Yves Mersch: Institutional overhaul of the euro area – progress and remaining challenges

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at a conference, organised by the Association Européenne de Droit Bancaire et Financier Luxembourg, Luxembourg, 5 May 2014.

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Ladies and gentlemen,

It is a pleasure to be with you today to discuss the institutional overhaul of the euro area, a few days ahead of the "Europe day" commemorating the Schuman declaration of 1950.

Introduction: from Schuman to Delors

With this declaration, Robert Schuman set the path towards the creation of the European Coal and Steel Community, the first of a series of supranational European entities that would ultimately become today's European Union.

The aim of this initiative was clear from the outset, as put in Schuman's words: "In this way, there will be realised simply and speedily that fusion of interest which is indispensable to the establishment of a *common economic system*; it may be the leaven from which may grow a wider and *deeper community* between countries long opposed to one another by sanguinary divisions"[1].

Less than forty years later, the Delors report which laid out the rationale and framework of Economic and Monetary Union followed a similar logic. Beyond its economic motivations, the introduction of the euro had also a political dimension: by setting up a *common Economic and Monetary system*, the founding fathers of the euro strived to create a *deeper community* among euro area Member States.

Due to the severity and duration of the current economic crisis we tend to forget that the euro – as a broader *political* project – has been and remains very successful. The geopolitical turmoil at the doors of Europe reminds us that political stability and security should not be taken for granted.

This does not mean that the title of today's conference has lost its relevance. On the contrary: the crisis has shown that in order to reap all the *economic* benefits of the euro – and more generally of the Single Market –, a number of reforms have been necessary. In adopting these reforms, a delicate, yet essential equilibrium has to be found between those who wanted to follow the path of further integration and those wishing to remain outside. But both dimensions, the euro area on the one hand and the broader EU on the other hand, are not incompatible. Indeed, a strong Single Market is essential for a well-functioning single currency. Reciprocally, putting the euro area on a stronger footing is important for the euro area itself but also benefits the countries that do not share the euro.

At the eve of the European elections, it is good to assess the concrete progress achieved in the last five years in the field of the institutional architecture and common set of rules for the euro area and the EU at large. In the immediate future, it is of crucial importance to implement the new legislation as thoroughly as possible, both at European and national level. Only then will Europe be able to provide stability, growth and job creation. Looking at the next legislature, further legislative action is necessary to complete the Single Market for

[1] "The Schuman declaration", Robert Schuman (9 May 1950, Quay d'Orsay, Paris).

financial services. In the longer term, reflection is warranted on how to further develop the institutional framework of the euro area.

The EU, and the euro area in particular, has drawn the right lessons from the financial and sovereign debt crisis

The crisis has painfully brought to light the ***shortcomings in the implementation of the Maastricht Treaty***. First of all, it was believed that European rules, together with pressure from the financial markets, would be sufficient to ensure fiscal discipline on the part of Member States while budgetary competences remained at the national level. Second, the emergence of macroeconomic imbalances was not monitored sufficiently as coordination of economic policies was considered to be a secondary objective. Third, there was no coherent strategy in terms of harmonisation of rules and surveillance of the financial sector. Finally, no European crisis management framework was in place when the sovereign debt crisis struck.

However, the crisis has provided the occasion for the euro area, and the EU at large, to equip itself with new instruments to address these weaknesses. Two key principles have guided the crisis response: self-responsibility and solidarity.

In line with the first principle, the six-pack, the two-pack and the Fiscal Compact have made the ***economic and fiscal governance framework*** more commensurate to the requirements of a monetary union. The Commission and the Council now dispose of tools and procedures to allow for the early recognition and correction of excessive macroeconomic imbalances and unsound fiscal policies. Most importantly, the new framework is completed with a set of more automatic sanctions in the event of a Member State deviating from agreed benchmarks.

In line with the second principle (i.e. solidarity), Member States have created a crisis management framework to deal with Member States losing market access. With the European Stability Mechanism (ESM) and the two-pack, both a ***permanent funding instrument and a governance framework*** have been created. A few days ago, the ESM has reached its target level of €80 billion in paid-in capital. The exit by Ireland and Portugal from their EU/IMF programme shows that reform efforts and sacrifices are bearing fruit.

Beyond these economic governance reforms, and reflecting the lessons drawn from the financial crisis, significant progress has been achieved with regard to financial sector policies, both in the EU as a whole and in the euro area.

First, in the late 2000s it became clear that the ***financial sector had to be put on a safer and more resilient footing.*** To this end, EU legislators adopted the Capital Requirements Regulation (CRR) and Capital Requirements Directive (CRD) in April 2013: this was an essential step towards strengthening the stability of the banking sector and thereby preventing future crisis. More recently, the Bank Recovery and Resolution Directive (BRRD) was agreed upon. To comply with the new rules of the BRRD, banks across the EU will have to develop in a harmonised way recovery plans, cooperate with resolution authorities and make necessary changes to capital holdings, business activities, legal and operating structures. Finally, harmonised standards for deposit guarantee schemes have been introduced.

