Yves Mersch: Towards a European Banking Union

Keynote speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the Bridge Forum Dialogue, Luxembourg, 30 September 2013.

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Ladies and gentlemen, dear colleagues and friends,

It’s a pleasure for me to be back at the Bridge Forum Dialogue that we established in 2000. 13 years later, the original goal to bring together EU institutions established in Luxembourg and the actors and institutions of Luxembourg financial, economic and legal life with an EU outlook and to foster constructive dialogues across countries is more relevant than ever.

My speech today is about the advancement towards a banking union in Europe. This step is essential to unravel the legacy of the financial crisis and will also be a cornerstone of a new Europe. It goes beyond re-establishing the indispensable financial health of banks and securing the robustness of the banking system.

No other economic activity touches upon so many aspects of our lives as banking does. Banks must again become the dynamic engines of modern economies. But they must shed past excesses to fit in a new world with new regulations, new instruments and new institutions.

Yet, in recent years, banks have been under tremendous stress. Those at greatest risk have caused much pain, public outrage and destruction of wealth. But, most banks did *not* engage in directly hazardous activities. *Neither* did the majority of bankers receive sky-high bonuses. Still, over the last two decades the global banking system has grown increasingly vulnerable. Most banks were undercapitalised, had fragile funding structures and – in hindsight – many engaged in unsound lending practices. Several banks, primarily based in the US, thrived on complex structured investments, whose risks were not truly understood. Rating agencies underplayed the potential risks. Furthermore, a small number of banks plunged into dubious acquisitions. During this period, regulators and supervisors around the world did not keep pace with the complexity of financial innovation. Neither did they recognise the riskiness embedded in ever larger volumes of derivative instruments. Moral hazard, adverse incentives and – in some cases – sheer greed and anti-social behaviour resulted.

Michael Sandel in his book “The moral limits of markets” asks: “Why worry that we are moving towards a society in which everything is up for sale?” and the answer is “For two reasons: one is about inequality, the other about corruption.”

When systemic risks materialised in 2007- 2008, the world was struck by a sudden systemic financial crisis: unprecedented when measured by financial losses and fiscal costs; unprecedented when measured by its geographical reach; and also unprecedented when measured by the collapse in worldwide trade, economic output and financial activity. We were on the brink of a global financial meltdown. The ensuing “Great Recession” hit the euro area hard due to its high economic openness and financial exposures to a bank financed system.[1] It triggered the euro area’s sovereign debt crisis, for which several distinct root causes were to blame.

As Tony Judt put it, we saw: “Uncertainty elevated to paroxysms of collective fear – which had corroded the confidence and institutions of liberalism.”

Today I have two messages. The first is that banks mirror their environment, but also contribute to shaping it in many respects. Over long periods of time the soundness and credit

[1] See also: Shambaugh, J.C. (2012), “The Euro’s Three Crises”, Brookings Papers on Economic Activity, Spring. And Schoenmaker, D. (2011), “The financial trilemma”, Economic Letters, 111 (2011), pp. 57–59.

standing of banks depends on good governance, shrewd planning, and their spirit of initiative. But, it also hinges on the dynamism of the economy, the sustainability of public and private finances, and the coherence of EMU's architecture and political economy. Sound banking regulation and supervision are also key: prevention must be the first line of defence. However, if adverse shocks hit or bank failures arise, there needs to be an effective crisis-management and resolution framework with credible backstops. Several of these elements were either weak or altogether missing in Europe and in Member States with a strong banking presence. At the same time, monetary union needs banking union because sound banks are an essential complement to sound money. Banks are the main transmission channel of monetary policy to the real economy.

The second message is that there were important similarities between banking developments and the evolution of the crisis across the Atlantic. But there were also relevant differences. The crisis is now practically over in the US and other parts of the world, whereas it is only slowly tapering off in the euro area. To understand how a European Banking Union can succeed we need to understand how we are now addressing *all* root causes of the sovereign debt crisis across countries and completing EMU's architecture.[2] I will now address the following two questions, while offering some reflections along the way:

- What is being done to fix the root causes of the crisis?
- How do we shore up banks and what will the European Banking Union achieve?

What is being done to fix the root causes of the crisis?

An important lesson from the sovereign debt crisis is that the "uniqueness of EMU" embeds systemic risks. It's not possible to partake in a strong single market and a strong single currency vis-à-vis weakly coordinated national fiscal policies, economic policies and financial arrangements. For example, at present, the single monetary policy is still transmitted in a regime of national banking regulation, supervision and resolution settlement. Another lesson is that we need to secure consistency between the various institutions, rules and instruments which now shape our political economy. Thus, while the crisis was still unfolding, policy-makers started to redesign the euro area.

