The banking union: A personal view on its past, present and future

Speech by Andrea Enria, Chair of the Supervisory Board of the ECB, at a dinner of the Centre for European Reform

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When Brexit was postponed to 31 October, and I realised that I was supposed to speak here just the day before, I thought: "well, a convinced European comes to London on the eve of Brexit to give a speech on the European banking union; this is either a very high bar or the beginning of a very funny joke."

It is now clear that the United Kingdom will not leave the European Union tomorrow. But still, Brexit is as close as ever. And when it comes, it will possibly be one of the gloomiest days in the history of European integration. Given this prospect, it is more than justified to ask how I can speak about a topic as apparently dry and technical as the banking union.

Well, it's quite simple. To me, the banking union is much more than a technical topic for a specialised audience. It is the most advanced achievement in the European project; it is the necessary complement to the single currency. After all, only unified supervision and an integrated safety net can make sure that one euro has the same value and is afforded the same protection regardless of the Member State in which it is deposited. As you know, the banking union is not yet complete. But we have made a lot of progress, and yes, the banking union shows that Europe does work. It shows that joining forces and taking things to a higher level – in this case, the European level – does have benefits for everyone.

I know that such a claim is easily made – especially by someone like me who has worked in European institutions for 20 years now. And I know, of course, that views are split when it comes to the benefits of a united Europe; views are split here in Britain, obviously, and they are split on the Continent. So I will try to support my argument with a personal history of how we came to the banking union.

I first joined the ECB in 1999. Those were the first months of Stage Three of Economic and Monetary Union. The euro had just become a reality. And at the time, there was a fierce debate about whether banking supervision should be centralised, too. It was Tommaso Padoa-Schioppa who was entrusted with supervisory and financial stability matters within the Executive Board of the ECB. And in that year, in 1999, he gave a seminal speech at the London School of Economics, arguing that there was an unprecedented split: monetary policy was now conducted at the euro area level, but banks were still supervised at the national level. So he clearly said that, in the long term, the euro would only be sustainable if the national supervisors stepped up cooperation and operated as a single authority when needed.

He then turned to the Banking Supervision Committee, which comprised all national banking supervisors from across the EU under the aegis of the ECB. He proposed that it should regularly pool relevant supervisory information on systemically important banks; that it should jointly assess risks; and that it should coordinate supervisory actions. But national supervisors strongly resisted his proposals. And what happened soon afterwards was that the UK Chancellor of the Exchequer, Gordon Brown, and the German Finance Minister, Hans Eichel, launched an initiative which then led to the establishment of the Committee of European Banking Supervisors, or CEBS. The CEBS was set up here in London, outside the framework of the ECB.

As a matter of fact, it was me who became Secretary General of the CEBS, and I am proud of the efforts we made in those years. But over time, I grew more and more aware of the shortcomings that such a decentralised structure has. We took decisions based on consensus, meaning that we were always pushed towards seeking unanimity, as any member could raise a red flag and block progress. This led to regulatory standards which were very broad, which could accommodate a wide range of national practices, and which led to regulatory fragmentation across the Single Market.

I remember that we saw the lack of common standards on the quality of capital and liquidity requirements as weak spots. We now know that they sowed the seeds of the financial crisis. But back then, we couldn’t fix it because some national authorities were reluctant to act. And when the crisis broke out, national authorities were just not willing to join forces and act collectively within the Committee. They pursued national agendas instead.

In 2010, the “wise men” group chaired by Jacques de Larosière proposed a significant upgrade of European supervision. They had drawn the right lessons from the crisis. And thus, the supervisory architecture was reformed. A genuine single rulebook made the regulatory framework more uniform. First, because it was partly implemented through European regulations, which are directly binding in each Member State. And second, because it introduced a European dimension to supervision. Ultimately, however, national authorities remained responsible for supervising individual banks.

In 2011, I came back to London as Chair of the newly established European Banking Authority, the EBA. And right away, the new arrangements were put to a harsh test. The sovereign debt crisis broke out, and pretty much everyone began to question the resilience of European banks. At the EBA, we identified the right priorities. We developed common definitions of capital and non-performing loans; we made bank data more transparent, reliable and comparable; and we pushed for significantly strengthened capital and a faster clean-up of bank balance sheets. But we struggled to defend the integrity of the Single Market as national authorities ring-fenced their national banking sectors.

