Peter Praet: The importance of a genuine banking union for monetary policy

Speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the EMU Forum 2016, Oesterreichische Nationalbank, Vienna, 24 November 2016.

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It was always understood that deep financial integration would be key to effective macroeconomic stabilisation in Monetary Union. The cross-border integration of credit and capital markets would facilitate a smooth transmission of the single monetary policy across the union, allowing the central bank to stabilise area-wide shocks. And the risk-sharing benefits of financial integration would help absorb local macroeconomic shocks that could not, by definition, be addressed through monetary policy – nor, by design, through a federal euro area budget. Indeed, financial risk-sharing would be crucial to prevent national budgets from being overburdened in severe local downturns.[1]

These benefits are one reason why, 15 years ago, the topic of this conference was "The Single Financial Market – Two Years into EMU". At that time, however, it was widely believed that the elimination of intra-EMU currency risk, coupled with a process of broad economic and regulatory convergence, would foster a market-led process of financial integration. And indeed, following the launch of the euro, financial markets did steadily integrate, in particular the money market but also bond markets. The integration of the banking sector deepened too. According to the ECB's financial integration indicators, euro area interbank markets became almost completely integrated prior to the crisis.[2]

Yet, as is well-known, the state of pre-crisis financial integration was shallow and largely illusory.[3] Under stress, the euro area financial market fragmented, providing little *ex post* risk sharing. This was made possible by the composition of cross-border flows – based more on short-term debt than on equity – which limited the potential for capital-market risk-sharing. And the integration of interbank markets was not matched by retail banking integration, hindering consumption smoothing through credit markets. Financial fragmentation in turn disrupted both monetary and fiscal stabilisation as public and private sector borrowers suffered the effects of the so-called "bank-sovereign nexus".

This failure of financial integration, and its effect on shock absorption, is an important reason why the crisis has been more protracted in the euro area than in other advanced economies. Hence a strong policy response has been needed. First, to make the financial sector safer by strengthening the regulatory and supervisory framework – what has been termed "risk reduction". And second, to deepen risk-sharing by creating the institutional conditions for more robust financial integration, which has been one key aim of the banking union. It is this latter aspect, and why it matters for monetary policy, that I would like to focus on in my remarks today.

The main point I would like to make is that we need a more integrated banking sector in the euro area to achieve greater macroeconomic stability. But to achieve this, private and public risk-sharing have to be seen as complementary – that is, we cannot expect to have a fully integrated banking sector that can share risks without common institutions that can also share risks, namely for deposit insurance and bank resolution. Without such institutions, there is a real prospect that the banking system will remain fragmented, and that is ultimately to the benefit of no one in the euro area.

Financial integration and monetary policy transmission

Why is financial integration in the euro area, especially in the banking sector, and the resulting degree of risk-sharing so important for monetary policy? The financial system helps smooth out temporary fluctuations in economic conditions. Companies and households can resort to financial intermediaries – in the euro area, typically banks – to accommodate their temporarily higher financing needs and reduce fluctuations in spending patterns. This leads to a higher degree of macroeconomic stabilisation. A sound financial system reduces the burden on monetary policy, which would otherwise have to step in to stabilise the economy. While banks in principle help to stabilise investment and consumption patterns, they can also contribute to procyclicality by becoming shock amplifiers or even trigger financial shocks. One of the main lessons of the crisis was that in order to effectively transmit monetary policy impulses to the real economy, banks need to be well capitalised through the cycle and conduct maturity transformation in a prudent manner.

The euro area consists of a diverse group of countries with different degrees of specialisation in different economic sectors and in different segments of the value chain. Short-term fluctuations as well as the long-term shifts in the global economy can have very different contrasting implications for individual euro area economies. These disparities have at times been compounded by diverging policy stances, for instance overly loose fiscal policies in countries that were already overheating compared with their euro area peers. In addition, varying macroeconomic dynamics are to some extent unavoidable in a currency union – and, as a matter of fact, in any major economy composed of structurally diverse regions.

How should such differences be addressed? This is where the interplay between financial integration and monetary policy comes in. Monetary policy is not well suited to cater for asymmetric shocks, which affect some countries more than others.

