"Making Banking Union work" - speech by Rolf Strauch

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Making Banking Union work
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(*Please check against delivery*)

Ladies and gentlemen,

It is a pleasure to be with you today. Savings and retail banks are the backbone of the European banking system because you fulfil a core function of banks – financing the economy. Providing credit to consumers and firms, in particular small and medium sized enterprises, is at the centre of your activities. If we want to make progress in working on Banking Union, as a European project, we must understand and define what it means for you. This is what I will try to do today – to spell out different initiatives at the European level which will shape the way towards a full completion of Banking Union and to reflect upon what this means for you.

The crisis and policy response

During the crisis, the euro area banking system disintegrated and did no longer

transmit coherently the ECBs monetary policy. Early on in the crisis, the interbank market broke down. Later, lending rates of banks across countries diverged, which made it difficult for the ECB to steer the economy. Problems in banks brought sovereigns into trouble, and vice versa. A negative feedback loop emerged between banks and sovereigns which had to be addressed.

Policy makers reacted in making banks safer, creating Banking Union, and creating the ESM as a crisis resolution mechanism. This was done to preserve and solidify the benefits which a single market offers for the EU and make monetary union work better and more robust. The euro area is economically and financially the most open major economy in the world. This marks its strength, but also the pressure to compete. I firmly believe – and I hope we can all agree – that a well-integrated European banking market with safe and profitable banks next to a fully developed capital market is the best financial structure to support growth in Europe. This is what Banking Union ultimately stands for.

A lot has been achieved in making the euro area banking sector safer. I do not need to go through the details of the regulatory changes, but I want to highlight some milestones. Bank supervision and bank resolution were moved to the European level for euro area countries through the creation of the Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM).

The ESM supported five countries – Ireland, Portugal, Spain, Cyprus and Greece. All countries but Greece have now successfully existed their programmes. In all countries, the restructuring and strengthening of the banking sector and financial infrastructure was an important part of the adjustment programme. In the case of Spain, our loan facility was especially targeted at the banking sector. Overall, we have disbursed 273 billion euro since the start of the crisis. 40 percent of this amount was used for bank rescues. An important lesson from these country programmes, which was stressed in our recent evaluation report, is that successful crisis management requires to address financial sector problems early on in a comprehensive manner to be effective.

Banks have recovered massively after the crisis. Equity capital has more than doubled and capital ratios are much stronger than before the crisis. Non-performing loans have started to come down, and are generally well-provisioned, though in some countries they remain far too high. A sector-wide crisis in any euro area

country, a risk that many were still talking about a year ago, is nowhere near.

Profitability has also been recovering, but it has done so at a much slower pace than in the U.S. and it is unlikely that banks will be able to cover their cost of capital for the foreseeable future. As bank managers, I don’t need to explain to you that in the long run, this is a situation that cannot last.

The euro area banking sector has undergone a massive rationalisation since the start of the crisis. The number of credit institutions has declined by a fourth from 6,768 in 2008, to 5,073 in 2016. This is partly the consequence of consolidation during ESM programmes. However, last year the largest decline in the number of credit institutions occurred in the Netherlands, Germany and Austria.[1] Recent cases in Spain and Italy were first test cases for the operation of the new resolution framework. Regulators acted firmly, but these cases also showed that there are still issues that need to be resolved.

The way forward

These challenges need to be addressed – and banks, national authorities, and authorities at the Euro area level all have to act. I will focus now on the European strategy to reduce legacy assets, regulatory proposals to make banks safer, and the need to make the infrastructure of Banking Union more robust.

We welcome the action plan of the European Union to deal with the issue of non-performing loans. Measures are envisaged in the fields of bank supervision to more forcefully reduce NPLs, the reform of insolvency and debt recovery frameworks, the development of secondary markets and the restructuring of the financial industry. Handling the NPL problem will reduce provisioning costs and create new profitable credit opportunities. Handling legacies of the past crisis is also a precondition to make further progress on Banking Union.

