Christian Noyer: Why the Economic and Monetary Union needs a banking union

Address by Mr Christian Noyer, Governor of the Bank of France and Chairman of the Board of Directors of the Bank for International Settlements, at the Lamfalussy Lectures Conference "The euro dilemma: inside or outside?", Budapest, 31 January 2014.

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Dear Governors,

Ladies and gentlemen,

Before I begin with my address, I would like to thank very warmly Governor Matolcsy for having invited me. I would also like to congratulate him and the Magyar Nemzeti Bank for the very prestigious and interesting conference you organized.

My address is about the latest step of European integration, namely the banking union.

As you are aware, these past 14 years of monetary union have brought huge benefits: the purchasing power of more than 300 million users of the single currency has been more protected than ever thanks to stable and moderate inflation; the currency risk between euro area countries has been eliminated, helping to foster growth and maintain stability; and the single currency has simplified and stimulated both trade and labour mobility.

However, even with all these benefits, the euro area still did not manage to escape the crisis, and one of the most important lessons from this period was that monetary union was insufficiently complete and coherent.

In 2012, a consensus was reached over how we could resolve this failing. The answer was crystal clear: Europe needed to move towards a banking union.

Let me go over some of the reasons why we chose this path.

The euro area crisis, and in particular the more acute episodes of banking turmoil, revealed a number of basic weaknesses at the heart of the monetary union.

i) First, the problems encountered by some of the big banks severely damaged the fiscal stance in certain countries, where the state had to step in to save these banks. This, in turn, undermined market confidence in the sustainability of the resulting fast growing public debts, which led to sharp rises in the rates at which those countries could borrow on the market, as, for example, in the case of Ireland.

ii) Second, there was a perception that countries with impaired public finances would have difficulty bailing out their respective financial systems in the event of a problem. This resulted in a widespread loss of confidence and pushed up borrowing costs for banks and sovereigns, as in the case of Italy.

iii) In response to these tensions, the European Central Bank took unprecedented steps to lower the cost of bank refinancing, cutting its key policy rates to historically low levels and providing unlimited 3-year liquidity. But even this proved insufficient to calm market tensions. In some countries at least, monetary policy measures were simply not being fully transmitted to the real economy.

What was the reason behind these three phenomena, which were largely responsible for the escalation of the crisis in the euro area? It was the vicious circle that developed between the state of a country's banking sector and its perceived sovereign credit quality. And why did this vicious circle emerge? Because of the lack of banking union:

- In a monetary union, capital can circulate freely and rapidly from one country to another, which can amplify the potential fallout from "banking panics", unless there are effective supranational mechanisms in place for supervision, resolution and the guarantee of deposits;

- As long as the financial health of the euro area remains at the mercy of the difficulties encountered by one of its member countries, there is a threat that negative interactions may develop between sovereign credit risk and banking risk;
- In reality, the lack of a banking union allowed a high degree of fragmentation to develop within the euro area banking system and this, in turn, nourished doubts about the "singleness" of the euro.

The crisis thus made it clear that a uniformly healthy financial system was vital to safeguard the stability of the euro area and ensure the effective transmission of a single monetary policy.

Once we had agreed on this reasoning, we had to come up with a concrete solution.

The key to banking union can be summed up as follows: the aim is to find a way to ensure that banks in the euro area are considered precisely as that, as "euro area banks", and not as "Irish", "German" or "Italian" banks. In other words, the goal is to ensure that credit conditions in the euro area will not depend on *where* you are but on *who* you are, which is what should be expected of an efficient financial market.

To achieve this, we need to have three things in place:

i) Federal bank supervision, to guarantee that all institutions are subject to the same rules and same methods of control. A supra-national supervisor is in fact better placed to assess the risks of cross-border activities and therefore to protect and encourage such activities; it is not subject to national biases that can lead to the temptation of economic introversion. It is therefore more credible and strengthens stability and confidence in the area;

ii) A unified mechanism for the resolution of banking crises, so that individual countries no longer have to shoulder the burden of major upheavals on their own;

iii) A unified deposit-guarantee mechanism to avoid banking panics.

Over the past year, these ideas and words have translated into concrete actions, and Europe has demonstrated that it can carry out rapid, in-depth reforms, to ensure it emerges stronger from the crisis. I would just like to tell you where we stand currently in the move towards banking union.

As you know, the area in which we have made the most progress is in supervision.

European heads of state agreed to the principle of a single supervisory mechanism at the end of 2012, and we are in the process of actively preparing its implementation.

By November, the main banks in the euro area will be supervised by a federalized system headed in Frankfurt. A Supervisory Board will be established to plan and carry out the ECB's supervisory tasks, undertake preparatory work, and propose complete draft decisions for adoption by the ECB's Governing Council.

Moreover, the entire European banking system, including Hungary of course, will be supervised on the basis of a single set of principles – the Single Rulebook – which has been compiled by the European Banking Authority. This is a huge step towards a more unified and consistent European banking system, and one that is therefore more robust and efficient.

The move towards a Single Supervisory Mechanism is firmly on track. Last October, we reached another important milestone with the announcement by the ECB that European banks will be subject to a Comprehensive Assessment prior to the set up of the SSM in November 2014.

This exercise is now underway. We must be aware that the exercise is an unprecedented one: about 130 participating banks – including 13 French banking groups – representing 85% of the total assets of European banks, will simultaneously undergo a thorough asset quality review (AQR) using a common methodology, and this will be followed up with stress tests this summer.

The purpose of this rigorous exercise is threefold:

- to foster transparency about the condition of the European banking system;
- to take the needed corrective actions;
- and finally to restore confidence.

Of course, this exercise is a challenge. But I think that it is also a great opportunity for European banks to show that they have cleaned up their balance sheets and that they are trustworthy.

As you can see, the SSM is well on track and I am fully confident that it will be operational at the end of this year, as expected. But this good result should not lead to forget that for the banking union to be fully successful, the SSM needs to be completed with the adoption of a Single Resolution Mechanism.

Indeed, in line with my colleagues at the ECB, I consider the Single Resolution Mechanism to be another essential pillar of the banking union, alongside the SSM. Ideally, the SRM should consist of three main elements: a single system, a single authority and a single fund.

This is why the ECB has constantly been encouraging all the relevant parties to make further progress in adopting the SRM, which should be in place by the time the SSM becomes operational. You know that a political debate is taking place currently between the European Council of Ministers and the European Parliament.

The version of the SRM that has been agreed among European governments at the end of last year is not ideal, notably because it requires a long transition period which could fuel uncertainties. But what matters most is that we have clear and common set of rules concerning banks resolution. For the mechanism in itself, Europe has proven in the past that, confronted to acute crisis, it was able to accelerate the processes and deepen its solidarity.

Ladies and gentlemen, I hope I have managed to give you a clear and up-to-date picture of the advance towards banking union. I would like to conclude by stressing just how crucial this development is in order to strengthen our economic and monetary union.

I think that the ECB proved, in the darkest moments of the crisis, that it was completely committed to the euro. Our actions were driven by a profound belief that the single currency is our most valuable shared asset and that it brings enormous economic benefits. Today, with the construction of a banking union, we aim to demonstrate that this is a long-term commitment.

Thank you for your attention.