Vítor Constâncio: The role of the banking union in achieving financial stability

Speech by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the FT Banking Summit "Ensuring Future Growth", London, 26 November 2014.

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Summary

The banking union can be seen as the biggest European reform after the inception of the euro, with vast implications that go well beyond the problem of the sovereign-bank loop. It is a structural and institutional step with wide implications for the deepening of European integration. Its two key elements – the Single Supervisory Mechanism and the Single Resolution Mechanism – will help address the negative loop between banks and sovereigns, notably by means of direct recapitalisation of European banks that would not overburden already indebted sovereigns.

Another important objective of banking union is to overcome financial fragmentation and promote financial integration. There are four ways by means of which I expect the SSM to make a difference to banking in Europe: by improving the quality of supervision; by creating a more homogenous application of rules and standards; by improving incentives for deeper banking integration; and by strengthening the application of macro-prudential policies.

There is a need to broaden the scope of the existing macro-prudential policy toolkit in general and also to broaden the toolkit available to the ECB in particular. One reason is that macro-prudential policy should become a fully effective policy to smoothen the financial cycle.

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Ladies and gentleman,

Thank you for inviting me to address you today on the suggested topic "Banking Union and financial stability". Financial instability and materialisation of systemic risk imply a situation of impairment of the financial sector's normal functioning to the point that it induces losses in the real economy. The impairment may take the form of disturbances in financial institutions or of boom/bust episodes in financial or other asset markets. The origins of instability may be exogenous to the financial system such as large macro shocks, or endogenous to the system. The latter comprise financial imbalances such as excessive leverage and risk or widespread contagion in the system, including across borders. Both the origins and amplification mechanisms of financial instability can relate to financial misconduct, wrongly designed policies or financial institutions' fragility.

Following the financial crisis erupting in 2007/8, the euro area was once again on the verge of a big crisis in the summer of 2012. Two initiatives proved to be essential to avoid disaster: a substantive institutional reform and a policy announcement. The latter was the ECB's decision to announce the Outright Monetary Transactions (OMT) programme at the beginning of August 2012. It was immediately successful in reversing the increase in yields in the bond market and in gradually reducing financial fragmentation in the euro area. Overcoming the tail risk of a collapse was not only very positive to Europe but also to the world economy.

But it is the other initiative that I want to concentrate on today: the decision by the European Summit of June 2012 to create a Banking Union.

Banking Union is a structural and institutional step with wide implications for the deepening of European integration. The political sign of Member States willingness to further increase their interdependence by sharing sovereign power was in itself a game changer for the markets.

As you may recall, the whole idea of launching a single European supervisor was born as a consequence of the decision to prepare direct European recapitalisation of weak banks. The crisis had convinced Member States to frontally address the negative loop between banks and sovereigns, notably by means of direct recapitalisation of European banks that would not overburden already indebted sovereigns. This naturally required that supervision would have also to be transferred to the European level. The embryo of Banking Union thus saw the light of day.

In the meanwhile, it was clarified that European direct recapitalisation could only happen after the Single Supervisory Mechanism (SSM) would become operative and following a comprehensive assessment of the banks' balance sheets. In this way, it would be ensured that direct recapitalisation would not be used to cover bad legacy assets stemming from the crisis or pre-crisis fragilities. Many months later, agreement was reached among Member States to accept the second element of the Banking Union – the Single Resolution Mechanism (SRM). As the ECB often underlined, these two components were necessary for the framework to work effectively. The Banking Union can thus be seen as the biggest reform after the inception of the euro, with vast implications that go well beyond the problem of the sovereign-bank loop.

In this way, the question of direct European recapitalisation ceased to be the main focus of attention. In the view of many commentators, the SRM became the expected instrument to achieve the separation of banks and sovereigns. This is a somewhat misleading view as only in combination with the later approval of the Bank Recovery and Resolution Directive (BRRD) could the SRM be effective in solving the bank-sovereign loop. The BRRD gave powers to the SRM to resolve banks using wide bail-in of shareholders and main bank's liabilities without having to utilise the resolution fund or public money.

