Jörg Asmussen: Banking Union – essential for the ins, desirable for the outs!

Speech by Mr Jörg Asmussen, Member of the Executive Board of the European Central Bank, at the Danske Bank Financial Forum 2013, Stockholm, 5 November 2013.

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Ladies and gentlemen,

It is a pleasure to participate in the Danske Bank Financial Forum here in Stockholm.

Sweden was hit very hard by the global financial crisis. It experienced a contraction of no less than 5 per cent of GDP in 2009. Yet economic growth rebounded strongly 2010 and 2011, recording an annual growth rate of 6.1% and 3.9% respectively.

This very strong recovery illustrates the resilience and adjustment capacity of the Swedish economy. This is not to say that there are no problems in Sweden. To name just one, unemployment has remained at rather high levels, hovering at around 8%. Yet overall the indicators point to solid fundamentals. As a matter of fact, Sweden's economic and financial policies can be considered to set a benchmark for many other economies in Europe.

The euro area did not manage to track Sweden's strong rebound from the Great Recession. Following a shallow recovery in 2010 and 2011, it fell back into recession in the course of 2012. Yet the darkest clouds hanging over the euro area now appear to have lifted. Recent economic and financial developments have indeed been encouraging. Following six quarters of negative output growth, euro area real GDP rose by 0.3% in the second quarter of this year. Although more recent data have pointed to a fairly slow start in the third quarter, survey-based confidence indicators are running near a 27-month high.

This gives some comfort that the turning point in economic activity that we saw earlier in the year has not reversed. Hard and soft data seem to suggest that the shoots of a recovery are there, yet they are still very green and need to be nurtured carefully. The recovery is indeed weak, fragile, and uneven. We are basically running on one engine – net exports; the other engine – domestic demand – is sputtering but has not yet really taken off.

These positive developments have not fallen out of the sky. They have been made possible by resolute actions, taken at both the national and the European level. Whilst these positive signs are obviously welcome, they also harbour the risk that they may be a prelude to complacency. We cannot and should not yet rest on our laurels, as our work is not yet finished.

High unemployment and financial fragmentation both remain a chief concern. The unemployment rate, currently at around 12%, remains unacceptably high. Market sentiment also remains fragile. To use an analogy, the needle of market sentiment has shifted from fear to caution. Now we need to move the needle from caution to confidence. And the way to do that is by avoiding any relapse in the progress made so far, and by moving forward towards a genuine EMU.

Bringing our banking system back to health is an essential precondition for restoring growth.

It is against this background that in my remarks today, I would like to focus on a key pillar of a genuine EMU, that is the Banking Union. I will try to answer three questions.

What are the necessary components of a Banking Union?

What does a Banking Union mean for countries inside the euro area and those outside, like Sweden and the home country of today's host, Denmark?

And is a Banking Union sufficient to kick-start bank lending and consolidate the recovery?

Elements of a banking union

Let me start with my first question. What are the necessary components of a Banking Union? To our mind, a Banking Union requires a Single Supervisory Mechanism (SSM) and a Single Resolution Mechanism (SRM).

The Single Supervisory Mechanism

A lot of progress has been made on the SSM. Last month, the EU legislature gave the final green light to the Regulation. The entry into force of the Regulation has allowed us, the ECB, to speed up our internal preparations.

We recently communicated on the comprehensive assessment that we will undertake in the run-up to the actual assumption of supervisory tasks, twelve months from now. In a way, this comprehensive assessment is the “founding act” of the SSM. And we are very much aware of the conventional wisdom that “there is no second chance to make a good first impression”.

So we are adamant that this comprehensive assessment needs to be thorough, credible, and transparent. We are intent to not only shed light on the potential weaknesses in banks' balance sheets, but we will also prescribe the necessary corrective actions that need to be undertaken. After all, there is no point in making the right diagnosis, if you don't apply the remedy and cure the disease.

