Yves Mersch: Powering into the future – Germany and Europe

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the 70th Banking Conference of German Cooperative Banks, Berlin, 14 May 2014.

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Ladies and Gentlemen,

Mr Hofmann's presentation has given us the view of Germany's cooperative banks with regard to banking union. I would like to use my speech to flesh out the ECB perspective, which is European, centralised and bank-specific.

I will focus on three areas:

1. first, how Europe's banking sector benefits from single supervision;
2. second, why the ECB is acting within its powers;
3. and third, what the advantages of a single financial market are.

How Europe's banking sector benefits from single supervision

In just under six months, the ECB will take over direct supervision of 80% of banking assets. We started preparing for this half a year ago by conducting a comprehensive assessment of the euro area's most important banks.

The basic premise is to obtain a precise picture of the health of the banks before we start the actual task of supervision. But the comprehensive assessment is more than just an accounting exercise.

A number of investors are fearful that impaired loans and potential losses are lurking in the books of some banks – and being tolerated by national supervisors. This has been evident in recent years from the fact that the share prices of listed banks in the euro area have been heavily discounted against their carrying values. Stockbrokers estimated that the actual value of banks was not even two-thirds that of the assets in their books. Investors therefore felt that banks had either over-valued their assets, would not achieve the expected rate of return, or needed more capital.

This kind of uncertainty has a negative impact on banks' funding costs, which in turn are fundamental to the terms on which banks can on-lend to the real economy.

The task, therefore, is to restore investor confidence. And this is exactly where our comprehensive assessment plays a key role. Although we are still in the middle of the process, we are already seeing some positive results. In the last few months, many banks have been tidying up their books in preparation for our review.

And this is clearly reaping rewards. The price/book ratio of the euro area's most important banks is now just under 0.9, and is thus closer to par than just a few months ago. So there are already signs that the European banking sector is benefiting from single supervision – even before we have begun the actual task of supervision.

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As we are limiting the assessment to the euro area's major banks, meaning that few of you here today are directly affected, I'll spare you the technical details of the comprehensive assessment for now. The key factor is that it is creating transparency, is credible and is restoring trust in European banks. This also brings benefits to banks and networks with a local presence.

We are therefore working closely with experienced national supervisors. They have the expertise we need. We are also supported by external advisers from the private sector. The credibility of the exercise can be significantly enhanced by involving a neutral "third party" that will operate in all the countries involved.

What this means in concrete terms is that more than 6,000 supervisors and advisers are currently conducting on-site reviews. The balance sheet assessment involves looking in detail at no fewer than 760 portfolios. This means we are checking some 135,000 credit files. So the assessment is *comprehensive* in both name and content. Of course, this does not come for free.

The process itself is designed to be highly transparent and consistent. At the national level, staff of the ECB and of the supervisory authorities of other Member States are evaluating implementation of the comprehensive assessment. Although the national supervisory authorities are providing us with assistance, the final review is always performed centrally by the ECB, to ensure that all the results are comparable. It is important that the central bank has ultimate discretion and power, so that national discretionary margins can be reconciled.

A similar rationale applies to the interaction between the assessed banks and the supervisor. With the stress test, for example, we have provided a dual quality control. We check whether the data in the bottom-up stress test are consistent, and whether the models and assumptions are coherent. But we also run our own top-down stress test.

And what happens after the stress test?

At the very end of the exercise we will publish the final results. But it is not our intention to spring a total surprise on the markets, or on the banks concerned. Misunderstandings and unnecessary speculation would certainly run counter to the aim of creating a more solid banking sector and restoring investor confidence.

Which is why we intend to consult the banks affected in advance on the format of publication. I also think it makes sense to publish the format template we are using before we release the final results. This will enable market participants to familiarise themselves with the type of information they can expect.

Clearly defined powers

Many people may be wondering whether the comprehensive assessment has given the ECB too much power.

The decision to entrust banking supervision to the ECB was above all a pragmatic one. Legislators were looking for a viable European solution within the existing agreements. The aim was to eradicate the previous supervisory culture, in which national supervisors occasionally had an incentive to take decisions that favoured national interests in particular. This was not always conducive to financial stability in other Member States or in the euro area as a whole. Governments and market participants trust the ECB in its role as an established, supranational institution to supervise the banks impartially and in the best interests of Europe.

And many in the ECB were also somewhat sceptical to start with. When all's said and done, our reputation is at stake. That's why we have always insisted on certain basic principles, including a strict separation between supervision and monetary policy.

