Vítor Constâncio: Towards a European Banking Union

Lecture by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the start of the academic year of the Duisenberg School of Finance, Amsterdam, 7 September 2012.

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1. Introduction

Ladies and gentlemen,

I feel honoured to have been invited to the opening ceremony of the Duisenberg School of Finance, a prestigious name that evokes the first President of the European Central Bank with whom I had the privilege to work in the initial stages of the launch of the euro as a member of the Governing Council. My presence here today is also a simple gesture to render my homage to his memory as a great contributor to the European ideal.

I would like to focus my remarks on the underlying reasons for the decision to set-up a Single Supervisory Mechanism as a major step towards a European Banking Union that was taken at the European Summit in June 2012.

What is the meaning of a Banking Union? In my view it involves a transfer to the European level of the regulatory and institutional framework responsible for safeguarding the robustness and stability of the banking sector.

The first pillar is regulation. It is already largely at the European Union level, particularly with the concept introduced by Tommaso Padoa-Schioppa of the "single rulebook" for the 27 Member States, which is based on the principle of maximum harmonization coupled with a wider use of directly applicable regulations.

Accordingly, what is now at stake in forming a Banking Union goes much further. It implies also achieving a European dimension for the main components of the institutional framework for implementing, monitoring and enforcing regulation, both in normal times and in situations of stress. According to theory and historical experience, this includes: Bank Supervision, Bank Resolution and Bank Deposit Insurance. These are precisely the components of the Integrated Financial Framework that has been presented to the June European Council by President Van Rompuy in his Report "Towards a genuine Economic and Monetary Union".

I would like to be clear that I refer to providing a European dimension to the institutional framework and not to a centralization of the competences pertaining to a Banking Union. Even a fully federal system implies, by nature, decentralization of tasks between the federal and the lower levels. In Europe, subsidiarity and proportionality are key constitutional principles in the exercise of European competences, which are particularly crucial for a well-functioning Banking Union.

The June Euro Area Summit initiated the construction of a Banking Union with the agreement on the establishment of a Single Supervisory Mechanism, with the involvement of the ECB. The reference to the ECB and the statement that the Commission will "bring forward proposals under Article 127 (6) of the Treaty" mean that there is a direct link to EMU. As it is well known, Article 127(6) provides that the Council by unanimous vote may "confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions." Accordingly, the single supervision will refer mainly to the euro area as the ECB can only have binding powers in relation to the 17 members that have adopted the euro. The focus on EMU is appropriate for several reasons, which I will elaborate in my remarks. However, this does not exclude possible mechanisms for other EU countries to be involved in the single supervisory mechanism, if so foreseen in the Council Regulation activating Article 127.6 of the Treaty. This could facilitate further financial integration in the single market as a whole.

The Statement of the June Euro Area Summit also makes clear that the single supervisory mechanism is directly related to the decision to grant the possibility of direct recapitalization of banks by the European Stability Mechanism. This new and important step in the effort to de-link the vulnerabilities of sovereigns from euro area banks implies an allocation of supervisory functions to the European level. Therefore, European recapitalization creates an immediate need for European banking supervision. Later in this talk, I will argue why I think that there are very good reasons for the involvement of *central banks* in the supervision of banks. It is essential that both of these elements – recapitalization and supervision on the European level - are implemented as expediently as possible.

2. Why the single monetary policy needs a Banking Union

The decisions taken at the June Euro Area Summit are part of the long term reflections on the future of the Monetary Union, which are addressed by President Van Rompuy Report. They are also clearly motivated by the challenges that we face in addressing the ongoing crisis. The recognition of the negative effects of the feedback loop between banks and sovereigns led to the decision to admit direct European bank recapitalization by the ESM. This, in turn, motivated the decision to create a single supervisory mechanism.

The deeper *rationale* is however the need to construct a Banking Union for ensuring a successful and well-functioning Monetary Union. Let me highlight the following arguments supporting this concept.

First, a single supervisory mechanism is necessary because of the ***increasing interconnectedness*** between financial institutions and markets across the euro area over the past decade, be it through internationally active banking groups, bilateral trading exposures, or presence in the same market segments. The recent financial crisis demonstrated how quickly and powerfully problems in the financial sector of one country can spread to another. This is especially the case in a monetary union. As a result, problems in the banking sector might originate at the national level, but are more and more likely to affect other countries of the euro area as well, and may quickly threaten the stability of the entire euro area banking system. Such developments and the underlying financial structures can best be assessed by a central authority rather than through cooperation between national ones.[1]

Seen from another perspective, the high degree of interconnectedness affects the impact of supervision and other national policies not only on the domestic banking sector, but also, as an externality, on other countries. This has been captured by the so-called “financial trilemma”. The concept of the trilemma is adapted from the famous “monetary trilemma” on the impossibility of simultaneously achieving three objectives: a fixed exchange rate, capital mobility, and national monetary policy.[2] In a very similar way, but applied to international finance, as put forward by Dirk Schoenmaker (2011) following a model by Xavier Freixas (2003)[3] a “financial trilemma” has been defined, which illustrates the impossibility of achieving three objectives in an environment with globalized financial markets. These

1 See, e.g. Gros, D (2012), “An incomplete step toward Banking Union”, CEPS discussion paper.

2 First put forward in Padoa-Schioppa, Tommaso (1982) “Capital mobility: why is the Treaty not implemented?” Address to the Second Symposium of European Banks and reproduced in Padoa-Schioppa (2000) “The road to monetary union in Europe” OUP. See also Paul Krugman (1987) “Economics integration in Europe: some conceptual issues” in T. Padoa-Schioppa “Efficiency, stability and Equity” OUP and Obstfeld, M, J. Shambaugh, and A. Taylor (2005), “The Trilemma in history: tradeoffs among Exchange rates, Monetary Policies, and Capital Mobility”, Review of Economics and Statistics 87, 423–438.

3 Schoenmaker, D. (2011): “The Financial Trilemma”, in Economics Letters, 111 pages 57–59; Freixas, Xavier (2003) Crisis management in Europe. In: Kremers, J., Schoenmaker, D., Wiert, P. (eds) 2009, “*Financial Supervision in Europe*” Edward Elgar p. 141–165.

objectives are: first, financial stability; second, financial integration; and third, maintaining national financial policies.

[Slide 1: The financial trilemma]

According to the financial trilemma, it is not possible to achieve all three objectives at the same time. The reasoning behind is that with increasing financial integration, pursuing national financial policies will generally not lead to financial stability, because national policies seek to benefit national welfare, while not taking into account externalities of their supervisory practices on other countries.[4] This leads to an under-provision of financial stability as a public good.[5] A lesson of the trilemma is that it is beneficial for the provision of financial stability to replace national policies with policies at the supranational level, thus geographically aligning supervisory incentives with the effect such supervision has on the financial sector as a whole.

