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SAFEGUARDING THE STABILITY OF THE GLOBAL BANKING SYSTEM: A CONVERSATION WITH ECB'S CLAUDIA BUCH

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WESSEL: Good morning and welcome to Brookings and the Hutchins Center on Fiscal and Monetary Policy. I'm David Wessel, director of the Hutchins Center and I want to welcome people in the room and online and on the C-SPAN audience. So we learned a couple of years ago or we were reminded a couple years ago when Silicon Valley Bank ran aground that it turns out that bank supervision is pretty important, and when you don't do it well, bad things happen. And so that's why we invited Claudia Buch to join us today. Claudia was named chair of the European Central Bank Supervisory Board, which oversees its single supervisory mechanism in January 2024. And the main aims of the single supervisory mechanism are to ensure the safety and soundness of European banks and to increase financial integration and stability in Europe.

Now, for the last decade, the European Central Bank has supervised 114 of the significant banks of the 20 participating countries in the euro zone. They hold more than 80 percent of all the banking assets in these countries. And I think it's worth reminding Americans just how big the European banking industry is. The banks they supervise have about $30 trillion worth of assets at today's exchange versus about twenty-four trillion dollars of the US Banking system and it’s also the case that banks are much more important part of the European financial system then banks are in the United States.

Before serving at in this challenging job that European Central Bank, Claudia Buch was deputy president of the Bundesbank for a decade and before that, she was a distinguished academic. She has an MBA from the University of Wisconsin at Eau Claire, if you want to know why, we can ask her that later, but a Ph.D. in economics from the University of Keele, and when the opportunity came to have Claudia Buch speak before us, I asked a number of my colleagues who have worked in bank supervision and regulation over the years, and she got very, very high marks and let me tell you that's not the way – that's not the response I often get when some European wants to speak on our stage. So we're very honored to have you, Claudia. Claudia is going to make some remarks, and then I'll be joined by a couple of panelists who I'll introduce later.

BUCH: Thank you very much for the very kind introduction and for the opportunity to speak here. Welcome to all of you who came here and I understand we also have an audience online. So thanks a lot. Yeah, it's very clear, I'm also from the discussions here in town these days, we have heightened geopolitical risks and what I want to talk about today is that this really requires resilient banks and also a stable international framework, guardrails, for the international banking system. Let me give you a few numbers. More than 70 percent of global – of risk officers, bank chief risk officers actually cite cyber resilience as one of the most important concerns that they have according to a survey that was done by the Institute of International Finance. Many of them consider geopolitical risk to be relevant. And also put a potential threat to their operational resilience.

And I think if we consider what has happened on markets recently in the aftermath of the announcement of tariffs, this clearly shows how quickly the environment can change in which banks operate. So to stay the course in this troubled waters, think we need strong safeguards for the stability of the global financial system and in particular the banking system because if you consider how the banking has expanded and how much it is the lifeblood of the of the globe economy, let me give you two numbers. So today the outstanding international claims of banks account for roughly 40% of GDP. If you go backward in time, the beginning of the, you know, the, the. Globalization period, if you look at the post-war period, 1963, this is the numbers we could find, that comparable number was just 2% of GDP.

So, outstanding claims of banks are just way more important than they used to be, and it's hardly conceivable how the global economy can flourish without resilient banks. So, similar to shipping, that ensures the smooth flow of goods across borders, banking services are essential for payments, for trade finance, for ethics services. And clearly global industries, the shipping industries and the banking industry needs global standards. So I will use a few analogies to shipping and sailing to make that clear. There's actually the International Maritime Organization that was founded in 1948. Founded to ensure the safety and security of shipping and the prevention of marine and atmospheric pollution by ships through global convention. So this was in 1948. Actually, global trade volumes have increased quite a bit since the early 1950s, despite these global rules that were implemented.

So global trade volume are now 37 percent times higher than in the early 1950s. So clearly, global rules, global standards do not impede international activity. Insufficient regulation and supervision, to the contrary, can have very severe consequences. So when banks take excessive risk, this can put public finance at risk and also the real economy at risk. And actually, when you look at the past half century there were only two episodes when global trade volumes fell, and this was during the global financial crisis and during the COVID pandemic. And we all know how long it takes for these wounds to heal along many dimensions. Again, fiscal, the real economy, and also the social consequences of financial crisis can be quite severe. So now the global finance crisis is more than 17 years behind us, and it may seem just like a fading memory, the lessons couldn't be more pertinent to today.

As I said earlier, the global economy really navigates through troubled waters with heightened geopolitical risk, trade tensions, and financial market volatility. And this is the point I want to make today, that actually maintaining global financial stability through regulation and supervision is really something that benefits all market participants. And the Basel Committee has been very instrumental in establishing that preventing regulatory arbitrage and promoting stability and the very same objectives that were relevant when the Basel Committee was founded in the 1970s, they're still very relevant today. Now, having said this, what you often hear is banking rules, regulations, standards are very complex.

But actually banks themselves are highly complex institutions, and I think the regulation also needs to properly address the industry's specific needs and vulnerabilities, and actually the same holds true in shipping, so I must admit I'm not a shipping expert, even though I use the analogies here, but if you look at the rules that are there also for the shipping industry. They may seem pretty complex but I'm sure that they serve all a specific and dedicated purpose and this is something we need to bear in mind in all the current discussions we're having. So the three main points I would like to make today and that's all later on discussed with you here is that open markets clearly have many advantages but we also need common guardrails to assure that we reap these benefits.

