Andreas Dombret: European banking union – where do we stand?

Speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at a press briefing, Frankfurt am Main, 23 July 2014.

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1. Introduction

Ladies and gentlemen

I am delighted that so many of you have been able to attend our press briefing. But before we kick off, I would first like to make a couple of points of my own.

I am certainly not overstating the case when I describe the banking union as the most ambitious European project since the launch of the euro. Yet at the same time, it represents a step forward that is as necessary as it is logical. A single monetary policy calls for integrated financial markets, and that includes the banking union.

The banking union is set to become a reality on 4 November this year – at least in the form of the European Single Supervisory Mechanism (SSM). The second pillar of the banking union – the European Single Resolution Mechanism (SRM) – does not come into play until 2016. The third pillar – a joint European deposit guarantee scheme – has been shelved for the time being.

But the main topic I would like to discuss with you today is the Single Supervisory Mechanism.

2. The world pre 4 November

Much remains to be done before the SSM can set to work on 4 November. The biggest project leading up to the launch of the SSM is the comprehensive assessment, in which a total of 128 banks across Europe will be subjected to a thorough health check, including a "cardiac stress test". This check aims to provide maximum transparency and strengthen confidence among market players, and to enable the SSM to get down to work free of legacy issues.

The comprehensive assessment is made up of two core components. The first is the asset quality review, or AQR. To stay with the medical metaphor, the AQR is rather like looking at an X-ray image – it allows supervisors to detect any nasty surprises that might be lurking on bank balance sheets. The second component is a stress test. This "cardiac stress test" gives an outlook for the patient's health going forward. Its aim is to gauge the extent to which banks can withstand a deterioration in the economic setting.

The bulk of the on-site inspections performed as part of the AQR have now been completed. These inspections focused on scrutinising credit exposures and collateral valuations, looking both at individual exposures and aggregate portfolios. The resulting data were used to ascertain whether there was any need for valuation adjustments. Level 3 fair value exposures were also inspected.

The findings, having been quality-assured at the national level, have, over the past weeks, been forwarded to the ECB, which is now engaged in central quality assurance. The next step will be to calculate an AQR-adjusted capital ratio. After that, banks will be asked to make the adjustments needed under the accounting standards.

In the stress test, banks need to simulate two macroeconomic scenarios, the aim being to discover how each bank's risks, and thus their CET1 ratios, respond under stress conditions. The baseline scenario is largely consistent with the European Commission's 2014 winter forecast, whereas the adverse scenario simulates a much more difficult economic setting in which the euro area experiences a recession, with GDP shrinking by 0.7% in 2014 and by 1.4% in 2015, followed by zero growth in 2016. This simulated economic slump is accompanied by rising unemployment and falling prices in the financial and real estate markets. At the same time, the scenario simulates an increase in general interest rate levels as well as renewed divergence in European sovereign bond spreads.

The final step of the comprehensive assessment is "joining up" the AQR findings with the outcome of the stress test. Generally speaking, we should work from the bottom up wherever possible – in other words, on the basis of the specific data provided by the banks. Generalised assumptions should be made as little as possible. But the tight time schedule naturally means that some trade-offs will need to be made. Publication of the final outcome of the comprehensive assessment is scheduled for the second half of October.

As I see it, clear communication is crucial for the success of the comprehensive assessment. The process needs to be as transparent as possible, and banks should be involved at the earliest possible stage, ad hoc reporting requirements permitting. In any case, supervisors constantly interact with the banks throughout the comprehensive assessment, from the clarification of issues during the credit file reviews through to the supervisory dialogue, which is when representatives from the ECB and the national competent authorities discuss partial and preliminary findings before the final results are disclosed.

There is one point I would like to make quite clear. These inspections are being conducted in an even-handed and open-minded manner. At the current juncture, it is simply impossible to say with any certainty how the results will turn out. That's why I find it downright ill-considered for third parties to suggest that they know the outcome. Bearing this in mind, I trust you will appreciate that the Bundesbank will refrain from making any further public statements on the comprehensive assessment as from mid-September.

If the AQR or the stress test reveal any capital shortfalls, it will be up to the banks to cover them as quickly as they can, first and foremost by approaching their stakeholders for additional funding. No later than two weeks after publication of the results, institutions will be required to submit capital plans in which they explain in detail how they intend to cover any capital shortfall.