Second, the events of the past few years have demonstrated that Monetary Union in Europe requires a ***high degree of financial integration***, in which financial institutions diversify their assets and liabilities across euro area countries. This is essential for an effective transmission of monetary policy. Until the start of the financial crisis and in particular until the beginning of the sovereign debt crisis, there was good progress in all aspects of financial integration. Unfortunately since then we have been facing a continuous development in the opposite direction with fragmentation of markets along national borders. Even more than that, we observe a reversal of flows with capital going to core countries and away from the periphery.

One example of very quick initial integration was the euro area money market which nevertheless has shown recently a much higher dispersion of rates, reduced cross border volumes with a virtual stop to peripheral countries. Chart 2 illustrates how quickly and profoundly interest rates in the short-term money market converged after 1999 and how the dispersion exploded following the crisis.

[Slide 2: Convergence and fragmentation of money market rates]

Money markets trade an extremely homogeneous good – central bank money –, and the changes made to the infrastructure (payment systems) were sufficient to establish a unified market with a single price. In other market segments, prices somewhat converged, but not fully. We are all aware how an exaggerated initial convergence of sovereign bonds yields changed into an abnormal dispersion.

[Slide 3: Evolution of sovereign bond yields]

Also, remuneration of bank deposits or interest rates paid on corporate loans for instance, started to diverge markedly across countries. At the same time, banks have started to reverse the diversification of their portfolio across borders in recent years, especially in detriment of stressed countries.

[Slide 4: Cross border credit exposures and cross-border share of assets]

In general, the crisis led to more disintegration. This can be seen for instance in the right hand chart, which illustrates the importance of foreign bank subsidiaries and branches in the total assets of the banking sector: there was a steep increase in integration in the first years of the euro, but after the Lehmann failure, integration declined consistently.

4 Holthausen, C. and T. Ronde (2004): “Cooperation in international banking supervision”, ECB Working Paper 245.

5 On financial stability as a public good, see for instance Beck et al (2010): Bailing out the Banks: Reconciling Stability and Competition An analysis of state-supported schemes for financial institutions.

Imperfect financial integration in a currency union of course complicates the task of the central bank in a very direct way: it becomes more difficult to achieve similar impact in the transmission of monetary policy and to ensure uniform levels of interest rates across countries. Thus, the tendency towards less financial integration has unwanted effects also for the conduct of our monetary policy. It is essential to reverse this fragmentation and restore the proper transmission mechanism of monetary policy. This does not imply that we should eliminate or artificially reduce the spreads of debt instruments across countries that are justified by pure credit risk. However it is certainly within the remit of monetary policy to intervene to mitigate risk premia that are related with fears of a break-up of the euro area and have been identified in several analysis.[6] This provides the rationale for the new programme of Outright Monetary Transactions (OMT) that we announced yesterday. A necessary condition for OMT is strict and effective conditionality attached to an appropriate European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) programme. The joint work of conditionality and bond market interventions can achieve, we hope, the elimination of the tail risk linked with a break-up fear that has been pervasive in the aggravation of the sovereign debt crisis.

Besides supporting an effective monetary policy, a Banking Union - comprising single banking supervision, common resolution schemes, and a unified deposit insurance - would further foster further the integration of the single financial market. It is my conviction that these elements would not only support the conduct of the single monetary policy, but also significantly contribute to breaking the home-bias in banking activity and to allowing banks to further diversify their portfolios across the euro area. Last but not least, a Banking Union will also contribute to the vital delinking of sovereigns and banks that has been so detrimental during the crisis.

The **third** reason why a Banking Union is beneficial to a Monetary Union is that the natural bias of national supervision, both in lender and borrowing countries, allowed the creation of large macro imbalances in several segments of the euro area. Indeed, a major lesson of the crisis is that financial supervision lagged behind financial integration and this contributed to the build-up of macroeconomics imbalances. Let me illustrate this with a few numbers.

[Slide 5: Evolution of public debt levels]

This chart shows the evolution of public debt levels since the inception of the euro in 1999 of a few selected euro area countries. As it can be seen, and perhaps contrary to public perception, overall government debt levels went down in the first years of Monetary Union, that is, in the period 1999 until 2007, by around 5.6%. Notably, we can see significant reductions in Italy (-14.8%), Spain (-35.3%), and Ireland (-10%). The resulting debt levels of several countries were still high in 2007, and in two cases far above 60%. Still, it cannot have been the overall increase of public debt alone that led to the eruption macroeconomic imbalances. It was the crisis, as can be seen from the chart that led to sharp increases of public debt across all countries only after 2008. The dangerous feedback effects between the state of sovereigns and their local banking systems emerged only after the start of the financial crisis. It operated in both directions: either the support of banks overburdened the sovereign or the sovereign weakness led the domestic banks to take on more recently a higher share of national public debt.

This is seen in the following chart that shows the pattern of domestic banks´ holdings of national debt going down until 2009 and then increasing afterwards.

[Slide 6: Public debt held by domestic banks]

[6] See Cesare, A., Grande, G., Manna, M. and Taboga, M. (2012) “Recent estimates of sovereign risk premia for euro-area countries.” Bank of Italy, Questioni di Economia e Finanza, Occasional Papers n. 128.

An aside aspect shown by the chart is that public debt was not taken predominantly by the domestic banking sectors until 2009 as the domestic share declined until then, indicating the progress of financial integration across member States during many years. To understand what happened in the run up to the crisis it should be highlighted that until 2007 the evolution of public debt in the countries now under stress was financed mostly by external investors and not by resident financial institutions.

Another aspect that is sometimes also ignored refers to the fact that the banks' portfolio of domestic public debt is not very high in percentage of total bank assets and even now is generally below the historical average.

[Slide 7: Public debt held by domestic banks in % of Total Assets]

The points I just made seem to run counter to the idea that the macro imbalances in peripheral countries was mostly driven by the public sector. As seen in the charts, with the possible exception of Greece, that seems not to have been the case. I will show in a moment that the imbalances came mostly from the private sector expenditure behaviour laxly financed by the financial sector. This fact is in turn connected with another major lesson of the crisis that reveals also a shortcoming in the initial design of the monetary union: the notion that it was enough to discipline public finance, through the Stability and Growth Pact, to avoid major imbalances in the euro area.

This mistake is surely related to two features of the dominant economic thinking at the time:

- ***first*** that the private sector is essentially stable and self-correcting composed of fully rational agents always optimizing inter-temporally with knowledge of the future probability distributions to infinity of economic returns and variables. In such a world no defaults are admitted or dangerous bubbles possible. Only the public sector can create instability.
- ***second***, that finance does not matter for real economy fluctuations. After the Real Business Cycles school, the rational expectations hypothesis and the intertemporal optimization paradigm, money and finance were considered not relevant anymore. Later, in the new Keynesian consensual macro model money crept back in through the introduction of wage and price rigidities, allowing for short-term real economy effects of monetary policy. On the contrary, finance became invisible with the Efficient Market Hypothesis ensuring a reliable plumbing as servant of the real economy. Banks and their credit activity and capital markets and their financing were not considered significant sources of instabilities with real economy effects. They were absent from macroeconomic models.

