Pentti Hakkarainen: Banking Union in the Nordic context

Keynote address by Mr Pentti Hakkarainen, Deputy Governor of the Bank of Finland, at the Nordic Opportunities/SEB Seminar, London, 3 September 2013.

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Accompanying slides can be found on the Bank of Finland's website: Slides (PDF)

It is an honor and a great pleasure for me to participate in this seminar here in the heart of the City. It is especially pleasant to do this under the benevolent eye of the present Lord Mayor. I am proud to say that Roger was actually one of the first investment bankers I got acquainted with at the beginning of my career in finance when working for a big industrial company's finance management in the 1980s.

The institution which I represent, the Bank of Finland, has had direct contacts with the City of London for more than 150 years now. It was year 1861 when the Bank of Finland first opened correspondent accounts with the London bank, N.M. Rothschild & Sons.

That correspondent relationship was our first outside the Baltic Sea basin and reflected commercial contacts with Britain as well as the desire of the Finns to take part in the growth of international finance.

I should also mention that only a couple of years later, we established banking contacts with a new entrant to the Nordic banking scene, the Stockholms Enskilda Bank, which evolved into today's SEB. The role of the founder, A.O. Wallenberg, became very significant for Finland, not least as a trusted advisor in financial policy.

Those were the early years of international banking, and the beginning of the great "first wave" of financial globalization which continued up till the First World War.

Now, of course, the global integration of finance and banking has reached totally new dimensions which the recent international crisis has underlined. It is now universally acknowledged, as a result of the crisis, that regulation and supervision must be brought up to date with the new realities of the market place.

Nowhere has the crisis been more sobering than in the EU which has been forced to face the problem of its fragmented structure of supervision and take the bold but long overdue step to establish what is now called the Banking Union.

The Banking Union is still at an initial phase and much remains to be done before we reach the goal. Also some changes are still possible.

It is my intention today to describe the most important features of the Banking Union as they appear from my point of view. I will emphasize the Nordic perspective, but with Finnish twist: Finland being the only country in the Nordic region which is also a member of the euro area, and thus by definition a full participant to the Banking Union project.

Why a Banking Union?

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The crisis since 2008 has made it clear that a highly interconnected and integrated financial sector requires a stronger institutional framework than what we currently have.

- A problem at one bank can quickly spread to other banks both at home and beyond national borders with devastating effects on the real economy and taxpayers.
- The crisis led to a sudden stop of capital flows within Europe, as banks withdrew from foreign operations and financial integration took serious setbacks.

- In 2010 it became desperately evident that the bank and sovereign risks are tightly interconnected with two-way causality.

All in all, the mismatch between the scope of bank operations and the institutional supervisory framework made the situation extremely challenging. As Lord Mervyn King so tellingly put it, "(global) banks are international in life but national in death".

Credibility of national supervision has suffered because of three reasons.

- First, national mandates of the supervisors led to inability to handle cross-border challenges.
- Second, the so called regulatory capture i.e. close relationships between banks and the supervisor led to excessive forbearance on the part of supervisors.
- Third, the large "publicly influenced" financial sector in Europe weakened the credibility of public authorities.

Regaining of confidence in the banking sector is a necessary condition for reversing the recent financial fragmentation in the EU, and for restoring a normal interbank market with capital mobility.

- Confidence and capital mobility are also important for restoring economic growth in the area and putting the single market programme back on track.
- Let me emphasize that public authorities play only a part in this work. Financial institutions and their stakeholders also have a very important role, in redefining business strategies, governance and risk management procedures, and strengthening their capital positions.

Key elements of the Banking Union

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The first main element of the Banking Union is the Single Rule Book for supervision.

- This is based on the idea of identical regulatory requirements (such as capital adequacy rules) for banks. These are achieved through European Regulations or binding standards issued by the European Banking Authority (EBA), while leaving leeway for national authorities to impose stricter requirements nationally for macro-prudential reasons – e.g. in order to contain real-estate bubbles.
- The EBA is charged with the task of harmonizing supervisory practices. It has the legal competence to develop and monitor the implementation of the Single Rule Book.

