Vítor Constâncio: Banking Union and the European crisis

Opening remarks by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the 6th Santander International Banking Conference, Madrid, 5 November 2013.

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Ladies and gentlemen,

Thank you for inviting me to speak today at the Santander International Banking Conference that has become over the years a very relevant event.

A window of opportunity is currently open for the banking sector in Europe. We have the possibility to change how the banking sector serves the economy; to implement adequate regulation and ensure its stability and efficiency; and with banking union, to reform how banks are supervised and resolved. If we make the most of this opportunity, we can put the banking sector on a sounder footing for a generation. We therefore face a profound responsibility as policymakers to get these changes right.

Today's conference includes many expert speakers who will go into detail on the on-going reforms of the banking sector. I would therefore like to use my remarks today to recall why the Single Supervisory Mechanism (SSM) was the necessary response to the crisis and how the design of the SSM is addressing some of the weaknesses in the initial architecture of EMU.

The point I will emphasise is that one of the main drivers of the crisis was private imbalances financed by banks in both core and peripheral countries. For this reason, one of the most important lessons we can take from the crisis is the importance of building a genuine banking union.

The crisis narrative

Indeed, the importance of banking union is related with the role of the banking sector in the development of the European economic crisis.

As you know, there are many explanations for the crisis: some observers like to focus on unsound fiscal policies and excessive sovereign debt; others on competitiveness losses engineered by uncontrolled unit labour costs; and others still see the crisis more as a traditional balance of payments crisis in a "fully fixed" exchange rate regime.

But there is one narrative that connects these explanations and it is oldest narrative of the crisis. It states there was essentially nothing wrong with the initial design of EMU, and the crisis resulted mostly from the fact that several peripheral countries did not respect that design – in particular the fiscal rules of the Stability and Growth Pact (SGP). In this story, the root of the crisis lays mostly with fiscal indiscipline in an over-heating economy. This led to wage and price increases, which implied a loss of competitiveness, which in turn led to the balance of payment crises.

This narrative is internally coherent, but in my view it exaggerates the role of fiscal policies as an initial cause of the crisis.

To begin with, it does not seem that fiscal soundness, as measured by compliance with the SGP, is particularly correlated with later developments in the crisis. Germany and France did not respect the Pact in 2003–4, while Spain and Ireland respected it more or less fully until 2007. Indeed, Spain was running a budget surplus before the crisis.

Neither does it seem that fiscal policies played a primary role in driving the economic cycle before the crisis. There was no uniform rise in government debt ratio in the euro area before the crisis, and in several countries debt-to-GDP ratios actually fell. In Spain, for instance, the

public debt ratio fell from 62% of GDP to 36% from 1999–2007 and in Ireland from 47% to 25%.

The more important factor driving the economic imbalances up to 2007 was the increasing private financial deficits – or put differently, rising private debt levels financed by the banking sectors of both core and peripheral countries.

Contrary to public debt ratios to GDP, private debt was increasing much more rapidly in all peripheral countries before the crisis. In Portugal the private debt ratio to GDP increased by 49% from 1999 to 2008, in Spain by 75%, in Ireland by 101% and in Greece by 217%. To fund this expansion of private debt, cross-border lending between euro area banks increased significantly, encouraged by the absence of exchange rate risks after the introduction of the euro. The exposures of banks from core to peripheral countries more than quintupled between 1999 and 2008.

These developments largely explain the evolution of fiscal, current account and competitiveness positions before the crisis. As a significant part of the credit growth was being financed from abroad, countries built up large capital account surpluses and corresponding large current account deficits as the mirror image. The mechanism that connected these financial and real trade flows was the loss of competitiveness – that is, an appreciation of the real exchange rate caused by economic over-heating.

As this audience knows well, all these developments later implied major problems in the financial sector in peripheral countries when the cycle turned. On the asset side, loan quality deteriorated, while on the liability side, those loans could no longer be funded from abroad. It was only at this point, due to the economic downturn and the need to backstop banks, that sovereign debt began its steep rise and became a driver of the crisis in itself.

Drawing the right lessons for the euro area

In emphasising this private debt-focused narrative for this crisis, my aim is not to negate the importance of fiscal policies. Fiscal policies certainly should not have been pro-cyclical, and fiscal discipline today is essential to ensure sustainable debt levels in the future. My aim is rather to ensure that we recognise the central role played by the financial sector in the crisis and so draw the right lessons for the future.

The most important such lesson is that the euro area needs stronger governance of financial policies – an ability to identify and curb cross-border financial flows and hence prevent debt-driven imbalances. The decentralised system of supervision we had before the crisis, based on loose cooperation between national supervisors, simply did not permit this.

It is therefore misleading to say that the crisis was solely the result of periphery countries living beyond their means as a matter of policy. The authorities had to respect the single market rules and could not contain alone the large capital inflows that were fueling the imbalances. Indeed, with a national approach to supervision, the forces driving financial developments lay largely outside the legal capabilities of national supervisors.

In saying this, I do not deny that supervisors were also too slow to react, due in part to a belief in self-regulating markets. Yet had they tried to contain these financial inflows, it is questionable whether they could have done so successfully.

