Sabine Lautenschläger: From supervision to resolution – a German perspective

Speech by Ms Sabine Lautenschläger Deputy President of the Deutsche Bundesbank, at the Institute of International and European Affairs, Dublin, 25 June 2013.

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1. Introduction

Dear Mr Halligan,

ladies and gentlemen

I would like to thank you very much for your invitation. It has been my pleasure to come to Dublin to discuss with you those new developments relating to the banking union which are of such great importance to Europe. The title of my remarks refers to the "German perspective". I would like to talk with you about my vision, and that of the Deutsche Bundesbank. And – I will make no secret of it – I have a case to put before you today.

One of James Joyce's most famous literary characters, Stephen Dedalus, once observed that errors were the portal of discovery. Having failed to prevent the crisis in the first place, policy makers and supervisors alike are at least rightly being called on to learn the right lessons. One of these lessons is the banking union, which was launched in June 2012. The eurozone summit resolved, amongst other things, to transfer banking supervision to the ECB. Further elements were added in December 2012. These include the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) here in the euro area. A single European deposit insurance scheme is also being discussed.

Adding a single resolution mechanism to a single supervisory mechanism is, in my opinion, not just a good idea, but one whose time has come. Control and liability should go hand in hand. But a European resolution mechanism likewise needs harmonised standards and instruments, which are currently being developed with the EU's Bank Recovery and Resolution Directive (BRRD). If I may say so here: the Irish Presidency has distinguished itself admirably during these difficult negotiations.

The third pillar of a banking union – a European deposit insurance scheme – is currently not regarded as a priority task. I concur with this view. After all, a deposit insurance scheme is a promise by a government to its depositors to indemnify them to a certain degree in the event of a crisis. A joint deposit insurance scheme would thus necessarily mean joint liability of the member states' taxpayers. However, joint liability in this area requires joint European control in economic and fiscal policy. And we are nowhere near that stage yet.

However, there are more conditions to be met for an effective and efficient banking union, which concern material supervisory legislation: a centralised European supervisory regime requires common supervisory rules. The adoption of the Capital Requirements Regulation and Capital Requirements Directive, and their probable entry into force on 1 January 2014, have brought us a major step closer to a "single rulebook" for banks and supervisors alike. I would also like to give my warmest thanks and congratulations to the Irish Presidency here, too, for their negotiating and organisational skills in this thorny matter, one on which no fewer than four presidencies had to work very hard at that. Well done!

2. Single supervisory mechanism

Where do things now stand with regard to the Single Supervisory Mechanism, the SSM? Where do I stand? A fundamental political consensus has been achieved. A formal resolution in Germany is still pending, however, as this significant transfer of powers requires a two-thirds majority in each of Germany's two houses of parliament. The required majority

was reached in the Bundestag, or lower house, on 14 June 2013; the Bundesrat, or upper house, will vote on 5 July 2013. I trust that everything will go smoothly, and that the Single Supervisory Mechanism Regulation will enter into force in the late summer so that, in the second half of 2014, the European Central Bank (ECB) can start supervising banks in cooperation with national supervisors.

I expect major benefits from the forthcoming European cross-border supervision of banks. The last five years, in particular, have brutally shown us that crises do not stop at national borders, especially in a monetary union. An advantage of the SSM is that it will draw on a broader and better basis of information across the eurozone, thereby making it possible to reveal undesirable developments more quickly. If designed correctly, with a strong arm in benchmarking and peer review, we can uncover trends in individual business lines and risk management much sooner in future. I also expect this to be a major step towards the consistent application of the supervisory rules, as a second pillar of the single rulebook, so to speak. I am hoping that European supervision, in teams of supervisors from various nations, will provide a new approach which incorporates the best elements of each nation's approach to supervision. This new approach will leave no room for a "home biased" supervisory regime.

However, the SSM also has some major weaknesses, and I would like to single one out for particular emphasis. It has to do with the fact that the final say on central decisions taken by the ECB – and thus also in the SSM – rests with the Governing Council of the ECB. It is true that these decisions will be prepared in a Supervisory Board, composed of representatives of all eurozone national supervisory authorities and central banks, and that the Governing Council of the ECB can only accept or reject the proposals. A mediation panel would resolve disagreements. However, the Governing Council would have ultimate responsibility no matter what. I have misgivings about this setup, for two reasons. First: this governance structure is quite complex, and its functional viability still needs to be demonstrated. I admit that I side with the sceptics here. Second: it will not be possible here to draw a clear dividing line between monetary policy and supervision: the Single Supervisory Mechanism Regulation only goes as far as EU primary law allows.

I therefore see the ECB facing conflicting aims: price stability and a stable banking system. This conflict of aims can threaten the ECB's "internal independence". Over the medium to long term, I believe it is necessary to put the SSM on a sound legal footing; there is no getting around changes to primary law to improve the governance structure and to draw a clear line between the monetary and supervisory functions. I am convinced that we need to tackle the issue of these changes.

3. Single resolution mechanism

Let me now turn to my second main topic for today: the Single Resolution Mechanism (SRM). The financial market crisis has shown us the magnitude of the hazards and costs associated with buzzwords such as "too big" or "too complex to fail". The G20 governments have therefore committed to take measures to prevent taxpayers from having to bail out distressed banks. The onus is now on policymakers and supervisors to develop a bank resolution and restructuring process.

This issue takes on a new dimension in the context of joint supervision. After all, within a cross-border supervisory structure, there also has to be a common restructuring and resolution regime in order to achieve a balance between liability and control.

To that end, we have to establish a central European resolution agency and a joint European resolution fund.

