This time it's different… for European bank supervision

The dynamics of the current evolving crisis are quite different for European banks than those of the global financial crisis, but the market nonetheless remains on high alert around regulatory risk. Analysts and investors are still assuming an adversarial relationship between banks and their supervisors. One where banks breaching prudential metrics – mainly on capital – might lead to supervisory intervention or even resolution; threatening the position of wholesale providers of bail-in-able AT1, Tier 2, and senior non-preferred debt in particular.

But this time it's different. First, because the banks are now spectators, not leading actors on the crisis stage. Second, because prudential metrics – capital, liquidity, funding – and risk profiles are on balance more reassuring than they were 13 years ago.

And third, because the structure, focus and quality of European bank supervision are diametrically different from where they were back then. Which is an essential aspect but not always appreciated by the market.

Then…

The financial crisis which hit in the summer of 2007 found bank supervision across Europe woefully inadequate. Arguably less so in Scandinavia[1], especially Sweden, where the institutional memory of the massive shake-up which had taken place a decade and a half earlier was still present. But virtually everywhere else, prudential bank supervision was passive, invariably limiting itself to box-ticking aimed mostly at the capital and liquidity criteria of the time, inadequate as they were.

As long as the lid was on the pot, whatever was cooking was of lesser importance. Notions like a bank's business model were ignored in the supervisory process and even considered beyond the supervisors' remit.

As for conduct supervision, it was marginal, focused mainly on normative consumer protection and insufficiently addressing market abuse or money laundering. The larger banks, especially those heavily involved at the time in far-flung wholesale and investment banking, very much felt they were in the driver's seat. Regulatory arbitrage was a popular game.

Beyond that, there was little supervisory co-operation and information-sharing between national jurisdictions, even within the EU. By and large, national supervisors were protective of their own institutions, glossing over the growing risk bubbles building up in the system.

When the crisis hit, many national supervisors rushed to ringfence their banks from passing capital or liquidity to their parents or subsidiaries in other jurisdictions be they EU or non-EU jurisdictions. And in the years following the crisis, as they were gradually getting their own acts together, the supervisors pressed the banks into complying with new and far tougher prudential and conduct norms.

…And now

This time around there has been a sea-change in European bank supervision. For the better. In fact, the very nature of the trade has changed dramatically.

[1] Denmark, Norway and Sweden.

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From a box-ticking approach, prudential supervision is now far more pro-active and primarily risk-based. The lid on the pot needs to remain secure, but it is substantially heavier than before. And notably, what is cooking in the pot is of paramount importance.

The new post-crisis EU regulatory architecture saw the establishment of new pan-EU supervisory institutions, including the European Banking Authority (EBA). A new EU supervisory framework was established through a single rulebook. The Supervisory Review and Evaluation Process (SREP) aims to assess where a bank stands in terms of capital and liquidity and how it deals with risks. One of the four yardsticks of a bank's prudential health is the assessment of its business model, the same concept that had been overlooked before and during the last crisis.

In addition, after an unconvincing start (the EBA's first attempt in 2011), stress tests have developed as relatively credible supervisory tools to assess whether a bank is adequately capitalised, funded, and liquid, and risks are properly managed and controlled.

But the most important change in the post-crisis supervisory framework was the creation of the European Banking Union, and especially of its first pillar, the Single Supervisory Mechanism (SSM). With the ECB as sole supervisor for the euro area's larger banks, the establishment of a supervisory level playing field improved the process with clearer and more transparent criteria and practices. For the first time, large banking groups across Europe are being compared on an equal footing – not only by the market but also by supervisors. Supervisors who have learned to speak the same professional language and apply the same criteria across the euro area.

In the post-crisis decade, banks have been pressed hard to strengthen their prudential metrics, including capital and liquidity, and avoid risking up unnecessarily. The other side of the coin has been underwhelming profitability, but smart credit investors have realised that it is the price to pay for preserving relative credit safety.

The Covid-19 crisis finds the European banking system in a substantially stronger condition than it was 13 years ago. But, importantly, it also finds European bank supervisors much more in the saddle than their predecessors were. Rather than being in an adversarial relationship with their banks, supervisors are aiming now to support them in providing support to business and households affected by the pandemic as well as helping economic reconstruction in the future.

The forthcoming challenges for European banks are enormous, with the probability of a dramatic drop in revenues this year and the likelihood of substantially higher loan-loss provisions piling up later on. But the fear of supervisory reprisals should not be of great concern for credit investors, unless a bank imprudently chooses to engage in new risky activities or geographies. Which, with a higher degree of transparency now prevailing, not only supervisors but investors and analysts too should promptly detect.

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