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Giving European banking supervision an additional boost

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In the last three years we have lived through several challenging events, which have affected the world economy and the European banking system in particular. An unusually prolonged low interest rate environment was followed by two unforeseen shocks – the COVID-19 pandemic and the war in Ukraine, which eventually triggered inflationary pressures and changes to monetary policy, leading to a steep rise in interest rates.

The level of uncertainty has increased significantly and several risks to the banking sector have worsened. In the current context, it seems clear that banking business models with poor governance of credit risk, asset liability management, IT or risk data aggregation and reporting, among other areas, are especially exposed.

The banking sector also faces challenges of a more structural nature, including: (i) the impact of growing digitalisation in our society and the financial services industry with the emergence of new technologies, players and business models; (ii) climate related risks – a relatively new area of supervisory focus of increasing relevance; and (iii) the expansion of non-bank financial intermediation since the global financial crisis (GFC), providing credit to the market but also representing additional sources of risk to the banking sector through their interlinkages.

Managing risks in this new uncertain environment has become a complicated task for institutions and poses a significant challenge to regulators and supervisors. Banking regulation, for its part, was significantly strengthened as a result of the GFC, with stricter capital and liquidity requirements that have enhanced bank resilience and made banks much better prepared for turbulent times. These improvements certainly have helped, and continue to help, the European banking system to successfully navigate the storms of the pandemic, the war in Ukraine and the recent US and Swiss banking crises. In addition, the full implementation of Basel III reforms is expected to further reinforce banks' solvency.

Under these circumstances, there seems to be no urgent need for major regulatory changes. Regulatory and supervisory bodies could now rather work towards ensuring that the existing wide-ranging banking rulebook is applied correctly and only make very specific adjustments if needed.

Supervision has also been strengthened since the creation of the Single Supervisory Mechanism (SSM) with the development of a common approach that ensures the consistent application of regulation and supervisory policies and fosters risk-based supervision. Nonetheless, it seems to be the right time to **emphasise the role of supervisory activities, which should take full advantage of existing regulations**. In this regard, we could focus on the following three areas:

1. **Allow for sufficient flexibility to be able to adequately respond to the current dynamic environment.**

   Supervision should provide an agile response to an ever-changing environment, finding the right balance between defining a clear strategic plan and allowing for the flexibility needed in the face of the current high level of uncertainty. In essence, the framework should be able to deliver a medium-term plan with relevant activities aimed at improving the structural weaknesses identified and, at the same time, be open to the possibility of shifting gear and deploying resources to address new, unexpected challenges that may emerge.

2. **Advance further in setting risk-based supervisory priorities to achieve greater effectiveness.**

   Over the last years, the supervisory framework of the SSM has evolved in the right direction by giving increasing prominence to achieving greater supervisory effectiveness with a risk-based approach instead of principally aiming for compliance with a set of methodologies and procedures. Continuing along these lines, the supervisor could further develop and implement a risk tolerance framework to focus on each bank's key vulnerabilities and empower the use of supervisory judgment.

3. **Design more action-oriented supervisory measures to enhance the impact of supervision on banking activities.**

   Banking supervision has to be intrusive and dig deep into banking operations, structures and decision-making processes. The findings identified should be directly linked to the measures requested, with clear indications to the bank and planned follow-up actions. Furthermore, the supervisor needs to review the actual effectiveness of its activity, with a regular assessment of supervisory results, and draw lessons for the following planning cycle.

In summary, banking supervision and regulation are becoming increasingly complex with the need to deal with emerging and structural challenges. In this context, an enhanced supervisory strategic direction is gaining increasing relevance. We propose the three action areas mentioned earlier as a way to further strengthen European banking supervision.