I would to explain a bit how we do this in Europe, how through the single supervisory mechanism in Europe through common supervision, how we contribute to the fact that the European banks remain trusted counterparts, how they contribute to financial stability also globally, and then third, how we remain committed to international coordination and cooperation when it comes to supervision. But let me just give you a very quick recap of how we do supervision in Europe. So the Banking Union was actually established 10 years ago, and I think it was a very strong response to the global financial crisis, the European sovereign debt crisis, which very painfully showed the deficiencies you can have if you have a supervision organized at the national level. There wasn't the ability to benchmark banks across countries, and there were also different supervisory standards across countries.

I think the policymakers listened very well to the deficiencies that were exposed at the time and they created the banking union, which has the single supervisory mechanism, a single resolution mechanism, and then deposit insurance, European deposit insurance would be the third pillar, and this is still the incomplete part, if you want, of the banking unions. So policymaker listened to the signal coming from the crisis, and markets also listened to the policy response because what we see is that the banking union has really been a crucial step in establishing trust in European banks through a consistent supervisory framework and a better resilience of the system. The way we do it, and the numbers have been mentioned, so we have 114 significant financial institutions which are under the direct supervision of the ECB, the single supervisory mechanism, and the less significant institutions are supervised by the national competent authorities, but we have an oversight function there.

I don't want to bore you with the details of how we do supervision, but let me just give you a few kind of key elements because I think it's important to understand how we also contribute to a resilient financial system. So at the core of our supervision is the supervisory review and evaluation process where we look at basically four key elements, the governance of banks, the business models, the capital situation and risk to liquidity. So these are four elements. We do the supervision together with the national competent authority so we have joint supervisory teams from the ECB, from the countries doing the supervision. And together we have decided on a big reform of our supervision. To make it more efficient, more effective, but also more intrusive, making sure that if we have findings that they are also remediated. And so basically the core of the supervisory reform, which is currently being implemented, is that we better target the most relevant risks and, as I said, also ensure that remediation happens sufficiently fast.

And I would argue that this is actually also to the benefit of the banks to get guidance from us. When it comes to capital requirements, the key output from our supervisory process is of course minimum capital requirements so-called pillar one requirements, but then we have pillar two add-ons requirements tailored to specific risks that are not covered under pillar one and we actually also we have now a simplified structure for these pillar two requirements in the context of our bigger reforms. And again, as I said, the big advantage of supervision, the way we conduct it, is that we can benchmark across institutions, we can compare, and this actually has a lot of benefits. In addition to this pillar one, pillar two requirements, we also have guidance on the pillar two capital.

And this comes from stress test results that we actually currently conducting within the context of the. European banking authorities stress test, and this is much motivated, the adverse scenario in the stress test by disruptions to global supply chains, international trade, slowdown in economic growth. So it's an adverse international risk scenario that is the foundation for this stress test and the results. So stay tuned. The results will come out in August this year. So this is just a very quick overview of how we do supervision. Let me speak a bit about regulations. So we basically have a regulatory framework with the EU's, the Europeans' single rule book, which gives us common standards, common prudential standards for all banks operating within all 27-member states of the EU. Europe has decided to implement the new Basel rule since January. This year onward.

And there's a gradual phase in of these new requirements until the year 2032, the end of the year 2032. The one distinguishing feature of the European framework is that although the Basel framework is primarily intended for the internationally active banks, but Europe is implementing the standards for all credit institutions which means, of course, that specific features of the European economy need to be taken into consideration. And just one example is the so-called small and mid-sized enterprising supporting factor, the SME supporting factor which is de facto implying reduced capital requirements for SMEs which are very important for the euro area economy.

And this is one of the reasons, so these deviations from the Basel rules is that the Basel committee assessed Europe in its 2014 assessment, so this is quite some time ago, to be materially non-compliant in certain areas, basically showing that, of course, with all the international standards and the application across countries, there always needs to be an assessment of how material also the deviations from the framework are. We have done, and the European Banking Authority has done an assessment of the, impact of the new Basel rules on the European banks and also whether there are potential unintended side effects. And what all these impact assessments show is that there's actually no negative material side effects in terms of reduced lending or reduced growth, and actually also the impact in terms capital on the Europe banks is not very big also because of the long phase in and because banks can adjust to mitigate the impact. So overall, but maybe you may say I'm a little bit biased because I'm the chair of the supervisory board I think this European approach has served us very well.

Just if you look at how the European banks have weathered recent storms, the COVID pandemic, the increase in energy prices, they have remained resilient throughout because of the work that we have done in terms of capital and liquidity requirements, but also because there was quite a bit of fiscal support also for the real economy. So let me give you a few numbers to substantiate this a little bit, the resilience of the European banks. So when you look at the past 20 years, so going back until a time right before the financial crisis, so 2006, we've seen an increase in capital ratios, the CET1 ratios from roughly 8% to 16%, also of course the quality of capital has increased. So this is quite a big increase.

