

14.09.2012

Remarks on banking union

Round table "Systemic risk and securities markets"

II International Conference on Securities Markets

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Let me first thank the organisers for their kind invitation to participate in this event held by the CNMV, of which I was Vice-Chairman from 2008 until my recent appointment in the Banco de España. I also had the privilege to participate in the highly successful conference organised in 2011. A glance at the quality of the papers and speakers in the programme of this conference is sufficient to confirm that the organisers have succeeded in maintaining the high standards achieved last year. Our Chairman today, Oscar Arce, deserves much credit for that. I am sure that the CNMV's new top management – who will be taking over in a few weeks – will continue to support this event, as the President Julio Segura and myself did the first two editions.

The current financial crisis has shown up numerous deficiencies in the functioning of the global economic and financial system. Many of those deficiencies are the consequence of imperfect rules, policy mistakes and inappropriate conduct by private agents. Some of those deficiencies are the subject of an ongoing policy debate and of regulatory reform which, with varying degrees of ambition, is taking place in different jurisdictions.

However, in addition to imperfect rules and policy actions, the crisis has revealed a series of institutional deficiencies which need to be eliminated in order to restore economic and financial stability.

The clearest example in this regard is probably the European institutional framework. Over the last three years we have witnessed how the perception of country risks has climbed to very high levels as a consequence of both sovereign credit risk as well as the so-called redenomination risk. This development has impeded the adequate functioning of monetary union by leading to sizeable differences in the financing conditions for agents located in different States within the monetary union and by instigating the renationalisation of financial markets.

There can be no doubt that much of what has happened is directly linked to the significant macroeconomic and financial imbalances accumulated by several euro area countries, as well as to the emergence of vulnerabilities within the financial sector. It is also clear that the main remedy for those destabilising developments lies in effective adjustment of domestic policies, which is currently being implemented in those countries suffering the most significant stress.

But, at the same time, the elimination of any perception of redenomination risks can only be fully accomplished if – in addition to the required domestic policy action – the central bank is fully and credibly committed to intervening in sovereign markets as far as is necessary to avoid the pricing of sovereign risk becoming self-fulfilling. In that regard, the recent announcement by the European Central Bank of its determination to conduct unlimited intervention in the sovereign secondary markets, provided effective conditionality is fulfilled, constitutes a significant step towards the normalisation of market conditions in the euro area.

Yet, the return to a smoothly operating monetary union cannot be completely achieved by simply relying on ad-hoc reactions by policy-makers. Institutional arrangements must be reviewed in order to restore adequate incentives for domestic authorities to prevent the reemergence of destabilising imbalances and to ensure that any residual risks arising in

specific jurisdictions that could affect the area as a whole would be addressed by integrated mechanisms operating at the euro area level. The recent changes introduced in the European Union to strengthen the requirements and the mechanism for the surveillance of domestic fiscal policies and structural reforms, together with the creation of the EFSF and the ESM – which we now know will be soon be launched – are good examples of the required institutional reforms.

At the same time, a specific source of risks for the smooth functioning of monetary union that needs to be addressed directly is the financial instability experienced in specific jurisdictions. As we have seen in the last few years, the deterioration of the perceived solvency of financial institutions located in specific countries within the monetary union can have spill-over effects across the financial sector as a whole, can contribute to a disorderly functioning of wholesale markets and can put great stress on the public finances of the countries affected. Consequently, the soundness of financial institutions is of systemic importance within the monetary union and should therefore be preserved through the appropriate integrated crisis prevention and resolution mechanism.

Against this background, a consensus has emerged of unprecedented strength on the need to take steps to create a banking union. The first step would be the adoption of a single supervisory mechanism. A regulatory proposal for such a mechanism has been released this week by the European Commission.

The proposal has three main features. First, the assignment to the ECB of supervisory responsibilities for all banks in the euro area, and possibly also for banks in countries outside the euro zone willing to enter into cooperation arrangements with the ECB. Second, the adoption of mechanisms to ensure that the ECB's supervisory tasks are strictly separated from the conduct of its monetary policy. Third, the involvement of national supervisors in the preparation and implementation of decisions.

