Benoît Cœuré: Why the euro needs a banking union

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the conference "Bank funding – markets, instruments and implications for corporate lending and the real economy", Frankfurt am Main, 8 October 2012.

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I would like to thank Carmelo Salleo for his contribution to the speech. I remain solely responsible for the opinions expressed herein.

Introduction

Ladies and gentlemen,

It is a great pleasure to be here with you this evening as part of this conference. I firmly believe that good research underpins policy choices and, as you know, the European Central Bank (ECB) is very committed to carefully conducted, high-quality analysis as the bedrock of its decision-making.

Bank funding has been the focus of policy-makers' concerns for the past few years, ever since the collapse of Lehman Brothers, which brutally reminded us all of the systemic dimension of liquidity and funding risk. Such a cataclysmic event elicited a host of responses, ranging from central bank interventions to prevent a meltdown of the financial system to the design of new regulations to limit risk-taking by financial institutions. The shock was global – and the response has been global. However, much work still needs to be done, so I welcome opportunities such as this conference to gain a better understanding of the dynamics and determinants of bank funding and of their implications for the financial system and the real economy.

Our interest in bank funding, as central bankers, stems also from the fact that it touches upon the very essence of our respective mandates. Money, remember, is the liability of the banking system. Central bank money represents but a fraction of broad money. To ensure that money is sound, and, in the euro area, that it is "single", we need the banking system to be equally sound, and importantly, single.

It is against this background that I will devote my remarks tonight to the latest development in European policy, specifically the decision to proceed with a banking union to complement monetary union in the euro area. I will discuss the desirable components of a banking union, towards which a single supervisory mechanism represents the first step.

The establishment of a banking union is a key factor in the completion of monetary union, and probably a turning point in the current crisis, with profound repercussions for the financial sector and the real economy alike.

Over the past few years, the mounting pressures in funding markets have led to a growing fragmentation of the banking system of the euro area along national lines. Links between banks and sovereigns have grown tighter, and in some countries the credit supply has been negatively affected. The conduct of a single monetary policy has become increasingly difficult as the transmission channels have become heterogeneous. This fragmentation was affecting the whole economy of the area, and a banking union has been proposed in order to re-establish a smooth transmission of monetary policy and ensure that the credit supply meets the real economy's needs.

Some evidence on the fragmentation of the banking system

First of all, let me give you some evidence on the fragmentation of the banking system.

The ECB has been continuously monitoring the degree of integration in the euro area financial markets. The latest Financial Integration in Europe report, published in April 2012, showed several indicators pointing to rising fragmentation in various market segments as the sovereign debt crisis has escalated.

In addition to the price-based indicators highlighted in the report, quantity-based indicators also continue to point to a further and significant renationalisation of euro area banks' funding markets. Banks located in peripheral countries continued to lose market funding, while those in some other countries retained it and managed to issue bank debt at attractive yield levels. The market for secured bank funding has also been affected by the increased tensions in some euro area government bond markets.

Differences between bank lending rates offered to non-financial corporations and households in euro area countries reflect divergences in bank funding conditions that go beyond country-specific economic conditions. Let me give you a few examples.

The coefficient of variation across euro area countries of the short-term cost of borrowing for non-financial corporations has been increasing towards all-time highs. Also, in some countries retail lending rates have increased markedly, while policy rates have decreased. Since mid-2011, the rate charged by the ECB on its main refinancing operations has decreased by 75 basis points but the composite cost of borrowing has decreased by a similar or greater amount in only 20% of cases. In another 20% of cases, it has even increased by more than 25 basis points.

The dispersion of lending rates has risen both across jurisdictions and across categories of enterprises. For example, the cost of short-term borrowing for corporates in France is still around the same level as that recorded at the beginning of 2011; by contrast, in Italy, over the same period of time, the cost of borrowing for corporates has widened by almost 100 basis points. In addition, in countries facing economic and financial distress, bank financing conditions are tightening further for small and medium-sized enterprises. This is particularly problematic not least because of the limited access that small companies have to alternative sources of financing. For example, the spread between rates on small and large-sized loans has widened further in the case of Spain and Italy: in August 2012 it stood at 286 bps in Spain and at 188 bps in Italy, the highest levels for both countries since 2003.

