Corporate Governance and Banking Union in a transatlantic perspective

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Session 4 - Implementing the Banking Union

16.00-17.30 Keynote speaker
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Keynote

Luc Coene

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1. Introduction

I am particularly glad to introduce the discussions of this panel today. Establishing the banking union constitutes a key step to reinforce the European integration and marks a major milestone in European history. The National Bank of Belgium strongly supports the banking union and its single supervisory mechanism which, if well implemented, will lead to a sound and robust supervisory model and will contribute to sever the link between the bank and the sovereign crises.

The banking union comprises three building blocks. The first one is the single supervisory mechanism. The second one, which is at least as important as supervision, consists in a common mechanism for the resolution of financial crises. The third one concerns the deposit guarantee scheme. These three blocks form, together, a coherent set of policies, which are difficult to dissociate in the long run, as it would imply a disconnection between decision making in supervision and fiscal responsibility. Yet, these three blocks, to function correctly, will also require more economic, fiscal and political integration in Europe.

Last week, political agreement was reached on the first of these three blocks: the single supervisory mechanism. A number of steps still need to be taken before the Regulation is adopted, but at least the work on implementing the single supervisory mechanism in practice can now start in earnest.

While we all know that setting-up a single supervisory mechanism - let alone a banking union - is a long and demanding political process, we also have to realise the series of conceptual, practical and operational challenges that will need to be resolved in order to achieve high-quality supervisory standards in all participating member states.

The National Bank of Belgium is in a very good position to discuss this topic today given the recent implementation of the so-called twin peaks model in Belgium. This move implied the transfer of all the bank and insurance supervisory activities from the former CBFA to the National Bank of Belgium in 2011.

The challenges to operationalise a single supervisory mechanism will obviously be incomparably more important in the banking union. The cross-border dimension tremendously complicates the implementation of the mechanism. Indeed, eventually, the National Bank of Belgium and the CBFA were only 500 meters away from each others, we were all working in the same jurisdiction, speaking the same languages, and were all accountable to the same people or authorities. This is not going to be the case when establishing the single supervisory mechanism.

In addition, while it took less than 19 months to implement the twin peaks model in Belgium, the single supervisory mechanism will face even tighter deadlines. There is a political will to go fast and the current crisis environment cannot accommodate protracted delays or a long period of uncertainty. Strong political will has allowed the SSM Regulation to be negotiated (at least at the Council level) in less than three months time since the original Commission proposals.

Obviously, this strong political will can be linked to the ongoing sovereign debt crisis in Europe, and to the political link that was made between, on the one hand, the unification of banking supervision at the European level and, on the other hand, the possibility for the European Stability Mechanism to capitalise troubled banks directly.

Yet, we cannot afford this desire and necessity to deliver quickly to become detrimental to the credibility of the mechanism. The legal and operational impediments will have to be addressed swiftly and decisively. Given the existing time and legal constraints, we have to set-up a mechanism which directly meets the objective of the banking union while still retaining sufficient flexibility for future evolution. The first elements that will be put in place will need to be solid, so that this further evolution can be built on solid foundations.

2. Objectives of the SSM

Improving the quality of banking supervision…

The launch of the SSM follows hot on the heels of other reforms of the European financial supervisory architecture. As recently as in early 2011, the European Systemic Risk Board and the European System of Financial Supervision were established. However, the launch of the SSM should have the ambition to be much more than just another episode in a series of institutional reforms.

In order to succeed in that ambition, we should focus on quality and credibility when setting up the single supervisory mechanism. We should eliminate any potential for home bias, aim to improve the quality and effectiveness of supervision and promote a European level playing field for the

European banking sector (or at least prevent disintegration). The mechanism should be include the right incentives, for supervisors and for supervised entities, and should not trigger moral hazard problems.

The focus on quality and credibility implies that the quality of supervision should be ensured in a steady state but also, and no less importantly, during the transition period, when the transfer of tasks from the national level to the European level is being implemented. Given the time constraints, the current crisis environment and instability, this will be a major challenge, but we are doomed to succeed.

… without affecting the independence of the ECB…

While focussing on the quality of the single supervisory mechanism, we should also remember that the new tasks conferred to the ECB should not be allowed to affect its capacity to carry out its other tasks and more in particular the conduct of monetary policy. Reconciling these two tasks is, however, not an impossible mission. Financial instability directly affects one of the channels of the monetary policy and as a consequence, the stability of the financial system is a prerequisite for the stability of prices. Similarly, monetary instability may strongly affect the resilience of the financial system.

… and subject to adequate accountability arrangements.

