Pentti Hakkarainen: Banking supervision and central banking

Speech by Mr Pentti Hakkarainen, Deputy Governor of the Bank of Finland and Chair of the Board of the FIN-FSA (the Finnish Financial Supervisory Authority), at the 3rd FIN-FSA Conference on "EU Regulation and Supervision", Helsinki, 5 June 2014.

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In her opening remarks, Anneli Tuominen, Director General of the FSA, touched upon a number of important questions concerning the costs and benefits of the banking union to the supervised banks themselves. I would like to follow up on this by asking how is the banking union beneficial from a central banking perspective?

In the euro area, the connection between the new supervisory mechanism and central banking is evident from the institutional set-up. The common Euroarea banking supervision, the Single Supervisory Mechanism (SSM) has been attached to the ECB, which will in November 2014 assume new supervisory powers. This solution – as opposed to establishing a separate European supervisory entity – follows largely the need to establish the SSM quickly within the limits of the current EU treaties.

We should not forget, however, that in many ways the ECB responsible for bank supervision is not the same ECB that is responsible for monetary policy.

The decision-making of the two functions have been purposefully kept separate and on supervisory matters the new Supervisory Board will have a predominant role, even if the Council must still approve these decisions afterwards.

The two functions will also have separate staff, restrictions on exchange of confidential information and are even located in separate buildings in different sides of Frankfurt.

So, apart from the institutional set-up, what does the banking union mean to the euro area and the European system of central banks? I would expect the primary benefits to relate to its impact on broader financial stability and the degree of European financial integration. Let me briefly touch upon each of these in turn:

- ***In the short-term, the ongoing comprehensive assessment of banks' balance sheets encourages euro area's ailing banks to return to full health.*** Balance sheet transparency and confidence in banks' capital levels will, in turn, contribute to the efforts to reduce the interdependence between banks and sovereigns.

To be clear, banking union is not a solution by itself to shore up highly indebted euro area economies back to financial and fiscal health. Addressing such problems require many additional efforts, not least of all political perseverance in implementing structural reforms in the affected economies themselves.

Similarly, the Banking Union will not directly limit the share of banks' assets tied to sovereign debt. Placing strict limits to banks' sovereign holdings would rather be a separate regulatory matter and would warrant careful, longer-term deliberations.

That said, the comprehensive assessment should enhance confidence in the European banking sector and add impetus to banks' efforts to improve their capital adequacy. In this respect, much has already been achieved in the run-up to the exercise. The improved confidence, in turn, promotes provision of healthy credit to the economy and thereby contributes to Europe's recovery prospects.

- ***From a longer-term perspective, the Banking Union will help us prevent and at least mitigate potential distortions and their destabilizing effects on the European financial markets.*** The SSM will be a key element in addressing banking sector risks before they materialize and, like the ECB in the area of monetary policy, lend credibility to national banking supervision by conducting it with a supranational perspective. I argue that this is a fundamental change in the culture of how European supervision and resolution are conducted. We move from national efforts to prop up domestic banks to appropriate pan-European supervision, i.e. to a system where the structure of decision making matches the international character of the banks and markets.

The change does not only include the improved supranational banking supervision, but also other elements. The SSM will be complemented by the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM). The new legal framework will allow early intervention in troubled banks. It will also make possible the bail-in of banks' shareholders, and so creditors help to dissolve the expectation that banks' resolution costs would fall on the tax payers. This new resolution regime is backed up by the cross-border risk-sharing via the single resolution fund, which will be financed by the banking industry itself. All this will alleviate concentration of the ultimate liability for troubled banks on any single sovereign. As an important result, the arrangements could decouple the banking industry from the fiscal condition of the sovereigns concerned.

Why does all this matter for the central banks? Financial stability and the central banks' key objective of price stability are obviously connected, both directly and indirectly through the real economy. But a stable financial system also fosters greater integration of the financial markets. And the more integrated the financial markets are in the euro area, the more effective will be the transmission of ECB's monetary policy decisions.

