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Prudential regulation is not calibrated to produce “zero failures”. It aims to reduce the likelihood and impact of banking stress, while facilitating financial intermediation and economic growth.

Prudential regulation is sustained, from my point of view, by three pillars: Governance, Supervision and Regulation

Governance

The Global Financial Crisis was a painful but also a key episode that showed us the importance of a **robust governance and risk management framework**. These functions are the first line of defence of a sound and profitable business. In this regard, remarkable improvement has been achieved in the European framework during these years since then. However, **challenges remain** in implementing changes in the governance framework and making them effective.

Governance is an area where supervisors pay a lot of attention, because we are aware of the importance of a robust governance structure and functioning. An example of this is that 7,371 findings have been raised in this area since the SSM was created, of which 1,303 remain open. This is because there is always room for improvement and governance should not be seen as a static element. On the contrary, as new challenges arise (climate risks, ESG, digitalisation, etc.), governance needs to be updated to properly address them.

Therefore, governance has been, is and will be an area where supervisors will continue to pay attention. It is a clear priority and the cornerstone of our activity.

Supervision

Supervision needs to be intrusive (as it is today), adaptive and forward looking, combining the micro supervision with the macro perspective. We need to complement the horizontal view with the expert judgment of our teams.

A strong and effective supervision includes:

- the ability and willingness of supervisors not just to **actively identify weaknesses** in banks but also to **take prompt actions**;
- the need to ensure supervisory teams have the appropriate quantity and quality of resources;
- the need to continuously monitor exogenous and structural changes to the banking system and adapt supervisory approaches to overseeing risks, especially for banks that are rapidly growing in size or adopting novel business models; and
- maintaining effective and timely cross-border supervisory cooperation across a wide network.

Supervision needs to be adaptive and flexible to the new environment and risks. We observe that in addition to the traditional risks that remain essential (e.g. credit risk), supervisors need to **scrutinise how banks adjust their business models, strategies and governance**

to the new risks. For instance, we are currently being more active on all risks related to the digitalisation process, IT infrastructure, third party providers, operational resilience, new comers… Although digitalisation has always been part of the banking business, the speed up process experienced in the last years have increased the risk exposure. In this sense, supervisory activities have to include these elements on the assessment.

I also consider that **the forward looking perspective** is very important in order to anticipate risks or areas of concern. That is what the SSM performed regarding interest rate risk, well ahead of the monetary policy shift.

Regulation

I consider that regulation has to be **also adaptive to the environment**. It is true that we need a **stable regulatory framework**, but this doesn't mean static. It takes years to agree and implement the main regulatory prudential framework (the first Basel III framework was published in December 2010 and it is not yet implemented in full in Europe). Nevertheless, regulation need to establish the rules and framework to tackle new risks such as climate risk or IT/digital/operational risks.

In this sense, it is necessary that all stakeholders reach an agreement to regulate these new elements. For instance, in Europe, we have made a great effort with DORA and MICA. These are good examples of how adaptive our regulation should be, but there are many others (Digital Finance package, Digital Service Act). On the contrary, for climate risk the situation is slightly different. Even if Europe is leading this effort, we need to speed up the regulatory process and foster international cooperation to set international standards. Although the ISSB has already published its 2 first sustainability related disclosure standards, we still need more clarity in many aspects (e.g. sustainability and social taxonomy).

In conclusion, I consider that **adaptability, flexibility and quick reaction capability** are the main characteristics for both regulation and supervision to cope with the changing environment we are experiencing nowadays. This must be **underpinned by a robust governance framework** that constitutes the cornerstone of a profitable and sustainable business model.

We also need sustainable business models which is very relevant given the challenges faced in the competitive and changing landscape.

Supervision at the global level

The banking turmoil during the past spring also highlighted the importance of strong and effective supervision across various dimensions. As the BIS has already confirmed, there are certain lessons learned regarding supervision.

First, the turmoil underlined the **importance of supervisors developing a thorough understanding of the sustainability of banks' business models**. This is a key factor in our activity in which supervisors face some challenges:

- How to best assess the sustainability of business models in a holistic manner (eg relying on a broad set of quantitative and qualitative indicators)
- How to challenge certain types of business models without owning the bank´s business strategy
- How to monitor medium-term structural changes to better identify their impact on different business models.

Second, a core element of supervisory work is **ensuring that banks have effective and robust governance and risk management**.