The conclusion I draw is as follows: to have an integrated financial market and overall stability there cannot be purely national supervision. Instead, there has to be supervision at level of the market – that is, at the European level.

Let me therefore turn to the Single Supervisory Mechanism.

The benefits of the Single Supervisory Mechanism

The SSM, which will formally take over supervision in November next year, is being designed to solve the “financial trilemma”[1] created by national supervision – that is, to support financial integration and maintain financial stability by moving supervision to the European level. It will address both the institutional and macro-prudential limitations that supervisors faced before the crisis.

Starting with the institutional limitations, the key innovation of the SSM is that it creates genuinely European supervision, by which I mean supervision on both core and peripheral banks. From November next year, every bank in Europe will be part of the same system. This puts supervisors in a better position to prevent boom-bust cycles caused by excessive cross-border lending – and if they fail to do so, there will be collective responsibility for that failure.

In line with the subsidiarity principle, European supervision will involve centralised and decentralised elements. For the big significant banks (around 130), the ECB will be the direct responsible supervisor, but supervision will take place at both the European and national levels. We will integrate these levels by setting up Joint Supervisory Teams (JST) for each significant bank.

Let me use the example of Santander to illustrate how this will work.

For the parts of the banking group resident within the SSM, there will be a core supervisory team comprising of staff from both the ECB and the national competent authorities (NCAs) in the countries where Santander is active – that is 9 within the euro area. Within this team there will be a national coordinator for each country, drawn from the respective NCA, and an overall coordinator, who will be an ECB staff member. The national coordinators will manage the permanent experts working at the national level, while the ECB coordinator will ensure quality and take responsibility for output sent to the Supervisory Board.

In this way, the expertise in the NCAs will be fully utilised, while final decisions will rest with the ECB – in keeping with the objective to have a European approach to supervision.

For less significant smaller banks, the balance will be tipped more towards decentralisation. The responsible supervisor will remain the national authority. However, banks will still be integrated into the single system of the SSM. They will be supervised according to a single supervisory model that we are currently developing, which will be approved by the future Supervisory Board, and the ECB has the legal right to take over direct supervision of any bank at any moment.

Turning to the macro-prudential limitations, the SSM will create new possibilities to make use of macro-prudential policies to curb pro-cyclicality in credit supply and volatility in cross-border flows. It will introduce two important changes to macro-prudential policy-making at the European level.

The first change is related to instruments. As part of the Capital Requirements Directive IV/Capital Requirements Regulation, the SSM will gain a series of new macro-prudential powers. These include, among others, the counter-cyclical capital buffer, the systemic risk buffer and the macro-prudential elements from Pillar 2. These instruments are designed to help cool credit-led booms and/or provide additional buffers in downturns to mitigate credit crunches.

There is some scepticism in academic circles as to the effectiveness of these tools, but a recent study on the Spanish experience with dynamic provisioning suggests we should be more optimistic. It finds that the buffers created by dynamic provisioning somewhat

[1] Dirk Schoenmaker (2011) “The financial trilemma” in Economic Letters, 111, pp. 57–9.

contracted credit availability in good times and helped expand it in bad times. The reason these provisions were insufficient to stop the credit boom was that they needed to be applied more evenly and aggressively.[2]

The second change is related to decision-making. As a European decision-maker, the SSM will be able, if needed, to apply prudential measures to banks in both borrowing and lending countries. This is important because, to the extent that macro-prudential measures mitigate credit booms by raising banks' cost of equity, this effect can be offset if there are large inflows from abroad that lower banks' cost of debt. Indeed, one can suppose that this was an additional reason that dynamic provisioning in Spain was not enough to avert the credit boom and the housing bubble.

The ECB's comprehensive assessment of the main European banks

Taken together, I am confident that these institutional and macro-prudential changes will help strengthen financial governance in the euro area. We will have the right supervisory powers at the right level of action – the European level. Before we start actually our supervisory tasks we will conduct a comprehensive assessment of the significant banks in the euro area.

This assessment will consist of three elements. First, a supervisory risk assessment which will identify the key risks in banks' balance sheet; second, a point-in-time Asset Quality Review (AQR) to enhance transparency over asset quality, provisioning and capital; and third, a stress test to examine the resilience of banks' balance sheet to stressed scenarios. The assessment will conclude with a single disclosure of the outcomes, which will be published before the ECB assumes its supervisory role in November 2014.

As the ECB has recently released a communication about this exercise, I will not go into more detail on its features today. Let me however stress that the exercise will be rigorous and transparent and will involve private expert firms, such as external auditors, consultants and specialised asset evaluators. Their presence, together with the announced "strong central governance structure", will enhance the credibility of the exercise.

National Supervisors and private firms involved in the assessment will work within the terms of a detailed framework defined by the ECB and their final output will be subject to a central review to assess their quality and analyse their consistency across banks and countries.

We of course do not know what the assessment will find. But we trust that the euro area banks are today better prepared to undergo such an exercise. They are much stronger than in recent years. They have significantly strengthened their capital positions and now compare reasonably well with US banks in that respect.

