Vítor Constâncio: Banking Union – meaning and implications for the future of banking

Speech by Mr Vítor Constâncio, Vice-President of the European Central Bank, at Banking Union Conference, organised by the Master in Banking and Financial Regulation, Navarra University, Madrid, 24 April 2014.

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Ladies and gentlemen,

Thank you for inviting me to speak here today.

I was asked to share with you my views on the latest developments regarding the European Banking Union: what is the meaning of what has been achieved and what are the implications for the future of banking and the financial system in the Eurozone?

There are many good arguments to explain the rationale of building a European Banking Union to complement the Monetary Union. I have addressed them in several recent speeches.[1] Today, I will skip the arguments related to correcting the flaws in the initial design of the monetary union that, by keeping supervision at the national level in both creditor and debtor countries, contributed to the large imbalances before the crisis, generated by the vast private capital flows intermediated by banks.[2] Contrary to the "it was mostly fiscal" view of the crisis, private financial sector developments largely explain the build-up of unsustainable current account and competitiveness positions in peripheral countries before the crisis.

The current account deficits in most peripheral countries were in fact led by very large capital inflows coming from core countries with capital account surpluses. The exposures of banks from core to peripheral countries more than quintupled between 1999 and 2008. Competitiveness losses in the periphery were simply the mechanism that connected the capital account surplus and the current account deficit – that is, an appreciation of the real exchange rate caused by economic over-heating. As John Williamson explained long ago, it is impossible to have "an immaculate transfer" from capital inflows to current account deficits.[3] National supervisors found it impossible to contain these developments because they had to respect the single market rules and lacked the macro-prudential tools to offset the effects of large capital inflows. But by introducing supervision at the European level, the Banking Union offers a possibility to better pre-empt such developments in the future – and therefore to better protect the real economy and financial stability in the whole area.

Today, I will concentrate my remarks on two more practical and immediate goals of the Banking Union: (i) to eliminate the sovereign-bank loop and thereby reduce financial fragmentation and (ii) to repair bank´s balance-sheets, recover the impaired credit channel and consolidate the on-going mild economic recovery. In my remaining remarks, I will discuss some implications for the financial system's future and for the role of macro-

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1 ***Banking union and the future of banking***, speech by Vítor Constâncio, Vice-President of the ECB, at the IIEA Conference on "The Future of Banking in Europe", Dublin, 2 December 2013; ***Towards the Banking Union***, speech by Vítor Constâncio, Vice-President of the ECB, at the 2nd FIN-FSA Conference on EU Regulation and Supervision "Banking and Supervision under Transformation" organised by the Financial Supervisory Authority, Helsinki, 12 February 2013; ***Towards a European Banking Union***, speech by Vítor Constâncio, Vice-President of the ECB, Lecture held at the start of the academic year of the Duisenberg School of Finance, Amsterdam, 7 September 2012 (ECB website).

2 See "***The European Crisis and the role of the financial system***", speech by Vítor Constâncio, Vice-President of the ECB, at the Bank of Greece conference on "The crisis in the euro area" Athens, 23 May 2013 (ECB website).

3 See Williamson, J., "Comment", in Bergsten, F. (ed), *International Adjustment and Financing: The Lessons of 1985–1991*, Institute for International Economics, 1991, p. 243.

prudential policies. I will conclude with a few words about what else is needed to complete the repairing of our monetary union.

1. The sovereign-banks' feed-back loop

As you may remember, the whole idea of launching a single European supervisor was born in the June 2012 Summit as a consequence of the decision to prepare direct European recapitalisation of weak banks. The acute situation of liquidity shortage in late 2011 that led us at the ECB to conduct two long-term refinancing operations (LTROs) with a maturity of three years, and the continuing sovereign debt crisis convinced Member States to frontally address the bank-sovereign link, notably by promising the possibility of European capital injections that would not overburden the already indebted sovereigns. This naturally required that supervision would have also to be transferred to the European level and the embryo of Banking Union saw the light of day. Later, the Van Rompuy Report elaborated the concept by adding a Single Resolution Mechanism and a future possible Deposit Guarantee Scheme. In the meanwhile it was clarified that European direct recapitalisation could only happen after the Single Supervision Mechanism would become operating and after a comprehensive assessment of the banks' balance sheets would be conducted. This is because direct recapitalisation would not be used to cover bad legacy assets stemming from the crisis. Many months later, agreement was reached among Member States on the second element of the Banking Union – the Single Resolution Mechanism (SRM) – to add to the Single Supervision Mechanism (SSM). As the ECB underlined many times, those two components were necessary for the framework to work effectively. The Banking Union can thus be seen as the biggest reform after the inception of the euro with vast implications that go well beyond the problem of the sovereign-banks' loop.