One of the features of the financial crisis was the impairment of this transmission mechanism as financial markets within the euro area started to fragment along the national lines. The interest rates faced by businesses and households diverged significantly between member states not only because of differences in their operating environment, but because banks' own borrowing terms were tied together with those of their home-country sovereigns.

In such circumstances, common monetary policy stance would also have different implications from country-to-country depending on the financial state of the sovereign. In the course of the crisis, reversing this financial fragmentation became an important policy question for euro area central bankers.

In thinking about the benefits of the banking union, we should also take a moment to think about the alternative. In theory, we could either (i) retain the status quo and accept the destabilizing features inherent in the pre-crisis financial system or (ii) reverse the past gains in European financial integration and revert our banking sectors back within their national borders.

From the perspective of a euro-area central banker, neither of these alternatives is desirable. As demonstrated by the crisis, the first option could cause devastating effects on the real economy with severe collateral damages. Without the steps taken in the past two years toward the banking union, the European financial market could lose its credibility as a deeply integrated and seamlessly functioning market.

As to the second option, I have already highlighted the interdependence between financial integration and common monetary policy. If the transmission of common monetary policy was restricted by national borders, its impact would be highly limited at best and destabilizing at worst. To a large extent, a nationally fragmented financial system could substantially set back other areas of European integration too, such as free movement of goods, services and labor.

Now, I've discussed why and how central banks benefit from the financial stability effects of the banking union. But the central banks themselves are, of course, integral part of the financial system and ***contribute to financial stability through their own actions***.

Here it is worth noting that, with the SSM, the ECB assumes responsibility for both bank-specific and system-wide prudential supervision. This means more systematic oversight of SSM-member states' overall financial stability, which is backed up by the set of macroprudential tools in the new capital requirement regulation and directive (CRR/CRD4). Where the primary responsibility for national macroprudential policy rests with the designated national authorities, the SSM regulation allows the ECB to call for stricter national measures based on its own independent analysis.

As with micro-prudential supervision, the benefit of ECB's oversight role is not only in the enhanced credibility, but also in the broader cross-country perspective inherent in the SSM's decision-making. This helps ensure that macroprudential policies are implemented in a consistent manner, thereby safeguarding the integrity of the EU's single rule-book.

At the same time, the additional oversight by the ECB limits the risk of the so-called inaction bias to ensure that systemic risks, where identified, are addressed in a timely fashion.

Furthermore, the macro-prudential tools allow targeted attenuation of national credit cycles, thereby also limiting heterogeneity in economic cycles within the euro area. This, in turn, helps support more balanced growth in the region and helps monetary policy to remain focused on the euro area aggregates.

Finally, let me admit that I have mainly focused on the banking union's impact largely from the perspective of a euro-area member state. The benefits of financial stability in the euro area will certainly be felt also outside its borders, but the overall balance of the banking union's costs and benefits may differ between its members and non-members. And having the banking supervisory and resolution regime fully effective only in the Euroarea – at least in the very beginning – would mean that the institutional arrangements do not fully correspond to the reality that banks can operate across national borders in Europe.

The banking union is open to members outside the euro area, but so far none have opted to join in. Should this remain so, the borders of the banking union would slice across our current, closely integrated financial markets in the Nordic countries. This raises the question how this level of financial integration can be sustained if the institutional supervisory and crisis resolution arrangements remain separate?

Although our current institutional set-up may not be optimal, we also have in the Nordic region long traditions of cooperation in financial supervision. If anything, the Banking Union should give us incentives to strengthen this cooperation and find collaborative working arrangements that help us to make the most of the Banking Union's benefits also at its borders.

The fact that most of us share the same EU-wide regulatory rule book (CRR/CRD4) and instructions for crisis resolution (the BRRD) provides a good basis for this. But we also need to make sure that our national financial stability decisions pay due regard to their effects on other countries.

Ladies and gentlemen,

The main benefit of the banking union is that through it we will correct one weakness in our European financial market structure; the supranational institutional supervision and resolution set-up will match to the real operational scope and scale of the banking industry.

In addition, let me summarize some key benefits for the European central banks;

- monetary policy transmission mechanism made more secured,
- prospects for financial stability and efficient functioning of financial markets are improved and
- we get a world class banking supervision in Europe.