

Yves Mersch: The European banking union – first steps on a long march

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the Finanzplatztag, Frankfurt am Main, 27 February 2013.

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Dear Mr Padberg,

Ladies and Gentlemen,

I am well aware that many of you are concerned that the European Central Bank's assumption of the supervisory role might overburden monetary policy. However, if well designed, set-up and managed, the banking union will eventually ease the burden on monetary policy. This will not happen by itself, though. Numerous stumbling blocks need to be cleared in the preparatory phase.

But let me start without further ado.

The success of monetary policy rests on integrated financial markets that operate efficiently and smoothly. They are:

1. the basis for the equal transmission of monetary policy across member states in a monetary union;
2. a key channel for the proper transmission of the monetary policy stance to the real economy – and hence for the ability of monetary policy to deliver price stability.

However, the crisis has brought the flip side of financial integration to the fore, namely interconnectedness and increased risks to financial stability. Indeed, an integrated financial and economic system is more prone to contagion from large adverse shocks. Financial turbulence can more easily spread across markets and regions.

This is particularly true if no institutional safeguards – such as euro area-wide crisis management arrangements – are in place.

Economic and Monetary Union (EMU) architecture – unity in monetary policy, but national plurality in financial policies – was built on the conviction that:

1. the EMU economies would grow closer together economically and financially;
2. financial market pressure would have a disciplinary effect on the Member States' national budgetary and economic policies;
3. national political measures would be fully sufficient to counter any economic or financial imbalances.

Today, after five years of the biggest post-war crisis in Europe, we know that these assumptions were not in line with reality. One of the consequences was a banking sector that was no longer able to provide sufficient credit to households and enterprises in the euro area during the crisis.

The pre-crisis national safeguards in the EU have proven incompatible with the single currency and monetary policy. The planned European Single Supervisory Mechanism (SSM) in combination with a Single Resolution Mechanism (SRM), will make a key contribution towards restoring financial stability in the euro area.

Nonetheless, the primary mandate of the ECB is, and will remain, to maintain price stability in the euro area. This objective will not change with the ECB's new responsibility for banking supervision in Europe. However, bearing in mind the role of financial markets for the transmission of monetary policy and the importance of well-integrated financial markets in a monetary union, measures to ensure a stable and well-ordered financial system in the euro area will be beneficial for the conduct and smooth transmission of monetary policy.

The banking union can therefore support our single currency and can relieve monetary policy of some of the tasks undertaken during this crisis – notably, the task to repair or, in some cases, to bypass a clogged transmission channel. The non-standard measures may then be gradually phased out, as the changes introduced in the monetary policy framework during the crisis will no longer be necessary. This should not be confused with a change in course from the accommodative monetary policy.

A phasing-out of certain emergency measures is desirable, given that new market distortions might otherwise emerge.

Financial fragmentation affects monetary policy

The years preceding the financial crisis were very favourable as regards the integration of capital markets in Europe, with the integration of euro area money markets forming a key pre-condition for the proper conduct of monetary policy. Our policy rate instantaneously transmits to the interbank money market rates and determines the refinancing conditions of the banking sector. In this regard, the money market further transmits monetary policy impulses to other markets and financing conditions and is key to the homogenous transmission of monetary policy across the euro area.

Moreover, the integration of securities and wholesale markets plays an important role for the funding of the banking sector. With the banking sector in the euro area being an essential source of financing of the real economy, the integration of these markets plays an important role in the pass-through of monetary policy decisions to the lending rates of the banking sector.

The financial crisis has challenged the stability and integration of European financial markets in an unprecedented way. It has thrown into reverse the steady integration seen since the inception of the euro. The causes for this were manifold.

First, heterogeneous economic developments caused by financial and structural imbalances across euro area Member States led to *outflows* of funds from the countries that were perceived as more risky – in view of their large cumulated imbalances stemming from ample competitiveness gaps, high current account deficits and high private sector leverage – and led to *inflows* into countries with a safe-haven status.

Second, imbalances in the banking sector arose from undue risk-taking, investment in opaque financial products and excessive leverage. This has caused some financial institutions to be cut off from wholesale funding markets and interbank funding. The seclusion of some financial institutions was also the result of the measures introduced by some Member States to ring-fence the domestic banking industry from foreign contagion. While this was an understandable response from regulators that had a domestic perspective in their institutional mandates, the consequence was a further fragmentation of financial markets.

