Vítor Constâncio: Establishment of the Single Supervisory Mechanism – the first pillar of the Banking Union

Opening keynote presentation by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the 11th Annual European Financial Services Conference "Reshaping Europe's financial markets", organised by Forum Europe Ltd., Brussels, 31 January 2013.

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Ladies and gentlemen,

It is a great pleasure to be here today.

The crisis has made it clear that a highly interconnected and integrated area such as the euro area, and a genuine Economic and Monetary Union needed a stronger institutional framework. An important element to strengthen the financial institutional framework is the creation of the Banking Union with the Single Supervisory Mechanism (SSM) representing its first pillar.

During my intervention today I will touch upon the different elements of the Banking Union and the underlying rationale for its establishment. Subsequently, I will review the main features of the SSM and mention the immediate challenges for the ECB to prepare itself to assume its supervisory task.

1. The key building blocks of a banking union

The Banking Union aims at building an integrated financial framework to safeguard financial stability and minimise the cost of bank failures. It consists of four complementary building blocks, of which the SSM forms an integral part.

The establishment of a ***European framework for Supervision forms the first pillar of the Banking Union***. As implied by its name, the SSM will be a mechanism, composed of national competent authorities and the ECB, with possibility of non-euro area Member States to participate. The process to establish the SSM is underway, with the Council proposal forming the basis for the current trialogue with the European Parliament. I am quite pleased with the Council's proposal as it lays down a robust legal framework for the SSM to operate in. In order to ensure a timely implementation it is now of the essence that the proposal is enacted as soon as possible.

An important element that will be supportive to the effectiveness of the SSM, is the ***completion of the single rulebook*** whose implementation is overseen by the EBA. The completion of the single rulebook will significantly contribute to the single market and towards creating a level playing field by harmonising regulation at the European Union level. Likewise, the SSM will also contribute to these same goals.

A ***second element of the Banking Union is the establishment of a Single Resolution Mechanism***. The framework for the Single Resolution Mechanism is still to be defined and I look forward to the Commission's upcoming legislative proposal. Let me nevertheless highlight the main features that in my view such a Mechanism should have. The Single Resolution Mechanism would have a Single Resolution Authority at its centre that would govern the resolution namely of significant banks, coordinate the application of resolution tools and reflect an organisational set-up similar to the SSM. It should have a comprehensive set of enforceable tools, powers and authority to resolve all banks in the SSM.

In order for the Single Resolution Mechanism to be perceived as credible, it should have sufficient funding. Let me be very clear I am not talking about bailing-out banks with public money. Resolution is about orderly resolving the situation of banks that have attained the point of non-viability and about doing it in a way that minimizes the involvement of public money. Resolution is not about bailing-out banks it is about bailing-in shareholders and creditors and using a Resolution Fund based on banking sector contributions. Resolution activity may require the temporary use of public money if the Resolution Fund would not have enough resources, for instance, to capitalize a bridge bank that will be sold later on to the private sector thus recovering the capital involved. In the US this is ensured by the existence of a Treasury credit line that can be drawn upon by the FDIC but that has to be later paid back.

This implies then a ***third element of a complete banking union – the existence of a Financial Backstop*** that will also be involved in the direct recapitalisation of banks.

Finally, ***the fourth element of the Banking Union is the establishment of a common system of deposit protection***. A first step in this direction will be the adoption of the legislative proposal on deposit guarantee schemes, providing a harmonised framework. This framework should ensure depositor confidence and the national deposit guarantee schemes, built on common EU standards, could interact with the SRM. A European deposit guarantee scheme is therefore not essential in the short term.

2. Rationale for a banking union

We see the Banking Union as essential to sustain and strengthen the EMU framework primarily because by establishing a ***European framework for Supervision, it addresses the so-called "financial trilemma"***.[1] The trilemma states that financial stability, financial integration and national financial supervision cannot really be made fully compatible. Furthermore, the Banking Union is instrumental to help break the ***nexus between sovereigns and banks,*** which was a key feature in the present crisis.

The process to build a Banking Union is the more far-reaching reform since the creation of the euro.

3. Main features of the SSM Regulation

The Single Supervisory Mechanism is to become operational in 2014. Let me briefly highlight its main features.

SSM as one system

The SSM will operate as a system, catering for all expertise of national supervisors and at the same time possessing a strong decision-making centre. This will ensure close proximity with the supervised entities and cross-border consistency. Appropriate decentralisation procedures will be defined while preserving the unity of the supervisory system and avoiding duplication.

As regards the ***scope of the banks to fall under the SSM***, the proposal is very clear. All banks established in the euro area will fall under the remit of the SSM. This approximates to around 6000 banks. The fact that all banks in participating Member States fall under the scope of the proposal, does not imply that the ECB will conduct direct supervision of all banks. Although the ECB will be ultimately responsible in the conduct of its supervisory function, the ECB will be assisted by national supervisory authorities – the system will be very much decentralised. National supervisors have the knowledge of local and regional markets and have a long-established expertise in supervision. Nevertheless, what ensures that the SSM is really one system are the Regulation dispositions that state that the ECB will issue guidelines and will define the framework for conducting supervision by all systems'

[1] D. Schoenmaker, (2011), "The Financial Trilemma", Economic Letters, No. 111.

components and, most important, that the ECB will have the power to centralise the supervision of any bank or group of banks when it recognises the need to do so.

