“Tomorrow’s financial services – breakdown or revival?”

WHU Campus for Finance New Year's Conference,

Klaus Regling, Managing Director of the ESM

Vallendar, Germany, 9 January, 2014

I. Introduction

- You have chosen a difficult and complex topic.
- But it is a good opportunity to reflect on this issue as we are moving out of the crisis.
- Financial systems are critical for the development and adequate functioning of our economies. Not only because they drive the flows from surplus agents (savers) to agents with needs (for investment), but also because they encompass the payment systems.
- Financial systems allow citizens to save for retirement, help finance long-term infrastructure projects, and facilitate risk-sharing across economic agents. In addition, the financial system addresses the underlying maturity mismatch in the economy by bridging the gap between a short term liquidity preference and projects that pay off in the long run.
- Financial systems, and especially banking systems, are sometimes prone to crisis or sudden adjustments, and this is a key reason why they must be regulated. When financial crises happen, its costs are usually very high.
- Experience shows that banking crises can lead to output losses from 20% to 60% of GDP. And banking crises occur, on average, once every 20 to 25 years.
- Current global regulatory efforts are focused on building a sounder financial system. Strengthened capital and liquidity regulation should reduce the probability and severity of banking crises; central counterparties will reduce interconnectedness and counterparty risks; and bank resolution regimes are meant to make restructuring of failed banks easier without using taxpayers’ money.
- In my presentation I will concentrate on the banking system rather than the financial system as a whole, because of the relevance it has had in the current crisis and the role that the banking system has always played in Europe.
- And I will put the on-going policy debate on banking union in the broader context of Europe’s response to the euro crisis.

II. Europe and the financial crisis

- Europe has been hard hit by the financial crisis. What apparently began with problems in the sub-prime market in the US quickly spilled over to European banks and markets to become a fully-fledged financial crisis, and at the same time unravelled other structural problems some economies had accumulated in the preceding decades (property booms for example, but also related to excessive leverage in banking and fiscal misbehaviour…).

- While it is always difficult to be prepared for a financial crisis, Europe was certainly not ready for this one. As a response to the level of fear in the system and due to the lack of appropriate tools to cope with the challenges, the main policy response was for the public sector to step in and support mainly the banking systems.
- The alternative could have been the collapse of the economy, the impairment of our payment systems, the flow of credit, the safety of deposits, and more generally, an implosion of the euro area.
- For the euro area as a whole, estimate of the direct fiscal cost of supporting the financial sector has been close to 4% of GDP and the increase in public debt has been almost 20% of GDP. In some individual countries, the financial sector support has been much higher. In Ireland, for example, the impact on public debt amounted to 40% of 2012 GDP. But also indirect support via asset purchases and guarantees was considerable. Between 2007 and 2011 this form of support amounted to 17.8 % in Germany and 7.7 % of GDP in Belgium.
- Europe has come a long way since the financial crisis hit in 2007 – from predictions about the future of our common currency to the current situation where we are moving towards the completion of a banking union. This is no small achievement. We have now entered a period where financial markets have stabilised, and economic activity is starting to show signs of improvement in most European countries.
- This does not mean that the crisis is over. Credit is still not flowing in southern Europe as a result of a fragmented financial system. The so-called light at the end of the tunnel is not seen yet visible for many parts of the population, particularly for those who have lost their jobs. However, recent data suggests recovery and continued stabilisation is taking place.

III. Europe's response

- This progress has only been possible due to a comprehensive response to the crisis. A response that was built on many policy layers.
- The first crisis response has been at national level. To tackle the disarray in public finances, member states have implemented significant fiscal consolidation programmes to recover lost confidence from investors. To give just a number: Greece is expected to have a primary balance surplus in 2013, which corresponds to an adjustment of 10 pp of GDP in 4 years.
- Significant progress is also seen in the area of competitiveness, as measured by adjustments to the unit labour costs and current account disequilibria, with some of the economies that were under stress now being close to or already in surplus coming from deficits over 10 of GDP in their external accounts.
- At the same time, countries adopted key structural reforms which are already laying the foundations for a sounder, perhaps less buoyant but more sustainable, growth.
- The second element of the response to the crisis is at the European level and it refers to stricter and broader economic policy coordination. There are four pillars to this new framework: a new fiscal compact; reinforcing the Stability and Growth pact; a new macroeconomic imbalances procedure; and a European Semester. I have no time to discuss them, but one should not underestimate the benefits and improvements these frameworks will bring going forward.
- The third layer of the crisis response refers to the establishment of financial crisis mechanisms – the EFSF and the ESM. This closed a major gap in the institutional design of EMU. Both crisis resolution mechanisms have helped to bring confidence to investors to

stabilise the markets. They are essential to buy time for euro area Member States to do their homework. The EFSF and ESM have disbursed over €220 billion to five Member States during the last three years, which is three times the amount disbursed globally by the IMF during this period. Without the EFSF and ESM, Ireland, Portugal and Greece would probably have left the euro area and Europe would be quite a different place today.