For the leverage ratio, so the unweighted capital ratio, we have a shorter time series, but they also, we see an increase from about 5%, 10 years ago to now close to 6%, and of course, the banks hold compatible buffers over and above the required capital ratios. Liquidity conditions remain quite favorable, so there's been a relatively smooth transition out of the period of quantitative easing. Low interest rates to higher interest rates, banks have good access to retail and wholesale funding, but we also, of course, monitor very carefully that they're prepared also for potentially environment with tighter liquidity conditions. Quality of banks' assets remains relatively strong, a clear decline in non-performing loans from about 7.5 percent when we started the banking union to now. 1.9 percent but of course we monitor very closely the areas where there might be a weakening of credit quality also of course due to the slowdown of growth that we might see also related to the tariffs.

Bank profitability clearly increased from the period of low interest rates from that was a number of around 5.5 percent. Almost double to close to 10 percent of course this is also driven to a large extent by higher interest rates but we must also say that the cost to income ratios have improved going down from about 66 percent in four years ago to 55 percent so there's also been an improvement there it's not just the interest rate effect but of course as supervisors we always have to remain vigilant and there's certainly headwinds that banks are which may affect their profitability in terms of net interest income likely having peaked, potential deterioration, asset quality, margin compression, and also loan volumes grow less fast.

And this is of course not just driven by domestic factors, but also by the international environment. So how are we responding to these headwinds that the banks are facing? We basically, and this is just about the European supervision, we have three main priorities. One is geopolitical risk and the heightened uncertainty. So we had a framework that we published last year how we deal with geopolitical risks. And let me make very, very clear, this is not a new risk category that we invented, but basically geopolitical is affecting the banks through the traditional risk categories. So we have this framework, and then we looked at the supervisory activities that we're doing to check whether we are addressing this Let me just give you a few examples.

Of course, it's good governance mechanisms in the banks that are needed so that the banks look at adverse scenarios, that they do scenario planning, that they make sure that their provisioning practices are not just based on historical data, which may not give them a good view of forward-looking risks. And as I mentioned, the EU-wide stress test has also been motivated by a geopolitical risk scenario. Second priority, and I mentioned this, is remediation. So we've certainly made progress in identifying weaknesses in the banks, but often the remediation is not sufficiently fast. So one example is the information infrastructures that the banks have internally. So this is about risk data aggregation and reporting. So we often find that banks don't have information systems internally that also provide sufficiently detailed information for the internal decision making, and so we follow up in case we have findings where we find these risk data and aggregation systems to be insufficient.

A third priority, digitalization very clearly because the competitive environment there for the banks has changed quite significantly. There's lots of opportunities in terms of cost reduction, greater efficiency, building scale, but there's also new risks as I mentioned earlier related to cyber resilience, outsourcing. So we've done a cyber resilience trust test last year and we also strengthened our oversight of outsourcing agreements. So these are things we do. Let's say, internally in Europe within the SSM. But we, of course, operate in a global environment where we also depend on global standards on coordination, supervisory coordination. And the European banks, as many banks globally, are really integrated into a global financial system, and as we all know, that risks that are exposed can cascade swiftly through the system.

And we all that many times in history we thought this time is different, and then often it's not different. So financial crisis keep reoccurring, driven by high leverage and painful market corrections to overvaluation. So this is, I think, why together we have to be very vigilant to make sure that the banks are, to stay in the sailing analogy, have sufficient balance to withstand sudden shifts in economic conditions that they navigate with sufficient distance to avoid collisions. And that they don't sail too close to the wind, take on excessive risks following short-term gains, and then only to find themselves being unable to stay afloat when conditions suddenly change. Unfortunately, we have a framework globally for dealing with these issues.

As I mentioned, the Basel framework, I think, is very important to make sure that we have cross-border cooperation, the same standards, fostering trust, reducing the probability of crisis. And this is why, just as we work on financial stability in Europe, why we also are very supportive of the work programs of the Basel Committee, the Financial Stability Board. These are exactly the four that we need to provide financial stability as a global, talking about global public goods seems very abstract, but I think actually the benefits of having this are there for the citizens who entrust their savings to banks, the taxpayers who would otherwise have to pick up the bill in case anything goes wrong, and also the banking industry, because similar standards across countries, trusting counterparts, and also

The absence of financial crisis, which means that losses have to be borne by equity holders, debt holders. I think this is in the interest of the industry itself and not just of the globally active banks.

Actually, in Europe, we have many banks that are regionally active that don't have that many international activities, but they all depend on trust in the banking system, in the financial system. So I think the benefits of global coordination span across business models. This is basically the key message that I want to bring here, that these common standards are not there to constrain activity, but to enable activity. We're coming out of a period of relative financial stability based on the common standards to cooperation that we have achieved.

We had a bit of a risk right now that the memories of the past crisis are fading. So we need to make sure that We don't prioritize short-term profits growth over longer-term resilience, but with that we retain the resilience standards and we are certainly very committed to this cooperative approach because the best safeguard against accident at sea is to have sufficient water under the keel and not to sail too close to the wind. Thank you very much and I look forward to the discussion now on the panel.

