Mario Draghi: Rationale and principles for financial union

Speech by Mr Mario Draghi, President of the European Central Bank, at the 22nd Frankfurt European Banking Congress, Frankfurt am Main, 23 November 2012.

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Lord Mayor Feldmann,

Dear Mr. Blessing,

Dear Mr. Fitschen,

Ladies and Gentlemen,

It is a pleasure to be here today to address the Frankfurt European Banking Congress.

A year ago, I gave my first speech as President of the European Central Bank (ECB) at this venue. It has been an intense year for the ECB and for Europe – challenging yet promising.

Introduction

The European financial crisis intensified at first, due to several interconnected factors: deteriorating fiscal and banking conditions in some countries, including large ones, increased financial fragmentation, and the first signs of a renewed weakening of the European economy.

The ECB reacted in a proactive way, by successively lowering policy interest rates and by devising at the end of last year a monetary policy instrument that was particularly effective in the specific circumstances at that time. To counter the impending risks for European banks, that were then concentrated mainly on the funding side, we supplied liquidity at very long maturity and at low rates, fully accommodating the demand by the market. We succeeded in calming the immediate tensions, averting a credit crunch that would otherwise have had grave consequences for the euro area economy, employment and price stability.

But that action in itself could not prevent a further fragmentation of financial markets, increasingly driven, in the early summer, by "redenomination fears" – the concern that euro area membership could prove unsustainable for some countries. The danger was concrete that the adverse loop between weak public finances and banks could propagate to a large set of countries in the euro area, leading to an uncontrollable spiral of rising interest rate spreads and feeding into the real economy. Credit and economic growth were falling, leading to rising unemployment and reduced consumption and investment. All of this meant that the outlook for the euro area economy as a whole was increasingly fragile.

The disruption of the monetary policy transmission due to financial fragmentation is something deeply profound. It threatens the single monetary policy and the ECB's ability to ensure price stability. This was why the ECB decided that action was essential and that a credible backstop against disaster scenarios was required, which led to the announcement of Outright Monetary Transactions. In this sense, the ECB has shown resolve and foresight in addressing within its mandate challenges in the economic and financial situation, so as to contribute to the stability of the euro area economy as a whole.

But also the cohesion and resolve of the European leaders was crucial in this period. In June this year, European leaders decided to accelerate the move towards a "financial union", by creating a single bank supervisor centred around the ECB and by linking to it the possibility that European banks, in due time and under certain conditions, could receive direct capital support from the European Stability Mechanism (ESM). Together with the announcement on the OMT, this led to the much more benign market conditions that have prevailed in the recent months.

Therefore, I can address you today against the background of a relative return of confidence in the prospects for the euro area.

The return of confidence is justified, but it relies on three things:

First, given that the return of confidence was related in part to the announcement of Outright Market Transactions, I would like to assure financial markets that we stand ready to implement this programme as and when required.

Second, euro area governments need to continue to pursue structural reforms at the national level. This is essential to regain competitiveness where it has been lost, and to lay the foundations for sustainable and balanced growth in the future.

Third, at the European level, leaders need to follow up with determination on their commitment to make the institutional reforms needed to complete economic and monetary union. That is what will fully restore stability to our continent.

The message conveyed in June by Presidents Van Rompuy, Barroso, Juncker and myself is that to succeed, institutional reforms must extend to the financial system, to the fiscal and economic policy framework and to the area of democratic legitimacy and accountability.

These building blocks form a consistent and interconnected whole. They can be addressed within different time frames and following a logical sequential order, so long as the commitment to address all four of them is unwavering.

In my remarks today, I would particularly like to elaborate on the rationale and principles for establishing a Single Supervisory Mechanism. It is important to understand exactly why we need such a mechanism to determine how it would be designed.

On the ideal schedule for establishing the single supervisor, I agree with those who say that we need to do it in a timely fashion but above all, we need to do it well. What is essential is to have the legal basis as soon as possible, ideally on 1 January 2013, so that preparations can begin.

The rationale for a financial union

The crisis has highlighted a fundamental inconsistency between the single monetary policy of the euro area and the responsibility of national authorities for financial policies. The single currency needs a single financial system that is not fragmented along national lines.

