Jörg Asmussen: Reintegrating financial markets

Speech by Mr Jörg Asmussen, Member of the Executive Board of the European Central Bank, at the General Assembly of the European Savings Banks Group, Berlin, 14 June 2013.

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Gentlemen,

Thank you for inviting me to speak today.

Let me start by reviewing briefly the overall economic situation in the euro area. We are currently projecting a gradual recovery in economic activity, with the economy expected to stabilise this year and then grow by 1.1 per cent in 2014.

Underpinning this outlook are, first, receding tensions in financial markets, notably the disappearance of the debate about the reversibility of the euro. And second, a more robust global recovery, mostly fuelled by emerging markets, but also by promising signs from across the Atlantic.

Our projections for inflation show an increase of prices of 1.4 per cent in this year and 1.3 per cent next year. Most importantly, inflation expectations as securely anchored. Hence, we see no upside risks to price stability at the moment.

However, this overall picture conceals considerable divergence within the euro area. This is visible in the very different economic and employment situation between Member States, but also – as you know well – in financial market conditions. Financial markets are still showing a considerable degree of fragmentation creating very heterogeneous financing conditions across the euro area.

This means that, as savings banks from across Europe, you will probably have quite different concerns. For some, I expect the main concern is constrained access to funding and too high interest rates. For others, it may be excess liquidity and too low interest rates. And both sets of concerns are valid: tight money is constraining growth in peripheral countries, while easy money could eventually pose long-term risks in core ones.

I therefore want to focus my remarks today on how we can deal with this problem of financial fragmentation, because it is a key issue in all parts of the euro area. I would like to approach the topic from three angles:

First, the role of governments.

Second, the role of the ECB.

Third, the role of Banking Union.

1. Dealing with financial fragmentation: the role of governments

I begin with the role of governments because it is important to stress that they have the first responsibility for dealing for financial fragmentation. While there is much media focus on ECB actions and Banking Union, it is only really governments that can deal with the root causes of the current situation.

There are three channels where this is particularly relevant.

First, one cause of financial fragmentation is the high public debt levels in some euro area countries, which, as domestic banks are heavily exposed to their own governments, harms banks' asset quality. In Italy, for instance, 65% of bonds were held domestically in early 2012, and in Spain 70%. Clearly, governments have a central role in dealing with this problem by ensuring that their debt is safe and sustainable. This requires credible fiscal consolidation.

Second, another cause of fragmentation is low growth, which deters banks from taking risk, especially lending to SMEs. Interest rate spreads on SME loans compared with those for large non-financial companies have widened by an average of 40 basis points since 2010. A key part of the solution here has to be structural reforms that improve the medium-term growth outlook and hence support risk appetite. Only governments can introduce them.

Third, fragmentation is also caused by weak bank balance sheets. Lack of capital, weak profitability or rising non-performing loans lead to lower credit provision or higher interest rates being charged on new loans to offset losses elsewhere. But it is governments that have to deal with this problem through recapitalisation and restructuring.

In other words, without actions from governments, we will not be able to reintegrate financial markets.

Fortunately, positive progress is being made. The Commission projects the euro area fiscal deficit to fall below 3% of GDP this year – less than half the peak reached in 2009. Under pressure from supervisors, euro area large and complex banking groups have continued to improve their capital positions, with the median core Tier 1 ratio reaching 11.1% in the first quarter of 2013, up from 9.6% at the end of 2011.

But there is still a long way to go before the “singleness” of the euro area financial market is restored. This means that there is no room for complacency for governments.

Most of all, they should not expect the ECB to substitute for actions that they must take themselves.

2. Dealing with financial fragmentation: the role of the ECB

What is then the role of the ECB in addressing financial fragmentation?

The ECB necessarily operates within certain constraints. We are the *European* Central Bank, and so our focus is the euro area as a whole, not the concerns of any particular country. And we can only address issues that fall within our mandate to maintain price stability.

Within these constraints, we have acted to reduce financial fragmentation in two key ways.

First, we have taken measures to reduce divergence between countries caused by *bank funding risk*.

We have provided unlimited liquidity to banks in need at fixed interest rates, extending the maturity of our operations up to 3 years. We have allowed national central banks to tailor collateral rules to national conditions. And we have narrowed the interest rate corridor between the deposit rate and our main policy rate to 50 basis points, which reduces cross-country heterogeneity in funding costs. All this was designed to support the transmission of our low interest rates more evenly across the euro area.

Second, we have taken measures to remove fragmentation caused by *redenomination risk*.

This risk was affecting some countries more than others as markets feared that, if one country were to leave the euro area, a domino effect would force certain others to leave as well. According to calculations, the redenomination premium being paid by Spain and Italy in July 2012 was up to 2%. And the threat this posed for future price stability was evident in the cost of deflation protection in the euro area: this rose from 198 bps in January 2012 to a peak of 270 bps in July that year.

Our answer to this was the Outright Monetary Transactions (OMT) programme. Its effects have so far been powerful, not only in reducing sovereign spreads, but also in improving funding conditions for corporations, banks and individuals across the euro area. Financial fragmentation has been reduced, as shown by the best summary indicator, the level of Target2 balances. They have declined by 285 billion euros, or 25%, since the peak last year.