Third, the turmoil highlighted clear **challenges in overseeing banks' liquidity risk**. These challenges relate to: the speed and volume of deposit outflows and changes in banks' funding profile; the importance of banks being operationally prepared for liquidity stress scenarios.

Fourth, we've been reminded once again that **supervisory judgment is a critical element**. A rules-based approach on its own is unlikely to appropriately identify, assess and allow the timely mitigation of key risks. This does not diminish the role of a rules-based approach in setting minimum standards. On the contrary, it can complement such standards by exercising judgment – and therefore intervene proactively even when specific rules have not been breached – to make bank supervision dynamic.

Fifth, it is important to reflect on the role and scope of existing **supervisory toolkits** as complements to minimum global standards and to ensure they are sufficient to drive concrete action at banks**.**

Finally, while there were several positive elements of cross-border **supervisory cooperation** during the turmoil consideration could be given as to whether broader information-sharing protocols at a cross-border level are necessary.

The events that shook the banking sector last spring put some focus on smaller banks, and I have some reflections on that.

First, the financial stability benefits of Basel III can only be secured if the standards are implemented as intended. This means both the **full and consistent implementation of Basel III standards and their application to internationally active banks.**

Second, depending on local circumstances, **it might be appropriate to adopt a proportionate implementation of Basel III for non-internationally active banks.** It is up to local jurisdiction to implement those rules but the Basel Committee has stressed that "**all banks should be subject to supervision commensurate to their risk profile and systemic importance".** As recent events have reminded us, there are multiple dimensions to the systemic importance of the failure of a bank, including both first- and second-round propagation effects.

Finally, the Committee has also underlined that proportionality should not seek "to dilute the robustness" of standards and that "any simpler proportionate approaches would need to be more conservative to compensate for their lower risk sensitivity".

Fortunately, as we have recently experienced, we apply same rules to all banks regardless size (in comparison to US). Supervision must be proportionate to the risk profile and systemic importance.

The SSM is currently applying this proportionality to less significant institutions and also among significant institutions depending on the specific risk type. Nevertheless, same rules must be followed by all institutions. Proportionality should not be understood as laxer conditions to operate.

In terms of coordination between supervisors, we have to bear in mind that the financial sector is regulated due to the impact of the financial activity in the real economy. Therefore, there is a wide ample of stakeholders, regulators, supervisors at all levels (international and national).

Regarding the banking sector, we have the European set of bodies:

- The **EU legislative bodies** (EC, EP) proposing and approving the regulation (eg. CRR, CRD…)

- The **Euopean Banking Authority** (EBA) as an independent EU authority which works to ensure effective and consistent prudential regulation and supervision across the European banking sector. The main task of the EBA is to contribute to the creation of the European Single Rulebook in banking. The aim is to provide a single set of harmonised prudential rules for financial institutions throughout the EU. The EBA also plays an important role in promoting convergence of supervisory practices and is mandated to assess risks and vulnerabilities in the EU banking sector.

- The **SSM** as Single Supervisory Mechanism, responsible for the direct supervision of the main banks of the euro area (currently 110).

- The eest of **national competent authorities**, responsible for the direct supervision of the less significant institutions.

- The **Single Resolution Board (SRB)** which is the central resolution authority within the Banking Union. Together with the national resolution authorities it forms the Single Resolution Mechanism. Its mission is to ensure an orderly resolution of failing banks, protecting the taxpayer from state bail-outs, which means promoting financial stability.

- The rest of financial supervisory authorities (**ESMA and EIOPA**) that together with EBA ensure consistent and appropriate financial supervision throughout the EU.

I am fully aware of the **complexity** of this picture, which, by the way, is not complete. We need to add here the international regulatory bodies (BCBS, FSB…). I believe that this is the other side of the coin that reflect the complexity of the financial sector.

One of the lessons learned from the Great Financial Crisis was that regulation and supervision should be reinforced in different dimensions and aspects. The consequences of that crises were extremely painful and it took many years for many economies to recover.

The recent banking turmoil in US also showed us deficiencies in the supervisory framework (too complex and not quick enough in escalating, implementing and enforcing supervisory measures). Those banks were not under the Basel III rules either and the primary cause for their problems was the fundamental shortcomings in basic risk management and governance.

So this set of bodies we have in Europe are necessary in order to mitigate the risk of another crisis. As I said before "zero risk" is not realistic but all this institutional architecture is necessary to have confidence in the financial system which is the key element for its functioning.