Unfortunately, despite all the progress made, it was not sufficient to hold back the storm unleashed by the sovereign debt crisis, which in the euro area led to a vicious feedback loop between banks and their sovereigns. The absence of a truly integrated framework for bank supervision and crisis management came close to destroying the integrity of the single currency.

In the end, only the banking union could provide the answers to the issues that Padoa-Schioppa had already raised in 1999. The political decision was taken in the summer of 2012 and implemented at breakneck speed. 2013 saw the start of the comprehensive assessment of the banks that would be directly supervised by the ECB, and in November 2014, almost exactly five years ago, the banking union was up and running.

While the monetary union was prepared over the course of years, the banking union was prepared and launched within a couple of months. I must pay tribute to the first Chair and Vice-Chair of the ECB Supervisory Board, Danièle Nouy and Sabine Lautenschläger. I admire the resolve with which they managed to set up a world class supervisor in a very difficult environment and coming from very different national supervisory backgrounds.

I believe the most urgent priorities that the banking union faced have been addressed. The capital position of euro area banks has been significantly strengthened: capital is of a better quality, also due to the ECB's strong emphasis on Common Equity Tier 1, the highest quality capital, which can absorb losses in a going concern situation.

At the same time, a common supervisory approach has been developed to promote a more active management of non-performing loans, NPLs for short. In 2014, NPLs stood at almost €1 trillion. Obviously, this was a huge drag on the sustainability of banks and their ability to lend to households and companies. So we started to create a consistent framework for dealing with NPLs across the entire euro area. And as a result, the €1 trillion of NPLs has gone down to less than €600 billion, with significant progress in the last two years.

And we have ensured that future NPLs will be adequately provisioned, using supervisory criteria which have now been incorporated into European regulation. There is still some way to go to restore the quality of banks' assets to pre-crisis levels, but the policies are in place and the banks have clear targets to achieve. The lack of confidence in the internal models used by banks to calculate risk-weighted assets has also largely been addressed: the EBA standards and guidelines, together with the targeted review of internal models conducted by the ECB, are driving a transition towards more robust modelling practices and ensuring consistency across banks.

Compared with a purely national approach, European banking supervision offers economies of both scope and scale. First, we have the 116 largest banking groups of the euro area within our direct scope – many more than any national supervisor. And the more banks we cover, the more we can learn about each of them and, thus, about all of them. We can learn about how they work, the challenges they face and the risks they pose. This wealth of information allows us to benchmark banks, improve our analysis and spot new risks more quickly.

Likewise, we can benefit from economies of scale. If you supervise just a small number of banks, it might not be efficient to hire an expert for each and every topic. But if you supervise the 116 largest banking groups in the euro area, highly specialised staff become worthwhile, as they can apply their expertise to many different banks. So, we can analyse a broader range of issues in more depth. This, in turn, allows us to be more effective.

Also, the ECB is at the helm of the Single Supervisory Mechanism, which closely involves the national competent authorities, or NCAs. We can benefit from the huge expertise and diverse background of staff in 19 NCAs, especially via the Joint Supervisory Teams that oversee each of the banks directly supervised by the ECB.

And then there's the issue of national interests. Being a national supervisor can expose you to huge pressure from established national interests. When we took banking supervision to the European level, we put national interests in the backseat. For a bank, it is much harder to lobby a European institution than a national one. There is just less room for national bias and less chance of being courted by lobbyists. So, at the European level we can be tougher and, thus, fairer.

The Supervisory Board of the ECB, comprising the Chair, Vice-Chair, four ECB representatives, and the heads of banking supervision in all Member States participating in the banking union, provides a formidable mechanism to achieve the right balance between national expertise and truly European decision-making. Although national perspectives do play a role, the Supervisory Board works less and less as a committee of national authorities, and more and more as a true decision-making body of a European institution. Majority decision-making plays an important role in this evolution, although we manage to reach consensus on most decisions.

Notwithstanding these achievements, we have to acknowledge that the banking union is still an incomplete construct. We have a much higher level of harmonisation, thanks to the single rulebook, but in a number of areas we still have to apply the rules stemming from the national implementation of European directives, or from a different use of the national discretions granted by European legislation. Aside from the complications this diversity of rules causes in our processes and legal analyses, the most significant drawback is that we are often forced to apply different decisions to similar situations.