- The ECB has also played a crucial role in stabilising the markets with their non-conventional measures, namely the LTRO and the announcement of OMT.
- Overall, thanks to the ESM and interventions by the European Central Bank, credible backstops for the euro area are now in place. Together with the mentioned reforms at national level and stringent economic policy coordination at European level, one can see good progress in moving out of the crisis even though the situation in the real economy remains difficult.
- Indeed, there is still a lot of work to do before the crisis is behind us. Economic adjustment takes time to produce results for everyone. But there is one very important area where further progress is required. This is in the area of banking, specifically banking union, the <u>fourth</u> policy layer in Europe's crisis response.
- We still see a trend towards banking fragmentation in Europe as confidence is yet to fully recover. Banks still rely on the ECB to meet their liquidity needs, and keep large cash balances in their accounts at the central bank. The interbank market still does not work properly. Financial integration in Europe, which was one of the benefits of EMU, is being reversed. This leads to unusually low interest rates in some countries whilst, at the same time, to very difficult financing conditions in others. This is a significant extra burden for the private sector in the periphery as financing costs for SMEs and corporates are significantly higher than in core countries.
- In a monetary union what one would expect is a negligible divergence in credit conditions for equal or comparable counterparties. This is not the case now, and in that sense, our monetary union is not delivering the intended benefits. The large dispersion of sovereign bond yields in the euro area remains a key challenge to a well-functioning monetary union and for a well-functioning single market.
- On top of this, and very much interlinked with these problems, we have the well-known sovereign/bank link issue and the fact that there has been a tremendous amount of public resources that have been used to support the banks.
- Why is all this really important? It is not only a problem of certain differences, however big they are, in the interest rates for financing SMEs across Members States. It goes much further than that and one can mention a few reasons why we see need for real action:
- First, what happens to banks is always important, but particularly so in Europe. The share of bank credit in overall credit supply to the real economy in the euro area is significantly larger than in the US (typically 70/30 versus 30/70 in the US in terms of the split between lending from banks and capital markets).
- Furthermore, it's not only about retail banking or cross-border retail banking but also about:
    - Balance of payments financing within the euro area
    - An impaired monetary policy transmission mechanism
    - Non-existence of a "euro area risk-free asset"

All this creates problems for Europe's economies because financial systems are fragmented along national lines, which:

        - Precludes efficient risk-taking
        - Facilitates sudden stops because of the home bias inherent in financial markets
        - And consequently diminishes the benefits of monetary union

- In this situation, policymakers need to address three interrelated issues:
    - Limit fragmentation of financial markets to the minimum possible
    - Break the sovereign/bank link
    - Protect taxpayers
- Several initiatives are either already in place or are being discussed, precisely trying to address these issues. They do that both from a national and a European perspective and they are discussed under the heading "Banking Union". We are not starting from scratch.
- The first reaction to the crisis was to strengthen our governance and oversight arrangements. Three new European supervisory authorities were established two years ago: a European Banking Authority, a European Insurance Occupational Pensions Authority and a European Securities Markets Authority. In addition, we created the European Systemic Risk Board which embodies an early warning system to identify and monitor macro-prudential risk.
- Also, in the aftermath of the crisis, banks were undercapitalised and the EBA set higher capital requirements, bringing core Tier 1 Capital ratio up to 9% or more. The European Commission estimates that banks' equity in the whole EU has risen close to €450 billion since 2008 (including public support).

IV. Towards Banking Union

- As I said earlier, these initiatives that are either already in place or are under discussion, precisely try to address these issues. They do that both from what we could call a coordinated national perspective and a European perspective.
- At the first level, the Banking Recovery and Resolution Directive – the BRRD – strengthens enormously the bank resolution process all across Europe and will establish a clear pecking order for bailing in bank liabilities in case a problem arises.
- According to the BRRD, in case of need, the first line of defence would be the bail-in of 8% of total liabilities including own funds. Subsequently and up to an additional 5% of total liabilities may be covered by national resolution funds for the absorption of losses. If still needed, additional bail-in would take place, with the fiscal backstop at the end. Bail-in will start as of January 2016.
- In addition to the BRRD, there have been also important advances in the Single Rulebook, which aims to provide a single set of harmonised prudential rules for all European banks.
- In addition, in what relates directly to the European Stability Mechanism, the Eurogroup agreed last June on the main features of the ESM direct bank recapitalisation instrument, which will provide a backstop for systemic banks.
- Direct bank recapitalisation will be one pillar of the banking union, together with the Single Supervisory Mechanism (SSM) and Single Resolution Mechanism (SRM). The agreement foresees that the ESM will be able to recapitalise banks directly provided that the bail-in