It is important to stress, however, that the benefits of lower financial fragmentation are not only being felt in struggling countries. I am aware that some of you here are concerned by the current low interest rate environment, as it reduces income for savers and squeezes returns for pension funds and insurance companies. Moreover, some are rightly worried that interest rates that are too low for too long could lead to misallocation of resources and reduce incentives for governments, banks, and corporates to adjust.

It is therefore worthwhile to note that the overall improvement of the situation has led to an increase in German government bond yields, which have gone up by around 25 basis points since the announcement of the OMT. This demonstrates that the more ECB actions help normalise the financial situation in the euro area, the higher these and other interest rates will eventually rise. This is why we have always said that OMT is a policy not for one or another group of countries, but for the euro area as a whole, in line with our mandate.

Indeed, there will always be some that want the ECB to "do more" and others that want us to "do less". I just attended as an expert the hearing of the German Constitutional Court, where those who brought the case to the constitutional court find the ECB has already done too much. But our answer, all along, has been consistent: we have done, and will continue do, what is necessary to preserve price stability within our mandate.

3. Dealing with financial fragmentation: the role of Banking Union

While the actions I have described by governments and the ECB have helped to combat financial fragmentation, there is no doubt that a third factor is also key: building a deep and genuine Banking Union.

The term Banking Union encompasses a number of regulatory initiatives, but it really has two key elements: a Single Supervisory Mechanism (SSM) and a Single Resolution Mechanism (SRM). These are complements and progress on both in parallel is essential.

As regards the SSM, close cooperation has now been established between the ECB and the National Competent Authorities (NCA) and preparatory work is well underway. Among other things, this work includes developing a common supervisory approach and preparing for the comprehensive assessment of all banks that will come under direct ECB supervision, as demanded by the SSM Regulation.

Let me say a few words on these two issues.

The creation of a common supervisory approach is essential to ensure that the overall system plays by a single set of rules. But it will not greatly affect day-to-day supervision for savings banks such as most of yours. This will still be carried out by local supervisors who understand the specificities and needs of smaller institutions. The SSM is not being created to interfere where local supervision functions well, but to ensure that there are no "blindspots" from which financial instability could emerge – as the crisis has shown, we cannot afford for even smaller banks to be completely off the radar.

The comprehensive assessment of banks under direct ECB supervision will involve an Asset Quality Review and Balance Sheet Assessment to be conducted by the ECB in the first quarter of 2014. This will then feed into the overall stress test to be conducted by EBA, in cooperation with the ECB, in the second quarter of 2014. This assessment is essential to ensure that the SSM starts with a clean slate and gain credibility in the market – we therefore want it to be as rigorous as possible.

How will these developments help financial fragmentation?

First, the creation of a common supervisory approach, together with uniform data reporting requirements, should reduce compliance costs for banks and encourage greater cross-border banking activity.

Second, the comprehensive assessment, if conducted to a high standard, should increase confidence in the overall health of the euro area banking sector. This is important to begin reintegrating the interbank and other bank funding markets.

But for these effects to be realised, it is essential that the SSM is accompanied by a credible SRM. Markets will only fully trust in SSM supervision if it is clear that banks can be safely wound down without damaging financial stability – otherwise they will expect supervisors to practice forbearance. Moreover, without a strong SRM bank funding costs will continue to be tied to fiscal situation of the sovereign, which will perpetuate financial fragmentation.

To deal with large and complex banking groups, we need an institution that can take swift, impartial decisions. To break the link with sovereigns, it needs to have sufficient resources to back those decisions up. This requires a single resolution authority and a single resolution fund, established at the European level. The first best option would be to entrust a newly established agency with this task. If this is not feasible in the short run, the ESM could be tasked with this for an interim period as a second best option.

Such a fund would be financed by *ex ante* risk-based levies on the banking sector, and in the build-up phase, any public support would be recouped by additional *ex post* levies on banks. This arrangement has two clear benefits: first, the financial sector itself would ultimately pay for the costs of financial crises, and second, less risky banks such as savings banks would pay-in less than institutions engaged in speculative activity.

An additional feature of the SRM, which may appeal to some in this audience, is that it to some extent reduces the need for moving towards a common deposit guarantee arrangements, at least in the medium-term. If banks can be safely wound down, and if there is a depositor preference rule that means that deposits are rarely bailed-in, then national deposit guarantee schemes should in most cases be sufficient.

Finally, let me say a word on direct bank recapitalisation by the ESM. There are various misconceptions about this instrument, such as that it opens up the possibility for debt mutualisation through the backdoor. That is absolutely not the case. Recapitalisation through the ESM will come only after, first, shareholders and creditors have been written down, and second, the beneficiary Member State has absorbed all incurred and expected losses based on a rigorous economic evaluation. So the prospect of losses for the ESM is limited.

4. Conclusion

Let me now conclude.

I have shown today that tackling fragmentation requires action of all fronts: from governments, from the ECB, and from the euro area as a whole through building Banking Union.

The challenge is now to build consensus behind such action, particularly Banking Union. And the case is clearly a strong one. For countries in difficulty, financial reintegration is essential to reduce interest rates for borrowers and restart growth. For those doing well, it is essential to raise interest rates for savers and prevent future distortions.

I therefore hope that you, as savings banks from across the euro area, will form a key part of this constituency.

Thank you for your attention.