This vision about the way the economic was supposed to work was discredited with the crisis but surely influenced the initial concept that it was enough to discipline the public sector. We know that in the end the SGP did not ensure that discipline and some countries deviated from prudent fiscal policy. Nevertheless, what was more relevant to explain the macro imbalances relates to the explosion of private debt in the peripheral countries financed by domestic banks which were themselves mostly funded by other European financial institutions and markets.

[Slide 8: Public and Private debt]

Contrary to public debt levels, the overall level of private debt increased in the first seven years of Monetary Union by 14 percentage points or 27%. The increase was much more pronounced in Greece (+217%), Ireland (+101%), Spain (+ 75.2%), and Portugal (+49%), all of which are countries that have been severely under pressure during the recent crisis.

Another illustration of the role played by private indebtedness is provided by an analysis of the evolution of the financial balances (savings-investment) of the different economic sectors including the external one.

[Slide 9: Financial balances by sector]

The Chart shows how in Spain, Ireland and Portugal it was the increase in the deficit of non-financial firms until the onset of the crisis that contributed, in turn, to the increase of the external deficit, whereas in Greece the public deficit had a bigger influence.

The willingness of banks, domestic and foreign, to fund private agents was essential for the creation of the large macroeconomic imbalances and the housing price bubbles that we have witnessed. These were fuelled by excessive credit growth. This also implies that supervisors, at least in some areas, appeared to have been overly lenient with the banking sector. To some extent, this is due to the promotion of national champions and the objective of supporting the local banking system. Some empirical support for this line of argumentation comes from the US. A recent study shows, for the US, that local supervisors tend to be more lenient with banks than federal supervisors are: they downgrade less frequently.[7] The authors justify this behaviour, among other factors, by regulatory capture. And indeed, there is no reason to believe that these findings would be any different for other industrialized countries, including the euro area. Therefore, following this argumentation, placing supervision at the European level would help to alleviate national bias and possible regulatory capture.

3. The ECB's involvement in a Banking Union

There are good reasons developed in the academic literature for allocating the task of banking supervision either to the central bank or to a separate supervisory authority. Some of these arguments have already been put forward in a 2001 paper of the ECB, which concluded that national central banks should have a fundamental role in prudential supervision in the euro area.[8]

Let me turn first to the ***benefits*** of allocating supervisory powers to the central bank.

- A first argument why the combination of both supervision and monetary policy under one roof is beneficial results from the fact that being responsible for monetary policy creates for the central bank an ***intrinsic and deep interest in a stable financial system***. Such stability can be jeopardized through the failure or break-up of an individual financial institution. If a banking failure occurs, the financial system might be destabilized through contagion which could arise through several possible channels: one such channel could be through bilateral exposures to the failing institutions. Other channels could be related to informational contagion such as uncertainty about such bilateral exposures, or uncertainty about the nature of the shock that hit the institution. Moreover, those direct channels might be amplified if resolution mechanisms are complex, lengthy or surrounded by too much uncertainty. A central bank has an interest in avoiding the risk of such a destabilizing situation because of its mandate for price stability: since the transmission of its monetary policy relies in the first instance on the smooth functioning of the money markets. Money markets are, however, one of the first markets to be affected if there are doubts about the solvency of an institution. This was clearly witnessed in August 2007, when the emergence of first doubts about the exposure of individual European banks to the US sub-prime mortgage market led to a temporary standstill of that market.[9]

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7 Agrawal, S., D. Lucca, A. Seru and F. Trebbi: "Inconsistent regulators: evidence from banking", Working Paper 17736.

8 ECB (2001): "The role of central banks in prudential supervision".

9 See Cassola, Durre, and Holthausen (2011): "Monetary Policy Operations: experiences during the crisis and lessons learnt", Proceedings of the Sixth ECB Central Banking Conference "Approaches to monetary policy revisited – lessons from the crisis".

- Second, there is a close relationship between micro-prudential control of individual financial institutions and the assessment of risks to the overall financial system, which constitutes the central bank's macro-prudential responsibility. Even in those countries where the central bank is not involved in individual bank supervision, the central bank's responsibility for systemic stability is unchallenged. This is one reason why the European Systemic Risk Board (ESRB) that was established in 2010 with a mandate for macro-prudential oversight, is chaired by a central banker (the President of the ECB). The assessment of systemic risk would quite naturally be facilitated if supervisory information about individual institutions was used.
- Further ***information-related synergies*** exist between the supervision of banks and the oversight of payment systems, which is a task usually allocated to the central bank. The ECB, for instance, is responsible for the oversight of all large-value payment systems operating in the euro area. Moreover, it is the owner of the largest of those systems, the TARGET2 system.
- Fourth, central banks have a lot of ***expertise on the financial sector***, because of their role in monetary policy and oversight as well as their general interest in financial stability. These roles imply a constant monitoring of different segments of the financial market in order to assess the transmission of monetary policy impulses, regular interactions with counterparts to their monetary operations, and operational and oversight activities in large-value payment systems. Such knowledge is likely to be crucial in situations of financial stress, and enables central banks to be able to assess such situations more quickly and profoundly than other institutions with different mandates and functions. Thus, if a central bank were entrusted with supervisory powers, it would be able to react relatively quickly in case of an imminent banking failure.[10] This ability would be particularly relevant in financial crisis times, in which a number of institutions would be on the brink at the same time, but in which there is great uncertainty about the depth and impact of the crisis in general, and about individual banks' solvency in particular. Such a situation would require particularly careful monitoring and expertise, which the central bank is in a relatively good position to deliver. I would like to stress that also in the case that the organizational structure of the central bank was such that the tasks of monetary policy and supervision were operationally strictly separated, the transfer of such knowledge about the state of different financial market segments could be institutionalized quite easily.
- A fifth argument is that the ***operational independence*** of the supervisory agency is important for effective supervision. Here, I refer to independence from political interference, and I have in mind situations in which local politics may have an interest in the avoiding bank resolutions for political reasons. This independence would be emphasized by allocating the supervisory responsibility to the central bank.

Let me now turn to arguments about ***potential downsides*** of having central bank involvement in banking supervision? The following arguments have been made in the literature:

1. First, there is the issue of ***reputation risk*** of the central bank (an argument brought forward by Charles Goodhart):[11] the monetary policy function of the central bank requires that it maintains a high level of credibility and reputation, since it is essential

[10] This point has also been made by Cecchetti, S. (2007): "Why central banks should be financial supervisors" Vox EU article.