In order to make such a single European restructuring and resolution regime lawsuit-proof, a change to primary law is required here, too. In my view, the current legal framework for the establishment of a special resolution authority for the euro area, with extensive powers of

intervention, is insufficient. As a European resolution authority will have extensive powers to intervene, its legal basis must be absolutely watertight. Resolution will invariably be followed by lawsuits – that much is certain.

What shape should such a resolution authority take in practice? Transferring the relevant tasks to the EU Commission, limited to only a subset of member states, and even if just for a transitional period, is not a really good idea. It harbours legal pitfalls: restricting the authority's powers to the euro area is hardly covered by Article 114 of the Treaty on the Functioning of the European Union (TFEU) and also poses the threat of conflicts of interest. Resolution and state aid would be merged into one single authority.

As in the context of the SSM, in this area, too, policy makers are called upon to tackle with determination the task of laying the groundwork under EU primary legislation for an independent resolution authority.

4. Hierarchy of liability

What other unfinished business is there? Well, there is, above all, the issue of the instruments and procedures to be applied when a bank is to be resolved or restructured.

At all events, the resolution and restructuring of a bank supervised directly by the ECB requires common instruments and procedures, which will also benefit EU countries which join the SSM. I therefore welcome the Irish Presidency's efforts to push ahead with the highly complex and controversial BRRD dossier.

The crucial precondition to finalising this dossier is agreeing on who will ultimately foot the bill. To this end, we need to define the hierarchy of liability clearly and ex ante:

Shareholders should be the first to bear losses; if that does not suffice we must not hesitate to bail in junior and senior debt holders as well – at least most of the time. The big issue is currently whether or not deposits should be put in a class of their own in the hierarchy of liability – in other words, should there be a "depositor preference". Some member states also want all deposits, or at least those insured up to €100,000, to be exempted from a bail-in.

A privately financed resolution fund is a further line of defence. All banks supervised directly by the ECB would have to contribute to this joint European resolution fund, which would supersede national regimes in the medium term. This fund should also be able to require additional payments from member banks.

Every now and then, I hear the notion that the Eurosystem could also make a contribution, for instance, by providing bridge loans. I don't think that's a good idea. True, a central bank can provide emergency liquidity – but only if a bank is suffering from temporary liquidity shortages. However, it may not, and should not, contribute aid towards resolution or restructuring, as this can easily cross the line into fiscal policy.

As a last resort, however, the fund could request public financial assistance for example, from the ESM, as there could be threats which, in extraordinary cases, could require recourse to public funding.

5. Direct recapitalisation through the ESM

Public funds is a buzzword and a hot-button issue, one that is inseparably linked to the question: who is the public that is supposed to be doing the funding? Should nation-states be called to pay up whenever a crisis occurs, or should there be a joint European fund? I see no compelling reasons why the costs of bank restructuring should be shifted entirely to the European level. You see: the weal and woe of a bank depends not only on the competence of its management but also on external factors: the quality of supervision; the financial and economic strength of its borrowers, which in turn hinges on a nation's economic policy; and also the fiscal policy of the country where a bank is based. Ample proof of this assertion is

provided by the fact that a bank's funding costs are dependent on the sovereign credit rating of its home country. Although we will be centralising supervision in Europe next year, other factors such as economic and fiscal policy will remain largely the responsibility of individual nations. And, as long as that is the case, the arguments for shifting losses completely to the European level do not appear to be compelling.

The Balance Sheet Assessment provided for by Article 27 of the SSM Regulation also acquires major significance in this context: this article requires the ECB to assess the portfolio quality of the banks it will be supervising in future. What the regulation does not say, however, is what happens if hidden losses are disclosed. I have two things to say about this.

I consider the Balance Sheet Assessment to be very important. For it to be successful, we should base our assessments of banks' balance sheets not only on supervisors' judgements. We should also enlist outside specialists – external auditors – for a quantitative assessment. Not only in order to restore market participants' confidence in the European banking industry, but also to minimise reputational risk for the ECB. All supervisors in Europe are familiar with ad hoc examinations. These are precisely the instruments we should be using here. This is the only way we can avert the suspicion of national supervisors taking too much account of national special circumstances.

My other remark follows on directly: it concerns the legacy risks of banks supervised under the SSM. As these risks were created in the past, under the responsibility of individual member states, they should be borne in a national context, too.

6. Changes to primary law

I have twice mentioned changes to primary law in the context of the banking union: once referring to the SSM and again with regard to the SRM.

I am indeed aware that many are recoiling at the thought of changing primary law, as it is a long and winding road. Ultimately, however, the project of creating a banking union is similar to the creation of the single monetary policy. And, we did things properly then and started by establishing a sound legal foundation. If it was good enough for establishing a monetary union, it will be good enough for a banking union.

That notwithstanding, I think the SSM and a restructuring and resolution mechanism should be launched prior to changing EU primary law. However, we should start working on amendments to primary law right away, given the foreseeable difficulties and the amount of time this endeavour will probably take.

7. Significance of the single supervisory mechanism to the Bundesbank

While I am here with you today, the ECB is visiting my colleagues at the Bundesbank to put on a "road show" extolling its virtues as an employer. As Goethe's Faust put it: "Two souls, alas! are dwelling in my breast" – as much as I look forward to a single supervisory mechanism, to the success of which many of my fellow Bundesbankers will be instrumental, I will be very, very sorry to have to do without them at the Bundesbank. The SSM, after all, is designed in such a manner that the quality and expertise of national supervisors will continue to be the decisive factor.

This constituent of the EU – the principle of subsidiarity – will have a place in the banking union, too. Nonetheless, themes relating to banks and their supervision and resolution will acquire a new European dimension. And, as long as it is done well, this is as it should be.