Vítor Constâncio: Towards the Banking Union

Speech by Mr Vítor Constâncio, Vice-President of the European Central Bank, at 2nd FIN-FSA Conference on EU Regulation and Supervision – "Banking and Supervision under Transformation" organised by the Financial Supervisory Authority, Helsinki, 12 February 2013.

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Ladies and gentlemen,

It is a great pleasure to be here today and I am grateful to the organizers for having invited me. All of us have been reflecting on the lessons to be drawn from the crisis relevant for the European project and in particular the ones related to the monetary union. The initial choice for monetary union was to have a minimalist framework: the adoption of a single currency plus a fiscal brake, the Stability and Growth Pact, to ensure stability, exclude free riders and help the single monetary policy. All other policies, economic or concerning financial stability like supervision, were left for the national level. It was assumed, in line with the economic thinking of the time, that monetary integration would spontaneously foster the synchronisation of the economic cycle and that national "shock-absorber" would be sufficient to deal with country specific developments.

The crisis has made it clear that a highly interconnected and integrated area such as the euro area, requires a stronger institutional framework. An important element to strengthen the financial institutional framework is the creation of the Banking Union.

The Council proposal on the Single Supervisory Mechanism of last December is testimony to the urgency in setting up a basic pillar of the Banking Union.

A strong and independent supranational supervisor will contribute in a significant manner to the smooth functioning of the monetary union and to restore confidence in the banking sector. The regaining of confidence in the banking sector is key to reverse recent developments towards financial fragmentation and help restart a well-functioning interbank market.

My intervention today is divided into two parts. In the first part I will touch upon the different elements of the Banking Union and reflect upon the underlying rationale for its establishment. In the second part of my speech I will focus on the SSM by reviewing its main features as well as the immediate challenges for the ECB to prepare itself to assume its supervisory task.

Part I – the Banking Union

The key building blocks of a Banking Union

The Banking Union aims at building an integrated financial framework to safeguard financial stability and minimise the cost of bank failures. As we all know, it consists of five complementary building blocks, of which the SSM forms an integral part.

The first block is the ***establishment of a single rulebook,*** which in a substantial way exists already. The European Banking Authority (EBA) has the legal competence to monitor its implementation. The addition of the CRD IV, the Resolution and Deposit Guarantee harmonisation Directives will lead to the creation of a single rulebook that will significantly contribute towards creating a level playing field. Likewise, the SSM will also contribute to reinforce the single rulebook, as a European dimension will be provided to the way supervision is conducted.

The establishment of a ***EU framework for single supervision forms the second element of the Banking Union*** and will be at the centre of my talk today. The SSM will be a mechanism, composed of national competent authorities and the ECB, with the possibility of non-euro area Member States to participate. The process to establish the SSM is underway, with the Council proposal forming the basis for the current discussion at the European Parliament. We at the ECB are quite pleased with the Council's proposal which is being assessed by the European Parliament. In all my comments I will refer it as it corresponds to the current basis for the future SSM.

A ***third element of the Banking Union is the establishment of a Single Resolution Mechanism***. An important pre-condition is a swift adoption of the Bank Recovery and Resolution Directive, as it lays out a harmonised toolbox of resolution powers. The Single Resolution Mechanism would build on the measures and tools laid down in the Directive, particularly by providing a robust framework that allows for prompt and coordinated resolution action, specifically where cross-border banks are concerned. As we all know, the swift and orderly resolution of cross-border banks is the Achilles heel that needs to be addressed.

The framework for the Single Resolution Mechanism is still to be defined and I look forward to the Commission's upcoming legislative proposal. Let me nevertheless highlight the main features that in my view such a Mechanism should have. It would have the same institutional and geographical scope as the SSM. The SRM would be an operationally decentralised system, where the ultimate responsibility rests with a Single Resolution Authority. The Single Resolution Authority would be at its centre, govern the resolution of banks and coordinate the application of resolution tools. It should have a comprehensive set of enforceable tools, powers and authority to resolve all banks in the SSM. In particular it would ensure that failing banks are resolved swiftly, through impartial decision-making focused on the European dimension. The timely resolution of banks should avoid the cascading of problems from one bank to other banks, thereby affecting European financial stability.