[11] Goodhart (2000): "The organizational structure of banking supervision", Occasional Paper 1, Financial Stability Institute, Basel.

to keep expectations of rising inflation at bay. According to this argument, if the central bank is in charge not only of price stability but also of banking supervision, poor supervisory performance (in particular, the occurrence of banking failures with notable economic consequences) would damage the reputation of the supervisor, and this may damage also the central bank's reputation as a competent monetary authority. This could endanger price stability, the central bank's main concern. In my view, this risk is overemphasized. The tasks of maintaining price stability and of supervising banks are very different in nature, and their results are easily measurable and distinguishable. If a central bank has a record of having achieved price stability over a longer period of time, then instability in the banking sector might complicate its price stability mandate, but it would not create doubts about its commitment to further pursue this task. I am fully convinced that the public will be able to distinguish between the two functions, and that repercussions from the reputation gained in one or the other function would be minimal.

2. A second argument against allocating supervisory powers at the central bank concerns possible ***conflicts of interest*** between the different central bank functions. At the heart of this argumentation is the question whether the central banks' concern for the health of banks would jeopardize its price stability objective. It could do so for instance by creating an environment of low interest rates with the aim of supporting the banking sector's health, or by using its capabilities for money creation to support individual banks. However, is it really conceivable that a central bank that is in charge of banking supervision takes these routes? To me, the solution to these concerns lies in the organizational structure of the central bank. A situation, in which the central bank puts at risk price stability in favour of financial stability, is not conceivable if the central bank is given a clear hierarchical mandate that places price stability before other concerns. Internal procedures can be, and should be, designed in a way that this is efficiently implemented. Of course, central banks may in crisis times be involved in lender-of-last-resort functions. But they might take on this role regardless of whether they have a supervisory mandate or not. And I should emphasize that such forms of liquidity support would in any case be very limited both in its frequency – central banks should take on this role only in case of a severe financial crisis – as well in duration. These limitations, connected with a recessionary situation, ensure that extended liquidity support would have no inflationary impact.

In practice, the allocation of supervisory responsibilities is handled very differently across countries, even within the euro area. At present, a majority of euro area central banks, that is, 12 out of 17 National Central Banks have full supervisory powers while 2 others are also involved in supervisory tasks.

Around a decade ago, the situation was quite different, and there was a tendency towards separation of the two functions. The recent trend, however, points towards combining both functions under one roof. This trend reversal can be observed also outside the euro area. For instance, in the UK, the FSA was founded in the late 1990s, but recent proposals aim at re-allocating it under the umbrella of the Bank of England. In the US, the FED was also given an extension of its mandate regarding supervision.

Indeed, the experience during the financial and sovereign debt crises has demonstrated the benefits of including banking supervision under the central bank's purview.

4. Elements of a Banking Union

All the arguments I summed up above support the notion of having a supra-national, euro area wide ***supervisory authority***.[12] As I have argued, this would be beneficial in order to foster further financial integration, to deal with the high degree of connectivity between financial sectors across borders, and would break the close link between banks and their sovereigns.

The precise set-up of the future supervisory arrangements is still to be decided. Let me express my personal views on the main principles that should guide such arrangements in order to achieve the objectives that I have outlined.

First, it is crucial to ensure that there are no loopholes of supervisory responsibilities. The euro area supervision should be conferred with a complete set of tasks and responsibilities, in a clear and unambiguous manner.

Second, as I mentioned at the beginning of this talk, supervision should be conducted in line with the principles of subsidiarity and proportionality. This implies that the operational conduct of supervisory tasks should be decentralized to the largest extent with national supervisors. Ideally, the single supervisory mechanism will consist of a network comprising the ECB and national supervisors.

Third, supervision should encompass all euro area banks in a way that the home/host distinction will cease to exist in the euro area, where all banks will become "domestic", equally subject to euro area supervision. This is essential from a supervisory and financial stability perspective, as well as to preserve the level-playing field among banks. The fact that the ECB would have ultimate legal responsibility does not imply that all banks will be supervised from Frankfurt and that the ECB will have to hire an army of supervisors. The degree of intensity of supervision at the centre will be closely related to the systemic relevance of banks. In this framework, the ECB would be closely supervising only the significant cross-border banking groups. Local supervisors, operating under the umbrella, guidance and monitoring of the ECB, would conduct the supervision of the overwhelming majority of credit institutions. Crucially though, the ECB would maintain, the ultimate legal responsibility, which would include the right to exercise at any moment a closer supervision of any institution or group of institutions if it finds it appropriate. This approach would ensure the harmonization and the level playing field in the implementation of the single supervisory mechanism and will be enough to overcome any inefficient national bias in conducting bank supervision.

Fourth, as I also argued already, there should a clear organizational separation between monetary policy and supervision. This can be realized at all organizational layers, from the analytical and informational level to the decision-making level. In a recent interview Commissioner Barnier referred that the Commission´s proposal includes the creation of Supervisory Board in the ECB which goes in the right direction.

Fifth, euro area supervision should be conducted in independence, in line with the Basel Core Principles, and also be subject to high standards of democratic accountability to ensure confidence in the conduct of this public function in the euro area.

Sixth, the single supervisory mechanism should contribute to the deepening and reinforcement of the single financial market. This implies that the role of the EBA should be fully safeguarded as regulator and as the entity responsible for monitoring the implementation of the "single rulebook" by all supervisors.

The euro area supervisory jurisdiction will need to be matched by two further institutional evolutions.

[12] ECB (2001): "The role of central banks in prudential supervision".

The first of these is the move towards a ***unified bank resolution scheme***. Quite naturally, this is an integral element of the Banking Union, which must have a resolution authority to close or restructure banks whenever appropriate. Again, it is not sufficient that banks operate in an environment only with somewhat harmonized rules about bank resolution. It is necessary that there is a unified legal framework that clearly and unequivocally specifies rules and procedures in case of a bank resolution.

An effective euro area wide resolution scheme would be an essential element of a Banking Union because it would be able to deal with large and complex banking groups. Indeed, banks and banking groups have continuously grown over the past decades. Reasons are mainly returns to scale in the banking industry which make larger banks more efficient than smaller ones, but also a tendency of national governments to promote and protect national champions. In some cases, banks have grown so much that their failure would, on the one hand, endanger the financial system of several countries at the same time, but on the other hand, be too large for the national government of the home country to be supported in case of stress[13] and thereby causing or exacerbate funding problems of the sovereign, which might further destabilize the banking sector.[14] For both reasons, a euro area wide resolution authority would be very beneficial. This Resolution Authority should be totally separated from the Supervisor and would be merged in the future with deposit insurance into an European Deposit Insurance and Resolution Authority (EDIRA) similar to the FDIC in the US. Of course, it is essential that such an authority has sufficient power and resources in order to deal with widespread instability in the banking sector.