The BRRD implements a true paradigm change, ending the culture of bail-out and ushering in a culture of bail-in. As of 2016, in all resolution cases, the BRRD will impose to the Resolution Authorities, a bail-in of shareholders and creditors equal to at least 8% of total liabilities including own funds of a given bank. It should be noted that the amount of 8% is very substantial when compared to the losses that banks faced in the recent crisis. To give you an idea: between 2008 and 2010 only one bank had losses exceeding the 8% threshold, and the average for all other banks was slightly less than 3%. If we look further back to the Nordic financial crisis in the 90s, none of the banks affected faced losses close to 8% of its total liabilities including own funds.

According to the new rules, only insured deposits are totally excluded from the bail-in tool. Only after the 8% amount is bailed-in from shareholders and creditors can the resolution fund, to which the banking sector contributes, take part in the process and for a maximum amount of 5% of total liabilities (including own funds) of the bank under resolution. Furthermore, only in case this is not enough (which, based on past crisis experience would be exceptional) can public sources be used. Public money, either from national governments or from direct European recapitalisation of banks, can only be used at the very end of the process which will make it an extremely rare event.

It is important to highlight that by avoiding the commitment of public money and protecting tax payers as much as possible – a goal widely shared –participant countries in the Banking Union must shed considerable sovereign power. In fact, large countries with strong public finances must renounce to provide domestic banks with the implicit subsidy of public support. This will reduce their strength in competing in the European space with an advantage and will be progressively reflected in banks' ratings and funding costs. On the other hand, countries with vulnerable public finances and smaller banks will no longer be able to support, and possibly keep, their national champions. Finally, in both cases, governments accept the transfer of supervision and resolution of banks to the European level in what has to be considered a remarkable sharing of sovereignty and a desire for "ever deeper union".

With these important steps, the first goal of Banking Union to separate banks from sovereigns has, in practice, been achieved. This is a crucial foundation for an integrated financial system that can support the real economy equally well across the whole of Europe.

Reducing fragmentation and eliminating macro-financial imbalances

Another important objective of Banking Union is to overcome financial fragmentation and promote financial integration. In particular, this will constitute a key task of the SSM.

There are four ways which I expect the SSM to make a difference to banking in Europe: by improving the quality of supervision; by creating a more homogeneous application of rules and standards; by improving incentives for deeper banking integration; and by strengthening the application of macro-prudential policies.

The prudential supervision of credit institutions will be implemented in a coherent and effective manner. More specifically, the Single Rule Book and a single supervisory manual will ensure that homogeneous supervisory standards are applied to credit institutions across euro area countries. This implies that common principles and parameters will be applied to banks' use of internal models, for example. This will improve the reliability and coherence in banks' calculation of risk-weighted assets across the Banking Union. On another front, the harmonisation in the treatment of non-performing exposures and provisioning rules will mean that investors can directly compare balance sheets across jurisdictions. The recent completion of a thorough Asset Quality Review (AQR) jointly conducted with demanding stress tests induced the banks to frontload significant balance sheet enhancing measures, build up confidence in the European banking sector and created a strong platform from which the Banking Union can confidently build on.

The SSM should create the conditions and incentives for deeper integration of the European banking market, which should, in turn make the euro area less vulnerable to fragmentation. Barriers to deeper retail banking integration that existed in the past will no longer be relevant with a single European supervisor. The substantial compliance costs that came from having to observe different sets of rules and interact with several different authorities should also be reduced.

At the same time, the benefits of cross-border integration should increase. Cross-border banking groups will be able to optimise their internal management of capital and liquidity. Additionally, more integrated banking markets contribute to intensify competition: banks, as well as other financial market participants, will have to change their strategies. More competition means that capital is allocated more efficiently. It should promote access to new funding opportunities for companies, encourage investment and thus contribute to higher economic growth. Small and medium-sized enterprises without direct access to capital markets, in particular, may benefit the most from de-fragmentation.

In monetary unions in general, genuine financial market integration helps smoothing out the effects of asymmetric shocks via a mechanism of risk sharing. This can operate through income insurance, for example, when a country's residents hold claims to dividends, interest or rental income from investments in other countries. In the U.S., this form of risk sharing has shown to be more important than federal budget transfers. In the euro area, such risk sharing will need to assume an increasingly important role, especially given the absence of a more significant central budget.

