A regime change in supervision and resolution

Keynote Speech by Yves Mersch, Member of the Executive Board of the ECB, European Supervisor Education (ESE) Conference, Frankfurt, 26 September 2013

Ladies and gentlemen,

Thank you for inviting me to speak today.

As you know, Europe has in recent years faced the worst economic and financial crisis since the 1930s. Growth remains weak and unemployment is unacceptably high, with only the first shoots of recovery showing through.

Yet out of these difficulties, some positives have begun to emerge. The euro area has recognised that, for its collective stability, it has to deepen integration in certain areas – and it is now beginning to do so. What we are seeing playing out today is not so much the "audacity of hope", but rather the "audacity of necessity".

In my view, the most significant change taking place is the development of Banking Union. Monetary Union needs Banking Union, not least because a stable banking sector is an essential complement to a sound money. I therefore see the project of building Banking Union as the most important integration step since the launch of the euro.

For those of us involved in supervision and other financial sector issues, it is an especially fascinating time. We are at what political scientists call a "critical juncture" – that rare time when a window of opportunity opens to fundamentally redesign institutions. It feels like being back 25 years ago when we were preparing EMU.

But this also imposes on us a responsibility. This window may not open again for many years, so we need to make sure that the decisions we take today are the right ones. Most importantly, we need to ensure that Banking Union is not just a label – that it initiates a genuine regime change in the way that banks are supervised and resolved.

How to achieve this regime change is what I would like to focus on in my remarks today.

The elements of a regime change

In my view, a genuine regime change has to involve two elements: first, building a *single system* for banking supervision and resolution; and, once that is in place, building a *stricter system* as well.

Why do we need both elements?

We need a *single system* to ensure that we have a level playing field for the banking sector across Europe – and hence to create a truly single financial market in Europe. 20 years after the Single Market was supposed to be completed, the banking sector in Europe remains fragmented along national lines. This has many drawbacks, not least that it disrupts monetary policy transmission, makes banks more exposed to country-specific shocks, and encourages home bias in government bond purchases that strengthen the bank-sovereign loop.

To give an example of how far short we remain of a fully integrated financial market, a recent study found that, between 2005 and 2012, the average number of bank mergers and acquisitions per year in the United States was 343, whereas in Europe the yearly average was just 58. One reason for this is that we have lacked a single system of supervision and resolution across Europe, which has discouraged cross-border activity.

We need a *stricter system* to ensure that, when we have the new tools of Banking Union, they are used proactively – namely, to create a stronger and more stable banking sector. We still have an uphill struggle in Europe to restore investor confidence in the banking sector. And this is partly because we do not have a consistently strict approach to banks – on balance sheet transparency, on loss recognition and on resolution.

Evidence of this is the divergence in the price-to-book ratio for large and complex banks in the euro area and outside. For banks outside it is currently around 1, while for euro area banks it is only 0.7 – in other words, euro area banks are priced by the market at less than their book value. An important reason for this is that countries outside the euro area have made much faster progress in acknowledging losses and resolving banks that were not viable.

Creating a genuine regime change, both in the system of supervision and resolution and in its application, could therefore have a powerful effect for Europe. In the near term, it could help accelerate the clean-up of banks' balance sheets and thus restart bank lending. In the medium term, it could help encourage the development of genuinely European banks.

So how do we get to this regime change?

Building a single system

Let me start with the first element, building a single system. In my view, for any system to be single, two conditions have to be fulfilled. First, there needs to be a single set of rules. Second, if those rules contain any discretion, there needs to be a central authority that can enforce them evenly.

A single system for supervision

For supervision, we are currently making progress on both these conditions.

In terms of rules, we now have a new rulebook for banks across Europe as part of the Capital Requirements Directive IV. Within the single supervisory mechanism (SSM), we will also have a single supervisory manual that will apply to all banks. This will cover issues like the methodology for the Supervisory Review and Evaluation Process (SREP), off-site and on-site reviews, risk assessments and model validations. We are thereby ensuring that the same supervisory standards will be applied across Banking Union – and indeed, through harmonisation with the European Banking Authority, across the EU as a whole.

In terms of decision-making, we are strengthening the centre by integrating the European and national levels of supervision. A particular innovation here will be the Joint Supervisory Teams, which will contain staff from both the ECB and the national competent authorities. There will be one team for each significant banking group directly supervised by the SSM, operating under the management of a coordinator working for the ECB. This guarantees a collective approach and ensures that there will always be a European element in the decision-making. Indeed, the final responsibility for decisions will rest with the ECB.

This process of creating an integrated SSM is of course a major organisational challenge. We are bringing together 17 or more different national supervisors, with different operating cultures and supervisory philosophies, into a single mechanism with a single culture and philosophy. And the ECB will be directly hiring around 1,000 new staff, of which around 750 will be involved in supervision. So it will take time to reach our cruising speed.

