Pentti Hakkarainen: Banking union – implications for Nordics?

Speech by Mr Pentti Hakkarainen, Deputy Governor of the Bank of Finland, at the Sveriges Riksbank, Stockholm, 5 May 2014.

* * *

Accompanying slides can be found on the Bank of Finland's website.

In Nordic countries we have a long tradition and experience on highly interconnected and integrated financial market. If we look at the banking sector, same names are represented in all countries. We had our own severe crises in early 1990s, but this time our financial sector has survived pretty well, keeping itself in a rather good shape.

Since 2008, we have experienced a series of different types of crises. Each of them has had devastating effects on the real economy.

In 2010 it became desperately evident that the bank and sovereign risks are tightly interconnected and with a two-way causality, the so called bank-sovereign loop, weak banks weakened sovereign and vice versa. A problem in one bank can quickly spread not only to other banks but also to sovereigns beyond national borders with damaging effects on the real economy and taxpayers both at home and in other countries.

The crises have made it very clear at least that international, highly interconnected financial markets require a stronger institutional framework than what we have had in recent years. The authorities need proper tools to deal with ailing banks operating in integrated cross-border markets. The creation of these tools has taken major steps forward since, but there is still a lot of work ahead.

The key lesson we have learnt is that economic dislocations without proper arrangements to tackle troubled banks have devastating effects on the real economy, taxpayers and the whole society. And coming back to "normal" proves to be painfully slow and long-lasting.

Financial market flaws

All in all, the mismatch between the scope of international bank operations and the national supervisory framework made the situation extremely challenging.

What to do? In principle, we can envisage three solutions. First of all, we could re-nationalize the financial markets. In such a solution, the single market would be lost. We would turn the clock back, lose benefits of integrated markets. Second, we could just accept the risk of financial instability and periodically pay the price. Or, finally, we could work to create a banking union, with better suited institutions and systems for single supervision and resolution.

Only the last one of these is acceptable. Institutional arrangements for supervision and resolution need to match the integrated structures of banking business in the real world.

Before I continue to the Banking Union, I would like to recall ideas that Stefan Ingves raised in 2006

> *"I propose the establishment of a new pan-European body, a European Organization for Financial Supervision (EOFS). The idea is to create a separate agency to follow the major cross-border banking groups in Europe".*
>
> *"The EOFS should only focus on the presently about 40 truly cross-border banking groups and not deal with the about eight thousand European banks with a predominately national character."*

"The EOFS should have three tasks: It should gather information about the banking groups and their activities in different countries. Importantly, it should also create unified risk-assessments of each cross-border banking group. Finally, it should also oversee the activities and risks of these banking groups."

"To achieve these tasks, there is a need for a separate agency, staffed with a sufficient number of competent employees. Initially, these employees could of course be recruited from the existing national supervisors. Also the staff of the EOFS would have to cooperate with the national supervisors."

At the moment, after eight years and severe crises, we are taking steps pretty much towards the direction proposed by Stefan. However, he also mentioned that the authority should be independent and not the ECB or the European Commission, but as we know according to the current EU-treaties this was not a feasible option..

The European Union is now taking a significant step forward by establishing the Single Supervisory Mechanism for the euro area and the non-euro area member states have a possibility to join in the form of "close co-operation". Therefore, it may be fair to ask whether we someday see Sweden to join the Single Supervisory Mechanism.

Banking Union

As part of the economic and monetary union and as a remedy for the crisis, the EU leaders agreed in June 2012 on creating a true Banking Union.

The Single Rulebook provides a foundation for the Banking Union. It is based on the idea of identical regulatory requirements, such as capital adequacy rules for banks. These are achieved through European legislation and lower-level technical standards.

One of the main pillars of the Banking Union is the Single Supervisory Mechanism. I will come back to the recent developments in its construction later on.

Another important pillar is the Single Resolution Mechanism. As you know, intensive talks in the form of EU trilogue ended in March and European Parliament approved the SRM regulation in April. In addition, deposit insurance schemes will be strengthened and harmonised as part of the banking union in the long run.

The Banking Union may also be complemented by structural reforms. The European Commission has made a legislative proposal based on the Liikanen report and it will be finalised under the term of the next European Parliament.

In the future, the Banking Union, when properly implemented, will help us resolve banking problems while avoiding to use taxpayers' money for bail-outs. This in turn means also better incentives in banking and hence a more stable financial system.

Preparations for Single Supervisory Mechanism

Let me now share with you some recent developments in the Single Supervisory Mechanism (SSM). The EU Regulation assigning supervisory tasks to the ECB became effective in early November 2013. Already well ahead of this time in late summer 2012, the ECB and national supervisors established the High-Level Group which steered practical preparations to ensure timely adoption of supervisory responsibilities by the SSM. Thus we have got a "flying start" for the whole project.