principles are applied and the requesting Member State contributes financially alongside the ESM, among other conditions. The maximum amount currently foreseen for direct recapitalisation is €60 billion.

- In the supervision arena, the Single Supervisory Mechanism is now established and should be up and running late in 2014. Significant work is currently in progress to conduct a balance sheet assessment of the large banks in the euro area (risk assessment, AQR and Stress Test) that should be concluded before next November, before the SSM takes full supervisory responsibilities.
- The ECB has all the incentives and capabilities to undertake a thorough assessment, as it will subsequently take over supervisory responsibilities. The Single Rule Book will lead to a harmonisation of rules regarding the classification of impaired loans across the euro area, which so far has been left to the discretion of national supervisors. The SSM will assure that the harmonized definitions will be applied. In my view, the SSM constitutes a complete game changer in European banking.
- Finally, the Commission has presented its proposal for a Single Resolution Mechanism (SRM) that includes a Single Resolution Fund. Initially, Member States views on this topic were very far apart. Some Member States were of the view that a network of National Resolution Agencies with their national resolution funds would be sufficient. Nevertheless, the SSM needs a pan-European counterpart because European supervisory actions may cause resolution cost at the national level. Hence, the Commission issued its proposal on a Single Resolution Fund (SRF). Under this proposal, the SRM would have at its disposal a Single Resolution Fund that will be built-up through contributions from the banking sector. The SRF will reach its target level after 10 years and will have a size of 1 % of covered deposits.
- On 18 December 2013, an agreement was reached by Eurogroup and Ecofin Ministers on the SRM and the SRF that combines elements of both views. The SRM will be in charge of resolution based on an assessment by the ECB (as a supervisor) and the national resolution authority. It will make a proposal for resolution in case an institution fails.
- The European Commission will assess the proposal made by the SRM Board to resolve a given bank. If it objects this proposal, the Council may intervene and demand changes. Decisions on state aid by the European Commission must be taken before an institution is put in resolution.
- The cost of resolution will be covered through the SRF. The SRF feeds itself from contributions of national banking sectors which – via an Intergovernmental Agreement – are channelled from the national to the European level. With the SRF, the contributions are fed into national compartments of the SRF which are gradually merged. During the transition period, the cost of resolution would first fall on the amount collected in the national compartment, then on the funds in other national compartments, and finally – if insufficient – on extraordinary ex-post levies. If this still is not sufficient, the extra burden would have to be covered by the Member States which could potentially borrow from the ESM.
- After the transition period has ended (i.e. 10 years after entry into force), a common backstop to the SRF will be in place. The SRM/SRF is primarily intended for euro area Member States and those that have their systemic institutions supervised by the SSM. However, it will be open to all EU Member States to join.
- The SRM and SRF are now being negotiated between the Commission, Council and European Parliament. Hopefully, agreement can be reached before the elections to the European Parliament in May 2014.

- The final component of banking union is a common deposit insure guarantee scheme. In December 2013, EU Member States and the European Parliament agreed on the amended Deposit Guarantee Scheme Directive (DGSD). It will introduce a harmonized set of rules for ex-ante funded DGS throughout the EU. The DGS will raise risk-based contributions from the industry which aim to reach 0.8% of covered deposits, or roughly €53 billion.

