Sabine Lautenschläger: European Monetary and Financial Union – what is needed in terms of banking supervision?

Speech by Ms Sabine Lautenschläger Deputy President of the Deutsche Bundesbank, at the symposium on "Central banking – Where are we headed?", in honor of Stefan Gerlach's contributions to the Institute for Monetary and Financial Stability (IMFS), organized by the IMFS and the House of Finance, Goethe University, Frankfurt am Main, 7 February 2013.

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1. Introduction

Ladies and gentlemen

We come together today to honour Professor Stefan Gerlach's contribution to the Institute for Monetary and Financial Stability. Stefan has certainly proven time and again to be an outstanding scholar who is able to connect theoretical considerations with the requirements of reality. And reality is what is needed, especially in times of stress like these.

Ladies and gentlemen, the crisis we are experiencing is without doubt the most extensive and worst economic crisis of recent decades. I would not miss it at all; but as we have to endure it, we should all look to fulfil the original meaning of the word "crisis", which is "turning point". And to reach this turning point in the positive sense of the term, we need to seize the opportunity and use the lessons learnt to make the financial system and the monetary union more resilient.

With regard to the banks as one important part of the financial system, we have made some important progress so far. Banks have to comply with higher capital and liquidity standards; the requirements for adequate internal control systems and an appropriate governance structure have also been tightened substantially. Furthermore, the requirements to be met by supervisors have changed significantly, too.

The fiscal and economic state of affairs of the EMU's member states is improving as well. To achieve further progress at the national level, governments need to adhere to their decisions to increase investor confidence and economic competitiveness with fiscal consolidation and structural reforms.

And we have seen some progress regarding the architecture of Europe's financial supervisory system – even if one might ask whether it is sufficient with respect to the risks and liabilities increasingly shared at the European level. National governments seem to have no great wish to give up major parts of their sovereignty, with one exception in my view. Over recent months, the European governments have agreed on a European banking union or, more specifically, a banking supervisory set-up at European level.

The Bundesbank welcomes the proposal. It has the potential to improve banking supervision and to help strengthen financial stability and the institutional framework of monetary union. I would like to focus on this "Single Supervisory Mechanism" in my speech and talk about the "why" and the "how" of such a European banking supervisory set-up.

2. European banking supervision – the "why"

European banks are financially interconnected to a marked degree. Thus, national banking crises do not stop at national borders but tend to spread across countries. From this perspective, a Single Supervisory Mechanism is a natural response. Compared to national supervision it would operate on the basis of more comprehensive information and with the benefit of cross-border comparison. Thus, it would enable us to pinpoint risks which threaten the banking system or emanate from it more easily and at an earlier stage. Furthermore it would lessen the risks national supervisors are exposed to: sometimes national supervisors

are too set in the ways of their supervisory systems and run the risk of being overprotective towards banks for national reasons.

In terms of the current crisis, the Single Supervisory Mechanism might also be a way of resolving one problem that has become apparent: the close link between banks and sovereigns.

If a lot of banks get into trouble at the same time, possibly owing to a large asset bubble bursting, financial stability as a whole is threatened. The government then often has no option but to step in if it wants to prevent a complete meltdown. But, as we all know, such a rescue can place a huge burden on public finances. From a more general perspective, this point is backed up by an empirical study brought out by Professor Gerlach in 2010, which shows that risks in the banking sector indeed translate into higher spreads for sovereign debt.[1]

But banking crises do not only place a burden on public finances. Conversely, weak public finances can destabilise banks – directly through their exposure to sovereign bonds or indirectly through worsening macroeconomic conditions.

What are the implications of these insights? It follows from them that loosening the links between banks and sovereigns is vital if the euro area is to be made more stable.

But how do we get there?

First, pinpointing excessive risk concentrations is essential. A European banking supervisor can weaken the nexus between sovereigns and banks by monitoring and putting a brake on the build-up of excessive risks, whether in specific economic sectors or in government financing – even if this can only be done in medium term.

Second, in order to insulate banks from weak public finances, we need not only appropriate supervision but also suitable regulation; regulation that will prevent banks from taking on excessive risk through state financing. Such regulation should, for instance, include upper limits for lending to governments. It should also encompass appropriate capital backing for government bonds – which is another proposal made by Stefan Gerlach, incidentally.

