Pentti Hakkarainen: Banking union – where do we stand in the Single Supervisory Mechanism?

Key talking points by Mr Pentti Hakkarainen, Deputy Governor of the Bank of Finland, at the working luncheon of the EU Ambassadors, Bank of Finland, Helsinki, 12 December 2013.

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Accompanying slides can be found on the Bank of Finlands' website: Slides (PDF).

We have experienced a series of different types of crises since 2008. Each of them has had devastating effects on the real economy. What have we learnt?

The crises have made it very clear that a highly interconnected financial sector requires a stronger institutional framework than what we currently have.

A problem at one bank can quickly spread to other ones both at home and beyond national borders with damaging effects on the real economy and taxpayers. The financial crisis led to a sudden stop of capital flows within Europe, as banks withdrew from foreign operations and financial integration took serious setbacks. By 2010, it became desperately evident that the bank and sovereign risks are tightly interconnected with two-way causality.

The key lesson we have learnt is that financial crises have devastating effects on the real economy, taxpayers and the whole society. Recovery from a crisis is always painfully slow and long-lasting.

Financial trilemma

All in all, the mismatch between the scope of international bank operations and the national supervisory framework made the situation extremely challenging. With the overarching objective of financial stability in mind, the situation can be described as "financial trilemma", as Dirk Schoenmaker has proposed.[1]

In principle, you can envisage three solutions to the financial trilemma. First of all, we could re-nationalize the financial markets. In such a solution, the single market as well as the single currency and single monetary policy would be lost. Second, we could just accept the risk of financial instability. Or finally, we could work to create a banking union, with 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.

Banking Union

In June 2012, EU leaders agreed to deepen economic and monetary union as a remedy for the crisis, including 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 provisions, such as binding standards developed by the European Banking Authority. The rulebook leaves, however, some leeway for national authorities to impose stricter requirements at the national level for macro-prudential reasons, such as containing real-estate bubbles.

The greatest progress has been achieved in the field of the Single Supervisory Mechanism. In November, an EU regulation came into effect assigning supervisory competencies to the

[1] Dirk Schoenmaker (2011) "The financial trilemma", Economics Letters 111, 57–59.

European Central Bank (ECB). When the ECB will assume its supervisory tasks next year, it will have two clearly separated functions – monetary policy and banking supervision.

Another important pillar of the banking union is the Single Resolution Mechanism. As you know, intensive talks have been going on among Member States on this field. In addition, deposit insurance schemes will be strengthened and harmonised as part of the banking union. In the future, the Banking Union, when properly implemented, will help us avoid using taxpayers' money for bank bail-outs.

The Banking Union may also be complemented by structural reforms, as suggested by the High-level Expert Group on reforming the EU banking sector.[2] The European Commission is currently finalising its stance on the issue, and further proposals are expected in the near future.

Preparations for Single Supervisory Mechanism

Today, I would like to focus on the status of preparations for the Single Supervisory Mechanism (SSM). The EU Regulation assigning supervisory tasks to the ECB became effective in early November. Already well ahead of this time, the ECB and national supervisors started practical preparations to ensure timely adoption of supervisory responsibilities by the SSM.

As a concrete step, the ECB Governing Council nominated Ms Danièle Nouy, the current Secretary General of the ACPR, the French supervisory authority, for Chair of the Supervisory Board of the new Single Supervisory Mechanism. Her nomination was confirmed yesterday by the European Parliament. A broader recruitment process for supervisory management positions has also been launched by the ECB.

The Supervisory Board of the SSM is now about to start its activities as soon as possible, most likely early next year. Before the ECB assumes its supervisory responsibilities, 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. Before the assumption of the SSM supervisory role, the results of the Comprehensive Assessment and possible corrective measures for banks – where necessary – will be disclosed.

In November 2014, the ECB starts to directly supervise significant banks – in close cooperation with national supervisors. In addition, while other banks continue to be supervised by national supervisors, the ECB can assume direct supervision of any one of credit institutions in order to ensure consistent application of high supervisory standards.

