Jörg Asmussen: Building Banking Union

Speech by Mr Jörg Asmussen, Member of the Executive Board of the European Central Bank, at the Atlantic Council, London, 9 July 2013.

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Ladies and gentlemen,

Let me thank the Atlantic Council for inviting me here to speak today.

This event is part of the Atlantic Council's Transatlantic Finance Initiative, and in recent weeks we have been reminded again just how important the transatlantic relationship is. We have seen how policy decisions in the United States can have immediate impact on markets here.

Similarly, when I speak to American colleagues I often hear how the euro area's reaction to the on-going crisis is seen as key risk factor for the outlook there.

To emphasise this interconnection, just yester-day negotiations started on the Transatlantic Trade and Investment Partnership, which is expected to give an annual boost to the EU and US economies of around 120 billion euro and 95 billion euro, respectively.

This underscores why strengthening dialogue through events such as these is important, to better understand how and why policy decisions in the US and the euro area are being made.

And in that context, I would like to use my intervention today to discuss a key issue for the euro area that also has a strong transatlantic dimension: Banking Union.

But before I turn to this, let me briefly say a word about the UK. I understand that there is intense debate going on at the moment about the UK's place in the EU, and a lot of questions are being asked about the value of continued membership.

But I firmly believe that the best place for this country is to be at the heart of Europe. That is where it can have most influence on the EU.

And that is where the EU can benefit most from its contribution, not least in transatlantic relations where the UK traditionally has a special link to the US. I therefore hope that, when the current debates are resolved, the UK returns to that position.

That said, it is clear now that the euro area will move faster than others in terms of economic and political integration: there will be a Europe of different speeds, with the euro area as its engine. But this need not be a threat to the EU.

The key is to ensure that integration remains open to all: the Fiscal Compact, where 25 out of then 27 countries chose to join, and the SSM, which is open to non-euro area countries, show how this can be done.

Moreover, as we have seen today in the case of Latvia, the euro area is still attractive to new members.

And for the time being, this trend should be helpful for this country: it will allow the UK to find a place in the EU that suits it, without holding back others that want to go further.

Supervision

Let me start by reviewing the state of play of the key elements of Banking Union, beginning with the Single Supervisory Mechanism (SSM).

As you know, the SSM Regulation is still being discussed by the European Parliament. The Parliament has scheduled a vote on the Regulation for its plenary session on 9–12 September.

If this vote passes, the text would then have to be agreed with the Council and enter into the official journal, which could take a few weeks. This means that we can tentatively conclude that the ECB will take over supervision in September or October 2014.

Following the approval of the Regulation, the members of the Supervisory Board can be appointed and we will start the general recruitment of staff for the SSM. This is key to get the SSM moving, as a number of major decisions can only be taken when the Supervisory Board is in place.

That said, this has not prevented us from progressing with the preparatory work.

Technical preparations have been on-going since September 2012, involving officials from the ECB and the national supervisory authorities. Some of the key issues we are working on are as follows.

First, a full mapping of the euro area banking system, so we can identify which are the significant and less significant banks – that is, those which will and will not be directly supervised by the ECB. Our current estimate is that we will directly supervise around 130 banking groups operating in the euro area which covers approximately 85% of euro area bank assets.

Second, we are developing a common supervisory model, which lays down how the different layers of SSM – national supervisors and the ECB – will work together. The aim is to create, for each banking group we supervise, a joint supervisory team that vertically integrates supervisors in Frankfurt with those in the national competent authorities.

As part of this work we are also developing a supervisory manual which will create a unified supervisory approach across all SSM jurisdictions. This will apply to issues like off-site and on-site reviews, risk assessments and model validations.

It is worth noting that the task we are undertaking here is comparable to the challenge of setting up the ECB and European System of Central Banks in the late 1990s. One difference is that central bankers in Europe had been cooperating for decades, not least to maintain the various European exchange rate regimes, and met frequently in the Committee of Governors in Basel. This meant that there was already a largely homogenous culture on which we could build.

