Peter Praet: Towards Banking Union

Remarks by Mr Peter Praet, Member of the Executive Board of the European Central Bank, in the session "(Do Not) Break It: Today's Europe at Full Speed" of the LUISS International Conference on "Europe 2017: Make it or Break it", Rome, 24 January 2017.

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Today’s conference title ‘Europe 2017: Make it or break it’ brings forth the notion that Europe is at a crossroads. It reflects an increasing polarization between the proponents and the detractors of European integration. Polarization does not do justice to the policy responses and the institutional reforms that have strengthened our Economic and Monetary Union in the aftermath of the crisis.

Today I would like to do justice to the significant progress towards Banking Union. In less than half a decade, the European Union moved from decentralized banking supervision and resolution to the Single Supervisory Mechanism and the Single Resolution Mechanism. The fact that more needs to be done to complete the Banking Union should not come as a surprise. The concept of Banking Union is simple I a European bank should be able to operate in the Banking Union exactly as it operates in its domestic market, but its implementation is complex. This entails fungibility of capital and liquidity, simplified governance structures, and lower operational costs. The institutional framework should create an environment fostering a more geographically diverse, more resilient banking system. There still are a number of legal, institutional, political and even cultural problems to overcome before we can declare this ambitious undertaking achieved. The direction of progress is clear, its speed less so.

Banking Union is not an end in itself, but a backbone of the single currency. First, for money to be truly single within a currency area there has to be full substitutability between its different forms, including full fungibility of deposits across border. Second, risk sharing channels are particularly important for countries in a monetary union, because the single monetary policy cannot cater to cushion asymmetric shocks. The financial system is a central channel of adjustment. In a mature monetary union like the United States, empirical evidence suggests that the bulk of shocks to individual states are smoothed through the financial system[1] and that the contribution of the federal budget to income smoothing is comparatively small. The financing of the economy has traditionally been market-based in the United States, and bank-based in the European Union. In the light of this, progress towards the Banking Union and the Capital Markets Union emerges as a priority for Europe.

The financial crisis taught us that the quality of financial integration matters. Risk sharing through the financial system can go into reverse, and banks can amplify and propagate rather than tame economic disturbances. This is what happened during the crisis, when cross-border capital flows dried up suddenly. The euro area saw itself confronted with financial instability and fragmentation[2], which severely challenged the single monetary policy. Overall, the crisis has led to a profound re-thinking of the financial system. Sound financial integration relies on a well-designed institutional framework, in particular a regulatory regime reducing the pro-cyclicality of banks. This is essential for them to perform well their role of shock absorber, to support the real economy throughout the business cycle, and ensure financial stability.

Several dimensions need to be taken into account in the institutional design of well-functioning risk-sharing arrangements. First, private versus public risk sharing. The financial system is a private risk sharing device, but we have learned the lessons from the financial crisis in terms of budgetary costs, when excessive risk-taking in the private sector was eventually borne by the public sector. Not to revert to the old world of implicit government guarantees for risky behaviour of financial institutions entails risk reduction in bank balance sheets through a more resilient lossabsorption capacity throughout the cycle. This makes banks equally liable across countries for the amount of risk they want to take into their respective balance sheet.

That is not to deny that creating a certain level of public risk sharing is necessary to create confidence in the overall financial system and thereby unlock the potential of private risk-sharing. Even well-capitalised banks can fall victim to runs and contagion. This is why central banks act as lender of last resort to illiquid, yet solvent banks in times of stress. Fiscal backstops are equally essential for ensuring trust in the stability of the financial sector, thereby supporting financial stability. The existence of fiscal backstops, however, does not mean that taxpayers have to end up paying the bill for individual bank failures. In Europe, significant progress to protect taxpayers' money has been made over the past few years: the Bank Recovery and Resolution Directive and the Regulation establishing the Single Resolution Mechanism provide for common rules how to deal with failing banks while minimising the recourse to public funds.

The principle of the new European rules is to absorb bank losses by bailing-in shareholders and uninsured creditors. This does not mean that bail-out is fully excluded, as the new rules contain sufficient flexibility to deal with exceptional situations where public money may be required to stabilise the banking system.

This brings me to the second important dimension of risk-sharing in the Banking Union, which is national versus euro area risk sharing. The debate on moving forward on EMU is held back by a standoff between the risk reduction and risk sharing camps. In theory, risk reduction in the banking sector and public risk sharing in a banking union should work in unison. Non-performing loans, however, are one of the major roadblocks on the road towards further public risk-sharing. Following up to the 2014 comprehensive assessment, when for the first time the assets of banks were assessed with the same yardstick across the euro area, the Single Supervisory Mechanism is preparing guidance to banks on non-performing loans. This forms a sound basis for the supervisor to evaluate banks' handling of NPLs and for banks to tackle this problem in a decisive way. While risk reduction is essential to provide the right incentives to banks and protect taxpayers' money, a common fiscal backstop remains key to increase the systemic resilience of the euro area banking system.

