Yves Mersch: The Banking Union – a European perspective: reasons, benefits and challenges of the Banking Union

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the seminar "Auf dem Weg zu mehr Stabilität – Ein Dialog über die Ausgestaltung der Bankenunion zwischen Wissenschaft und Praxis", organised by Europolis and Wirtschaftswoche, Berlin, 5 April 2013.

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Ladies and Gentlemen,

Let me focus on three specific reasons for the establishment of a European Banking Union: first, delinking sovereigns and banks and fostering the reintegration of financial markets, second, avoiding national bias in supervision, and third, restoring the proper transmission of monetary policy.

The importance of preventing sovereign problems from spreading to banks (e.g. Greece) and preventing banking problems from spreading to sovereigns (e.g. Ireland, Cyprus) is a key lesson drawn from the crisis. Actual or expected bank bail-outs by national governments increase borrowing costs for sovereigns, while also driving up banks' funding costs even further. This "doom loop" undermines national efforts to re-establish fiscal sustainability.

Moreover, growing pressures in funding and lending markets have led to a fragmentation of the euro area banking system along national lines. The funding costs of banks and the correlated borrowing costs for their respective sovereigns have increased, particularly in the peripheral economies. Countries that lose market confidence become progressively dependent on domestic sources of funding, more prone to capital outflows and less responsive to monetary policy. The divergence in bank funding conditions at national level in turn gives rise to cross-country differences in lending conditions. Lending conditions for households and firms in the periphery have become tighter than they should be given the prevailing monetary policy stance. This results in an inefficient allocation of funding across the euro area and hence has a negative impact on growth and employment.

The establishment of a Banking Union would help to break this negative feedback loop between sovereigns and banks.

A single supervisor with a truly European focus could rebuild depositor and investor confidence. A central supervisor will not be suspected of allowing banks to hide bad assets in some countries. Neither would a European supervisor insist on national asset and liability matching, which increases fragmentation.

A Single Resolution Mechanism (SRM) – the necessary complement of the Single Supervisory Mechanism (SSM) – would avoid rising funding costs amid the risk of bank bail-outs by national governments, because it would become more common to resolve banks rather than save them. Hence, the private sector would bear the cost rather than the taxpayer. Any residual fiscal burden on sovereigns would be contained through a federal fiscal backstop.

The shift of supervision from the domestic to the European level, at which supranational interests are pursued, should also eliminate national bias and the associated supervisory forbearance that the financial crisis has brought to the fore. With hindsight, in the past supervisors were often lenient towards "national champions", constrained either by their mandates or by other national pressures, or perhaps both. Supervisors should be free from local pressures and interests; they should be able to independently assess the situation of individual banks in a systemic context.

From a monetary policy perspective, the Banking Union can relieve monetary policy of some of the tasks undertaken during this crisis, notably that of repairing and bypassing a clogged

transmission channel. Early supervisory action limits the necessity to access central banks' financing, including non-standard measures.

Reasons and benefits for entrusting the ECB with the SSM

All of these reasons were the driving forces behind the establishment of the SSM. Let me now spend a moment on the reasons why the ECB is being entrusted with these centralised supervisory tasks.

First of all, there are legal reasons. Given the need to establish the SSM quickly, a treaty change, which would take several years, was not really an option. Article 127(6) of the Treaty on the Functioning of the European Union provides that the Council by unanimous vote may "*confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions.*" But a treaty change in the future should not be ruled out.

Second, the decision was guided by practical reasons. Over the years, the ECB has built up a unique expertise in analysing financial institutions and markets. In other words, the ECB has the means and, in conjunction with the national authorities, in most cases coinciding with the national central banks, the technical capability to carry out this complex task. Moreover, most of the national central banks already have prudential competence.

Key principles for the implementation of the SSM

Let me now describe how the SSM will function.

One of the conditions for the success of the SSM is that it ensures a truly European perspective. It is a myth that politically protected banks or banking structures or "national champions" were in the interest of the respective taxpayers. The elimination of potential national bias is therefore key.

Implementation of the European dimension depends on several elements. The first is the appropriate scoping of participating jurisdictions. The establishment of the SSM will bring all banks established in the euro area, and the credit institutions established in those Member States which have entered into a close cooperation with the ECB, under the supervision of the ECB. This creates a level playing field.

