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**Address by the Governor**

First Banco de España-OMFIF Economists Club Meeting

Luis M. Linde

Governor of the Banco de España

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Dear colleagues and friends, ladies and gentlemen:

It is a pleasure to host this first Banco de España-OMFIF Economists Meeting. I am fully confident that it has provided an excellent opportunity to review and assess the latest developments in the Spanish and European economy and the present situation of the Spanish Financial System.

I would like to share with you some reflections on the Banking Union in Europe which is, as we all know, a very important matter for the present European financial scenario.

The thrust for the design of such a fundamental reform as the Banking Union in the economic governance of the European Union has come from the crisis, both international and European. The euro zone financial and sovereign-debt crisis has shown the shortcomings of the European institutional framework, triggering a wave of reforms that would, otherwise, most probably, not have taken place.

Last year, the Presidents of the Council, ECB, European Commission and Eurogroup agreed on the milestones for building a new Economic and Monetary Union, based, in principle, on four blocks: the banking union is the first of those blocks, to be complemented, according to the political design, a later stage, with a fiscal union, an economic union and, finally, a political union.

The Heads of State and Government of the European Union committed to a banking union in June 2012. Since then, major steps have been taken, within a very challenging timeframe, to set the basis for common supervision, through the single supervisory mechanism and common resolution arrangements; as for harmonized rules to protect depositors, they are also on the agenda, but the progress is clearly lagging behind. Let me now address each of these three pillars of the Banking Union.

### **Single Supervisory Mechanism**

Last week the European Council adopted the Regulation establishing a Single Supervisory Mechanism (or SSM). Within one year, the ECB will, together with the national supervisory authorities, assume broad supervisory competences over the whole banking sector of the Euro area and of those other EU countries which decide to opt-in.

The ECB will be the central player within this new mechanism. Those credit institutions deemed to be significant according to the criteria laid down in the Regulation will be directly supervised by the ECB with the assistance of the national supervisory authorities, while the rest of the system will be indirectly supervised by the ECB through the national supervisors. In numbers, out of approximately 6,000 credit institutions in the Eurozone, the ECB will directly supervise around 130 banks, covering around 85% of total banking assets.

The single mechanism will be based on the idea of centralised supervision, offering a common view for the supervision of the whole sector, while building on the knowledge and expertise which exist at national level. This common view will be established in a set of rules and standards which will be laid down and developed by the EBA and the ECB itself.

With the Single Rulebook as a basis, other instruments will also ensure that the same approach is used in the supervision of all banks. This will include the Supervisory Manual and ECB regulations, guidelines and general instructions.

### **Resolution of Credit Institutions**

Single resolution, the second pillar of the banking union, is a necessary complement of single supervision. It is essential that if a bank enters into difficulties, it may be efficiently resolved with no or minimal costs for European taxpayers and with little impact on the European financial system and on the real economy.

The draft Regulation on Single Resolution, submitted by the European Commission to the Council and the Parliament last July, builds on the concept, envisaged by the European Council more than a year ago, that is, a resolution system comprising a single resolution authority and a single resolution fund.

In such a system, resolution will be based, first and foremost, on common EU "bail in" rules, whereby banks' shareholders and creditors should first bear the cost of a bank resolution. Only if this were not enough, would the single resolution fund -meaning, the Industry- step in, making the fiscal backstop the very last resort.

This "bail in" principle is embodied in the proposal of the Bank Recovery and Resolution Directive which was approved by the ECOFIN last June; we expect that it will be approved shortly by the European Parliament. Obviously, this Directive will enter into force in all EU member countries, independently of their participation in the Banking Union. However, the Regulation establishing the framework for a Single Resolution Mechanism or Authority and a Single Bank Resolution Fund is just beginning to be negotiated, after, as I said before, a draft was presented by the Commission in July. Ideally, the Regulation should be in force by January 2015, but we all know that there are difficult political and technical problems, in particular in relation to the Single Resolution Fund and the role of the European Stability Mechanism.

### **Deposit Guarantee Scheme**

A functioning banking union also needs to properly address depositors' protection.

A first step was made in the middle of the crisis to harmonise coverage of European deposit guarantee schemes up to €100,000 per deposit.

Later on, the Commission presented in July 2010 a Draft Directive on deposit guarantee schemes. This reform mainly deals with harmonisation and simplification of protected deposits, faster payout and improved financing of schemes. After a controversial first reading in the European Parliament in February last year, the legislative process was delayed pending agreement being reached for the Resolution Directive. At a later stage, we will have also to move on this.

## **Challenges to turn this framework operational**

Let me now move on to challenges for this framework to become operational.

We have been working since the end of 2012, on the preparation of the Single Supervisory Mechanism. Now that the Regulation has finally been approved by the European Council, the challenge is to turn this new framework operational before the ECB assumes its supervisory tasks.

This poses, first, a logistical challenge as a new institution has to be created and numerous professionals have to be recruited. But most importantly, a complete set-up has to be developed to underpin the supervisory decision-making process, keeping it properly separated from the monetary policy structures at the ECB. And last but not least, before the SSM is fully operational by November next year, a comprehensive assessment of the European banking system will be performed by the ECB.

### **From domestic to joint supervision**

The transfer of responsibilities from the National Authorities to the ECB should be a smooth process.

The National Authorities have the expertise in the supervision of credit institutions. We will have to provide information, knowledge and staff, and we should not preclude the possibility of running certain processes in parallel for a while. Both the ECB and the National Authorities should seek to attain mutual confidence and understanding.