However, it should be underlined that incomplete financial integration also carries significant risks. As the crisis has demonstrated, financial integration increased the risk of contagion, without in parallel generating adequate risk sharing arrangements to offset its adverse effects. For example, increased cross-border interbank funding was not accompanied by a sufficient diversification on the asset side. As a result, in some jurisdictions banks quickly accumulated significant exposures to local assets (such as real estate), and when the crisis

hit, cross-border funding was quickly withdrawn and sizeable losses had to be absorbed within national borders.

Supervision exclusively at the national level allowed excessive imbalances to build up within the currency area. For example, net cross-border claims of banks in non-distressed EMU countries vis-à-vis distressed countries almost tripled between 2003 and 2008 while cross-border claims within the core countries increased by factor of about 1.7 over the same time period. Lack of genuine financial integration and low financial sector resilience would continue to expose us to systemic risks further down the road.

The new centralised bank supervision organised in the SSM can however help prevent such developments. The prudential supervision of credit institutions will be implemented in a coherent and effective manner. A fully integrated approach will be taken to the supervision of cross-border banks. Joint Supervisory Teams will directly supervise significant banking groups – comprising supervisors from the SSM within the ECB and National Competent Authorities. This will enable the SSM to detect, early on, the build-up of imbalances and excessive risk-taking related to exposures to single sectors and across borders, and therefore to be proactive should local financial developments become threats to broader financial stability.

Closer financial integration will also enhance the transmission of monetary policy decisions throughout the euro area and thereby contribute to financial stability. In the medium to long-term, the Banking Union will support the formation of a genuinely European financial system that will foster competition and consolidation in the banking industry. Adequate regulation will ensure that the associated efficiency gains can be reaped without the risk of creating too-big-to fail institutions.

Enhancing the macro-prudential toolkit

Another important dimension that the Banking Union introduced relates to the new macro-prudential policy instruments that, for the first time, were given to the ECB/SSM. This is particularly important at a moment when we expect monetary policy stance to remain very accommodative for an extended period of time in order to attain our price stability objective. Inflation became very distant from our official target since October 2013 and threatens to continue on the low side for some time to come. The environment of low nominal growth now prevailing creates serious risks to the social and economic fabric of the euro area.

The ECB is responsible for price stability which is always effectively controlled by monetary policy on a medium-term basis. This is a basic tenet of monetary theory that justifies the independence of central banks. Having reached the zero lower bound of our policy rates, we decided on a package of measures that include medium-term provision of liquidity conditional on banks' lending behaviour and two programmes of asset purchases. To explore new channels of transmission of monetary policy that have worked in other countries like the U.K. and the U.S., we are aiming to increase the size of the monetary base and our balance sheet by directly injecting money also into non-bank economic agents.

We expect that within the time of the programme, the adopted measures will lead the balance sheet to return to the size it had in early 2012. We have of course, to closely monitor if the pace of its evolution is in line with that expectation. In particular, during the first quarter of next year, we will be able to better gauge if that is the case. If not, we will have to consider buying other assets, including sovereign bonds in the secondary market, the bulkier and more liquid market of securities available. It would be a pure monetary policy decision, buying according to our capital key, within our mandate and our legal competence.

The transmission channels involved include signalling and influencing inflation expectations, exploring spill-overs resulting from investors using the cash received to buy other assets, including foreign assets with influence on the exchange rate, and finally, the freeing up of space in banks' balance sheets to increase credit to the real economy. Therefore the counter

argument that the policy would not be effective on account of already low sovereign yields is not well founded. The transmission goes well beyond the direct effect on the yields of the purchased securities. Even less valid is the argument that sovereign bond purchases, should these be deemed necessary, would ease the pressure on governments to do structural reforms. It is not the task of a central bank to exert more or less pressure on governments to adopt policies for which they are responsible. Central banks deserve their independence on account of their responsibility for price stability in a symmetric way, which means in both directions.