The establishment of the Single Supervisory Mechanism (SSM) is the second main element of the Banking Union.

- Contrary to the Single Rule Book the institutional framework in the Banking Union will only cover a subset of EU member states – the euro area countries and the countries opting in.
- As the name implies, the SSM will be a unitary supervisory system, composed of national competent authorities and the ECB – and close cooperation between them – and with the possibility of non-euro area Member States to participate.
- The ECB will assume direct supervisory responsibility and major decision making powers for significant banks meeting certain criteria. We expect the number of banks falling under direct ECB supervision to reach some 130–140.
- I will return to the subject of the SSM in a moment.

The third element of the Banking Union is the Single Resolution Mechanism (SRM).

- The single resolution mechanism is needed to coordinate and direct the resolution policies of the member states, in particular of institutions whose failure would have cross-border implications.
- An important precondition for the SRM is a swift adoption of the Bank Recovery and Resolution Directive (BRR), as it lays out a harmonised toolbox enabling the orderly resolution of even a systemically important institution.

The Single Supervisory Mechanism

The SSM will operate as a system, gathering all of the expertise of national supervisors and at the same time possessing a strong decision-making centre.

- Appropriate decentralisation procedures are being planned, while preserving the unity of the supervisory system and avoiding duplication.
- The justification for the two-tier system is that the local supervisors will have an information advantage with respect to local banks. The centralized decision making is required to address cross-border issues and to minimize the risk of excessive forbearance on the part of local supervisors.
- The shared competence is important also because credit cycles differ nationally and the associated potential problems need to be mitigated through nationally differentiated ways.

The SSM, with the ECB at its centre, is entrusted with an extensive set of micro- and macro-prudential powers, covering all key tasks relating to the prudential supervision of credit institutions.

The SSM will possess early intervention powers according to the draft Bank Recovery and Resolution Directive. The early intervention powers are significant and make it possible to take action with respect to institutions which are approaching the point of non-viability.

To ensure a strong centre, the ECB's overall responsibility for supervision is matched by controlling powers over the system as a whole.

- First, all the components of the system will have to act in accordance with a system of guidelines, ECB-specific regulations and manuals of supervisory practices.
- Second, the ECB supervisory function will have the power to overtake direct supervision of any bank or group of banks, if this is deemed necessary in order to preserve financial stability and confidence in the institutional framework.
- Third, the centre monitors that adequate supervisory quality prevails in national competent authorities.
- Fourth, the ECB supervisory function, at the centre, will receive all supervisory data regarding all the banks. This will make the power to overtake the supervision of any bank effective, and will also make it possible to ensure overall supervisory quality.

The supervision will, in practice, be based on a risk-based approach.

- A common SSM Risk Assessment System is being developed, relying on an integrated and harmonized information base.
- The System will be used for assessing the capital and liquidity needs of banks and also to direct supervisory resources (e.g. inspections planning) on the basis of the risk- and impact assessment.
- Common methods and processes will be developed for assessing the adequacy of banks' capital and liquidity levels. This establishment of common supervisory

practices within the SSM will go considerably deeper than the work of the EBA in developing the Single Rule book and harmonizing supervisory practices at the EU-level as a whole.

The governance structure of the SSM has been designed so as to separate the ECB's monetary policy and supervisory roles, and to make the position of different participating countries as fair as possible.

- A new body, the Supervisory Board, will be responsible for the supervisory functions of the SSM. While the decisions are formally and finally adopted by the Governing Council of the ECB, the Supervisory Board will be, de facto, the main decision-making body in supervisory matters.
  - The Governing Council cannot alter the decisions of the Supervisory Board, but only prevent their entry into force.
  - Such a veto power could be exercised when the decision is seen to be in conflict with monetary policy.
  - This principle was accepted at the level of the European Council by all governments, which seems to indicate that in the future we see an extension of the SSM further beyond the euro area.

The special status of the non-Euro Area countries is taken into account in the decision-making mechanism.