If you read some press reports, one could get the impression that the euro area banking sector is terminally ill. This is not the case. A lot of “healing” has already taken place. Since the start of the financial crisis, half a trillion euro of additional capital has already been pumped into the banks (totalling to over 5% of area-wide GDP).

Results for the second quarter for euro area banks also show an improvement in return on equity. However, both the geographic location and the size of banks remains a crucial determinant of financial performance. The funding situation has also normalised somewhat; still, it remains challenging given persistent fragmentation in funding markets.

Our comprehensive assessment is aimed at completing this ongoing “healing process”, by identifying remaining pockets of weaknesses and prescribing and fostering the necessary corrective actions to overcome them.

How those corrective actions should be financed is clear. Private-sector money should be first in line to reinforce the banking sector. Banks could increase their capital by various means, they could retain earnings, raise equity in the market, or sell some of their assets.

Public money should only be used when private solutions are not available or have been exhausted. Whilst it is not yet clear whether these public backstops will need to be tapped, it is essential to have them in place. If not, the credibility of the whole exercise is put at risk, as the outcome will then almost certainly be negatively perceived by market participants.

Doing this balance sheet assessment without a backstop in place would be a bit like getting on a boat in rough weather conditions, and not taking a life jacket on board. Discussions are progressing in the European fora on putting in place these backstops.

The Single Resolution Mechanism

Whilst the progress on the SSM is a step in the right direction, it is not enough. We at the ECB consider the SRM to be an indispensable second pillar of the Banking Union. In economist jargon: the current state is not a stable equilibrium.

Indeed, a SSM without an SRM will not set the right incentives for national authorities. If they have to pick up the tab when the banks need to be resolved, we cannot expect them to fully cooperate within the SSM. So, we need to put in place a strong SRM. We support the main tenets of the Commission's proposal on the SRM. In particular, having a single system with a single Fund is of the essence.

Experience in recent years has in fact shown that any form of coordination of national resolution authorities and national funds was beyond reach. On the basis of this experience we do not believe that a network of resolution authorities and funds can cater for swift, effective, and impartial decision-making, which is so much needed in case of resolution.

In the recent discussions surrounding bank resolution, a lot has been said on bail-in versus bail-out. Allow me to take the opportunity of being here in Stockholm, at an event organised by a Danish bank, to make a few points on the Danish and Swedish experience with banking crises, and draw lessons for the future.

The Danish case

The Danish government's first reaction to the financial sector woes in 2008 was in many ways similar to those of other European states: ample recourse was made to bailouts, loans, guarantees etc. However, at the peak of the banking crisis in 2010, Denmark chose to take a tougher stance than its European counterparts. With its third Bank Package, it was the first European state to force senior creditors to take a hit when banks failed. Haircuts of 16% and 14% were imposed on senior creditors of Amagerbanken and Fjordbank Mors respectively. As Danish banks were deemed to be benefiting less from an implicit government guarantee than their competitors, they were penalised by rating downgrades and a hike in funding costs.

The Danish experience illustrates the need for a harmonised approach across the EU to ensure a level-playing-field. Whereas the rationale may have been sound, market effects can be negative and even volatile when Member States implement such policies alone and unexpectedly, particularly in times of market stress.

It is important to allow banks as well as investors adequate lead-time to anticipate for such regime shifts. With this in mind, the ECB is of the view that the envisaged bail-in rules should be introduced at the same time across the EU and that this should be done by 2015, thereby providing the required certainty for market actors and ensuring a level playing field.

The Danish example also teaches us another lesson: the debate on resolution should not be reduced to a mere question of bail-in versus bail-out. There are other tools in the resolution toolkit – apart from bail-in – that can be used to deal with troubled banks and be equally effective in shielding taxpayers.

While reviewing their response to the crisis, the Danish authorities decided that facilitating bank consolidation was the primary path towards a healthier sector. They decided to push for private sector buy-outs of troubled lenders by offering a financial dowry to strong banks willing to take over their struggling counterparts.

