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Presentation of the book "The institutional architecture of the refounding of the euro"

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It is a pleasure to share with you the presentation of the report "The institutional architecture of the refounding of the euro". I must first thank the Fundación de Estudios Financieros and in particular its Chairman Juan Carlos Ureta for their kind invitation, and Román Escolano, President of the ICO, for allowing us to gather together in this auditorium.

I consider that the study presented today, inviting reflection on the initiatives under way to improve the design of the euro area, could not be more timely. The authors of its seven articles offer most worthwhile contributions with specific proposals to make resolute headway towards a genuine banking, fiscal and economic union in the euro area. Let me take this opportunity to back these reflections on the reforms needed to address the weaknesses evidenced by the euro area in recent years.

Undoubtedly, these reforms require a balanced mix of domestic and European measures.

I believe that in Spain, as in other countries, significant steps are being taken to adopt measures that will improve the economy's capacity to adjust in the event of idiosyncratic developments, to reinforce its competitiveness and to reduce the likelihood of marked macro-financial imbalances being generated in the future.

These measures at the domestic level are vital for shoring up the functioning of the Monetary Union.

Clearly, though, at the same time, we need an institutional strengthening of Economic and Monetary Union, to prevent any hint of uncertainty as to its continuity; as the recent past testifies, such uncertainty can prove highly destabilising. I shall focus today on what is unquestionably one of the most ambitious institutional reforms: the project to create a Banking Union.

Introduction

The current euro area crisis has chiefly been manifest in the fragmentation of its financial markets, understood as the re-emergence of a country-risk component in the cost of funding to issuers and borrowers whose scale depends on where they are located.

As you are aware, this market fragmentation has its origin in various Member States' budgetary difficulties, against a background marked by the absence of effective, Europe-wide, risk mutualisation mechanisms. These budgetary difficulties have been fuelled by the impact on economic activity of the sharp correction in certain macrofinancial imbalances, in those economies that underwent a highly pronounced expansionary effect following the adoption of the single currency and which lacked sufficiently flexible product and labour markets to absorb this impact in a balanced way.

These maladjustments took on a particularly destabilising dimension when they ultimately affected the banking industry in those countries where the size of the sector, its solvency position or the situation of public finances hampered the use of national budgetary funds to preserve financial stability. This feedback loop between banking and sovereign risk is,

therefore, at the root of the current crisis, and exiting the crisis will involve eliminating or at least effectively containing such feedback.

As early stated, the solution to these problems clearly entails adopting domestic measures that allow for containment of structural fiscal maladjustments, mitigation of macrofinancial imbalances and an increase in the resilience of the banking sector. At the same time, the euro area should be institutionally bolstered to promote greater integration of its constituent economies. That involves the creation of centralised mechanisms for the coverage of contingencies and, in exchange, a greater relinquishing of sovereignty in policies relevant to preventing and managing such contingencies.

I believe European leaders have largely learnt their lesson, as the notable progress in recent years in reforming the euro area's institutional architecture shows.

Specifically, the progress in improving the procedures for monitoring a broad range of national policies, in the face of macroeconomic imbalances, marks a significant step forward. In particular, budgetary policy surveillance mechanisms have been notably reinforced, especially following the introduction of the so-called "Fiscal Compact". Further, resources have been allocated to detecting and monitoring systemic risks, with the creation of the European Systemic Risk Board (ESRB). Finally, with the institution of the European Stability Mechanism (ESM), a permanent vehicle has been established for channelling financial aid to those euro area countries that might need it.

In any event, the progress during the initial years of the crisis did not suffice to curb the instability of euro area markets. This became evident in the summer of 2012 when tensions heightened enormously, prompted by the perception of re-denomination risk, which harboured the possibility of a break-up of the euro.

The response in this case was, as has traditionally occurred in the past when the European Union has faced acute problems, a qualitative leap towards a new, stronger union, which began to take shape in the agreement reached in June 2012 by the euro area Heads of State and Government. Among the various measures agreed, the Banking Union project is a key element for restricting the perverse interaction between sovereign and banking risks we have witnessed during this crisis.