Third, in some countries, fiscal fragilities interacted with banking fragilities. On the one hand, high fiscal deficits and debts eroded confidence in the ability of some governments to support domestic banks, increasing their counterparty risk vis-à-vis banks located in countries with sounder fiscal positions. On the other hand, bank fragility had severe budgetary implications in some countries as public funds were mobilised to recapitalise ailing institutions. In addition to the impact of financial instability, fiscal fragility also affected financial integration directly, by creating an uneven playing field among institutions: banks in countries with fiscal problems were consistently confronted with higher funding costs, reflecting the higher headline risk of the sovereign. Moreover, government guarantees on bank bonds, an instrument that has been widely used during the crisis, had different values depending on the fiscal situation of the sovereign. Furthermore, in an environment of dried-up liquidity, the large refinancing needs of some governments led to concerns that the public sector would

crowd out bank debt issuance. National banking systems with the highest exposures to domestic sovereign markets were hit particularly hard through this channel.

Inadequate institutional safeguards

At a more fundamental level, however, this instability and fragmentation of euro area financial markets was the unavoidable consequence of a structural inconsistency in the European monetary and financial architecture, namely the dichotomy between, on the one hand, a common currency and central bank and, on the other, a system of banking regulation, supervision and safety nets that is largely organised along national lines.

While this dichotomy did not appear problematic before the crisis – indeed, the presence of national regulation was often viewed favourably as a component of a more flexible regulatory and supervisory framework in Europe, which could be more easily adapted to country-specific conditions – it led to important deficiencies that were first laid bare by the crisis.

- The lack of a robust regulatory and supervisory framework led to the failure to identify and control an unbalanced and unsustainable expansion of credit in some countries, during a period characterised by low interest rates, abundant liquidity and easy access to credit.
- A framework fundamentally based on the national perspective was also not conducive to identifying cross-country interdependencies and the potential for spillovers, which therefore went unaddressed.
- When the crisis erupted and the vulnerabilities materialised, the framework also revealed the lack of adequate crisis management mechanisms. National supervision proved to be a major obstacle towards a more efficient management of the crisis, leading to a serious setback in the process of financial integration.

Monetary policy in the crisis

In this environment of financial refragmentation of euro area financial markets, central banks had to step in. If risks to financial stability hamper the proper transmission of monetary policy, monetary policy may be rendered ineffective, thereby impeding the ability of central banks to safeguard price stability.

Financial cohesion, in turn, ensures that the monetary policy signals are properly and evenly transmitted to all jurisdictions of the monetary union, without, however, levelling out the premiums for different credit and liquidity risks. In fact, during the crisis, the divergence of bank funding conditions at national level has led to cross-country differences in both the costs of financing and the availability of loans. The retrenchment of credit supply within national borders, coupled with funding pressures, has impaired the transmission of monetary policy. The need to counter these adverse developments has been a key rationale behind the extraordinary monetary policy actions undertaken by the ECB in the wake of the crisis, such as the full allotment, the longer-term refinancing operations (LTROs) or the relaxation of the collateral framework. At the same time, the emergency liquidity assistance (ELA) provided by the national central banks was used more intensively. Although this is carried out by the national central banks at their own risk and for their own account, it might lead to tensions between the national and European levels of monetary policy, which would not be sustainable. A renationalisation of the monetary architecture would not be effective.

Our non-standard measures can and should only provide temporary support for two reasons. First, keeping our non-standard measures in place for too long can adversely affect agents' incentives in the economy at large and lead to moral hazard. Various actors in the economy may be relieved from pressures to take up their own responsibilities, thereby lowering the incentives to correct imbalances, unwind past excesses and redress the course of unsustainable economic and financial policies.

Second – and more fundamentally – non-standard monetary policy cannot solve the underlying structural economic and financial problems.

The banking union – restoring financial stability and reintegrating financial markets

The banking union aims at building an integrated financial framework to safeguard financial stability. To this end, it is absolutely imperative to have both an EU framework for single supervision, the SSM, as well as an integrated resolution framework, the SRM. Stability comes from having two pillars.