In the US, the Federal Deposit Insurance Corporation's (FDIC) similarly plays an active role in promoting private solutions to banks failures through mergers and acquisitions. Indeed, 450 out of the FDIC's 490 bank resolutions since 2008 have involved what is called "Purchase and Assumption" – selling parts of banks to other banks, often located in different states. In the EU, almost no cross-border mergers or acquisitions have taken place and only around 50 banks have been wound down, and at a heavy cost for tax payers due to delayed restructuring. I dub this approach the "US' private banking union" and this is a route that Europe needs to explore further, not just within borders but also cross-border to complement its public banking union.

M&A in the context of resolution can not only bring down resolution costs, but can also be a solution to the "excess capacity" and the resulting depressed margins that are arguably present in various pockets of the euro area banking system. Whilst this could contribute to a further consolidation of the banking sector, it also increases the need for a workable SRM that is able to effectively wind down bigger banks, thus avoiding the "too-big-to-fail" syndrome.

The Swedish example

Having looked at Denmark's experience, let us now also take a look at the experiences at the other side of the Øresund. The way Sweden dealt with its troubled banking sector in the 90s also holds some useful lessons.

The Swedish government took a very different approach from the recent Danish one. Faced with a systemic banking crisis, the government resolutely took control of the banks, came public with the expected losses and write-downs, and subsequently cleaned the banks' balance sheets, and gradually returned them to private ownership. This proactive approach allowed the banking system to continue to function during the crisis, with no bank runs and hardly any signs of a credit crunch. Estimates from the IMF suggest that, although the gross fiscal cost for banking support amounted to 3.6 per cent of GDP, the cost to the taxpayer is likely to have been recovered after the liquidation of the assets taken over by the government[1].

Given these different experiences, it is no surprise that the Swedish and Danish governments took different positions during the discussions on the Bank Recovery and Resolutions Directive (BRRD). Denmark very much pleaded for a strongly harmonised scheme, thereby ensuring a level-playing field across the EU. Sweden on the other hand called for greater national flexibility, especially when facing systemic crises. In order to allow governments to still play an active role, they proposed to include the possibility of temporary public ownership of financial institutions and called for adequate flexibility in tapping the resolution fund and applying the bail-in tool. To my mind, the Council position on the BRRD duly incorporates the lessons from both the Danish and the Swedish experiences. And in doing so, it probably strikes roughly the right balance.

By setting common rules, it ensures a level-playing field in the internal market, thereby catering for legal certainty and predictability as to what will happen to troubled banks from Riga to Porto. But it also allows for some flexibility. For instance, recapitalisation outside resolution can be considered in certain cases. And creditors can be exempted from bail-in in specific conditions and after quite high hurdles have been reached. Arguably, this flexibility – if pushed too far – could challenge the level-playing field. This is a concern also for us at the ECB. Yet what is clear is that for the countries in the SRM, this is not an issue, as the decisions on availing of this flexibility will be taken at the European level. Therefore, the wider the regional scope of the SRM, the more the level-playing field within the internal market will be maintained.

Ins and Outs

This brings me to my second question: how does the banking union relate to countries inside and outside the euro area? I will make three points here.

First, the banking union is *critical* for the Euro Area countries.

Second, it is also *desirable* for Member States, which do not share the euro.

And third, the banking union should be about strengthening the internal market, rather than dividing it in two.

The banking union is critical for the euro area…

Let me start with the first point: the banking union is critical for the euro area countries.

[1] Valencia, F., and Laeven, L., (2012), *Systemic Banking Crises Database: An Update*, IMF Working Papers 12/163, p. 26. International Monetary Fund.

The reason why we are building it is to break the vicious circle between sovereigns and banks, the manifestations of which are much more acute and disruptive in a monetary union.

That is why we need the Banking Union in the single currency area. But one thing must be clear: putting the Eurozone on a stronger footing will also benefit the countries that are not in the eurozone. The crisis has clearly shown that in Europe a receding tide lowers all the boats, not just the ones which are in trouble.