- Non-euro area member states can participate through establishing a close cooperation agreement with the ECB.
- By giving non-euro area Member States full membership and voting rights in the Supervisory Board they are placed on an equal footing with the euro-area members.
- If the Governing Council prevents the entry into force of a decision, which results in a modification of the decision, a non-euro area country may announce non-satisfaction with such a decision.
- If the Governing Council decision prevails, the non-euro area country can choose not to adopt the decision. For its part, the ECB could then consider breaking up the agreement of close cooperation.

Joint Supervisory Teams will be established. They will integrate the ECB and national competent authority staff into single supervisory units responsible for the conduct of the on-going supervisory activities, planning of on-site inspections and other supervisory work and for preparing supervisory decisions.

- The Teams will be established and led by the ECB.
- There will be one Team for each significant banking group, tailored to the needs of each banking group (proportionality).
- The Joint Supervisory Teams will provide a single interface for the supervised banks and a single entry point for applications e.g. concerning internal models to be approved by the supervisor.

The crisis has shown that micro-prudential supervision at individual bank level is not sufficient, and that macro and micro risks can actually be mutually reinforcing. This calls for very close cooperation between the macro- and micro-prudential functions. The SSM has powers also in the macro-prudential area, which is a shared competence with national macro-prudential authorities.

- The ECB will comment on national measures and has the possibility to tighten the national measures if they are deemed inadequate.

- Macro-prudential instruments could also be applied to the euro-area financial system as a whole.
- The role of the EU macro-prudential supervisor, the European Systemic Risk Board (ESRB), is broader both geographically and functionally than the SSM. The ESRB covers all EU member states and the whole financial system rather than only the banking sector.

The practical preparation of the SSM has been well underway since autumn 2012.

- The main elements of the supervisory model and the Supervisory Manual are in the process of being developed.
- The ECB is preparing a Framework Regulation, setting out the main responsibilities of the ECB and national authorities and the main requirements set for banks in the SSM.
- The main features of the SSM Risk Assessment System should be available and the list of significant banks entering into SSM direct supervision should be completed in the next few months.
- Provided that the SSM regulation is accepted and promulgated in time, the Supervisory Board of the SSM will be established in October 2013.
- During late 2013 and the spring of 2014 the newly established SSM Supervisory Board carries out the needed consultations and then adopts all the basic documents setting out the operations of the SSM.
- The ECB supervisory functions will be staffed during the remainder of 2013 and the beginning of 2014 in order to have the SSM fully operational as of October 2014.

Of particular relevance for the start of the SSM and a key element in confidence rebuilding will be the Balance Sheet Assessment of banks to be conducted before the SSM is up and running.

- The Balance Sheet Assessment is intended to make sure that legacy asset problems will be detected and sufficiently addressed before the operational start of the SSM.
- The plan is to have the BSA finalised in the spring 2014, after which pan-European stress tests will be conducted in close cooperation between the European Banking Authority and the SSM.

The Single Resolution Mechanism

The need for swift and orderly resolution of failing cross-border banks is the Achilles heel that needs to be addressed. Europe needs to move from national to supranational resolution arrangements for significant banks.

Enhanced resolution policies complement and would be supported by the structural regulations proposed by the Vickers commission in the UK and the Liikanen report on the EU level.

The Single Resolution Mechanism will be based on the Bank Recovery and Resolution Directive. This will create an institutional framework with enhanced powers to restructure and wind down failing banks.

- The new powers to bail-in bank debt holders are a crucial, element of the future resolution mechanism, which should limit the use of bail-outs significantly. The intention is that in the new regime, bail-in will be the rule, bail-out a rare exception.