I am aware of the complexity of the framework I have described but each of the authorities that I have mentioned have a different responsibility. Despite this, they all have a common goal: "promoting financial stability". I must also acknowledge the level of cooperation among all of them. We need to coordinate strategies and views.

I believe that despite the complexity of Europe, we have been extremely successful in setting a common regulatory, supervisory and resolution framework. This is not complete and we have to still work on the completion of the Banking Union but the we must be proud of what we have already achieved.

We had different backgrounds, different supervisory cultures and it has not been easy to set up common supervisory procedures and a single risk culture. I think that this is work in progress, aligned to the changing economic and financial environment.

Although sometimes the current European regulatory and supervisory framework could be seen as too burdensome I think the responsibilities are well defined and there is a fluent coordination. I agree that in some cases the reporting requirements are high and this could be fine-tuned depending on the circumstances.

In this sense, the EBA already performed an assessment about cost reporting[1] in 2021. The report sets out 25 recommendations to further improve the significant proportionality that already exists in the supervisory reporting. It also considers the benefits of the standardised supervisory reporting to the public authorities using that information to carry out their role. The combined effect of the identified recommendations could reduce the reporting costs faced by up to 15-24%. For small and non-complex institutions this reflects savings in the range of EUR 188-288 million.

[1] https://www.eba.europa.eu/sites/default/documents/files/document_library/Publications/Reports/2021/1013948/Study%20of%20the%20cost%20of%20compliance%20with%20supervisory%20reporting%20requirement.pdf

The diversity of bank models in Europe

I agree that the "one size fits all" approach "per se" is not valid in such a diverse system as the European banking business.

I believe that the **SSM is an example of success** form the inception. The supervisory process has evolved since 2014 adapting to the circumstances, moving from one system that is predominantly rules-based and heavily codified, to one that is more risk-focused and adaptable to rapidly changing economic circumstances. We are increasingly concentrating our supervisory resources on the risks that are most material. And as this **implies increased discretion for our supervisory teams, we are also implementing more rigorous internal controls and more transparency** and accountability towards our stakeholders.

Our style of supervision has sometimes been criticised as excessively heavy handed and conservative. I believe we should aim at enhancing our efficiency, also with an eye on the compliance burden we impose on our banks, while in no way lowering our guard and actually strengthening our monitoring of risks and risk controls at the banks we supervise.

In this sense, we make use of a great variety of tools that allow us to compare and set different standards and to identify outliers. This is the main benefit of the SSM as we can now better compare at least 110 banks that are under our direct remit.

Nevertheless, we must dig in into this data and understand the potential differences among banks. The JST are the most knowledgeable and acquainted with the idiosyncrasy of each institution.

That is the reason why we have reinforced our risk-focused approach in our supervision for the long term as I have mentioned,

To do this, **we have decided to introduce a new, supervisory risk tolerance framework**, which is designed to enable supervisors to better adjust to bank-specific needs. Under the new framework, supervisors will be able to devote more time to address our strategic priorities and those vulnerabilities that are key for a specific bank, focusing their efforts where they are most needed. To make this possible, we are enabling our supervisors to plan their activities in a more flexible way, in accordance with a multi-year SREP.

This approach will allow our supervisors to better calibrate the intensity and frequency of their analyses, in line with the individual bank's vulnerabilities and broader supervisory priorities. This will also streamline the supervisory activities in a proportionate and risk-based manner, as we wouldn't tick all the boxes every year. As a result, we expect a reduced burden for the banks too.

Importantly, **this will not mean less supervision, or a "light touch" approach**, but rather more focused and impactful supervision homing in on the most material risks. It will also give us more flexibility to tackle new and emerging risks in a rapidly changing macroeconomic and interest rate environment.

But increasing supervisors' scope for discretion to prioritise among risks must not come at the expense of lowering the consistency of our supervision across banks. Therefore, alongside allowing our supervisors greater discretion, we are also bolstering our internal controls functions, to preserve the principle that **like risks be treated in a like manner**.

We introduced in 2020 a supervisory risk and second line of defence function, which conducts strategic planning, proposes supervisory priorities and contributes to the consistent treatment of all banks via both on-going and ex-post checks.

So, we are increasing supervisors' discretion to focus their resources on the most important risks, and we are increasing our centralised controls to preserve and even enhance the degree of consistency we achieve in addressing risks across banks.