Most importantly, the third pillar of the banking union, the European deposit insurance scheme (EDIS), is still in the making, and political agreement seems difficult to achieve. While no insured depositor lost a single euro during the crisis, and the current national arrangements are providing the necessary safeguards, the lack of a European mechanism has two important shortcomings.

First, depositors in a crisis-hit country may feel that they do not enjoy the same protections as depositors in other Member States. This may induce them to start moving funds out of their national banks and sending them abroad. This increased mobility of deposits was to some extent experienced during the crisis and generated unwarranted additional strain. It also challenges the singleness of the currency, as a euro deposited at a bank in a crisis-hit country could be perceived as being worth less, reflecting the lower reliability of the guarantee provided by a stressed sovereign.

Second, the lack of a European scheme gives rise to home-host concerns even within the banking union, as a crisis could challenge local deposit guarantee schemes. This implies that we are still struggling to dismantle the ring-fencing measures set up during the crisis, notwithstanding the progress made with the establishment of the banking union. To a large extent, the banking market remains segmented along national lines. The ECB is committed to deploying all its tools to support an integrated functioning of the market for banking services. Still, a clear roadmap towards the establishment of EDIS would greatly simplify our task.

Another structural challenge for the banking union is facilitating the removal of the excess capacity still in the system, which is dragging down bank profitability. Consolidation would be beneficial for the sector, but there seem to be a number of impediments blocking progress. Supervision should ensure that the merged entities provide sufficient reassurance about their capital trajectory, the sustainability of their business plan and the effectiveness of their governance arrangements. But it should not be an obstacle to healthy transactions.

What I have often heard during my first months in the job is that the new supervisory arrangements are very effective, but rather cumbersome. And this view is shared by both banks and supervisors. Thus, we have begun to simplify our administrative processes and make them less heavy-handed. We have already made some progress, and we should be more ambitious while making sure that we do not make supervision less effective.

We should also place more weight on making our actions transparent and predictable. During the start-up phase, it was crucial that we departed from established national practices and moved to a common, higher standard of supervision. This was done through a number of foundational projects. It started with asset quality reviews and stress tests, and then moved on to a joint approach to NPLs, a review of internal models, the valuation of complex trading book assets, internal governance, IT risk and many other areas.

In all these areas we have built on best practices, and we have raised the bar. This has led to the impression that we keep raising capital requirements – an impression that is still widespread among analysts and investors. So, now that the big foundational projects are coming to an end, we should aim to stabilise our way of operating.

And there is one thing I have not yet mentioned. To me, the best advertisement for the banking union is that we now have two more EU countries on track to join the club: Bulgaria and Croatia. The banking union is growing. And, thus, the overlap between the banking union and the EU is growing. An ever larger part of the Single Market will also be part of the banking union. This process is also hastened by the fact that the EU itself will shrink very soon, as you all know.

In the long term, the boundaries between the banking union and the Single Market should gradually disappear as more Member States decide to participate. In the near future, though, we will most likely have a key financial centre outside the EU. And this requires us to rethink how we interact with each other. Because one thing is clear: cutting institutional ties does not mean cutting all ties. The financial sectors of the United Kingdom and the EU will remain closely intertwined. Brexit will change things. It will make many things harder and more complicated. But it will not put an end to the relationship between the United Kingdom and the EU.

In any case, banks are well prepared for the post-Brexit world. Many UK banks have now set up subsidiaries in the EU, so they will be able to continue doing business there. And the same is true for European banks that operate in the United Kingdom. As long as regulations in the United Kingdom and the EU fulfil the criteria of equivalence, business between the two areas will remain a significant feature of our financial markets.

Against this backdrop, supervisors will continue to cooperate in the future much like they have done in the past. So far, we have worked very well with the Prudential Regulation Authority, and we are strongly committed to doing so in the future. To this end, we have already concluded a memorandum of understanding that will govern our future relationships.

Ladies and gentlemen,

Let me come to the end of my short speech. As they say about dinner speeches: leave your audience before it leaves you. And that is as much of a Brexit joke as I dare to attempt today.

But in any case, I am certain that this will not be my last speech here in the United Kingdom. Because, as I said, even post-Brexit, the financial sectors of the United Kingdom and the EU will remain closely intertwined. When it comes to finance, no country is an island – not even the United Kingdom.

Thank you for your attention.