

Mario Draghi: The Benefits of European Supervision

Speech by Mario Draghi, President of the ECB, at the ACPR Conference on Financial Supervision, Paris, 18 September 2018

It has long been understood that deeper financial integration would lead to a better functioning of Economic and Monetary Union.^[1] And when the euro was first introduced there were encouraging signs that this integration was taking place. Price-based indicators of financial integration showed a pronounced increase, and the standard deviation of interbank lending rates across the euro area fell to close to zero.^[2] Quantity-based measures of financial integration only adjusted sluggishly, as crucial parts of the banking sector, such as retail banking, remained mainly national.

Financial integration proved to be shallow and reversible. At the outbreak of the crisis, interbank markets fragmented along national lines and threatened the integrity of the single currency, laying bare the existing fault lines in our Monetary Union.

One of these fault lines was the fragmented system of national supervision and resolution. The tendency of supervisors to promote and defend national champions often prevailed over the Union's pursuit of efficiency and stability. Measures deployed during the crisis, such as liquidity ring-fencing may have focused on securing domestic financial stability, but they neglected the adverse external effects on other countries. Domestic policies thus tended to reinforce negative spillovers and exacerbate systemic risk across the euro area.

The Banking Union addresses these shortcomings by pooling national financial policies at the EU level. It has two main objectives: ensuring that banks are sound; and encouraging deeper integration in the banking sector.^[3]

European Supervision makes a significant contribution to these objectives. Stronger and uniform supervision leads to resilient banks and provides a more coherent policy framework for cross-border banking.

The benefits of European supervision

European supervision brings three important benefits when compared with the fragmented system of national supervision.

First, European supervision **harmonises supervisory practices**. It has merged the 19 national approaches into one single supervisory method. The Supervisory Review and Evaluation Process allows supervisors to treat all banks equally by measuring risks against the same yardstick and setting

capital requirements accordingly.

Risk assessments have become more harmonised and systematic, significantly improving the consistency with which capital add-ons are applied across banks. The correlation between banks' risk profiles and capital requirements increased to 82% in 2017, from just 40% in 2014. In other words, banks with equivalent risk profiles in the euro area now face similar capital requirements.

Second, European supervision adopts **a system-wide perspective** when monitoring and mitigating risks. Supervisors can draw on a comprehensive dataset and information on banks across the euro area. On this basis, experienced staff from 28 different countries can make comparisons, spot common weaknesses and monitor potential channels of contagion.

This has two benefits. It helps address systemic risks, as better analysis of cross-border linkages and spillovers improves the coherence of macro-prudential policies set by national authorities and the ECB, which contributes to reducing excessive risks and cross-border externalities.^[4]

And it supports the identification of bank-specific risks. For example, supervisors have developed analytical tools to carry out detailed, comparative assessments of banks' business models. Comparisons within peer groups have helped identify bank-specific issues early on, which are then addressed with each bank individually.

The third benefit of European supervision is that it **reduces fragmentation in the supervisory framework**. In the past, broad discretion in applying EU rules led to significant national differences in key prudential aspects, such as the definition of funds, or capital and liquidity requirements. The resulting divergences in the capital strength of banks undermined confidence in their soundness.

European supervisors identified 175 options and discretions (O&Ds) available under EU law, 130 of which are available to national supervisors and are now applied in a uniform way across the euro area. More harmonised rules have helped re-build confidence in banks and reduce compliance costs for cross-border groups.

However, the remaining O&Ds exercised by national legislation still stand in the way of a level playing field for banks, and so further legislative action is still needed.

Similarly, the decision as to whether a bank should be resolved or liquidated is made more difficult by different insolvency rules. As a result, some harmonisation of national insolvency rules is needed to make European resolution more effective.

Overall, these three qualitative benefits of European supervision have been instrumental in making banks more resilient.

Substantial risk reduction has also taken place. The CET 1 ratio of banks

supervised by the ECB increased by 300 basis points between the end of 2014 and the end of 2017 and funding and liquidity are now more stable. In the same period, banks raised their leverage ratios from 4.9% to 5.8%, catching up with their US peers.

Banks' improved strength helps them withstand potential shocks. Recent ECB analysis, as published in the ECB's latest Financial Stability Review, has shown that the majority of banks would maintain average capital buffers over 10% in the event of an adverse shock such as a sharp repricing of risk premia or a strong economic slowdown.^[5]

Improving European supervision to foster banking integration

Despite having a single supervisor and more harmonised rules, the banking market in Europe remains fragmented. 86% of euro area bank lending to firms and households was domestic in 2017. And cross-border consolidation, which is one way to increase cross-border lending, has recently reached historic lows.^[6]

More efforts are needed if we want to reap the benefits of an integrated market that helps share risks through the private sector and improve macroeconomic stability in the monetary union.

In the United States for example, retail banking integration has led to a significant increase in the number of multi-state banks. That was not always the case. For example, following the oil price collapse in the mid-1980s, almost every bank in Texas failed, creating a state-wide credit crunch. One reason was that that banks were not allowed to operate across states, so the balance sheets of local banks were completely concentrated on their home state.^[7]

In a more integrated US banking sector, banks have geographically more diversified loan-books and deposit bases. By offsetting losses made in crisis-hit states with gains in other states, US banks are more resilient to local shocks and can keep their lending stable.^[8] As a result, US credit markets smooth out a quarter of local shocks, which is significant given banks' much smaller role in financing the economy compared to capital markets.