WESSEL: Thank you very much Claudia Buch for quite a comprehensive and clear summary of the challenges that we face these days. So I'm joined on the stage by two people who have a lot of perspective on this. Michael Silva has one of those resumes that you wonder like how could you fit all this into one lifetime. He was a lieutenant in the US Navy. He spent 20 years at the New York Fed, where he was a lawyer. He was dispatched to help the Central Bank of Iraq after the invasion. He was chief of staff for two presidents of the New York Fed, Tim Geithner and Bill Dudley. And then for his sins, he was in charge of supervision of Goldman Sachs when Goldman Sach's became a thing.

So that wasn't enough. So he went to work at GE Capital. He was the lawyer at DLA Piper. And then he was head of compliance, US Compliance for UBS. And now he's the lead director of an unusual bank called Column, which is a nationally chartered bank that is funded by a software guy and which does a lot of work with FinTech’s. So he's got the whole private sector, public sector perspective. Nicholas Véron is a senior fellow at the Peterson Institute for International Economics across the street and one of the founders of Bruegel, a think tank in Brookings in Brussels, rather. Sorry about that, that he helped co-found. Nicolas is a French citizen and he studied math and physics.

And I learned today that he went to Polytechnique in Paris, which was a forerunner of West Point. So although he didn't sit in the backseat of F-14s like Mike Silva, he did sit in the back seat of tanks for a year. Apparently, that convinced him that he should go into think tanks and studying bank regulation. Nicolas is a very well-known commentator and analyst of bank regulation and banking issues. He's been an advisor to the French labor ministry. He's a financial officer of a publicly listed internet country. He was for a while a board member of the Depository Trust and Clearing Corporation.

So we have people who really know a lot more about what Claudia Buch is talking about than I do, which is why I invited them. Mike, I wonder – Claudia Buch made, I think, a very strong point that – international cooperation among bank regulators and supervisors is good for everybody. And you've had a lot of experience in that world, and I wonder if you could talk about how you think about that and whether that's at risk given the current approach that the America first administration is taking.

SILVA: Well, thank you, David. First of all, I couldn't agree more. And my career has given me three particular perspectives on that that I feel very passionate about. First, as David mentioned, I was Chief of Staff for Tim Geithner during the financial crisis. And during a crisis, and we will, as long as we have a financial system, we will have financial crisis, there is absolutely no substitute for being able to pick up phone at three in the morning and talk to your international partners all around the world, speak a common metric, be talking about institutions that are more or less a level playing field.

And if Tim hadn't been able to do that and Chairman Bernanke and Secretary Paulson hadn't been able to that, we would have been a very difficult situation. And it takes a lot of working together and a lot trust to develop those kind of relationships. We will be at 3 a.m. in the morning again in another financial crisis. Second thing that during my own career that particularly relevant is there are some risks that you just absolutely can only be assessed on a global basis. They cross borders. We're looking at one right now. AI, AI has tremendous potential, right? But there's also immensely important safeguards and potential risks and some coordination. And standard setting for that very, very important technology that's coming forth is critical. And then cyber security is another one. Personally, I think there's a very good chance the next crisis comes out of some sort of cyber event.

And there, in particular, the system is only as strong as the weakest link. And coordination with our international partners would be absolutely critical. And then finally, very simply, without international coordination, what you have is a race to the bottom. I think that's just a very basic thing. Do I think this is going to change? I think not substantially is my hope. Yes, there's been a change in administration, but not a change in certain concrete realities in terms of managing risk, dealing with crisis, trying to promote a level playing field in the financial system. So I think there's going to be certain. As I say, sort of laws of gravity that continue to compel this very important international cooperation.

WESSEL: So Nikolas, how do you see the state of international banking coordination on supervision, the fate of Basel III, which the US seems to have decided is too hot to handle for a while?

VÉRON: First thanks to…

SILVA: It's in the bottom of the thing.

WESSEL: Nicolas told me that he learned after a year of military service that he wasn't good at that. So he's demonstrating that exactly well It works. Problem solving.

VÉRON: Yeah, but when it doesn't work the first time in a military context, sometimes it's a problem. Well, thanks for your kind introduction. Just for the sake of clarity, you mentioned DTCC at the end. I haven't been a board member of DTTC. I still am a board member of their trade repository arm, which is a more limited. Important, but limited. But it doesn't create, in my opinion, any conflict in what I'm going to talk about today. Well, there is a risk that there might be a little bit too much agreement on this panel, including on the question you asked to me, David, international cooperation and the Basel framework.

For the reasons that have already been mentioned, the Basel Framework is essential. It's a very important public good. It has been there for more than 50 years. There have been ups and downs. But if it wasn't there, we would need to invent it, basically. So this is, as you know, the Basel committee is a committee on banking supervision. Its primary purpose is to have coordination on supervisory practices. It was born from the Herstadt crisis in 1974, and it is very important, as was just emphasized, and I completely agree, that supervisors know each other, that they Have a common playbook. And that they have a common language. Now, the Basel Committee, as you referred to, has also been famous or notorious, depending on the point of view for its regulatory standards. So these are non-binding standards, of course, because they are set at a global level, but there is a strong recommendation to individual jurisdictions to transpose them in their own rule book, which has been by and large a case for the jurisdictions that are members of the committee.