Whereas only the most significant banks will fall under the direct supervision of the ECB, less significant banks, while remaining under national supervision, will not be excluded from the ECB's supervisory reach.

1. National authorities will have to abide by ECB regulations, guidelines and general instructions and be subject to the ECB's broad oversight mandate over the functioning of the SSM.
2. To ensure the consistent application of supervisory standards, the ECB may decide at any time to exercise direct supervision on less significant credit institutions.
3. The possibility for non-euro area Member States to join the SSM emphasises the EU-wide dimension. This also implies that they will have to adhere to the guidelines and instructions issued by the ECB.

The design envisaged for the SSM is based on building a strong centre, supported by an adequate allocation of tasks between centre and periphery.

The responsibility and decision-making power for the overall functioning of the system will be held by the ECB. Its efficient operationalisation, however, will depend on the national competent authorities, whose expertise and proximity to the supervised entities are essential in ensuring that no aspect is overlooked. Even in the case of banks directly supervised by the ECB, experts from national authorities will be involved in on-site inspections. These and

other operations should be conducted in the context of joint supervisory teams headed by ECB experts.

The conferral of supervisory tasks to the central bank mirrors the prevailing consensus in many jurisdictions. The crisis has actually reinforced this trend of central banks acquiring supervisory responsibilities, benefiting from the synergies between monetary policy and supervision. These first include potential benefits from the sharing of information with regard to monetary policy, the supervision of banks and the oversight of payment systems. Second, central banks can draw on expertise in the field of financial stability analysis. Third, the institutional independence of central banks, with clearly defined rules of accountability, can positively contribute to the effective conduct of financial stability policies. International institutions and fora like the International Monetary Fund or the Basel Committee on Banking Supervision in its Core Principles for Effective Banking Supervision clearly stress the advantages of an independent supervisor.

Although the conduct of supervision will be a new task for the ECB, a wealth of experience is at hand in macroeconomic and financial stability matters. While safeguarding any potential conflicts of interest between the monetary and supervisory function, the benefits of combining these two tasks in one institution are evident and should be reaped.

Accessing the existing analytical expertise will insure high quality input for the supervisory decision-making process and will enhance the effectiveness of the SSM. Effective supervision is no free lunch; fees will have to be levied on banks. However, there will be efficiency gains from avoiding the duplication of services that provide input to both tasks, so the cost burden for the financial industry will be contained.

Despite the potential synergies, the dual role of central bank and supervisor is assumed to involve potential conflicts of interests. Although, monetary policy and financial stability measures are mostly in accordance, we must take these concerns seriously to stay credible. Specifically, people have warned against (i) the risk of supervisory forbearance associated with the central bank being the liquidity provider, (ii) the reputational risk that may arise from the potential conflict of interest between the ECB's two areas of activity, and (iii) legal risks, which warrant particular scrutiny and which I will discuss more intensively.

From an institutional perspective, the SSM Regulation provides specific safeguards against any conflict of interests by enshrining the principle of separation of the monetary policy and the supervisory function. This is reflected in the important role given to the Supervisory Board vis-à-vis the Governing Council. Additionally, deliberations of the Governing Council on supervisory matters will be strictly separated, with separate agendas and meetings. The envisaged decision-making process for supervisory decisions should mitigate any risk of supervisory forbearance: actual supervisory decision-making power rests within the Supervisory Board, and the Governing Council should ultimately be empowered to *reject* the decisions agreed upon.

The combination of the supervisory and central bank function in one institution warrants safeguards to mitigate reputational risk. It is sometimes inevitable that mistakes are made in the exercise of supervisory tasks, e.g. when the supervisor is dealing with fraudulent behaviour. From a reputational risk perspective, the aforementioned appropriate separation of the two functions is hence particularly important. It is critical, for instance, to couple the *internal* separation between supervisory and monetary functions with an *external* dimension, reinforcing the outside perception of clear separation in terms of operations and accountability.

These risks might be contained successfully with the appropriate institutional and organisational set-up. More caution is warranted amid the legal risks stemming from the draft regulation that is currently on the table.

