Jens Weidmann: Banking supervision and regulation – what action does the Bundesbank consider necessary?

Speech by Dr Jens Weidmann, President of the Deutsche Bundesbank, at the Club of Hamburg-based economic journalists (Club Hamburger Wirtschaftsjournalisten), Hamburg, 30 August 2013.

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1. Introduction

Mr Nicolai

Ladies and gentlemen

I'm delighted to have the opportunity to speak to you today at the Club of Hamburg-based economic journalists. Of course, I can hardly say that I don't have much contact with economic journalists. But it's unusual for me to have the chance to discuss current issues with so many members of the media at once.

The contact between central bankers and the press is so close because we need you, the economic journalists, to help the public understand our decisions and actions. Despite our best efforts, our publications simply do not reach the same number of people as your media.

But it is incredibly important for the public to understand our decisions so that they have confidence in our work. And this confidence is vital to maintaining a stable currency. After all, monetary policy mainly works by influencing expectations – the current issue of "forward guidance" being a case in point.

Yet the public have to be confident not just in a central bank's monetary policy decisions but also in its role in payments or banking supervision and regulation. There are no half measures: either a central bank has the public's trust or it doesn't.

And bearing in mind the old adage that it takes years to build up a good reputation and only minutes to ruin it, it's easy to see why we central bankers – especially those in Europe – are focusing so intensely on banking supervision and regulation at the moment.

Today, I'd like to give you a brief overview of the state of play in banking supervision and regulation and the steps that still need to be taken.

2. Year five of the crisis – where are we up to?

The financial and sovereign debt crisis has exposed substantial flaws in the financial system, which various reform projects are now seeking to address.

Many banks proved unable to withstand losses on their assets without outside help and had to be bailed out by taxpayers. This shook the foundations of some countries' public finances, too. Some European countries became less and less solvent, worsening the banks' economic woes, as they had to take write-downs on their government bond holdings.

The crisis therefore revealed a fatal feedback loop between government finances and the banking system: when one player ran into financial difficulties, the others would get caught in the maelstrom.

To solve this problem we need two approaches, each working in tandem with the other.

First, the banks themselves have to increase their resilience: Basel III has now been transposed into EU law, significantly tightening capital and liquidity requirements.

Second, we need to loosen the close ties between banks and governments.

And it is this second point that I would like to discuss in more detail today. In my view, there are two main components to this approach: first, better rules restricting banks' balance sheet risk arising from government debt holdings and, second, the banking union.

We want to ensure that banks' economic situation no longer depends so heavily on the solvency of their home country. We can only achieve this if we stop giving government debt preferential regulatory treatment over other loans or securities. Government debt should therefore be backed with a level of capital which adequately reflects the risks it carries and caps should be imposed on bank sovereign debt holdings.

I am well aware that making these kinds of changes during the current crisis might exacerbate the funding problems that some countries are experiencing, which is why I think there is an argument for a transitional period.

But it would be wrong to dismiss a reform like this out of short-term considerations. I'm convinced that if bank balance sheets do not take adequate account of sovereign risk, this will remain an "Achilles heel" in the financial system.

Indeed, appropriate capital rules and caps on lending to governments also have a disciplining effect on national fiscal and economic policy. Kenneth Rogoff, former Chief Economist at the IMF, considers this effect to be stronger than that of stricter fiscal rules.

On top of this, however, we also need to minimise the implicit government guarantee for systemically important banks as far as possible. To achieve this, we will need both higher capital requirements and stricter banking supervision which is not geared to national interests.

In addition, the cross-border effects of bank turmoil also mean that we need a harmonised approach to bank restructuring and resolution.

To achieve both of these goals, Europe is in the process of setting up a banking union which will initially be based on two pillars:

- the Single Supervisory Mechanism, or SSM, based at the European Central Bank (ECB). A "single rulebook", which has yet to be finalised, will help to ensure harmonised supervisory practices and standards and avoid a home bias among national supervisors.
- the Single Resolution Mechanism, or SRM, aimed at reinforcing the no-bailout principle.

A good deal of progress has already been made in creating an institutional framework for the first pillar of the banking union, the SSM. The SSM Regulation is likely to be adopted by the EU institutions this autumn. Based on this ambitious schedule, the SSM is due to be launched in autumn 2014.

The plans for the second pillar of the banking union, the Single Resolution Mechanism (SRM), have not yet progressed quite as far. The political discussions are still ongoing; the European Commission put forward a draft regulation on the SRM in July this year.

The Commission envisages the SRM being approved next year and launched in January 2015.

3. Challenges in banking supervision and regulation

The banking union may play a key role in making the financial system more stable and strengthening the European regulatory framework. But in order to achieve this, it is important to get the details of the set-up right.

Let's look at the SSM first: the plans for its institutional structures are now largely in place. Yet we still face certain organisational challenges, particularly concerning the organisational set-up of banking supervision at the ECB and the process of setting common supervisory standards.

One of the main difficulties will be to ensure, as far as possible, the necessary separation between monetary policy and banking supervision. The ECB Governing Council could find itself torn between these two allegiances, risking conflicts of interest.

While the compromise reached on the SSM's institutional structure will allow a swift transition to European-level banking supervision, it does not separate monetary policy and banking supervision strictly enough.

Although the ECB will have a dedicated Supervisory Board for banking supervision, it is the Governing Council which will have the final say. This situation cannot be changed without amending the EU treaties – as is required by the ECB statute.