These basic principles also apply during actual implementation. For example, we separate monetary policy and supervision by separating employees who are involved in supervision from monetary policy at an organisational level. Supervisory work is planned and carried out by a separate body, the Supervisory Board. The Board has already started meeting and is responsible for the ongoing preparations for single supervision. The ECB's Governing Council convenes separately on issues of supervision. And we are also accountable separately for supervision and for monetary policy.

As you know, only the most important banks will be supervised directly by the ECB. This will be done by joint supervisory teams comprising ECB employees, national supervisors and supervisors from the Member States in which the banks operate on a cross-border basis. Smaller banks will continue to be monitored by the national supervisory authorities. For most of you, this therefore means they will continue to be supervised by the Bundesbank and BaFin, which know the characteristics of both the German banking system and your banks inside out.

The important thing is that all participants play by the same rules, regardless of the Member State in which they are based. The ECB will ensure that this is the case. First, it will keep a close eye on the work of the national supervisory authorities and ensure that strict supervisory standards are maintained everywhere. And second, the ECB can, where necessary, take over direct supervision of smaller banks.

This is how we will ensure a single supervisory culture the length and breadth of the euro area. It is an important step towards a single financial market in the euro area.

The benefits of a single financial market

I'd now like to give you three reasons why a single architecture for the euro area financial market is beneficial – including for smaller German banks.

First, price stability in a currency union pays no heed to national borders; and likewise financial stability – or instability – does not stop at national borders either.

The financial interrelationships are far too entwined for that to happen. Without common European standards, national supervisors have an incentive to exploit lax supervision to the advantage of their location. This can lower the overall standard of supervision.

Second, the purpose of banking union is a single capital market. The more capital flows within the euro area normalise, the more long-term Bund yields will do the same. These act as a benchmark or anchor for savings rates.

Third, savers are also taxpayers. As soon as banking union – with its two key elements of a single supervisory mechanism and a single resolution mechanism – is up and running, taxpayers' money will be better protected and less in demand for bailing out banks than was previously the case. This also applies to Germany.

Banking union is therefore in no way a transfer union.

With single supervision, the first benefit that banking union will bring is to reduce the likelihood of banking crises. If a bank nevertheless gets into difficulties, it must be able to exit from the market in an orderly manner. Otherwise sick banks might be shored up by healthy ones. That would definitely be tantamount to a transfer regime, and would be neither in line with market rules nor economically viable.

Banking union creates conditions and incentives whereby in future, those who enter into a risk also bear the related costs if that risk materialises. And not taxpayers.

In concrete terms, what the new resolution rules mean is that those first in line for the costs of winding down a failing bank are those who previously derived profits from it, but who by investing in it also assumed a risk.

Under the hierarchy of liability laid down in the Bank Recovery and Resolution Directive (BRRD), a bank's owners, i.e. the shareholders, will be called upon first, followed by its creditors. Only then, and in extreme circumstances, can taxpayers' money be called upon.

Uniform rules alone cannot achieve this, however. They also need to be implemented and applied uniformly. This is the job of the single resolution authority.

The details of implementing the single resolution regime, which has only recently been agreed, are currently under discussion. Central to this discussion is the precise detail of the levies to be paid by banks to the resolution fund, which therefore begs the question: who pays what?

The target level of the fund is €55 billion, to be paid in over a period of eight years starting in 2016. How much individual banks will pay has not been definitively clarified. The European Commission is working out the details at the moment.

We know that some banks have riskier business models than others. That's why – and this is what the legislation provides – the levies to be paid by banks to the fund include a risk-weighted component in addition to a flat levy. Not every bank will pay the same amount, therefore.

The single resolution mechanism is intended to ensure that banks can be wound down more efficiently than in the past. This will reduce the costs of resolution and hence the potential burden on the single resolution fund.

Another side effect will be to reduce the urgency of having a single European deposit guarantee scheme. If banking supervision and resolution are conducted at a European level, the probability of banks defaulting should fall. If a bank still gets into difficulties, supranational structures are in place to ensure it can exit the market in an efficient and orderly manner.

This exit will be conducted in line with the Bank Recovery and Resolution Directive (BRRD). The directive envisages preferential treatment for depositors within the hierarchy of creditors, so they will have to be compensated far less often. This reduces the need for funds from national deposit guarantee schemes, which will only have to be drawn on in absolutely extreme cases.

The Directive on Deposit Guarantee Schemes is itself in the process of being revised. Its purpose is to harmonise national deposit schemes and provide them with more funds. This should also help ensure that national deposit guarantee schemes have sufficient funds for the time being.

Conclusion

Viewed from a historical perspective, banking union is being established very quickly, which is good news. Because everyone benefits from a single financial market architecture: Europe's banks, investors and savers, the real economy; and our monetary policy can also be more effective if the financial markets are less fragmented along national borders.