Box 2.3

CONSIDERATIONS ON THE EFFECTIVENESS OF SUPERVISORY ACTION

The crisis experienced in the first half of 2023 by certain US and Swiss banks has been the subject of analysis by the main international supervisors and bodies. In its report on the factors that contributed to the collapse of Silicon Valley Bank, the Federal Reserve noted that supervisors failed to adequately identify vulnerabilities as the bank grew in size and complexity. Also, when these vulnerabilities were identified, the necessary actions to correct them were not taken quickly enough.

As a result of this experience, the effectiveness of supervision has been at the centre of debate in the supervisory community, as evidenced by the analyses of the lessons learned from this episode carried out by various bodies (e.g. the International Monetary Fund (IMF) or the Basel Committee on Banking Supervision (BCBS)) and the work initiated by certain supervisors, including the Single Supervisory Mechanism.

The first precondition for effective supervision is a sound supervisory framework. In this regard, there is a broad consensus on a series of minimum standards, which are set out in the BCBS's "Core Principles for effective banking supervision" (updated in 2023). These standards cover a very wide range of issues, such as the institutional supervision framework, the treatment of key risks, the supervisory approach and the powers granted to supervisory authorities.

Effective supervision should ensure that institutions have adequate capital and liquidity buffers and that indicators of key risks are kept at manageable levels. In this respect, the evolution of the banking sector in Spain and in Europe has on the whole been very favourable in recent years: average capital ratios show a clear upward trend over the years; a notable effort has been made to reduce the portfolio of non-performing assets, as reflected in the significant decline in NPL ratios and foreclosed assets; profitability, another focus of supervisory attention in recent years, has improved, favoured by the normalisation of monetary policy; and liquidity ratios are also at comfortable levels.

In addition, European institutions have passed various stress tests and vulnerability analyses, which show high resilience under hypothetical stress scenarios, and have successfully withstood certain significant shocks in recent years, such as the COVID-19 crisis, the implications of the war in Ukraine and other geopolitical tensions, as well as the instability associated with the banking crises in the first part of 2023.

Supervisory activity within the SSM framework has contributed to this positive performance, tending towards higher standards and seeking a greater impact on institutions, and focusing on the most relevant risks and shortcomings. In recent years, special emphasis has been placed on areas such as credit risk management, the functioning of institutions'

Chart 1
IDENTIFICATION OF SHORTCOMINGS WITH HIGH SEVERITY. SPANISH SIGNIFICANT INSTITUTIONS (a)

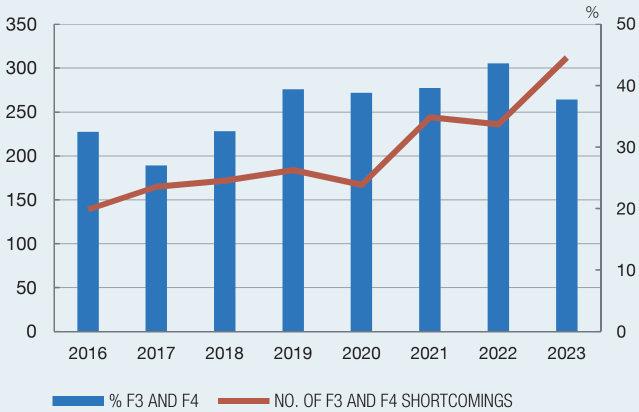
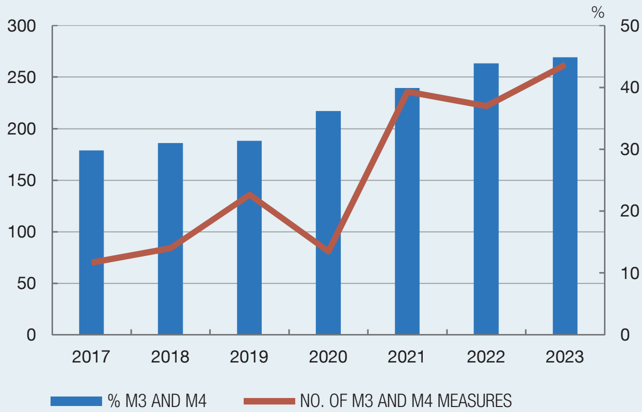


Chart 2
CLOSURE OF MEASURES WITH HIGH SEVERITY. SPANISH SIGNIFICANT INSTITUTIONS (b)



SOURCE: Banco de España.

a The Chart represents the number of shortcomings with high severity (F3 and F4) identified each year (left-hand scale) and their relative weight with respect to the total shortcomings with severity assigned (right-hand scale) of Spanish significant institutions.

b The Chart represents the number of measures with high severity (M3 and M4) closed each year as they are considered to be reasonably remedied (left-hand scale) and their relative weight with respect to the total measures with severity assigned closed in the year (right-hand scale) of Spanish significant institutions.

management bodies, the sustainability of business models and the operational resilience. More recently, liquidity and funding risks, interest rate risk and climate risk have become increasingly significant.