All in all, we can say that the renationalisation of the credit supply, coupled with funding pressures on both banks and sovereigns in certain countries, has weakened the impact of monetary policy, as partly unjustified domestic spreads keep rates applied to households and non-financial corporations higher than what would be consistent with monetary policy rates.

Why does financial integration matter so much for monetary policy?

In order to clarify why financial integration is crucial for monetary policy, let me use a metaphor drawn from agriculture: ever since ancient times farmers have watered their fields through a complex network of canals fed by wells or rivers. Whenever a canal was blocked, the farmer had to act quickly to unblock it in order to save his crop. The practice of irrigation was in fact first described in the Epic of Gilgamesh in the second millennium BC.

Credit is the water of the economy, and for the economy to run smoothly it needs to reach all its parts in the same way. Central bank money is the well, banks are the canals and we are the farmers. Whenever a canal of this kind is obstructed, we must find a way of restoring a smooth supply and we must act rapidly, as without adequate credit the dynamism of an economy quickly fades. And I should add that the Epic of Gilgamesh also describes the damage caused by a flood, a reminder that liquidity can become destructive if it gets out of control.

Indeed, the ECB has taken a number of measures to provide liquidity to credit institutions in the euro area, thereby alleviating their funding needs. Such measures include fixed-rate tender procedures with full allotments, longer-term refinancing operations up to a maturity of

36 months, the expansion of eligible collateral accepted in the refinancing operations, and FX tenders aimed at mitigating funding costs in foreign currency. And the ECB will stand ready to withdraw liquidity when upward risks to medium-term price stability materialise.

Right now transmission channels are obstructed for two reasons, one conjunctural and one essentially structural.

The conjunctural reason is that sovereign spreads in some peripheral countries, which are today the basis for the pricing of bank funding, can rise above what fundamentals would suggest, as they reflect various concerns felt by market participants, from over-pessimistic views of macroeconomic trends to redenomination risk.

The correlations between the yield levels of euro area bank bonds and those of the respective banks' sovereigns are elevated and have lately increased somewhat further, particularly in the peripheral economies. This has also been the case for credit default swaps. This reflects a spillover effect from the sovereign market to the banking sector's funding costs and impairs the transmission of lower monetary policy interest rates to the real economy.

In response, the ECB has announced the Outright Monetary Transactions (OMTs) – interventions on sovereign bond markets to repair the transmission channel when the level of spreads hampers monetary policy transmission and reflects market's perception that the single currency might break up. OMTs would be implemented to the extent that they are warranted from a monetary policy perspective for countries under an EFSF/ESM macroeconomic adjustment or precautionary programme, as long as programme conditionality is fully respected. IMF involvement will also be sought. OMTs would not be carried out while a given programme is under review, but they would resume after the review period once programme compliance has been assured. The announcement of the OMTs has reduced concerns about the materialisation of destructive scenarios. But it is essential that governments continue to implement the necessary steps to reduce both fiscal and structural imbalances and proceed with financial sector restructuring measures.

The structural reason that the transmission channel is malfunctioning is the tight link between sovereign and bank funding conditions. The risk that banks' balance sheets would be contaminated by sovereign risk was highlighted at an early stage by Barry Eichengreen and Charles Wyplosz (1998).[1] If banks are to transmit monetary policy impulses evenly, they need broadly similar funding conditions. However, if the ultimate responsibility for the stability of the banking system falls within the domains of individual sovereigns, clearly the two are linked and when one of the two becomes riskier, this risk is transmitted to the other. Hence the need to sever this link by transferring responsibility for the stability of the banking system to the European level.

How to re-integrate the banking system: the rationale for a banking union

To have one banking system again, several measures need to be jointly implemented.

First of all, each government must deliver fiscal consolidation – this is the objective of the Fiscal Compact that was agreed on last December. Once all sovereigns have fiscal balances that are sustainable in the long run, sovereign spreads should narrow again – but this will take time. In the meantime, we are facing a long transition.

Second, we need to strengthen the banking system to the point where its creditworthiness is less dependent on that of sovereigns. Euro area banks have to improve their resilience, both in terms of capital and of liquidity. This objective has been fostered by the European Banking

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[1] See Eichengreen, B and C. Wyplosz, 1998, "Stability Pact? More than a minor nuisance?", Economic Policy, 67–113.