Let me give some examples: under the trialogue compromise, the appointment of the Vice-Chair of the Supervisory Board requires approval by the European Parliament as well as an

implementing decision by the European Council. While the Chair of the Supervisory Board does not necessarily belong to an independent EU body, the SSM draft regulation provides for the selection of the Vice-Chair by the Governing Council from among the members of the ECB's Executive Board. The same applies to the dismissal procedures for the Chair and Vice-Chair of the Supervisory Board.

As this provision may be beyond the red line of the ECB's statutory independence, and that of the Executive Board and of its members, it might be legally challenged and create a reputational risk should the SSM become subject to litigation.

The foreseen *de facto veto right* of the European Parliament to a nomination proposal of an ECB Executive Board member seems inappropriate, as a veto could be based on the following considerations.

1. The member's past track-record on monetary policy or on other ECB basic tasks. This would be tantamount to a political interference on exclusive and independent ECB tasks.
2. The member's prospective supervisory policy views. This would condition the member's use of discretion in his or her supervisory activity, against the principle of supervisory operational independence.
3. Any reason entailing a discrimination prohibited under the Treaty and the EU Charter of Fundamental Rights.

Moreover, there is already an institutional balance in the appointment procedure for Executive Board members, in which the European Parliament opines on nominated candidates. Such an institutional balance could be disturbed by the new veto right. Strangely enough, for the primary ECB tasks the Parliament "merely" opines, while it has a veto power for the secondary task – relating to a person already scrutinised by the Parliament when appointed to the Board (and thus to the Governing Council) and who is nominated by the Governing Council to an additional position in an internal ECB body.

In addition, a parliamentary rejection or dismissal of an ECB's Executive Board member nominated by the Governing Council for the Supervisory Board, would in practice affect that member's stance in the ECB decision-making bodies, thereby institutionalising potential conflicts between the ECB and the Parliament. This could lead to political interference with the ECB, in contradiction with the concept of central bank independence framed under the Maastricht Treaty. It would also create a reputational and credibility issue for the affected Executive Board member and the Executive Board as a whole.

An external veto right would affect the autonomous capacity of the Executive Board to organise its internal allocation of tasks. It thus seriously jeopardizes the independent functioning of the Executive Board. Article 130 of the Treaty on the Functioning of the European Union and Article 7 of the Statute of the ESCB and the ECB requires EU institutions to undertake "not to seek to influence the members of the decision-making bodies of the European Central Bank." It may also create competitive dynamics between the Executive Board members, internally and externally, affecting collegiality.

Complementing the SSM: the Single Resolution Mechanism

In order for it to function effectively, the SSM needs to be complemented with a Single Resolution Mechanism (SRM) to deal with non-viable banks. It is crucial that the SRM framework is in place once the SSM is operational. If not, there is a risk of encouraging supervisory forbearance based on the expectation of the central bank granting liquidity. It would be a mistake to assume that there will be no more troubled banks once the SSM is in force and supervisory responsibility is transferred to the ECB. Therefore a resolution mechanism needs to be put in place to ensure that non-viable banks are closed down and resolved.

As in the case of supervision, a European dimension is of paramount relevance for effective resolution. It should shield timely and impartial decision-making from national bias. The SRM institutional mandate should ensure that banks are not preserved at the taxpayers' expense. The era in which the privatisation of profits and socialisation of losses was possible should belong to the past. In a private market economy, institutions cannot be shielded from a market exit. In view of unintended consequences, this must however be done in an orderly way and free of national bias.

The set-up of the SRM depends on the swift adoption of the Bank Recovery and Resolution Directive, containing a harmonised toolkit of resolution powers. The SRM could then rely on the resolution measures set forth in this directive, which will provide a robust framework for prompt and coordinated resolution action, in particular where cross-border banks are concerned.

The framework of the SRM has yet to be defined and a proposal by the Commission is expected to be submitted later this year. I would like to outline what the main features of the future SRM should be.

