Pentti Hakkarainen: Banking union – any national interests?

Key talking points by Mr Pentti Hakkarainen, Deputy Governor of the Bank of Finland, at the working luncheon of the Bank of Finland – OMFIF Economists Meeting, Helsinki, 6 February 2014.

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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 at least that international, highly interconnected financial markets require a stronger institutional framework than what we have had in recent years.

A problem in one bank can quickly spread to others both at home and beyond national borders with damaging effects on the real economy and taxpayers. We saw a sudden stop of capital flows within Europe, as banks withdrew from foreign operations. The financial integration took serious setbacks.

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.

Banking union

As a 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 provisions, such as binding standards being developed.

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 are currently going on the issue. 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 the European Parliament will handle it in the future.

In the future, the Banking Union, when properly implemented, will help us resolve banking problems while avoiding using 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, the ECB and national supervisors started 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 as well. A broader recruitment process of supervisors is under way.

The Supervisory Board had its historical first meeting last week, accepting and confirming a lot of 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 wants. 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.

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 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. Such measures could include, for instance, recapitalisation, also through profit retention, equity issuance, re-orientation of funding sources, asset separation and sales.

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.

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 include the 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 their supervisors. To this end, a high-standard data reporting framework and the associated infrastructures for the SSM are being developed.

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.

Macroprudential policy

Finally, I would like to point out that alongside the preparations for the SSM, a new systemic angle is being 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; not only central bankers but also other public authorities are showing great determination in developing the Banking Union and 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 aligned with the general objectives of the Banking Union.