Finally, the system need to be clear and transparent in terms of accountability. This implies to clearly define the respective responsibilities of both national competent authorities and the European Central Bank and to align fiscal responsibilities as closely as possible to the envisaged allocation of tasks, in order to avoid the development of any form of moral hazard.

3. Translation of these objectives into a specific organisation for the SSM

In the rest of my speech, I will focus on the concrete translation of these three objectives: how to improve the quality of banking supervision, without affecting the independence of the ECB and subject to adequate accountability arrangements.

3.1. Banking supervision and the organisation of the ECB

Central level versus national level…

The organisation of the Single Supervisory Mechanism will be crucial to achieve these objectives successfully. National Supervisory Authorities now dedicate substantial teams to the supervision of the largest banking groups, and their expertise needs to be preserved. However, the ECB itself will also need to develop sufficient expertise to support its responsibility for the effective and consistent functioning of the single supervisory mechanism. The ECB can not rely on improvisation. Staff exchange will need to be promoted, but will not in itself be sufficient. Indeed, because of the relatively low thresholds, including any banks with a balance sheet of over 30 billion euros, a big number of banking groups, will be supervised directly by the ECB, with the assistance of the national authorities. It is of paramount importance that the ECB receives adequate resources, both qualitatively and quantitatively, to execute its new duties.

The direct supervision by the ECB will not be limited to consolidated supervision. It will also include solo supervision, not only in respect of the parent bank of a banking group, but also for all of the subsidiaries and branches of such banking groups, regardless of their standalone significance. Furthermore, for banks that are not part of a significant banking group, the SSM Regulation foresees a possible role for the ECB in the adoption of material decisions by the national supervisor.

This means in practice that thousands of decisions will need to be taken across the Single Supervisory Mechanism. The challenge is now to organise the SSM in a way that does not overburden the ECB with administrative processes which might distract it from carrying out its main tasks which is identifying major risks to banks, supervising them, and ensuring that they are sufficiently resilient to cope with these risks. This also could turn a system which should be risk-based in a system that eventually become compliance based.

The existence of this risk pleads not only for a strong coordination between national supervisory agencies and the ECB, but also for the devolution of certain tasks and responsibilities to national competent authorities. If we want to achieve a system that remains manageable we have to make sure that national authorities carry out part of the job.

… internal organisation of the ECB…

The second governance question, next to the relationship between the ECB and the NCAs, is the question of the internal governance of the ECB.

In this respect, the choice to establish the SSM without treaty change somewhat constrains the possible governance arrangements of the SSM.

First, the Treaty did not expressly anticipate a "supervisory mechanism" that consists of the ECB and the national competent authorities. This is in contrast to the Treaty provisions on monetary policy, which have created the "Eurosystem", with a clear allocation of responsibilities and a clear decentralisation principle for the conduct of monetary policy.

Second, under the Treaty, the ECB has only two decision-making bodies: its Governing Council and its Executive Board. As soon as we confer the supervisory responsibilities on European credit institutions to the ECB, decisions taken in accordance with these powers need to be endorsed somehow by these bodies. The establishment of a new Supervisory Board within the ECB is an important element in the design of the single supervisory mechanism, where no distinction will be made between eurozone countries and participating non-eurozone countries. The SSM Regulation goes even further, and installs a 'Mediation Panel' to resolve differences between the Supervisory Board and the Governing Council. However, I believe that the concerns of the 'out' countries can not be limited through complex governance arrangements only. Equally essential is our commitment to the single market.

It is obviously of the utmost importance to ensure the legal soundness of the single supervisory mechanism. It would be a disaster if a decision of the ECB, legally challenged by a credit institution supervised by the SSM, was declared void or annulled, just because the SSM would rest on a shaky and contestable legal basis or be contrary to the Treaty. Such an outcome would definitely block the whole system and lead to prolonged uncertainty.

… *and link between monetary policy and supervision.*

Finally, while the discussions on the organisational structure of the SSM have focused on the necessary separation between the monetary policy and the supervisory function the benefits of synergies between these two functions deserve to be recognised. Under the Treaty, the primary objective of the ECB is the stability of prices, and this will not change. However, as I said in my introduction, both functions are, in the long run, necessary complements, and at the end of the day, the Governing Council will be accountable for the efficient conduct of both policies. Therefore, there should be a close interaction between the supervisory and monetary policy functions within the ECB and the organisation of tasks should allow for synergies between the two functions. An example of synergies would be the assessment of the financial soundness criterion for both the access to monetary policy operations and Emergency Liquidity Assistance. Yet it is true that there might also be trade-offs in the short run, especially in times of crises. The way these trade-off will need to be addressed in the future deserves further attention.