But the Single Supervisory Mechanism and suitable regulation are just two elements of a banking union, and there are also other means available for severing the link between sovereigns and banks. The third tool in this respect is a European recovery and resolution mechanism for banks that has access to "European" funds. In this context, it is necessary that any such mechanism ensure that investors are first in line to bear the risk of their investment decision. Taxpayers must be spared the burden of other people's investment decisions – at the national level and even more so at the European level – for as long as there is no proper balance between liability and control.

Ladies and gentlemen, I have very briefly highlighted a few arguments in favour of European banking supervision – the "why", so to speak. Now, let us take a look at the "how".

3. European banking supervision – the "how"

The establishment of the Single Supervisory Mechanism will see wide-ranging banking supervisory functions being transferred to the ECB. At least seventeen countries will give up their sovereignty in supervisory matters to the ECB; the ECB will be directly responsible for the supervision of the most systemically important banks domestically and at European level. Nevertheless, national legal systems and national market structures will still be of utmost importance for the welfare and success of these banks. Given the multitude of different

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[1] S Gerlach, A Schulz, G Wolff (2010), Banking and Sovereign Risk in the Euro Area. Centre for Economic Policy Research, Discussion Paper, No 7833.

supervisory traditions, legal systems and people involved in supervision, the SSM will only be successful if appropriate governance and transparent cooperation and task-sharing are installed.

One of the "hot" topics when swiftly organising a banking supervisory function for the ECB is future cooperation between the ECB and the national supervisors. Organising a European banking supervisory mechanism in such a short time firstly means building upon existing structures. Secondly, supervision will only be successful if the ECB is able to benefit from cross-border comparisons, taking into account the macroeconomic and microeconomic knowledge and experience of national central banks. Even if interconnectedness between banks was and still is one of the major issues of the last five years, a crisis usually originates in national developments. Remember the US subprime real estate market and its effects on globally active banks. Thus, it will be essential to combine the knowledge of global, national and regional economic conditions, infrastructure and legal systems with knowledge about banks' business and risk profiles, governance structures and control systems. In short, setting up a new European supervisor within a year or so is extremely ambitious, but doable.

However, with regard to the governance structure, there is a problem that cannot be fully resolved under the current framework – the strict separation of monetary policy from banking supervision within the ECB. Such a separation is not possible without amending the ECB's institutional framework as enshrined in primary law – a step that has been carefully avoided so far.

With the goal of strictly separated functions in mind, the current proposal establishes two new bodies within the ECB: first, a Supervisory Board with representatives from the ECB and from national authorities; second, a mediation panel which includes one member from each country that participates in the Single Supervisory Mechanism. Now, what are the tasks of these two bodies?

The Supervisory Board submits proposals for supervisory decisions to the Governing Council. The Governing Council, in turn, can only agree or disagree, but will not be able to amend these proposals. If the Governing Council disagrees, it will be up to the mediation panel to resolve differences of opinion. The panel will decide by simple majority whether to accept the proposal in its original form or not.

And in order to actually separate the two functions, it would be imperative for the Supervisory Board to have the final say in all supervisory decisions. However, under prevailing primary law, the ECB Governing Council must have and will have the last word on banking supervisory decisions.

There are additional problems I would like to focus on: because of prevailing primary law it is at least a questionable idea for the Governing Council to be able only to accept or reject decision-making proposals from the Supervisory Board, but to be unable to influence the proposals. If the Governing Council, consisting of the ECB board members and the governors of the EMU central banks, is responsible for supervisory actions, it also has to be in a position to shape the measures being taken.

Additionally, the independence of the ECB and its Governing Council would be restricted if it were obliged to regard the decision of the mediation panel as binding.

The problems I have just set out highlight the crucial importance of a principle which the founders of the Eurosystem were keen to safeguard: the independence of the ECB, and of its governors. If the governments decide to mandate the ECB with additional tasks, this basic principle still applies, as long as the treaty is not changed. Thus, if the ECB is mandated with banking supervision, the Governing Council of the ECB will be the one deciding on all relevant supervisory matters, as long as there are no changes in primary law. This implies that – following a common principle of reason – those responsible for a decision need to be able to shape that decision.

4. Conclusion

Let me sum up my main points. The Single Supervisory Mechanism is a good step forward towards improving the European institutional framework. There is no doubt about that.

However, the envisaged institutional set-up needs to take into account a basic feature of the Eurosystem – the independence of the ECB and of the members of the Governing Council. Hence I am not only looking forward to working with my supervisory colleagues within the SSM, but also to reading the final regulation governing the new system. Thank you for your attention.