Jörg Asmussen: Towards a banking union – the state of play from the ECB's perspective

Speech by Mr Jörg Asmussen, Member of the Executive Board of the European Central Bank, at the Handelsblatt Conference "Banken im Umbruch", Frankfurt, 4 September 2013.

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Ladies and gentleman,

We are about to embark on one of the most decisive changes in the history of the European single currency. I expect that the European Parliament will approve the legislative proposal for a single supervisory mechanism next week, bringing the effective start of banking supervision at the European level in autumn 2014 into sight.

The relative calm in the financial markets that has now prevailed for over a year must not mask the huge significance of this project. Only a sound banking sector in Europe can ensure an ample supply of credit to enterprises and households.

But it would be wrong to believe that the recovery of the banking sector will solely depend on the transfer of banking supervision to the ECB. The single supervisory mechanism is a necessary step towards restoring the health of the banking sector, but it is not sufficient in itself; the need for reform and action in other policy areas has not abated. Nonetheless, the single supervisory mechanism is an essential component of a genuinely European banking union.

A European banking union in all its aspects forms the prerequisite for a truly integrated European financial market.

Who will benefit? First, banks, because they will in future be subject to a single regulatory and supervisory framework;

Second, borrowers, because they will once again be assessed by their creditworthiness rather than by their location;

Third, taxpayers, because they will no longer be first in line to pick up the bill in the event of bank failures.

All of this will help to restore confidence in the banking sector. Banks will be able to resume their core business, supplying credit to the real economy, offering secure savings accounts and making sure that payments are conducted safely.

Especially at this formative stage, we must now lay proper foundations to enable the banking union to fulfil these high expectations.

We want a banking union that will be resilient to future crises and will ideally prevent them from arising in the first place.

Given the at times differing national interests, the project will not sell itself. So we are seriously committed to the preparatory work. Today I would like to review the state of play and take a look ahead to the single supervisory mechanism, presenting my view of what still needs to be fine-tuned.

Let me start with banking supervision.

The single supervisory mechanism – where do we stand?

If, as I said, the European Parliament approves the legislative proposal for a single supervisory mechanism next week, we can begin exercising this single supervision in autumn 2014.

We will thereby create a level playing field for all banks in the euro area, because the same standards will apply overall. For cross-border banks especially, it will be simpler when they need only adhere to one framework.

And banking groups operating in several euro area countries will immediately enjoy more scope in their liquidity management.

European supervision also means that banks will no longer be obliged to hold national assets against national liabilities.

Particularly in the years of the financial market crisis, this nationally oriented supervision contributed to the increasing renationalisation of the financial markets. Our aim, however, is exactly the opposite.

It may sound very straightforward. But we still need to resolve some highly practical issues.

For example, where can we quickly find suitable staff for the single supervisory mechanism? Or who will bear the costs if we come across problems when carrying out the planned balance sheet assessment.

Some questions can only be answered once the legislative process has been finalised. But our preparations are already advancing at full steam.

As soon as the legislation is in place, we will start to recruit experts and managers for the single supervisory mechanism, which I assume will number no less than 1,000 employees.

Some 700 of those employees will be directly entrusted with banking supervision. At present, close on 80 staff members of national supervisory authorities are helping us for the transition period. They have been specially seconded to the ECB for this purpose.

Our internal preparations are concentrated on four main areas:

- First, the construction of a database with information on all euro area banks. With the help of this comprehensive overview of the banking system, we will then decide which banks will be directly supervised by the ECB. Our current estimate is that around 130 banks and banking groups will come under direct supervision. These banks cover around 85% of euro area bank assets.
- Second, the reporting to the single supervisory mechanism. In order to harmonise the data collection we have drawn up extensive guidelines, which are now being tested in a pilot study.
- Third, a uniform supervisory model, which will lay down how the different layers – national and European – will work together. We aim to form a team of national and European supervisors for each banking group we supervise so that both sides will benefit from each other’s know-how. Prior to the finalisation of the detailed rules of this supervisory model, a public consultation will be held this autumn.
- Fourth, a comprehensive assessment of the banks that will be directly supervised by the ECB. As this comprehensive assessment – which will involve a risk assessment, balance sheet assessment and a stress test – is currently attracting most attention, I would like to deal with it in more detail. For it makes clear that the banking union can only be a success if we take the correct approach from the out-set. For various reasons, two stress tests have not led to a restoration of confidence in the European banking sector. This will be our third and last chance.

