

## **Benoît Cœuré: Reviving credit growth in the euro area**

Speech by Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, at the Paris Europlace International Financial Forum “Growth and investment opportunities in Europe”, Paris, 11 July 2013.

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*I wish to thank Jean-Francois Jamet for his contributions to this speech. I remain solely responsible for the opinions contained herein.*

Ladies and Gentlemen,

I would like first to thank Paris Europlace for inviting me to speak today.

Every year, this conference offers the opportunity to take a closer look at the challenges for the European financial sector that have been thrown up by the crisis.

They come under three headings: deleveraging, fragmentation, recession. And all three are interrelated.

As banks, households and governments deleverage, some economies in the euro area are being affected more than others. Financial conditions across the monetary union have diverged significantly, and resulted in large cross-country dispersion in loan dynamics.

Financial fragmentation, uncertainty and a subdued macro environment have also manifested themselves in a contraction of investment, which is currently the most important drag on growth in the euro area. In the first quarter of 2013, investment in the euro area was 22 % below its pre-crisis level in 2007 Q2. This year, the European Commission expects investment to further contract by 2.6%, or 0.5% of euro area GDP.

So, if the principal answer to the crisis is a return to growth, a core concern has to be how to revive credit provision in all parts of the euro area.

I will today discuss in turn the role of three key factors in that respect: monetary policy, Banking Union and financial market structure.

### **The role of monetary policy**

Let me start with the role of monetary policy.

Throughout the crisis, the ECB has played an important role to ensure, within its price stability mandate, the proper financing of the euro area economy in a context of subdued credit dynamics.

*First*, we have reduced our main interest rates to historic lows. We have narrowed the interest rate corridor to 50 basis points which helps reduce fragmentation between banks that rely on ECB liquidity and those that can borrow in the interbank market. And last week, unanimously, the Governing Council took the important step to introduce forward guidance within our two pillar monetary strategy. We expect the key interest rates to remain at present or lower levels for an extended period of time. Consistently, liquidity will remain ample.

*Second*, we have introduced a series of measures to ensure that banks can pass on these low interest rates in the real economy, in particular where they are needed the most. These include providing as much liquidity as they need to euro area banks, reviewing our collateral framework, lengthening the maturity of our operations to three years when euro area banks were facing severe funding stress, and removing redenomination risks in financial markets through our announcement of Outright Monetary Transactions (OMT).

These measures have resulted in a significant reduction of financial fragmentation in practically all market segments.

For example, since the OMT announcement, spreads on investment grade corporate bonds fell by 70 basis points in the euro area, while spreads on high-yield corporate bonds decreased by around 300 basis points<sup>1</sup>. The cost of both deposit and bond funding for banks has also fallen significantly. In addition, banks' reliance on Eurosystem funding has decreased, as reflected in the repayments to date of 60% of the circa EUR 500 billion injected in net terms into the banking system by our two very long-term refinancing operations. Target2 balances have been reduced by EUR 320 billions, or nearly 30%, since their peak level of July 2012.

However, the improvement in financial conditions has not yet been fully reflected on the real side of the economy. Loans to households are stagnating and credit to non-financial corporations is receding. There is still significant heterogeneity between financing conditions in stressed and non-stressed countries. While the ECB cut its main refinancing rate by 50 basis point in the twelve months before end-May 2013, the rate charged by banks on non-financial corporations went down by 25 basis points in Spain and less than 20 basis points in Portugal.<sup>2</sup>

This reflects the fact that monetary policy is only one factor that matters for financing of the real economy. Another crucial factor is confidence in the banking sector.

### **The role of Banking Union**

Euro area large and complex banking groups have increased their median core Tier 1 capital ratio from 8.3% at the end of 2009 to 9.6% at the end of 2011 and 11.1% in the first quarter of this year, and their leverage has improved considerably, mainly through capital increases. Yet, price-to-book ratios remain less than 1 for many institutions. This reveals persistent lack of trust by financial market participants in their true solvency positions and their underlying asset quality.

Banking Union is a key part of restoring that trust.

How governments intervene in systemic banking crises is critical. Bank restructuring measures that provide banks with incentives to liquidate or restructure bad loans, while allowing for sufficient recapitalisation, significantly accelerate the recovery from recessions related to banking crises.<sup>3</sup>

This suggests that Banking Union can help boost credit provision through two key channels.

*First*, by increasing transparency over the quality of banks' assets, which is key to distinguish strong from weak banks and hence remove the concerns hanging over the whole banking sector.

*Second*, by ensuring that banks that are not in position to lend can be restructured or resolved without creating financial instability.

These two channels correspond to the two main elements of Banking Union: the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM).

The SSM should be established later in 2013 and start operating twelve months later as a single system, with a common supervisory manual applying to all participating banks, and the

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<sup>1</sup> See the ECB's Monthly Bulletin of June 2013, "Box 4: Recent developments in spreads on corporate bonds issued by euro area non-financial corporations".

<sup>2</sup> Rates on outstanding loans to non-financial corporations over 1 and up to 5 years. Respectively from 3.8% to 3.55% and 5.2% to 5.03%. Source: ECB.