Agency (EBA), notably in its final report on the recapitalisation of European banks which was published last week. It has revealed a significant reduction in banks' capital gap. In this respect I would like to stress the importance of the EBA's recommendation that banks keep high absolute levels of core Tier 1 capital, corresponding to the current 9% ratio, in the transition to the Basel III standards.

Finally, in order to cut the ties between individual sovereigns and banks and achieve a fully integrated banking system that mirrors and supports a fully-fledged Economic and Monetary Union, we need to construct a banking union.

Let me first define what I mean by a banking union. It is an institutional framework which ultimately should have three legs: a single supervisory mechanism (SSM), a common resolution structure and a shared deposit insurance. The SSM would bring all supervisory decisions about euro area banks under one roof, at the ECB, allowing supervisors to take into account externalities and general exposures to systemic risk. The common resolution structure, with a unified resolution regime and single resolution fund, would manage efficiently the wind-down even of large cross-border banks. Shared deposit insurance would reassure depositors that their money is safe in any euro area bank, regardless of its country of operations or legal domicile.

These three elements, when operational, would effectively sever the link between banks and sovereigns, and support the functioning of the EMU. Euro area institutions would be responsible for the euro area banking system, and the euro area sovereigns as a whole would back it. What I would like to stress here is that the banking union, agreed upon by the Heads of State or Government at the end of June, is both a game changer for the crisis and a leap forward for Europe. It will change the dynamics of investors' decisions. Moreover, within the euro area there would no longer be a host or a home supervisor, and this arrangement should ensure that cross-border allocation of capital and liquidity would be primarily driven by business considerations. Banks' funding costs should start to indicate again their individual creditworthiness, without the premia that reflect their sovereign's fiscal position or redenomination risk. A common resolution fund would decrease the too-big-to-fail problem and thus reduce moral hazard; furthermore, it would spread the burden of resolution rather than saddling any single sovereign with it. Finally, depositors would not need to consider shifting their funds across the continent in search of a safe haven, as all banks would offer the same insurance coverage.

Of course, as with all structural changes and new institutional constructions, setting up a fully-fledged banking union will take some time. The most urgent component of the banking union is in my view the SSM, which should enter into force as early as possible in 2013 to allow the ECB to prepare for its new tasks, with full accountability and a governance structure that strictly separates monetary policy from supervisory decisions. I won't go into the details of the current proposal put forward by the European Commission. For this, since we are at a research-oriented conference, I would refer you to the report[2] on the European Commission's banking union proposals which has just been published by the Advisory Scientific Committee of the European Systemic Risk Board.

The implementation of the SSM and the resolution structure should be closely coordinated, which means that proposals on the latter will be needed in 2013. Yet the exact structure of the deposit insurance scheme will depend also on what reforms are enacted after the recommendations of the Liikanen Report,[3] published last week, that aim to protect retail

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[2] See "A contribution from the Chair and Vice-Chairs of the Advisory Scientific Committee to the discussion on the European Commission's banking union proposals" at http://www.esrb.europa.eu/pub/pdf/asc/Reports_ASC_1210.pdf?490dce9cc2a2bf39b76ae4b06604b0ca

[3] See "High-level Expert Group on reforming the structure of the EU banking sector" at http://ec.europa.eu/internal_market/bank/docs/high-level_expert_group/report_en.pdf

depositors from excessive risk-taking by banks with structural measures that would reshape the industry.

Common challenges to both the resolution structure and deposit insurance scheme will be to agree on adequate *ex ante* burden-sharing rules between governments that provide market participants with the right incentives while preserving financial stability, and adequately deal with legacy issues. The final form of the banking union will appropriately reflect these considerations, and we are confident that implementation will start as planned with the establishment of the SSM in early 2013.

Conclusions

Let me conclude by stating once more that for monetary policy to work we need an integrated banking system, and to have an integrated banking system we need it to be supervised across the euro area as a whole, which will make it possible to be backstopped by the euro area as a whole.

This is the vision put forth in the Four Presidents' Report, this is the commitment made by the euro area governments, and the ECB supports it wholeheartedly. The monetary and the banking union are symbiotic, and they are the logical extension of the Maastricht Treaty, both in historical and political terms.

I look forward to a stimulating discussion and wish you a very successful conference.