In this way, the question of direct European recapitalisation – for which a framework has not yet been decided – ceased to be the main focus of attention. In the view of many commentators, the Single Resolution Mechanism became the expected instrument to achieve the separation between banks and sovereigns. This is a somewhat misleading view, as I will explain later.

What makes the question of the link between sovereigns and banks important relates to the fact that weak banks weakened the sovereign and the reverse was also true in the financial crisis. Some governments had to support their national banks with significant consequences to their own debt. In other cases, weakened sovereign with low ratings and difficulty in accessing the financial markets, enfeebled the banks who saw their ratings tumble and their funding become more difficult. At the same time, as the sovereign debt crisis in 2010 became explicit and triggered contagion effects across countries, banks' holdings of domestic debt rose, thereby increasing their dependence of the sovereign's fortunes.

These different forms of dependence created a negative feed-back loop that induced financial fragmentation among member of the monetary union and contributed to impair the credit channel and the transmission of monetary policy. Monetary policy interest rates were not properly transmitted and deposit and credit rates became much too different among countries as if we were not related to the same currency and to banks operating in a monetary union.

The ECB did the utmost to repair the transmission of monetary policy and restore the credit channel. The OMT initiative coupled with the development of the Banking Union project, proved finally effective reducing fragmentation. The recent world market developments and the perception that the tail risk of euro redenomination was overcome, contributed to an inflow of capital looking to the European periphery, further mitigating fragmentation of financial markets in the Eurozone.

Both components of the Banking Union, the SSM and the SRM help reduce the negative feed-back loop between banks and sovereigns but do not completely eliminate it.

Let me start with the first building block: the SSM. One important objective of the SSM regulation is to improve the quality of supervision and to ensure homogenous supervisory standards across the euro area. The SSM, upon its operational start in November, will root its supervisory work on the best supervisory practices. The general principles, processes, and methodology for supervision will be described in the SSM Supervisory Manual of which a comprehensive public version is being prepared.

The SSM will lead to a convergence of rules and standards and a harmonised supervisory culture. For example, by imposing common principles about methods and models' parameters that improve the reliability of banks' internal models it will address the problems created by differences in the way that banks calculate risk-weighted assets. Importantly, the SSM will ensure that the same risks are given similar weights, knowing of course that the same types of risk can have different manifestations in different markets, in accordance with the local economic situation. There will also be a harmonised treatment of non-performing exposures and provisioning rules, which at present varies between jurisdictions and is not directly comparable for investors. More generally, the substantial compliance costs, from having to observe different sets of rules and different sets of reporting requirements, as well as having to interact with several different authorities, will be reduced.

Direct supervision of significant banking groups will be undertaken by joint supervisory teams that will comprise supervisors from both the ECB/SSM and National Competent Authorities, thus enabling a fully integrated approach to the supervision of cross-border banks. Compared with supervision at national level, this integrated approach will enable the SSM to detect excessive risk-taking and the cross-border externalities associated with it, and to be therefore proactive if local financial developments develop into threats to broader financial stability.

I expect all these changes in the supervisory framework to contribute to reducing fragmentation by creating a level playing field for financial institutions and spreading best practices across borders, thus removing the barriers that existed in the past. Essential for de-linking banks from sovereigns is the trust that the financial system at large will develop in relation to the banks both directly and indirectly supervised by the SSM. This can help normalise interbank markets and overcome financial fragmentation.

That said, high standard banking supervision is not centred on preventing bank failures at any cost. In fact, to effectively perform its tasks, a supervisor must also be able to let failing banks exit the market. This is the reason why the SSM has also been given the competencies to withdraw from credit institutions, the authorisation to operate. However, given the role of banks in the financial system and in order to safeguard financial stability, the supervisor has to feel confident that the resolution of banks is conducted in an orderly fashion. This brings me to the second pillar of the Banking Union.