The Single Supervisory Mechanism

One particular institutional shortcoming of Economic and Monetary Union (EMU) derives from the inconsistency between a single monetary policy and national supervisory competences. A step up of supervisory powers to the supranational level was therefore needed to reverse financial fragmentation, with a view to breaking the link between sovereigns and banks, restoring the principle of self-responsibility and avoid objectionable transfers.

By centralising supervision, the SSM should ensure uniform practices across Europe and overcome the home-host cross-border supervisory discussions and the associated national bias. The establishment of a single supervisor marks a new epoch in the EU financial framework, which may be comparable to the creation of monetary union at the end of the last century. It can significantly contribute to the prevention of ring-fencing measures conducive to the fragmentation of funding channels, which leave credit institutions and the real economy exclusively reliant on domestic funding. Additionally, before it can become operational, the SSM will support the European Banking Authority's development of the single rulebook for financial services that, together with the single supervisory handbook, will contribute to a level playing field in the European financial market.

The exclusion of banks from the direct supervision of the ECB is not tantamount to exclusion from the ECB's supervisory reach. First, national supervisory authorities will have to abide by ECB regulations, guidelines and general instructions and be subject to the ECB's broad oversight power over the functioning of the SSM; second, to ensure consistent application of supervisory standards, the ECB may decide at any time to exercise direct supervision on less relevant credit institutions, upon its own initiative after consulting with national authorities or at the request of the national supervisory authority.

Although aimed at revising the institutional arrangements of the euro area, the SSM is not a closed system. It is open to those national competent authorities of non-euro area Member States that intend to participate by entering into a close cooperation with the ECB. Once a Member State enters into a close cooperation, national competent authorities will participate on equal footing as regards supervisory decisions, but will equally have to adhere to the guidelines and instructions issued by the ECB. Enlarged participation in the SSM is a great opportunity for setting a level playing field in supervisory practices across the EU. At the same time, a series of conceptual questions need to be addressed. For one, it is hard to imagine that countries not participating in the European Stability Mechanism (ESM) might act as a financial safety net for troubled but solvent banks, in the event that a privately financed resolution fund is not yet adequately funded.

The next steps

The establishment of the SSM represents a great opportunity for financial integration in Europe. Let me now turn to the next steps in the establishment of the SSM.

First, the swift adoption of the SSM Regulation is essential. Definite plans are crucial in order to uphold the current momentum of the stabilisation of the euro. The general expectation is

that the SSM will be established early this year, with an effective operational start 12 months later.

Second, the design of a supervisory model, including the allocation of tasks between centre and periphery is critical for the success of the SSM. In this regard, work is already under way by the ECB in cooperation with national competent authorities – subject to the final legal wording.

Third, the SSM will need to carry out a comprehensive review of the banks that fall under the direct supervision of the ECB. As set forth by the Regulation, this exercise should include elements of an asset quality review as a basis for a thorough solvency analysis. This analysis should also be instrumental in identifying potential legacy problems. It is important that the financial clean-up of these legacy problems will be undertaken by the responsible Member States and not by the ESM and certainly not by the ECB. Just like an insurance policy, the SSM can cover future risks. Past omissions must be resolved by those who are accountable for them. This does not rule out interim solutions involving actions by the SRM and (privately financed) resolution fund as well as by the ESM.

Fourth, appropriate safeguards to mitigate reputational risks – for both the supervisor and the monetary policy maker – are needed. It is therefore critical to implement an actual *internal* separation between supervisory and monetary functions, that should also be coupled with an *external* dimension, reinforcing the outside perception of such clear operational and accountability separation. The Chair of the Supervisory Board is responsible for discharging the accountability duties towards the European authorities (European Parliament, finance ministers of participating Member States, the European Commission). They may also, on occasion, be asked to report to national parliaments. More regularly, the representatives of the national competent authorities will perform such a role at the domestic level.

The Single Resolution Mechanism

Let me now turn to the establishment of a Single Resolution Mechanism (SRM), which constitutes the second pillar of the banking union and is a necessary complement to the SSM. It is crucial that the SRM is in place once the SSM is operational. There would otherwise be a danger of creating potential conflicts between supervisory and central bank perspectives. It would be a misunderstanding to believe that there will be no more troubles at banks as soon as responsibility for banking supervision is conferred to the ECB. On the contrary, non-viable banks will have to be closed down and resolved in order to prevent the “zombification” of the European banking sector. The viable parts of certain banks may nevertheless require transitional funding – which should not be mistaken for a bail-out.