The most visible elements are a *crisis management and resolution framework.* There are five adjustment programmes for Greece, Ireland, Portugal, Spain and Cyprus. They are jointly supported financially by the European Financial Stability Facility (EFSF) and the permanent European Stability Mechanism (ESM), plus the IMF.

Such risk-sharing in turn requires a strengthening of the governance framework to counter the moral hazard inherent in such an insurance scheme. And this is precisely what we have seen over the last three years. There is a new governance to restore fiscal sustainability and prevent or correct macroeconomic imbalances. The Stability and Growth Pact has been tightened up by the so-called "six-pack" of economic governance measures, including the Macroeconomic Imbalance Procedure. They, in turn, have been complemented by the "two-pack". Programme countries are undertaking painful domestic adjustment programmes which show first signs of getting them back on a sustainable track.

Something new emerged at the June 2012 Summit of euro area leaders: glimpses of a ***shared European vision for a coherent and viable architecture of EMU***. The Presidents of the European Council (Herman Van Rompuy), the Eurogroup (then Jean-Claude Juncker), the European Commission (José Manuel Barroso) and the ECB (Mario Draghi) drew up what

[2] See also Mongelli (2013) "The mutating euro area crisis: is the balance between "sceptics" and "advocates" shifting?", ECB Occasional Paper No. 144, at http://www.ecb.europa.eu/pub/pdf/scpops/ecbocp144.pdf.

is known as the "Four Presidents' Report".[3] The report backs a new architecture for European Economic and Monetary Union by creating four unions over the next decade:

- a ***banking union***, comprising an integrated financial framework, including the Single Supervisory Mechanism or SSM and a bank resolution framework;
- a ***fiscal union***, comprising an integrated budgetary framework that will go beyond the fiscal compact;
- an ***economic union***, comprising an integrated economic policy framework; and
- a political union, enhancing the democratic legitimacy and accountability of all decision-making bodies within the EU.

These "four unions" are envisaged to mesh and engage with each other, like cogwheels in a mechanical apparatus. Think of a finely crafted automatic watch: the spin of one wheel sets the others in motion. Conversely, when the momentum of one decreases, that of the others follows suit. The banking union, the fiscal union, the economic union and the political union can transmit and reinforce the dynamics of European integration.

Last year's announcement concerning Outright Monetary Transactions reassured markets. Confidence is slowly returning. Recent data show that growth and – following with a lag – job prospects are slowly improving. Imbalances are gradually receding, while deleveraging and recapitalisation have started. European countries can turn themselves around. Yet, while risks of extreme outcomes have receded, the situation is still very fragile. We must exploit this room for manoeuvre.

Hopefully, Jean Monnet was right when he noted that "Europe will be forged in crises, and will be the sum of the solutions adopted for those crises".

How do we shore up banks and the banking system, and what will a European banking union do?

Looking ahead, how can we secure a level playing field for the banking system across Europe, reduce the risks of financial crises, reduce their impacts if they occur, and ensure that banks contribute to financial stability and prosperity? I will split this question into three parts.

First, how do we fix the problems which all banks faced globally?

We have seen that there were relatively similar global failings in banking governance, risk management and capital adequacy. Basel III is the basis for global banking reform efforts to increase the resilience of the banking system, recover market confidence and provide a level playing field for the industry. Basel III will provide the opportunity to ensure a harmonised set of prudential rules for all credit institutions across every country.

In the EU, Basel III is transposed through two pieces of legislation, namely the Capital Requirements Directive and the Capital Requirements Regulation. Negotiations on these items of legislation, which will enter into force in January 2014, were very intense.

We welcome the availability of uniform rules and standards but will have to make sure that they are also implemented in a common way. Thus we need to overcome all the waivers, exceptions as well as grandfathering claims and options. Andrea Enria, the Chair of the EBA

[3] "Four Presidents" of the European Council, European Commission, Eurogroup and the ECB. European Council (2012), "Towards a Genuine Economic and Monetary Union", June http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131201.pdf.

with whom I shared a panel at a conference in Frankfurt last week, mentioned that more than 100 of such “flexibilities” still exist even in the new framework.

Second, what will a European banking union do and how will it work?