The establishment of the SRM is the second crucial step towards addressing financial fragmentation and breaking the sovereign-bank nexus. The main point here is that the orderly resolution of banks, even big ones, may contribute to avoid costly rescues by sovereigns that may endanger their own finances.

The SRM puts in place a single authority responsible for the resolution of banks in the euro area and participating Member States. This will enable swift and unbiased resolution decisions, which will address notably cross-border resolution cases in an effective manner. In this respect, the SRM should be viewed as a necessary – and logical – complement to the SSM. It would indeed be ill-advised to elevate the responsibility for supervision to the European level, while keeping resolution at the national level. This would create a mismatch of responsibilities, undermine the credibility of the SSM as supervisor, and delay the resolution of banks, a task that has to be done swiftly.

An important element of the SRM is the Single Resolution Fund, which will be financed via levies on the banking sector and gradually mutualised. Starting with national compartments, it will become one truly single European Fund in the course of eight years. By mutualising the cost of bank resolution, this approach will loosen the link between domestic banks and their sovereigns and further level the playing field. A shortcoming of the SRM is the absence of a clear common financing arrangement that would provide additional temporary resources when needed.

However, the SSM and SRM are not enough to completely sever the ties between sovereigns and their domestic banks. The SSM and harmonised supervision may not be enough to build sufficient trust among banks and, on the other hand, the SRM may face legal limitations to autonomously manage orderly resolutions of significant banks, using its own funds. These limitations come from the ***Bank Recovery and Resolution Directive (BRRD)*** which, in my view, is the most crucial regulatory change in Europe of late, applicable to all 28 EU member countries, and will significantly contribute to breaking the bank-sovereign nexus. Let me explain.

The BRRD implements a true paradigm change, ending the culture of bail-out and ushering in a culture of bail-in. As of 2016, in all resolution cases, the BRRD will impose to the Resolution Authorities, a bail-in of shareholders and creditors equal to at least 8% of total liabilities including own funds of a given bank. This amount of 8% is very substantial if we compare it to the losses which banks faced in the recent crisis. To give you an idea: between 2008 and 2010 only one bank had losses exceeding the 8% threshold, and the average for all other banks was slightly less than 3%. If we look further back to the Nordic Financial Crisis in the 90s, none of the banks affected by this crisis faced losses of more than 8% of its total liabilities including own funds.

Let me first briefly describe what happens once a bank enters into resolution and how the so-called "bail-in tool" works under the new framework. The bail-in tool follows a sequential approach. Before any resolution fund can be tapped, shareholders and creditors have to first absorb losses amounting to at least 8% of total liabilities including own funds. Although uninsured deposits from individuals and small firms come last among liabilities possibly subject to bail-in, they would be included if needed to attain the 8% total. According to the new rules, only insured deposits are totally excluded from the bail-in tool. Only after the 8% amount is bailed-in from shareholders and creditors, can money from the resolution fund be used and for a maximum amount of 5% of total liabilities (including own funds) of the bank under resolution. Public resources can then be used only in case this is not enough (which, based on past crisis experience would be exceptional).

Public money, either from national governments or from direct European recapitalisation of banks, can only be used at the very end of the process which, in practice, should happen exceedingly rarely. Bail-in of shareholders and creditors plus the use of the Resolution Fund should in most conceivable cases, be enough to ultimately cover for the losses incurred by the bank. The "Government financial stabilisation tools" that the Directive introduces are an instrument of last resort after having assessed and exploited the other resolution tools to the maximum extent possible. We are still far from the initial plan regarding this important question but the goal of avoiding to burden the sovereign with banks' rescues has in practice been achieved.

While we all agree with the objective of protecting taxpayers' money, it is important to examine what are the implications of the new rules for the banking market and for the sovereignty of member states. As a natural result of the backlash against banks in our democratic polities following the huge crisis rooted in the financial system, the new framework imposes that banks' bailout with public money is the ultimate resource after extensive bail-in tools have been activated. I agree that bailouts, especially when shareholders and bank management are not penalised, create moral hazard that may feed subsequent reckless management behaviour down the road. The difficult judgment is of course to navigate in a general financial crisis between the Scylla of moral hazard and the Charybdis of financial collapse.