In terms of risk-weighted assets, the median Core Tier 1 ratio of the largest euro area banks currently stands at 12.7%, above their American counterparts. The majority of significant euro area banks already comply with the minimum capital requirements of the fully implemented Basel III framework.

In terms of leverage – as measured by the ratio of equity over total assets – EU banks may at first sight appear to have lower ratios than their US peers, but as FDIC Vice Chairman Thomas Hoenig has showed, if the same accounting standards are applied then the median of the leverage ratios of large EU and US banks are quite similar.

In terms of absolute nominal size, if we look at the 20 largest banks in the EU and the US, the EU banks now have a capital level approximately 100 billion dollars larger.

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[2] Gabriel Jiménez, Steven Ongena, José-Luis Peydró and Jesús Saurina (2012), "Macroprudential Policy, Countercyclical Bank Capital Buffers and Credit Supply: Evidence from the Spanish Dynamic Provisioning Experiments" Sveriges Riksbank working paper.

Where euro area banks do not compare so favourably with their US peers, however, is in their low profitability and fragile investor confidence. Investors seem to be uncertain whether banks have proper asset valuations and are adequately provisioned. But this is precisely the issue the comprehensive assessment should address – it is an exercise in removing uncertainty by giving investors all the facts.

I said some time ago that markets had an excessive negative perception of European banks. In fact, euro area bank share prices, as well as price-to-book ratios, have been rising in recent months in part in anticipation of the assessment. This would suggest that investors expect the clarity provided by the exercise to be clearly positive for the euro area banking sector.

Regarding the response to the exercise, if some capital shortfalls are revealed, the private sector is today in a position to play a major part in filling them. This is more feasible than in recent years given the improvement in market conditions.

Indeed, since last year banks have been improving the robustness of their balance sheets by increasing capital and provisions in anticipation of our comprehensive assessment. In this sense, the exercise is already producing results – and it indicates the willingness of banks to resolve existing problems within the sector itself.

In the same vein, given the number and size of European banks, there is scope for some consolidation within the banking sector without reinforcing the so-called "too-big-to-fail" problem. Our recent "Banking Structures Report" shows that this trend is already ongoing in Europe. Nevertheless, as a last resort, confirming the existence of public backstops is important to reassure all stakeholders of the credibility of the whole assessment exercise.

Conclusion

Let me conclude.

Although various explanations exist for the crisis, I am pleased that what I view as one of its important lessons is now being learned. This lesson is that a single financial market with a single currency needs a single system of supervision – and alongside this, a Single European Resolution Mechanism (SRM).

The SRM is an essential component of banking union. It helps break the bank-sovereign nexus by allowing banks to be resolved at the European level with minimum use of taxpayer funds. And it adds credibility to the European supervisor by providing reassurance that banks can be resolved in an orderly and efficient manner without creating financial instability – especially large cross-border banks.

With the development of banking union, we are creating the conditions for a more stable financial sector in the future and a better functioning monetary union. But we also need a banking sector that takes responsibility. As supervisors, we expect the banks to be better capitalised and less leveraged, more stable and efficient, to perform their indispensable role in financing the economy and supporting the on-going, fragile economic recovery.

Because the crisis of the European economy is not over. It is true that modest growth has returned in the last six months and that countries under stress have gone through a painful but successful adjustment, reducing their deficits, correcting their initial loss of competitiveness in terms of unit labour costs and even achieving external accounts surpluses. At the same time, the recession has been deep and has left unprecedented and unacceptably high unemployment. Until economic growth is able to significantly reduce unemployment, the authorities should not become complacent in their efforts to continue the structural and institutional reforms essential to overcome the crisis.

It is clear that for the successful completion of the rebalancing process Europe needs more investment and higher domestic demand growth. We therefore need a more coordinated approach to macroeconomic policy at the euro area level to achieve higher demand growth,

as well as the continuation of structural reforms in all member countries in order to increase growth and facilitate a more encompassing rebalancing process.

At the same time, to support national structural reforms in stressed countries, the enactment of the announced contractual programmes with financial means to support their implementation should play a significant role.

Finally, it would be important if a future decision could be reached to implement at the euro area level what is referred in the President Van Rompuy's Report "Towards a genuine Economic and Monetary Union" as "….the establishment of a fiscal capacity to facilitate adjustment to economic shocks. This could take the form of an insurance-type mechanism between euro area countries to buffer large country-specific economic shocks. Such a function would ensure a form of fiscal solidarity exercised over economic cycles, improving the resilience of the euro area as a whole and reducing the financial and output costs associated with macroeconomic adjustments".

In the view of the President Van Rompuy's Report, a stable EMU needs to be built on four pillars: financial union, fiscal union, economic union and political union.

Member States have been able to decide a remarkable sequence of reforms in the past few years and there is now a much clearer vision of what rules and institutions are essential for monetary union to function more effectively. The single currency needs strong common institutions. Strong institutions to supervise and stabilise the financial market; to guide fiscal policies; to coordinate economic policy, guarantee competitiveness and encourage sustainable growth.

This is the vision that should guide us in all our endeavours to definitely overcome the European crisis.

Thank you for your attention.