In order for the Single Resolution Mechanism to be perceived as credible, it should have sufficient funding. I am not talking about bailing-out banks with public money. Resolution is about resolving the situation of banks that have attained the point of non-viability and about doing it in a way that minimises the involvement of public money.

First, the writing-down of capital instruments and bailing-in of creditors should be fully exploited. Second, funds accumulated in a European Resolution Fund should be used to provide additional funding needed to realise a least-cost resolution strategy. These contributions should be risk-based and collected ex-ante from all banks participating in the SRM. Third, as a last resort, if the resources of the European Resolution Fund do not suffice, funds could be drawn from a European-level fiscal backstop mechanism. However, any fiscal support to the SRM should come in the form of credit to the European Resolution Fund. The Fund would need to repay the loan through additional levies on the banks under the SRM according to pre-specified rules. This should ensure that the mechanism is fiscally neutral over the medium term. Resolution activity may require the temporary use of public money if the Resolution Fund would not have enough resources, for instance, to capitalise a bridge bank that is sold later on to the private sector thus recovering the capital involved. In the US this is ensured by the existence of Treasury credit line, limited to 50bn dollars that can be drawn upon by the FDIC and later repaid.

The existence of this ***financial backstop*** can be considered as the ***fourth element*** of a complete banking union, especially because, as announced by the European Summit, there will be the possibility of direct capitalisation of banks by European funds. This element, whatever its terms, will be of great important for the achievement of one goal of the banking union project, namely to mitigate the negative feedback loop between banks and sovereigns.

Finally, ***the fifth element of the Banking Union will be the establishment of a common system of deposit protection.*** A first step in this direction will be the adoption of the legislative proposal on deposit guarantee schemes, providing a harmonised framework. This framework should ensure depositor confidence and enable the national deposit guarantee schemes, built on common EU standards, to interact with the SRM. A European deposit guarantee scheme is therefore not essential in the short term. Nevertheless, a common system, built on common EU standards, will be important in the future to ensure enhanced depositor confidence in the robustness of all European banks. This element would also contribute to reduce the risks of financial fragmentation that results from contagion fears and is detrimental to the smoothing functioning of the single monetary policy.

Rationale for a Banking Union

I see the Banking Union as essential to sustain and strengthen the EMU framework. It is worthwhile to dwell upon the reasons why I consider it so. After all, the nature and features of banking union must be strictly connected with what justifies its existence.

First, a single supervisory mechanism is necessary because of the ***increasing interconnectedness*** between financial institutions and markets across the euro area over the past decade, be it through internationally active banking groups, bilateral trading exposures, or presence in the same market segments. The recent financial crisis demonstrated how quickly and powerfully problems in the financial sector of one country can spread to another. This is especially the case in a monetary union. As a result, problems in the banking sector might originate at the national level, but are more and more likely to affect other countries of the euro area as well, and may quickly threaten the stability of the entire euro area banking system. Such developments and the underlying financial structures can best be assessed by a central authority rather than through cooperation between national ones.[1]

This has been captured by the so-called "financial trilemma". The concept of the trilemma is adapted from the famous "monetary trilemma" on the impossibility of simultaneously achieving three objectives: a fixed exchange rate, capital mobility, and national monetary policy.[2] In a very similar way, but applied to international finance, as put forward by Dirk Schoenmaker (2011) following a model by Xavier Freixas (2003)[3] the "financial trilemma" illustrates the impossibility of achieving three objectives in an environment with globalized financial markets: financial stability, financial integration and national financial policies, especially supervision.