Moreover, for the effective functioning of the single monetary policy, and therefore for delivering price stability in the euro area, banks are key in transmitting monetary policy impulses to the real economy. It is important to avoid significant differences in transmission arising from the countries in which banks happen to be located. Yet such fragmentation within Europe's financial system has occurred as a consequence of the sovereign debt crisis.

The relationship between the credit of sovereigns and that of their financial system is well understood; it runs both ways. Divergence in sovereign credit has resulted in divergence in bank funding conditions at the national level. This in turn has brought about differences in lending conditions, which hamper the transmission of monetary policy.

Banks facing funding pressures react by tightening the lending conditions for firms and households, which ultimately leads to a breakdown in the relationship between lending rates and monetary policy rates that prevails in normal times.

The adverse feedback loop between banks and sovereigns also has negative effects on efforts to re-establish fiscal sustainability. Countries undergoing fiscal adjustments are increasingly penalised by financial markets because of their additional burden of supporting domestic banks.

Against this background, the need to break the loop between banks and sovereigns at the national level, by taking responsibility for financial stability to the European level, becomes

evident. This is why a financial union is a necessary step to improve investors' confidence. By restoring financial stability, it also provides the most effective response to the fragmentation of Europe's banking markets. Monetary stability, financial stability and defence of the single European market are all closely linked.

The principles and key elements of a single supervisory mechanism

Financial crises differ in many respects, but they tend to have common origins. These include the rapid expansion of credit, increasing leverage, asset price bubbles and rapidly declining credit quality standards.

National supervisors were often lenient in the face of these developments, partly because of regulatory arbitrage, partly because they were subject to a variety of constraints and pressures.

The single supervisor should possess all the qualities necessary to guard against these risks on a durable basis. It should be rigorous and even-handed, free from local pressures and interests. It should have the vision and take on a broad-ranging approach, independently assessing the situation of individual banks in a systemic context.

As to the specific institutional arrangements, several alternatives have been proposed. The solution chosen by European leaders – to build the system around the ECB – is the only pragmatic one in the present circumstances. Fourteen out of seventeen national central bank governors in the Eurosystem already have a supervisory role. Therefore, working jointly with the national supervisory authorities, the ECB will have the legal authority and technical capability to carry out this complex task successfully.

As part of the European System of Financial Supervision, the single supervisor will closely cooperate with national authorities and with the existing European authorities, notably the European Banking Authority (EBA). Moving supervisory powers to the European level should not and will not change their respective roles and tasks.

But some observers have suggested that the presence in the same institution of monetary policy and supervisory decisions can lead to excessive burdens, a potential confusion of roles and/or distorted incentives.

These concerns must be taken seriously. To guard against them materialising, certain principles must be fulfilled. Let me elaborate, based on reflections that are being conducted within the ECB's Governing Council.

Rigorous separation of monetary and supervisory policies

The first principle is the need for rigorous separation of monetary and supervisory policies.

Let me emphasise that we are taking this issue very seriously and we have envisaged ways to address it. The ECB has the advantage of having a very clear goal of price stability, expressed in a transparent and measurable way. This objective has never been compromised in the 14 years of the euro so far and it will not be compromised in the future. The ECB's attachment to the primary objective of price stability remains unquestioned.

The proposal of the European Commission provides for the establishment of a separate Supervisory Board within the ECB, which will include representatives from national authorities. This proposal allows for a pooling of supervisory expertise and knowledge, and will help to ensure that decision-making lines on monetary and supervisory policy are clearly separated.

To separate day-to-day activities, the Governing Council will define internal procedures, making a clear distinction between the monetary and supervisory functions within the organisation. We can build on a wealth of experience in this field, looking at best practices

from the many central banks in Europe and around the world that combine supervisory and monetary policy functions.

Independence and higher standards of accountability

The second principle is the need to safeguard the ECB's independence, implying higher standards of accountability. Independence is not a new concept to the ECB. Neither is accountability.

We are proud of our independence, and in the context of supervision, the ECB needs to be safeguarded from external interests and national bias. With the activation of article 127/6, the provisions of the Treaty are extended to the new supervisory task. These include independence in the preparation of supervisory assessments. In addition, the ECB as supervisor will enjoy operational independence, as foreseen by the Core Principles of the Basel Committee on Banking Supervision with which it will be compliant. It is essential that independence extends to all members of the Supervisory Board. Such independence in the assessment is crucial for the credibility of the supervisory system.