The crisis has shown that an economic and monetary union cannot function without a banking union. We are now building one, from the ground up, to tackle the “doom loop”, curb financial fragmentation and enable banks to rebuild trust and provide a sustainable supply of credit to the real economy in every country and for every sector.[4]

About the SSM: first part – the micro-prudential

The regulation for establishing a single supervisory mechanism (or SSM) has recently been approved by the European Parliament. It is in the process of being finally agreed by the European Council. The ECB will be the central authority of the SSM and it will be supported by national supervisory authorities. Its mandate will be to supervise the whole banking sector of the euro area, plus those of any non-euro area Member State wishing to join. The ECB will be entrusted with the whole toolbox for banking supervision including: authorising and withdrawing bank licences, collecting on and off-site information, undertaking on-site inspections in cooperation with the national supervisors, and validating banks internal models and risk controls. Whenever necessary, the ECB will also be able to solicit additional capital, liquidity and other prudential requirements.

This is a huge set of responsibilities for which the SSM will draw extensively upon the expertise of national supervisors. The basis for SSM activity will be, as for any other supervisor in the EU, the Single Rulebook. But this is at a very high level. Embedded will be the ECB Supervisory Manual to install a single supervisory approach with sufficient granularity to overcome a fragmented regulation.

At the moment it appears that the ECB will directly supervise approximately 130 banks that are found to be “significant” according to the criteria laid down in the SSM Regulation.[5] This is less than 5% of all active euro area banks which are our counterparts in monetary operations. Nevertheless, these cover around 85% of the total banking assets.

What about all the other banks? Would it be realistic – or even desirable – for the ECB to supervise 6,000 additional credit institutions? Given also the wealth of expertise at the national level, and the advantages stemming from proximity in supervision, the answer is clearly “No”. An efficient decentralisation of supervisory activities within the SSM will bring about effective decision-making. But does a “two-tier system” imply different treatment? No. The difference between the two groups of banks will concern only the degree of centralisation of supervisory action within the SSM. The “singleness of the SSM” is ensured by applying the same common supervisory approach to all banks:

- First, the Supervisory Manual will be binding for all Banks under SSM supervision, although some alleviated reporting might be envisageable for less significant institutions.

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4 See Mersch, Y. (2013), “A regime change in supervision and resolution“, Speech at European Supervisor Education (ESE) Conference, Frankfurt, 26 September 2013.

5 The methodology was devised by the ECB. Included are at least (i) those banks having a total value of assets of more than €30 billion, (ii) those banks representing more than 20% of domestic GDP (unless less than €5 billion in assets), (iii) the three most significant banks in each country and (iv) those banks receiving direct assistance from the EFSF/ESM. Furthermore, the ECB can, at any time, decide to exercise direct supervision of any other bank if considered necessary.

- Second, the national supervisory authorities will have to comply with ECB regulations, guidelines or general instructions;
- Third, the ECB will have access to all data of all banks; and
- Finally, the ECB, can decide to exercise supervisory powers directly.

We are facing a huge logistical challenge. There is a vast amount of preparatory work which has to be ready 12 months after the regulation enters into force, including: selecting highly skilled staff; drawing up the final list of significant banks to be directly supervised by the ECB; harmonising supervisory approaches and reporting requirements; mapping the euro area banking system; developing a supervisory manual and publishing a framework regulation within six months after public consultation. These tasks are already completed by around ninety per cent. The next big challenge is the design and undertaking of the asset quality review (AQR).

The comprehensive balance sheet assessment is essential for ensuring that the SSM gets off to a good start and avoids reputational damage stemming from the possible emergence of problem banks in the early days of operation. It is like a due diligence before the actual start of the banking union. It consists of a risk assessment which will be the basis of AQR, and the AQR will flow into a stress test to be jointly taken with EBA.

All three elements must be completed before the SSM becomes operational. Together they will allow a comprehensive view of banks' balance sheets, bringing together quantitative and qualitative aspects of banks' outstanding risk.

Which risks? Risks already present, or ones that may emerge over time. The AQR should therefore be a rather static, point-in-time exercise according to rigorous standards on all aspects of asset quality and with an emphasis on the level of provisions. More forward looking assessments could then be provided in the baseline scenario of the stress test.

For us, this is an exercise on an unprecedented scale, and we will also call on external experts to enhance its credibility.

About the SSM: second part – accountability and independence

The SSM Regulation provides a clear separation between monetary policy and supervisory tasks, the latter entrusted to the newly established Supervisory Board. This organisational separation is necessary to comply the increased accountability requirements of the supervisory function and still respect the independence of the monetary policy function.

The Governing Council's deliberations on supervisory matters will be strictly separated, including separate agendas and meetings.

The SSM will also have its own accountability framework vis-à-vis the European Parliament, the Eurogroup and national parliaments. It will apply to the Chair of the SSM's Supervisory Board of the SSM, and not to the ECB's President. This is intended to avoid any confusion among the two sets of tasks, also in the public perception, and further protects the ECB's independence.

