Elizabeth McCaul: Objects in the rearview mirror are closer than they appear

Keynote speech by Ms Elizabeth McCaul, Member of the Supervisory Board of the European Central Bank, at the European Banking Federation Executive Committee meeting, Frankfurt am Main, 26 November 2024.

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Introduction

Thank you very much for inviting me to speak today.

You have asked me to speak about the achievements and future challenges of the Single Supervisory Mechanism (SSM).

As my mandate as ECB Representative to the Supervisory Board comes to an end, I would like to reflect on the evolution of the SSM and give my perspective on the changing financial and political landscape in which banks operate.

A resilient and well-functioning banking system forms the backbone of a thriving economy, acting as the engine that drives innovation and sustainable growth. By providing reliable access to credit and financial services, banks help people invest in their education, start businesses and achieve long-term financial security. A safe and stable banking system gives depositors the confidence to save and plan for the future, knowing their money is protected.

I would like to make three main points.

First, ten years after successfully establishing a banking union and helping strengthen the banking sector – no small feat – the SSM is evolving in its supervisory approach to ensure that we continue to deliver effective supervision amid a changing financial landscape.

Second, I will argue that we need to use our full range of vision to tackle the current risk environment. This includes the challenges posed by the growth of the non-bank financial intermediation (NBFI) sector and rising geopolitical risk, which manifests itself in several ways, such as concerns about cyberattacks as well as nature and climate risks. Addressing these risks will contribute to the continued resilience of the financial system.

Third, our playing field has shifted dramatically. A stable and secure financial system is essential for long-term competitiveness, and we should not see safety and competitiveness as opposing forces. They are both preconditions for resilience. And to achieve long-term competitiveness, we need to embrace digital transformation.

Evolution of European banking supervision

It is important that the hard-won lessons of the global financial crisis are not for naught. In the last few years, the banking sector faced the triple threat of the pandemic, energy shocks from the war in Ukraine and a rising interest rate environment after a prolonged period of low interest rates. Or as President Lagarde put it[1]: "We have faced the worst pandemic since the 1920s, the worst conflict in Europe since the 1940s, and the worst energy shock since the 1970s".

These all were the kind of events that happen infrequently; any one of them could have resulted in significant weaknesses in the banking system. But thanks to the work of my predecessors, the banking system proved resilient in the face of these threats.

The robustness of the system is evident in the data: in 2015 the average ratio of non-performing loans (NPLs) for significant banks in the banking union was 7.5%, at a time when some banking systems had ratios nearing 50%. By the end of the second quarter of this year, it had decreased to 2.3%, driven mainly by the reduction of NPLs in high-NPL banks.

Likewise, the Common Equity Tier 1 ratio for significant banks has improved, rising from 12.7% in 2015 to 15.8% today. Bank profitability has increased considerably in recent quarters, benefiting from higher interest rates, and return on equity now stands at 10.1%.

This resilience is also a result of the strengthened supervisory and regulatory framework after the global financial crisis, including the creation of European banking supervision. The limited repercussions from the banking sector turmoil of March 2023 are also testament to the robustness of our banking union.

In the meantime, the environment in which banks operate has substantially changed, becoming more complex because of a range of exogenous shocks and structural shifts in the financial services landscape. Novel risks are intensifying, such as those stemming from macro-financial and geopolitical shocks, digitalisation and climate change, which have increased the overall level of uncertainty.

When considering the competitiveness of the European banking sector, I am aware that we are living through a technological renaissance. The rapid pace of change presents both opportunities and challenges, and without proper investment, the threat to competitiveness will undoubtedly become a reality.

It is against this background that we reviewed our Supervisory Review and Evaluation Process (SREP) to ensure that we can continue to deliver effective supervision to promote banks' resilience.

One of the cornerstones of this reform project is to further improve the way we use qualitative measures to make them enforceable and legally binding. In my view, good supervision is characterised not only by a robust framework, but also by predictability. Just as good drivers use their turning signals, good supervisors use indicators to signal transparently their direction of travel. This means we need to be upfront about supervisory standards and expectations, as well as the consequences banks will face if these are not met in a timely manner. Where banks are too slow to remediate their

weaknesses, we will apply supervisory measures with clearly defined objectives and timelines, targeting the root causes rather than just the symptoms. We will make full use of the available measures, remediation tools and enforcement actions, including, if necessary, sanctions for severe or persistent issues.