And right now we have Basel 3 which was created in different phases between 2010 and 2017 and Basel three is still not implemented in a comprehensive way. So there's a very long lag since the final agreement was reached in 2017 and that long lag is to a certain extent attributable to the US reluctance, the politicization of this agreement in the US context, which has been in a way encouraged by the banking community. Maybe we'll come back to that. I will actually be reasonably optimistic in terms of the resilience of the Basel framework. I think the very large American banks, most of them, maybe not all of them but most of them, the GSIBs as we say in the banking jargon, the Globally Significant Institute.

SILVA: Uh, globally significant.

VÉRON: Yeah, international banks? We all forget.

SILVA: Systemically important, globally. Well, the problem is that there are two adverbs, right?

VÉRON: It's globally and systemically, and it makes it very confusing. Anyway.

SILVA: Probably worse in German, but.

VÉRON: So the USD Sibs, from what I gather, are not hostile to Basel III implementation, including the one piece of the Basel III Accord, which is most impactful in terms of global competition and globally integrated segments of the banking space which is the fundamental review of the trading books, FRTB maybe will reuse that acronym. So right now the EU and the UK have suspended their implementation of the FRTD because the US is not implementing it. They have, the EU has implemented the rest of the agreement by and large with the variations that Claudia alluded to, the UK has delayed the reason why US GSIBs, the JP Morgan and Wells Fargo of this world, why they're actually favorable in my understanding, but things may be a bit more complicated, to the implementation of Basel III is that there's something that could be even worse for them, which is fragmentation of the regulatory framework.

And that means global fragmentation with different rules and different jurisdictions for global banks like JP Morgan or Citi. Those which now are banks like Goldman Sachs or Morgan Stanley or custodians, State Street, Bank of New York, which address a global market, but also the prospect of fragmentation in the US. Because in the US, you have this complicated system where you have state banks, national banks, you have a lot of state regulators. And it's pretty clear that if the federal level doesn't do its job of regulating banks, some states, not all of them, will take that into their own hands. And that's not good for the banking industry.

So I think it's going to be very interested, and I'll stop there for the moment, to observe the behavior of the Fed and other federal regulators, but also to look at regulators in the current environment where Secretary Besant has said in no uncertain terms that he wanted the regulation of the banking sector in the US And to see how the dynamic between the risk of fragmentation both inside the US and internationally will be managed by the US Political system including the lobbying by banks with the trade-off versus what banks always do want which is reduction of capital requirements.

SILVA: Do you worry, Claudia, about fragmentation of the global regulatory and supervisory?

BUCH: Well, I mean, this is what I was saying. I think I agree with what has been said and then I also said in my speech that actually having global standards is in the benefit of the industry, because it's benefiting the larger institutions that are active globally, but it's also benefiting the smaller institutions that would also be at risk if anything goes wrong. So, in that sense I would agree, I mean, I'm more on the optimistic side, that we get an agreement and that also we have international implementation of

Basel. One must say I mentioned Europe, but many other countries globally have also implemented the Basel standards already. So in that sense, I tend to be optimistic. But I guess the question is, is there a political consensus?

Well, I can't judge on what's happening in this country. So there's people on the panel who know much better than I do, and it remains to But I think Nicolas said something very interesting also about the fragmentation within currency union, the EU as you mentioned, the potential risk that there's more fragmentation. And in Europe, we clearly have a big discussion. We have, again, we have a single supervisor where we have a single rule book when it comes to prudential regulation. But we have many national rules that are affecting banks, which are not harmonized. So actually the discussion in Europe is a little bit the opposite right now. How can we go to a more better integrated single market?

How can make sure that we also use the current situation a little as a stimulus to promote integration in Europe? And this is certainly something we would advocate for. It was running under the heading of the Capital Markets Union, Banking Union Project, now this has been combined under the Umbrella Savings and Investment Union. But this could be a great opportunity for Europe also to harmonize rules that are currently different across countries, again, not the banking rules, but other rules that are relevant and so then lead to more integration, less fragmentation in Europe. I think that would be important.

SILVA: One of the lessons of the Silicon Valley bank crisis in the US Was that supervisors and analysts hadn't paid as much attention as they should have to concentration risk among depositors and interest rate risk. And I wondered how that's affected, if it has at all, your approach to supervision in Europe.

BUCH: No, I mean, this was clearly something I mean the findings from the 2023 turmoil, SVB, Credit Suisse. So this was, I think it was also very grateful to all the supervisors and regulators who wrote reports and so that the rest of the world could learn from these episodes. This is clearly something we looked at very, very carefully. For us, it was a little bit, it came a bit in parallel to the big reform that we initiated already in 2023. Of our supervision, how we want to conduct supervision to become more effective, more efficient to make sure there's remediation. So this was clearly, I think, from a supervisory perspective, maybe an episode we all collectively would have liked to avoid, but something which helped us looking into this specifically when it comes to liquidity. We do a very, very careful liquidity monitoring for the banks. We introduced in the fall of 2023 weekly liquidity monitoring so that we have continuously good information about the liquidity situation of banks and of course we look very carefully at the indicators that were found to be difficult for SVB but this was a very specific case but we clearly took the lessons from it.

SILVA: Mike, you mentioned, as Claudia Buch did, the cyber risk. I wonder if you could expand on that. What do you mean by cyber risk? What specifically? And what do you think, how well equipped is the banking industry in general to protect against it?

