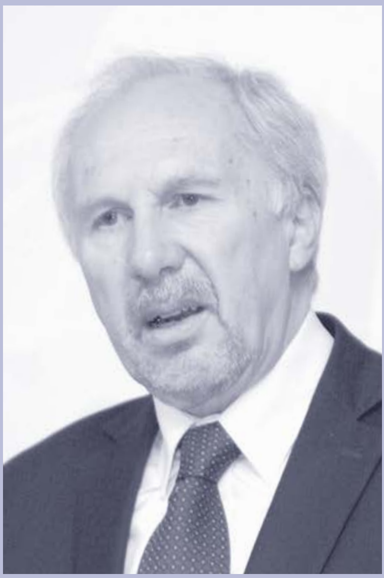
Ewald Nowotny
Governor
Oesterreichische Nationalbank



Opening Remarks

Ladies and gentlemen,
On behalf of the Oesterreichische Nationalbank (OeNB), I am very pleased to welcome all of you to the OeNB's 42nd Economics Conference here in Vienna.

I am especially honored to welcome Sonja Steßl, State Secretary in the Austrian Ministry of Finance, and this year's keynote speakers, Axel A. Weber, Chairman of the Board of Directors of UBS, and Vítor Constâncio, Vice President of the European Central Bank. We are once again fortunate to have a distinguished panel of speakers and discussants consisting of academics, policymakers from supervisory authorities and central banks as well as financial practitioners. Thank you for contributing your ideas and research to our conference. I would also like to take the opportunity to thank the staff members of the OeNB for their great efforts in organizing this event.

At last year's conference, we addressed the "changing role for central banks", and today and tomorrow we are going to follow up on this theme, so to speak, by taking stock of the progress we have made toward a European banking union. Central banks have assumed additional responsibilities in supervision, and conferring the role of single banking supervisor in the euro area on the European Central Bank is one of the cornerstones of the system of bank regulations that is commonly referred to as banking union. At this year's conference, we will not only assess the effects the upcoming banking union will have for central banks, but we will also examine the consequences for economic policy, for the banking sector and for the economy at large.

The term *banking union* has been coined in analogy to *monetary union* – and most likely also to *political union*, which continues to be an overarching aim in Europe. What does banking union stand for in a nutshell? It means that the *key instruments of banking policy are being centralized at the European level* with a view to strengthening and extending the supervision and the resolution of banks. The aim of the Single Supervisory Mechanism (SSM), designed to reduce the probability and severity of banking crises, is mainly *preventative*, whereas the Single Resolution Mechanism (SRM) and the Bank Recovery and Resolution Directive (BRRD) are primarily remedial, designed to protect

national public finances from the consequences of bank failure.

Even if the banking union's setup may be deemed by many as being far from perfect – and we will have ample opportunity to discuss its flaws and imperfections in the next two days – the very fact that this project has been brought on track shows that European decision makers are *able to act*, and reach a consensus, on important matters *in a timely manner*. Creating the legal framework of banking union has taken less than two years: At the June 2012 EU summit, the heads of state or government announced their intention to transfer key instruments of banking policy to the European level, and last month, the European Parliament approved the SRM and thus the final pillar. Given the complexity of the matter, this has been rather swift, not only by European decision-making standards.

The motion to set up a banking union has been an integral part of the response to the crisis. Consequently, banking union must be seen in the wider context of the new European

financial architecture. The crisis exposed a host of *weaknesses in the banking sector*, ranging from a dramatic increase of nonperforming loans, which required banks to repair their balance sheets and triggered a process of deleveraging, to an impaired profitability that undermined the capacity of banks to retain earnings. This brought about a considerable loss of confidence within and into the banking system, and banks' refinancing conditions deteriorated severely as a result. Moreover, as these effects varied across euro area countries, the trend toward greater financial market integration that had been observed since the start of monetary union went into reverse, and market fragmentation increased again. The crisis also revealed *flaws in the institutional framework* of the European banking markets, which continued to be regulated at the national level despite the far-reaching integration of the euro area financial market.

From a short-term perspective, announcing the "banking union" project and taking steps toward its implementation have – together with other measures – already reassured markets, as can be seen for instance in the stark reduction of risk spreads over the past two years. However, the full benefits of this project will materialize only over the long term. While not "curing" the current crisis, the banking union will help prevent and mitigate future problems in the banking sector.

