
24.07.2024

**Ten years of the Single Supervisory Mechanism: key aspects of
modern banking supervision***

KPMG

Madrid

Margarita Delgado

Acting Governor

* English translation from the original in Spanish.

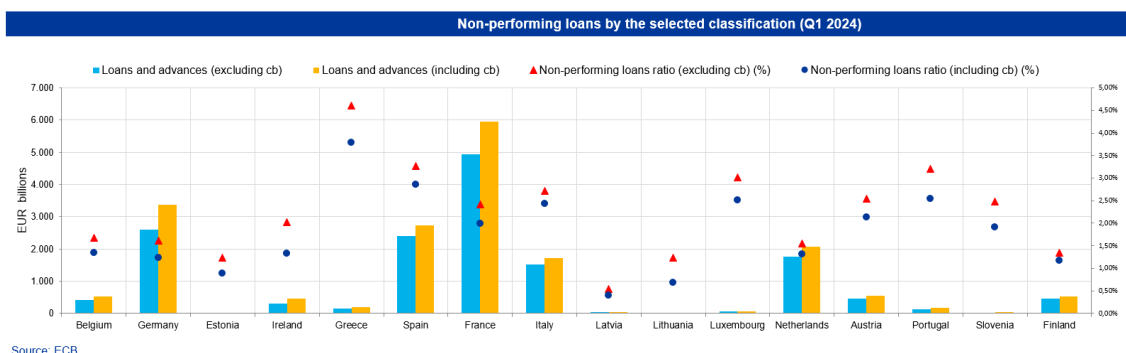
Good morning.

Welcome to this celebration of the tenth anniversary of the Single Supervisory Mechanism (SSM). This is a landmark occasion: a chance to, first of all, cast our eyes back and look at what has happened in the banking sector over the last ten years and, second, reflect on what the near future may hold for us in supervision.

This anniversary represents, then, an opportunity to take stock of the current situation of the banking sector, how it has been affected by the new supervisory model implemented a decade ago and, above all, what lessons can we learn to continue improving, thereby strengthening our financial system?

I will divide my speech today into three parts. I will begin by considering the current situation of the banking sector under direct SSM supervision, before looking back at what has been achieved in these ten years and then finishing with my perspective on the challenges facing supervision in the future.

First, we must acknowledge that the banking sector is in generally good health, as indicated by the main ratios we use to measure the most significant risks.



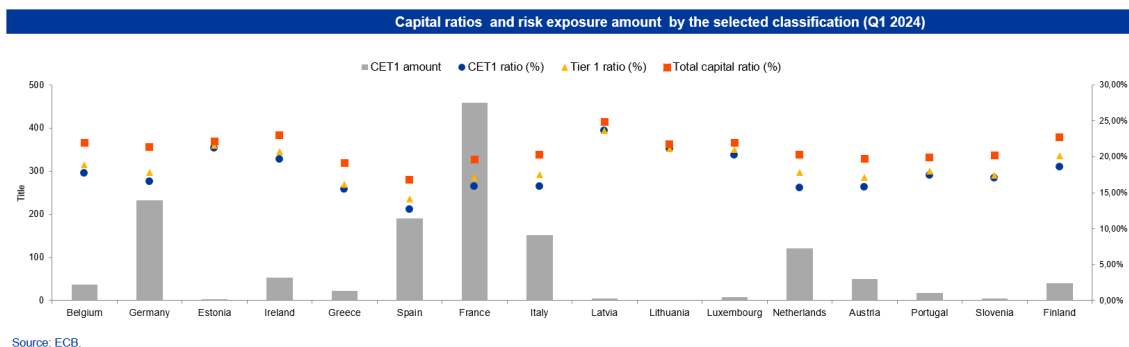
Source: ECB.

Beginning with **credit risk**, the non-performing loans (NPL) ratio stood at 2.31%¹ in 2024 Q1, according to the latest report by the European Central Bank (ECB), with NPLs amounting to €354.8 billion, which was a slight increase, of 1 basis point (bp), over the previous quarter, although it remains at a low level historically speaking, as we will see later. These figures are the Eurosystem average but, as usual, vary across countries.