In a monetary union, banks or other financial intermediaries may also prove unable to absorb country-specific shocks, if they are themselves overly exposed to their respective economy. They risk facing financing constraints at the same time as everyone else. In such a situation, the financial system will not avert, but rather amplify, the retrenchment in the real economy. And, if the shocks are as violent as they were, for example, during the last crisis, financial intermediaries may face threats to their own solvency, with pernicious effects on bank-based monetary policy transmission.

As I mentioned earlier, for an effective transmission of monetary policy, banks need to be in a position to pass on changes in financial conditions set by the central bank, for example in money and longer-term credit markets, to households and companies. But if solvency is their chief concern, banks will retrench rather than generate new, or at least maintain existing, business. This means that the central bank’s efforts to stabilise the economy cannot work as effectively as they should. So not only will banks fail in their macroeconomic stabilisation efforts, they will also obstruct the efforts of monetary policy to play that role.

In fact, this is what we saw during the crisis. To avoid that happening again, we need a deeply integrated financial system with well-capitalised intermediaries that are active across borders and benefit from the risk diversification options that the economic diversity of the euro area offers. Sound risk diversification within the euro area financial system will make the task of monetary policy easier even when confronted with common shocks.

Public and private risk sharing

Having discussed the importance of financial integration for the transmission of monetary policy, I would now like to turn to the issue of risk sharing. There is an ongoing debate on the broader need for public risk sharing in monetary unions, and even on the need for fiscal capacity to strengthen macroeconomic stabilisation at euro area level. Clearly, more private risk sharing through the financial system should not be seen as a substitute for public risk sharing, but to be fully effective, private risk sharing through the financial system needs not only common supervision, regulation and resolution, but also a common fiscal backstop. In the debate about public risk sharing in the euro area, the question of the fiscal backstop to the banking union is essential.

Let me be clear: it is not the task of the public sector to backstop private banks' risk taking. This would be the very definition of moral hazard. Public policy is responsible for creating the right framework for a sound and integrated European banking system so that taxpayers do not end up footing the bill for bank failures. In this regard, significant progress has been made over the past four years: we have common institutions for supervision and resolution at European level, we have a Single Rulebook and European supervisory authorities to ensure that the rules are applied in a harmonised manner across the Single Market. However, rules and institutions are not enough to create a genuine banking union. Let me highlight two points:

First, the present institutional architecture of the banking union is one where supervisory responsibilities are shared, while the consequences of supervisory failures are not.

Second, the banking union appears at times more like a collection of national banking systems than a single entity, especially when we consider banks' balance sheet exposures. As long as this is the case, country-specific shocks cannot be absorbed via integrated markets and procyclicality will prevail.

Barriers to cross-border banking

So what is holding back financial integration? And what are the barriers to more cross-border banking in Europe? The answer isn't simple. A comprehensive explanation would probably need to include not only institutional and regulatory aspects but also non-regulatory barriers, and it would go far beyond the scope of my speech. However, one of the key reasons for the lack of cross-border integration, on which I would like to focus now, is that capital and liquidity are not yet fully fungible in our banking union.

Let me explain. Many aspects influencing banks' decisions to engage in cross-border activities remain under the purview of national authorities rather than European ones. And even where this is no longer the case in principle, national options and discretions still provide for distinct cross-country differences. This ranges from financial regulation and accounting to insolvency practices.

Take, for example, a banking group that operates across different countries. Where should this group's prudential safeguards, such as capital and liquidity, be located? Should each local subsidiary of the banking group hold a minimum of liquid assets, irrespective of whether they are needed for its business model? Or is it sufficient to fulfil liquidity requirements at the consolidated level? Centralised liquidity management at group level seems clearly beneficial from the perspective of financial integration.

However, there are also risks associated with closer integration in the banking union. As supervisor, the ECB can grant waivers for liquidity requirements at national as well as cross-border level on a case-by-case basis. While the creation of a truly European banking system is certainly in the ECB's interest, its supervisory mandate calls, above all, for the safety and soundness of the institutions under its supervision. Waiving liquidity requirements and large exposure limits could increase the interconnectedness within the banking group and lead to possible contagion effects[4] in a banking union which has no common deposit insurance scheme and where the Single Resolution Fund (SRF) still lacks a fiscal backstop.