Before launching the single supervisory mechanism, we should know the state of the banks that we will be supervising. We want to be free of old liabilities when we take on our new task.

But it is also beneficial for the supervised banks themselves for us to have a clear picture of the health of each individual institution.

By performing the comprehensive assessment we will provide transparency for investors – and that is exactly what is required to sustainably reinforce confidence in the banking sector.

The average price/book ratio for large and complex banking groups in the euro area is currently just over 0.5. This reflects the opinion of investors that banks overestimate the value of their assets, will not deliver the expected rate of return or will require fresh capital.

Moreover, confidence in the banking sector is much lower in some euro area countries than in others.

That also causes fragmentation in the single market, as reflected in the difficulties some banks face in obtaining market funding.

The results of our "inventory" are then incorporated in a stress test, which the European Banking Authority (EBA) will perform in close cooperation with us. Our staff members are now elaborating the methodical details of the comprehensive assessment.

The final decisions will be made as soon as the legislation comes into effect and the decision-making Supervisory Board is in place.

To enable the Supervisory Board to start operating promptly, the Chair and Vice-Chair should be appointed as soon as possible after the final adoption of the legislation.

We should now consider how to deal with any weak spots that are revealed during the assessment. Funding for any capital shortfalls should preferably come from the market. But we also need a backstop in the event that some banks fail to raise the necessary capital.

This is the only way to credibly perform the balance sheet assessment and stress test. Otherwise we may be accused of glossing over the results.

The whole point of the exercise, however, is to look the whole truth in the face. That is why we need such a backstop, before we even start the exercise. In the final statement of their most recent summer, the Heads of State and Government referred to "appropriate measures" before the finalisation of the assessment. Ideally, a credible and robust backstop should be in place before the start of the assessment.

Banks should recapitalise themselves through the market. In case that route fails in individual cases, a safety net is required. Initially, the respective euro area Member States are responsible. The banking union is not a back-door transfer union.

Every institution should cover its own former liabilities. If both these options – private sector and national budgets – are exhausted, the existing European Stability Mechanism (ESM) could step in, as it did last summer in Spain.

At this point I would like to clarify that this back-stop should not be confused with the direct bank recapitalisation through the ESM. With the exception of very rare and highly unlikely cases, direct bank recapitalisation via the ESM will only be available once the single supervisory mechanism is operational.

I would like to look more closely at two points that I find especially important in relation to the transfer of banking supervision to the ECB.

First, monetary policy and banking supervision should not lead to a conflict of interests. On the contrary, central banks have an interest in stable financial markets, not least for the proper functioning of their monetary policy. It may therefore make sense to assign banking supervision to the central bank alongside monetary policy.

A possible consequence of having banking supervision and monetary policy under the same roof may be that supervisors shy away from placing a bank into resolution.

After all, the central bank could postpone such decisions by providing liquidity support. That is the reproach made by some critics.

However, such conflicts of interest can be avoided by setting out strict conditions and clear rules for the combination of monetary policy and banking supervision in a single institution.

The legislative proposal for the single supervisory mechanism provides for a far-reaching separation between banking supervision and monetary policy within the European Central Bank.

In many Member States, banking supervision is already assigned to the central bank – with good results.

Second, single banking supervision must be democratically legitimised and subject to control. The single supervisory mechanism is therefore accountable to European citizens.

That goes beyond the accountability we have for our monetary policy. We will work out the optimal form of the new accountability obligations in cooperation with the European Parliament.

Banking resolution – what remains to be done?

A rigorous comprehensive assessment before the start of the single supervisory mechanism can strengthen confidence in the banking sector.