Thus, for example, NPL ratios in the large economies range from 3.26% in Spain to 1.55% in the Netherlands. The extremes are found in Greece (4.60%) and Latvia (0.54%). The range narrows if analysed by business model, with ratios between 3.07%, for banks deemed to be diversified lenders, and 1.17%, for custodian banks.

¹ Excluding central bank exposures.

French and German banks have the largest NPL portfolios by volume, which is understandable given their joint weights in the banking system as a whole. Indeed, French banks hold 34.8% of all loans by euro area significant institutions, far ahead of German banks (in second place, with 16.6%) and Spanish banks (in third place, with 15.3%).



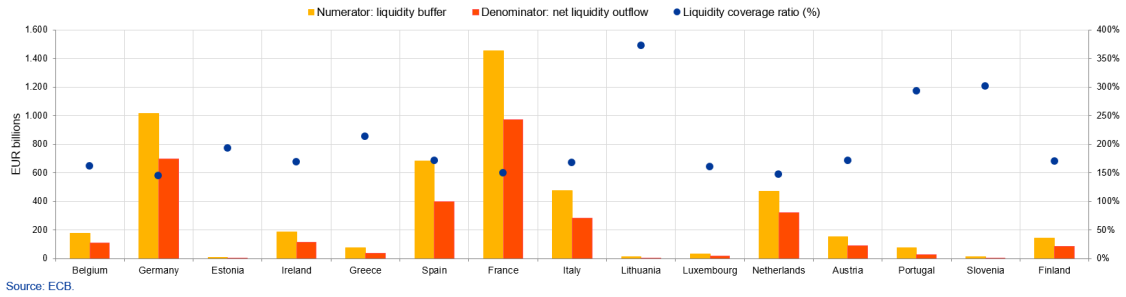
Source: ECB.

Turning to **solvency**, the CET1 ratio stood at 15.74% in 2024 Q1, with the total capital ratio at 19.81%, figures similar to those of the previous quarter. Similar to credit quality, the differences across areas and business models are even starker in the case of solvency. The CET1 ratio varies between 14.14% among global systemically important institutions and 33.68% among development and promotional banks. The most robust CET1 ratios in the large economies range between 16.52% in Germany and 12.66% in Spain, with the latter having the lowest rate in the euro area. As we have often noted, the predominant business model of Spanish banks revolves around international activities that generate recurring revenue, but which also lock up larger amounts of capital in risk-weighted assets (RWAs).

As also mentioned in the past, internal models (normally linked to lower capital requirements) are less commonly used by Spanish banks. 51% of credit RWAs in Spain are reported under the standardised approach, compared with 43% in Italy, 37% in France, 29% in Germany and 13% in the Netherlands. The average leverage ratio in the European Union is 5.71%.

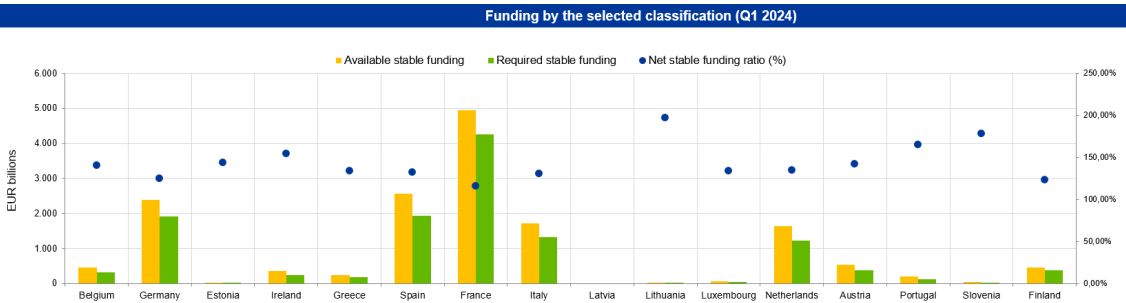
At 158%, the average **liquidity** coverage ratio (LCR) remains well above the legal minimum.² The situation is comfortable in all countries, given that this ratio drops no lower than 145.2% (in Germany), and the same can be said if we group by business model.