For instance, the financial stability objective could possibly be pursued with national financial policies and supervision but only at the expense of further integration. The resulting fragmentation of the single market is however clearly at odds with the EMU framework and the requirements of the single monetary policy. Similarly, financial stability cannot be safeguarded as financial integration progresses (with an ever greater degree of interconnectedness between financial institutions and markets) and financial sector policies remain a strict national competence. Pursuing financial stability and integration as joint objectives requires true European level policies. This is particularly illustrated in a ECB working paper by Holthausen and Ronde (2004)[4] showing that with increasing financial

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1 See, e.g. Gros, D (2012), "An incomplete step toward banking union", CEPS discussion paper.

2 First put forward in Padoa-Schioppa, T. (1982) "Capital mobility: why is the Treaty not implemented?" Address to the Second Symposium of European Banks and reproduced in Padoa-Schioppa (2000) "The road to monetary union in Europe" OUP. See also Paul Krugman (1987) "Economics integration in Europe: some conceptual issues" in T. Padoa-Schioppa "Efficiency, stability and Equity" OUP and Obstfeld, M, J. Shambaugh, and A. Taylor (2005), "The Trilemma in history: tradeoffs among Exchange rates, Monetary Policies, and Capital Mobility", Review of Economics and Statistics 87, 423–438.

3 Schoenmaker, D. (2011): "The Financial Trilemma", in Economics Letters, 111 pages 57–59; Freixas, X. (2003) Crisis management in Europe. In: Kremers, J., D. Schoenmaker, and P. Wiert (eds) 2009, "Financial Supervision in Europe" Edward Elgar p. 141–165.

4 Holthausen, C. and T. Ronde (2004): "Cooperation in international banking supervision", ECB Working Paper 245.

integration, pursuing national financial policies will generally not lead to financial stability, because national policies seek to benefit national welfare, while not taking into account externalities of their supervisory practices on other countries. This leads to an under-provision of financial stability as a public good. From a different perspective, Goodhart and Schoenmaker (2009)[5] show, both in a model and using European data, that a coordination failure emerges when ex-post coordination among different national supervisors leads to an underprovision recapitalisation of cross-border banks after a banking problem.

A lesson of the trilemma is, therefore, that it is beneficial for the provision of financial stability to replace national policies with policies at the supranational level, thus geographically aligning supervisory incentives with the effect such supervision has on the financial sector as a whole. Other welfare enhancing benefits will come from the reduction of reporting costs for international banks, the easier centralised management of liquidity and the improving of the overall management of risks.

The materialisation of all these benefits will depend, however, on a vital condition for the functioning of the SSM, namely that it ensures a truly unified European perspective and does not act as a sort of an inter-governmental body of national supervisors. The elimination of any possible national bias implies that it has to function really as one system with a strong center and this will be its greatest challenge.

A ***second reason*** that justifies the banking union project regards the requirements for a smooth functioning of the single monetary policy. Its transmission mechanism across all member countries of the euro area requires an appropriate level of financial integration that ensures well performing cross border money markets. After a spectacular integration of money and financial in the first 10 years of monetary union we have observed increasing fragmentation that only recently, after the creation of our OMT programme, started to abate. This fragmentation has impaired the transmission mechanism of monetary policy. It has, of course, several different causes but could have been mitigated in the first place if some elements of a banking union had been in place. This would have contributed to a stronger separation between sovereign and banks by creating enhanced confidence in the national banking sectors´ solvency and liquidity situations. This would happen not only as a result of an effective overall supervision but also would stem from the elimination of ring-fencing practices condoned or even incentivised by some national regulators.

The elimination or mitigation of the banks and sovereigns negative feedback loops will then be promoted by several elements of the banking union acting together: the Single Supervisory Mechanism, the Single Resolution Mechanism and the European direct recapitalisation of banks.