After ten years of the SSM functioning, the supervisor's knowledge of the system as a whole has progressively increased and ever more mature tools and methodologies have been developed to assess the main risks. This greater level of scrutiny has led to an increase in the number and significance of shortcomings identified in supervisory work, despite institutions' progress.

In the case of Spanish significant institutions under the direct supervision of the ECB, there is an upward trend in the identification of shortcomings with high severity (levels 3 and 4), which also account for a higher relative weight of the total shortcomings detected in recent years (Chart 1). Similarly, growing supervisory pressure on institutions to give priority to remedying their most significant shortcomings has been reflected in the greater remediation of shortcomings (corrective measures) with high severity in recent years as compared to previous years, in both absolute and relative terms (Chart 2).

In the case of the Spanish less significant institutions under the direct supervision of the Banco de España, the identification of shortcomings from inspections increased in the period from 2018 to 2023 (Chart 3), while the proportion of weaknesses with high severity (levels 3 and 4) with respect to the total has remained stable, with the exception of 2022, when it was significantly higher (Chart 4).

However, despite the overall improvement in institutions' resilience, the degree of progress across the SSM as a whole has not been the same for all risks. For example, in areas such as governance or risk data aggregation capacity, some problems are persistently being detected, the correction of which is slower than is desirable, partly because the shortcomings in these areas, especially in the case of governance, are of a qualitative nature and tend to take longer to remedy.

The effectiveness of supervisory action is linked to the selection of an appropriate combination of supervisory measures. In this regard, the report on the SREP, entrusted by the SSM to a group of independent experts, stresses that capital is not sufficient to address all risks, and recommends that the ECB make extensive use of the tools at the supervisor's disposal, including a more ambitious use of qualitative measures, aimed at getting banks to address necessary improvements in their business models and governance.

In this vein, the SSM has focused on improving supervisory effectiveness, especially in those areas where the weaknesses detected are most persistent. To this end, the supervisor must make an effort to prioritise and communicate its concerns to institutions as clearly and precisely as possible. In addition, work is being done on the design of escalation processes, using progressively more intrusive supervisory

Chart 3
LSIs

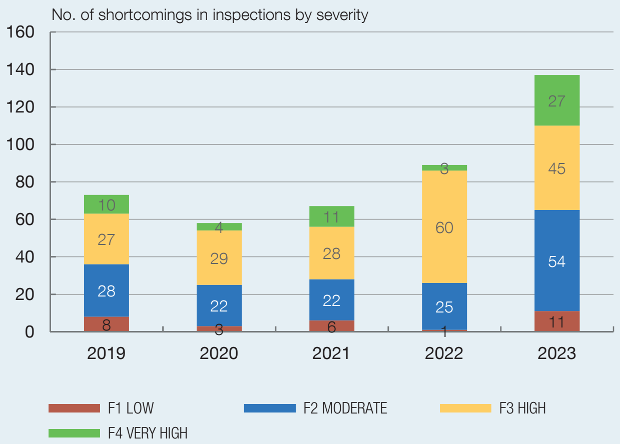
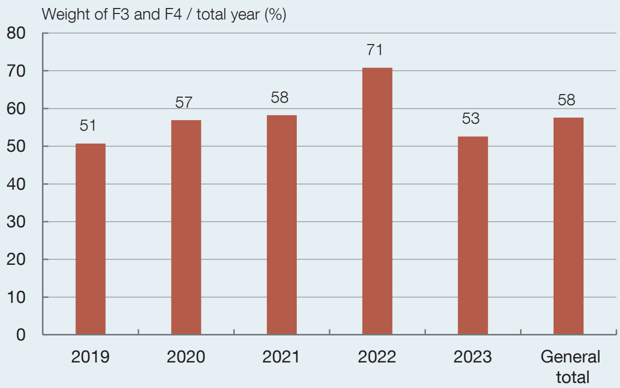


Chart 4
LSIs



SOURCE: Banco de España.

Box 2.3
CONSIDERATIONS ON THE EFFECTIVENESS OF SUPERVISORY ACTION (cont'd)

measures to incentivise corrective actions by institutions. This includes more intensive use of the qualitative requirements in the SREP and, where necessary, of the framework for sanctions and periodic penalty payments provided for in the SSM Regulation.

The increased focus on supervisory effectiveness also applies to less significant institutions. In the supervision of these institutions, which are smaller and have less complex business models, the focus is being placed on prioritising the most significant risk areas and on increasing supervisory pressure, including thematic actions on the highest priority issues and the adoption of binding measures within the SREP framework, in order to bolster institutions' resilience.