² The legal minimum LCR is 100%.



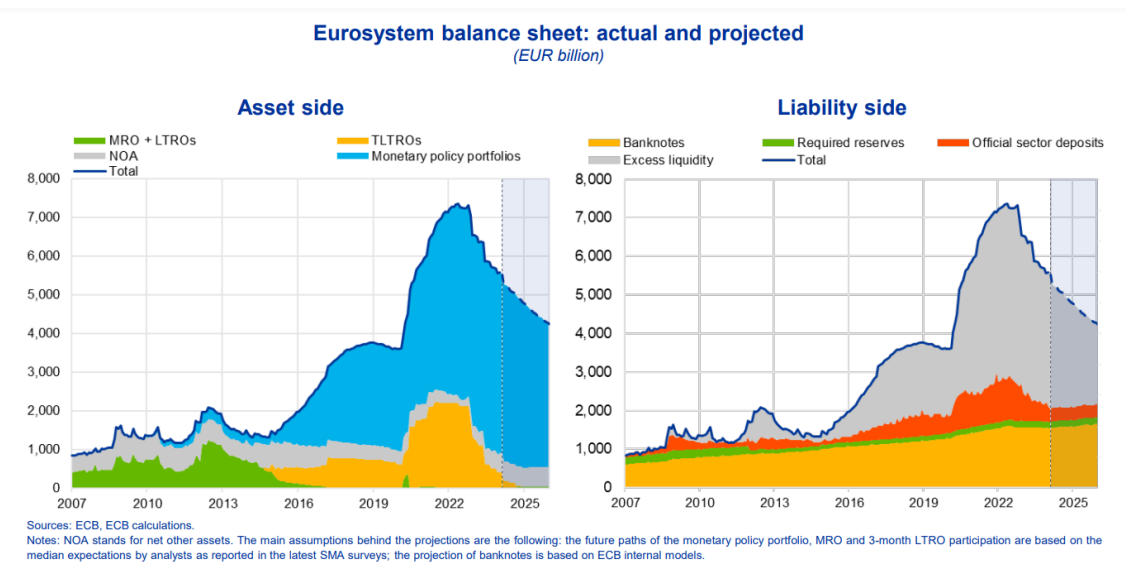
Source: ECB.

The same is true for the net stable funding ratio, which, at 126.8% in 2024 Q1, is also well above its regulatory minimum.

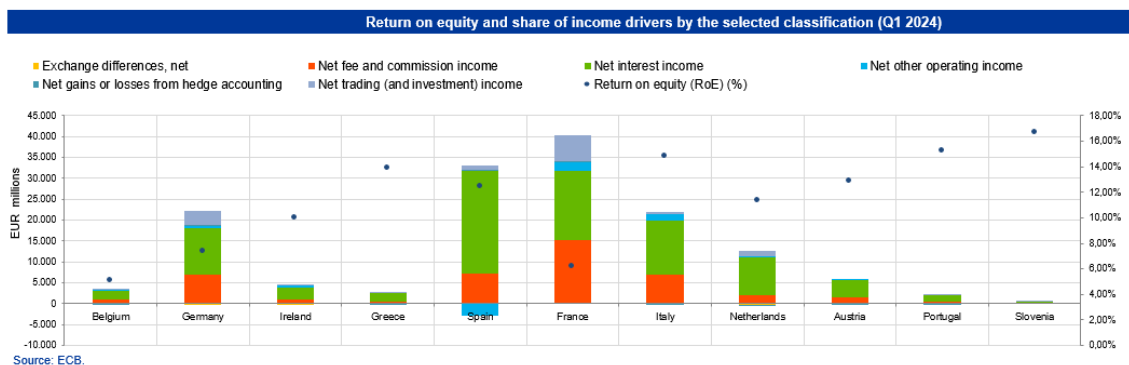


Source: ECB.

This shows that the system still has a high level of liquidity despite the ECB's gradual reduction of its balance sheet and the repayment of the targeted longer-term refinancing operations.