The second aspect I wish to highlight is that by avoiding the commitment of public money and protecting tax payers as much as possible – a goal widely shared –participant countries in the Banking Union must shed considerable sovereign power, showing a remarkable willingness to continue to deepen European integration, thus reinforcing monetary union. In fact, large countries with strong public finances must renounce to provide domestic banks with the implicit subsidy of public support. This will reduce their strength in competing in the European space with an advantage and will be progressively reflected in banks' ratings and funding costs. On the other hand, countries with vulnerable public finances and smaller banks will no longer be able to support, and possibly keep, their national champions. Finally, in both cases, governments accept the transfer of supervision and resolution of banks to the European level in what has to be considered a remarkable sharing of sovereignty.

Another aspect of the BRRD reflecting the reluctance in the use of public money is the disposition that foresees that a criterion to put a bank formally into resolution is that it "requires extraordinary public support". This disposition will apply as of January next year and will very likely be in force when the corrective supervisory action stemming from the SSM Comprehensive Assessment will be in course of implementation. I rush to indicate that there is a possible exemption to this rule. But according to certain interpretations, the rule is applicable, for instance, to a listed bank that fails the baseline scenario of a stress test, cannot raise private capital and has to request public assistance. Very likely, if such bank is formally put into resolution it may suffer irreparable damage in the market place, further complicating its situation and generating spillover effects on other banks.

This could mean, according to those interpretations that under the BRRD, a bank may be put into resolution before actually attaining the point of non-viability if it just fails a baseline scenario of a stress test. We should be mindful that resolution does not lead to resurrection of the institution and, as seen by the market, implies deep restructuring, downsizing or even the winding down of an institution.

The interpretations already mentioned would also imply that the public backstops for the purposes of the SSM Comprehensive Assessment announced last November, if used, would trigger putting the bank into formal resolution if the exemption I mentioned before would not apply. The terms of the exemption, surrounded by several conditions, are basically dependent on the need to avoid a serious disturbance in the economy of a Member State and preserve financial stability. We certainly hope that in the context of such a wide-ranging undertaking to assess the robustness and resilience of European banks, there will be reasonable financial stability aspects to justify, in several cases, such exemption. Also, in 2015 such an exemption should have no operational implication for the bail-in rules of the Directive as, contrary to the rest of the BRRD articles, bail-in rules will be applicable only after January 2016. Also, the granting of such exemption would not preclude the application of the only bail-in rule in place in 2015 which exists in the context of State Aid principles. Therefore, it is an exemption without substantive consequences in terms of bail-in rules.

The rules now in place stem from the European Commission's communication on "State Aid rules to support measures in favour of banks in the context of the financial crisis" of July 2014[4], which establishes that any public support to banks considered as State Aid should be preceded by bail-in of bank shares, capital hybrids and subordinated debt, as mentioned. Again, in this case, the text contemplates that exceptions "can be made where implementing such measures would endanger financial stability or lead to disproportionate results". For concrete cases, at the end of the SSM Comprehensive Assessment, it may be adequate to invoke such principles.

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4 "Communication from the Commission on the application from 1 August 2013 of State Aid rules to support measures in favour of banks in the context of the financial crisis ("Banking Communication") 2013/C 216/01.

In 2015, another potential complication may come from problems of a legal nature that can create difficulties to the maintenance of a level playing field in the context of our exercise. Some countries may have no national law or legal ability to implement burden sharing rules ahead of the entry into force of the BRRD bail-in rules in 2016.

Amid these concerns, it is hoped that all the relevant legislation and related exemptions are applied in the wake of our Comprehensive Assessment with the adequate balance between the different values of avoiding moral hazard, assuring market discipline and level playing field, and safeguarding financial stability.

The present situation of apparent easy access to capital markets driven by investors' appetite to invest in banks is however reassuring. Hopefully, this situation will remain unchanged until November so that banks that need to reinforce their capital buffers will be able to raise money in the private market and the whole question of public backstops can move to the background. Nevertheless, I advise all banks, besides raising adequate levels of capital, to carefully study the new legislation on resolution and bail-in because the bank market and even competition for capital control will be significantly affected as it enters into force. On the other hand, investors should be incentivised to learn and interiorize the new bail-in rules that will dominate the market for banks' securities from now on.