The proposal is in my view well founded. In particular, it makes sense to subject all financial institutions in the euro area to a single supervisory mechanism. Recent experience shows that the instability of medium-sized or small institutions with limited links to other European institutions may sometimes generate disruption at both the national and the euro area level. Moreover, the coexistence of different supervisory regimes for institutions sharing the same market place may generate competitive distortions, which should be avoided.

Similarly, it is important to establish institutional mechanisms to mitigate any potential conflict between the objectives pursued by the supervisory and the monetary policy functions. I believe that the crisis has already helped to allay our concerns about the extent to which those conflicts could actually arise in practice. Indeed, most central banks have understood that financial stability considerations should be taken into account when designing monetary policy measures without challenging the priority that should be given to the price stability objective. In any case, from a procedural point of view it seems reasonable for the Governing Council of the ECB –the interest-rate setting body- to make relatively extensive delegations to the Supervisory Board envisaged in the draft regulation as the operational body through which the ECB will exercise its new supervisory functions.

Finally, on the involvement of national supervisory authorities, the draft regulation envisages a model under which the ECB will have ultimate responsibility for the tasks conferred on it by the new regulation. In performing the new functions, the ECB will however take full advantage of the expertise of national authorities. The principle under which national central banks and supervisory authorities are to help in preparing and implementing decisions is an essential ingredient of the new supervisory mechanism. At the same time, it is probably reasonable to develop that model in such a way that the principle of delegation is flexibly used so as to take into account the different nature of the supervised financial institutions and the specific supervisory functions to be performed. Although the involvement of national authorities should always be required, the ECB should normally participate more directly when institutions of systemic importance and actions of a strategic nature are involved.

The draft regulation foresees that the ECB will start performing its functions through national supervisors already in January next year and that the new system will be fully operational in 2014. That is quite a demanding timetable. I can well understand the need to speed things up as much as possible as the new system should already be being used to help solve the problems the euro area is facing now. That includes the possibility it will open for direct recapitalisation of financial institutions requiring public aid by the European Stability Mechanism, thereby helping to mitigate the destabilising association of sovereign and financial risk.

It is probably reasonable to expect that the overall supervisory framework should evolve over time beyond January 2014. In particular the distribution of responsibilities between the centre and the national authorities could naturally change as a result of the accumulation of expertise in the ECB and the progress made in developing the other two pillars of banking union: namely, an integrated resolution regime and a common deposit guarantee scheme.

Indeed, the idea that a fully effective banking union requires also the establishment of those two additional components is quite compelling in my view. Moreover, it could be argued that the combination of a centralised supervisory mechanism with decentralised resolution schemes may generate some dysfunctions and incentive compatibility issues.

More importantly, the mitigation of destabilising financial risks and of their impact on sovereign risks requires not only a strong crisis prevention scheme, but also an effective common crisis resolution regime. Even if banks are supervised under a common system, episodes of financial distress may still deteriorate the perceived cohesion of the eurozone if purely domestic mechanisms are used to restructure or resolve weak banks and to protect depositors. That is conceptually contradictory with the goals of a banking union. In that context, the communication by the Commission to shortly make legislative proposals in this area above and beyond the Directives which are currently under discussion is obviously welcomed.

In any event, there is a lot of work to be done in the short term to put in place the new unified supervisory mechanism. At present, important differences remain between the characteristics of the national supervisory models which affect powers, means, practices

and procedures. The use of permanent on-site supervision, the link between off-site supervision and on-site inspections or the powers of the supervisory authority (if any) in relation to accounting regulations, are simply some examples. Differences between national supervisors also exist regarding the availability of data. To give you an example, Central Credit Registers - which in our experience are a highly valuable source of information for prudential supervision purposes - are not yet available in all jurisdictions.

The EBA has played a very important role by improving cooperation between national supervisors and promoting supervisory convergence. But these improvements fall short of the needs of an effectively unified supervisory system. Substantial and swift progress in this field is therefore needed.

Let me just finish by making a general comment. It is obvious that the creation of a banking union poses enormous challenges for Europe that will require strong political support and effective cooperation among all authorities involved. The good news is that if we look at the process of European integration from a historical perspective, we realise that this is not the first time that the way forward has been highly complex. And, past experience has regularly shown that the response has always been to deepen integration and increase the transfer of national powers to the Union as the best –and possibly only– way to preserve all the achievements made so far.