Yves Mersch: The single market and banking union

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the European Forum Alpbach 2013, Alpbach, 29 August 2013.

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Ladies and gentlemen,

Thank you for inviting me to speak today at the Alpbach Forum. The topic of my remarks will be Banking Union, and in particular the role of Banking Union in supporting the Single Market in Europe.

Governments have recognised that certain powers need to be at the European level for a Single Market to function. But what we have seen in the crisis is that we do not yet have the right powers at the European level to support a Single Market in *capital*. When placed under stress, financial markets in Europe have renationalised, with negative effects on the Single Market in goods and services as well.

We see Banking Union, therefore, not only as a necessary complement of monetary union but also as a way of putting in place the necessary institutions, rules and instruments to sustain a genuinely single financial market. These include a single supervisory mechanism (SSM) – and a single resolution mechanism operating under a harmonised resolution framework. And I would like to use the main part of my remarks today to highlight three specific channels where I think Banking Union can be strongly positive for the Single Market.

First, by encouraging greater cross-border banking integration.

Second, by increasing confidence in banks' balance sheets.

Third, by helping to break the bank-sovereign nexus.

Channel 1: Encouraging cross-border banking integration

Starting with the first channel, we expect Banking Union to play an important role in boosting financial market reintegration in Europe and the creation of a truly European banking sector. Ideally, we would like to see a situation where, if the Spanish SME cannot borrow at reasonable rates from a Spanish bank, it would be able to borrow from an Austrian bank instead. This is what a Single Market in capital means.

Banking Union can facilitate this by creating the same standards for banks across Europe. Let me point to three developments which may encourage banks move out of their domestic markets.

First, we are harmonising technical approaches to supervision, which will reduce compliance costs for banks and increase comparability across borders. Every bank that is part of the SSM will be supervised according to a single supervisory model and use the same data reporting template.

Second, we are building a single supervisory culture, which will provide a basis for genuinely European banks. It will take time, but we are moving from a system where we have multiple different supervisory cultures, with multiple different philosophies, to a system where we have only one.

Third, we expect supervision to be practiced with a European view as stated explicitly in the regulation, which will make liquidity between countries more fungible. We saw during the crisis that some supervisors required their banks to match national assets with national liabilities, which had the effect of fragmenting the Single Market. But in the SSM, national borders would simply be the wrong frame of reference.

Some of you may be wondering whether these changes will really support the Single Market, or simply create a "market within a market", with countries that join the SSM divided from those that do not. I do not see this as a real risk.

The introduction of the Single Currency did not impair the Single Market either. And that was a far more radical change than establishing a single supervisor.

With respect to the SSM, the European Banking Authority (EBA) has a crucial role to play in ensuring that there is a level playing field across the whole EU, and I am confident that the SSM will in fact reinforce its ability to do so.

To begin with, the EBA will remain responsible for developing regulatory policy and technical standards that will form the basis of a single rulebook for banks across Europe. The creation of the SSM should help this process, as having a significant number of countries participating in the SSM will reduce the scope for coordination failures, thus making the EBA's coordination function easier.

The EBA is also currently developing a supervisory handbook which reflects best supervisory practices across the EU. The ECB is cooperating with the EBA to ensure that its own supervisory manual and the EBA handbook are consistent. Here again, the existence of the SSM has the scope to help the EBA's work, as all SSM members will naturally converge in their supervisory practices.

In short, when I talk about a genuinely European banking sector, I see this as consistent with the Single Market. And in any event, I hope that, over time, such a distinction will not be necessary as most EU countries will join Banking Union.

Channel 2: Increasing confidence in banks' balance sheets

Turning to the second channel where I see that Banking Union can help support the Single Market, investor confidence has been damaged by the perception that some supervisors have not been tough enough with their domestic banks. The average price-to-book ratio of large and complex banking groups in the euro area, for instance, is currently only 0.5, which implies that investors think banks are overvaluing their assets, will not meet their required rates of return, or will require new capital. And trust tends to be lower in some jurisdictions than others, creating fragmentation, as shown by certain banks' lack of access to market funding.

How will Banking Union help restore confidence across countries? In general, we hope that the SSM will bring about a regime change in supervision and increase trust by creating more stable banks. But this is more a forward-looking consideration. The immediate challenge is to address the concerns about banks' balance sheets that are already there. And this is why the ECB is putting a great deal of importance on the balance sheet assessment we are required to conduct for those banks that we will directly supervise.

The methodology for this assessment is currently being designed and we want it to be rigorous. We also expect to use external consultants to ensure a credible exercise. It is essential for us that at the end of the assessment we have a clear picture of the real situation in the sector – both to allay market concerns, and to be able do our job properly as supervisor.

I will not go into greater detail at this stage on the methodology or timing, as many decisions can only be made when the SSM Regulation is approved by the European Parliament and the SSM's Supervisory Board is appointed. But let me add one qualification: the exercise may reveal capital shortfalls, and we need to know how they will be filled. Without solid backstops in place, I fear markets will not see the exercise as credible as they will expect the results to be fudged. While I am pleased that the European Council in June acknowledged this issue, it called for backstops to be in place before the assessment is *completed*, which leaves too much room for uncertainty. Backstops need to be in place before the assessment has *begun*. Put simply, if there are no backstops, there will be no assessment.

If as we hope the Parliament adopts the Regulation at its plenary session on 9–11 September, the Supervisory Board should be established as soon as possible, and we have to overcome bureaucratic hurdles. If it takes until the first quarter of next year to have the full-fledged Supervisory Board in place it will be quite challenging to have the SSM itself operational one year after the entry into force of the legal act, the earliest date foreseen by the regulation.