A single resolution mechanism is hence an essential condition. It will ensure timely and impartial decision-making focused on the European dimension and that resolution costs are borne by the private sector, thus putting an end to the expectation that taxpayers will foot the bill. The era in which the privatisation of profits and socialisation of losses was possible should belong to the past.

The SRM should be equipped with a comprehensive set of enforceable tools and powers to resolve all banks participating in the SSM. This mechanism should under no circumstances be placed with the ECB, in order to nip any potential conflicts of objectives in the bud. However, the flow of information to the SSM must be safeguarded.

This calls for urgent adoption of the Bank Recovery and Resolution Directive that will provide a harmonised toolkit across the EU.

The SRM should have control of and access to a European resolution fund for resolution financing. This fund should be funded by *ex ante* risk-based levies on the industry. The European resolution fund should have access to a temporary emergency facility that is fiscally neutral in the medium term, meaning that any temporary public support will be recouped by *ex post* levies on the industry.

Restoring financial integration will unburden monetary policy

From a monetary policy standpoint, the banking union will alter neither our policy objective nor our policy strategy. The pursuit of price stability as our prime objective is set out in the EU Treaty. We have delivered on our mandate.

However, the banking union will change the environment in which we conduct our policy for the better. A banking union has the potential to unburden monetary policy in two important dimensions.

First, the banking union has important implications for the ECB as liquidity provider to the banking system. Sound supervisory assessments and access to a powerful resolution framework is paramount for ensuring liquidity provisions to sound and solvent counterparties. In its role as supervisor, the ECB will have strong incentives to make sure its supervision is rigorous in order to protect our balance sheet and to ensure tight control over the risks we assume. This will safeguard our independence and credibility as monetary policy maker and will ensure that monetary policy is not affected by considerations outside of the realm of monetary policy, for example the state of the banking sector. This is particularly important in the context of our emergency liquidity assistance (ELA), the provision of which is based on a sound and reliable solvency assessment. In the future, we will have these assessments at hand "in house". Moreover, a strong resolution framework, with effective tools for orderly resolution, will in turn help to remove the pressure on the central bank to unduly prolong the life of banks through liquidity provision.

Second, the banking union will help to unwind the reliance of the euro area banking sector on central bank intermediation. As mentioned, during this crisis we have activated a set of non-standard monetary policy tools that – by nature – were intended to alleviate impaired monetary policy transmission and ultimately serve our primary objective to maintain price stability in the euro area. By alleviating funding pressures and undue risks in securities markets, our measures have provided temporary relief for the banking sector and complemented policy efforts on the financial stability front. However, our measures cannot and should not solve the underlying structural problems. This is a task for governments and the banking industry.

In this regard, the banking union with effective supervision and bank resolution can foster the necessary restructuring in the euro area banking sector, can further spur balance sheet repair and can restore the banking sector's intermediation function. In particular, a European resolution mechanism with adequate powers and tools will be needed for effective resolution without involving taxpayers' money. At the same time, this framework will ensure the revitalisation of the banking sector and revive financial integration.

The early repayment by banks of the liquidity received from the first three-year LTROs has given initial mild indications for improvements in banks' funding conditions and the overall health of the banking sector. But complacency is not warranted. Balance sheet repair in the euro area banking sector has to continue to fully restore wholesale and interbank funding markets, which will allow banks to return to their normal sources of funding, releasing them from the strong dependence on central bank intermediation, particularly in the case of banks receiving ELA.

Conclusion

Let me conclude.

The sovereign debt crisis has thrown into reverse the steady financial market integration seen since the inception of the euro. This trend was largely driven by the link between banking and sovereign risks.

The crisis has hampered financing conditions. By consequence, the monetary policy transmission channel has been clogged and ECB has been compelled to apply unconventional measures to repair the distorted flow of credit in the euro area.

To overcome the damaging fragmentation, Europe needs to advance its institutional framework towards – among other things – a true banking union with single supervisory and resolution mechanisms.

The set-up of euro area wide supervision under the auspices of the ECB is a prerequisite for breaking the vicious circle of sovereign and banking risks. Moreover, it will reinforce financial integration, mitigate macroeconomic imbalances, and – last but not least – unburden monetary policy.