Towards a banking union: the single supervisory mechanism

An essential step in the development of the project is the creation of a Single Supervisory Mechanism, which is possibly the most far-reaching institutional reform to be agreed in the EU since the introduction of the euro. I should like to mention three characteristics of the design of this mechanism.

1 Integrity

Firstly, the apportionment to the Single Supervisory Mechanism of all relevant supervisory responsibilities for credit institutions as a whole. This is clearly the best option for ensuring the across-the-board application of the most rigorous supervisory standards and for

reducing the distortions that might arise from the coexistence of different supervisory regimes for institutions that share the same market.

While in principle the ECB will only directly supervise significant banks (those whose balance sheets exceed €30 billion), the Single Supervisory Mechanism actually spans all euro area credit institutions and possibly, too, those from non-euro area countries that are prepared to subscribe to cooperation agreements with the ECB.

Naturally, setting in place a sound internal organisation within the ECB for its new supervisory remit is a complex and demanding task. In particular, it is important to strike a balance between the management of potential conflicts of interest and the harnessing of synergies within the ECB.

One of the concerns here is to mitigate any potential friction between the objectives of supervision and the ECB's monetary policy functions. To this end, the Regulation stipulates organisational arrangements – which turn on a newly created Supervisory Board – that should help ensure monetary policy decisions are not distorted by supervisory considerations.

2 A unified system that benefits from national experiences

The second aspect I would highlight refers to the participation of the Competent National Authorities (CNAs) in the Single Supervisory Mechanism.

The Single Supervisory Mechanism is far from being a federation of national supervisors or a macro-college of supervisors. In fact, it has been set up as a system in which the support role of the national supervisory authorities is clearly defined: to contribute to the preparation and implementation of decisions, which will always be adopted in a centralised fashion. To this end, the CNAs will assist the ECB in preparing and implementing all types of supervision-related tasks, including regular on-site inspections.

On the basis of these principles, and to ensure a fluid and effective transition from purely national supervision to that pursued by the Single Supervisory Mechanism, change must be made following a gradual approach. This means that, at least initially, participation by the CNAs should be particularly significant to avoid discontinuity impairing the effectiveness of the supervisory function.

3 Accountability

Thirdly, for the Single Supervisory Mechanism to have a sound institutional structure within the ECB, it is inevitably important that it should enjoy the necessary public acceptance both across Europe and domestically.

As always, the counterpart of independence, ensured in this case by the ECB statute, should be the exercising of accountability, before both the legislative and the government authorities, bearing in mind the possible effects of supervisory measures on public finances.

It is telling, however, that supervisory policy, unlike monetary policy, does not pursue a euro area-wide macroeconomic objective – such as price stability – with which to justify the measures it adopts. Indeed, supervision entails the application of specific measures for each bank and its success will be assessed in each country, bank by bank. This means that the ECB must be much more visible to citizens across the different countries and interact frequently with national authorities, parliaments and interest groups.

Single Resolution Mechanism

Yet despite the importance of setting in place a Single Supervisory Mechanism, a true banking union further requires an effective Single Resolution Mechanism and possibly a Common Deposit Guarantee Scheme, too. Without these ingredients, institutional reform is unlikely to prove decisive in radically breaking the vicious loop between banking risk and sovereign risk.

The key objective of a banking union is in fact to prevent credit institutions' liabilities from having a different value or risk, depending on where they are located. Unified supervision is unquestionably conducive to this end. Yet supervision cannot and probably should not seek to cancel out the likelihood of bank crises emerging. Thus, insofar as crises persist and potentially affect the viability of specific banks, the bank liabilities affected should receive similar treatment in all jurisdictions. In other words, the existence of heterogeneous national crisis-resolution arrangements is incompatible with a banking union.