One area I would like to highlight concerns strong governance and sound risk culture – the hallmark, I would even say the "North star" of a safe banking system. They are more important than ever, especially in the current risk environment, in which banks are facing economic, competitive and geopolitical headwinds. This is why we recently published for consultation a draft Guide on governance and risk culture, with the final version scheduled for publication in early 2025. The draft Guide clarifies expectations regarding management bodies and committees, the roles and responsibilities of internal control functions, risk appetite frameworks, and remuneration practices.

Finally, we are adjusting our supervision to harness the potential of technologies such as artificial intelligence. Since the inception of European banking supervision in 2014, we have built and continuously improved our core IT systems, launched our SupTech efforts and created multiple cutting-edge tools which are already up and running. These tools have changed the way we conduct supervision, and I am incredibly proud of what we have already achieved.

However, as the world is changing, we too need to continue to change and improve. Our technology work is geared towards ensuring that our supervisors have the knowledge and prowess they need for the future: by developing and deploying the latest technology, not only are we helping supervisors assess risk more effectively, but we are also enabling them to learn the risks the technology itself poses, so as to better recognise and understand these risks in the institutions we supervise. In this context, we have recently adopted our SSM tech strategy for 2024-2028 to connect technology and people, and to empower our supervisors to continue delivering effective supervision today and tomorrow.

Tackling emerging risks – NBFI and rising geopolitical risks

Just as a doctor must diagnose a patient's condition accurately to provide proper treatment, we need to understand the broader structural trends shaping our economies and societies to supervise with the highest degree of effectiveness.

While we may not be medical doctors saving people's lives, our mission as banking supervisors – protecting people's life savings – is also important. So, I think it is useful to draw from the medical field, in particular from the discipline of optometry, for some lessons about how we can save people's economic lives most effectively. After all, in today's complicated world, reducing opacity helps us discern risk in a more clear-sighted manner.

Opticians distinguish between central vision, fringe vision and peripheral vision.

Peripheral vision is the ability to detect what occurs outside our direct line of sight, beyond 60 degrees. It encompasses everything that can be seen on the sidelines and provides spatial awareness, helping with navigation and balance. Improving peripheral vision is crucial for athletes as it enhances reaction times, improves anticipation and

reduces the risk of injury. In banking, the periphery of our gaze captures the structural transformations of our societies and economies. Think of the acceleration of technological progress, including the emergence of generative artificial intelligence and the impact of social media on depositor behaviour; the reconfiguration of the financial value chain; and the new competitors in the market or the growing share of non-bank financial institutions.

While non-banks may help in financing the significant costs of the twin green and digital transition, they also need to be adequately regulated and closely monitored.

Growth in the NBFI sector, globally and in the euro area, is staggering. The global sector expanded from €87 trillion in 2008 to €200 trillion in 2022, an even larger increase than in the euro area sector which has more than doubled in size, from €15 trillion in 2008 to €32 trillion in 2024.

The private credit market is a particular concern. It accounts for €1.6 trillion of the global market and has also seen significant growth recently. Growth in the European private credit market has accelerated by 29% over the past three years, but the market in Europe is still much smaller than it is in the United States, which is where investors and asset managers are often based.

Why is this a concern? Certainly, growth of the market alone is not the main worry.

First, the end investors are pension funds, sovereign wealth funds and insurance firms, but banks play a significant role in leveraging and providing bridge loans at various levels to credit funds. We recently completed a deep dive on the topic and found that banks are not able to fully identify the myriad ways they have exposure to private credit funds. Therefore, concentration risk could be significant.

Moreover, private credit often involves lending to unrated, illiquid counterparties, which means that the assets are usually not marked to market, at least not with the same frequency as those traded in liquid markets. Indeed, valuation methods in private markets may disguise potential losses. And, looking at it from the perspective of our supervised banks, we see that 43% of the market belongs to the eight largest providers, meaning that the remaining 57% is driven by smaller providers who may be less experienced in the vagaries of credit cycles. Indeed, since this growth has emerged, we have not seen a significant downturn in the credit cycle. In addition, some of the individual players have grown to such a scale and have reached such a level of interconnectedness that they now exhibit systemic characteristics, making their stability integral to the health of the broader financial system.

We also know that risk from the NBFI sector can materialise through various channels. One such channel is the correlation of exposures, especially given the growth in private credit and equity markets. We supervisors do not have a full picture of the level of exposure and correlations between NBFI balance sheets and bank lending arrangements, lines of credit or derivatives to and from NBFIs.

To make the market less opaque, we should further harmonise, enhance and expand reporting requirements and make information-sharing between authorities easier at the global level.

