Carlos da Silva Costa: From Banking Union to Financial Union – overcoming current challenges

Address by Mr Carlos da Silva Costa, Governor of the Bank of Portugal, at the seminar "Banking Union: The new frontier of financial regulation in the European Union", Lisbon, 25 January 2016.

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Accompanying slides can be found on the Bank of Portugal's website: Slides (PDF).

Banking Union – Where do we stand?

Where we came from: from the Single Market to the Banking Union

Underlying the Banking Union are two steps that are almost causally linked.

The Economic and Monetary Union (EMU) was established in 1999 in response to the need for exchange rate stability, to protect the orderly functioning and integrity of the single market. The establishment of a single currency and the adoption of a single monetary policy, managed by a European Central Bank, resulted from the practical impossibility of reconciling the free movement of capital with national monetary policies and exchange rate stability under the European Monetary System. The European Monetary System was incompatible with both the openness of economies within a single market and the existence of national monetary policies. Indeed, even when monetary policies were aligned, the lack of confidence over this trilemma could give rise to exchange rate fluctuations. This inconsistency led to the 1992–93 exchange rate crisis, when the magnitude of fluctuations made it necessary to widen the fluctuation bands, which had a direct impact on intra-EU trade flows.

Following the onset of the international financial crisis in 2007–08, the limitations to the EMU institutional framework became clear. The mechanisms in place – particularly, the Stability and Growth Pact and the single monetary policy – were unable to prevent the build-up of major imbalances across the euro area countries. Such imbalances resulted from excessive indebtedness of various institutional sectors in several countries and divergent developments in their competitive positions, amid particularly favourable market conditions, which did not properly reflect the sovereignty of national economic policies.

The divergence in competitive positions was exacerbated most notably by: (i) the lack of both cooperation mechanisms to monitor wage developments under the EMU and price-setting mechanisms against a background of low inflation rates, and (ii) some disregard for the build-up of external deficits in several countries, which could have been due to the lower severity of external account imbalances in economic unions at a later stage of integration.

When these imbalances became apparent, the change in the markets' risk perception led to financial fragmentation in the euro area, which affected not only the most vulnerable economies via an inability to access external financing, but also the monetary policy transmission mechanism itself, and, consequently, the EMU.

The fragilities brought to light by the EMU framework made its deepening inevitable, which over the past few years has resulted in:

- The strengthening of fiscal discipline mechanisms, with the adoption of the Fiscal Compact, the Six-Pack and the Two-Pack, and the establishment of the European Semester as an annual cycle for policy coordination in the EU;
- The establishment of mechanisms to prevent the build-up of imbalances impacting on the competitive position of euro area countries (the so-called Macroeconomic Imbalances Procedure);

- The creation of a Banking Union, with the purpose of breaking the bank-sovereign nexus, which was behind the severity of the euro area crisis;
- The establishment of a common mechanism for last-resort lending subject to conditionality (European Stability Mechanism).

Where we stand: a Banking Union under construction

Today, we stand on undeniably stronger ground than we did before the onset of the international financial crisis, but which is still insufficient to break the bank-sovereign nexus and safeguard the existence of a genuine European financial market.

The remaining shortcomings result mostly from three factors:

First, the Banking Union, which is composed of three pillars, is still institutionally incomplete. We have:

- A Single Supervisory Mechanism, which has been the single supervisory authority since November 2014;
- A Single Resolution Mechanism, invested with resolution authority powers since 1 January 2016, but still subject to the limited funding capacity of the European Resolution Fund;
- The intention, agreed but yet to be implemented, to establish a common deposit guarantee scheme.

Second, Europe lacks as yet a network of large banks established across all territories, as country-based banking systems are still predominant. Institutions tend to have a limited presence at EU level, while having systemic importance in the territory where their business is concentrated. This stands in contrast to what is seen, for instance, in the United States, where large banks with reach across the country coexist with small local banks, which are not systemic in nature.

In the current framework of a banking union still under construction, national authorities continue to be responsible for national financial stability, i.e. they continue to be responsible – and therefore accountable – for the safeguarding of depositors' confidence and the financing of the economy in their own countries. Nonetheless, they have neither the powers nor the instruments to deal with the impact of decisions in terms of supervision, resolution and implementation of competition rules, which are taken at European level and significantly restrict the options available to national authorities. This limitation of powers and instruments, however, is not perceived by the common citizen, given that national authorities – with responsibility for national financial stability – continue to be the most visible decision maker and communicator. The depositors' incomplete reading of the decision-making process inevitably weakens confidence in the conduct of financial policy and in the system itself. Therefore, European restrictions on national authorities' action, in a context where risk-sharing at European level is not complete, not only hinder the safeguarding of financial stability, but also heighten the underlying risks, affecting agents' confidence in the financial system.

Third, in Europe, multiple entities define and implement sectoral policies with material impact on financial system developments, especially the Single Supervisory Mechanism (and the Governing Council), the Single Resolution Mechanism and, with regard to the implementation of regulations and competition rules, the European Commission. These entities are focused on their respective mandates and, in spite of the evident spillovers, their action is not appropriately coordinated or framed within an overall view of sectoral policy for the financial system.

In effect, both regulation and its discretionary component, i.e. the practice of supervision, resolution and the enforcement of competition rules, have sectoral and national consequences. These tend to be more relevant the lower the coordination is among the different authorities and the further away the decision centre is from the territory affected by the decisions. Such difficulties are further hindered by the absence of decision-making mechanisms at European level which may ensure the agility, swiftness and confidentiality indispensable for an effective banking resolution function.

The current situation poses significant challenges that require urgent reflection and action at European level; otherwise, the growing negative perception regarding the European project may deteriorate further.

The asymmetry between powers and accountability and the limited vision arising from the fragmentation of responsibilities and the absence of a consistent sectoral policy at European level give rise to perverse incentives. If these are not adjusted in due time, they may jeopardise the sustainability of the Banking Union itself and the objectives underlying its creation.

Where we are going: from the Banking Union to the Capital Markets Union

The Banking Union is a necessary but insufficient condition to ensure the existence of a single European financial system, efficiently channelling savings to investment opportunities within the European Union territory.

Given that financing in Europe is dominated by the banking system, it must be ensured that banks are granted the possibility of securitising their credits and placing those securities with institutional investors. On the one hand, this would allow European banks torelease funds to finance new investment and to have alternative sources of funding in the capital market; on the other hand, insurers and pension funds, which currently invest in long-term securities issued outside Europe, would have the opportunity to invest in European securities.

The development of a European securitization market is hindered by the fragmentation of the fiscal and regulatory frameworks (capital markets, insolvency, etc.) prevailing in Europe. Although the harmonisation of national frameworks within a reasonable time frame is not realistic, it would be advantageous, in particular for smaller countries, to develop an opt-in European scheme that would make it possible to overcome the identified barriers.