Mario Draghi: Financial integration and banking union

Speech by Mr Mario Draghi, President of the European Central Bank, at the conference for the 20th anniversary of the establishment of the European Monetary Institute, Brussels, 12 February 2014.

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Summary

A banking union will contribute to more sustainable financial integration in the euro area, says ECB President Mario Draghi. Speaking at a conference celebrating the 20th anniversary of the European Monetary Institute in Brussels, Draghi explains how stronger supervision, cross-border banking integration and resolution frameworks can reduce the risk of financial fragmentation. It was that kind of fragmentation which contributed to the recent financial crisis.

Draghi explains that financial integration is necessary for an effective monetary union. But "the euro area did not succeed in achieving sustainable financial integration", the ECB's President says. "And we can see the importance of financial integration all the more in its absence."

According to Draghi, financial integration before the crisis was incomplete. While the interbank market was fully integrated, retail banking remained fragmented. That led to a situation where banks used short-term and debt-based funding to increase lending to favoured domestic sectors such as real estate. "As banks' assets were not well allocated, nor well diversified geographically, they were more vulnerable to domestic shocks. And as their foreign liabilities were mainly interbank, they could not share the subsequent losses with other jurisdictions." So when the crisis hit, the cost of repairing balance sheets fell largely on their domestic fiscal authorities. "The result was the infamous bank sovereign nexus", Draghi says.

A banking union will generate a higher quality of financial integration. The Single Supervisory Mechanism will enable supervisors to mitigate the possible destabilising effects of financial integration. It will also help to maximise the benefits of integration by creating a policy framework more conducive to cross-border banking. If problems still occur, the planned European resolution framework will help by improving private risk-sharing while insulating sovereigns. To reach that aim, Draghi makes a case to improve the design of the Single Resolution Mechanism and the Single Resolution Fund. The proposed ten-year period to mutualise national compartments into a single fund "creates uncertainty", the President says. "We would see merits in doubling the pace of mutualisation to have a genuine European fund within five years."

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Dear Members of the European Parliament,

Dear Alexandre,

Dear Jacques,

Dear Luc,

Dear Governors,

Ladies and Gentlemen,

It is a pleasure to speak today at this conference marking the 20th anniversary of the European Monetary Institute (EMI), and in particular to be part of this session that recognises and celebrates the contribution of Alexandre Lamfalussy.

The discussion today has naturally focused on the EMI, the euro and monetary policy, but I would like to take this opportunity to reflect on another issue which is vital for the single currency, and to which Alexandre has made an immense contribution – that is, financial integration.

Financial integration and the single currency are in many ways two sides of the same coin. One fundamental reason for the single currency was to maximise the benefits of the single market for capital. And, conversely, it was understood when the euro was conceived that integrated financial markets would be necessary for an effective single currency.[1]

Alexandre's experience in academia, the private sector and central banking put him in a unique position to contribute to this process. He contributed intellectually, for example through his leadership of the SUERF[2] network set up to promote discussion of financial and monetary issues among academics, central bankers and market participants. He contributed practically, not least as chairman of Euro-MTS, the European electronic fixed income market, late in his career. And he made significant policy contributions, from overseeing the creation of the TARGET payment system at the EMI to launching what became known as the "Lamfalussy process" for supervisory and regulatory convergence in Europe.

For this reason, the ECB recognised and honoured his role by establishing about ten years ago a "Lamfalussy Fellowship" programme. It sponsors five young economists each year to conduct research on the integration, structure and performance of the European financial system.

However, we know – and to our cost – that ultimately the euro area did not succeed in achieving sustainable financial integration. While financial integration deepened significantly after the euro was introduced, the global financial crisis caused that process to go into reverse. And we can see the importance of financial integration for the single currency all the more in its absence.

In the periphery, financial fragmentation has led to high interest rates for firms and households, and disrupted monetary policy transmission. In the core, it has led to exceptionally low interest rates for savers and potentially distorted asset prices. Consequently, the whole of the euro area would benefit from lasting financial reintegration – and indeed, addressing financial fragmentation has been one of the key tasks of euro area policy-makers, including the ECB, over the past years.

What I would like to focus on today is one aspect of reversing fragmentation that is perhaps underplayed – that is, the importance of raising the *quality* of financial integration in the euro area. My view is that the incomplete financial integration we achieved before the crisis made it susceptible to fragmentation. But I am confident that with a banking union we can create the pre-conditions for more sustainable financial integration in the future.

Financial integration before the crisis: what went wrong?

Let me start by outlining how financial integration evolved before the crisis.