I want to finish this section with some general considerations concerning the delicate judgment calls that dealing with financial crises necessarily entail. We should be reminded that not only direct public support for banks has a cost to taxpayers but that financial instability may imply significant costs for taxpayers. We just have to compare the worldwide costs for taxpayers stemming from no public intervention in the case of Lehman Brothers, with zero cost for taxpayers following the USD 700 billion injection in US banks to rescue them in 2008, which have by now been totally repaid by the banks. Financial instability can have a meaningful cost to taxpayers even if that it is not visible in the very short term, a notion that all policy makers should keep in mind. Obviously, to avoid moral hazard, any intervention should penalise shareholders and managers appropriately as it was done in the exemplar case of the Nordic banking crisis, where financial and economic collapse was avoided with, in the end, virtually no costs for taxpayers when the restored banks were sold. After the financial crisis and the misbehaviour of several institutions, which by the way, is still being uncovered, the change of culture from easy public bailouts to a new culture of private bailing-in is justifiable and I support that trend. The burden of proof should be put on those who want to invoke exemptions to the new approach. However, for those of us able to understand the externalities to the whole economy and society that a financial crisis can generate, balanced and complex judgements have always to be applied. A distinction has to be made between how to deal with a few individual cases and the way to address the risks of generalised financial crises. The new European legislation contemplates the necessary exceptions that, as a last resort, foresee interventions that can safeguard financial stability in a Member State or in the area as a whole. I trust that the new legislation will be applied by the competent authorities with rigour, wisdom and a sense of proportion in the aftermath of our Comprehensive Assessment.

2. Banks' balance-sheet repair and the economic recovery

I turn now to the implications of Banking Union for other economic aspects. Some economists are of the view that negative developments in bank credit in the Eurozone are predominantly due to credit supply restrictions linked with insufficient capital to absorb losses supposedly still unrecognised.[5] This view is not entirely correct. We have observed a marked

[5] Acharya, V. and S. Steffen, "Falling Short of Expectation? Stress-Testing the European Banking System", (2014); Kashyap, A. commentary on similarities between EU and Japan; Kashyap, A. et al. "How does financial regulation change bank credit supply?" (2014).

increase in banks' capital ratios since the beginning of 2009. Since the onset of the global financial crisis, the top 20 European banks have increased capital in dollar amounts, net of share buy-backs, by much higher numbers than the corresponding top 20 American banks: USD 289 billion by EU banks against USD 179 billion by US banks. And according to the FDIC, the leverage ratios of the biggest European banks, calculated according to the same accounting standards, are very close to their American peers.[6] Since mid last year in particular, European banks have implemented write-offs and increased provisions and capital, partly anticipating the Comprehensive balance-sheet Assessment that the ECB is conducting this year. As a result, confidence in the euro area banking sector is now starting to rise. This development has been recognised by the stock market where banks' share prices increased by 41% in 2013, above market average growth of 20%.[7]

Nevertheless, the task of bringing back confidence in the EU banking sector is still underway. This is why the Banking Union, and in particular the Comprehensive Assessment of banks' balance-sheets, is so important. It will trigger corrective supervisory action where it is needed and dispel any remaining doubts about asset valuations and the corresponding level of provisions. This in turn, will help bring the deleveraging process in the banking sector to a swifter conclusion.

In the short-term, this may have a pro-cyclical effect. However, a fast and targeted rebooting of the banking system could have two positive effects going forward.

The first effect is cyclical. A well-functioning banking sector will support the transmission of our monetary policy in all parts of the euro area, thus helping observed growth to rise towards potential growth and the output gap to close. This is because, on the asset side, banks that are restructured and recapitalised will no longer have incentives to ration lending towards smaller firms with higher capital charges. And on the liability side, as they gradually reach their target loan-to-deposit ratios through raising deposits, the funding costs between banks in the core and periphery of the euro area will further converge.

The second effect is structural. To the extent that the Comprehensive Assessment helps fixing the bank lending channel and ends the so-called "ever-greening" of loans[8], it will support an efficient credit allocation process. This could in turn support the overall process of reallocation within the euro area economy, thus boosting productivity and possibly reversing the slowdown in potential growth.