The current incomplete banking union is asymmetric: while decisions on liquidity waivers are taken at European level, the relevant risk-sharing mechanisms are still national. In each country, bank depositors are protected by the national guarantee scheme. If a bank fails and the Single Resolution Fund does not have sufficient resources available to finance its resolution, which may well be the case for some time, until the common element of the SRF is sufficiently advanced, it is a national credit line that backs the SRF. In this context, the ECB's Supervisory Board decided this spring that there should always be a floor on the liquidity coverage ratio for those subsidiaries that are significant on a stand-alone basis. This is to ensure that they hold a sufficient level of high-quality liquid assets to respond to liquidity needs at national level.[5] Liquidity ring-fencing reflects the absence of a common fiscal backstop in the banking union.

Completing the banking union

It would be unfair not to acknowledge the progress that we have made towards the banking union. My main point is that we have to be more ambitious. Completing the union is not a long-term project. If the aim is to foster cross-border integration of banks, finalising the union has to be done within a timeframe that banks can work with when they make their strategic decisions on how to adjust their business models.

In the political debate, completing the banking union is sometimes framed in terms of a trade-off between risk sharing and risk reduction. In the banking sector, however, risk sharing and risk reduction are often closely linked. A lack of risk sharing can trigger panic and contagion, which has in the past led to the establishment of fiscal backstops and deposit insurance arrangements. Well- functioning risk-sharing arrangements are based on controlling the degree of risk in the banking system. I believe both routes need to be followed and to move forward in parallel – and they need to be pursued ambitiously. I am convinced that leaving the banking union unfinished would be the opposite of risk reduction.

A European Deposit Insurance Scheme would enhance overall depositor confidence by protecting deposits in a uniform manner wherever they are in the EU. It would thus reduce the probability of depositor payouts or the probability of resorting to other risk-sharing mechanisms, such as the European Stability Mechanism. This is the very foundation of insurance: by pooling resources and risks across a larger and more diverse group, the overall shock-absorbing capacity of the system increases. In this sense, risk sharing turns into risk reduction. Take another example: tackling legacy issues by cleaning up banks' balance sheets will increase trust between banks and facilitate cross-border lending, possibly even cross-border mergers, thereby fostering private risk sharing, independently of the discussion on how to progress with public risk sharing.

On the risk-reduction side, we still have important elements of the international regulatory agenda to implement in the EU, including the binding leverage ratio requirement, the net stable funding ratio or the Financial Stability Board's total loss-absorbing capacity. With this in mind, I am looking forward to the discussions on the risk-reduction package that the Commission adopted very recently.

Completing the banking union requires a comprehensive approach: a symmetric institutional architecture, where liability and control are aligned, harmonisation of the rules, strengthening of the regulatory framework where needed to control the escalation of risks, and also a certain level of public risk sharing to underpin confidence in the area-wide financial system. The Single Resolution Fund was created in 2016, with national compartments and a mutualised compartment available to fund capital and liquidity needs. Currently, the backstop for national compartments consists of national credit lines. Looking ahead, it will be essential to establish a common fiscal backstop in the Single Resolution Mechanism to ensure that the SRF has sufficient resources to support any necessary resolution measures.

Conclusion

15 years ago the topic of this conference was the Single Financial Market – and by the way, the keynote speaker back then was Wim Duisenberg. As he noted, "The gradual dismantling of regulatory obstacles to remaining market integration in Europe will contribute to enhancing its depth and efficiency, in turn contributing to an improved allocation of funds to the most profitable investment opportunities, and thus supporting economic growth." This vision is still relevant

today. But to take it forward, it is crucial to be more ambitious and thus to ensure a better balance between risk reduction through implementation of the regulatory agenda and supervisory priorities, and risk sharing through the establishment of a common fiscal backstop in the banking union.

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[1] I would like to thank Malte Jahning and Fédéric Holm-Hadulla for their contributions to this speech.

[2] ECB (2008), Financial Integration in Europe, April 2008.

[3] See Special Feature A entitled “Financial integration and risk sharing in a monetary union” in Financial integration in Europe report, April 2016.

[4] See Special Feature B entitled “National options and discretions in the prudential regulatory framework for banks” in Financial integration in Europe report, April 2016.

[5] See pages 10–14 of the ECB Guide on options and discretions available in Union law.