The ***third reason*** that justifies the banking union project has to do with the development of large financial imbalances within the euro area in both public and private sectors. In particular, the development of macro and external imbalances was significantly driven by private sector indebtness, proving that the fiscal brake was not enough to guarantee macro stability and excessive heterogeneity among member states. This provided the rationale for the recent creation of a formal Macroeconomic Imbalances Procedure to monitor and promote timely policy measures to avoid the building up of macroeconomic instability in member states.

This was in part because fiscal rules were implemented weakly, not applied rigorously and subsequently watered down. Some countries therefore ran persistent deficits in good times or maintained high levels of debt. But the greater imbalances in fact emerged in the *private sector*.

[5] Goodhart, C. and D. Schoenmaker, (2009) “Fiscal burden sharing in cross-border banking crises” International Journal of Central Banking, vol. 5,n.1, March.

Between 1999 and 2007, the ratio of public debt to GDP in EMU declined on average by 5.6 percentage points. But in the same period, the ratio of private sector debt to GDP increased by 26.8 percentage points. For the same period, in the stressed countries, the cumulative increase in the private debt ratio to GDP versus the public debt ratio, amounted respectively, to 49 and 24 per cent for Portugal, 75 and minus 35 per cent for Spain, 101 and minus 10 per cent for Ireland, 217 and 4 per cent for Greece. In 2007, just before the crisis started, the level of public debt on average in the euro area was 73% but was 63% in Portugal, 46% in Spain and 26% in Ireland.

Private debt levels were able to increase so significantly because the integration of national markets allowed for higher borrowing from abroad and increased leverage. Banks were at the centre of this process both in lending and borrowing countries. As we now know, these flows were not perfectly optimised by rational private agents. The minimalist institutional construction of the euro area lacked the tools to discourage these developments.

The official bodies that could – and perhaps should – have intervened more to prevent these developments were national supervisors both in lending and borrowing countries. Yet they lacked the perspective to do so and also the instruments to contain private capital flows that were considered to result from optimizing self-equilibrating markets. Only macro-prudential measures agreed through a consensus at the European level could have dealt with the situation. In other words, there was a mismatch between the degree of integration and the scope of governance. In retrospect, the euro area was not prepared to deal with the build-up of systemic risks.

This was in a large part the result of two features of the dominant economic thinking at the time:

– ***first*** that the private sector is essentially stable and self-correcting composed of fully rational agents always optimizing inter-temporally with knowledge of the future probability distributions to infinity of economic returns and variables. In such a world no defaults are admitted or dangerous bubbles possible. Only the public sector can create instability. The Stability Pact was then supposed to be enough to ensure stability.

– ***second***, that finance does not matter for real economy fluctuations. After the Real Business Cycles school, the rational expectations hypothesis and the intertemporal optimization paradigm, money and finance were considered not relevant anymore. Money crept back in the new consensual macro model through the introduction of wage and price rigidities, allowing for short-term real economy effects of monetary policy. On the contrary, finance continued to be invisible with the Efficient Market Hypothesis ensuring a reliable plumbing of the real economy. Banks and capital markets were not considered endogenous sources of instabilities with real economy effects. They were absent from macroeconomic models.

All these features are being corrected, both in economic theory and models and in institutions. The important consequence for the monetary union framework is the launching of the banking union project and within its supervision component the attribution to the SSM of macroprudential policy instruments. Previously, the ESRB had been created only with the competence to issue warnings and recommendations. Economic theory and the overwhelming evidence of the importance of systemic risk in the crisis explain why the ECB insisted from the beginning that concrete macroprudential instruments were given to the SSM. The participant countries in the mechanism, which also can use those instruments, can feel more reassured that systemic risk at the European level will be better addressed in the future.

Part II – the Single Supervisory Mechanism

Main features of the SSM regulation

The Single Supervisory Mechanism is to become operational in 2014. Let me briefly highlight its main features some of which are related with the previous analysis.

SSM as one system

The SSM will operate as a system, catering for all expertise of national supervisors and at the same time possessing a strong decision-making centre. As I mentioned before, this is an important feature necessary for the effectiveness of the new entity. Appropriate decentralisation procedures will need to be defined while preserving the unity of the supervisory system and avoiding duplication.

