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Transcript

The Nature and Significance of Banking Union

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Vítor Constâncio:

Ladies and gentlemen,

Thank you for inviting me to speak to you at Chatham House today. The topic of my address is the nature and significance of establishing a Banking Union in Europe. To many this seems like a new initiative borne out of the experience of the crisis. But it is in fact based on an older debate. During the preparations for the Maastricht Treaty in the early 1990s, there was already the strong conviction that a single system of banking supervision was as a key element in the construction of monetary union. Indeed, one of the foremost proponents of this view was a Bank of England official, Brian Quinn, who chaired the preparatory sub-committee on banking supervision.

This conviction was based on the relatively logical observation that the single currency would deepen financial interdependence in Europe and so require an integrated system of supervision. It was also in line with the prevailing model at the time of banking supervision being entrusted to the central bank. And although in the end a different approach prevailed, the force of this conviction explains why the EU Treaty left open the possibility – through Article 127(6) – to give supervisory powers to the ECB based on a unanimous decision of the Member States.

At least to clear-sighted observers, it was evident that at some point this article would have to be activated. The late Tommaso Padoa-Schioppa, who preceded me as the member of the ECB's Board responsible for financial stability, wrote in 1999 that:

'I am convinced that in the future the needs will change and the multilateral mode will have to deepen substantially. Over time such a mode will have to be structured to the point of providing the banking industry with a true and effective collective euro area supervisor. It will have to be enhanced to the full extent required for banking supervision in the euro area to be as prompt and effective as it is within a single nation'.

That said, those like Padoa-Schioppa could not have complete foresight about how monetary union would evolve. We have meanwhile learned a lot that is new from the crisis. The events of recent years have revealed a variety of weaknesses in the governance of the financial sector that were not foreseen before 1999 – and that also need to be addressed through common solutions. Hence, the Banking Union we are aiming for today goes beyond purely banking supervision: in my view it must comprise five elements.

First, a single rulebook for banks.

Second, a single framework for banking supervision.

Third, a single mechanism for resolving banks, funded by levies on the sector itself.

Fourth, a common backstop in case temporary fiscal support is needed.

Fifth, a common system for deposit protection.

How would Banking Union have helped during the crisis?

To illustrate why these elements are so important, it is helpful to think through how a genuine Banking Union in Europe could have helped both prevent and mitigate the crisis.

Preventing the crisis

Turning first to prevention, one of the key causes of the crisis was the unacknowledged build-up of large private financial imbalances in the period from 1999 to 2008. They were unacknowledged because the governance framework that existed in Europe was focused exclusively on fiscal policies via the Stability and Growth Pact. This reflected the prevailing belief at the time that the private sector was composed of fully rational agents and was essentially stable and self-correcting – hence only the public sector could create instability.

This was of course a fiction: the private sector was where some of the largest imbalances were concentrated. Between 1999 and 2007, the ratio of public sector debt to GDP in EMU declined on average by around 6 percentage points – while the ratio of private sector debt to GDP increased by almost 27 percentage points. To give just one example, in Spain the ratio of private sector debt to GDP increased by around 75 per cent, while the ratio of public debt to GDP fell by around 35 per cent.

The key point for this discussion was that all of these private flows were being intermediated by the banking sector, which had become much more integrated as a result of monetary union. Hence the official bodies best placed to identify these growing risks, and act to prevent them, were national bank supervisors both in lending and borrowing countries. However, they lacked both the cross-border perspective and also the instruments to do so. After all, their mandates were national and did not extend to systemic risks building up for the euro area as a whole. European financial integration went far ahead any European oversight and financial stability and as a result financial stability was unwittingly sacrificed.

How would Banking Union have helped? By moving supervision and other national financial policies to the European level, the problem can be solved. Supervisors can take a euro area-wide view of financial developments, identify early the build-up of systemic risks, and use appropriate macro-prudential tools to counteract them. Had a single European supervisor existed prior to the crisis, it could have spotted the unsustainable growth in private sector debt and the excessive leveraging of banks' balance sheets associated with it – and hopefully taken early preventative measures.

Mitigating the crisis

What about the role of Banking Union in mitigating the crisis? Here I can see two key ways in which it would have been instrumental.

First, it would have lessened the so-called 'bank-sovereign loop' that drags down the fiscal sustainability of sovereigns. This loop is driven by bank bailouts or just by the expectation that sovereigns will have to bail-out struggling banks, which then increases borrowing costs for sovereigns and further drives up funding costs for banks. A Single Resolution Mechanism would avoid this by resolving banks rather than saving them and by making the private sector rather than the taxpayer pick up the bill. Moreover, any residual fiscal burden on sovereigns would be distributed across the euro area through the common fiscal backstop.

Second, a Banking Union would have reduced the fragmentation in financial markets that holds back bank lending and economic growth. At present, market fragmentation is severely disrupting the transmission of the ECB's monetary policy. In some countries, changes in our main interest rate are being passed on fully by banks; in others, because bank funding is tight, interest rate changes are being passed on hardly at all. This is making credit very hard to come by or unduly expensive in some parts of the euro area.

Banking Union would limit financial fragmentation in a number of ways. An impartial supervisor conducting credible stress tests would lessen fears that banks are hiding bad assets in some countries. Depositors' confidence would be mitigated by harmonising deposit guarantee schemes. And a supervisor with a truly European focus would never undertake actions that can encourage fragmentation, like insisting on national asset and liability matching.

So we can see that there is a strong case that a genuine Banking Union would have made a big difference both before and during this crisis. But while

one might accept this in theory, it of course begs the question, is this what is happening in practice? Is the Banking Union we are building truly effective? Or are we just seeing a new label placed on what will remain an essentially unchanged and nationally driven process? These are the questions I want to take up in what follows.