SILVA: Well, in the first instance and the most worrisome instance, cyber security refers to the possibility of a bad actor. They could range from anybody sitting in a basement in Eastern Europe to a state actor, getting into the banking system, and causing immense chaos, and without too much difficulty shutting down the clearing systems or denying access to accounts, and particularly with the introduction of AI, which the bad guys have as much access to as we do. This risk is only going to escalate. And, you know, as we've mentioned before, currently it's a very heightened geopolitical tensions.

And we know there are state actors that have cyber tools as part of their toolkit. I also, when I say cyber security, and this is probably not the most accurate use of the term, but I also refer to the chance of an internal. Cyber mishap. I'm immensely concerned having now been associated with a purpose-built cutting-edge core banking system and seeing what advanced technology can do in terms of risk management, in terms of resilience, in terms of scalability, flexibility and especially in terms of cyber security, I'm very aware of what an immense IT deficit many of the large banks have. They've under-invested for decades in their core systems and those systems are vulnerable. So I do worry quite a bit about that.

WESSEL: Nikolas, how much should we worry about non-bank financial institutions? I understand it's not the remit of the you have plenty to do on banks, but I'm curious whether you think we're focusing too much on the banks and not enough on all the non-

VÉRON: I actually tend to see it the other way around. Interesting. I think there's a good reason we focus on the banks, because the banks create money. We have deposits in the banks. And time and again, we've seen the banking industry distracting the conversation away from themselves and pointing to NBFI, non-bank financial institutions, I got that acronym right, to say, hey, here's where you should look at for risk. Silicon Valley Bank, you mentioned Silicon Valley bank. Let's spend one more minute maybe on that. It was a very powerful reminder that there's something about banks. And if you don't focus your attention very, you know, obsessively on the banking sector, you're going to have bad experiences.

Claudia was very diplomatic in the way she answered your question. I can afford to be a bit less diplomatic. The Fed, the supervisors in the US didn't have their eye on the ball. So European, and for that matter also British, supervisors did. In 2021, a year and a half before. The incident, the ECB banking supervision at the time it was led by Andrea and Rhea, listed its supervisory priorities and they said business model risk, interest rate risk, front and center. The Fed didn't do that. So I think it's always a bit difficult in Washington DC to say maybe the US system could learn from experiences outside of the US I don't even dare call them foreign. But it is the case that in this episode the US supervisory system was not the global best practice, demonstrably.

The Silicon Valley Bank incident happened with a very parallel trajectory of interest rates and interest rate shock and inflation shock between the US and the eurozone and again the UK for that matter and also jurisdictions. And basically, the US failed the test to European banking supervision, despite its being so young, passed the test. And I think there's a lot of thinking to be had from them, but also, frankly, of the great financial crisis in 2007, 2009. When it was the exact same thing. You went to a financial stability conference in say 2006, 2007, that's about the time when I started to be in this business. Everybody was talking about hedge funds and private equity. This is where the next financial crisis will come from. Well, it was banks.

Or things that should have been regulated like, as banks like, you know, Lehman Brothers, Fannie Mae, AIG financial products, and the like. So, and Washington Mutual. So we shouldn't we shouldn't forget that banks are at the core of financial stability and NBF eyes are important Of course, I don't want to say don't look at…but there essentially, from a financial stability perspective, leaving aside insurance and pension funds, that's a separate discussion. But for the rest, they're important only to the extent they affect banks. If you think of Archegos, Archegos could lose all their money, but the banks which had exposure to Archegos, that was a systemic risk. So that's what we shouldn't forget.

WESSEL: So do you want to contradict Nicholas' praise of the European supervisors?

BUCH: No, of course, I wouldn't contradict you on that. But one nuance when it comes to non-bank financial intermediation and the links of the banks, I fully agree that we should, and this is why I cited the numbers also on the importance of global banking assets and clearly for the European economy that the banks are core so this is what we need to make sure they remain resilient, but they link to the non-banks financial intermediations sector and they sometimes themselves have relatively limited visibility as to what exactly these links are, where vulnerability is building up in that space.

So I think we do need a bit more reporting also and more transparency as to what is happening in the non-bank financial intermediation sector for the risk management of the bank and also the banks and the supervision. And there's also, there can be sources of systemic risk in the NBFI sector and we may also need tools for that to address that type of systemic risks. So I think this is really, you know, this is where our ability is limited to address this risk because we can, we look at the banks but there can be sources of risk building up and they need to be addressed in the proper place. I don't know if I can, can I come back very briefly on the cyber resilience point, because I think this is really critically important. So as important as we think that financial resilience is capital and liquidity, this is core and as I said, this is core to our supervision.

But we also think this operational resilience part is really critical and the banks need to invest into their IT systems, their IT infrastructure to be, to have a sufficient degree of cyber resilience. So we did a cyber resilience stress test last year. This was about a hypothetical scenario. What if a cyber-attack is successful? How well are the banks prepared? Do they have recovery mechanisms in place? Can they assess the cost of such a cyberattack? And I think that was very useful for us as supervisors, but also for the banks. So they also, through the SSM, we give them the opportunity to learn from best practices of others. So this was really one of the exercises. That was also appreciated I would say by the industry and the reason being that we've seen doubling in the number of cyber-attacks between 2022 and the current numbers and also the severity of the attacks has increased and this is clearly also what they are also mentioning in the survey that I mentioned.