It was always understood that financial integration could have both stabilising and destabilising effects.[3] Some of the main stabilising effects were expected to come from increased portfolio diversification. As banks and other investors became more diversified across borders within the euro area, they could reduce their exposure to domestic shocks,

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1 *Report on Economic and Monetary Union in the European Community* (Delors Report), 1989.

2 SUERF, the European Money and Finance Forum, is an abbreviation of the Association's original name "Société Universitaire Européenne de Recherches Financières".

3 For example, Ferguson, R., P. Hartmann, F. Panetta and R. Portes, *International Financial Stability*, Ninth Geneva Report on the World Economy, International Center for Monetary and Banking Studies, 2009.

and this would be reflected in greater income and consumption risk-sharing.[4] Indeed, global and European evidence suggested that financial openness and integration had reduced consumption growth volatility.[5]

Another benefit of financial integration was thought to come from improved allocative efficiency. Research suggested that large cross-border banks in Europe could improve overall economic performance, by making sure that productive capital was channelled towards the most efficient firms. This would in turn reduce the risk of crises stemming from mispriced investment risk.[6]

Destabilising effects of financial integration, on the other hand, were expected particularly through risk-taking and contagion. Asymmetric information problems associated with cross-border lending could lead to misaligned incentives and increased risk-taking. Similarly, savings imbalances abroad could compress risk premia and lower financing costs, allowing an increase in leverage in the domestic financial sector.[7] And if negative shocks were to occur, contagion could quickly spread through the interbank market, and lending to the real sector across borders could be affected, too.[8]

As financial integration deepened, it was anticipated that the stabilising effects would overall be more important than the destabilising ones – that is, the welfare benefits of better diversification and improved allocative efficiency would offset the welfare costs of occasionally higher risk-taking and contagion effects.[9] So why were the costs of the European crisis so high?

There are many reasons for this, but in my view one important factor was the incomplete nature of financial integration in the euro area. Price convergence in many asset classes created an appearance of financial integration, but it was in fact relatively shallow, in particular in the banking sector. According to the ECB's financial integration indicators, while euro area interbank markets became almost completely integrated, retail banking integration remained largely fragmented.[10] This mismatch had at least three consequences.

The first was on the asset side of banks' balance sheets. A main channel through which retail banking integration is expected to improve allocative efficiency is by increasing the distance between the main shareholders and management of a bank and the vested interests in the country where the bank operates, i.e. by reducing so-called "related lending". But without meaningful foreign competition, these gains did not materialise in the euro area. In fact, the ability to borrow freely in interbank markets allowed local banks to increase lending towards favoured domestic sectors such as real estate. This is essentially what we saw in Spain and Ireland. In the process, financial integration concentrated rather than diversified risk.[11]

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4 Demyanyk, Y., C. Ostergaard, and Bent E. Sørensen, 2008. "Risk sharing and portfolio allocation in EMU", Economic Papers 334, European Commission.

5 Bekaert, G., C. Harvey, and C. Lundblad, 2006. "Growth volatility and financial liberalization." *Journal of International Money and Finance* 25, 370–403.

6 Giannetti, M., and S. Ongena, 2009. "Financial Integration and Firm Performance: Evidence from Foreign Bank Entry in Emerging Markets." *Review of Finance 13*, 181–223.

7 Caballero, R., and A. Krishnamurthy, 2009. "*Global imbalances and financial fragility*." American Economic Review 99, 584–588.

8 Popov, A., and G. Udell, 2012. "Cross-border banking, credit access, and the financial crisis." *Journal of International Economics* 87, 147–161.

9 Fecht, F., Grüner, H., and P. Hartmann, 2007. "Welfare effects of financial integration." CEPR Discussion Paper 6331.

10 *Financial Integration in Europe*, European Central Bank, April 2008.

11 Fecht, F., H. Gruener and P. Hartmann, 2012. "Financial integration, specialization and systemic risk", *Journal of International Economics*, vol. 88.

The second consequence was on the liability side of banks' balance sheets. As banks' funding from abroad came mainly through the interbank market, the composition of their foreign liabilities was short-term and debt-based. This meant that funding could quickly dry up at the first sign of distress.[12] With a more integrated banking sector, however, this effect would have been less dramatic. As foreign banks would have equity stakes, they would have an incentive to maintain cross-border funding within the group. This is what happened, for example, in the Baltic countries where foreign ownership of the banking sector was high.[13]

These two consequences combined to create a third effect. As banks' assets were not well allocated, nor well diversified geographically, they were more vulnerable to domestic shocks. And as their foreign liabilities were mainly interbank, i.e. not equity-based and short-term, they could not share the subsequent losses with other jurisdictions. This meant that when the crisis hit, the cost of repairing their balance sheets fell largely on their domestic fiscal authorities. The result was the infamous bank-sovereign nexus that has perpetuated financial fragmentation in the euro area.[14]

My conclusion from this experience is as follows: the quality and comprehensiveness of integration matters. There are costs which can arise from a type of financial integration that is short-term and reversible; or from having perfect integration in one market and fragmentation in another. A key question for the euro area is therefore: how can we generate a higher quality of financial integration for the future?