How far are we towards completing Banking Union in Europe?

On the five elements of a genuine Banking union that I mentioned at the beginning, progress is currently positive on all fronts – but it is also uneven.

First, the single rulebook to a large extent already exists, and will be complemented by the agreement on the Capital Requirements Directive IV expected in the next months. This will contribute significantly towards making the banking sector in Europe more robust and creating a level playing field.

Second, a Single Resolution Mechanism will hopefully be proposed by the Commission in the second half of this year. In the meantime, the Bank Recovery and Resolution Directive should be adopted by the middle of this year, which will provide a better framework for coordinating resolution of cross-border banks and provide national authorities with new resolution powers. These new powers – like writing down capital instruments and bailing-in creditors – should help ensure that the financial sector, rather than taxpayers, bears the burden in future bank resolution.

Third, the creation of a common backstop is already underway with the ongoing discussions on direct bank recapitalisation by the European Stability Mechanism (ESM). This is an important tool for the near term to help break the bank-sovereign loop and exit the crisis. In the longer term, the fiscal backstop to the Banking Union could perhaps replicate the successful arrangements we see in the U.S. where the Treasury provides a credit line to the FDIC, which is repaid over time through additional levies on the financial sector.

Fourth, the establishment of a common system of deposit protection will begin with the adoption of the Commission's proposal on deposit guarantee schemes, expected by mid-2013. This provides a harmonised framework and should help shore up confidence in national schemes – particularly, in my view, if there is a 'depositor preference' rule in situations where banks are resolved. This means that a single European scheme is not an essential component of Banking Union in the short term.

Key features of the SSM

Finally, there is of course the Single Supervisory Mechanism, or SSM. As you know, progress here is already well advanced: the Regulation setting up the SSM has already been approved by Council and is now being discussed by the European Parliament. So what are its key features?

Above all, the SSM will be one system. Some commentators have claimed that, because the SSM is decentralised, nothing will change and supervision will remain essentially national. This is not correct. The ECB will be the legally competent supervisor for all banks in participating countries. It will have direct supervisory powers over large, systemic banks, which we estimate to number around 140. We will not directly supervise the thousands of remaining smaller banks, because this would be inefficient when national supervisors are already in place with the necessary knowledge and technical skills. But the ECB and the national supervisors will act as a single system.

To ensure cohesiveness, all the components of the system will have to act in accordance with guidelines, ECB specific regulations and manuals of supervisory practices that will be approved by the Supervisory Board. Moreover, the ECB will receive supervisory data on all banks in the SSM allowing it to keep track of developments across the system. On this basis, it can decide to transfer to direct supervision any bank or group of banks that may be considered relevant or the origin of systemic risk. This incorporates the lesson of the crisis that not only big banks can be the source of general financial instability.

The SSM's micro-prudential role will also be complemented by extensive macro-prudential powers. Unifying micro- and macro-prudential powers within the central bank aligns practice in the euro area with that in most other advanced economies. The Bank of England, for instance, will have the Prudential Regulation Authority for micro- and the Financial Policy Committee for macro-prudential issues. And there are in fact additional reasons for doing this in a multi-country monetary union like the euro area, as the level of the main interest rate may not be appropriate for all countries at all times, meaning macro-prudential tools play an important role as a 'counter-weight'.

A final point to note about the SSM, according to its Regulation, is that its launch will be associated with a comprehensive review of participating banks' balance sheets. The objective of this review is to identify legacy problems and start with a system that avoids reputational risks for the SSM down the line. This process may have financial implications if impaired assets have to be

written down. And this is a further reason why having a Single Resolution Mechanism in place for participating countries is a matter of urgency.

Benefits for the non-participating Member States

The SSM is open to the participation of all EU member States, including those that have not adopted the euro and perhaps many will do so. How will those states that do not participate in the SSM be affected by Banking Union?

It is important to stress here that the playing field really will be level. There will be no disadvantage for banks in countries like Britain that stay out of the SSM. Banking Union will benefit all Member States that are part of the single financial market. And as the leading provider of financial services in Europe, I can see only advantages for Britain from its creation.

First, Banking Union will facilitate the completion of the single financial market by simplifying supervisory and regulatory practices, which will facilitate wider market access for banks and investors across Europe.

Second, Banking Union will reduce the scope for coordination failures between national supervisors, which will in turn allow for more effective implementation of the single rulebook and convergence of supervisory practices. In this way, the presence of the SSM can be seen as reinforcing the coordination function of the European Banking Authority. The SSM will operate in full compliance with EBA guidance and actively contribute to its work.

Third, Banking Union will enhance financial stability in the Europe – and this, more than anything, is what is required for the single market in financial services to thrive. This would bring huge potential benefits for all Member States in terms of enhancing financing for the real economy, managing risks and pooling the resources of investors from European and elsewhere.

Conclusion

Let me now conclude.

What we are aiming for in Banking Union is to create a system that is truly European and not just an inter-governmental framework for national authorities. We have seen that a Banking Union would have made a real difference during the crisis – and for this reason, there is no pressing reason to carry on with national arrangements that have not functioned effectively.

I believe that this message has made its way into the SSM legislation. The elements are there for a truly European approach to supervision. And I hope

that it will also translate into a strong Single Resolution Mechanism, to be launched as soon as possible. The SSM and the Single Resolution Mechanism are complements and we need progress on both these fronts.

As Victor Hugo once remarked, 'you can resist an invading army; you cannot resist an idea whose time is come.' I believe that Banking Union is just such an idea. But it now depends on us – as policymakers, as commentators, as citizens – how it is turned into reality. If we are anything less than wholly ambitious, then we will have learned nothing from this crisis.

Thank you for your attention.