completed in a short timeframe; however, it needed to be completed reasonably soon, in order to provide a stable regulatory environment. He noted, though, that this issue did not just relate to the regulatory environment, but also to the financial and technological environment. He did not entirely agree with the implication that the only challenge to the banks' business models came from some degree of regulatory uncertainty; there were also fundamental issues regarding competition, technological innovation and market developments to consider.

A Head of supervision stated that regulatory uncertainties had existed while the regulation was being finalised; although the importance of this should not be minimised, he would want to draw attention to two other important issues, which were non performing loans in the banking system in Europe and the uncertainty around profitability and business models.

Non-performing loans had recurred as a source of concern.

According to this speaker, this was 'a bit of a paradox', because at the end of 2014, there had been a very comprehensive assessment and provisions had been increased to the necessary level. At present, the collateral and the provisions were in place, but investors did not accept this when banks had non performing loan percentages of 20% or higher. Addressing this via the SSM would be an important task, and would be led by the Head of Supervision of Ireland. Additionally, some of the jurisdictions within the SSM were making good progress; for example, in Italy, changes to the insolvency regime would improve the situation in relation to non performing loans. This was a very important endemic cause of uncertainty throughout the banking system in 2016.

Other aspects were more related to the industry and to the issue of NPLs. According to a Central Banker, at the moment, there was uniform definition at EU level; it was possible to compare the banks' asset quality. NPL was an important indicator; however, from a supervisory capital and equities calculation perspective, prudent and concrete asset value was more important. High NPL ratios with high provision coverage ratios could show the same conservative approach as a low NPL ratio of good quality portfolios. Ultimately, capital adequacy was the most important ratio, and if the value of assets was correct, differences in NPL ratios did not distort the analysis and comparability of the banks.

The banks in his country had had 19% NPL levels in 2011; currently, this level was between 5% and 6%; its receipt was very simple: it recognised losses in a conservative manner. If possible, a bank should get rid of assets and write off loans as soon as it became clear that no recovery was possible; however, he noted that different situations had different strategies and different views on how to solve the issue. A representative of a national bank added that the legal framework was also important.

Improving and Sustaining Profitability

Non-performing loans did not help profitability. A Head of supervision specified that with the present low interest rates they had not yet caused much damage to the interest income of banks but, eventually, they would do so. There was also concern about how banks would develop their business models. There were therefore a number of endemic issues in the banking system in Europe, and some uncertainty arising from the regulations that were currently being finalised.

According to a bank representative, profitability would be lower in future, which would be a challenge in the current economic and monetary context. This could not be avoided, but it was important to have clarity and guidance on the regulatory framework. Investors wanted to discuss the Basel landscape with European banks, because they sometimes struggled to understand what was happening; and banks need to be able to answer their questions and concerns. Banks had not been in a position to do so in relation to the recent MDA issue, as well as other topics, and this could create volatility in European financial stocks, which was something that definitely needed to be avoided in the current, already volatile context.
A Central Banker stated that the current environment was a very demanding one, for reasons including regulatory issues, macro issues, financial aspects, and competitive pressures. Banks had a significant role to play; they would restructure to varying degrees, depending on how they were affected, and the need to do this well was the reason why people working for these banks were paid so highly.

He concluded by mentioning that supervisors' roles had three aspects: promoting a stable regulatory environment while completing the project in the appropriate way; promoting consistency and a level playing field, both within the SSM and globally with peers; and to militate against the huge amount of pressure that was placed on institutions to be profitable. Supervisors should identify weak practices reaching for yield, inappropriate risk return, and short term type behaviour; the SSM should look at profitability drivers, governance, risk appetite and deep diving in areas like leverage finance, commercial real estate, and shipping. This was to make sure that institutions, as they transformed their business models, did so in a way that was sustainable in the long run.