… and desirable for the outs

My second point is that the banking union – whilst critical for the ins – is also desirable for the outs. The so-called financial trilemma[2] – in other words the impossible trinity of financial integration, financial stability, and national responsibility for crisis prevention and management – holds for the entire region, and not just for the euro area. The Swedish and Danish banking system are not only large in proportion to your GDP, but they are also very closely integrated with the rest of Europe.

Let me focus on the case of the Danish banking sector. Danish banks' consolidated assets are almost four times Denmark's GDP. The biggest banks have considerable cross-border activities. For these reasons, it would make perfect sense for Denmark to join a Banking Union that is composed not only of a single supervision mechanism, but also a single resolution mechanism with a resolution fund that can serve as an insurance scheme in relation to systemic banks. Whilst participating in the banking union therefore appears desirable, the terms of that participation should also be right. Indeed, we at the ECB consider it of the utmost importance to ensure that the participation of the outs occurs on equal terms as the Euro Area countries. The safeguard clauses in the SSM Regulation, which for example allow for objections to decisions, should ensure that national specificities will be duly taken into account.

On resolution, we need to find creative solutions to ensure a level-playing field between ins and outs. This holds *a fortiori* for the backstop for the single resolution fund which is currently the subject of much discussion. Taking part in the Banking Union from the beginning would bring many benefits. Having a chair at the table now allows participants to steer the practical implementation of the SSM – for example the development of the supervisory manual, guidelines and general instructions, as well as benefit from the "healing effect" that the comprehensive assessment should bring.

Banking union and financial integration

Let me now come to my third point: The banking union should be about strengthening the internal market, rather than fragmenting it. Both the single currency and the single market are key pillars of growth and prosperity in Europe. Both should be maintained and enhanced. Hence, the banking union should not create new barriers within the internal market. If countries choose not to join, they should not be discriminated against. Two safeguards will be crucial in this regard: having a single rulebook that sets the same standards for all, and having a strong and effective EBA with a fair representation of the outs.

Banking union and the real economy

I now come to my last question: is Banking Union sufficient to kickstart bank lending and consolidate the recovery? A banking union can make an important contribution to overcome financial fragmentation, and support lending. Without healthy banks, there can be no strong and sustainable recovery. Yet a banking union is not a "silver bullet". The drought of credit is a multi-pronged problem, which requires a multi-pronged solution.

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2 Schoenmaker, D., (2011). "The financial trilemma," *Economics Letters*, vol. 111, pages 57–59, April.

In addition to a banking union, I see three additional requirements for restoring lending and putting the recovery on a solid footing. The first condition is not to unravel what has already been achieved, sometimes at a high cost. As regards fiscal policies, substantial fiscal adjustment has been undertaken by the euro area countries over the last few years.

The average fiscal position of the euro area countries is much stronger than that of global peers. The euro area budget deficit is expected to have more than halved from its crisis peak of 6.4% of GDP in 2009 to 2.9% of GDP this year. National authorities should not backtrack on these efforts.

The second condition is to address our well-known structural problems, through well designed reforms aiming at ensuring a smooth functioning of the EMU and the single market. Euro area governments must decisively strengthen their efforts to implement the needed structural reforms in product and labour markets. These reforms are required not only to help the respective countries to regain competitiveness and to rebalance within the euro area, but also to create more flexible and dynamic economies that will generate sustainable growth and employment.

The third and last condition is continue resolutely on our road towards a genuine EMU. This should be our long term objective, of which the Banking Union is now at the forefront.

Yet the other unions are equally important. If I may pick out just one, further progress on economic union is needed, as the experience with the European Semester shows that economic policy coordination is still very much a “paper tiger”. Only one tenth of last year’s country-specific recommendations have been implemented by the member states. We need to explore all possible avenues to give greater “teeth” to the economic coordination processes. To our mind, the idea of reform contracts backed up by some financial incentives continues to be an interesting avenue.