Last, over and beyond such clear separation of mandates, decision-making processes, rules and instruments between the two functions of the ECB – there need to be an exchange of information to reap synergies. Having for example the financial stability function and thus macro-prudential tasks under the roof of the central bank is of course nothing new. Different from the micro-prudential perspective it is there mostly docked at the National Central Banks.

It therefore makes sense, to have different institutional arrangements for macro-prudential decision-making within the SSM than those that are foreseen for micro-prudential. In the latter case there is a need for a clear separation of functions between the ECB as monetary policy-maker and supervisor.

The SRM – a necessary complement to the SSM

For banking supervision to be effective, a Single Resolution Mechanism (SRM) is also indispensable to resolve non-viable banks. Without an SRM, we might face a misalignment of incentives between the supervisory and the resolution functions. Moreover, the supervisor's judgments must also be enforceable. The Commission recently proposed setting up a single resolution authority backed by a single bank resolution fund. The authority and the fund must be separate from the SSM, independent and supranational. Jointly, they constitute a single resolution system with the ability to intervene directly in banks losses, dividing them among shareholders and creditors.

Please note that if we are not going to have a joint SRM, beware that presently not all countries have a national resolution authority and fund: those ones have to set one up very rapidly.

In fact, supervisors could face a dilemma. On the one hand, there may be a danger of contagion and financial market panic. On the other, supporting insolvent banks with central bank liquidity might give rise to "zombies" and weaken the credibility of banking supervision and resolution, and thus the banking union as a whole. Therefore, I strongly support the timeline envisaged for the SRM to start functioning on 1 January 2015.

An important prerequisite for the SRM is the Bank Recovery and Resolution Directive. The Directive still has to be agreed with the European Parliament. In my view we should push for a start date of 2015 for bail-in so that we have the full resolution toolbox available from the outset – instead of over-extending the State Aid rules as a proxy.

In the future, the burden of a bank's failure will be shifted away from the public. *How?* Shareholders and creditors will be first to bear the resolution costs. Only if this is insufficient should the banking industry as a whole step in via resolution funds – making the fiscal backstop the very last resort. To ensure adequate loss-absorbing capacity, each bank has to fulfil a minimum requirement of own funds and eligible liabilities for bail-in.

Third, what do we expect from banks and genuine banking integration?

The banking union is not an end by itself. *Is it instrumental?* Yes. *And why?* Because in the euro area about 80% of the financing of the real economy originates from the banking sector. Genuine banking integration is important in many respects. *Why?* Because a more integrated banking market intensifies competition by changing the focal point of the strategies of banks and other financial market participants. More competition means that existing capital is allocated more efficiently. This promotes access to new funding opportunities for companies, encouraging investment and thus contributing to growth. Small and medium-sized enterprises with no direct access to capital markets may benefit most.

For the ECB, an integrated banking space eases monetary policy transmission and the effectiveness of monetary policy. A successful European banking union will also relieve the ECB of some of the tasks undertaken during the crisis and the need for non-standard measures.

Moreover, financial market integration helps smooth the effects of asymmetric shocks through income insurance when a country's residents hold claims to dividends, interests and rental revenue from other countries. In the US, such risk sharing has been shown to be far more important than federal budget transfers.

Some final reflections

Talking about flaws in EMU's design is a bit reductive. It certainly doesn't capture the depth of the "repair work" going on in Europe and the euro area in particular. We are in fact adding new foundations to a framework that has brought us as far as it could, and that couldn't cope with a systemic crisis: it actually aggravated it.

Now, we need determination in completing the constitutional framework envisaged under the "four unions", the four cogwheels that must work together in a synchronised manner and in one direction. There must be no complacency: no "wait and see what happens next".

In recent years, a significant part of the banking system in several countries has been kept alive by public capital injections and state guarantees, plus the liquidity support of the ECB. Most banks were no longer masters of their destiny. In hindsight, many of them generated instability and became part of the problem. Now, we need them to be active parts of the solution. Hence the call for a European banking union: the biggest cogwheel that we can complete right now.

I hope that you agree that we have come a long way since the start of the crisis. But we still have further to go! Implementing the banking union will take a great deal of hard work and cooperation. However, once it's in place we shall have a healthier financial system.

To conclude, let me quote Alexis de Tocqueville here: *"I cannot help fearing that men may reach a point where they look on every new theory as a danger, every innovation as a toilsome trouble, every social advance as a first step toward revolution, and that they may absolutely refuse to move at all."*

Thank you for your attention.