In the supervisory field, however, cooperation has historically been looser, and as a result there are several different supervisory traditions and philosophies that we need to unite into a single system. In other words, we are working together to create a single supervisory culture and find our leitmotif, but it will take time.

Third, we are preparing to conduct a comprehensive assessment of all banks that will come under direct ECB supervision, which is required by the SSM Regulation. The assessment will involve a Balance Sheet Assessment (BSA), including an Asset Quality Review, to be conducted by the ECB together with the national supervisors and assisted by external expertise. This will then feed into the overall stress test to be conducted by EBA, in cooperation with the ECB.

Technical work on the design of the BSA is al-ready underway, and it will accelerate throughout the summer. While the methodology and timing of the assessment can only be finally established when the Supervisory Board is in place, we currently expect the whole exercise to start in Q1 of next year and to be completed be-fore the SSM takes over supervision.

We want this exercise to be rigorous to restore confidence in the European banking sector after two previous stress tests failed to do so. This means that it may reveal capital shortfalls. It is therefore essential for market confidence that supervisors and governments make clear ex ante how such shortfalls would be dealt with. I am pleased that the recent European Council has acknowledged this issue and called for backstops to be in place before the assessment is completed – otherwise we would not be in a position to undertake it.

The first backstop for any capital needs will of course be the market, and for the time being national budgets and the existing ESM facilities will form the second and third line of defence.

Direct bank recapitalisation via the ESM – with the exception of very rare and unlikely cases – will only be available once the SSM is fully operational.

A further issue we are working on is the accountability arrangements with the European Parliament. We place a high priority on this, because supervision may directly affect citizens' and companies' property rights and therefore has to be given full democratic legitimisation at the right level.

We believe that level is the European Parliament. We expect the discussions to be finalised soon.

I mentioned above the EBA, and some of you may be wondering what the creation of the SSM will mean for this authority. In my view, the SSM will in fact be very positive for the EBA, for two reasons.

First, the EBA will remain responsible for developing regulatory policy and technical standards that will form the basis of a single rulebook for banks across Europe.

The creation of the SSM should help this pro-cess, as having a significant number of countries participating in the SSM will reduce the scope for coordination failures, thus making the EBA's coordination function easier.

At the same time, the interests of non-SSM members will be protected by double-majority voting: for a vote to pass, there will have to be a majority by voting weight of all EU members, plus a simple unweighted majority of the euro-zone "outs" and the "ins".

Second, the EBA is currently developing a supervisory handbook which reflects best supervisory practices across the EU. The ECB is cooperating closely with the EBA to ensure that its own supervisory manual and the EBA handbook are fully consistent. Here again, the existence of the SSM should help the EBA's work, as all SSM members will naturally converge in their supervisory practices.

Resolution

Let me now turn to the other key element of Banking Union, which is a Single Resolution Mechanism operating under a single legal framework for resolution.

Looking at the US financial sector shows the value of a strong and clear resolution regime. The FDIC has resolved around 480 smaller banks since the start of the crisis, and it is probably no coincidence that there a few concerns there about “zombie banks”.

Dodd-Frank has created a similar resolution framework for larger banks, strengthening market discipline and reducing distorted incentives linked to “too big to fail”. This is what we should be aiming for in Europe: we cannot afford to have a regime that is too weak or too complicated.

The process of building a stronger resolution framework has now begun with the recent agreement by the ECOFIN Council on the Bank Recovery and Resolution Directive (BRRD), which now needs to be agreed with the European Parliament.

Overall, I welcome the Council general approach and hope that the Trialogue process with European Parliament can be completed swiftly after the summer break.

But let me single out two issues that I find positive in the agreement, and two which I believe could still be improved.

Starting with the positives, it is important that we have now established the principles that bail-out is out, and bail-in is in.

Under the Council approach, banks can only be recapitalised with resolution financing arrangements – such as a resolution fund – after a minimum level of bail-in equal to 8% of the total li-abilities including own funds, has been imposed on shareholders and creditors. While this of course does not mean that taxpayers will never again be on the line, it should give them more protection, and sharpen incentives to exercise discipline in the financial sector.