As a concrete step, the ECB Governing Council nominated Ms Danièle Nouy for Chair of the Supervisory Board of the new Single Supervisory Mechanism. The Heads of Directorates, four Director Generals have been appointed and most of the mid-level managers have been nominated as well. A broader recruitment process of supervisors and analyst is under way and they will join the ECB in waves by the end of the year.

The Supervisory Board had its historical first meeting in January and now on it meets twice a month. At the beginning many of the issues have related to accepting, confirming and further developing the issues prepared by the High-Level Group.

Now there is an on-going transition period, during which a comprehensive assessment of significant banks is carried out. During the same period other preparations for the SSM are to be completed.

Comprehensive Assessment

The Comprehensive Assessment of European banks is an essential element of the preparations for the SSM. It should be noted that the SSM Regulation also enables the ECB not only to obtain all the relevant information from the national authorities necessary for making the assessment but also to take over direct supervision of any credit institution it deems necessary. This is important to guarantee consistent application of high supervisory standards.

The Comprehensive Assessment has three main goals. First of all, the assessment aims at transparency through enhancing the quality of information available on the condition of banks. Its second goal is to repair banks' condition by identifying and having the necessary corrective actions implemented where necessary. Finally, the Comprehensive assessment builds confidence by assuring all relevant stakeholders that banks are fundamentally sound and trustworthy.

The ECB will conduct the Comprehensive Assessment in close cooperation with national authorities, and also with ESRB and EBA. The ECB will detail the design and strategy of the assessment exercise, monitor its execution, perform quality assurance as well as collect and consolidate the results and finalise and disclose the overall assessment. National supervisors execute the exercise at the national level, benefitting from local knowledge, but following common data requirements and methodology. As an example of the extensive methodology, the Asset Quality Review Phase 2 Manual was published in March. The manual provides specific guidelines for all involved parties on the conduct of relevant steps of the exercise.

The Comprehensive Assessment is indeed comprehensive. First we do a Risk Assessment addressing key risks in the banks' balance sheets, including liquidity, leverage and funding. After that an Asset Quality Review is carried out examining banks' balance sheets based on information at the end of 2013. And finally, a Stress Test, done in collaboration with the EBA, complements the asset quality review by providing a forward-looking view of banks' risk-absorption capacity under stress.

The Asset Quality Review has progressed and some details of its coverage have been released. Approximately 135 000 loan books will be examined by the authorities. The loan file review covers both corporate and retail portfolios. It covers total banking book risk-weighted assets (RWA) of approximately € 3.7 trillion, representing 58 % of total credit risk-weighted assets across the banks subject to the assessment. In addition, 29 banks with material trading book exposures are subject to a specifically tailored AQR of the trading book.

The structure of the Comprehensive Assessment also clarifies the frequently asked question, how this assessment differs from previously conducted EU level stress tests? The key differences to my mind are as follows:

- Banks' risks and asset quality are assessed in a comprehensive manner at the Banking Union level. Assessments are made applying common definitions, abolishing – or at least showing explicitly – any diverging national interpretations.
- Sufficient corrective measures can be guaranteed as the ECB in its supervisory role will have all the necessary supervisory powers.

- Quality of assessments is ensured not only by the ECB's strict procedure for on-going quality assurance, but also by the involvement of third party evaluators.

The results of the assessment will be published in a single disclosure, including all three parts of the exercise.

The results of the Comprehensive Assessment will be followed by corrective measures where necessary. The ECB published last week more details on how banks' should cover possible capital shortfalls. Capital shortfalls will be expected to be covered within six months for those identified in the AQR or the baseline stress test scenario, and within nine months for those identified in the adverse stress test scenario. Recapitalisation measures to cover any shortfalls detected should rely on capital instruments of the highest quality, unless the shortfalls are reduced through other means. Such other measures could include, for instance, retained earnings, and reduced bonus payments, new issuances of common equity, suitable strong contingent capital and sales of selected assets at market prices.

Other preparatory work for SSM

Alongside the Comprehensive Assessment, a lot of other preparatory work is going on.

The SSM Supervisory Model is constructed so that the decision-making on supervisory matters and other related procedures are kept separate from the monetary policy. As regards supervisory matters, the new Supervisory Board will have a predominant role; in most of the cases, it will be the final decision maker. In addition to internal rules and restrictions on exchange of information, a concrete example of this separation is that supervisory function and monetary policy are located in separate buildings and from 2015 even in separate areas in Frankfurt.

At the practical level in the supervisory model, the joint supervisory teams are key actors. Such teams are created for each significant bank or banking group that will be directly supervised by the ECB. Joint supervisory teams are responsible for day-to-day supervision of significant banks. Each team will be composed of staff from both the ECB and national supervisors.

