Claudia Buch: Hearing of the Committee on Economic and Monetary Affairs of the European Parliament

Introductory statement by Prof Claudia Buch, Chair of the Supervisory Board of the European Central Bank, at the Hearing of the Committee on Economic and Monetary Affairs of the European Parliament, Brussels, 18 November 2024.

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Thank you very much for the invitation to this exchange with you, the members of the European Parliament's Committee on Economic and Monetary Affairs. Today, I would like to provide an update on the European banking sector's resilience and potential vulnerabilities, our supervisory efforts to ensure that the sector remains resilient, and the legislative foundations required to further strengthen our ability to respond to future challenges.

Risk outlook

European banks are operating in a macroeconomic environment characterised by a moderate growth outlook, subject to considerable uncertainty. The gradual recovery in economic activity and expectations of further monetary policy easing have led to benign risk pricing in financial markets, which could result in sudden shifts in market sentiment. Protectionist tendencies could disrupt the global supply chains that are essential to European industries, with a negative impact on firms' growth potential, competitiveness and financial resilience. These cyclical developments are further amplified by long-lasting structural challenges, such as an ageing population, low productivity, and weak innovation dynamics.

The European banking sector is well capitalised. Strong capital positions allow banks to provide funding to the real economy. While lending growth has slowed down since mid-2022, the volume of loans available to households and firms did not, overall, contract. Banks tightened credit standards, reflecting their perception of heightened risk and lower risk tolerance. Lending dynamics were also affected by the negative impact of higher interest rates, weak investment, and worsening consumer confidence on loan demand.[1]

Banks' resilience in terms of capital and liquidity buffers, including during periods of stress in recent years, is due to several factors. Better regulation and supervision have certainly played an important role, as better capitalized banks tend to show more stable lending patterns also during crises. In addition, banks have benefited indirectly from policy measures taken in response to exogenous shocks. Loan losses have remained muted. Looking ahead, however, public policy may be more constrained in buffering shocks, potentially putting larger demands on the financial sector's own resilience.

In an environment of heightened geopolitical risks, the likelihood of tail events materialising has risen. Adverse events are difficult for banks and markets to predict or quantify, as traditional risk models fail to capture their uncertain nature. This may lead to a delay in identifying emerging risks. However, these events impact banks through the traditional risk channels such as credit, market, liquidity, and operational risks. For

instance, surges in energy prices can place a strain on energy-intensive industries, affecting corporate creditworthiness and exposing banks to higher default rates. Escalating geopolitical tensions can increase financial market volatility, triggering asset price corrections. Financial sanctions or cyber-attacks can exacerbate risks.

Management bodies should thus ensure that banks are sufficiently resilient from a financial and operational perspective. This requires risk management frameworks that capture adverse scenarios relevant for each bank. In addition, banks should reduce vulnerabilities to geopolitical risks through provisioning practices, capital planning, cyber resilience, and outsourcing arrangements.

Strengthening supervision

ECB Banking Supervision is adjusting to this new environment to better identify and address emerging risks. An ongoing comprehensive reform of the Supervisory Review and Evaluation Process (SREP) aims to make supervision more efficient, effective, and intrusive. Our objective is to facilitate more focused risk assessments by supervisors, enhance our communication with banks and ensure that banks remediate supervisory findings more quickly. Supervisory tools such as moral suasion and recommendations are always used first, but we will then use increasingly binding tools to ensure that banks address any identified shortcomings in a timely manner. These include quantitative and qualitative measures or sanctions and enforcement measures, such as periodic penalty payments.[2] In addition, we are currently simplifying our methodology for the Pillar 2 requirement (P2R), and we will communicate key elements of this soon.

