Christine Lagarde: Welcome address - fifth European Central Bank Forum on Banking Supervision

Speech by Ms Christine Lagarde, President of the European Central Bank, at the 5th European Central Bank Forum on Banking Supervision "Europe: banking on resilience", Frankfurt am Main, 30 November 2023.

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It is a pleasure to welcome you to the fifth ECB Forum on Banking Supervision.

Ten years ago, on 15 October 2013, the EU Council approved the regulation launching the Single Supervisory Mechanism. It was the most significant step in European integration since the introduction of the euro. And there were two main reasons for taking it.

First, it would lead to stricter and more uniform supervision – a single supervisor enforcing a single set of rules for a single banking market.

That would, in turn, make it possible to establish a true banking union, with a common safety net. And a banking union would strengthen the monetary union by ensuring that bank deposits were seen as equally safe everywhere.

As Andrea Enria eloquently put it, "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".[1]

Second, single supervision would help make monetary policy more effective, because a weak banking system can complicate our task of stabilising inflation – in both directions.

When central banks are easing policy, a fragile financial sector can impede the transmission of lower rates to the economy, especially if banks are unable to lend. We saw this after the euro crisis when banks were deleveraging as the ECB was cutting rates.

At the same time, weak banks can also interfere with rate hikes. If monetary policy gives disproportionate weight to financial stability risks, it might tighten less than it ought to.

Setting up a single supervisor was a necessary condition to achieve both these goals. But, of course, there was no guarantee of success. It had to be tested by events and shaped by leadership – notably that of Andrea and his predecessor, Danièle Nouy.

In my remarks today, I will explain how European banking supervision has brought about key improvements to the supervisory landscape and to the effectiveness of monetary policy.

The benefits of single supervision for the banking sector

Three improvements to the supervisory landscape stand out.

First, European banking supervision has led to sounder banks, thanks to supervisors enforcing tougher regulatory standards and topping them up where necessary.

The aggregate Common Equity Tier 1 (CET1) ratio of supervised banks stood at 15.7% in the second quarter of this year, up by 440 basis points since the start of European supervision. Banks benefit from liquidity coverage and net stable funding ratios well above their minimums – at 158% and 126%, respectively. And non-performing loans fell from around €1 trillion in 2014 to below €340 billion at the end of last year.

Second, the single supervisor has made supervision more uniform, meaning that supervisory practices are now applied in a consistent way.

For example, single supervision has led to capital add-ons being applied much more consistently across banks. When European supervision began, the correlation between banks' risk profiles and their capital requirements across Europe was just 40%. This meant that, for the same risk profile, supervisors were applying very different capital requirements. Today, however, that correlation has risen to 86%.

Third, European supervision has helped us identify common priorities in terms of risk management and address them in a forward-looking way.

Climate risks are a case in point. There is mounting evidence that the costs of delaying are substantially higher than those of a timely transition towards a more sustainable economy.[2] And without a single supervisor, these risks would likely be addressed in an inconsistent way. But thanks to European supervision, banks have been made well aware that failure to take into account the transition would be incompatible with sound risk management.

This is why last year's thematic review required banks to shine a light on climate-related and environmental risks[3]. And it revealed that, while banks have made progress, they still have some way to go to properly incorporate these risks into their risk management frameworks.

So, even if the banking union is not yet fully complete, its first pillar – a strong and unified European supervisor – has been achieved.

Single supervision and effective monetary policy

What are the implications of this for our monetary policy?

The last few years have tested the interactions between monetary policy and banking supervision in both directions.

First, the impact of the pandemic shock required monetary policy to ease significantly in order to prevent a deflationary bust. But unlike in the previous crisis, European supervision was able to leverage the strong position of banks to sustain lending.

Supervisors provided capital and operational relief measures to banks. And this enabled banks to maximise the funds accessible through the ECB's targeted longer-term refinancing operations to channel credit to the economy.

This joint effort was crucial to keep the economy afloat, especially while fiscal measures were still being rolled out. From March to May 2020, bank lending to companies in the euro area surged by nearly €250 billion, the largest jump we have ever seen in a three-month period.

We then faced a sequence of shocks which pushed inflation in the opposite direction. That led to the fastest monetary policy tightening in the euro area on record. We ended net asset purchases and increased rates by 450 basis points in little over a year.

This sudden reversal could have severely stressed the European banking sector – just as we saw elsewhere in the world. Indeed, research suggests that the transition from low to higher rates can negatively affect the banking system.[4]

But European supervisors have worked diligently over the past few years to help banks realign their business models, which enabled them to face the rate reversal on a solid footing.

In particular, when the ECB began normalising its monetary policy at the end of 2021, European supervision proactively prepared banks to face the risks arising from the new environment.[5] Supervisors focused on banks' funding strategies and encouraged them to improve their management of interest rate risk. This included increased scrutiny of risks in banks' held-to-maturity portfolios and disclosure of their unrealised losses – which turned out to be significantly lower than the unrealised losses in other parts of the world.[6]

In this way, European banking supervision has not only empowered our monetary policy response to the pandemic, but also facilitated our fight against inflation by readying banks for the new environment.

The conclusion is clear: single supervision has complemented the single monetary policy – just as theory predicted it would.

Conclusion

The 18th century English poet Alexander Pope said that "blessed is he who expects nothing, for he shall never be disappointed".

But a decade ago, as we emerged from the euro crisis, we did not have that luxury.

We launched European banking supervision with high expectations – not only for it to be a strong supervisor, but an essential piece of a complete monetary union.

And it has not disappointed. In fact, faced with severe tests that we could never have imagined at the time, it has exceeded most reasonable expectations.

We have a strong banking sector in Europe. It has transformed from a shock propagator into a shock absorber. And under European supervision, banks are now more alert to new risks that may lie around the corner.

So, Andrea – and everyone at European banking supervision – you can look back on a job well done. And I have great confidence that success will continue in the future.

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[1] Enria, A. (2019), "The banking union – a personal view on its past, present and future", speech at a dinner of the Centre for European Reform, London, 30 October.

[2] Emambakhsh, T. et al. (2023), "The Road to Paris: stress testing the transition towards a net-zero economy" *Occasional Paper Series*, No 328, ECB, Frankfurt am Main. For a discussion of the effects of a delayed transition on potential output, see Parker, M. (2023) "How climate change affects potential output", Economic Bulletin, Issue 6, ECB.

[3] ECB Banking Supervision (2022), *Walking the talk: banks gearing up to manage risks from climate change and environmental degradation – results of the 2022 thematic review on climate-related and environmental risks*, November.

[4] Jiménez, G., Kuvshinov, D., Peydro, J.-L. and Richter, B. (2022), "Monetary policy, inflation, and crises: New evidence from history and administrative data", *CEPR Discussion Paper*, No 17761, CEPR Press, Paris and London.

[5] ECB Banking Supervision (2021), *Supervisory priorities for 2022-24*, December.

[6] ECB (2023), *Unrealised losses in banks' bond portfolios measured at amortised cost*, July.