Jörg Asmussen: Financial stability in Europe and the progress towards banking union

Speech by Mr Jörg Asmussen, Member of the Executive Board of the European Central Bank, at the event "The way forward for the Eurozone and Europe – a conversation with European policymakers", organised by the Brookings Institution and the Center for the United States and Europe, Washington, 18 April 2013.

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Ladies and Gentlemen,

Thank you for inviting me today to the Brookings Institute to share my views on financial stability and the progress towards Banking Union.

Financial stability in Europe

Financial stability in Europe has improved according to the Global Financial Stability Report and the stress for the euro area financial system has eased tangibly. For some in the market, the "great risk normalisation" is the overarching theme for trades and strategies this year. And broadly speaking, I think this trend is intact, in particular when taking into account the following facts, while financial fragmentation in Europe still remains a fundamental concern:

- There has been a marked reduction of spreads and yields of stressed countries' sovereign bonds. For example the yields for ten year bonds have declined for Spain from a peak of 7.6% to currently 4.7% and from 6.6% to 4.3% for Italy.
- Bank debt funding conditions improved early this year in terms of lower financing costs and increasing breadth of issuance across banks.
- Deposits of euro area residents in banks in stressed countries have increased by about 130 billion euro since August 2012.
- TARGET2 balances of the national central banks in these countries have declined by more than 200 billion euro, or about 20% since their peak.
- And finally, bank's dependence on central banks liquidity intermediation is waning, to some extent as the early repayment of more than a quarter of the LTROs shows.

Looking at the banking sector, the aggregate solvency position of euro area banks has been steadily improving. For large and complex banking groups, the median core Tier 1 ratio reached 11% at the end of 2012, up from 6.8% at end-2008. Notwithstanding this progress in improving resilience, capital buffers are very unevenly spread throughout the banking system. Questions arise like: do we know enough about the true quality of banks' balance sheets and are the banks capable to absorb potential further losses? Clarity about balance sheet valuation and recognition of unrecoverable losses would be helpful to bolster confidence in banks' calculation of risk-weighted assets.

A healthier banking sector that stands on a sounder foundation would also be very helpful – to say the least – in the context of setting up the single euro area supervisor. This leads me to the second aspect of my remarks tonight: the progress towards banking union.

The progress towards banking union

Recently, the Economist was speculating that Europe might be "turning away from its promised 'banking union'" and contemplated "banking disunion".

Banking sectors that act as regional financial hubs require vigilant supervision. This applies especially to cases were potentially "hot" capital flows on the liabilities side are financing a growing pool of domestic assets. It has to be ensured that undue investment risks are not taken on the basis of fickle capital.

Many commentators noted that if only banking union had already been in place, developments in Cyprus could have gone different. I think they may have a point.

After all, why are we establishing banking union?

- First, it will break the vicious feedback between weak banks and weak sovereigns;
- Second, it will help restore the proper transmission of monetary policy; and
- Third, it will improve the incentives for proper supervision and limit the susceptibility to any prospective regulatory capture.

In essence, banking union is a means to fully reap the benefits from European financial market integration, while at the same time containing the risks of financial contagion.

Currently, we can only talk about the banking union project – we do not have such a union yet. This is why, basically, the same questions are asked time and again, both in Europe and over here:

- Where do we stand in the process?
- And are we getting off course?

Let me share some thoughts on these issues with you.

The rather benign market situation over recent weeks and months seemed to have lulled policy-makers in a false sense of complacency. Some wonder whether the enthusiasm and ambition for banking union is waning. Voices from some countries seem to suggest a backtracking on the idea of direct ESM bank recapitalisation.

On the Single Supervisory Mechanism (SSM), agreement was reached between the European Parliament, the Council and the European Commission in March. Some technical details still need to be clarified. Once that is achieved, I expect the SSM regulation to be formally adopted by the Council and the European Parliament, hopefully around the middle of the year.

At the ECB, preparations for the new tasks are in full swing. In this, we naturally closely cooperate with national supervisors. At staff level, a stock-taking exercise of existing supervisory issues and practices is under way.

But final decisions on organisational details of the SSM can only be taken once the SSM Regulation has been formally adopted. This is why swift adoption of the legislative act is now crucial. We expect to be ready to take up the new tasks in March 2014.

We still lack clarity regarding the details of the envisaged European framework for resolution which should come hand in hand with a single resolution fund which is funded by the banking industry itself via levies and not with taxpayers' money. And before the ECB takes over the task as the single supervisor, I would strongly advise to conduct a thorough and credible asset quality review of those banks which will be supervised by the ECB. It will be key for a successful start in the new supervisory structure to have a very clear picture of the risks and vulnerabilities in the European banking industry.

But, as former Treasury Secretary Hank Paulson once said, "when things look the bleakest, they almost never are as bad as they seem. Similarly, when they look too good to be true […] they almost always are".