Banking union is aimed primarily at *breaking the nexus between government and banks* and to decouple sovereign creditworthiness from banks' creditworthiness in a given country. Under the current setup, when bank solvency is put into question, the looming restructuring implies a heavy financial burden for the sovereign, which increases doubt over the creditworthiness of this particular state. According to Eurostat data, public interventions in support of financial institutions, such as direct recapitalizations, overall fiscal support measures and the nationalization of banks, are reflected in a cumulative 5% of GDP increase in the national debt of euro area countries until 2013. However, this link between weak sovereigns and weak banks works both ways. As sovereign bonds account for a large share of bank assets, doubts about sovereign creditworthiness directly translate to a re-evaluation of banks' assets, and consequently to doubts about the solvency of these banks. In the future, the SRM will ensure that the costs of bank failure are borne first and foremost by the private sector, with sovereigns providing funds only in exceptional circumstances. The SRM structure is explicitly based on the principle that any losses are to be borne by shareholders and creditors and that any public assistance should only be transitory and be recouped by means of ex post levies on the banking sector. By improving private risk-sharing, the banking union will importantly sever the link between financial system instability and resulting threats to fiscal sustainability of individual euro area countries, especially smaller ones.

The high risk premiums some banks faced in refinancing markets meant that they did not benefit from the low interest-rate environment provided for by the accommodative monetary policy stance of the ECB. Consequently, they were not in a position to pass on these favorable interest rates to their customers. Therefore, in some countries, the low interest rates and unconventional measures did not feed through to the customer level. Decoupling the correlation between the cost of funding of euro area banks and that of their respective sovereigns will *remove an impediment to the proper functioning of monetary policy transmission* and will ease the fragmentation of banking markets. In a number of euro area countries under stress, not only had interest rates for loans remained elevated, but also volumes of bank loans had contracted during the crisis. When this contraction had been due to tighter credit standards as a result of banks' impaired access to market funding, breaking this link should benefit the private sector, and especially the corporate sector, in these countries. In Austria, loan developments had been less worrisome, and the corporate sector has not so far suffered from credit constraints witnessed in the euro area as a whole.

Banking union is expected to increase the *efficiency of financial intermediation by banks*. In a bank-based economy like the euro area, this is particularly relevant, because enterprises rely to a much greater extent on banks for funding than e.g. firms in the U.S.A. According to a recent ECB report, loans on bank balance sheets account for close to 50% of nonfinancial corporate debt in the euro area, but only 20% in the U.S.A. Therefore, strengthening the banking system is also essential for the real sectors of the economy, as more resilient banks are much more effective in *performing their vital functions vis-à-vis the real economy*. First of all, a credible and respected supervisor together with clear rules on bank resolution will reduce the uncertainty premiums that many European banks currently pay on their refinancing. As the ECB is set to be an exacting and respected supervisor, banks subjected to its supervision will enjoy high confidence, and this should result in a reduction of the uncertainty premiums. Moreover, the principle of bail-in in case of bank failures and the uniform cascade of liability as it is laid out in the Banking Recovery and Resolution Directive (BRRD) will help strengthen market discipline, although the ensuing effects on banks' funding costs will differ depending on the structure of their liabilities. In some cases, this may entail additional costs, as banking industry representatives have pointed out. For example, unsecured creditors that until now have almost always avoided a bail-in will demand higher risk premiums. At the same time, deposits can be expected to become less sticky, which again might exert upward pressure on funding costs (which will definitely be the case with the annual contributions to the Resolution Fund, scheduled at EUR 5.5 billion). But overall, banking union will result in a more stable refinancing structure of the banking sector and thus enable banks to better contribute to the economy.

Likewise, banking union will be a strong incentive for banks to improve their risk management. Yet, while it is certainly one of the central aims of banking union to make banks' lending policies more risk sensitive, supervisors will also have to bear in mind the impact their actions have on the real economy. Banks' *willingness and ability to share the risks of the real sectors of the economy* lies at the heart of the house bank principle that prevails in much of the euro area (and certainly in Austria). Close long-term relationships with their customers have so far enabled banks to continue financing enterprises and projects that are relevant to the economy also in times of less favorable cyclical conditions. Without doubt, the issue of forbearance has to be addressed properly; however, banks that immediately take action on the first signs of a customer's potential default do not fulfill their economic function properly. Vice versa, banks that persistently fail to take measures against nonperforming debtors would not fulfill their function as intended, either. Overall, even if this ability of banks to share risks with the nonfinancial sectors were to be preserved, it can be expected to diminish. Capital markets are likely to gain in importance for corporate finance. However, as this funding option is available primarily to larger companies, this leaves the issue of SME finance.

Let me now turn to the institutional design of banking union. For one thing, this project is also aimed at remedying political weaknesses in the supervision process. In regulation economics, the term *regulatory capture* refers to a phenomenon when regulators or supervisors end up identifying too strongly with the interest of those they were charged with regulating. I do not think that this theoretical concept is very relevant for the role of the Oesterreichische Nationalbank and can imagine that the Austrian bankers present in this room are not always too happy about that. But generally speaking, once supervision is elevated to the more remote European level, supervisors are expected to be less prone to *deal making* and forbearance might be less likely to occur –which could, of course, add to the increasingly pro-cyclical effects of the newly emerging supervisory structure in Europe. An entire session of the conference will be devoted to this aspect and we will be able to discuss these problems in more detail. Monetary policy making was centralized one and a half decades ago, and now banking supervision is about to follow suit, which can be regarded as a further decisive building block in completing economic and monetary union.