3.2 Macroprudential policy and role of national authorities

The steps towards the banking union will also have implications on the conduct of macro-prudential policies. Before the financial crisis, no specific attention was devoted to the creation and the building-up of systemic risks. Banking supervision was mainly micro-based. The current financial crisis has however highlighted the need to develop adequate macro-prudential policies, including institutional structure and instruments. In my foreword to the NBB's 2011 annual report, I wrote that "*The financial crisis clearly revealed the limits of the conventional division between microprudential supervision, focusing on individual financial institutions, and macroprudential supervision of the stability of the financial system as a whole*."

The question which arises in the current discussion related to the SSM is therefore how should this important component of the financial supervision be integrated in the new framework.

In designing adequate macro-prudential policies in the new European banking framework, I am convinced that, as it is the case for supervision, there should be an adequate and optimal coordination between the centre and the national designated authorities.

Despite the creation of the SSM, the national component remains important in macro-prudential policies. Indeed, not only are national authorities expected to have a better knowledge of their own financial system, but more importantly, financial cycles might vary considerably across countries as highlighted by the current financial crisis. The implementation of macro-prudential instruments should, therefore, be at least differentiated across countries. Furthermore, given the fact that the current euro area has not yet reached its final level of integration, it is important to maintain some instruments at the national level to balance the impossibility for national authorities to use traditional monetary policy instruments, especially given the low room of manoeuvre on the fiscal side in the coming years in most member states. In addition, as long as the financial implications of financial crisis remain at the national level in the absence of a fiscal union, national authorities should maintain the ability to reduce these potential costs. Last but not least, national authorities will remain in charge of important instruments, such as requirements with regards to Loan to Values and Debt to Incomes ratios. These instruments are potentially important to reduce risks related among others to real estate bubbles. Therefore, to avoid potential conflicts between the decisions taken by the centre on the one hand, and by the national designated authorities on the other hand, national authorities should be strongly involved in the decision making process.

At the same time, it is important to recognize that instruments that might be used for macro-prudential purposes are not necessarily different from traditional micro-prudential instruments, consisting essentially of capital requirements, liquidity requirements or limits to reduce excessive leverage and excessive mismatches, which will be under the responsibility of the SSM. In addition, the use of macro-prudential instruments might generate negative externalities. For these reasons, it is also important that the SSM is closely associated in macro-prudential policies.

For all these reasons, I am personally in favour of a system whereby both the European and the national level can take responsibility to activate macroprudential instruments, subject in both cases to a strong coordination framework.

The European Systemic Risk Board can continue to play its role, although its role may need to be reconsidered in case the SSM would be expanded to include all or virtually all of the EU Member States.

4 Crisis management and role of national authorities

The allocation of crisis management responsibilities also needs to be clarified. Currently, the ECB is responsible for the recourse to early intervention measures but all the other crisis management tools remain in the hands of national authorities. The European Commission has, however, already announced that it would present a legislative initiative, aiming at setting up a single resolution mechanism in charge of coordinating bank resolution and the application of resolution tools.

Yet, the current European Commission proposal on recovery and resolution very much relies on the idea that all banking crises can be resolved without public funds. While it is true that thorough recovery and resolution plans, combined with a new set of resolution tools and a pre-financing arrangement may help to limit state intervention, we have to acknowledge that the framework has not been tested and its capacity to resolve crisis is still unknown, especially in systemic crises. As the experience has shown in several countries since 2008, state intervention may remain necessary at least in residual cases where the application of resolution tools would lead to market disruptions or spreading out contagion.

If we accept the assumption that public funds may be needed, at least temporarily, to resolve a crisis, we then need to decide how the bill will be divided, in case a cross-border, or even a purely national credit institution supervised by the SSM needs to be resolved. This also raise the difficult question of the legacy. In that context, the link made between the establishment of the SSM and the recourse to the ESM to recapitalise banks may need to be further exploited to come up with a true European public backstop. As I already said, any disconnection between the conduct of supervisory functions and the fiscal responsibility in case of crises may lead to forms of moral hazard that would not be desirable.

4. Conclusions

As wee see, many obstacles will pop up on the road to an efficient single supervisory mechanism, and choices will need to be made. It is, however, crucial to address these obstacles decisively and work to ensure high quality supervision in all participating member states.

A reflection on the choices to be made, on the priorities to be tackled first, and on the ultimate aims of the banking union is therefore very important, and therefore, I very much appreciate the chance of discussing these matters with you today.