This comfortable level of liquidity in the system is one of the reasons why banks have not had to raise remuneration rates on retail deposits as forcefully as policy interest rates have increased. As a result, strong **net interest income** has led to broad-based growth in return on equity, which reached an average of 9.67% in 2024 Q1 (12.43% in Spain), 36 bp above its level at end-2023. Net interest income reached 1.62% (2.90% in Spain), with low levels for the cost of risk, at 0.50% (1.15% in Spain). These developments ought to be seen against the backdrop of weak credit among banks supervised by the SSM. Indeed, the amount of loans to households increased by just 0.1% in the last quarter and by 0.6% over the past year. Lending to firms rose by 0.3% in the last quarter and remained stable over the last year.



Spanish significant institutions also continued to improve their profitability as the increase in net interest income offset both the growth in operating costs and credit impairments and the outlay of the bank levy. Net interest income was mainly driven by the price effect as lending volumes remained somewhat subdued. On the other hand, net fee and commission income grew at an annual rate of 9.6%, mainly among international banks. Notably, there was a 34% increase in the bank levy, to €1,652 million (from €1,236 million in 2023) owing to growth in the base used to calculate the levy (net interest and fee and commission income). Naturally, domestic banks were relatively more affected. Moreover, overhead costs increased above inflation (7.7% year-on-year), driven by staff costs (up by 10.9%).

These figures must be understood in the context of a European banking system that is generally traditional in nature, with loans constituting the bulk of the balance sheet (60.8%), followed by cash and balances at central banks (12.3%). Loans are principally concentrated in lending to households (37.9% of loans) and firms (34.9%). In turn, Spanish banks subject to SSM supervision operate with an even higher share of retail customers, who constitute a higher share of lending (65.5% of the total balance sheet), centred around credit to households (48.2% of all loans).

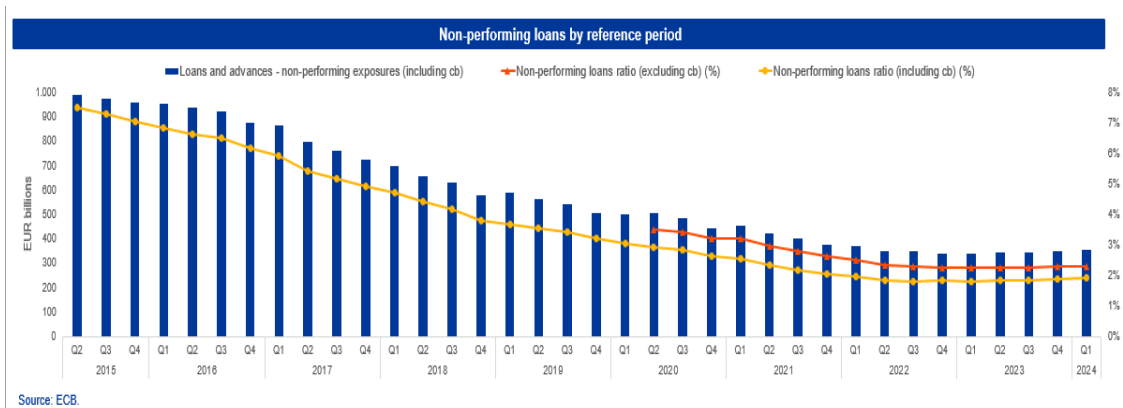
By business type, global systemically important institutions account for 44% of assets, while universal banks account for 34.3%.

Following this overview of the current context of the most significant banks in Europe, let us now look back at the path trodden. Over the past ten years, this road has not been easy