The four pieces of legislation just mentioned apply to the financial system in the EU at large: this is key to ensure a ***level playing field within the Single Market***. Taken together, these new rules constitute the ground floor of the European "house" for financial services.

The euro area Member States decided to build an additional floor in this common house by creating the banking union. They are currently in the process of setting up powerful institutions for the supervision and resolution of their banks at the European level. Many will agree with me if I say that this project is the most significant step forward in the integration of European financial markets since 1999. It is an indispensable complement to the single currency and should contribute to addressing the adverse feedback loop between banks, public finances and macroeconomic conditions. It should also help to reduce the fragmentation of euro area banking and money markets and thereby facilitate the transmission of the ECB's monetary policy.

The first element of the banking union, which is ***the Single Supervisory Mechanism***, will soon be fully operational. On 4 November this year, the ECB is set to start directly supervising about 130 significant banks in all euro area Member States. All smaller banks will continue to be supervised by national supervisors, however subject to the single supervision framework enacted by the ECB. We are working very intensely to meet this deadline, together with the national competent authorities in all euro area countries. In order to ensure a clean and sound start, the ECB has also designed a comprehensive assessment to restore the health of the banking sector and confidence in it. As announced by the ECB on 29 April, banks will be expected to cover capital shortfalls within six to nine months after the disclosure of the results. The EBA will be closely associated to this exercise which has to be fully in line with the Single Market to ensure that the EU financial system as a whole will be revitalised.

Let me also say a few words about the second element of Banking Union that has been agreed in March: ***the Single Resolution Mechanism***. The SRM, together with the rules of the BRRD, will provide a comprehensive framework allowing banks to be wound down in an orderly way in the future. If the resolution of a bank requires additional resources after bail-in, they will not come from public budgets but from a fund that will be financed by the banking sector. Such a system will shield taxpayers from having to pay again for the mistakes made by private banks.

Both elements of the banking union ***remain open to Member States*** which do not share the single currency. In other words, any co-owner of the house willing to participate in the construction of the additional floor is welcome to join. Forming part of strong and unified institutions for supervision and resolution clearly have direct benefits also for Member States that have not (yet) joined the euro area.

Those wishing to stay on the ground floor are free to do so. At the same time, I see it is very much in their interest that a solid floor is being built upstairs as they would immediately feel the consequences of a weak construction. The crisis has shown that financial instability in the euro area can negatively affect non euro area Member States.

Of course, safeguards have to be implemented to ensure consistency between this new construction and the ground floor – and thereby stability and harmony in the whole house. This is what has been done with the revision of the EBA regulation simultaneously with the adoption of the SSM regulation. The banking union project is about reinforcing, not dividing, the Single Market. However, such safeguards, which do have a bearing on the design of euro area integration, should not prevent euro area members from taking the decisions that are necessary for the smooth functioning of EMU.

To sum up, a lot has already been done over the past five years to draw the lessons of the financial and sovereign debt crisis. But this is not the end of the process.

As most of you are lawyers, you know very well that once legislation has been enacted, implementation by the relevant authorities is equally important. At the European level, the agreed tools and procedures have to be fully enforced by the Commission and the Member States. This applies in particular in the field of economic governance. At the national level, Member States have to adjust their ***domestic regulatory framework*** to the new European environment. Enjoying the benefits of being part of the banking union should come together with the adequate responsibilities. In some cases, the timeline for implementation is ambitious and requires speedy and determined action by national authorities: for example, the main provisions of BRRD need to be transposed until 31 December 2014. A number of Member States, including smaller ones, have to close a number of outstanding gaps and loopholes.

Further legislative action is necessary to complete the single market for financial services

Let me now turn to the next five years and the legislative agenda for the EU. I see a number of areas where further progress is required in order to complete the Single Market for financial services. This would benefit all 28 Member States: if I may use again the metaphor, solidifying the walls of the ground floor is in the interest of all co-owners. But it may be even more important for those involved in the construction of the additional floor, i.e. the euro area Member States.

Two major legislative proposals which are highly symbolic for citizens as an EU response to the crisis are now on the table and need to be carefully analysed against their potential benefits and drawbacks. Let me mention first the ***Commission's proposal on structural measures*** for banks. A few years after the start of the crisis, assessing the banking sector's structure and reflecting on how to make banks safer is essential. A coherent approach would contribute to reducing the potential fragmentation caused by different national structural regulations. Nevertheless, the devil is in the detail when implementing such reform, especially because the potential benefits are still untested. Second, in a different domain, the ECB shares only some of the objectives that have motivated the proposal for a ***Financial Transaction Tax*** (FTT), for example further integration of the single financial market and increased financial stability. However, as you know, the FTT is currently discussed among only 11 countries which have decided to enter into an "enhanced cooperation" on that specific issue. As all Member States will not be part of this arrangement, it should be ensured that the planned tax would not have unintended side effects such as hampering the transmission of the single monetary policy and the smooth functioning of settlement systems. In particular, a coherent approach with countries which are not part of the enhanced cooperation is vital to avoid regulatory arbitrage.