- The draft BRR Directive requires that national resolution authorities cooperate with each other and that resolution colleges are established from all the resolution authorities of the countries where the bank has business operations. This takes us some way in facilitating orderly resolution of cross-border banks. There are some weaknesses that remain:
  - The draft BRR Directive or any other existing arrangement do not contain compulsory coordination of resolution measures before they are taken by home and host authorities. Hence, there is no explicit and binding resolution mechanism for cross-border banks.
  - Conflicts of interest and incentives for ring-fencing that have plagued cross-border crisis management will still be inherent to the framework. Both home and host authorities could exercise ring-fencing at their own discretion.
- It is thus doubtful that a resolution college could effectively coordinate in time the necessary decisions involved in the resolution of a cross-border banking group and resolve the conflicts of interest.
  - We need a supranational decision making body with resolution powers and good decision making procedures, and the same institutional and geographical scope as the SSM.
  - Ideally there should be a Single Resolution Authority, which would govern the resolution of banks and coordinate the application of resolution tools. It should have:
    - a clear and relatively narrow mandate to protect it from political pressure and to achieve credibility.
    - a comprehensive set of enforceable tools, powers and authority to resolve all banks under the SSM.
    - a task to ensure that failing banks are resolved swiftly, through impartial decision-making focused on the European dimension.

Agreeing on the mandate and powers for the EU-level resolution authority will be easier if unfounded national interests are not allowed to play a role, and if it is clear that the following two principles are respected in reorganizations:

- Minimizing taxpayers' liability (with regard to the governments)
- Striving for the least cost solution (with regard to the financial sector).

Even though these principles are the main thrust of the commission proposal, a clear statement on the principles is warranted. I believe that kind of explicit statement would facilitate discussions on who is deciding and about what.

Orderly and efficient resolution is not only a problem for the so-called peripheral countries which have made the headlines recently.

- The UK has had its share of these cases, as you know.
- In the Nordic region there was earlier experience from the banking crisis of the early 1990's.
- The dramatic crisis in Iceland had some repercussions in the other Nordic countries, and in the UK and the Netherlands as well, when local host country authorities had to intervene in order to control the situation, with more or less satisfactory outcomes.
- There have been also other cases of authorities' intervention in the Nordic region, mostly in Denmark, where the local property financing market threw a number of

banks into trouble. In Sweden and Finland there have been cases of small "boutique" type banks which have been closed.

Deposit guarantee schemes

A Pan-European Deposit Guarantee Scheme has also been proposed as an element of the banking union. The planning of such a scheme is still in a very early phase. It is clearly more difficult to establish than the SSM or the SRM. One reason is that the existing national systems are very heterogeneous.

- A politically sensitive issue is the possibility of mutualisation of risks, or national funds in a situation in which significant funds have already been gathered in some countries while at the same time none, or very little, have been gathered in other countries.
- Nevertheless, as long as deposit guarantee systems are predominantly national, a strong channel of potential contagion remains between banking sectors and the states.

It may be that once the SSM and the SRM have established an effective control of the European banking sector, and the legacy issues from the previous crisis have been solved, the discussion about a common deposit guarantee scheme will move forward.

- As a first and important step, further harmonization of national schemes along the lines suggested by the Commission in the draft Directive is called for.

The Nordic dimension

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The cross-border character of the Nordic banking sector has a long tradition and has become more and more pronounced. It calls for a corresponding structure for its supervisory framework.

- The Nordic banking sector is dominated by a small number of international banks, which are large relative to their home-country GDP. The assets of the six largest banking groups (Nordea, Swedbank, SEB, Handelsbanken, Danske Bank and DnB) comprise roughly 94 percent of the total assets of all 53 publicly-listed Nordic banks and equal over 180 percent of the combined Nordic GDP. Four of these have their parent banks in Sweden, one in Denmark and one in Norway.
- Each of the large banking groups is nationally very significant. However, their operations, credit exposures and depositor base are typically regional. About 85 percent of the largest six banks' exposures and deposits are located in the four Nordic countries and roughly ¾ of their full-time employees are based in the region.

Local banking groups add to the heterogeneity of the Nordic banking sector.

- Of the six large banking groups, only the DNB limits almost all of its operations to its home country (Norway).
- OP-Pohjola Group, with cooperative roots, focuses its operations on the domestic market and is one of the two largest banks in Finland.
- The national networks of savings banks have a strong footing in many Nordic countries.

The establishment of the SSM is very interesting from the perspective of the Nordic banking sector.

- As a euro area country, Finland will automatically participate in the Banking Union.