Basel III implementation

The full implementation of Basel III will have an impact but it will be limited according to the latest researches performed by the ECB[2] and EBA[3].

Actually, EBA published last Tuesday its **second monitoring report on Basel III impact on EU banks**. The estimated capital shortfall to comply with the Basel III reform, EUR 0.6 billion of additional Tier 1, has been practically eliminated. Overall, the results show that European banks' minimum Tier 1 capital requirement would increase by 9.0% at the full implementation date in 2028. The main contributing factors are the output floor and credit risk. The overall minimum Tier 1 capital requirement for large and internationally active banks (Group 1) would increase by 10.0%. The requirements for the global systemically important institutions (G-SIIs, subset of Group 1) and for Group 2 banks would increase by 16.0% and 3.6%, respectively.

Similarly, the conclusion of the ECB report is that the **transitory economic costs of the plain vanilla Basel III approach are outweighed by its permanent long-run benefits.** The costs of the phase-in of the plain vanilla Basel III finalisation are moderate and amount to a **transitory reduction of GDP growth by 0.1 percentage points from the second to the fourth year af**ter its initialisation, and eventually disappear in the seventh year after the introduction of the reform. **Completing the Basel III reforms will benefit long-term bank solvency and profitability**. Banks will be in a better position to absorb losses in adverse economic conditions and will face lower funding costs. The **resulting economic benefits amount to a permanent long-run increase in economic resilience**.

The results show that implementing EU specificities may reduce the already moderate transitory economic costs but also reduces the long-run benefits of the Basel III finalisation. The macroeconomic costs of the main EU-specific approach[4] are small, staying

[2]https://www.ecb.europa.eu/pub/financial-stability/macroprudential-bulletin/html/ecb.mpbu202107_1~3292170452.en.html

[3]https://www.eba.europa.eu/eba-second-mandatory-exercise-basel-iii-full-implementation-shows-significantly-reduced-impact-eu

[4] which involves implementing the SME supporting factor on top of the Basel SME preferential risk weight treatment, continuing the existing CVA exemptions and employing discretion with regard to the operational risk capital charge.

below a 0.05 percentage point reduction in annual GDP growth in the years directly following the initial phase-in, and gradually fading over the medium horizon. However, the long-run benefits of the main EU approach are around 40% less than the benefits under the plain vanilla implementation.

Most of the assumptions underlying the estimates of costs and benefits of the report are conservative, which is likely to lead to an overstatement of the costs of the reforms. For example, it is assumed that banks will not have anticipated the moment of the Basel III finalisation phase-in, while in reality banks have several years to prepare and adjust before the new rules come into force. Furthermore, the model used in this research study, only incorporates the dynamics of the largest euro area banks. Since such banks are expected to be those most impacted by the final Basel III rules, this assumption overstates aggregate cost estimates. It is also assumed that banks do not tap equity markets and that they cannot raise capital by issuing new shares.

Therefore, I have to say that **the implementation of Basel III will not constrain the amount of resources that our economy needs** to face the challenges to come. I mostly refer to the transitioning economy to more sustainable models but I am also thinking of the challenges that the digitalization process will bring to the table. Conversely, **it will strengthen the position of banks to fulfill the financing needs**.

In fact, the report published last Tuesday that the estimated capital shortfall to comply with the Basel III reform has been practically eliminated.[5]

The two sides of securitisations

I would like to end with a reference to **securitisations**, I perceive them as a double-edged sword. On the one hand, securisations foster the financing capability of banks. They have a multiplier effect which is important to provide finance the economy. On the other hand, they also imply some specific risks that are not always easy to identify.

Related to this, a number of regulatory reforms were introduced in the aftermath of the 2008 global financial crisis to address the information asymmetries and incentive problems associated with securitisation markets. The reforms included increases in required capital in relation to banks' securitisation-related exposures; improving disclosures and facilitating standardisation; and addressing incentive problems through retention requirements and by enhancing the rating process.

It is extremely important that **banks set a clear governance around securitisations** where they can identify risks and set the conditions for the risk transfer. Similarly, supervisors need to clearly be able to understand the securitization strategy of banks and identify the risk profile of each transaction. Securitisations cannot be used merely as a mean to reduce capital requirements. It has to be embedded in a clear strategy.

[5] https://www.bis.org/bcbs/publ/d554.pdf