The problems with cross-border banks are indeed quite complex. The resolution case of Fortis in 2008, a Belgian/Dutch financial conglomerate with substantial subsidiaries in Belgium, the Netherlands and Luxembourg, illustrates the tension between the cross-border nature of a group and the domestic focus of national legal frameworks and responsibilities for crisis management. To start with, there were no bank resolution frameworks in place in the Netherlands and Belgium, which would have provided the authorities with resolution powers and tools to resolve individual banks in a manner that maintains financial stability in urgent situations, overriding the rights of shareholders. This severely limited the options for the authorities. In addition, the supervisory authorities assessed the situation differently despite having a long-standing relationship in ongoing supervision and information sharing. The differences in the assessment of available information and the sense of urgency complicated the finalization of the whole process.

The precise design of a bank resolution scheme is a highly political decision, since it inevitably implies redistributive effects, since stakeholders in different countries can be affected in quite different ways.[15] I fully agree with the principles laid out in the recent Commission´s proposal with its broad approach about early intervention powers and the general bail-in rules with a precise definition of the pecking order of different type of creditors and depositors.[16]

I should stress that when I am talking about a resolution scheme, I am not referring to the bailing out of banks with public money. Resolution is for institutions that have reached the point of non-viability and includes the sale or merger of the institution or the creation of a bad

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[13] Demirguc-Kunt, A. and H. Huizinga (2012): "Do we need big banks? Evidence from performance, strategy and market discipline", mimeo.

[14] Gros, D. and D. Schoenmaker (2012): "Cleaning up the mess: Bank resolution in a systemic crisis", Vox EU, 6 June.

[15] Pisani-Ferry, J., A. Sapir, N. Veron and G. Wolff (2012): "What kind of European Banking Union?", Breughel Policy Contribution, issue 2012/12.

[16] See Beck, T., D. Gros, and D. Schoenmaker (2012): Banking Union instead of Eurobonds – disentangling sovereign and banking crises', Vox EU, 24 June.

/ good bank with or without a bridge bank or, finally, the orderly liquation of what is really non-viable. An effective resolution regime – interacting with applicable scheme and arrangement for the protection of depositors – should ensure the continuity of systemically important financial functions and allocate losses to the shareholders and creditors, and not rely on public solvency support. As the experience of the FDIC in the US shows public money may be temporarily necessary but not in relevant amounts. This explains why the creation of a European Resolution Authority with a European Resolution Fund on the basis of industry contributions does not depend on the deepening of the fiscal union as some have argued.

The other element that should complement supervision and bank resolution in a Banking Union concerns a ***deposit insurance scheme***.

Such a scheme would have several benefits. It would be commensurate to the European supervisory regime, and ensure that decisions that are taken at the supranational level affect depositors in all countries in the same way, thus ensuring a level playing-field: depositors would be treated in a uniform way across countries, independently of their location and the location of the bank they have entrusted their savings to.[17]

The scheme would thereby also foster financial integration. To achieve this, indeed more than a harmonization of local frameworks would be needed, but rather the setting up of a euro area wide deposit protection agency. In particular in times of widespread financial instability, deposit insurance payoffs depend not only on the legal framework they are based on, but also on the ability of the deposit insurance fund to cope with large-scale banking failures. Doubts on this ability, for instance due to concerns on the fiscal health of the sovereign, could easily reinforce (local) bank runs.

At the moment, deposit protection schemes in the euro area are still fragmented along national borders. While there have been waves of harmonization - for instance in 2009, a uniform minimum coverage of EUR 100,000 was introduced -, they still display significant regional differences.

From a central bank perspective, the establishment of a common deposit insurance scheme is of less urgency than the other components of a Banking Union. I also understand the concerns with potential liabilities to be incurred in a moment of financial crisis. The fact that the rationale of deposit insurance schemes is linked to the few bank failures that may occur and for which the accumulated funds paid in by the sector may be sufficient, it is perhaps not accepted in the present situation on the basis of fears of tail risks which require larger resources. This means that its implementation will take more time, even if it is mention in President Van Rompuy Report as a component of a deeper integrated financial sector framework. A European deposit insurance scheme is an important element that that should be pursued further, as it will be important to fend off bank runs and thus enhance trust in the European banking sector.

In my view, the careful design of the different elements of a Banking Union is indispensable for its success. It is essential that it creates the right incentives for both bank managers and authorities to contribute to the goal of financial stability, by truthful reporting of facts and effective cooperation between authorities, be they national or European. Finally, I regard it as important that in the future such a framework does not apply only to large, internationally active banks, but would universally cover all banks that are operating in the euro area. This would be important to establish a level playing field between different types of banks and banking activities, and leave as little room as possible for regulatory arbitrage.

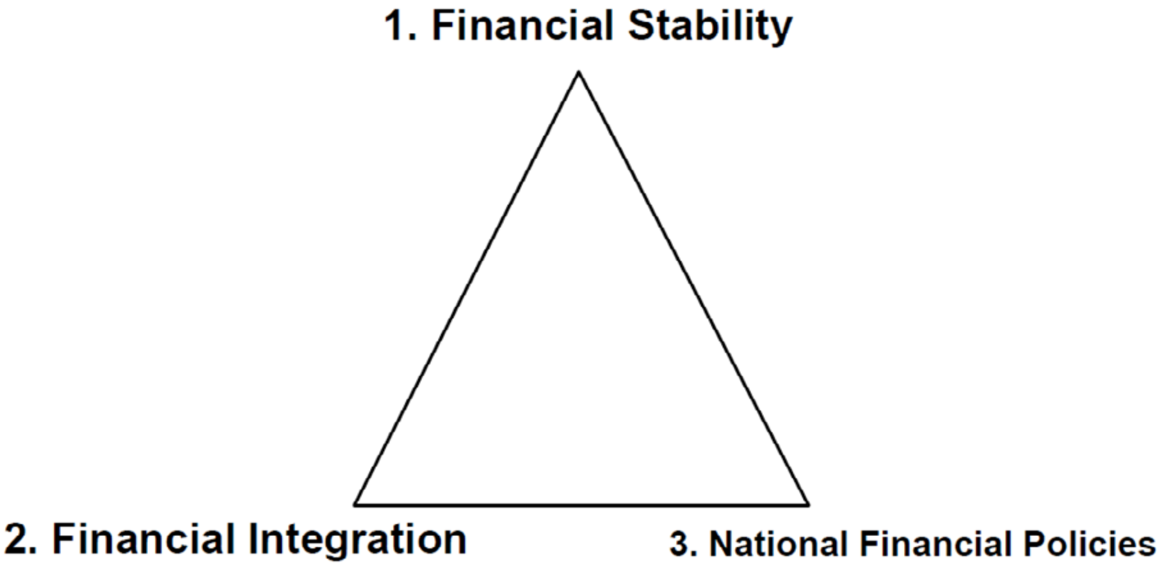
[17] See Lannoo (2012) on benefits of a common deposit insurance fund.