To separate monetary policy and banking supervisory tasks effectively, it will be necessary in the long run either to reform the institutional basis upon which the ECB is founded or create an independent European banking supervisory authority. Swift steps should be taken to initiate the treaty change that this will require.

While I believe that the current compromise of basing European-level supervision at the ECB should only be an interim solution, the Bundesbank is giving the ECB every possible support in the process of setting up the SSM, not least by providing experienced staff. In addition, the Bundesbank will bring its experience to the table through the joint supervisory teams coordinated by ECB staff. And it will continue to play a major role in the supervision of smaller financial institutions.

To build the banking union on solid foundations and avoid shaking confidence in the ECB, a "balance sheet assessment" will be carried out before the SSM is launched. This will be rather like a doctor's check-up.

And that brings us back to the problem of legacy assets. As you may recall, this issue has been part of the banking union debate right from the start.

The balance sheet assessment will screen the balance sheets of the around 130 significant institutions which will fall under the ECB's direct supervisory remit. The aim is to ensure that these banks' finances are sound before the SSM is launched so that they are not found to have major write-down needs just after the SSM has started its work. That would be a heavy political burden for the SSM to bear – especially if banks then had to be recapitalised or restructured following such write-downs.

Precisely because this balance sheet assessment could uncover some inconvenient truths for the current national supervisors, it is important to ensure that it is carried out correctly, competently and consistently. That is why we should also draw on external expertise – by enlisting the help of external auditors, for example.

If the assessment reveals that banks need to be recapitalised, this should be achieved as far as possible via the capital market. If this isn't possible, the next step is to establish whether the bank actually has a sustainable business model at all or whether it needs to be resolved. Only if the bank cannot be resolved because of a threat to financial stability will it be recapitalised by its home country. The ESM will only be involved in exceptional cases; then, banks will not be recapitalised directly but via a loan to their home country.

At this point, I'd like to emphasise one key overarching concept: taxpayers should not have to prop up banks which have unsustainable business models.

Setting up the SSM offers us the opportunity to subject bank balance sheets to strict scrutiny. We must not let this chance slip through our fingers. Otherwise, we could jeopardise confidence in the banking union.

Ladies and gentlemen, the process of setting up the Single Resolution Mechanism (SRM) also poses certain institutional challenges.

Concerning the specific set-up of the mechanism, I regard the following points as important:

When a bank is restructured or resolved, there should be a sequence of liability, defined clearly ex ante, in which private funds – not public money – are the first port of call. This means that European taxpayers will no longer have to form the first line of defence.

Generally speaking, decisions should be rules-based as far as possible. Discretionary ad-hoc decisions must have democratic legitimacy.

The principle that shared liability should lead to shared control also applies the other way around: shared control via the ECB will lead to shared liability at the European level. This means that banks subject to European supervision will generally also need a European resolution system.

As I mentioned earlier, the European Commission put forward a proposal for the SRM's institutional framework in July. One welcome aspect of this draft is that it includes the guidelines for burden-sharing I have just outlined.

Nonetheless, I take a critical view of the leeway that the draft would allow member states in their restructuring decisions.

In addition, the Commission proposes creating a European Resolution Fund and making itself responsible for resolution decisions. This is problematic under EU law. The existing EU treaties do not provide for such a transfer of responsibilities, which could also have far-reaching financial implications for the member states. Treaty change would therefore be needed to provide a rock-solid legal basis for these measures, too.

A conceivable interim solution would be to form a network of national resolution authorities, as proposed by the German government. But to be able to resolve conflicts between the different national resolution authorities, there needs to be a powerful European body at the heart of the system which ensures that common resolution standards are applied and carries out binding mediation. This interim solution would probably be quicker to implement and stand on firmer legal ground than the Commission's proposal.

Essentially, though, in the legal groundwork for the SRM it is more important to be thorough than to be fast. These decisions have to be legally sound: where there are resolutions, there will also be law suits.

Still, I'm well aware that such a network of national resolution authorities would stand in conflict with the desired harmonisation of banking supervision via the ECB and a European resolution system. But that is a price I would be willing to pay until we find a solution with a rock-solid grounding in EU law.

Particularly in the early days of the banking union, emerging burdens will have actually accumulated, above all, on the watch of national banking supervisors. It would therefore make no sense to fully communitise burdens just after the banking union has been launched – say, via a European Resolution Fund – not least because many economic policy decisions which have a considerable impact on the quality of bank balance sheets will still be taken at national level. In addition, the network solution would also allow the possibility of agreeing to share burdens among the participating countries if national funds do not suffice.

4. Conclusion

Ladies and gentlemen

A great deal of progress has been made in banking supervision and regulation since the crisis broke out. Yet we still face major challenges. The aspects I've touched on today reflect only some of these issues.

Let's face facts: creating a banking union is a similarly major undertaking to the launch of monetary union.

The transfer of European-level banking supervision to the ECB will increase not only its range of tasks but also the responsibility that lies with the Governing Council.

Clear institutional structures and transparent decisions are essential as the basis for public confidence in our work as banking supervisors. But creating this confidence will hinge on our ability – yours and mine – to help the public understand the particular difficulties associated with the banking union project.

Ladies and gentlemen, I look forward to our discussion and will now pass the floor to our host, Mr Birger Nicolai.