One focus area is risk data aggregation and reporting. The emerging risk environment requires banks to have sound governance and risk management in place. Banks' management bodies need accurate and timely information to be able to take informed decisions. However, banks have been slow in enhancing their internal risk data aggregation and reporting capabilities. Currently, around one third of banks under ECB supervision assess their data governance frameworks to be only partial, which reduces their ability to provide relevant information in a timely manner varies. ECB guides on risk data aggregation and governance will help clarify supervisory expectations in these areas.[3]

The SSM is committed to further simplifying supervisory procedures. Our efforts to make supervision more effective and efficient aim to ensure sufficient financial and operational resilience of banks. At the same time, we are mindful of the need to avoid unnecessary complexity of regulation and supervision. In the area of reporting, for example, the ECB and other authorities are working to reduce regulatory costs by designing an integrated reporting framework.[4]

Strong regulatory groundwork

The current regulatory framework gives the SSM a mandate to ensure that the European banking sector remains safe and sound, thereby protecting depositors. Using a traffic analogy, our role is similar to that of the transport police. Legislators set traffic rules; the police enforces these rules. In banking, robust regulations provide boundaries to ensure that the risks banks take are commensurate with their levels of resilience, that

their capital buffers can absorb shocks and that the risk of contagion remains limited. Conversely, laxer rules and safety requirements increase the risk of accidents, leading to costly repercussions for the economy and society at large. Banking regulations codify how much risk, how many "accidents", society is willing to tolerate in the financial sector. This provides supervisors with a basis to take action and enforce the relevant rules.

Good regulation and supervision ensure financial stability and are prerequisites for growth and innovation. Well-capitalised banks support economic growth by lending to the real economy, absorbing losses during economic downturns and acting as a first line of defence against financial crises.[5] In addition to microprudential supervision, we need a strong macroprudential framework to address systemic risks. Instead of relaxing banking rules or delaying the implementation of Basel III, completing the banking union and the capital markets union is the most important contribution policymakers could make towards financial stability and economic growth. This would further strengthen our ability to respond to future shocks.

The crisis management and deposit insurance (CMDI) framework currently being considered by co-legislators aims to strengthen and broaden the toolkit available to authorities when dealing with failing banks. However, we are concerned that we may end up with a weaker and less flexible toolkit, given that the Council's position would not ensure adequate resolution funding, particularly for medium-sized banks. The failure of these banks would thus likely continue to be dealt with under national rules, which could reduce the credibility of a common resolution approach and increase risks to financial stability.

Moreover, renewed momentum towards introducing a European deposit insurance scheme (EDIS) is needed to ensure that depositor protection does not differ across countries. This would promote the integration of banking markets and prevent the re-emergence of the sovereign-bank nexus. In contrast to national schemes, which might ultimately have to rely on taxpayers' money in the event of large shocks, a European deposit insurance scheme would benefit from diversification and the pooling of resources. With common supervision and a significant reduction in legacy assets, two key preconditions for EDIS have been met. We welcome the recent progress made by the European Parliament on this matter.

In addition, further progress on the capital markets union would complement the important role that European banks play in funding the real economy. The capital markets union would provide better access to equity capital to finance long-term, risky investment projects and improve private sector risk sharing. It can support the integration of banking markets by removing national rules that currently limit banks' cross-border activities.

We hope that the European Parliament will continue legislative work to sustain the European banking sector's resilience and foster its integration. We stand ready to engage further with you and contribute our expertise where needed.

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[1] See "The euro area bank lending survey - Third quarter of 2024", ECB website, 15 October 2024.

[2] For more information, see Elderson, F, "Preparing for the next decade of European banking supervision: risk-focused, impactful and legally sound", speech at the "10 years SSM and beyond" event organised by Allen & Overy, 27 June.

[3] See Guide on effective risk data aggregation and risk reporting, ECB, May 2024, and the public consultation on the Guide on governance and risk culture which was closed on 16 October 2024. The final Guide on governance and risk culture will be published in 2025. It covers management bodies and committees, internal control functions, risk culture and risk appetite frameworks of banks.

[4] The Integrated Reporting Framework will integrate, standardise and minimise the burden and costs of the Eurosystem's statistical requirements for banks. For other examples of efforts that the ECB is contributing to with a view to enhancing supervisory data sharing and reducing reporting requirements, see the Opinion of The European Central Bank of 21 June 2024 on "the proposal for a regulation of the European Parliament and of the Council as regards certain reporting requirements in the fields of financial services and investment support", (CON/2024/21).

[5] See letter from Claudia Buch, Chair of the Supervisory Board, to Mr Eero Heinäluoma, MEP, on banking supervision, 28 October 2024