Further, setting in place unified supervision without a common resolution regime may give rise to certain operational risks. Specifically, European supervision with national resolution systems could trigger problems relating to the compatibility of incentives that might affect the proper conduct of supervision. In addition, it might impair the legitimacy of supervisory action as far as national citizens are concerned. In this respect, it might not always be straightforward to ensure all citizens' acceptance of the use of national public funds to support credit institutions whose vulnerability has been highlighted by supervisory action conducted by an institution that is not formally accountable to national authorities.

A common resolution framework for financial institutions is, then, a necessary complement as far as creating a true banking union is concerned. Allow me to briefly outline the main characteristics which, in my view, a unified resolution system should have.

Firstly, a harmonised regulation of the resolution regime is urgently needed. Here, the advanced stage of the new Directive on the resolution of credit institutions is encouraging. I trust that the final wording will meet expectations and offer a complete resolution system that can be applied uniformly in all jurisdictions.

Specifically, the resolution framework should be designed in a sufficiently harmonised manner, with common rules and approaches, leaving minimal leeway for potential exceptions at the national level. Otherwise, if the Regulation allows relevant exceptions or specific situations in national resolution arrangements that involve a different treatment of creditors of similar types, that might weaken its capacity to correct market fragmentation by promoting arbitrage across instruments and jurisdictions.

In my view, such consistency and harmonisation is, possibly, even more important than the fairly heated debate on the specific treatment of different types of bank liabilities in bail-in processes involving loss-assumption in by private investors.

Secondly, to achieve the uniform application of the regulation, a common resolution authority is needed, at least for the countries participating in the Single Supervisory Mechanism. Halfway-house solutions based on a possible network of national resolution authorities do not seem to be the appropriate option for Europe-wide crisis-management.

The common resolution authority should be independent and have the means to adopt the necessary decisions as soon as the situation demands. At the same time, the resolution authority should maintain a close relationship with the single banking supervisor so as to benefit from its knowledge of banks and to smooth decision-making in crisis situations, when a broad set of factors relating to financial stability has to be taken into account.

In principle, it would seem preferable to advocate the creation of a specific resolution authority of a scope similar to that of the Single Supervisory Mechanism. I am of course aware that establishing a new EU-wide authority might require complex amendments to the EU Treaty, which would delay the process excessively. Other more pragmatic means of creating a common resolution system should thus be explored, possibly housing it in one of the institutions currently in place which, ideally, would begin to function before the time the mechanism is scheduled to commence operating, in the summer of 2014.

I am convinced that the proposal in this connection to be submitted to the European Commission in the coming months will contain ideas allowing us to draw closer to meeting this objective.

Lastly, a common resolution framework also requires a euro area-wide financing system.

Resolution rules, based on the principle of minimising the burden on taxpayers, should establish a uniform framework of conduct that includes the corresponding assumption of losses by the holders of the various instruments that may be subject to bail-in exercises. This could suffice, in principle, to ensure in many cases the ordinary resolution of credit institutions.

However, as experience shows, additional funds are often needed to support the resolution of vulnerable banks, even when they are not particularly big or complex. These funds need not be contributed in their entirety by governments, since the industry could also contribute through the timely design of resolution funds.

Indeed, it might be viable to design mechanisms in which the expected taxpayer contribution to resolution could be minimised and even limited to exceptional scenarios. Frankly, however, if we believe in the establishment of an effective banking union, that can contribute significantly to combating fragmentation, I see no other alternative than to envisage the adoption of support measures financed under a common arrangement, incorporating both the private- and public-sector participation deemed appropriate.

To conclude, I would say we are undoubtedly making great headway in reinforcing the institutional design of EMU. Its completion, along with the introduction of the necessary national measures, will make for a sufficiently sound institutional framework enabling us to prevent and effectively manage developments with the potential to destabilise the monetary union.

As I said, the Banking Union project is a clear example of this. Moving towards more Europe is the only effective way of tackling the problems of the current crisis. Let me then reiterate my gratitude to the authors and editors of the Report for their contribution in enriching the debate on such an important issue. Thank you for your attention.