<sup>3</sup> Van Wijnbergen, S., and Homar, T. (2013), "Recessions after Systemic Banking Crises: Does It Matter How Governments Intervene?", *Duisenberg school of finance - Tinbergen Institute Discussion Paper*. According to this paper bank restructuring reduces expected recession duration by a half.

ECB directly supervising larger banks. Generally, the SSM should reduce concerns over hidden losses by creating common oversight of risks in the euro area banking sector and reducing regulatory forbearance.

Specifically, before the ECB takes over its tasks as single supervisor, it will undertake a rigorous balance sheet assessment of the banks it will directly supervise, including an asset quality review. The assessment will be undertaken together with national supervisory agencies and, as needed, with external consultants. In case it reveals capital shortfalls, it is the responsibility of the banks to raise capital themselves. As acknowledged by the European Council, public backstops will ensure that any remaining shortfalls are filled. Such backstops can be provided at national or, as last resort, at euro area level.

Regarding the SRM, the legal framework for resolution contained in the Bank Recovery and Resolution Directive (BRRD) creates a stronger set of tools for winding down failing banks in the future. By ensuring that bail-in must precede bail-out, the BRRD achieves a level playing field and reduces financial fragmentation linked to the strength of national budgets. Moreover, in the transition to the BRRD, and as of next month, new State aid rules will require the burden-sharing of losses by shareholders and creditors, if resolution actions involve public funds. This will ensure that shareholders and creditors are the first to bear losses, and not the taxpayers.

But it is key, particularly for cross-border banks, that there is a strong central authority that can use these tools in a swift and impartial manner. The ECB has been clear that we need a single European resolution authority and a single resolution fund as a fundamental complement to the SSM. I welcome the proposal of the European Commission in this respect and will assess it in detail. The plan that the SRM comes into force in 2014 and can start its operations as from January 2015, when the BRRD enters into force, is also welcomed.

Banking Union is about restoring the single market for capital. European companies should be able to tap a single pool of savings to fund their global expansion.

Banking Union will ensure that the funding cost of a bank depends on the quality of its assets, not on the jurisdiction in which its headquarters are located. There might be fundamental reasons why Portuguese SMEs do not borrow under the same terms as German SMEs. But they should borrow under the same terms from Portuguese and from German banks.

### **The role of market structures**

However, even if Banking Union can reduce financial fragmentation *across* countries, it may not, by itself, be sufficient to reduce it *within* countries – as epitomised by the significant mark-up on loans paid by SMEs compared with larger firms.

Indeed, according to the results of the ECB survey on the access to finance of SMEs in the euro area, conducted in February-March 2013, 16% of SMEs (that is more than 2 million) report access to finance as their main problem. Furthermore, interest rate spreads on SME loans compared with those for large non-financial companies have widened to an average of 40 basis points since 2010.

This links to the third factor in restoring credit provision: improving market structures, in particular to help specific sectors like SMEs.

The ECB has supported the EIB and European Commission in examining the constraints hindering the development of securitisation instruments for SME loans and the revival of the ABS market.

We welcome the on-going work by the Commission and the EIB on joint risk-sharing instruments to support SME lending, which would combine the EU budget resources with the EIB and the EIF lending capacity<sup>4</sup>. The European Council has supported this initiative and called for these instruments to begin operating in January 2014. In parallel, a more balanced regulatory treatment for ABS, acknowledging the past credit performance of these instruments, would ensure a level playing field with other securities regarding risk, rating and maturity.

The ECB can support the revival of the ABS market, provided that the risk to the Eurosystem is controllable, and the underlying instruments are simple and transparent. But it cannot be a substitute for market mechanism, nor can it subsidise risk taking of market participants.

### **Concluding remarks**

Let me now conclude.

Reviving credit growth is one of the most pressing challenges for the euro area today, but it can only be achieved by all actors playing their part.

The role of banks has been reduced after the crisis, and the euro area will probably move towards a more balanced financing mix, with a greater role for arms' length finance based on capital markets. Being more balanced, this model would be more resilient. But the euro area is and will remain a bank based economy. In fact, there are essential constituencies, namely SMEs and households that still obtain credit almost exclusively from banks. Accordingly, there can be no sustained recovery without a healthy, competitive and prudent banking system. Cleaning up the banks, as was done at an early stage in the US, is not merely desirable, it is a condition to finally emerge from the crisis and move on.

The ECB can help reduce divergences in bank funding. But governments have to ensure that banks are properly capitalised and that their balance sheets are cleaned up.

Similarly, the ECB can help support the economy and improve the macroeconomic outlook. But governments have to introduce the structural reforms that are essential to open up investment opportunities, and without which banks will not sustainably alter their risk assessments.

Low interest rates and improved financial market conditions may give a sense that reforms can be deployed over extended periods of time. But reforms are a matter of urgency. Deleveraging, fragmentation and recession weight on the most vulnerable in society, in particular on the youth. Time lost increases the risk of a permanently lower rate of growth and of a lost generation.

In other words, the key to reviving growth and investment in the euro area is for each stakeholder to take responsibility for what it can change, within its mandate – and then just do it.

Thank you for your attention.

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<sup>4</sup> See European Investment Bank – European Commission (2013), “Increasing lending to the economy: implementing the EIB capital increase and joint Commission-EIB initiatives”, report to the European Council, 27–28 June 2013.