In the euro area by contrast, risk-sharing through credit markets is much less advanced, despite the predominantly bank-based nature of the economy. Only 12% of local shocks are smoothed through credit markets.^[9] Research finds that during the sovereign debt crisis Italian banks tightened their lending and increased interest rates more than foreign banks operating in Italy.^[10]

So what are the obstacles standing in the way?

Of course, there are fundamental legal, judicial and cultural differences between countries, which hinder cross-border integration. But there are also

two important obstacles that exist in the area of supervision.

The first is related to legacy assets, which have weighed on cross-border lending over the past years.^[11] Banks with high levels of legacy assets have reduced their cross-border exposures in an effort to shore up impaired balance sheets. They have also kept their lending low as their ability to build up capital is limited. Similarly, low profitability and uncertainty regarding the valuation of legacy assets reduce the appeal of cross-border M&As, as banks still expect larger gains from internal restructuring and cost cutting.

Significant progress has been made in reducing legacy assets, which include non-performing loans (NPLs) and level 2 and 3 exposures.

Over the past three years, the NPL stock of significant banks decreased by one third.^[12] Targeted supervisory action helped banks to draw up ambitious reduction plans and governance structures for the disposal of NPLs.^[13] And more uniform supervisory standards and stricter classifications make it less likely that new NPLs will emerge.^[14]

But while NPLs are washing out as the economy strengthens, supported by our accommodative monetary policy, the NPL ratios of euro area banks are still higher than those of US banks. Further efforts are needed from banks, supervisors and regulators to reduce the remaining stock of NPLs, especially in those countries where the NPL ratio remains high.

European supervision also needs to continue and extend its work on the valuation of level 2 and 3 exposures.

The share of Level 1, 2 and 3 assets on the balance sheets of significant institutions has come down from above 30% to 23% of significant institutions' total assets. Level 3 assets decreased from €188 billion to €132 billion, constituting less than 1% of significant institutions' total assets. Although the average share of Level 3 assets on the balance sheet of the largest euro area banks is now lower than that of US banks, some banks in the euro area still have high shares of Level 3 assets, if compared with international competitors, hampering further bank consolidation in the EU.

It is crucial that banks have sound and effective valuation and risk management frameworks in place. Therefore, sustained supervisory efforts are needed to identify and address potential problems with banks' valuation and classification methods.^[15]

The second obstacle to cross-border integration lies within the prudential framework.

At present, regulatory capital cannot be freely allocated across subsidiaries of cross-border groups. Banks are required to comply with capital requirements on a standalone basis and waivers can only be applied to domestic banking groups.

Similarly, while the free movement of liquidity across borders is made

possible by cross-border waivers, the practical application of these waivers is hampered by the remaining national prerogatives in the regulatory framework which allow national authorities to apply large exposure limits on intragroup lending and ring-fence liquidity.

For example, the requirement to comply with the liquidity coverage ratio at individual level locks up liquidity in cross-border subsidiaries of G-SIBs of up to €130bn. Some of this liquidity could potentially be freely allocated if impediments, such as large exposure limits on intragroup lending, were removed and euro area waivers granted.^[16] The effects may be significant, given the importance of intra group lending in the euro area, which in 2017 accounted for 70% of cross-border lending.

The free movement of funds is a precondition for a single banking market. With the establishment of European supervision, there is less reason to restrict this free movement. European supervision is able to identify and address financial stability risks posed by cross border groups^[17], reducing the need for national safeguards. And this is all the more true as national safety nets for resolution and deposit protection are gradually being shifted to the EU level.

Removing the obstacles to the free movement of funds could improve financial integration by allowing banks to allocate resources efficiently across countries. US banks, for instance, rely on intra-group funding to respond to local shocks and manage the credit growth of their subsidiaries, allowing them to keep their lending and income streams more stable to economic fluctuations.^[18]

Other regulatory factors are also hampering cross-border integration. Currently, the international regulatory framework does not treat the euro area as a single jurisdiction for the purposes of calculating capital surcharges (G-SIB buffers). In other words, intra-euro area cross-border loans from euro area banks are considered foreign loans, leading to higher systemic risk scores and capital requirements relative to their international peers. Against this background, it is crucial that reforms to complete the banking union do not lose steam, so that the euro area can be treated as a single jurisdiction in the international G-SIB framework.

Conclusion

As much as the global financial crisis has exposed weaknesses in the regulation and supervision of banks around the world, in the EU such weaknesses were exacerbated by fragmentation. From the early stages of the crisis the banking sector fragmented along national lines, driven by diverging macroeconomic conditions in different countries and by governments' diverging responses in dealing with failing banks. Differently from the US, common resolution frameworks backstopped by public money were absent. Governments that could do so, because of their sound budgets, massively bailed out their failed banks. An opportunity for bank consolidation was lost, but their economies were spared a credit crisis after a financial crisis.

In other countries where bailouts were not possible due to constrained finances or new regulatory restrictions introduced by the Bank Recovery and Resolution Directive (BRRD), the crisis lasted much longer. European supervision and the European framework for managing bank failures, of which the BRRD is an important part, have made such a cause of fragmentation, namely the different countries' responses to banking crises less likely today. But more needs to be done.

Progress in completing the Banking Union – namely, first harmonising options and discretions, completing resolution, and laying the groundwork for the creation of an effective deposit insurance – is essential and I am confident that significant steps in this direction will soon be taken.

But let's keep in mind that fragmentation starts with the decision by banks not to operate in regions where the risk-return of lending is judged to be insufficient to remunerate their invested capital

Ultimately, what ensures a steady flow of bank lending to the economy, even in times of unforeseen stress or disruption, is a growth-friendly environment, which can only be assured by the appropriate government policies.