Stefan Gerlach: Banking and Fiscal Union

Introductory remarks by Mr Stefan Gerlach, Deputy Governor of the Central Bank of Ireland, at a panel session at the EUI conference on “The state of play in the euro area – fixing the EMU for the long term”, Florence, 21 January 2013.

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I am grateful to Rebecca Stuart for her help in preparing these remarks.

While plenty of work has been undertaken since last summer on establishing a European banking union, progress has been uneven and it has stalled in some areas. Of course, it is difficult to build consensus in a situation where bank resolutions may become necessary, and deposit insurance schemes could be called on, in the near future. This is a matter that ideally should have been discussed and settled when EMU was formed, much in the same way as a car must be insured before it can be driven. Unfortunately, that route was not taken.

Much of the interest in banking union arises because it is a necessary, but not sufficient, condition for the ESM to recapitalise banks. Indeed, the establishment of the Single Supervisory Mechanism (SSM) with the ECB is frequently seen as having been adopted precisely because this is the fastest road, legally and institutionally, to banking union.

It is of course essential and urgent to enable the ESM to support banking systems in order to overcome some of the tensions in the euro area, and there is intense public debate about how best to structure the SSM. In my introductory remarks today, however, I would like to take a step back from that debate and instead reflect more broadly on why a banking union is important for any monetary union to function well and why it is natural to locate the SSM with, or at least “close to”, the central bank in such a union.

Banking supervision

Why might it be beneficial to have a SSM in a monetary union? To my mind, one important reason is that a greater remove between supervisors and the banks they regulate can help improve the capacity for challenge and ensure a broader, more detached, perspective on the issues. In particular, it would ensure the independence of the supervisory and regulatory decision-making process from national political pressure, and avoid regulatory capture. For example, a distant supervisor may take action to address risks arising from a bubble in good times that a national supervisor would come under pressure to overlook. It also seems unlikely that a banking supervisor from, say, Italy or Ireland, sitting in Frankfurt, supervising a bank in Spain or Slovenia will let career considerations influence his or her decisions.

That said, local knowledge about the banking market and economic conditions are important. Systemic banking crises can be exceptionally costly and are likely to remain national phenomena, in much the same way as they are largely regional in the US. One reason for this is that fiscal policies and many economic policies that can play an important role in setting the stage for a bubble will remain largely national. Retaining some capacity to implement national macro prudential policy will therefore be important. Overall, it seems essential to combine both union-wide and national factors in designing a SSM.

Another reason why a SSM is desirable in a monetary union has to do with the credibility of the supervisory framework. When banks in a country run into trouble or a bubble is forming, outside observers tend to attribute part of the problem to weaknesses in the national regulatory and supervisory regime. They naturally ask if other undetected problems may be brewing in the financial system in question. This may lead to deposit withdrawals or to a national risk premium to develop even if the Sovereign has sufficient capacity to backstop the financial system. To my mind, a SSM, provided it is well-equipped and resourced, is less likely to have its credibility eroded in such a situation.

Furthermore, combined with a single supervisory rulebook, a common supervisory culture can create a level playing field and increase transparency and confidence in the system. A SSM can also eliminate barriers to the flow of information between supervisors of cross-border institutions. The development of a common resolution framework and a resolution fund will also facilitate an efficient management of cross-border banking difficulties.

Indeed, while the debate around banking union is dominated by the capacity of the ESM to break the link between sovereigns and banks, a resolution framework alongside a common deposit guarantee scheme can help ensure that this link does not develop in future crises. The benefits of a resolution framework and fund in ensuring that taxpayers are insulated from the direct costs of resolving banks are clear. However, a common deposit guarantee scheme can be equally important; fears about the ability of individual sovereigns to backstop national deposit guarantee schemes have led to large intra-euro area retail deposit flows during the current crisis, significantly impacting on funding costs of banks in stressed sovereigns.

Monetary policy

Let me next turn to monetary policy. It is sometimes felt that monetary policy and banking supervision should not be conducted by the same institution to limit the risk of a conflict between policy objectives that could hurt the credibility of monetary policy. Several concerns have been expressed. Thus, the realisation of the reputational and legal risks that supervision entails could damage the credibility of the monetary policy function. Furthermore, the incentive and, crucially, ability of the supervisor to practice forbearance towards a regulated institution which is facing difficulties is greater when the lender of last resort and the supervisor are one and the same. Finally, for certain shocks the appropriate policy response of low interest rates or abundant liquidity provision may fuel asset prices, jeopardising financial stability and the price stability objective.

While the concerns are real, in my view there are several mitigating factors:

First, the design of the governance framework is critical. The primary objective for monetary policy must be price stability and the membership in the decision-making bodies for monetary policy and banking supervision should differ.

Second, the geographical perspectives of banking supervision and monetary policy are likely to differ. While monetary policy is union wide, banking problems are likely to remain national. It seems unlikely that the realisation of financial instability in one or a few countries will lead to changes in union-wide monetary policy.

Third, episodes of financial instability are contractionary. I suspect that a careful review of financial history would provide little support for the view that periods of high inflation have been triggered by episodes of banking instability.

Fourth, a conflict between the monetary policy and financial stability objectives is only likely when a large, expansionary aggregate supply shock occurs. In this case, the text book prescription until now has been to relax monetary policy to permit rapid non-inflationary growth, leading to a risk of excessive credit expansion and a bubble forming. However, macroprudential policy is available to deal with the asset price consequences of expansionary monetary policy.

A SSM is also likely to be helpful for monetary policy from an information perspective. For instance, in implementing monetary policy, central banks require their counterparties to satisfy certain criteria, most obviously being solvent. Moreover, Emergency Liquidity Assistance shall only be provided to solvent banks. Thus, there is an on-going need for the central bank to have at least some information about individual banks.

Furthermore, in setting monetary policy it is important to have a sense of how a change in policy is transmitted through the banking system to the broader economy. Also this information flows more easily if the supervisor is not too distant from monetary policy makers.

Similarly, developments in the broader economy may first be reflected in supervisory information which may therefore be useful in setting monetary policy.

Of course, the intensity of the debate about banking union reflects its importance.

Thank you.