- If the national competent authorities of non-euro area Member States, Denmark and Sweden, opted to participate in the SSM the supervision of the significant banks in these countries would be the direct responsibility of the ECB.
- Should the home-country authorities of the large banking groups headquartered outside the euro area remain outside of the SSM, the ECB would assume the responsibility of a host supervisor of the major subsidiaries in the euro area.
  - Nordea and Danske Bank have significant subsidiaries in Finland, which would bring them under direct supervision of the ECB.
  - Also some other banks from the outside potentially fall under SSM supervision. The Swedish SEB, for instance, has a subsidiary in Germany.
  - Other large subsidiaries of non-euro area banks in the euro area include Bank of America (Ireland), HSBC (France and Malta), RBS (Netherlands), Bank New York Mellon (Belgium), Barclays (Spain), GE Capital (France), State Street (Luxembourg) and Cerberus (Austria).

A strong Nordic dimension in the Banking Union would be a positive development, not only for the Nordics themselves, but it would also help in building highly competent regulatory bodies.

- It would simplify the supervisory structure if all Nordic authorities would operate under the SSM roof.
- I believe that the Banking Union would benefit from the tradition of integrity and transparency which are at the core of supervision practices in the Nordic countries.
- Good supervisory practice in the region is built on the experience from the banking crisis that struck the Nordic countries in the early 1990s. I believe that the whole Banking Union could benefit from this experience.

There is a long and evolving tradition of cooperation between Nordic supervisors. Participation in the SSM would strengthen the governance of this cooperation and make it better aligned with the structure of the major banks in the region.

Implications for banks

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The changing structure of supervision will probably have some interesting implications for competition in banking and the operating conditions of the banking sector.

Banks will find that the SSM brings benefits in the form of reduced administrative costs and increased certainty and commonality in supervisory practices.

- Even within such a closely integrated region as the Nordic, there are still differences in the supervisory practices. Without the SSM, this generates uncertainty and additional administrative costs.

Banks in the SSM can benefit from uniform supervisory practices and the single entry point to authorities, which should reduce the supervisory burden on cross-border banking groups, including reporting costs. It will also provide additional assurance of a level playing field across the banking market.

- Participating in the SSM may also mean easier conduct of cross-border mergers and acquisitions as supervisory decisions and approvals on such transactions are centralised at the ECB.
- With the creation of a banking union, it might also be that the idea of the European corporation, which was discussed some 5 to 10 years ago, and some Nordic banks

were contemplating, will revive. This would have implications in particular for the operational efficiency of cross-border banks.

The unified supervision and the resolution tools of the SRM in particular may have some impact on funding costs.

- While the net impact of the Banking Union on the banks' funding costs is less straight-forward to assess, the benefits of better credibility of supervision and eventually also of a larger pool of resources for crisis resolution would be positive for banks. Cutting the bank-sovereign linkage of creditworthiness, which is the aim of the Banking Union, would be important for banks based in countries where government finances are weak.
- However, the net impact on the funding costs of banks will depend on how much of the implicit government guarantee remains. Within the banking union, large cross-border banks are likely not able to continue to enjoy their too-big-to-fail status. This will correct the artificially low funding costs that these banks enjoy. In countries outside the banking union, where there will be no pooling of resources to alleviate the too-big-to-fail problem, systemically important banks will likely continue to have lower funding costs than less significant banks.

There are reasons why the Banking Union may have an impact on the market value of banks.

- The increased confidence in banks based in countries participating in the banking union may increase investors' interest in them, thus facilitating their funding.
- The core factor is a credible assessment of bank balance sheets.
  - There is an "uncertainty discount" attached to (almost) all banks due to opacity of bank's balance sheets creating some uncertainty as to the quality of the assets. The market (currently) assesses assets with some caution and is hence undervaluing many, if not most, banks to be on the safe side.
  - The Banking Union and in particular its Balance Sheet Assessment, provided that it is seen as credible, will increase transparency and thus reduce the uncertainty attached to the market value of banks.
  - Pricing will more correctly reflect the true value of the banks. The discount unfairly attached to good banks will be reduced, or even eliminated. The weak banks will, however, most probably see their share price drop even further. Banks that are no longer deemed viable need to be restructured or wound down through orderly resolution processes.
  - An unanswered question still is the potential impact on the required return on equity. While some studies suggest that owners could accept lower returns due to a safer and more stable business environment, there is no really clear evidence on that yet.
- The Banking Union will moreover reduce the impact of the financial position of the country in which the bank is headquartered on the market value of the bank.
  - The size and significance of the cross-border banks will no longer be related to the size and fiscal strength of a single country but rather to a region that reflects its operations in a more appropriate way.