WESSEL: Mike, how much do you think about digitalization and how it could change the banking system and the need for supervision? I'm thinking about stable coins, the digital euro, all the things that the FinTech’s are doing that we couldn't even imagine 10 years ago. How big a challenge is that? It's obviously an opportunity, but how big a challenging do you we're managing it well?

SILVA: You know, digitalization, tokenization, AI, there is a tsunami of AI, I'm sorry, IT-related innovation that I think is just going to engulf the banks much more quickly and the regulators than we expect. As much as we're talking about it, I see it happening even faster. And I don't right now believe that the regulators have the right tools. In part because I have been exposed to a very modern platform and the abilities of AI, if the regulators start investing now and the largest banks too as well, the ability to build up the capability for systems for real-time monitoring, real- time monitoring of liquidity risk of capital levels of market manipulation is possible. I've seen it and I think it could be very useful and very important with respect to stablecoin.

WESSEL: I want to ask you one question before I turn to the audience for some questions. How much do you think about climate as a concern of supervisors?

BUCH: Well, as one of our priorities has been for some time, in the following sense, and let me make this very clear, so we are not climate policy makers, we are policy takers. So whatever climate policy decisions are being taken, that can have implications for the risks of the bank, so, we look at it entirely through a prudential and supervisory lens, but there's transition risk, there's physical risk that are very relevant, and we started working with the banks around 2020, a little bit earlier and trying to see whether banks have frameworks in place to manage climate and environmental related risk. And at the time, there was relatively little. So we did also stress test the banks that their own assessments. And then we had formulated supervisory expectations of how we think the banks should address these risks. And a lot of progress has been made in the meantime, one must say. So most of the banks. We supervise, have frameworks in place, consider the topic to be important and of course I mean as usual as a supervisor if you find deficiencies you also follow up upon those deficiencies but it's really it's clearly an important like the geopolitical risk, it's a risk driver, it is not a novel risk that we have invented but it can affect all risk categories that banks are exposed to so this is why they need frameworks, governance frameworks, information infrastructures in place to deal with these risks.

WESSEL: So I'm going to take some questions. We have mics. I'm gonna suggest that you, there's three hands. I'm take all three questions, and one of you will take a fourth afterwards. You wanna start over there? Please stand up, tell us who you are, and remember the questions end with a question mark.

AUDIENCE MEMBER: Hi, so my name is Ujwala Palluri, and my question is, given the Basel committee's increasing focus on proportionality, do you see room for a standardized Basel-like framework that enables credit unions, cooperatives, and SME-focused banks to scale lending while still maintaining resilience? What would be the key challenges and opportunities in implementing that globally or even regionally?

WESSEL: Great, thanks. I'm going to pass it to the front there with someone. Tell us who you are, please.

AUDIENCE MEMBER: My name is Kara Allen, just to follow up on the digitalization conversation, you mentioned kind of introducing real-time AI, but I think, you know, another issue is having people on the supervision side who have that expertise to accurately understand the risks. And if you don't necessarily have that on the bank side, I guess my question is two part. One, how do you deal with that disparity? And two, in terms of focusing on those skills. Kind of what are you planning on the ECB side? Is it going to be increased training, increased hiring, consulting, that kind of thing?

WESSEL: Want to take the two over here?

AUDIENCE MEMBER: Hello. My name is Hugo Doyle. My question refers to the frameworks that you require for dealing with geopolitical risks. You mentioned last year that not only should frameworks be required to tackle the Rumsfeld categories of known unknowns, but you mentioned also frameworks to deal with unknown unknowns. How do you expect this kind of complicated?

WESSEL: Those three meaty questions, I'm going to let you—I don't—this proportionality, credit union cooperative thing, does that—do you know what he—does that— Bring it back?

BUCH: Yeah. Well, I can say something, thanks for the question on what we do in Europe in terms of proportionality. So proportionality is really key to everything what we do. So it's about, you know, from a substance perspective, so what we do needs to be proportionate to the underlying risk also that can be related to the size of the institution. So, it's also actually a legal concept that we need to be proportionate in what we do, so sometimes it's confused with the size of the institution but it's actually covering the whole spectrum of our activities and I think it would be too complicated now to go into the details of all the institutions that were mentioned and how it's related to the Basel framework but this is a very clear message that whatever supervision we do it needs to be proportionate in a legal and also proportionate to the risk.

WESSEL: And dealing with skills of supervisors on digitalization. And yeah, I'm gonna let you take all three and then all those guys want to weigh in. They can, if not, we'll try another question.

BUCH: No, I mean, thanks for the question because that's obviously key for us that we need our supervisors need to have the, you know, up to date skill set and it point in time and digitalization is really a key challenge here and also, yeah, and I would say we have at least a twofold approach. One is clearly training. So we have a lot of training programs with a lot work on AI to make sure that the supervisors are sufficiently skilled and up to day. And of course, we would also draw on.

Expertise from outside of the organization to get that skills, but we need also the skill set inside the organization that is very clear. And the second is, it's a bit, I don't know what I should call it, learn it by doing, or also using the tools ourselves. So we have a big sub-tech agenda, so we're using AI IT tools also to improve our own supervision, to be faster, to be more effective. Large language model that is feeded by our internal documents. So I think this is the best way to actually, I mean, not just theoretically do training, but also apply these tools. And we see a lot of benefits coming out of it. So it can be much faster. We can process information much faster and then again, in the spirit of proportionality, really focus on the things that are relevant.