To ensure a strong centre, the ECB's final responsibility for supervision within the SSM is matched by control powers over the system as a whole, as well as by very close cooperation arrangements with national authorities. The first aspect in the draft Regulation approved by the Council that ensures that the intention is indeed to create one system of European supervision results from the legal competence given to the ECB over all the banks in the participating countries. Naturally at the centre of the system, the ECB could not directly supervise all the thousands of existing banks. Only the more significant banks will be subject to that direct supervision. All the others will continue to be supervised by the competent national authorities. The SSM is more than just the ECB and includes all the national supervisors and central banks and so will have to function in a much decentralised way. Decentralisation does not mean fragmentation. What makes the SSM work truly as one system, besides the legal competence over all the banks, are some other main features:

First, all the components of the system will have to act in accordance with a system of guidelines, ECB specific regulations and manuals of supervisory practices that will be approved at the center by the Supervisory Board. The respect for these rules will be monitored and subjected to peer reviews.

Second, the center at the ECB will receive all the supervisory data, regarding all the banks

Third, the bodies at the center of the system, at the ECB, have the power to transfer to direct supervision any bank or group of banks that may be considered relevant and may be the origin of systemic risk. As we know from the crisis not only big banks may the source of more general financial instability. This legal competence is also an important persuasive tool to ensure harmonised supervisory practices throughout the system.

Extensive powers of the SSM

A second important feature of the SSM regards its extensive powers in the conduct of its supervisory function. ***The SSM, with the ECB at its centre, is entrusted with an extensive set of micro- and macro- prudential powers***, covering all key tasks relating to the prudential supervision of credit institutions. This broad array of tasks and powers is crucial, as it is the foundation for the SSM to effectively supervise banks.

In concrete, the micro-prudential tasks range from the authorisation of credit institutions to having the power to carry out early intervention when a bank is in financial distress. These tasks are matched with a broad set of powers to carry them out. In this context, the ECB may conduct all necessary investigations and on-site inspections and obtain all necessary information to carry out its task effectively. In addition, in order to enforce its decisions and rules, the ECB also avails of sanctioning powers.

Beyond all these aspects that are usual in respect to supervisory authorities, there are two other points I would like to underline. The first refers to the so-called early intervention powers as they are foreseen in the draft Directive about bank resolution that should be approved in the near future and long before the SSM will start operating. These early intervention are vast in what concerns the governance and scope of activity of institutions that start to have problems that can lead them to a point of non-viability. As such, these powers are related to what is usually called "prompt corrective action" regarding problematic banks and can be applied before the bank is delivered to the Resolution Authority.

Another important competence conferred upon the ECB as the centre of the SSM concern the macro-prudential instruments to be possibly applied both to the euro-area financial system as a whole or to individual countries. These powers are shared with national authorities that can also take measures in this field but it is nevertheless another essential element of the proposal. The crisis has shown that supervising the micro-prudential risks at individual banks separately is not sufficient and that macro- and micro- risks can actually be mutually reinforcing.

Involvement of non-euro area Member States

A third important feature of the SSM relates to the preservation and deepening of the Single Market, particularly the fact that ***national competent authorities of non-euro area Member States have an option to participate in the SSM***. They can participate through establishing a close cooperation with the ECB. By giving non-euro area Member States full membership and voting rights in the Supervisory Body, the body responsible for the preparation of decisions on supervisory matters, they are placed on an equal footing with euro-area Member States. However, as the ECB Governing Council is the ultimate the decision-making body of the ECB, its role in the SSM is reduced to the possibility of accepting of accepting or rejecting the decisions of the Supervisory Board. At the same time, a system integrating a mediation panel is foreseen in the Regulation in case of divergences that may involve a non-euro area Member State. All these mechanisms were accepted at the level of the Council by all governments which seems to indicate that we might see an extension of the SSM well beyond the euro area.