The proposed regulation stipulates the thresholds that will define the significant banks that will fall under more direct ECB supervision. In addition, the ECB may also on its own initiative consider an institution to be of significant relevance and thus decide to exercise direct supervision.

Based on a preliminary assessment, the ECB will conduct direct supervision of approximately 150 banks, representing around 80% of the banking sector in Europe.

Extensive powers of the SSM

A second important feature of the SSM regards its extensive powers in the conduct of its supervisory function. The ***SSM, with the ECB at its centre, is entrusted with an extensive set of micro- and macro prudential powers***, covering all key tasks relating to the prudential supervision of credit institutions. The inclusion of macro-prudential powers is a key element because as shown by the crisis, macro- and micro- risks can actually be mutually reinforcing.

Involvement of non-euro area Member States

A third important feature in the SSM is that ***national competent authorities of non-euro area Member States have an option to participate in the SSM***. Thus the proposal extends to cover all Member States. They can participate through establishing a close cooperation with the ECB. By establishing a close cooperation they need to adhere to the decisions taken by the ECB, if not the cooperation may be suspended or terminated.

Separation of monetary and supervisory functions, while benefiting from synergies

Another of the SSM Regulation I would like to highlight relates to the ***principle of separation of the monetary and supervisory functions***. The important role given to the Supervisory Board vis-à-vis the Governing Council is one of the various safeguards ensuring a clear separation between the monetary and supervisory function of the ECB.

Finally, the concentration of these new functions at the ECB implies ***a higher level of accountability***. The Council proposal also addresses the issue by creating a Review Panel of the SSM decisions from a legal point of view and, in particular, by defining the accountability of the SSM before the European Parliament.

4. Main immediate tasks of the SSM

One of the main priorities for the ECB during 2013 is ensuring the operationalization of the SSM, so that it can assume its responsibilities effectively and efficiently.

Building a strong centre

Creating a strong centre in a decentralised system such as the SSM, will be crucial to provide the ECB with the necessary means to ensure it will have the resources to effectively fulfil its functions without endangering its reputation. In this context, the articulation of appropriate decentralisation procedures through close cooperation arrangements with national authorities within the unity of the supervisory system will be essential.

The knowledge and skills of the system’s human capital will contribute to creating a strong centre. Therefore the recruitment of skilled and experienced staff, particularly banking supervisors, will be a priority.

Harmonising risk assessments

An immediate task of the SSM will be a comprehensive review of the banks that will fall under direct supervision of the ECB. As foreseen in the Regulation, this exercise should include elements of an asset quality review as a basis for a thorough solvency analysis. This review should be instrumental in identifying potential legacy problems.

The treatment of ***legacy assets in the overall Banking Union project is an important issue in connection with European direct recapitalisation of banks***. It has to be ensured that in the setting up of a European Resolution Mechanism, the losses of legacy assets, in accordance with good resolution principles, will be borne first by the banks' shareholders and/or partly by the countries where they are domiciled, so that the use of any European funds do not raise issues of moral hazard and/or unjustified excessive mutualisation of losses coming from the past. As it happens when a private investor takes a stake in the capital of a troubled bank, appropriate due diligence is conducted and will impact the determination of the price of entry thus diluting previous shareholders.

The SSM in conducting the initial assessment of the banks' situation will benefit from the fact that the ECB is well prepared to conduct these reviews and related assessments on individual banks, in cooperation with other national and EU authorities and possibly third parties. This is particularly the case for forward-looking analysis of banks' solvency through the appropriate analytical tools. The ECB, similarly to other national central banks, has over the years strengthened its analytical capacity to support its financial stability function, notably the activity of carrying out systemic risk assessments in real time to support policy discussions.

At a larger scale, fundamental work needs to be conducted by the ECB in cooperation with the EBA is the development of a ***manual of supervisory practices***, implementing the process and procedures for conducting supervision in the EU. This should ensure a harmonised approach to the way supervision is conducted and increase comparability across supervisory assessments – e.g. regarding provisioning and risk mitigation policies – under the new EU supervisory framework.

The establishment of the SSM requires also the creation of some sort of European Risk Analysis System that will analyse and classify the risk profile of the supervised banks. Work is thereby also needed on harmonising current national supervisory rating systems and on the use of early warning indicators of bank distress. The ECB is also investing on its analytical capabilities in this front.

5. Conclusion

Let me conclude.

The agreement reached on the SSM by the Council shows the resolve to reinforce the EMU by strengthening the institutional financial framework. The momentum needs to be kept. The SSM is a key component, but it is only one component of the Banking Union. In particular, a European framework for resolution of banks – with a Single Resolution Mechanism centred on a Single Resolution Authority needs to follow.

Throughout 2013 the ECB will prepare itself for its new supervisory function. I am confident that in cooperation with national supervisory authorities we will achieve the goal of establishing an effective and robust SSM.

Thank you.