With the SSM Regulation foreseen to enter into force at the beginning of November, we are ready to publish the vacancy notice for the Chair of the Supervisory Board, followed by those for the top management of the SSM – the four Directors General of the main departments and the six Deputy Directors General. The vacancy notices for the middle management will follow a few weeks later, and then – in accordance with the cascade principle – the broad recruitment will begin. We need to be ready with the basic structure of the organisation for the Asset Quality Review (AQR) towards the end of the first quarter of 2014.

Let me therefore briefly take this opportunity to describe how we foresee the SSM's organisational structure.

The SSM will contain four Directorates General and a Secretariat Division. Two of the Directorates General (DGs Micro-Prudential Supervision I and II) will conduct the direct and day-to-day supervision over significant banks. The division of responsibility for supervision between these two departments will be largely determined according to a risk-based approach, allowing them to specialise by risk exposure, complexity and business model of the credit institutions.

The third Directorate General (DG Micro-Prudential Supervision III) will host the conduct of indirect supervision over less significant banking groups. Direct supervision of these banks will still be carried out by the relevant national competent authorities (NCA) on a day-to-day basis, but with regular reporting to the ECB.

The fourth Directorate General (DG Micro-Prudential Supervision IV) will perform horizontal supervision and specialised expertise functions, such as supervisory quality assurance, methodology and standards development, enforcement and sanctions, crisis management, capital market risk analysis and model validation.

Within the organisational set-up, the middle management below the Directors General will encompass Heads of Division and Section and Senior Advisors, from which the Joint Supervisory Team (JST) coordinators will be chosen.

Let me also say a few words on how we foresee the practical work and the organisation of the off- and on-site-supervision.

The Joint Supervisory Teams (JST) are responsible for the day-to-day supervision of significant banks. They propose inspections, in which they participate without leading the inspections. That task is allocated to the Head of Mission. The Head of Mission is nominated by the horizontal Directorate General, Micro-Prudential Supervision IV – that is, by the ECB. Generally, on-site inspection teams are led by NCA staff. This does not preclude, however, the possibility of the ECB taking the lead.

The JSTs prepare the recommendations, lead the closing meeting of the inspection with the credit institution, and provide the follow-up of the recommendations.

The horizontal DG is in charge of maintaining the on-site inspection methodology. Moreover, it plans the on-site inspections to be conducted at significant banks on a yearly basis and updates on a half yearly basis the global inspection planning.

On-site inspections are specific in-depth investigations of risks, risk controls and governance. They are carried out on the basis of a predefined scope, timeline and resources, and use investigating and inspecting techniques to test controls and substantive procedures, following common standards.

They follow specific procedures and are conducted in an independent manner – vis-à-vis the JST, the NCAs and the respective inspected credit institutions. The outcome of on-site inspections will be a report containing findings and an executive summary.

A single system for resolution

A single system for resolution is just as important as a single system for supervision. Banks need to know how they will be treated both in life and in death – as do the creditors that invest in them. So here again, having a single set of rules and a central authority that can enforce them is essential.

The single set of rules for resolution – the Bank Recovery and Resolution Directive – has already been agreed by the Council of the European Union, and discussions are now under way with the European Parliament.

In principle, I welcome this Directive as a vast improvement on the status quo. Before the crisis very few countries had resolution frameworks in place, and this has led to ad hoc and inconsistent approaches in different countries.

However, where I think this Directive falls short is in the discretion it still allows to national resolution authorities to exempt certain classes of liabilities from bail-in. In my view, this is not conducive to the building of a single system, as it leaves too much uncertainty about how bail-in will be applied.

One can imagine a situation, for example, where a particular class of investors is excluded from bail-in owing to national political economy concerns. Or a situation where larger countries with larger resolution funds are in a position to exclude more creditors than smaller countries. Investors will be forced to second-guess these issues.

In this context, having an authority that can take central decisions becomes even more important. If there is going to be discretion in how resolution rules are applied, then we need to ensure that this discretion is applied in the same way across different countries. This underscores why a strong single resolution mechanism is so necessary – and, more concretely, why that mechanism has to have independent decision-making powers and no national vetoes.

A single resolution mechanism is also essential to ensure that we have a single approach to the resolution of cross-border banks. Dividing resolution along national lines has not proven an efficient way to solve cross-border coordination problems and achieve a least-cost resolution strategy overall. Moreover, in a divided system we can anticipate protracted wrangling over burden-sharing, which only delays the clean-up from a crisis.

To address this issue, I see it as essential that the mechanism comprises not only a single resolution authority, but also a single resolution fund. The Commission's proposal for the single resolution mechanism foresees such a fund, financed by levies on private banks. According to Commission estimates, it will reach a size of about €55 billion by 2025.

I welcome this proposal in principle. But I think that, during the build-up phase, clarification is needed on what will happen if there are exceptional circumstances which lead to the fund's resources being exhausted. The proposal is unclear here. In my view a credible backstop is essential to ensure that resolution costs can be separated from national budgets.

To sum up, what defines a single system is having a single set of rules that can be enforced evenly from the centre. We are on the way to achieving this for supervision. I see it as essential that we also achieve it for resolution. Banking Union is ultimately a way of establishing a single financial market where banks are separated from their sovereigns. To paraphrase Mervyn King, we therefore need to ensure that banks are both European in life and European in death.