Separation of monetary and supervisory functions, while benefiting from synergies

A final feature of the SSM Regulation I would like to highlight relates to the ***principle of separation of the monetary and supervisory function***. The important role given to the Supervisory Board vis-à-vis the Governing Council, already referred to, is one of the various safeguards ensuring a clear separation between the monetary and supervisory function of the ECB. Additionally, deliberations of the Governing Council on supervisory matters will be strictly separated, including separated agendas and meetings.

The ECB fully subscribes to the need for a clear separation between its monetary and supervisory function and the provisions to this end mentioned in the proposed legislation. But let me stress that separation does not mean isolation. The conferral of supervisory tasks to a central bank is in line with the responsibilities of many other central banks that combine these two functions. In fact, the crisis has only strengthened the trend of central banks acquiring supervisory responsibilities and there are many good ***reasons for conferring supervisory powers to the central bank***.

A first argument is that a stable financial system is a necessity for the smooth conduct of monetary policy and as such a major concern of any central bank. Second, there are information synergies between the oversight of payment systems and the supervision of banks. The ECB is not only responsible for the oversight of all large-value payment systems operating in the euro area, but also the owner of the TARGET2 system, the largest of such systems. Third, central banks have a lot of expertise on the financial sector. The constant monitoring of the different market segments in order to assess the transmission of monetary policy contributes to their understanding of the financial sector and to act quickly in situations of financial stress. Fourth, central banks will be able to achieve a better management of its counterparties´ creditworthiness in monetary policy operations. Fifth, central banks are particularly prepared to manage macroprudential policies as they have a deep knowledge of the macroeconomic and financial cycles and monetary policy shares the same concerns with macroprudential policy, namely the stabilisation of the cycle to ensure price stability in the medium and long term. This provides the justification for the fact that in Europe and around the world Central Banks are given macroprudential authority even when they not have micro supervisory powers. In fact, the usual arguments to separate monetary policy from supervision do not apply to macroprudential policy. In particular, the potential conflicts, the sensitivity and reputation risks resulting from decisions about individual institutions do not arise in what regards macroprudential policies. It is then to be expected that the Governing Council of the ECB will show more interest in those policies. On the other hand, there are also advantages in not subsuming the macroprudential perspective in the micro supervisory body as the systemic risk is not the natural standpoint of observation of such body. Macroprudential concerns should be functionally separate in any organization that has both functions as it happens currently with various central banks in Europe.

Thus, although the conduct of supervision will be a new task for the ECB, as the euro area's central bank, we have built up extensive expertise in macroeconomic and financial stability issues. 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.

Of course the concentration of more powers at the ECB, implies ***a higher level of accountability***. The Council proposal also addresses the issue by creating a Review Panel of the SSM decisions from a legal point of view and, in particular, by defining the accountability of the SSM before the European Parliament.

Main immediate tasks of the SSM

One of the main priorities for the ECB during 2013 is ensuring the operationalization of the SSM, so that it can assume its responsibilities effectively and efficiently.

Building a strong centre

Creating a strong centre in a decentralised system such as the SSM, will be crucial to ensure the ECB's reputation is safeguarded. The monetary policy function of the central bank requires that it maintains a high level of credibility. This is essential to keep anchored inflation expectations. When the central bank is responsible for both price stability and banking supervision, weaknesses in supervision could damage the reputation of the central bank as a competent monetary authority. Furthermore, it could be argued that the central bank faces higher reputational risks in conducting its supervisory function than its monetary policy function. This is simply due to the very different nature of the tasks. News about a failing bank can be automatically wrongly perceived as a result of deficient supervision cancelling out reputation built over a stream of years with no news about problem banks.

In addition, the ECB will need to build up its reputation in its supervisory function. While the full independence and legal means are at the core of the system in the SSM construction, the close proximity with the supervised entities and expertise of national supervisory authorities are essential to ensure that no aspect is overlooked. As I mentioned before the system will be very much decentralised. Even in the case of banks directly supervised from the centre, the experts from national authorities will be involved in on-site inspections and these and other operations should be conducted in the context of joint supervisory teams headed by ECB´s experts.