Channel 3: Breaking the bank-sovereign nexus

Let me now turn to the third channel where I think that Banking Union can support the Single Market in capital, and that is by – at least partially – breaking the bank-sovereign nexus.

This nexus has a number of aspects, but the most relevant for the Single Market is the connection between the fiscal strength of the sovereign and the funding costs of banks. In general, banks with stronger sovereigns can fund more cheaply as they benefit from an implicit sovereign guarantee. This leads to lower borrowing costs for firms located in that territory.

The key to creating a level playing field in Europe is therefore to reduce the capacity of sovereigns to intervene in failing banks – while allowing those banks to fail in an orderly manner. And this has now been set in motion with the agreement by the EU Council on the Bank Recovery and Resolution Directive, which provides a harmonised legal framework for resolution across the whole EU.

This Directive – which still needs to be agreed with the European Parliament – makes bail-in rather than bail-out the first line of defence if a bank does not manage to recapitalize via the market. Sovereigns will not be allowed to step in when resolving a bank until private investors have first taken a hit. Specifically, under the Council agreement, banks can only be recapitalised with resolution financing arrangements, such as a resolution fund, after a minimum level of bail-in equal to 8% of total liabilities has been imposed on shareholders and creditors.

I welcome this focus on bail-in, as it should encourage investors in all banks to price risk properly, rather than expecting only reward. But there are also some details about the use of bail-in in the Council agreement where I am more critical, mainly because I fear they will slow down the process of reducing fragmentation.

First, bail-in would only be available in January 2018 at the latest, which in my view is too late. As the Directive will enter into force in January 2015, it means there would be a gap of up to three years where a key resolution tool cannot be used. The risk is that this leads to *ad hoc* national solutions which create unevenness across the Single Market.

Second, the possibility for discretionary exclusions from bail-in is too great. The ECB has taken the position that categories of liabilities that could be excluded from bail-in should be well-defined upfront, with limited discretion to take into account financial stability and macroeconomic concerns. But the Council agreement allows considerably more discretion for national resolution authorities. This creates a possibility for those authorities to exclude certain creditor classes due to national political economy concerns, creating uncertainty for investors about how bail-in will in fact be applied.

To ensure consistency in the Single Market, in my view only two options for applying the resolution framework are really possible. Either we have national resolution authorities taking decisions with very limited discretion; or we have a central resolution authority taking decisions with some discretion. I see the current agreement – decentralisation plus discretion – as the wrong combination.

One solution to this, at least for countries that participate in the SSM, is the creation of the Single Resolution Mechanism (SRM) to centralise resolution decision-making. The Commission recently released its proposal for such a mechanism based on Art. 114 TFEU, and the ECB supports the main elements of this proposal. In particular, it meets what we consider to be the three essential requirements for a credible SRM: a single system, a single authority, and a single resolution fund. And we strongly support the timeline put forward by the Commission, which would see the SRM entering into force in January 2015.

On the key issue of how the SRM takes decisions, we support the Commission's idea to establish a central resolution Board based on majority voting. To be effective in dealing with cross-border banks, and to be consistent across different countries, the resolution authority must be able to make independent decisions in the European interest, and this is not possible if national vetoes remain. We agree with the Commission that all this can be achieved without a change to the Treaty.

This generally positive assessment notwithstanding, there are some areas where we think the proposal could still be improved.

First, in our view, determining when a bank is failing or likely to fail should be the sole competence of the supervisor. Under the current proposal, the Commission can also decide to trigger resolution on its own initiative. We think that the new system should have a clear allocation of responsibilities.

Second, we disagree with the proposal to put a voting member of the ECB in the Board of the SRM. It is better to maintain a clear functional separation between supervision and resolution and avoid potential conflicts of interest.

Third, the State Aid framework is important in defining common parameters for national public support within the context of bank resolution across the Union. But its application should not unduly delay or supersede resolution measures, by which financial stability could be at risk. We have to bear in mind that once the SRM is fully operational, resolution decision will be taken at Union level, thus preserving a level playing field and respecting the single market. Let us also keep in mind that we operate in principle with the funds from the private sector.

Fourth, indeed only in exceptional cases do we see temporary access to fiscal resources as a helpful element of the SRM's backstop arrangements. Remember the proposal from last year's Four Presidents' Report on a Genuine EMU, which suggested a credit line from the European Stability Mechanism (ESM) as a possible option for euro area countries while fiscal neutrality will be respected in principle.

How does ESM direct bank recapitalisation fit into this framework? The answer is that it is the very last line of defence: it can only be used after bail-in has been exhausted, and only when going via the national budget would seriously damage a country's fiscal sustainability. As such, it helps break the bank-sovereign nexus, but once agreed will operate within the new bail-in framework. The "new normal" remains that, wherever possible, the private sector pays.

Conclusion

Let me now conclude.

A successful policy regime is based on an effective accord of rules, institutions and instruments. We have this for the Single Market in goods and services, where the rules are laid down by EU legislation, the Commission oversees them, and it has various instruments, like infringement proceedings, to enforce its decisions.

And we now need to build a similarly effective regime for the Single Market in capital. We already have some new rules in place, for instance on capital requirements. We are on the verge of agreeing to a new mechanism for supervision. But now we need to make sure that we have a strong authority for resolution, and that it has proper instruments to do its job, like the bail-in tool from 2015.

Willy Brandt once said that “what we want is a Europe of daily reason and of common sense, and we must be prepared to state this and, where necessary, to act.” It is my conviction that Banking Union is one of the clearest examples of where elevating powers to the European level is common sense: it brings benefits for citizens, who have a safer banking sector; for banks, who have a more consistent environment; and for governments, who are less liable for bailing-out.

And so act we must.

Thank you for your attention.