While supervisory decisions are taken at European level, the relevant risk-sharing mechanisms such as deposit insurance schemes are still at national level. Supervision is common, but the consequences of potential bank failures are still predominantly national. National considerations therefore continue to affect supervisory decisions. This is not without consequences for the incentives for banks to become more European. Let me just develop some concrete examples. First, the current institutional framework has not yet reached a sufficient degree of harmonization in the underlying rules and standards. Since the aim is to create a single European banking system, it is essential that credit institutions face a single set of rules and conditions regardless of the location of their activities. This was the intention of the Single Rulebook but it is not yet the reality, also because of national divergences in the transposition of directives or the non-harmonised exercise of so-called Options and National Discretions (ONDs). A second example relates to a lack of fungibility of liquidity. Still prevailing liquidity ring-fencing reflects the fact that the interests of a banking group management, which is responsible for the allocation of liquidity within the group, is often not aligned with the public interests of the Member States where the subsidiaries are established[3]. A third example is the methodology to identify G-SIBs (Global Systemically Important Banks), which includes size, interconnectedness, subsituability and infrastructure, complexity and cross-jurisdiction. The euro area is not considered as a single jurisdiction, which may result in applying higher capital buffers to euro area G-SIBs. This environment contributes to the persistence of banking systems overly exposed to their own national economy.

The institutional underpinnings of the Banking Union do not yet meet the requirements of a genuine single financial market with free financial flows. Nevertheless, significant progress has been achieved over the past years. The creation of the Single Supervisory Mechanism has been a leap forward in the establishment of a coherent regulatory framework. One of the first priorities of the Supervisory Board has been to promote integration through harmonized implementation of ONDs, thereby evening the level playing field in the euro area. It is an ongoing process that started with intensive efforts to identify ONDs in a complex web of legislation. Regarding liquidity requirements, the Single Supervisory Board can grant waivers at national as well as cross-border level on a case-by-case basis. Waiving liquidity requirements could increase financial interconnectedness and lead to possible contagion effects in a framework where the consequences of bank failures are still mainly national. At the same time, ring-fencing has a direct impact on cross-border banking and the free flow of funds in the Banking Union. In the current institutional context, where the free flow of liquidity within the same banking group but across border could be impeded, a prudent supervisory approach has led the ECB's Supervisory Board to still maintain a floor on the liquidity requirements of significant subsidiaries.

Whereas the uniform application of prudential law by the Single European Supervisor contributes to financial integration, further progress in the institutional framework is needed. Both supervisory responsibility and the fiscal backstop need to be at European level, to underpin durably confidence in the area-wide financial system. A major step in this direction has been the establishment of the Single Resolution Fund 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 to ensure that the Single Resolution Fund has sufficient resources to support any necessary resolution measures taken by the Single Resolution Board. Just as necessary is the establishment of a European Deposit Insurance System (EDIS), with a credible backstop, as the degree of harmonisation recently introduced under the Directive on national deposit schemes still present differences that may affect the choice of group structure between subsidiaries and branches in other countries and limit banks' appetite for cross-border banking in the euro area.

Let me conclude. Overall, the banking landscape still resembles too much a collection of banking systems highly exposed to their domestic economies, with limited cross-border private risk-sharing. At the same time, unprecedented institutional progress has been achieved in a relatively short time span since the establishment of the Single Supervisory Mechanism. One should recognise that banking union is both an objective and a process of fundamental structural changes in the euro area's financial architecture. Today we certainly are more than midway, but this does not imply that one can step back and wait. The next steps are clearly set out in the ECOFIN roadmap to complete the Banking Union. It is now urgent to agree on an ambitious timetable for its implementation. This would foster financial integration in the euro area and contribute to the smooth functioning of our Economic and Monetary Union.

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1 One estimate suggests that the standard deviation of income growth uncertainty is reduced through financial markets by as much as 35% across U.S. states (see Stefano G. Athanasoulis and Eric van Wincoop, (2001), "Risk Sharing Within The United States: What Do Financial Markets And Fiscal Federalism Accomplish?," *The Review of Economics and Statistics*, 83(4), pp. 688–698. According to a recent IMF paper, cross-country risk sharing in the euro area is not only more limited (roughly half that seen in existing federations), but also falls sharply in severe downturns. See "Fiscal Risk Sharing: New Evidence for the Euro Area", IMF Technical Background Note, September 2013. This is largely in line with recent evidence contained in the ECB's annual report on financial integration, which stresses that risk sharing in the euro area has increased with the introduction of the euro, but remains at relatively low levels. It also suggests that risk sharing is particularly fostered through various forms of equity holdings, underlining the importance of the capital markets union and its emphasis on equity markets. See ECB (2016), "Financial Integration in Europe", April 2016.

2 See Special Feature A entitled "Financial integration and risk sharing in a monetary union" in Financial integration in Europe report, April 2016.

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