The success of the SSM will hinge on the knowledge and skills of its human capital. Therefore the recruitment of skilled and experienced staff, including banking supervisors, will be a priority. This will be, to a large extent, built on the system resources, in line with the experience in cooperation within the Eurosystem.

Review of banks' balance-sheets

An immediate task of the SSM will be a comprehensive review of the banks brought under its responsibility, namely the banks that will come under the direct supervision of the ECB. This is requested in the Council Regulation in view of possible legacy issues, which could put the SSM reputation at stake further down the road. Ahead of assuming the responsibility for the supervision of banks, the ECB in cooperation with national supervisory authorities will need to carry out a comprehensive assessment of their balance-sheets. This exercise will include elements of an asset quality review which is instrumental in identifying potential legacy problems.

The treatment of ***legacy assets in the overall Banking Union project is an important issue, notably in connection with the European direct recapitalisation of banks***. It has to be ensured that in the setting up of a European Resolution Mechanism, the losses of legacy assets, in accordance with good resolution principles, will be borne first by the banks' shareholders and/or partly by the countries where they are domiciled, so that the use of any European funds do not raise issues of moral hazard and/or unjustified excessive mutualisation of losses coming from the past. As it happens when a private investor takes a stake in the capital of a troubled bank, appropriate due diligence is conducted and will impact the determination of the price of entry thus diluting previous shareholders. Solutions will need to be worked out whenever legacy assets threaten to overwhelm the fiscal capacity of Member States. In such cases, mechanisms would need to be found so as to provide support at the European level ensuring that the scheme of incentives remains aligned. Member States will need to keep a fair share of their responsibilities so that resolution objectives are fully and timely complied with.

The ECB is prepared to conduct the necessary balance-sheet reviews and related assessments in cooperation with other national and EU authorities and possibly third parties. This is particularly the case for forward-looking analysis of banks' solvency in the form of stress tests for individual banks, envisaged in the legislative proposal establishing the SSM.

The ECB, similarly to other national central banks, has over the years strengthened its analytical capacity to support its financial stability function, notably the need to carry out systemic risk assessments in real time to support policy discussions.[6] Such analytical capability supporting financial stability assessment work has furthermore been essential to support country-specific analysis to support discussions on the financial sector of countries under financial assistance and in support to the EBA in conducting EU-wide macro stress tests. The systemic risk concerns of macroprudential policies has led to the development of a suite of tools and models with a view to assess and quantify the impact of systemic risks on the banking sector and ultimately on the real economy. The existing macro stress testing framework is particularly suited to assist the reviews of banks' balance sheets and provide comparable forward looking assessments of banks' solvency on an individual basis.

More broadly, these comprehensive reviews will provide transparency into the composition and credit quality of banks' loan portfolios, in the spirit of asset quality reviews. Such financial due diligence would furthermore inform about provisioning and loss mitigation policies and broadly validate banks' reporting. This exercise should contribute to increase comparability across banks – in line with EBA efforts on harmonisation of definitions and practices supervisory processes.

Harmonising supervisory procedures and risk assessments

At a larger scale, the ECB needs to conduct fundamental work – in cooperation with the EBA – to develop a manual of supervisory practices, defining processes and procedures for conducting supervision in the EU. This should ensure a harmonised approach to the way supervision is conducted and increase comparability across supervisory assessments – e.g. regarding provisioning and risk mitigation policies – under the new EU supervisory framework.

[6] See ECB (2010), Financial Stability Review, June, "Analytical models and tools for the identification and assessment of systemic risks" as well as (2012) "Report on the First two years of the Macro-prudential Research Network", October.