Comprehensive Assessment

The Comprehensive Assessment is an essential element of the preparations for the SSM, also stipulated by the regulation assigning the supervisory responsibilities to the ECB (also known as SSM Regulation). It should be noted that the SSM Regulation not only requires the ECB to carry out the comprehensive assessment, but it also enables the ECB to obtain all the relevant information from the national authorities necessary for making the assessment.

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 implementing necessary corrective actions where necessary. Finally, the Comprehensive assessment

[2] See High-level Expert Group on reforming the structure of the EU banking sector, Chaired by Erkki Liikanen, Final Report, Brussels, 2 October 2012.

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. 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.

The Comprehensive Assessment is a truly huge effort, involving around 130 banking groups, with a very large coverage in the euro area. For Finland, the Assessment will cover three main banking groups, OP-Pohjola Group, Nordea Bank Finland Oyj, as well as Danske Bank Oyj.

The Comprehensive Assessment comprises three main pillars: First, a Risk Assessment Exercise addresses key risks in the banks' balance sheets, including liquidity, leverage and funding. Second, an Asset Quality Review examines banks' balance sheets based on information at the end of 2013. Third, a Stress Test complements the asset quality review by providing a forward-looking view of banks' risk-absorption capacity under stress.

The structure of the Comprehensive Assessment also clarifies the frequently asked question on the differences between the exercise and previously conducted EU level stress tests with clearly identified problems. The key difference is that the separate risk assessment exercise and asset quality review are conducted before the stress-test, applying common definitions. Three targets can be achieved:

- Banks' risks and asset quality are assessed in a comprehensive manner at the Banking Union level. Assessments are made applying common definitions, not allowing for 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.

In addition, a critical approach will be taken in stress-testing on banks' internal models and their own assessments on performance.

The ECB will conclude the Comprehensive Assessment in October 2014, before assuming its supervisory role. 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. Such measures could include, for instance, recapitalisation, also through profit retention, equity issuance, re-orientation of funding sources, asset separation and sales. The Member States will make appropriate arrangements for ex ante availability of national backstops to be used only in case if private sources of capital are insufficient for corrective measures.

Other preparatory work for SSM

Alongside the Comprehensive Assessment, a lot of preparatory work is on-going for the SSM supervision.

The SSM Supervisory Model is the heart of the structure of the SSM activities. For supervisory issues, the ECB decision-making structure is different from the monetary policy. Following the legal provisions, all key decisions are to be finally approved by the ECB Governing Council. However, as regards supervisory matters, the new Supervisory Board will have a predominant role. The Board will provide the Governing Council with a draft decision, and the Governing Council approves it through a so called non-objection procedure. This procedure also helps keep monetary policy and banking supervision separate within the ECB.

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.

The SSM Regulation requires the ECB to take on the direct supervisory role for banks which are deemed "significant" under its provisions. For the identification of significant institutions, mapping of euro area banking systems is necessary. This exercise involves surveying banking group structures and collection of the data on relevant banking groups.

For the legal dimension of the SSM, preparations include development of the so called Framework Regulation on covering cooperation within the SSM, among other things. In this respect, a public consultation is expected to take place during first half of 2014.

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

Banks' perspective on SSM

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. 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 other supervisors. High-quality supervision will benefit those banks acting prudently and with most efficient business structures.

Macroprudential policy

Finally, I would like to point out that alongside the preparations for the SSM, a new systemic angle has been added to supervision. Also through the new EU capital requirement legislation, macroprudential policy is becoming effective in the EU.

Macroprudential policy is about identifying, preventing and mitigating systemic risks through the application of macroprudential instruments. A key macroprudential instrument to be included in the toolbox of authorities in the EU is the counter-cyclical capital buffer. The relevant authorities may require banks to hold an extra buffer of capital in addition to minimum requirements, for instance if credit growth in the financial system is deemed excessive.

Macroprudential policy responsibilities lie in the first place with the national authorities, but 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.

As a conclusion, I would like to end my presentation on a positive note, based on the fresh news we have heard from the Ecofin meeting held the day before yesterday. Discussions about the Single Resolution Mechanism seem to be progressing, and we can expect some good results from Brussels next week.