With this huge challenge that monetary policy faces, a continuing accommodative stance is warranted as we have indicated in our forward guidance. At the same time, we see a worldwide trend for some froth in financial asset markets. Even in Europe, where the trend is less marked, we have some asset segments of "localised buoyancy". However, monetary policy cannot address the problems inherent to the financial cycle, especially in the present situation. This is the role of macro-prudential policy with a different set of policy instruments. Fortunately, the Banking Union attributed the ECB/SSM with a range of policy instruments of this nature.

Importantly, the SSM introduces a co-ordination mechanism between national macro-prudential authorities and the ECB in preparing macro-prudential policy decisions. This mechanism – by taking into account the wider geographical area on which many European banks operate – allows macro-prudential policies in the SSM to be well co-ordinated, better targeted to risks having cross-border implications and, hence, more effective than national ones.

However, I see a need to broaden the scope of the existing macro-prudential policy toolkit in general and also to broaden the toolkit available to the ECB in particular. One reason is that macro-prudential policy should become a fully effective policy to smoothen the financial cycle. This is not the case at present since macro-prudential tools to address the credit cycle applicable to the non-banking sector are largely missing.

Recent regulatory and policy measures were targeted at the banking sector, for example – and perhaps most crucially, within the Capital Requirements Regulation and Directive (CRR/CRD IV). However, bank credit in the euro area is still declining and whatever froth can be observed in some market segments these cannot be driven by bank credit. Instead, entities in the non-bank sector – the so-called shadow-banking sector – are expanding credit-intermediation and maturity transformation activities.

Just to quote some figures, since the end of 2012, the total assets of banks under SSM supervision have decreased by 11%, whereas investment funds of all types have increased their asset holdings by some 30%, having doubled since 2009. The so-called shadow-banking sector represents already more than 60% of total bank assets in Europe. Therefore, I see a need to expand the scope of macro-prudential instruments to the non-bank sector. Some of these measures are already available to policy makers in the U.S. and in the U.K.

Let me briefly list some of these extensions to the macro-prudential apparatus that I think are necessary.

First, we need to ***improve the quality and range of data*** to cover the whole financial system, in order to have credible notion of the overall development of leverage and maturity transformation.

Second, ***exposures of banks to the shadow-banking*** sector should receive more specific limitations. A specifically tailored treatment was missing in the Basel Committee's large exposure rules that were agreed earlier this year. However, the EBA is currently developing principles that will provide a basis for closer management of this activity in future.

Third, macro-prudential authorities should have the power to identify and require that ***systemically important non-bank financial institutions should be subject to more***

enhanced surveillance standards similar but not equal to the bank supervision regime, as it is the case in the U.S.

Fourth, we would like to see ***counter-cyclical margin requirements for the extension of credit for trading in securities markets***. The Federal Reserve Board has this competence through the so-called Regulation T.

Fifth, given the tight interaction between credit, housing and business cycles, all ***macro-prudential authorities should possess powers to directly regulate real estate and housing credit***. They are already available to U.K. or Irish authorities. Loan-to-value or debt-to-income limits are obvious measures that could be considered

Finally, ***over the-counter derivatives should be traded on exchanges or electronic trading platforms*** when they are sufficiently standardised and cleared through central counterparties – as was committed to in the Pittsburgh G20 Summit.

Conclusion

Let me conclude.

Today I have emphasised how Banking Union is an essential complement to the Monetary Union and how it will enhance confidence and foster integration in the European financial system.

We have made impressive progress in developing and establishing the new European regulatory framework. The Comprehensive Assessment has made a big contribution to increase transparency in the European bank sector and ensured a successful operational start of the ECB's new regulatory and supervisory powers.

At this point, I believe that we will begin to see that banks are once again ready to play their role in financing the real economy. As borrowers' demand resumes, I am convinced that European banks will be in good shape to provide the funding that will support investment, jobs and growth.

Nonetheless, new macro-prudential challenges seem to be building in the non-banking sector, which have to be carefully monitored and authorities given the policy tools needed to properly address them. The ECB would need to be entrusted with macro-prudential instruments because only then can it be made fully accountable in ensuring financial stability in the euro area.

Thank you for your attention.