Making financial integration sustainable: the role of a banking union

The pre-crisis experience suggests three changes are needed.

First, stronger *ex ante* supervision to mitigate the possible destabilising effects of financial integration. Second, an improved policy framework to maximise the stability benefits, namely by encouraging deeper cross-border banking integration. Third, better *ex post* risk-sharing arrangements, such as resolution frameworks, so as to prevent shocks from spilling over to sovereigns.

I see that a banking union – the Single Supervisory Mechanism (SSM) and the new European resolution framework – can make a significant contribution to these objectives. Let me address each in turn.

Strengthening supervision

To begin with, the SSM will enable supervisors to better identify emerging risks and to act counter-cyclically. This is thanks to its independence, its incentives and its instruments.

The SSM has been designed with the necessary independence to lean against localised booms, being not only legally independent, but also independent of any single government or national financial system. And that independence is reflected throughout its organisational structure, for example by having mixed-nationality joint supervisory teams to supervise each significant bank.

By virtue of its accountability, the SSM also has incentives that are clearly aligned with its European financial stability objective – it has to answer for the failure of any bank in the SSM

[12] Schoenmaker, D., and W. Wagner, 2011. "The impact of cross-border banking on financial stability", Tinbergen Institute Discussion Paper TI 11–054/ DSF 18, Duisenberg School of Finance.

[13] Gros, D., and C. Alcidi, 2013. "Country adjustment to a 'sudden stop': Does the euro make a difference?", Economic Papers 492, European Commission.

[14] Acharya, V., I. Drechsler and P. Schnabl, 2014. "A pyrrhic victory? Bank bailouts and sovereign credit risk", forthcoming *Journal of Finance*, or Nikolov, K., and A. Popov, 2014. '"The sovereign-bank nexus", ECB Research Bulletin, No 20, 2–4.

area. Compared with national supervisors, this gives it all the more reason to take account of excessive risk-taking and the cross-border externalities associated with it, and therefore to be proactive if local financial developments pose increasing systemic risk.

Finally, the SSM has not only micro-prudential powers but also new macro-prudential instruments to counter financial imbalances. For all the instruments in the EU legislation, it may apply stricter measures than national authorities if it observes emerging risks. This further strengthens the capacity at the European level to prevent financial instability.

Deepening integration

The SSM can also help maximise the benefits of financial integration by providing a policy framework that is more conducive to cross-border banking integration.

Before the crisis, supervisory coordination mainly took place through the Lamfalussy process and committees, which were a major step forward and the best that could be achieved at the time. However, they were unable to fully iron out supervisory differences between EU jurisdictions.[15] This presented cross-border banks with substantial compliance costs and reduced the economic synergies of integration.

For example, a Commission survey in 2005 found that opaque supervisory approval procedures were a major deterrent to cross-border banking M&As in Europe. The need to comply with different sets of rules and interact with several different authorities was also reported to be a barrier to cross-border activity.[16]

The lesson from this period was that, while financial integration is ultimately a market-driven process, policy plays a key role in creating the conditions for it to progress. To quote the Lamfalussy report, “the EU has no ‘divine right’ to the benefits of an integrated market – it has to build one”.[17] This SSM should help us in this building process.

A single supervisor automatically removes some of the dividing lines between jurisdictions that create compliance costs. For example, there will no longer be a distinction between home and host supervisors for cross-border banks. Instead, there will be a single supervisory model and eventually a single supervisory culture, rather than one per country. And cross-border groups will be able to report at the consolidated level.

Another benefit of the SSM – and perhaps a more important one – will be the lack of “hidden barriers” to cross-border activity linked to national preferences. With a European supervisor, borders will not matter. Issues such as protecting national champions or supervisory ring-fencing of liquidity will not be relevant. This means that banks will be in a better position to achieve the economies of scale that were promised by the single financial market – and that they also need to be competitive at the global level.

It is of course for banks to decide whether such integration makes business sense. And some obstacles to cross-border integration that lie outside the remit of supervision – like company law and tax – still remain. However, the low profitability and excess capacity of the European banking sector suggests that efficiency gains could be achieved, and without exacerbating the “too big to fail” problem.