However, that is no more than a momentary effect. We can only secure long-term – and, above all, sustainable investor confidence – if we, as the banking supervisor, may in future also decide that a bank is no longer viable. And may do so in a way that does not set off shock waves across the financial system. We therefore require clear rules that are valid throughout Europe – rules on the orderly resolution of banks and rules on who will cover the ensuing costs.

The EU Council of Ministers has already agreed on a framework for the resolution and recovery of banks. I hope that the legislative process, too, may now be swiftly brought to a conclusion.

The idea underlying these new rules is simple and makes good sense: whoever takes on a risk must also take the responsibility for the consequences. In future, the costs of wrong decisions will not be borne by taxpayers alone. Shareholders will be the first in line, followed by creditors. Within the pecking order of creditors, subordinated creditors will come first and then preferred creditors. Only then will it be the unsecured depositors' turn.

This clear pecking order represents a major break-through: "bail-out" is out, "bail-in" is in.

For a truly integrated European financial market we need to remove the tight links between banks and sovereigns along national lines. When the new resolution rules come into effect, states may only intervene after private investors have been bailed-in. This is a sound approach, because the clear rules ensure that investors can, and must, properly estimate their risk.

As I see it, however, the current compromise leaves countries with quite some room to manoeuvre. The representatives of the European Parliament, the Council and the Commission should improve this aspect during their negotiations in the Conciliation Committee.

The bail-in rules are not due to take effect until 2018. I hope that the trialogue is able to bring this date forward in order to give more security to investors.

A single resolution mechanism, along with a single resolution authority and a single resolution fund for the supervised banks, is just as important as the single supervisory mechanism itself. The European Commission has presented a legislative proposal under which this mechanism could become fully operational as of 2015. I'm greatly in favour of this ambitious schedule, which does justice to the urgency of the project.

The ECB will shortly publish an opinion on the Commission's proposal. Without wishing to anticipate this detailed analysis, I would like to share a few thoughts with you on a good way of designing this mechanism.

The proposal covers the core elements required to resolve failing banks efficiently, whilst minimising costs for taxpayers and the real economy: a single system with a single authority and a single bank resolution fund.

It is right and important that resolution decisions will be taken at European level, i.e. at the same level at which supervision will be exercised in future. Quick and efficient decisions will enable the closure of credit institutions that are no longer viable – without impairing the stability of the rest of the financial system.

But who will actually decide that a bank is no longer viable? In answering this question I see that the current proposal still needs to be improved.

In my view, such a decision should be made solely by the banking supervisor, i.e. in future by the ECB.

This would allow for rapid, coordinated decisions, and subsequent action, without unnecessary disputes about competencies. Once the decision has been made that a bank is no longer viable, the resolution authority could take over. It would then decide how to carry out the resolution in that particular case. Such a clear division of tasks makes good sense.

Let me add, however, that the resolution fund will be financed through contributions from the banking sector.

Moreover, when banking supervision and resolution are brought to the European level, a single European deposit guarantee scheme will be less urgent.

Because thanks to the pecking order laid down in the Bank Resolution and Recovery Directive, less funds will be required for the compensation of depositors in extreme cases. For one, the framework for the recovery and resolution of banks, that is due to be adopted shortly, provides that depositors will be treated favourably. So the need to compensate depositors will more rarely arise. That means that national deposit guarantee schemes will only need to be invoked in absolutely extreme cases.

In addition, the revision of the Directive on Deposit Guarantee Schemes aims to harmonise national deposit guarantee schemes and to provide them with more resources. Both aspects will help ensure that the national deposit guarantees have sufficient funding.

Conclusion

Let me conclude.

A European banking union is the prerequisite for a genuinely integrated European financial market. That is also crucial for us as a central bank as only then can our monetary policy signals be properly transmitted throughout the euro area.

A single financial market is the prerequisite for the uniform transmission of our interest rate decisions to the real economy.

A banking union is a central element of a stable euro area.

It stands for a Europe that has learnt the right lessons from the crisis; for a Europe that will come out of the crisis stronger and more robust.

The banking union is in Europe's interest – and it is in Germany's interest too.

Many thanks for your attention.