More progress in managing NPLs can be achieved in the short-run with national bad banks, rather than a European bad bank. A bad bank or asset management company would be one way of divesting NPLs from banks’ balance sheets. Andrea Enria, who heads the European Banking Authority, has proposed an interesting model for a European asset management company, which avoids the mutualisation of legacy assets. We see its benefits. But there is no political agreement on this

project and we also have concerns regarding some practicalities of establishing such a European-wide bad bank. It would take years to establish it and transfer all bad assets, and it would be complex to run. In our view, a blue-print for national bad banks, as has been proposed by the European Commission, is a more viable option in the short-run. It would lead to a range of mini-bad banks that could play a useful role to address the issue, as long they have an appropriate governance structure and can work efficiently.

Further regulatory risk-reducing measures will support a level playing field, but must be well calibrated to work for all banks. The key words for the package of risk-reducing measures proposed by the European Commission last year are: safer, equal treatment, and proportionality. The last point is crucial from your perspective: smaller savings and retail banks can be overburdened. We share this concern.

As part of our work at ESM we were involved in financial sector repair during adjustment programmes and we continue to monitor banking sectors in countries to which we extended loans. We do this under the so called “early warning system”, where we look at countries including their banking systems. We assess whether we can expect risks to repayments – and a payment shortfall could cause an impairment also for us – and whether we can expect any repayments from the measures taken during the crisis. For example, Greece last year repaid 2 billion euros of our loans which had been used for bank recapitalisation. Therefore we understand the concerns expressed by small financial institutions in Greece, Cyprus and other countries on the cost of regulation. Among many factors the constrained funding situation makes the implementation of regulatory measures, such as MREL requirements, more difficult and expensive to achieve.

At the same time, we keep the European perspective in mind. One point that matters particularly for the further integration of the banking sector. It is the attribution of capital in bank holdings and home-host relationships. The ability to account for capital and liquidity at the holding level and waive requirements at the subsidiary level can support the profitability of banks. It creates benefits through a more efficient allocation of capital across borders, and therefore also promotes bank integration. But we fully understand the fears of host countries that subsidiaries become empty shells and taxpayers would be stuck with the cost if the subsidiaries would land in trouble. Therefore it is necessary to also think about the upstreaming of losses and risk-sharing at a European level before we move fully into this

direction.

This brings me to my last point regarding the completion of Banking Union. It is important to put the so called third pillar – the financial arm for bank resolution - fully in place. The first element to get to a more robust structure is a backstop for the Single Resolution Fund. This is a role that the ESM could play in the eyes of many Member States, and euro area finance ministers are discussing the idea of such a backstop.

The second step is setting up a common deposit insurance in the euro area. I know of course that this is a controversial topic and there is no agreement at the political level. But having lived through the crisis, I cannot simply be silent on this topic. The economic benefits are clear: it helps to reduce the risk of bank runs and adds to financial stability across all euro area countries. The amounts needed for emergency liquidity assistance (ELA) and ESM programmes during the crisis could have been lower with a functioning common deposit insurance. We learned during the crisis that the euro area economy and financial system is too interconnected to ignore the negative spill-overs form systemic banking problems in other Member State. Therefore, the appropriate way forward is in my view to discuss the conditions to make such a step acceptable to all parties. This is also the approach set out in the European Council statement on the completion of Banking Union, which outlines that the right balance between risk reduction – related to legacies and ongoing business – and risk sharing must be struck. The recent communication of the European Commission on Banking Union – therefore spells out different stages towards the creation of a common deposit insurance.

Ladies and gentlemen, let me finish here. Banking union offers great benefits for the single European market and the robustness of the euro area. Making it work for all means that the core banking services which can be best delivered by savings and retail banks in an open competitive environment, should be delivered by you. But at the same time, we must allow for integration also across borders – both for banking activities and ownership. In our view, a European protection offers the best setup for a safer, profitable and integrated banking sector and we should productively think about the necessary steps to get there.

[1] See European Central Bank (2017) Report on financial structures. Frankfurt: ECB.

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