Related work that is underway and coordinated by the EBA, notably on forbearance risk and impaired asset classification will represent in this connection valuable contributions to the convergence of procedures to best practices. Provisioning and loss mitigation policies may differ quite substantially across countries at present. The need for harmonisation is apparent as these represent key elements affecting assessments of banks' capacity to withstand credit losses. Furthermore, work done within EBA on risk assessment inputs to the supervisory review process – a topic that I will return to in a second – also represent important steps in this harmonisation process.

The establishment of the SSM also requires the harmonisation of supervisory risk assessment frameworks. In fact, amid a vast range of indicators of bank-specific vulnerabilities and partial analysis, there is no harmonised risk assessment methodology across Europe that could support a common framework for supervisory assessments in the EU.

This would entail the creation of some sort of European Supervisory Rating System in the spirit of the Uniform Financial Rating System introduced by US regulators in 1979. Special emphasis is needed on definitions and forward-looking dimensions that could signal bank distress further down the road. Quantitative indicators and qualitative judgements about governance and risk management will be included in the risk profile of banks and their overall classification.

Here as well, the ECB stands out as well equipped to support this SSM task, in cooperation with EU and national authorities. Over recent years, efforts have been made to strengthen the risk surveillance function to assist ECB responsibilities in the field of financial stability. This has to a large extent published in official financial stability publications, most prominently, the ECB Financial Stability Review.

I would highlight, in particular, the importance of ***work conducted in the area of early warning models***. Beyond investments in developing analytical tools and models that can provide early warnings of the build-up of financial imbalances at the aggregated level, efforts have also gone in the direction of the analysis of individual banks. Methodologies combining bank-specific indicators, in the spirit of the CAMELS indicators, with country-specific indicators for the banking sector and country-specific macro-financial indicators are being used and will be further explored to predict distress in banks.[7] In this respect, model-based frameworks of contagion accounting for vulnerabilities arising from interdependencies across banks are also being developed. There is a long way to go on the analytical front but these are already important first steps that should cater for a solid establishment of the new framework for supervision in Europe. These efforts are essential in the construction of the Banking Union.

Conclusion

Let me conclude. The agreement reached on the SSM by the Council shows the resolve to strengthen the EMU by strengthening the institutional financial framework. The SSM is a key component, but it is only one component of the Banking Union. In particular, a European framework for resolution of banks – with a Single Resolution Mechanism centerd on a Single Resolution Authority needs to follow. We fully support the intention announced by the Commission to present a legislative proposal for a single resolution mechanism, having at the center a resolution authority that should be approved before the SSM becomes fully operational.

[7] ECB, (2012) Financial Stability Review, December, Special Feature A "Predicting bank distress and identifying interdependencies among European banks".

The prospect of the creation of Banking Supervision at the European level, complemented by future European banking resolution, is the more far reaching change introduced since the inception of the euro. It reveals the willingness of Member States to continue to deepen European integration and create at the same time a better framework for the effective functioning of the euro area.

Few could have foreseen such momentous developments. A man of vision and a great European, Tommaso Padoa-Schioppa, who preceded me as the member of the ECB´s Board responsible for financial stability wrote in 1999 a few weeks after the inception of the euro:[8] *"I am convinced, however, that in the future the needs will change and the multilateral mode*[9] *will have to deepen substantially. Over time such a mode will have to be structured to the point of providing the banking industry with a true and effective collective euro area supervisor. It will have to be enhanced to the full extent required for banking supervision in the euro area to be as prompt and effective as it is within a single nation".*

At the time this might have sounded as premature to many but they should have listened to another man of great vision, Jean Monnet, who wrote in his Memoires: "There *are no premature ideas, there are only opportune moments that it is necessary to wait for ….. Everything is possible in exceptional moments provided we would be ready.*"

I am confident we will be ready.

Thank you for your attention.

[8] Padoa-Schioppa, T., " EMU and banking supervision" Lecture in the London School of Economics, on 24 Feb 1999.

[9] The way Tommaso Padoa-Schioppa named the European approach in this text.