However, let us not forget one thing. The comprehensive assessment is based on balance sheet data as at 31 December 2013. When considering the published results, it is therefore important to pay particular attention to the column listing the capital measures taken in 2014. We expressly welcome the fact that several banks have strengthened their capital base in recent months. This helps make the banking system more stable.

If there are not enough private funds to fill any capital shortfalls identified, the state in question will be obliged to provide a "backstop". As a last resort, the government is to recapitalise banks, issue guarantees or take on risks. However, this government support is subject to strict conditions. The bank must be solvent, and the support must not offset any accrued losses. Moreover, government assistance may be granted only if it serves to avert disruption to the real economy or dangers to financial stability.

The comprehensive assessment is a major organisational undertaking for all involved, and one which must, furthermore, be implemented under massive time pressure. At its peak, more than 1,700 auditors and 230 Bundesbank and BaFin supervisors were involved in Germany alone. Moreover, my experience in the Bundesbank is that, ultimately, far more colleagues are, of course, involved in the comprehensive assessment than just those officially assigned to the project. Some are helping out temporarily or indirectly, while others have had to take on tasks originally performed by staff now directly involved with the comprehensive assessment.

For banks, too, taking part in the assessment involves a lot of work. And yet, the comprehensive assessment is decisive if the Single Supervisory Mechanism is to get off to a good start.

3. The world post 4 November

Under the Single Supervisory Mechanism, the ECB will take on direct responsibility for supervising the 120 most significant euro-area banks from 4 November.

What does that mean for Germany? First, BaFin and the Bundesbank will continue to directly supervise around 2,000 smaller German credit institutions; second, we will hand over direct supervisory responsibility for the 21 German SSM banks to the ECB, but will continue to provide them with ongoing supervision; third, we will be involved in supervising the 99 foreign SSM banks.

How will that work in practice? Supervision of the SSM banks will pass to what are known as Joint Supervisory Teams. These teams will be headed by an ECB coordinator. Under current plans, the coordinator of a Joint Supervisory Team may not come from the country in which the supervised bank is headquartered.

The teams themselves are largely made up of staff from the national competent authorities. The Bundesbank and BaFin will consequently continue to supervise the German SSM banks. That ensures that national supervisors' expertise is not lost. In terms of the Bundesbank, it is not just our know-how and experience that count, but also the fact that we have offices in those locations where the banks are headquartered and operate – whether that be Munich or Hamburg.

The SSM's clout hinges on the people behind it. And herein, too, lies a major challenge. The ECB is planning to employ around 770 staff for the new supervisory body. In addition, it is looking for some 200 employees to undertake support functions.

Given the proximity, moving to the ECB is, of course, particularly attractive for Bundesbank staff working in Frankfurt. So far, 48 colleagues have taken up regular SSM positions, nine of which are managerial positions, including one Deputy DG post, while 32 have taken working level positions and 7 are employed in support functions. In addition, 19 Bundesbank staff are currently seconded to the ECB to assist with the SSM on a temporary basis. A very prominent example of a Bundesbanker currently working for the ECB is, of course, our former Deputy President, Sabine Lautenschläger.

As the majority of the selection decisions are yet to be taken, we expect more Bundesbank staff to switch to the ECB by November. To fill the resultant gaps, we carried out what we refer to as "frontloading" at the beginning of the year. Our plan is to fill any vacancies that arise in the meantime as rapidly as possible by advertising internally and externally and by allocating more junior staff to the area.

Allow me to mention one last point. Who will pay for the new European supervisory authority? How can the costs be distributed fairly across institutions, and what is the right allocation key? In my opinion, all banks should be involved, albeit in proportion to their size and risk weight. A level playing field can be guaranteed only if supervisory activity is exercised appropriately, ie in proportion to a bank's size and risk. The Bundesbank is particularly committed to this objective, but our ECB colleagues have also stressed this to be a concern. Ultimately, however, smaller institutions will also benefit from the Single Supervisory Mechanism, even if they are not supervised by the ECB directly.

4. Conclusion

Ladies and gentlemen

We have set ourselves an ambitious goal, to make the financial system more stable. The banking union is, without doubt, one of the largest steps towards achieving this objective. I am confident that it will get off to a smooth start when the Single Supervisory Mechanism is launched on 4 November. Then, when the Single Resolution Mechanism starts its work in 2016, we will have gone a long way towards creating a more stable financial system. However, there is still a lot of work to be done.

Thank you very much.