In order to prevent any potential conflict of objectives, this mechanism should under no circumstances be placed with the ECB. Its institutional and geographical scope, however, should replicate that of the SSM. The SRM's ultimate responsibility would rest with a Single Resolution Authority, charged with governing the resolution of banks and coordinating the application of resolution tools. As regards the jurisdictional scope, the SRM should in principle have the power and the authority to resolve all banks within the SSM.

Funding is one of the most critical aspects of resolution. To be credible, the new framework should count on sufficient financial resources. I am not talking about bail-outs with taxpayers' money, rather minimising the expenditure of public money. To attain this goal, the following mechanisms should be put in place.

1. The write-down of capital instruments and bail-in of creditors should be fully exploited.
2. A European Resolution Fund should be set up to provide additional funding if needed. It should be financed by ex-ante risk-based contributions by all the banks falling within the SRM jurisdiction.
3. As a last resort, if the resources of the European Resolution Fund are not enough, funds could be drawn from a EU back-stop mechanism. However, any fiscal support to the SRM should be in the form of credit to the European Resolution Fund to be repaid ex post. For this purpose, the European Resolution Fund should have the authority to impose additional levies on the banks under the jurisdiction of the SRM. This should ensure that the mechanism is fiscally neutral over the medium term. Resolution activity would possibly require the temporary use of public money if the Resolution Fund did not have enough resources, for instance, to capitalise a bridge bank that is later sold to the private sector, thus recovering the capital involved. The existence of this financial backstop can be considered an integral part of a complete Banking Union, also taking into account the possibility for the ESM to directly recapitalise banks. A loose network for the coordination of national funds would weaken the SSM; its remit must go beyond that of the European Banking Authority, which coordinates national supervisors.

The timetable for implementation

The ECB has stepped up the preparatory work for the establishment of the SSM in close cooperation with national supervisors. The preparations are steered by a High-Level Group, chaired by the ECB President, which discusses the main strategic lines. On the technical level, a Task Force on Supervision is conducting the preparatory work. Both of these groups include representatives of each National Competent Authority (NCA). Moreover, a restricted

Project Team, composed of managers from the supervisory and financial stability areas, has been created between the ECB and the national authorities to foster the communication and cooperation within the system. The technical work is organized in five work streams, focusing on an initial mapping of the euro area banking system, legal issues, the development of a supervisory model, the coordination of the comprehensive assessment of the credit institutions and the preparation of a future supervisory reporting template for the SSM.

The formal establishment of the Supervisory Board will take place shortly after these preparations and mark the start of a transition period of approximately one year until the SSM becomes operational. During this transition period, the Supervisory Board will adopt draft decisions on a number of legal acts and also decide about key organisational matters. Given that most of these processes can only start formally once the SSM Regulation enters into force, a delay of its adoption would constitute a risk to the timely start of the SSM's operations in mid-2014.

Conclusion

Let me conclude. The establishment of the SSM must be seen in a broader perspective. The SSM is a key element of the European Banking Union which itself is embedded in the process of further European integration. Among the achievements on the path towards a fiscal and economic union in Europe, we should reap the benefits from the recent dynamics of institutional reforms by building the Banking Union rather than stepping on the brake. The corresponding tightening of economic links will ultimately require institutional adjustments with a view to democratic accountability regarding the transfer of sovereignty; this concerns the European Parliament and the European Commission and will require treaty adjustments. This is the price for a well-functioning Monetary Union, in which the ECB focuses on price stability while ensuring that financial stability does not stand in the way of its primary objective.

For the ECB, and for the more seasoned authorities that carry out supervision in the Member States, the new supervision mechanism will represent a sea-change, a "new frontier", comparable in many ways with that of creating a new currency and a new central bank before the start of this century.

The ECB is keenly aware of this and consequently puts an enormous focus on the careful, yet efficient, execution of the preparatory work, drawing on all available sources of expertise, both internal and external.

However, as the preliminary agreement between the European Parliament, the Commission and the Council from 19 March is now being renegotiated further to a new request, a delay in the final adoption of the SSM Regulation cannot be excluded. This would constitute a risk to the timely start of the SSM's operations in mid-2014 and generate legal uncertainty. A policy of procrastination, however, would send the wrong signals. Both the SSM and the SRM are elementary building blocks for the reintegration of Europe's banking landscape. So they must be implemented swiftly and decisively.