At the same time, it is equally crucial that these strong supervisory powers should be matched with very strong arrangements for accountability. Let me assure you that we are eager to comply with the highest standards of democratic accountability at all levels, that is vis-à-vis both European institutions and national institutions.

Complete range of supervisory instruments

The third principle is that the single supervisor should possess a complete set of supervisory instruments.

All banks established in participating Member States would in principle fall within the remit of the single supervisor. This is important to ensure a level playing field. It will also prevent fragmentation in the financial system, which is precisely what we are aiming to repair.

One lesson of the financial crisis is that not only large cross-border banking conglomerates have the capacity to destabilise the financial system. Due to interlinkages and mechanisms of contagion, even smaller institutions may turn out to be systemically important.

Such banks have a strong presence in Europe: in almost half of the euro area countries, more than 60% of the total bank assets are held by smaller banks. Taking the euro area as a whole, approximately 30% of the total bank assets are held by smaller banks[1]. These are significant amounts. To preserve financial stability, the Supervisory Board would be able to assert control over all banks in participating countries.

Let me say something more on how such a system could operate.

The European supervisor will work as a decentralised system with the Supervisory Board at the centre. The Supervisory Board will itself be predominantly composed of top representatives of the national supervisory authorities; hence the working method and decision-making will be collective, based on a collegial approach and will directly benefit from the skills and experience of the national supervisors. They will be prime actors in the framework, not passive performers subject to a central authority, and will contribute with knowledge of national, regional and local banking markets.

The intensity of centralised supervision will be the highest for those institutions deemed systemically important. But also for these institutions, close cooperation with national authorities on daily activities will remain. The role and responsibilities of national supervisors

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[1] Banks are considered to be large when their total assets exceed EUR 40 billion or, for smaller countries, when they constitute the largest domestic bank.

will increase when going down the dimensional scale, to banks of predominantly national or local relevance.

The single supervisory mechanism should also strengthen the single European market. Therefore, all Member States, also the ones that have not adopted the euro, should have the possibility of participating in the single supervisor. I am confident that the proper legal framework that serves this objective can be identified and adopted.

How European banks can benefit from a single supervisor

I have touched on the elements needed for the new authority to function successfully. Let me now address what I see as the main implications for banks.

A strong area-wide supervisor, capable of acting quickly and effectively, can restore and uphold business confidence in all banks, regardless of their location. It can therefore contribute to a revival of interbank and credit markets.

Second, the single supervisor should ensure homogeneous supervision, convergence of practices, a level playing field and therefore a reduction in banks' compliance costs. An important element to achieve convergence is the single rulebook that the EBA is developing. But ensuring convergence of regulation is not enough. Supervisory practices also need to converge. The envisaged creation of a single supervisory handbook by the EBA is complementary to this approach. Best practices should become standard practices. The single supervisory handbook should also ensure that in cases where banks are supervised in a decentralised manner within the system, practices are consistent across countries.

Third, the single supervisor will more easily identify cross-country linkages and exposures, and therefore contribute to a reduction of systemic risk.

The next steps towards a financial union

The establishment of a Single Supervisory Mechanism would represent a major step towards a financial union. But in case we were in need to resolve financial institutions, we want to be able to do so without taxpayer money and without disrupting the payments system, even in the case of systemically important institutions. For that we need a common resolution regime and an independent European resolution authority.

The existing legislative proposal on bank recovery and resolution is a development in the right direction, and the ECB supports its rapid adoption. It would best be implemented through an independent European Resolution Authority, immune from national bias and national vested interests.

Conclusions

The establishment of a financial union in Europe is a major component of the institutional framework for a genuine economic and monetary union. The Single Supervisory Mechanism forms an integral part of this framework.

With the new system in place, a critical cause of instability – the link between fiscal authorities and banks at the national level – will largely be removed and a level playing field will be ensured. This is one important step towards a more stable European economy.

Over the course of this last year, the ECB has continued to follow its monetary responsibilities in a highly demanding environment and continued to exert its mandated role in coping with the crisis with a high degree of responsiveness and farsightedness.

Three things have been essential here. First, the ECB has not stepped in to any roles that belong to governments – they too have to take their responsibilities for coping with the crisis

in a resolute manner. Second, the ECB has continued to cherish its independence. And third, the ECB has continued to deliver what it is tasked to deliver: price stability for the euro area.

Thank you for your attention.