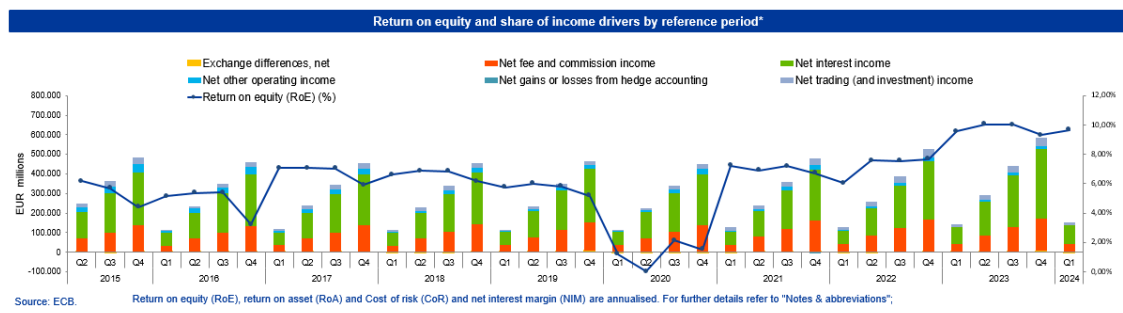
and we should acknowledge that banks have proven resilient to recent exogenous shocks, from the COVID-19 crisis to the economic tensions brought about by bottlenecks, inflation driven by energy price rises as a result of the war in Ukraine and the various banking crises in 2023, to give just some examples. This is undoubtedly the fruit of our work to strengthen solvency, governance and, in many cases, also adapt business models to a historically low interest rate environment that lasted for years.

We should remember that the SSM was created at a very complicated time, when the consequences of the great financial crisis could still very much be felt, some countries' sovereign debt was coming under scrutiny and parts of the banking system were undergoing critical moments. I would like to highlight four key aspects of the last ten years:

First, the **balance sheet restructuring** performed by banks.



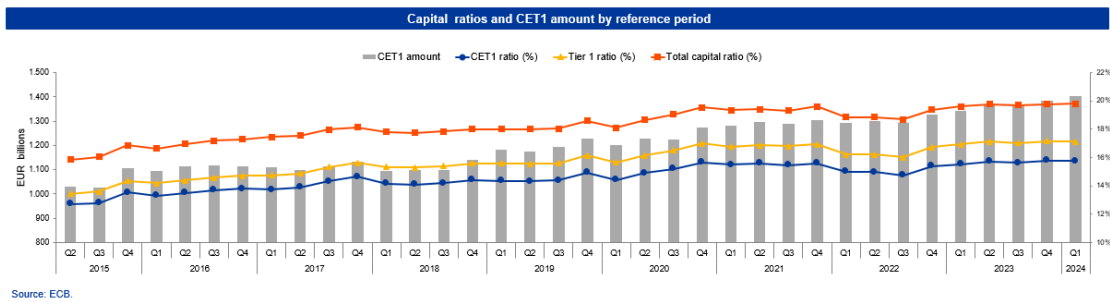
This has seen NPLs fall from nearly €1 trillion (€989 billion) to slightly less than €355 billion today. NPL ratios have dropped from 7.48% to 1.91%.³ One contributor to this process was supervisory pressure to improve balance sheet quality, which weighed on banks' profitability over a number of years when interest rates were even negative. This was particularly significant in some areas that were severely affected by the build-up of portfolios with high NPL ratios. Other contributory factors were banks' improved credit management policies and a more favourable macroeconomic environment.



³ Including amounts held by central banks.

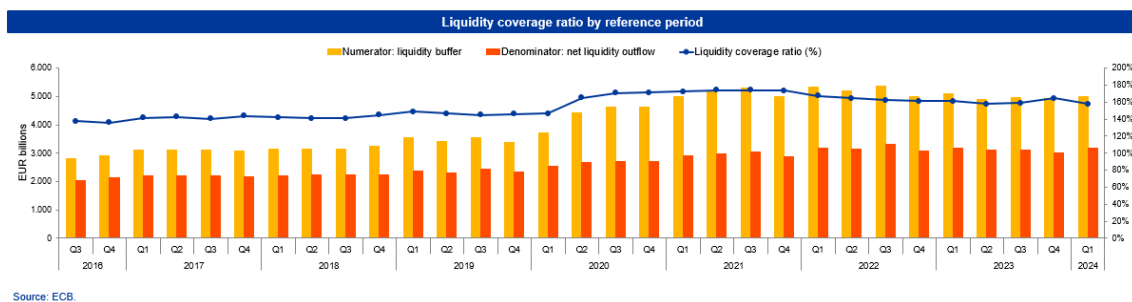
The outcome of this exercise, and of containing other costs, was that banking profitability remained at between 5% and 6%, in spite of such an adverse interest rate environment. As we have pointed out before, the normalisation of monetary policy has strongly driven bank profitability in the last two years.