Nevertheless, a word of caution is warranted in the sense that a sudden jump start of credit growth may not result immediately. Recent behaviour of credit is not explainable only by credit supply restrictions, but it is largely linked to lack of demand. Completing banks' balance-sheet repair is thus a necessary but not sufficient condition to consolidate the on-going recovery.[9] The weak domestic demand outlook prevailing in the Eurozone combined with slack industrial capacity is the most important explanation for the drop in private investment during the crisis, and the most important limiting factor for higher growth.

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6 "Basel III Capital: A Well-Intended Illusion", remarks by FDIC Vice-Chairman Thomas M. Hoenig to the International Association of Deposit Insurers, 2013 Research Conference in Basel, Switzerland.

7 Changes in banks' share prices and overall stock market in the euro area (from early April to end 2013).

8 Although the identification of "evergreening" practices is challenging, a large number of analyses have been conducted on this issue, looking at Japan's "lost decade". See, among others, Caballero, R., T. Hoshi and A. K. Kashyap (2008), "Zombie Lending and Depressed Restructuring in Japan", American Economic Review, Vol. 98, No. 5. One more recent study looks at the global financial crisis and identifies lending patterns consistent with evergreening practices, although limited to smaller banks; see Albertazzi, U. and D. Marchetti (2010) *Credit supply, flight to quality and evergreening: an analysis of bank-firm relationships after Lehman*, Bank of Italy Working Paper No. 756.

9 See "***Growing out of the crisis: Is fixing finance enough?***" ,speech by Vítor Constâncio, Vice-President of the ECB, at the Annual Hyman P. Minsky Conference on the State of the US and World Economies, Washington D.C., 10 April 2014 (ECB site).

3. Other important effects of the Banking Union

I believe the on-going overhaul of bank supervision and resolution frameworks will have implications that go well beyond the primary objectives of financial stability and completion of the monetary union. I will focus on three aspects.

Further integration of the European banking market

The first effect is the probable consolidation of the European banking sector. Some restructuring in the euro area banking sector has already been on-going since 2008. For example, in net terms the number of credit institutions has fallen by 9% since 2008, or around 600 institutions, while total assets of the euro area banking sector have declined by almost 12%. However, this consolidation was more due to retrenchment than to active M&A deals in the industry, which have instead been rather weak. From 2008 to 2012, the overall value of deals decreased fourfold to just EUR10 billion, with cross-border deals being the most affected. Yet, the Herfindahl-Hirschman concentration indicator for the euro area banks remains, at the 690 level, well below the 1600 level above which concentration becomes detrimental, which means that there is margin for further efficiency-driven consolidation. The weak profitability and excess capacity of the European banking sector also suggests that efficiency gains could be reaped from more consolidation. This, together with the on-going repair of bank balance-sheets, should set the stage some time down the road for a new phase of M&As geared towards improving efficiency.

It seems likely that the Banking Union will create the conditions for further integration of the European banking market. Unified supervision should create greater trust among banks and cross-border banking groups will be able to optimise their internal management of capital and liquidity and reduce compliance costs. On liquidity and capital, we expect hidden barriers to disappear and allow their management at the level of the whole SSM space. A movement to subsidiarisation that we observe in other parts of the world has no justification inside the SSM perimeter. In this context, it is only natural that the establishment of the SSM and the Comprehensive Assessment of banks' balance-sheets could open to a period of general restructuring in the European banking sector spontaneously driven by market forces.

Enhancement of the capital markets role

In the euro area, banks have historically played an important role in financing the real economy. Bank loans account for most of household borrowing and around 50% of non-financial firms' external financing, which is very different from the US where around 75% of firms' financing comes from capital markets (equity and debt securities). However, recent evidence from the euro area and the US suggests that corporate bond financing was an important alternative to bank financing during the financial crisis, when banks were unwilling or unable to lend, mostly reflecting pressure to de-lever.[10] Although these pressures have eased and the economic recovery is beginning in Europe, I expect the move towards more capital market-based intermediation to persist going forward. One reason is that the new regulatory environment gives banks incentives to hold marketable, liquid securities, such as corporate bonds or asset backed securities, as opposed to corporate loans. This will, in my view, increase the complementarities between marketable assets and corporate loans within banks' balance-sheets, where in the past they were considered as substitutes.

