Patrick Honohan: Banking Union challenges

Opening statement by Mr Patrick Honohan, Governor of the Central Bank of Ireland, to the Joint Oireachtas Committee on EU Affairs, Dublin, 30 April 2013.

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We thank the Committee for the invitation to appear before it and contribute to its important work on the future of Economic and Monetary Union. Important because of the scale of the challenge to restore stability and create sustainable growth and jobs. Important also because of the role of the Committee in ensuring democratic participation and accountability on EU issues.

The euro area has been battered by the fall-out from the great financial crisis that broke out in 2007. When the flood of financial globalisation receded, it exposed interrelated banking and fiscal and competitiveness weaknesses in many euro area countries. Cross-border banking claims threatened to transmit weakness from stressed countries such as Greece, Portugal and Ireland, to banks elsewhere in the monetary union. High indebtedness of some countries no longer seemed as easily supportable as had previously appeared. And even stronger countries experienced sizable banking losses.

Accelerated balance sheet repair associated with aggregate macroeconomic demand weakness has meant that recovery has been slow and tentative. This combination of pressures – primarily related to banking and wider financial sectors, as well as to macroeconomic and fiscal imbalances and divergences in competitiveness, has represented a significant challenge to the cohesion of the Union. Both borrowers and lenders became apprehensive and protective of their interests. At certain moments in 2011–12, the combination of problems seemed to market participants to threaten the very sustainability of the institutional arrangements supporting the common currency.

While such fears have been allayed by the credibility of subsequent action, most notably the announcement of the Outright Monetary Transactions (OMT) programme of the ECB, the wider need to rebuild trust and strengthen the institutional architecture of the system is evident and confirmed in a general recognition that progress needs to be made on four dimensions, Banking, Fiscal, Economic, and Political, as adumbrated in the report of the four Presidents (of the European Council, the European Commission, the Eurogroup and the ECB) last June.

I think it will be most appropriate for me to focus my remarks today chiefly on the Banking pillar, i.e. Banking Union.

We need Banking Union to transform the financial system from a source of risk and instability to a source of growth and support to the real economy. We have in fact made considerable progress in recent months – especially under the Irish Presidency – in its construction. However much remains to be done.

Announcement of action to build a Banking Union combined with the firm commitment of the ECB has contributed greatly over the past several months to the gradual but clear restoration of confidence in euro area financial markets. While it is not appropriate for me to touch on monetary policy issues today (ahead of the ECB Governing Council meeting), it is evident that (with some exceptions) sovereign spreads have generally declined in the stressed economies, not least in Ireland, and this trend has held, even through the Cyprus situation. The financial markets are counting on the completion of Banking Union. We must avoid that any easing of tensions in the markets leads to a slackening in the pace of reform.

Banking Union, shifting supervision of banks to the European level, combined with a single resolution regime and a common system for deposit protection will reassure citizens and markets that a common, high level of prudential regulation is being consistently applied. Together with greater fiscal and economic coordination it will help build the necessary trust between member states which is a pre-condition for the introduction of common financial arrangements

The Irish Presidency has given top priority to the Banking Union files. At the Central Bank we have been heavily involved and a large number of my colleagues in the Bank have been assisting in the discussions and negotiations around the large body of legislative reform that is associated with Banking Union.

First the Irish Presidency brokered final agreement on the Capital Requirements Directive and Regulation (CRDIV). This will greatly strengthen the capital and liquidity provisioning of Europe's banks and improve governance and remuneration practices. It is now expected to apply from January 2014.

Agreement has also been reached, following the informal ECOFIN held in Dublin in April, on the Single Supervisory Mechanism for banks in the Euro area. This will transfer bank supervisory tasks to the European level and will provide strong and consistent supervision. Preparations are well advanced within the ECB to take on this task as early as July 2014, depending on the formal implementation date. It has been a remarkable success to obtain agreement on this proposal within 7 months of its publication.

Attention is now focused on negotiations to agree a Bank Recovery and Resolution Directive. This would ensure that authorities throughout Europe would have the means to intervene decisively when problems occur and that the costs of dealing with failing banks fall in a clearly defined order on the owners and creditors. Ministers will discuss this text on May 14th and there is a target to reach agreement by the end of the Irish Presidency.

Linked to this is the need to get agreement on a common scheme of Deposit Guarantee Funds throughout Europe, also an objective of the Presidency.

However the combination of a European supervisor of banks with responsibility for the resolution of bank failures remaining at the national level may not be a stable equilibrium in political economy terms, as individual member state governments may question and resent the imposition from the SSM of bank resolution requirements potentially including recapitalisation costs. Supervision and resolution should therefore be placed at the same level. The need for this has been acknowledged at successive European Councils which affirmed that it is imperative to break the vicious circle between banks and sovereigns. Now that there is agreement on a Single Supervisory Mechanism it is especially important to press ahead with establishing a Single Resolution Mechanism and Authority and a Single Deposit Guarantee scheme.