The ECB supervisory powers will cover all tasks relating to the prudential supervision of all credit institutions. This entails supervising over 6,000 institutions.

We will have to devise a system to make ECB responsibility compatible with a rational division of work, so the ECB will have the direct oversight of significant banks with the cooperation of the national competent authorities. The direct supervision of the Less Significant Institutions is for the National Authorities, which will have to comply with regulations, guidelines and general instructions issued by the ECB. In fact, the ECB will indirectly supervise such banks, having access to their data and the power to assume, if so decided, the direct supervision of any of them.

It is important to underline that this is not going to be a two-tier system, but a single one with a distribution of tasks; this is not going to be a “confederation” of supervisors, but an “Union” of supervisors under a single European authority.

### **Preparatory work already done to launch the Single Supervisory Mechanism**

At this point, I will briefly describe the work we have done, how the SSM is going to be set up in organisational terms, and the work ahead of us.

Steered by a High-Level Group on Supervision, chaired by the President of the ECB, a preparatory structure has laid down the work schedule regarding the following areas:

- (i) The mapping of all the EU banking institutions, to determine the supervisory regime applicable under the Single Mechanism Regulation.
- (ii) The preparation of the organisational framework, which will include the practical arrangements for cooperation between the ECB and the National Authorities, within six months of the entry into force of the Single Mechanism Regulation.
- (iii) The drafting of the ECB Supervisory Manual, which will address procedural and methodological matters, including the risk assessment system that the Single Mechanism will implement, on-site inspections and other processes that form an integral part of the supervisory review process.
- (iv) The introduction of the Technical Standards on prudential and accounting Supervisory Reporting, which will allow a significant degree of cross-country consistency to be achieved regarding the periodic confidential reports that banks file with supervisory authorities.
- (v) A comprehensive assessment of the credit institutions of the participating Member States, including a balance-sheet assessment at a given point in time. I will elaborate on this in a moment.

Integrating seventeen national supervision systems (some of them made up by two authorities) along with the ECB in order to set up the Single Supervisory Mechanism is, indeed, a major challenge.

The centrepiece of this integration has been the concept of Joint Supervisory Teams (JSTs), which are going to take care of the direct supervision of the significant banks. These teams will be made up of supervisors from the ECB and from the National Authorities; under the guidance of an ECB coordinator, they will be entrusted with the supervision of each of the significant banks. These Teams are, therefore, to be the backbone of the direct supervision by the ECB of significant banks.

The ECB plans to devote two Directorate Generals to this direct supervision of significant banks, DGs I and II. Additionally, a DG III will be created to deal with the indirect supervision of the Less Significant institutions. Finally, a DG IV will carry out horizontal functions such as supervisory quality assurance, methodology and standards, enforcement and models approval.

Overall, including the Secretariat, the ECB will need around 1,000 new staff, 750 of them directly involved in supervision.

As said before, each Joint Team will be responsible for the overall supervisory activity in respect of a credit institution. To conduct such supervision, the JST will first determine the risk profile of the bank. In this regard, it is of paramount importance to have a common assessment system that guarantees consistent valuation across the population of banks and the different jurisdictions. To that end, part of the effort in the preparatory work is being devoted to designing a “risk assessment system” anchored in objective data and ratios.

## **Some final remarks on key issues**

Let me conclude with some comments on the comprehensive assessment of all banks that will come under direct ECB supervision. This will consist of three elements: a supervisory risk assessment, a balance sheet assessment and a stress test, and shall be concluded before the ECB assumes its supervisory functions in a year from now.

The Supervisory Risk Assessment will incorporate supervisory judgment on all risk factors, aiming to evaluate measures and summarise in a comparable form across banks all potential sources of risk. This risk assessment will also be used for the portfolio selection to be undertaken as part of the balance sheet assessment.

The second element, the Balance Sheet Assessment, will be carried out at a given point in time and on an accounting basis. This assessment will be broad and inclusive, covering credit and market exposures, on and off-balance sheet positions, domestic and significant non-domestic exposures. One key issue is going to be the capital threshold used for this exercise, which, in accordance with the definitions of the Capital Requirements Regulation and Capital Requirement Directive IV, based on Basel III recommendations, will take into account the need for a demanding threshold. The main content and details of this exercise will be made public in the next few days.

The third element, the Stress Test, will review the major risks of banking groups under various scenarios, testing the sensitivity of bank balance sheets to hypothetical external shocks. The features of the stress test will be defined in conjunction with the EBA, and publicly disclosed at a later stage.

The results of the assessment will be published once finished and prior to the ECB assuming its supervisory role.

The ECB will manage and oversee the exercise in close cooperation with the National Authorities and with the support of an international consultancy firm. The National Authorities will conduct the exercise at the national level, on the basis of data requirements and centrally developed methodology, and may ask for the support of third parties if they deem it necessary. To ensure consistency in execution across banks and countries, quality assurance processes will be in place at every stage. It is in the interest of all that this exercise be rigorous and transparent, so as to fully restore confidence in the European banking sector.

## **Conclusions**

We have in front of us a year “fully loaded” – to use the jargon we all use in connection with of the Regulatory Basel Framework-. The European Union is trying to make a big step forward and we will need the intelligence and best cooperation of all for this great design to be carried out.

Thanks again to the Official Monetary and Financial Institutions Forum and to his Chairman, David Marsh, and to all the participants. I wish all of our visitors a very good stay in Madrid.