The course of events during the crisis has shown that safeguarding financial stability is a key theme for central banks. What is, however, less clear is the exact definition of the role central banks are supposed to play in this context. Just think of the microprudential versus the macroprudential aspects of supervision. There cannot be any doubt that macroprudential policy is a task for central banks. *Macroprudential policy*, aiming to identify, prevent and mitigate systemic risks, was recognized as an important instrument early on during the process of drawing lessons from the crisis. While not being directly part of banking union, macroprudential policy is a precondition for the proper functioning as macrosystem instability can put individual banks at peril. Therefore, the European Systemic Risk Board (ESRB) was established in 2010, well ahead of the SSM and SRM, to add a new systemic perspective to supervision. Nevertheless, when we talk about the microprudential supervision of individual banks, the role for central banks is less clear cut. The SSM was established under the responsibility of the

ECB in order to avoid changes to the EU treaties. The legal basis for the banking union reform was Article 127(6) of the Treaty on the Functioning of the European Union, which allows for conferring specific tasks concerning policies relating to the prudential supervision of credit institutions upon the ECB.

Let me note in this context that the *supervision of individual banks is not an overly attractive task*. When it works well, nobody will notice, but if not, it entails considerable reputation risks. Moreover, there might be conflicts of interest between banking and financial system stability and the price stability objective of the central bank (something we discussed at our last year's conference). While political economy considerations explain why, at this point in the euro area's history, the SSM needs to be hosted by the ECB, we should nevertheless always bear these risks and potential conflicts in mind. Having said this, there is a strong argument for keeping the Resolution Agency clearly separate from the ECB.

Frictions may arise between national and European supervisors, between the various supervisory institutions at the European level or within the resolution regime, where the tasks to be solved are complex and the intricacy of the decision-making process is especially pronounced. These complexities might give rise to operational concerns and therefore need to be properly addressed right from the start as only the most stringent implementation and enforcement can restore confidence in the banking system and the institutional framework.

Another point of criticism is that banking union *only covers deposit-taking institutions*. Apart from competitive aspects, this contradicts the lessons from the financial crisis of 2007/08, which exposed risks to financial stability that resided outside the traditional banking sector. Thus, there is a danger that intensified regulation in the banking sector might cause important and risky business activities to be shifted into less regulated areas such as shadow banking entities.

Competitive distortions could also arise from a failure to establish a genuine Single Rule Book and from the discretion that national authorities maintain regarding, for example, the implementation of macroprudential tools. Notable national differences in supervision might therefore remain in place; in other words, the playing field would then not be completely level. On the other hand, it may be argued that there should be scope for *some degree of differentiation below the euro area level*. After all, different cultures and languages will continue to exist within the euro area. In the same vein, the question remains if the new supervisory system is

apt to address national problems properly. For instance, there will still be national or local financial cycles, as has been the case for business cycles to this day. As small banks will remain within the remit of national supervisory authorities, there will in any case be the need for a two-tier supervisory regime.

Banking union will not only affect relationships among the various players within the euro area, but also *relationships with players outside the euro area*. The fact that banking union currently only covers the euro area may give rise to competitive concerns. To be sure, all EU Member States can be expected to benefit indirectly from banking union via a more stable financial system in the participating countries. But let me stress here that it would be in the interest of all if as many countries as possible decided to join. Banks domiciled in countries that opt to join will enjoy the reputational gains from being subject to the same supervisory standards as their euro area peers, which might for instance dampen risk premiums on their debt. Obviously, this might encourage a number of Central, Eastern and Southeastern European countries which are not (yet) part of the euro area to join banking union.

To conclude, centralizing banking policy at the European level undoubtedly constitutes a milestone in deepening and completing the euro area's economic and institutional integration. At the same time, banking union is of course *no panacea*, and in itself does not solve the problems surrounding banks. Furthermore, the problems of the banking sector were by no means the only reason behind weak growth, rising government debt or fragmentation in the euro area. Banking union can therefore only be one – albeit an important – element in the overall set of measures which are instrumental in putting the future development of the euro area on a more sound economic and institutional footing.

Ladies and gentlemen,

I hope one thing has become obvious from my short remarks: the European banking union, while being an important step, will require a lot of work in its implementation and in the process will require a lot of further thinking, creative problem solving and persistent work. I am confident that today's and tomorrow's distinguished lineup of speakers will shed light on a number of challenges that have yet to be tackled on the road toward full banking union. I very much look forward to two days of lively discussions with all of you, given the multitude of perspectives represented here. I hope you will find our conference useful and insightful.