V. The future of finance in Europe

- As you can see, a lot is happening in Europe's financial sector. What are the implications of all of this for tomorrow's financial services in Europe, which is the overarching theme of this conference?
- First of all, I am convinced that there will be a revival and not a breakdown. But the financial actors will have to change. We cannot go back to business as usual.
- In my introductory remarks I mentioned that regulatory reforms are focused on building a sounder financial system. I am convinced that once the regulatory reforms are fully implemented, our banking system will be less vulnerable and less procyclical than in the past.
- Some worry that the strengthened capital and liquidity standards for banks would increase financing costs for businesses and households. But studies carried out by the BIS and regulatory bodies have shown that by reducing the probability and severity of banking crisis, and through this the output losses associated with them, there will be net economic benefits.
- The excessive leverage banks built-up ahead of the current crisis was partly a result of poor creditor monitoring against the backdrop of implicit government guarantees of bank debt. Bank bail-ins and resolution regimes are meant to break this link and force bank creditors to better monitor bank risks.
- Central clearing of standardised OTC derivatives trades, enforcing two-way margining requirements on bilaterally cleared derivatives trades, and stricter standards for applicable haircuts on collateral posted, will all contribute to a significant reduction in counterparty risk and interconnectedness in the financial system.
- Collectively, all these reforms will steer banks to perform their core function in the economy, that is to source short-term deposits and funds from savers and extend long-term loans to households and corporates.
- More regulation should not be an end in itself. In particular regulation should be smarter and more focused to dampen the incentives in the financial industry to take excessive risks. One major change that will shape the regulatory environment in the near future is Basel III and its implementation in Europe (under the CRR/CRDIV framework). This will raise capital requirements and by 2019 the entire Basel III package will have been phased in. More capital means that banks cannot leverage up as much anymore which will in itself limit the contagion effects. The newly introduced leverage ratio will limit pro-cyclicality which results from the links between risk perception and asset prices.
- More intrusive supervision (a lesson from the crisis) will assure that the tighter regulations will be observed. The ECB's AQR is the first step in a more thorough and in depth assessment of banks and their risks. Also, since all major banks will be supervised by the same supervisor according to the single rule book, they will have to comply with the same standards. The risk of supervisory evasion is reduced since supervision is moved to the European level.

- Better resolution tools will have a positive impact. Before the financial crisis, resolution of financial institutions in Europe was mostly ad hoc. There were no consistent resolution frameworks in place. This resulted in costly and disorderly resolutions in the crisis. The Bank Recovery and Resolution Directive is going to change that now. It will create equal resolution frameworks across Europe. In addition, it organises cross border resolution, which is particularly important in the European context. This will make banking more of an ordinary industry where the incompetent can go bankrupt because the fallout from bank insolvency is contained by a comprehensive resolution framework.
- At the same time, the increased importance of regulators, supervisors and resolution authorities implies a greater use of "judgement" and discretion by these authorities. Hence, we will have to accept that regulators/supervisors will be taking bigger risks (not only reputational) when performing their tasks.
- More generally, the thorough changes in the way public authorities will regulate and supervise the financial sector, will change the structures in the financial sector. There is no reason to believe that this will lead to a breakdown. But these changes will take time to materialise and the exact result the regulatory changes and their interplay will produce cannot be foreseen. Hence one needs to follow up on developments, being prepared to change course if necessary.
- Over time, the landscape of the financial services industry and the investment products they offer will evolve in response to changing demands on the type of services that the economic agents demand.
- As I noted earlier, the reliance on bank funding among corporates in Europe is significantly larger than in the United States. This is partly because Europe has a significantly larger share of SMEs, which tend to have no or limited access to capital market funding. But as banks face higher funding costs and caps on leverage, many larger corporates in Europe will find it more attractive to turn to capital market funding. This will mitigate the problem of credit availability in times of deleveraging in the banking sector. They serve as a spare tyre as Greenspan once put it and we see this happening in Europe now. In this context, we should monitor developments in shadow banking to make sure this growing part of financial markets functions in a sound manner.
- Other changes in the financial services industry are likely to be driven by the type of investment products and returns that investors demand.
- Here I have in mind the changes that can be linked to the consequences of an ageing population.
- One implication of the decline of working age population will be that trend growth rate of the economy will be lower than what we have seen in the past, and this will have implications for returns on financial assets.
- In my view, this can lead to significant changes in the way insurance companies and pension funds manage their assets in the future. As these institutional investors reach for yield to deliver on their liability commitments, the agents offering the investment products they demand may well be outside of the regulated sector.
- We may therefore see more dis-intermediation of banks and the emergence of alternative sources of funding to SMEs. This might deliver the much needed capital to the SME sector.
- Finally, one lesson should be clear for all: generating returns that are substantially higher than the growth rate of the economy is not sustainable.

VI. Conclusion

- Let me come to the end. The financial reforms at global as well as EU level will deliver a stronger and safer financial services industry. Within the euro area, more work needs to be done to address the fragmentation of access and terms of credit for finance to SMEs. Progress towards a fully-fledged banking union will go a long way towards addressing this problem. The first important steps have been put into place. A revival of the financial services industry is around the corner, but it will be subject to greater oversight and regulation to ensure that it delivers its core function of transforming savings to investments for the economic benefit of all, without taking excessive risks.