5. Conclusions

Together, the various elements that integrate the concept of a Banking Union constitute a solid and consistent framework that will foster financial integration and be supportive of Economic and Monetary Union. They would overcome a shortcoming of the initial design of the monetary union that allowed financial supervision to lag behind monetary and financial integration. Their implementation will also contribute to address the current crisis by helping to separate banks from the sovereigns and reverse the on-going fragmentation of markets along national borders. This in turn will help to restore the proper functioning of the monetary policy transmission mechanism. In particular, the new structure of the supervisory framework would reflect and complement the single market in financial services. I regard as normal that the ECB will be given, according to the European Summit decisions, a major role in the supervisory framework. It is with an acute sense of responsibility and awareness of the involved risks that I look to the new competences about to be bestowed on the ECB, confident that our Institution will continue to serve well the inspiring goals of our European Union.

Ladies and Gentlemen, I thank you for your attention.

1. Financial trilemma



Source: Schoenmaker, Dirk (2011): "The Financial Trilemma", in Economics Letters, 111

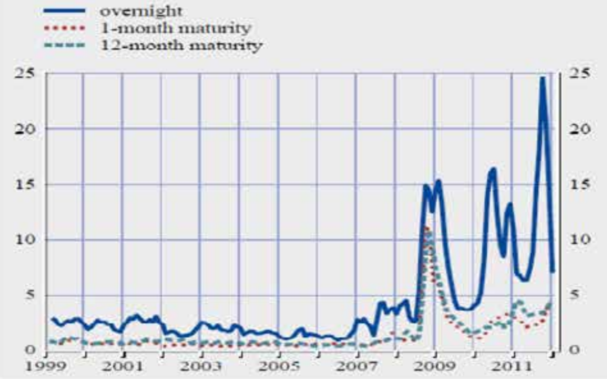
EUROPEAN CENTRAL BANK 2

2. Money market integration – setback mirrors stress in sovereign debt markets

- In 2011, the cross-sectional standard deviation of unsecured EONIA lending rates across euro area countries has risen sharply. This pattern is linked to the sovereign debt risk.
- Even in aggregate terms the amounts of interbank lending to other non-domestic euro area countries decreased

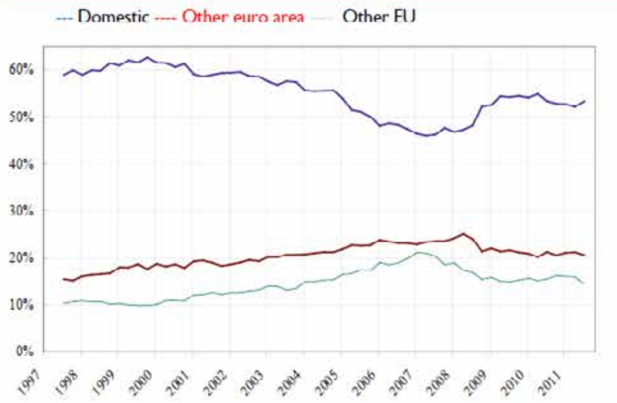
Chart 3 Cross-country standard deviation of average unsecured interbank lending rates across euro area countries

(61-day moving average; basis points)



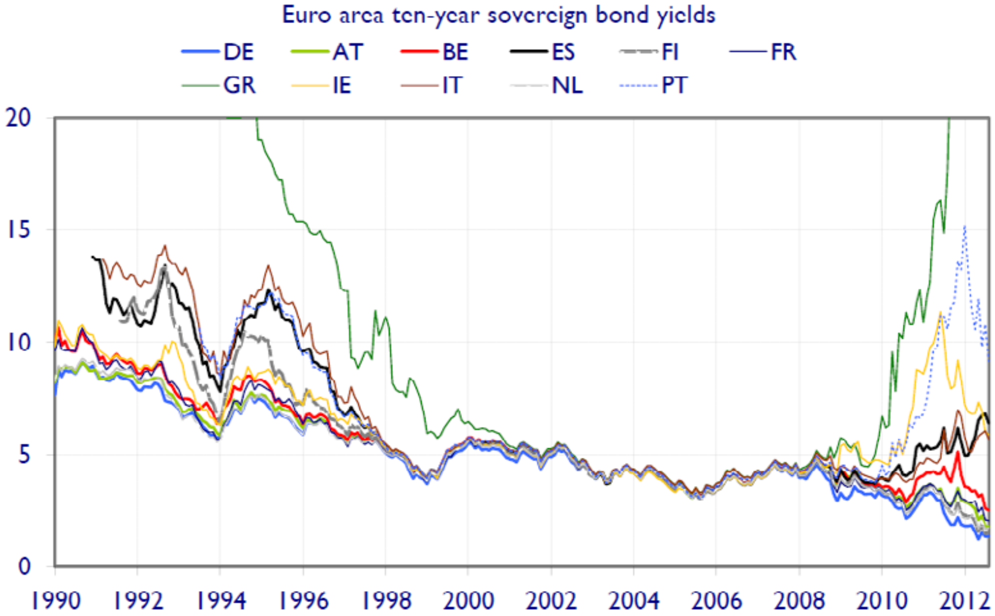
Sources: EBF and ECB calculations.

Interbank loans: share of outstanding amounts by residency (%)



3. Convergence of sovereign debt rates

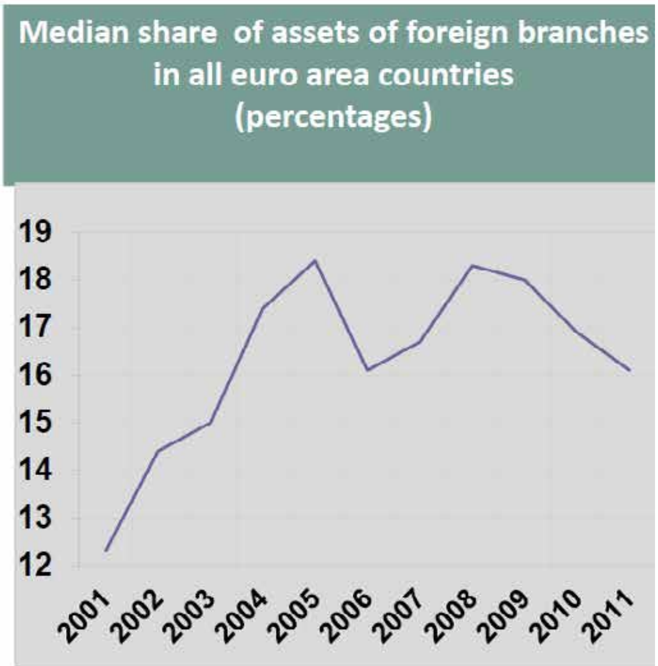
(monthly; percentage points)



Sources: Thomson Reuters and ECB
Notes: Sovereign yields for Cyprus, Estonia, Luxemburg, Malta, Slovenia and Slovakia are excluded owing to infrequent or lack of observations. Largest value for Greece: 46% (not shown).

