Banking Union, the EMU and the EU single market – speech at "Euro 50 Group" roundtable conference

Lisbon, 15 September 2014 – Klaus Regling, Managing Director, ESM

To discuss the main theme of the conference, the Banking Union and the role of my institution, the EFSF and the ESM, I'd like to first update you on the ESM's role in restoring credibility for the euro during the recent crisis and then outline how we may provide support for the Banking Union. After all, if we had not gone through those dark days we would not be discussing banking union today.

The EFSF and the ESM have become well-established, well-functioning institutions for the euro area. During the last three and a half years, we have disbursed €232 billion to five countries (three times more than the IMF globally during the same period). We have raised this money in the markets - unlike the IMF – and on very favourable terms.

I see four positive and important results of these EFSF/ESM activities.

1. The ESM and its predecessor, the EFSF, ensured that all euro area countries stayed in the euro.

Remember that less than three years ago, this seemed a near impossible task. Many bankers, academics and journalists predicted with conviction that a Greek exit from the euro area was unavoidable. Happily, they were proved wrong.

Without the financial support from the EFSF and ESM, several countries would have left the euro area and Europe would be a very different place today. "If" we were even talking about Banking Union in those circumstances, it would be within a very different euro area.

2nd positive result: Our programme countries have become the reform champions of Europe.

As you know, our lending comes with conditionality, which obliges borrowing countries to introduce agreed reform programmes. The benefit of these reforms are clear, although often very painful in the short run. In the medium and longer term, they create the foundation for much stronger growth.

Conditionality works: we know that from many successful IMF programmes during the last 30 years, for example in Brazil, Indonesia and Turkey. These countries went through their respective crisis with painful adjustment; but the implementation of IMF programmes laid the foundations for the excellent economic performance of these countries in recent years. The good news, is that according to the OECD and the Lisbon Council, our five programme countries, Ireland, Portugal, Spain, Greece and Cyprus are the top reformers in the EU and in the OECD area. Therefore, they are best positioned for future growth if they continue their adjustment process. This also acts as a timely reminder that some of the non-programme countries in the euro area really need to tackle reforms now.

3rd point: EFSF and ESM lending significantly improves debt sustainability in the programme countries.

The magnitude of the European solidarity offered through our institutions is not well understood, so let me point to the benefits for Greece as the most striking example.

Our loans, with an average maturity of 32 years, an interest rate of 1.5 % (equal to our funding cost) and a 10-year moratorium on the payment of interest produces annual budget savings of €8.5 billion per year, or the equivalent of 4.5% of Greek GDP - year after year. Consequently, there is no debt overhang in Greece over the next 10-20 years, despite very high debt to GDP ratios.

We have introduced a new system in Europe that goes far beyond the traditional IMF approach. Our approach not only provides emergency financing against conditionality, but also includes substantial solidarity. Budget savings in Ireland, Portugal, Cyprus and Spain are smaller than in Greece, but still significant.

4th point: EFSF and ESM lending takes some pressure off the ECB.

In a single country, the central bank is not only the lender of last resort for banks, but – in a crisis - also for the sovereign. In the euro area, the ECB cannot play that role as monetary financing is prohibited. However, as we have demonstrated during the last three and a half years, the ESM can play that role quite effectively, and that reduces demands on the ECB to do more.

Looking at these four positive results of EFSF/ESM activities, I believe we can be quite proud of what the youngest IFI has achieved during a relatively short period of time with a very small staff:

- massive lending, at low interest rates, without cost for the taxpayer has kept the euro area intact

- this has promoted reforms and debt sustainability

- and made the life of the ECB a bit easier

Let me now look at the future of the ESM and more specifically how it ties in with the main theme of the conference, banking union. ESM involvement in banking union is a further area where its strength as a backstop or "line of defence" plays out.

When the role for the ESM in the banking union was first discussed two years ago, it was seen as the main instrument to break the link between sovereigns and banks. By providing capital to banks, a euro area member state wouldn't have to do it.

However, the institutional architecture that has been developed since 2012 is quite different, with the Bank Resolution and Restructuring Directive (BRRD) now setting out the path to resolve troubled banks. This path relies on bail-ins, national resolution funds, the Single Resolution Fund and – only as a last line of defence – direct recapitalisation through the ESM. I fully support the shift in focus towards bail-in. It is financially and politically healthy to let investors participate in the resolution costs, rather than socializing them.

The ESM can still have a significant role as a financial backstop. ESM will provide support when a bank is deemed to be viable, yet where its home country cannot afford to support it; in such a case the ESM can be used, but only as the last line of defence. We are developing this new instrument internally and it will be ready when the results of the AQR and stress test become available.

In addition, the ESM can also use its “traditional” tools in the context of the banking union: macro-economic adjustment lending, where some of the money is used by the government to support banks, which was the case for most of our programme countries, or, as in Spain, it can finance a programme to restructure the entire banking sector.

These are the three possible ways the ESM can be involved in the banking union. Whether we will be needed, depends on the results of the AQR, the stress tests and on the market situation. But, it is good to have these instruments available – now and in the future.

The financial architecture of the resolution regime is not yet fully completed. Its final design will only become clear after the 8-year transition period when the Single Resolution Fund is fully funded. The assets of the fund will then be fully mutualized and a common backstop will be created. It is an open issue what role the ESM may take in that setup as a common backstop. This issue will have to be resolved over the coming years.