For the legal dimension of the SSM, preparations included the development of the SSM Framework Regulation on covering cooperation within the SSM, among other things. In this respect, after the public consultation, it was published on 25th of April.

From accountability point of view, the SSM has started to publish periodically a report called the SSM Quarterly Report to the European Parliament, the EU Council and the European Commission. The next report will be published in these days and it covers progress achieved since the publication of the first report in the beginning of February.

Banking supervision requires a smooth flow of information between banks and their supervisors. To this end, a high-standard data reporting framework and the associated infrastructures for the SSM are being developed.

SSM vs national interests

Banking, and financial services more generally, is a high value added industry and there are national interests at play. One can even say that national banking supervisors have traditionally had a dual role to play: first, to carry out effective supervision and thus promote financial stability but, second, to also promote the interests and competitiveness of the national financial industry. In today's economies and also for banks themselves it may be better to create level playing field internationally and enhance competition than look after interests of domestic banks only. Over time, the banking union is envisaged to lessen the role that national interest play but, in the short term, the banking union may exacerbate the conflict between the two roles.

The ECB, as an established and strong European institution, is well placed to tackle the emergence of national interests in supervision. It is therefore imperative that the powers are concentrated at the ECB. The structures and the processes of the SSM must support European perspective and interests. So far, all the developments seem to point to this direction. The fact that the ECB can, if deemed necessary, take over the direct supervision of any bank operating in the Banking union area underlines that the ECB is fully in charge of the SSM.

Banks' perspective on SSM

Are there any benefits for banks? From the banks' perspective, the introduction of the SSM means numerous changes. I will mention here only a few of them.

For a cross-border bank, operating in multiple countries within the Banking Union, the single supervision effectively simplifies its contacts with the authorities. It will need to work with a single supervisor and operate following a single rulebook. This implies lower costs for the bank in complying with the regulatory requirements.

Common rules and methods of supervision also have a broader impact on competition among banks, not only for international but also domestically oriented banks. The banks are treated equally in supervision and regulatory capture can be fully avoided, thereby ensuring a level playing field.

In general, I believe that the SSM will become one of the leading banking supervisors in the world, applying the best possible tools for supervision – and developing such tools also for the benefit of other supervisors.

Bank resolution

The second pillar of the Banking Union is the Single Resolution Mechanism (SRM), which is the necessary complement to the Single Supervisory Mechanism. The SRM creates a single authority, which is responsible for swift and orderly resolution of cross-border banks in the euro area and participating member states. The SRM is complemented by the Single Resolution Fund which will be financed via levies on the banking sector itself. The Fund will start from national compartments but it will gradually, in eight years, mutualise to become a truly single European Fund.

Underlying the new regime is the Bank Recovery and Resolution Directive (BRRD) which dramatically changes the culture. It ends the era of the bail-out and moves us to the culture of the bail-in. Bail-in will be the rule, bail-out a rare exception. As from the beginning of 2016, or in some countries even earlier, the BRRD requires bail-in of shareholders and creditors equal to at least 8% of the total liabilities of a bank. In most cases this should be enough. Only after the threshold of 8% bail-in can money from the resolution fund be used and only at the very end of the process can public money be used. It is notable that public money can, in exceptional cases, be used to fund resolution functions, not to bail-out nonviable banks.

Macroprudential policy

Finally, I would like to make a couple of short remarks on macroprudential policy that is becoming effective in the EU alongside the changes in microprudential supervision due to the establishment of the SSM

In Finland, a government bill was submitted to Parliament in April, including provisions establishing macroprudential policy tools and the Board of the Finnish FSA as macroprudential policy authority. The law is expected to become effective in June 2014. Following the adoption of this law, the macroprudential policy frameworks in Sweden and Finland are likely to resemble each other in several respects. While the supervisory authority would be the actual macroprudential decision-making body in both countries, other relevant

authorities, including central banks, have a role in analysing the systemic risks and needs for macroprudential action.

However, there is one notable difference between the macroprudential frameworks in our countries if Sweden remains outside the banking union. Within the banking union, while macroprudential policy responsibilities lie in the first place with the national authorities, the SSM Regulation assigns some macroprudential tasks also to the ECB. In particular, the ECB may decide on stricter measures than national authorities, using the counter-cyclical buffer or other macro-prudential tools provided for by the EU legislation. The role of the ECB in making macroprudential decisions within the banking union can be seen as a useful complement to our framework so as to avoid the so called inaction bias in macroprudential policy.

As a conclusion and positive end of my presentation, let me recognise the very good cooperation we have had not only between authorities from Banking Union countries but also with authorities outside the Banking Union. Indeed a lot of progress has been made to correct basic flaws we have had in our internationally integrated financial markets. And in doing that, national interests, and I argue that banks' interests as well, are taken care of when matching regulatory and supervisory institutions with the reality of banking business.