Building a stricter system

Let me turn to the second element of a genuine regime change, building a stricter system. Putting in place new rules and institutions for supervising and resolving banks is essential. But it is equally important to use them in a way that leads to a measurably stronger and more stable banking sector.

How can we achieve this?

A new approach to supervision

The first building block is a willingness on the part of policy-makers to make bank balance sheets more transparent according to the common standards of the SSM. The SSM Regulation puts us in a position to do this by requiring a comprehensive assessment of the banks the ECB will directly supervise. This requirement goes beyond a purely accounting exercise. We have to ensure that the assessment is rigorous and managed from the centre. There is no point in having a new pair of glasses if you are not willing to open your eyes.

Our current plan for the comprehensive assessment is to have three elements. First, a risk assessment, which will identify broad risk factors, including funding and liquidity risks. Second, a balance sheet assessment, which will review asset quality using calculation, qualification and valuation checks of a broad risk-based nature, with central quality assurance according to a common methodology. This will draw on the expertise of external consultants. Third, a stress test, which will apply the results to an adverse scenario.

The linkages between the balance sheet assessment and the stress test still need to be defined in detail. What is clear, however, is that both are communicating vessels. If the former is a more thorough point-in-time stock-taking, then the later has to contain more forward looking elements.

As a consequence of this three-pronged exercise, some banks might face capital gaps to close. In our view, it is very important for the credibility of the exercise that the scope of the process remains ambitious; this implies, for example, that a data integrity validation is undertaken.

Of course, we need to be alert to the practical concerns of the stakeholders of the exercise, including the banks. It is important that all requirements for the banks are clearly defined, finalised, explained and delivered to them well ahead of the official starting date. Ideally, the final templates, including the accompanying instructions on how to use them, should no longer be altered once data is being compiled for the balance sheet assessment.

But we will not compromise on the scope and strictness of the exercise.

We would like to launch the exercise, starting with the determination of the risk portfolios, by the end of this year already – although this depends to some extent on when the full Supervisory Board is appointed. I am confident that, once the SSM Regulation has been approved, the ECB and the European Parliament can work in a constructive spirit in appointing the Supervisory Board – in particular in ensuring a fast-track procedure for the appointment of the Chair.

When we have the results of the assessment, policy-makers also need to be willing to deal with the consequences. Certainly, European banks are in a stronger position today than they were a few years ago. For example, in Spain banks have provisioned €184 billion euro – that is 10.5% of their loan books – and have raised €22 billion in new equity since 2008. But we cannot rule out the possibility that the exercise will still reveal capital needs. It is essential that there are backstops in place to address this.

If the backstops are not there, I fear that the exercise will create a lose-lose situation for the banking sector. If the results reveal only small capital needs, markets will think they have been fudged to save public money. If they reveal significant capital needs, markets will question how they will be filled, creating uncertainty. Either way the confidence boost we hope to gain from the assessment will be lost.

A new approach to resolution

The second building block of a stricter system involves changing the way in which we deal with non-viable banks.

To begin with, we need to make sure that we use the new resolution powers to their full extent. As most European countries do not have much experience with winding down banks, there may be a tendency to avoid putting banks into resolution – by practising supervisory forbearance and allowing banks ever more time to restore viability. The ECB as supervisor has an important role to play here in ensuring that this does not happen.

To ensure that resolution powers are used in full, it would also help to have all the elements of the new resolution framework in place at the same time. The supervisory powers of the SSM will apply in principle from November 2014 onwards. The Bank Recovery and Resolution Directive framework is foreseen to take effect in January 2015, and the start of the single resolution mechanism is planned for the same date. But under the current agreement, the new provisions on bail-in would only be applicable from *January 2018*. This means that there will be a period of three years where the resolution authority is unable to use one of its key resolution tools.

For this reason, I favour bringing forward the entry into force of bail-in. The Directive still has to be agreed with the European Parliament, and in my view we should push for a start date of 2015 for bail-in so that we have the full resolution toolbox available from the outset – instead of over-extending the State Aid rules as a proxy.

Conclusion

Let me conclude.

What I have tried to illustrate today is that a regime change involves two components. First, the right rules and institutions to ensure a single system. Second, a willingness to use those rules and institutions in a stricter manner. It is therefore a question not only of mechanisms, but also of mindsets.

We have already made some encouraging progress, in particular on the SSM. But there is still a long way to go, and success is only possible with a cooperative effort. Whether Banking Union achieves a regime change will ultimately depend on the cooperation and dedication of literally thousands of legislators, regulators and supervisors. It is the very definition of a "team effort".

In the same vein, we need to strengthen our joint training efforts in supervision skills. The European Supervisor Education initiative is an example of a common cross-border approach which could be built upon.

Yet in my view Banking Union is the challenge of our times. The crisis has presented us with a once-in-a-generation opportunity: to build a safer banking sector; to strengthen our Monetary Union; and in the process to take forward the historical process of European integration. We are privileged to have this opportunity – and we need to take it.

Thank you for your attention.

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