The growth in the NBFI sector is not the only concern we have about the current risk environment. We have ample evidence of rising risks in our constant media feeds. We need only switch on the news or glance at our mobile phones to see frightening images of human tragedy such as Russia's invasion of Ukraine, the widening conflagration in the Middle East, or escalating China-Taiwan tensions.

There are many reasons to be concerned about rising geopolitical risk, such as supply chain disruptions, energy disruptions and inflationary pressures. They all pose threats to resilience. I'd like to highlight one resulting risk – the increased risk of cyberattacks, in particular the increased threat from nation state actors. Our IT risk questionnaire shows a significant uptick year after year. In 2022, 50% of our supervised entities were subject to at least one successful cyberattack, rising to 68% in 2023, as our forthcoming annual horizontal analysis will show. In absolute terms, the number of cyber incident reports has also risen considerably. The number of cyber incident reports we received in 2023 was 77% higher than in 2022, and we expect the total number of incident reports in 2024 to be similar. The IMF also reports that the number of attacks has doubled since the pandemic.

Heeding the lessons from the past

As we celebrate ten years of European banking supervision, I think it is helpful to recall what was happening in the world when it was set up.

European banking supervision was launched at a moment when the sovereign debt crisis threatened the cohesion of the euro area, when taxpayers' money was used to bail out banks and the global financial crisis was not far behind us.

As the global financial crisis fades into the rearview mirror, it seems that competitiveness considerations have taken the wheel. However, just as guardrails on a motorway do not impede drivers but ensure they stay on the road, a robust regulatory framework sets safe boundaries for banks, enabling them to fulfil their role of lending to the real economy. And it is important to recall that, just as in the movie "Jurassic Park", objects in the rearview mirror are closer than they appear. The global financial crisis is not so far behind us that we should not heed its lessons.

Let me take this motorway metaphor even further. Countless studies show that speed limits not only reduce danger but also minimise congestion, thereby reducing the overall travel time. It's a fallacy to think that higher speed limits mean faster travel, just as laxer regulation does not lead to more sustainable growth. Similarly, regulatory competition across countries is more likely to lead to a race to the bottom than to a robust regulatory framework.

By contrast, the lack of a complete banking union is a significant impediment to a competitive and integrated European banking sector. Achieving this goal means removing unnecessary barriers to cross-border banking and enabling cross-border groups to manage liquidity and capital at the group level. A fully integrated, cross-border European banking landscape would enable banks to diversify their risks and revenue streams, not only making them more efficient but also more resilient to domestic shocks. This would support private risk sharing and enhance the overall economy's robustness and efficiency, benefiting European citizens.

Similarly, deepening the capital markets union is vital for the European economy to attract the necessary private investments to support innovation and the digital and green transition, thus bolstering EU competitiveness. For banks, this means more cross-border activities, which would make them more competitive compared with their international counterparts. In a more integrated pan-European capital market, banks could fully exploit economies of scale by offering similar products and services across multiple countries.

Targeted harmonisations across Member States could facilitate such cross-border lending, enabling banks to better assess risks and opportunities from borrowers in other Member States. Completing the banking union would significantly accelerate the push towards a truly integrated European banking landscape.

Securitisation is another measure to advance the capital markets union where banks play a key role. Given the constraints on banks' balance sheets, capital markets can complement bank lending and increase the funding available to the private sector while transferring risks to other intermediaries. Securitisation is crucial as it provides a diversified funding base for banks, a tool to transfer credit risks and new assets for investors. This can also create space for additional lending to the economy.

Conclusion

Let me conclude.

While the public debate on banking regulation may have shifted, we need to uphold robust regulatory frameworks that balance safety with competitiveness. Our banks need to focus on digital transformation to bolster competitiveness. Completing the banking union and the capital markets union remains a critical priority that can enhance the overall competitiveness of the sector. In addition, we must remain vigilant in addressing the emerging risks posed by the growing NBFI sector and rising geopolitical risks that threaten resilience.

By staying committed to these priorities, we can build a stronger, more integrated European financial system that supports innovation, protects consumers and enhances the overall resilience of our economy for all European citizens. Crises fading in the rearview mirror should not signal a shift in supervisory and regulatory priorities leading to a weaker, less competitive and less resilient sector.

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[1] Lagarde, C. (2024), "Setbacks and strides forward: structural shifts and monetary policy in the twenties", speech at the 2024 Michel Camdessus Central Banking Lecture organised by the IMF, Washington, DC, 20 September.