In thinking about the effects of the Banking Union on individual countries and banks we should bear in mind that the Banking Union is built for the long term.

- The current positions of strength or weakness of various countries and banks will not be permanent: "The last will be first and the first will be last". We should therefore evaluate the Banking Union from a general, not particular or transitory perspective.

- Finally, the increased confidence in banks that fall under the SSM supervisory umbrella may open up wider cross-border business opportunities for banks and re-ignite the integration process of the European banking sector.

Customer perspective

The SSM will also impact bank customers.

- For retail customers and depositors especially, there can be some enhanced comfort through perceived high-quality supervision that can come to some benefit for SSM banks as e.g. attracting new customers is facilitated. This is particularly true for foreign subsidiaries, which may be perceived as less reliable than the well established banks.
- Again such matters can become particularly significant if the financial standing of the national safety nets is put in doubt.
- Despite the strong financial position of the Nordic countries and the high integrity of Nordic supervisors, there, may still be a positive impact on the customer perception.

One could also expect that improved prudential supervisory procedures could have positive spill-over effects on the market-conduct supervision and even consumer protection which will remain national responsibilities within the SSM.

Conclusions

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The disparity between international banking and national supervision and resolution powers have been the Achilles heel of the European banking market, a problem that is now finally being addressed. It is regretful that we had to wait until the recent crisis before progress started on this front.

- This is particularly important for the Nordic banking market, which is exceptionally integrated and interconnected, while the countries' starting positions are so divergent, not all being members of the euro area. I hope that the different currency arrangements in the region will not prevent progress in supervision.

An important impulse for the establishment of the Banking Union came from the desire to protect taxpayers and reduce their liability in the banking system. However, in my view, the SSM should also offer significant benefits to the supervised banks: supervisory requirements will be harmonised across borders and there will be one entry point into supervision. Group-level supervision will be emphasised rather than the supervision of subsidiaries.

- This should be quite beneficial especially for those banks which have large cross-border activities. Big Nordic banks are prime examples of such banks. Clearly, the SSM will ease banks' international operations and help ensure a level-playing-field for banks.

To the above we can add the benefits of stronger investor confidence which should result from the strong, objective and high-quality supervisory work.

Finally, the billion dollar question: would the recent financial crisis have been avoided in Europe if the EU had established the banking union before the problems surfaced?

I think probably not completely, since the reasons for the crisis were to a large extent global in nature. But the crisis would likely have been milder and less damaging. The European market would have been less fragile and the authorities could have been able to act more quickly and more decisively. Both supervision and resolution would have contributed to that.

On the supervision side, better, more credible and internationally uniform supervision would have reduced uncertainty among investors and politicians about the condition of the banking systems of the highly indebted countries. That would have made markets more resilient and avoided some of the costs of the drying-up of the interbank market, which hurt even the fundamentally healthy banks.

On the resolution side, if clear ex ante rules for dealing with problem banks had been in place when the crisis hit, the resolution of unviable banks could have been enforced more quickly and more efficiently.

The bail-in tool would have been available to reduce the cost of the crisis to taxpayers. Also, favouring of “national champions” would have been avoided, so recovery and resolution policies would have been more consistent and effective. Healthy competition in the banking sector could have been restored sooner without compromising the stability of the system.

To conclude: Bygones are bygones, but by learning from the past we can prevent or at least mitigate many risks and problems in the European banking sector in the future. This requires unifying our regulatory structures to match the European financial market. We should avoid the use of taxpayers’ money and leave unfounded national interests aside. The Nordic region should certainly be no exception.