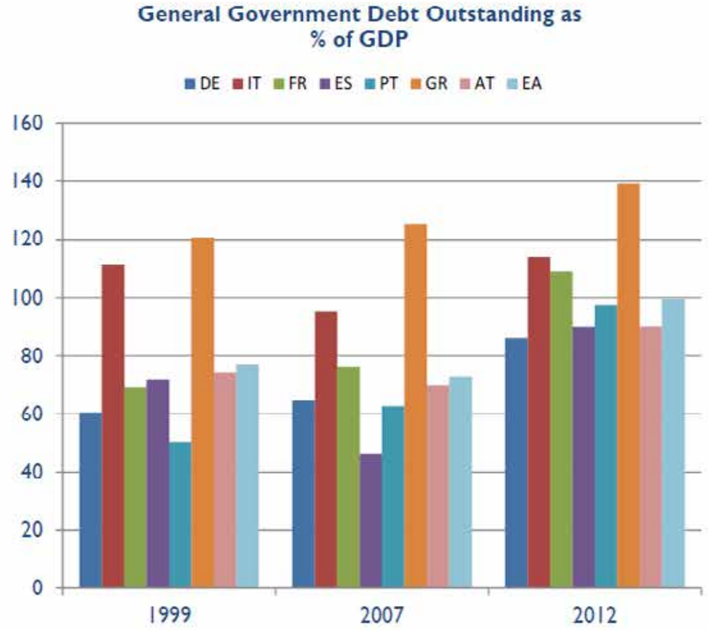
EUROPEAN CENTRAL BANK 4

4. Credit market: cross-border activity



EUROPEAN CENTRAL BANK 5

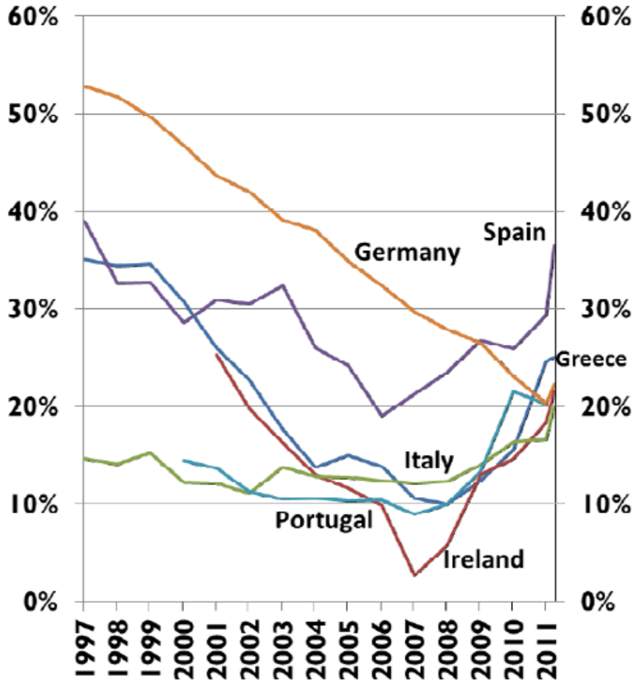
5. Public debt levels in the euro area



Source: Haver, Eurostat and NCBs

EUROPEAN CENTRAL BANK 6

6. Domestic sovereign debt held by resident banking sector (% of total)



Date	1999	2007	Q1 2012
Germany	43.7	29.7	22.3
Spain	30.9	21.2	36.5
Greece	26	10.6	25
Ireland	25.3	2.7	21.5
Portugal	13.7	8.9	20.2
Italy	12.1	12.2	20.1

Source: "Bruegel database of sovereign bond holdings developed in Merler and Pisani-Ferry (2012)"