Improving risk-sharing

Even with a higher quality of financial integration, we know that shocks may still occur that cannot be contained within the private sector. The US, for example, has a well-integrated

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[15] *Review of the Lamfalussy Framework: Eurosystem Contribution*, November 2007.

[16] *Financial Integration in Europe*, European Central Bank, March 2007.

[17] *Final Report of the Committee of Wise Men on the Regulation of European Securities Markets*, February 2001.

financial market, and the Federal Deposit Insurance Corporation (FDIC) still plays a prominent role in managing crises. Our challenge in the euro area is to ensure that, when banks fail and the public sector has to intervene, it does not result in a recurrence of the bank-sovereign nexus. The new European resolution framework will be key to achieving this.

This framework can help insulate sovereigns by improving private risk-sharing within the euro area. First, it will ensure that the costs of bank failure are borne first and foremost by the private sector, with sovereigns providing funds only in exceptional circumstances. The key innovation here is the Bank Recovery and Resolution Directive, which provides the legal underpinning for the bail-in of shareholders and creditors and other resolution tools.

Second, the new framework will allow resolution costs to be more evenly spread across the euro area banking sector, and less concentrated in the affected countries, thus enhancing the potential for cross-border risk-sharing. Specifically, the Single Resolution Mechanism (SRM) will introduce a single resolution fund that is funded by and available to all euro area banks.

Will this help break the bank-sovereign nexus today? In my view, the impact will certainly be positive. The fact that the costs of any bank rescue will fall less on sovereigns should lift expectations of government debt sustainability, thus improving asset quality for banks exposed to their governments. And the fact that bail-ins will precede bail-outs means banks' funding costs should be better decoupled from the fiscal condition of their sovereigns.

That said, in terms of breaking this nexus, there are some elements in the Council agreement on the SRM that I believe could be improved. The main problem is uncertainty about resolution financing arrangements. This is important, because if markets cannot ascertain *ex ante* how resolution will be financed, and in what quantities, they may find themselves having to price-in a residual risk of national government involvement, thus perpetuating the bank-sovereign nexus.

One issue that creates uncertainty is the protracted time period – currently 10 years – over which national compartments are to be mutualised into a single resolution fund. As legacy risks will be addressed by the ECB's comprehensive assessment, this seems an unduly long period. We would see merits in doubling the pace of mutualisation to have a genuine European fund within five years. To be clear, this would not imply that banks have to pay higher fees. The fund would still only reach its target level after 10 years, yet it would be a truly single fund after five years.

Another issue that needs clarifying is what backstop arrangements will be in place in this transition period, and also in the steady state. What makes resolution authorities credible is the knowledge that, when private sector solutions do not suffice, they can draw on temporary public bridge financing. This steadies expectations and supports financial stability.

Indeed, the job of a resolution authority could become more complicated if there are doubts about the adequacy of its resources in times of systemic stress. Even in the US, where such a public backstop is in place, the FDIC felt that its job was complicated during the financial crisis by media scepticism about its finances.

For this reason, we believe that a single resolution fund needs a solid public backstop – be it an ability to temporarily borrow from the market backed by guarantees from participating Member States, or access to a credit line, potentially from the European Stability Mechanism. This would not be a transfer system between taxpayers: as in the US, such borrowing would be recovered by additional levies on the banking sector in the future. Therefore, the only transfer would be an intertemporal one among banks.

Conclusion

To conclude, financial integration is essential for a well-functioning single currency, but it is not something we can take for granted. We have learned a painful lesson here. Incomplete financial integration is an Achilles heel: it creates vulnerabilities and is liable to fragment. With the banking union, I am confident we are laying the foundations for more complete financial integration in the future.

There are two final points I would like to make.

First, while I have spoken mainly about banking sector integration, a single financial market must also ultimately extend to capital market integration – a theme that was close to Alexandre's heart. There are still several barriers to such integration, and these call for the attention of policy-makers. One example is barriers to high-quality securitisation of bank loans, whose removal may help to promote lending to households and SMEs, and reduce fragmentation. In the spirit of Alexandre, we need to begin addressing these issues in a pragmatic manner, while never losing sight of our goal.

Second, we should not forget that fragmentation also comes from the demand side. If less competitive countries undertake structural reforms that promote higher economic growth, their economies will converge towards more competitive ones, and finance will tend to follow.[18] This is why, in addition to the banking union, the re-establishment of country competitiveness is essential to reintegrate financial markets. In other words, *all* participants have to help achieve and sustain financial integration.

Thank you for your attention.

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[18]]Recall, for example, the early intellectual debate among economists about whether finance follows the real economy (e.g. Joan Robinson, 1952, The Generalization of the General Theory) or drives the real economy (e.g. Joseph Schumpeter, 1911, The Theory of Economic Development).