Second, and as a result of the above, European banking **solvency** has also been strengthened over the last decade.



The CET1 ratio rose from 12.7% in 2015 Q2 to 15.7% in 2024 Q1. The regulatory changes to the solvency framework made in the light of the great financial crisis drove this significant increase. Nevertheless, the leverage ratio saw a more modest rise, from 5.04% at end-2016 to 5.71% in 2024 Q2.

The third aspect to consider is **liquidity**. Here, banks have also strengthened their liquidity positions, with the LCR rising from 138% in 2015 to 158% at present.



At a time when accommodative monetary policy – with high liquidity indices in the system – is becoming tighter, liquidity management has taken on particular significance, and despite there still being comfortable liquidity levels, it is an area that will need closer monitoring and management. Moreover, the markets are more sensitive in these times of geopolitical turmoil and uncertainty and, therefore, susceptible to volatilities that have an impact on liquidity.

The final aspect I would mention, and perhaps the most important one, is **improving governance and risk management**. This has been, and continues to be, a supervisory priority, because we are convinced that the first line of defence for a strong, profitable and efficient banking system is a well-defined, robust and professional governance structure and a solid and prudent risk management framework. This is a message often repeated by supervisors, but reality shows that banks with weak risk management systems or governance frameworks can find themselves in situations that jeopardise their own existence or financial system stability, as we saw last year with the US banking crises. Although numerous supervisory activities focused on governance have been conducted over the last decade (from strengthening the fit and proper procedures to reviewing data management and aggregation systems, among many other tasks), in the past three years they have centred more on aspects related to organisational structures, management bodies and risk management functions. Since the SSM was created, 8,735 governance-related findings (accounting for nearly 14% of the total) have been detected, of which 1,624 currently remain open. In addition, a higher percentage of governance-related findings have been closed than those related to other risks. As a result of all this, banks are much better managed today than a decade ago. However, as I have mentioned, this is an area that is and will continue to be a supervisory priority in the future owing to its extraordinary importance.

The progress made over the last decade can therefore be clearly appreciated. In a relatively short period of time, we have been able to integrate different supervisory cultures and sensitivities into a single mechanism capable of supervising banks with a wide variety of profiles and activities. There has also been a successful drive towards more prudent and efficient risk management, which has simultaneously reinforced banks' positions in aspects as diverse as solvency, liquidity and governance.

But the supervisor must not fall into complacency, and it is precisely at this point that I would like to reflect on the future of supervision and the changes we need to implement to adapt it to the new age. Back in September 2022 the ECB considered it necessary to assess the functioning of the SSM, and appointed a group of independent external parties to prepare a report with proposed improvements. Published in April 2023,⁴ the report contains a wide range of proposals, and reforms to supervisory tasks have since begun to be implemented.

The most noteworthy reform aims to establish a more risk-based approach to supervision. This means that the inspection teams will have more flexibility in flagging the areas of focus for their supervisory activity. The aim is not to conduct a global and comprehensive review of the banks every year, but rather to focus resources on the most significant risks at each bank. This will help make more efficient use of the ever-scarce resources available. Although this new approach will entail risk-taking by the supervisor (as some areas will be left outside the supervisory perimeter for some time), it is a risk we must take if we are to become more efficient, focused and, at the same time, more flexible.

⁴ https://www.bankingsupervision.europa.eu/ecb/pub/pdf/annex/ssm.pr230417_annex.en.pdf.

Flexibility and agility are essential in such turbulent and evolving times, and we must be able to react swiftly to any new scenarios that could affect the financial system. Although the events of recent years have demonstrated how, as supervisory authorities, we have been able to adapt our activity, priorities and procedures to the circumstances of any given moment, this quality needs to be reinforced and incorporated more explicitly into our methodology.