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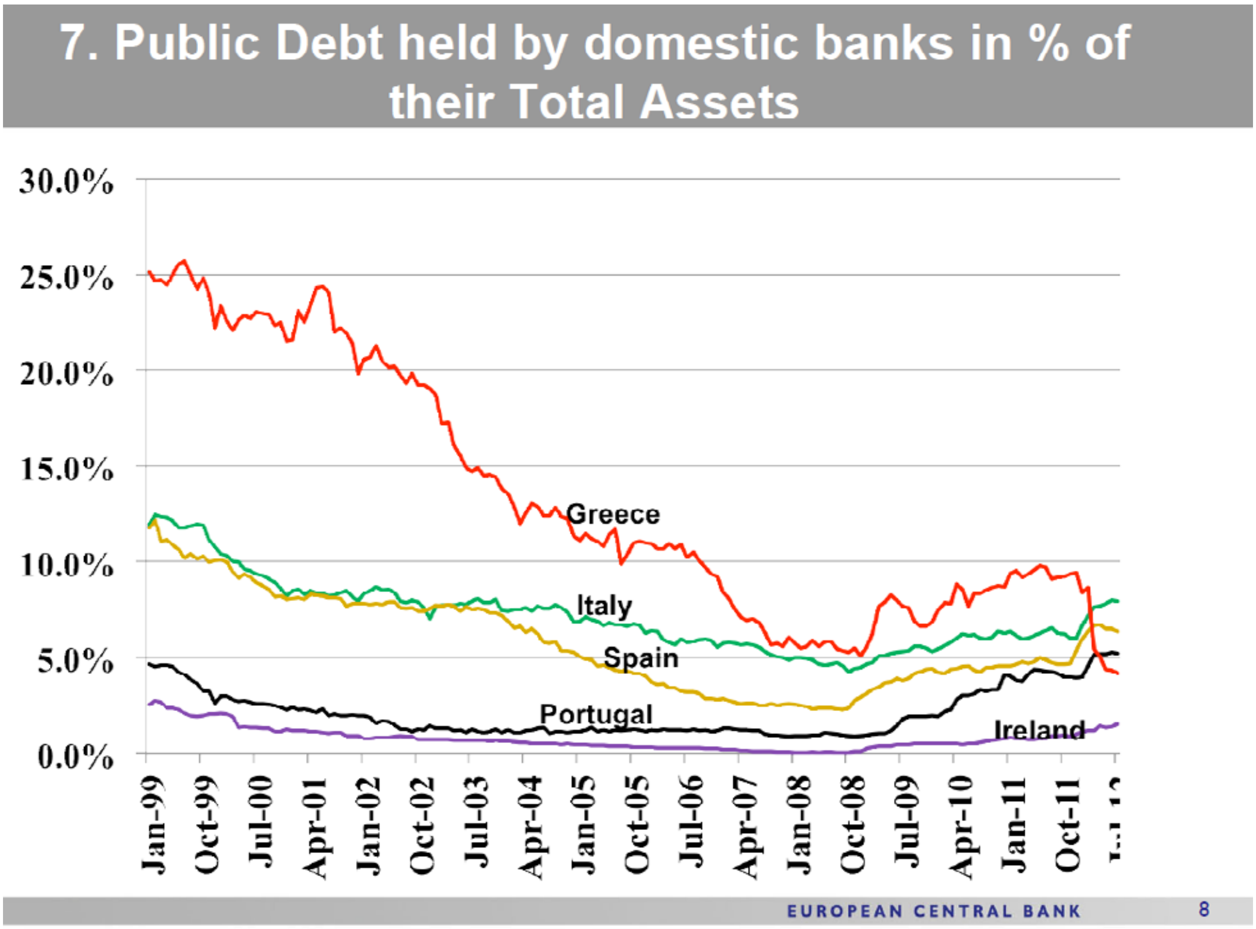
7. Public Debt held by domestic banks in % of their Total Assets
30.0%
25.0%
20.0%
15.0%
10.0%
5.0%
0.0%
Greece
Italy
Spain
Portugal
Ireland
Jan-99
Oct-99
Jul-00
Apr-01
Jan-02
Oct-02
Jul-03
Apr-04
Jan-05
Oct-05
Jul-06
Apr-07
Jan-08
Oct-08
Jul-09
Apr-10
Jan-11
Oct-11
EUROPEAN CENTRAL BANK
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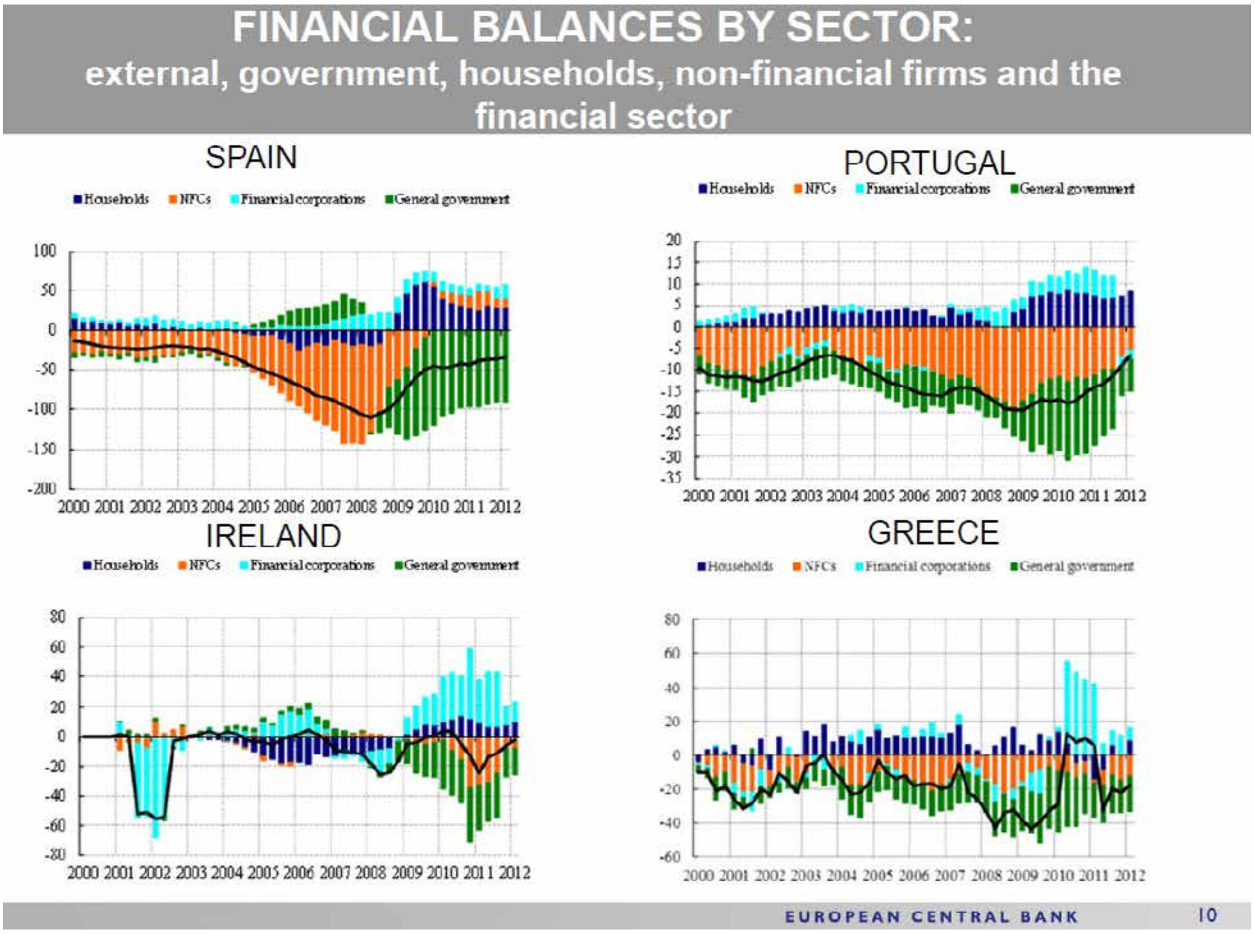
8. Public and Private Debt in the Euro Area (% of GDP)

	Public Debt			Private Debt		
	1999	2007	Δ In %	1999	2007	Δ In %
Euro Area	77.0	72.7	-5.6%	52.2	66.2	26.8%
Germany	60.6	64.6	6.6%	72.6	62.9	-13.4%
Greece	120.8	125.2	3.6%	16.0	50.8	217.5%
Italy	111.6	95.1	-14.8%	26.0	44.5	71.2%
Spain	71.7	46.4	-35.3%	49.6	86.9	75.2%
Portugal	50.3	62.7	24.7%	65.8	98.0	48.9%
Ireland	29.6	26.6	-10.1%	52.1	104.7	101.0%

EUROPEAN CENTRAL BANK 9


FINANCIAL BALANCES BY SECTOR:
external, government, households, non-financial firms and the financial sector
SPAIN
Households NFCs Financial corporations General government
2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012
PORTUGAL
Households NFCs Financial corporations General government
2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012
IRELAND
Households NFCs Financial corporations General government
2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012
GREECE
Households NFCs Financial corporations General government
2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012
EUROPEAN CENTRAL BANK
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