What I am suggesting is not that Europe will – or should – abandon its intermediated model of financing but that it will complement it, more than in the past, with alternative sources of finance. This, combined with the structural deleveraging of the banking system and the new

[10] See De Fiore F. and H. Uhlig (2011), "Bank finance versus bond finance", Journal of Money, Credit and Banking, 43(7), 1399–1421, and Adrian, Colla, and Shin (2012), "Which financial frictions? Parsing the evidence of the financial crisis of 2007–09", in NBER Macroeconomics Annual 2012.

regulatory regime, should enable the banking sector to keep providing adequate levels of credit to the economy. The diversification of the financing mix will have obvious advantages for euro area firms, as it will allow them to access a larger pool of non-bank investors and to better insulate themselves from shocks in the banking sector.

The role of macro-prudential policies

The third effect linked to Banking Union is the emergence of new macro-prudential policy tools for the ECB. Before the crisis, banking supervision in most (but not all) countries was fundamentally "micro-based", focusing on the safety of individual institutions. But the crisis has shown that the stability of individual financial institutions alone is not enough to ensure the stability of the financial system as a whole. This is the reason why the SSM will have, not only micro-prudential powers but also new macro-prudential instruments to counter financial imbalances and apply prudential measures in both borrowing and lending countries which was not possible before the crisis.

At the current juncture, macro-prudential policies can address at least two related issues. First, by strengthening banks they can contribute to enhance credit flows to the real economy, and mitigate the likelihood that a so-called credit-less recovery materialises, a type of recovery that is generally quite mild.[11] At the same time, as macro-prudential policies can be targeted to specific sectors or regional developments, they can help attenuate the credit cycle heterogeneity characterising the euro area, and support a more balanced recovery.

Second, one cannot exclude that present accommodative monetary policy generates pockets of instability in some specific market segments. Macro-prudential tools can in principle allow the ECB/SSM to address such financial imbalances in a granular way. For example, instruments like the counter-cyclical capital buffer can be applied at the national level to curb domestic credit booms, allowing monetary policy to remain focused on euro area aggregates.

Going forward, by dealing with imbalances specific to a group of countries or to a given sector of the euro area economy, macro-prudential policies should effectively take into account heterogeneities among Member States and thus contribute to reducing dispersion, which in turn enhances the uniform transmission of monetary policy.

Conclusion

Let me conclude. Banking Union is an essential complement to monetary union and a project with vast consequences for European integration. It is not, however, the end of the journey. Banking Union must provide a stable and efficient framework for the major endeavour of completing the economic and monetary union. The dynamics of Jean Monnet's functional method of integration is still fully operational. From each institutional innovation, others become necessary and more pressing. For instance, to fully reap the benefits of Banking Union, we need legislative changes that the Commission should promote, in order to complete the programme of financial services integration, particularly in relation to the capital markets. That would include changes to company law, bankruptcy rules and procedures, and higher harmonisation in the taxation of financial products.

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[11] See, for instance, Takats, E., and C. Upper, 2013, "Credit and growth after financial crises", BIS Working Paper No 416; Abiad A., G. Dell'Ariccia, and B. Li, March 2011, "Creditless Recoveries", IMF Working Paper no. 58; Claessens S., M A. Kose, and M. E. Terrones, April 2011, "How Do Business and Financial Cycles Interact?", IMF Working Paper no. 88; Abiad et al. (2013) define credit-less recoveries "as episodes where real credit growth is negative in the first three years following the recession".

Other institutional developments are also well identified in the President Van Rompuy's Report "Towards a genuine Economic and Monetary Union".[12]

First, a more complete fiscal union going beyond mere disciplinary rules seems necessary, along the lines described in that Report when it asks for *"….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".*

Second, under the umbrella of Economic Union, we need further progress in the completion of the single market of services and a more co-ordinated approach to macroeconomic policy at the Eurozone level.

The sovereignty-sharing that monetary union represented implies further progress towards more political union. The euro area is, in the end, a political project and what we now need is to complete the integration of European nations in this unique community that is neither a nation nor a State. It is a powerful vision of preserving and defending national identities and interests in a globalised and very challenging world.

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[12] See "Towards a genuine Economic and Monetary Union" a Report by the President of the European Council in close collaboration with the Presidents of the European Commission, the Eurogroup and the ECB, (http://www.european-council.europa.eu/the-president/eurozone-governance).