In this respect, I consider that the suptech tools we currently have and the ones we will develop over time will prove to be highly efficient in the early detection of weaknesses and areas for improvement in banks' management and their risk profiles. This will improve the efficiency of supervision.

Another key element we need to reinforce is the implementation of supervisory measures. Unless the corrective measures are duly complied with, any problems or shortcomings detected will not be properly addressed. This is another lesson learned from the crisis at mid-sized US banks in spring 2023. Such tools should be governed by the principle of proportionality and able to adapt to the seriousness of the shortcomings they seek to address. Moreover, the deadlines set for implementing the corrective measures should also be reasonable and commensurate with their complexity and the severity of the deficiencies, establishing intermediate milestones where applicable. To this end, an escalation ladder has been designed, which specifically seeks to strengthen the corrective measures process following these criteria. There are a wide variety of tools available to the SSM in this respect, and this new escalation ladder will allow adaptation to the specific circumstances in each case. Corrective measures can range from quantitative and qualitative requirements to periodic penalty payments or other types of sanctions in the event of a serious breach of any ECB decision or regulation.

But not all shortcomings can be addressed with quantitative measures. Matters related to governance or business models, for example, can only be mitigated through qualitative measures. Perhaps we have put too much focus on capital requirements over the years, at the expense of these other measures. This is why we need to strengthen this other aspect because, as I have pointed out, governance is key to strengthening the banking system.

For instance, we have found that there are still numerous shortcomings related to data governance that have not been adequately addressed in a proper and timely manner. Therefore, we need to recognise the importance of qualitative measures and ensure that they are sufficiently clear and specific, that they have fixed deadlines and that non-compliance would in any event entail other more forceful measures within the escalation system I mentioned earlier.

In increasingly digital environments where data management is key and will become even more so in the future, proper data governance is a cornerstone for the sound management of banks.

This is why I believe that supervision over the coming years will increasingly target aspects related to digitalisation and new technological environments, such as operational resilience

frameworks, the management of external providers and the adaptation of business models to new customer needs, new operators and new products.

The results of the recent cyber resilience stress tests will be announced in the coming days. This exercise, which focused more on qualitative aspects, has been very useful in understanding banks' responsiveness to such events, as these will doubtless become an increasing priority, against which banks must establish safeguards.

Nor can we forget other emerging risks, such as those posed by climate change. The materialisation and management of such risks are and will continue to be subject to supervision, which will no doubt evolve in step with regulatory requirements.

Lastly and again looking to the future, I would like to recall that the banking union is incomplete. We have not yet finished the work we began ten years ago. Although the single supervisory and resolution mechanisms are fully operational, the European Deposit Insurance Scheme (EDIS) is still pending. In the absence of political consensus, work is currently under way on an intermediate solution, namely the Bank Crisis Management and Deposit Insurance Framework (CMDI). Last June⁵ the Council of the EU agreed on a joint position with the European Parliament, which has to be ratified. Without going into detail, I firmly advocate aiming for the creation of this common framework, in order for the banking union to have true substance.

In conclusion, the uncertain and changing environments in which banks operate today require that supervisory processes also be adapted so as to quickly and flexibly capture all elements related to their risk profile and be able to establish timely corrective and mitigating measures.

Supervision needs to be more efficient, targeted and transparent, both now and in the future. As with the world around us, supervision also has to evolve, if it is to fulfil its purpose: ensure a robust and stable financial system that provides the real economy with the resources it needs for its activity.

Banks' ability to react to unexpected shocks, and the existence of operational frameworks that strengthen their resilience in vulnerable digital environments with unforeseen or deliberate failures, will be key elements of tomorrow's supervisory agenda. Nor must the other aspects I have mentioned be neglected, such as governance, climate risk management and liquidity. If it is to be efficient, supervision needs to evolve in step with changes that impact the financial system.

⁵ <https://www.consilium.europa.eu/en/press/press-releases/2024/06/19/bank-crisis-management-and-deposit-insurance-framework-council-agrees-on-its-position/>.