The second positive is that Council approach on BRRD contains a depositor preference rule which puts some types of deposits at the end of the resolution pecking order and exempts insured deposits from bail-in.

Depositor preference is important to give the same reassurance to depositors in all parts of the euro area, especially smaller depositors like ordinary citizens and micro-, small- and medium-sized enterprises, who will be given preference over depositors from large corporations.

Moreover, it helps reduce financial fragmentation based on varying credibility of national deposit guarantee schemes. As deposit guarantee schemes will be given highest priority in resolution, they should only have to pay out in extreme cases. This means that the existing arrangements backstopped by individual countries should be sufficient.

The two issues which I believe could be improved are as follows.

First, the entry into force of the bail-in tool un-der the Council approach would be 1 January 2019 at the latest, and in my view, this is too late.

It means that there is a time gap where a harmonised resolution framework has entered into force but one of the key resolution tools is not available to national resolution authorities. In the interim, not having access to this tool may impact the timely and orderly resolution of an institution or result in possible ad hoc national solutions which should be avoided in a Single Market.

The European Parliament proposal for bail-in to enter into force in 2016 is an improvement, but January 2015 would be better. Markets will in any case anticipate bail-in earlier.

Second, the arrangements for bail-in could be more rules-based.

The ECB has always argued for discretionary exclusions from bail-in to be limited so as to make the rules of the game clear for global investors. The Council approach gives the resolution authority powers to discretionarily exclude any type of liability for reasons of impossibility within a certain time frame, or to avoid wide-spread contagion. In our view, there would have been a benefit in defining ex ante the categories of liabilities that could have been excluded.

This means that investors will lack certainty about how the new framework will be used, and in my view it may slow down the process of reducing financial fragmentation.

For instance, there will inevitably be a political economy dimension to how national resolution authorities decide to exercise their discretion, with creditor classes that have particular importance in different national contexts likely to be favoured. This will affect the level-playing field between Member States.

Moreover, the BRRD foresees that after 8% of a bank’s liabilities have been bailed-in, the national resolution authority has the option to use its resolution fund to bail-out a further 5% of the bank’s liabilities. However, some countries will have larger resolution funds than others, for instance if they have more banks paying into the fund. This means that these countries would be able to bail-out more domestic banks before they exhaust the fund than those with less resolution resources available, who would need to use more bail-in. This will also not help reduce fragmentation.

The Single Resolution Mechanism (SRM) – comprising of a European resolution authority and a single resolution fund – could remedy both these fragmentation problems of the BRRD, which is a further reason why it is so essential.

First, a central authority would not be influenced by national preferences when applying discretion.

Second, a single resolution fund, financed by levies on the whole banking sector and with a European backstop, would be effectively de-linked from national budgets. However, these benefits will of course only apply to countries that join the SSM and SRM.

Moreover, it is essential that the European resolution authority will be in a position to act swiftly – if needed over a weekend for example – in order to avoid uncertainty about its course of action with a specific bank.

As you know, we await the release of the Com-mission's proposal on the SRM which is expected tomorrow, and I expect it goes in this direction.

As to its institutional structure, the first-best option would be to entrust a newly established agency with full decision-making powers.

If this is not feasible in the short run, a second-best option would be to use the ESM for this purpose for an interim period.

Conclusion

Let me now conclude.

There is no doubt that the banking system in the euro area is suffering from a confidence problem. Investors remain unsure about the health of banks' balance sheets; about the rigour of their supervision; and about the capacity of fiscally-constrained countries to resolve banks that are no longer viable.

This is why advancing with Banking Union is such an urgent priority for the euro area.

It is essential to build trust in the banking sector; to increase transparency over asset quality; and to ensure that banks that need to be wound down, can and will be. From the perspective of the ECB, it is also indispensable to reintegrate financial markets and so to restore the even transmission of our monetary policy across the euro area.

The progress made so far has been impressive, by any measure. The SSM is a milestone in European integration. But this is no time to rest on our laurels. We cannot afford a half-baked Banking Union. So I hope that, as of tomorrow, policy makers will now take up with urgency the task of building a strong SRM.

Thank you for your attention.