The crisis has also spurred discussions on how to better bring the financial sector back to its core mandate: ***being at the service of the real economy***. I strongly believe that more can be done to unlock affordable financial resources for European SMEs. As 99.7% of firms in the EU are SMEs, euro area economies' well-being is intertwined with the financial health of SMEs. By assisting banks' ability to fund and distribute risk the ***securitisation of SME loans*** could contribute to connect the financing needs of SMEs with the funds of investors who would otherwise not invest in those SMEs.. Looking forward, at least three steps are necessary. First, more work should be done to distinguish 'high quality' segment of the ABS market and make them more robust to market stress, thereby providing banks with a more resilient form of funding. Second, available data and general standards applied to all ABS should be further improved. Third, the regulatory treatment of securitisation should be revised to better reflect the risk-mitigating features of high quality securitisation and to address current inconsistencies in the legislation.

More generally – going beyond the notion of banking union, we should work towards creating an integrated financial market union that supports the real economy. This requires in particular two elements: developing cross-border capital markets offering a real alternative to banks' financing; and ensuring that banks are able to operate smoothly across borders and to undergo mergers and acquisitions without any national bias.

In this context, let me also focus on what is often referred to as the plumbing of the financial sector, that is, the ***Single Market for payment and cross-border securities settlement.*** Harmonisation is key to ensure that both the Single Market and the single currency function smoothly. The ECB has delivered an important contribution in this regard. In the early 2000s, the Giovannini reports identified 15 barriers to efficient clearing and settlement across national markets in the EU. For quite a long time, there was no progress in removing these barriers. This is about to change significantly with a common settlement platform and a common set of rules. TARGET2-Securities (T2S) will go live in June 2015 and will be the common securities settlement platform of 24 CSDs, both inside and outside the euro area, for settlement in central bank money. The CSD Regulation will enter into force in early 2015 and complement from a regulatory perspective what the single platform T2S ensures from a technical perspective.

Harmonisation is also essential with regard to ***retail payments***. This is an area where citizens can see the tangible benefits of the Single Market in their everyday life. Soon, we will migrate to the common European schemes that have been developed for credit transfers and direct debits. Whether you make a bank transfer within Luxembourg or from Luxembourg to, say, Finland or Portugal, this will not make any difference. The recent proposals of the European Commission for a revised Payment Services Directive and for an Interchange Fee Regulation should also be adopted swiftly. When implemented, they will significantly enhance integration in the market of card payments. That said, a lot remains to be done, including in the field of technical standardisation, to support that objective.

How to develop further the institutional framework of EMU

Allow me now to go beyond the area of financial sector policies and take a broader look at the future of the EU and in particular of the euro area. In 2012, the Report by the four Presidents of respectively the European Council, European Commission, the Eurogroup and the European Central Bank identified four building blocks of a genuine EMU: banking, fiscal, economic and political union. The banking crisis made the first building block, the "house" I referred to, a priority. However, we must not forget that much remains to be done on the three other construction sites.

In the longer term, it seems appropriate to reflect on the limits of the current framework in which we are evolving. A Treaty change could enlarge our horizon of possibilities.

As regards ***fiscal union***, the Four Presidents' Report mentioned the need for true oversight over national budgets. The consequences of misguided fiscal policies in a monetary union are too severe to remain self-policed. Beyond the recent reform of fiscal governance, the euro area centre could be endowed with veto rights over those national budgets that violate the European rules.

As regards ***economic union***, the euro area needs to achieve a higher degree of economic convergence, in terms of competitiveness, growth potential and flexibility. This is essential for each individual country and for the smooth functioning of the euro area as a whole. The framework for policy coordination should be made more stringent and enforceable at European level. At the same time, due attention should be paid to fostering national ownership of the necessary reforms.

Progress in these fields would require commensurate steps towards ***political union***. In view of the multiple geometries implied by the EU integration process, the need for an enhanced political dimension is even more pressing for the euro area. Sharing a single currency implies a substantial sharing of sovereignty and economic integration, going well beyond the requirements of a single market.

There are a number of possible options to enhance effectiveness and legitimacy of decision-making in the euro area. For example, a permanent Eurogroup President as the nucleus for a ***euro area Finance Ministry*** with proper analytical capacity and more autonomous decision-making powers could be a step in the right direction. This could be accompanied by stronger accountability towards the European Parliament, in particular for the implementation of the governance framework, for example in a euro-area sub-committee of the European Parliament.

Let me conclude by broadening again the scope of our discussion and coming back to the founding declaration of 1950. Going beyond the establishment of a *common economic system,* the EU project was from the beginning aiming at creating a *deeper community* of Member States. Recent progress in the financial and economic field should not make us forget that citizens also expect Europe to deliver on broader public goods such as ***internal***

and external security. The Single Market and the EU's "four freedoms" (i.e. free movement of goods, capital, services and people) have brought new challenges for law enforcement authorities. Moreover, the fragility of external security, especially at the borders of the EU, remind us that, as put forward by Schuman in 1950, "world peace cannot be safeguarded without the making of creative efforts proportionate to the dangers which threaten it". It requires going beyond the economic foundations of the European project.