WESSEL: And then the third question, I had this, so when you think about geopolitical risk, we all understand what's going, well, I shouldn't say we understand, we all see what's going' on with tariffs and all that, but I think geopolitical risks are bigger than that. How do you even begin to think about doing stress tests or making sure the banks are equipped for things that we can't even quite imagine what they are? The known risks are bad enough.

BUCH: I know, I know. Well, I mean, we thought it would be useful to kind of first of all start from the traditional risk categories of banks and we mentioned a few of them, credit risk, market risk, liquidity risk, and then see how geopolitical events, geopolitical risk could impact on these risk categories. And so we basically, we looked at the financial markets channel, which is typically the fastest, you know, that all of a sudden there's a repricing of risk, there's market stress, how does that affect the risk categories. But it's also the real economy channel, the trade channel that I mentioned, that's also kind of a motivation of the EBA stress test scenario. And then of course there's this operational risk of the type that we've just been discussing.

So if you, there's a paper we issued last year which is kind of doing the mapping basically, and then we went through it and we said, okay, so are we addressing these things? And we found, for example, for cyber risk that yes, we have the stress test, we have work ongoing. And do we see any gaps between what needs to be done and what we are doing and we found that we're covering most of these transmission channels but then of course there's work also that the banks need to do too and for example with the known unknowns the unknown unknowns you need scenario planning and this needs to have tone from the top so the senior management and the boards have to be involved in this and also make sure that there's sufficient response to the high uncertainties that are there and to make sure that the banks have robust strategies to deal with that. So that's basically how we are trying to tackle that.

WESSEL: Thanks. Let me take one other question. I'll get back to you guys. There's a gentleman in the back.

AUDIENCE MEMBER: Hi, I'm Karthik Shankaran. Just following up on the last one, I have a couple of alarming things potentially geopolitically. One of the issues in the European banking system is that the banks are vastly more internationalized than the currency is, which makes European banks critical intermediaries in global dollar finance. And at a time when you have somewhat more difficult geopolitical relationships across the Atlantic. I had questions about three different aspects to this. One is sanctions risk, potentially an expansion of the pace of sanctions. We saw this already with BNP in 2014. Secondly, there is periodic loose talk. I think it's only loose talk about swap lines and the weaponization of swap lines. I hope it's loose talk, and the third thing here is a real emphasis in this administration not to do a CBDC but to do stable coins which then potentially creates financial stability risks maybe in the US But certainly outside by permitting the currency substitution.

WESSEL: So why don't I let Nicolas, Mike, and then Claudia respond. Lot of meat there.

VÉRON: You can take one slice. Too much to address, really. I will just add to the complexity of the pictures that Karthik just painted by saying that in European perceptions, in European reality, since, you know, the sequence in February from the van speech in Munich to the notorious Oval Office situation was President the lens key. At this point, geopolitical risk includes the US. We cannot be in a situation in Europe where the fight of Ukraine to defend itself is existential, not just for Ukraine, but for Europe. There's a US Administration that appears to favor the other side. So that's the situation we have, and it has direct translation into the banking space. It's very unfortunate, maybe, but that's our current situation. Let me stop here.

SILVA: I would just comment from a US perspective that we're adding to the risk right now, but I'm very optimistic that there are certain laws of gravity with regard to the markets, with regard to the realities of what it takes to end a war, and with regard to the importance of our global alliances, certain realities that are going to eventually moderate behavior. We'll see. Your stablecoin point is very relevant. And I would be worried about it if I was. Outside of the US I think it does pose some great potential for the US in terms of its reserve currency, but some real possible stability questions outside of US

WESSEL: So if I can boil down Karthik's question, I think it was the dollar is very important to the European financial system, to payments, to the swap lines when there's a demand for dollars, which doesn't seem to be so great right now. How much of a – how do you think about that as a supervisor, your vulnerability, the fact that the dollar's such a big part of the European –

BUCH: Well, I said it a little bit before, so clearly what we do is we do a very careful monitoring of liquidity. This is business as usual, this is always how we do supervision. And of course also, we look at ethics funding, so this is kind of where we currently are, so that we're monitoring this very closely. When you look at the response of the market and also the banking sector to the recent revaluation on markets, I think we haven't seen any significant event or liquidity shortages. So I think I tend to believe this is also due to the fact that we monitor this very carefully and that we make sure the banks have good funding plans there.

But I mean my response to the question would also be that it's actually what we're seeing is also reason why we also need to strengthen the European framework and I mentioned there the single market and what needs to be done there, and we also have, and Nicolas, most importantly here on the panel, we have some things on our to-do list for Europe, also when it comes to the crisis management framework, when it comes to European deposit insurance, so there's also still a whole package of things that we have to do in Europe. The digital euro I think will also be an important response to generally these global developments that we're seeing with regard to digitalization of finance. So I think we just need to do our homework and stay vigilant. It's not an easy environment in which we live.

WESSEL: Well, Claudia Buch, I want to thank you very much for spending time with us and Michael and Nicolas for your comments and also for such good questions from the audience.