

The implications of the resolution framework and the common backstop for banks - speech by Rolf Strauch

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Good afternoon.

It's a pleasure to meet you all virtually. I am speaking to you from Luxembourg today, where the ESM is based.

Before we discuss the ESM's new enlarged mandate as a backstop to the Single Resolution Fund and its implications for banks, I would like to put this into the context of the current Covid-19 crisis and explain why the completion of banking union has now become more pressing. The current pandemic has stalled the improvements to banks' balance sheets that followed the euro debt crisis, thereby highlighting vulnerabilities that still remain.

This time, banks were better prepared for a downturn than in the past. Policymakers and banking supervisors tightened up the regulatory toolkit and set the right system of rules and incentives to make banks develop their risk management capabilities and decrease their risks.

As a result, euro area banks have significantly improved their capital positions in the last years; levels are, on average, higher than ever. In the third quarter of 2020, the median Common Equity Tier 1, so the CET1 ratio, used to gauge a bank's capital strength, was around 15.6%, based on a sample of 80 large banks. It has almost doubled over the past decade. In response to the pandemic, moreover, the Single Supervisory Mechanism SSM decided to provide significant capital relief to allow banks to lend to firms facing liquidity problems. In parallel, governments provided massive lending guarantees and the ECB continued to offer very favourable funding conditions. Taken together, these measures allowed banks to successfully channel credit to the economy to contain the impact of the lockdowns.

In addition, banks have successfully tackled the legacies of the past crisis. Non-performing loans, or NPLs, have significantly decreased since their peak. The biggest improvement came from those banks with the highest NPL ratios. The median level of NPLs for the largest banks in the euro area was around 3.2% in the third quarter of 2020. All banks have come closer to this value, although there are still a few outliers, particularly in Greece and Cyprus. The overall level of NPLs for euro area banks is back to where we were before the last crisis.

Despite this promising progress in recent years, the banking sector was not quite as robust as we had hoped when the pandemic-induced recession hit. Banking union remains incomplete and some banks may be exposed to heightened vulnerabilities in an adverse scenario.

As I said earlier, banks significantly supported the financing of the economy throughout the pandemic. So far, we have no clear visibility of the actual risks this implies. Much of the ability of firms and households to repay loans will depend on the shape of the recovery across sectors and regions. Once support measures have been phased out, we will see to which extent credit risk can be expected to materialize and how this will consume bank capital through provisions and losses.

We see two weaknesses here:

- First, banks are still in the process of implementing agreed rules, such as the Minimum Requirement for own funds and Eligible Liabilities (MREL). Once implemented, this will strengthen their capacity to withstand losses and make banks better prepared for a resolution without needing to draw on the SRF.
- Second, and more importantly, banks' profitability remains anaemic. The system suffers from overcapacity and low operational efficiency. While business models are being transformed, this is happening at a slow pace when assessed against competition from neo-banks and overseas institutions.

Markets have experienced a strong rally in the last few months, especially after the news of the availability of vaccines. Banks' share prices increased by almost 70% on average since they bottomed out in April last year. However, prices remain about 15% lower than before the crisis outbreak and the price to book value remains depressed, hovering at just over 0.5.

At the same time, US competitors were well above par. This implies that the market expects euro area banks to continue to yield little value and that prospects of recovery are still too uncertain. According to our calculations, the annualised return on equity in September was around 1.8% for the entire euro area. This is far below any reasonable remuneration investors would expect for the equity risk they take. There are of course huge variations across countries - Ireland, Greece and Cyprus were in negative territory.

In short, banks have limited overall capital generating capacities and it cannot be excluded that some banks may face problems to survive due to a deteriorating quality of assets on their balance sheet.

To strengthen our safety net in these challenging times, policymakers have agreed on an earlier introduction of the common ESM backstop from 2022 onwards. As we are expecting further pressure on bank profitability and capital, bringing the implementation of the backstop forward ensures that sufficient funds are available in case a bank needs to be resolved. A strong and well-financed resolution mechanism reassures and stabilises markets, prevents spill-over effects and thereby protects savers.

The ESM backstop to the Single Resolution Fund is part of a wider ESM reform, which also strengthens our precautionary tools and gives the ESM a larger say in future country programmes. The reform was agreed upon by all 19 euro area finance

ministers and it will enter into force after ratification by national parliaments, a process which is scheduled for completion this year.

The ESM is well equipped to act as the SRF's safeguard, given its strong market presence and experience in issuing bonds in a crisis. For the first time, the ESM's new lending facility under the common backstop allows the ESM to provide financing to a euro area institution and not just governments. The backstop replaces an ESM tool for dealing with bank failures – the Direct Recapitalisation Instrument – that was devised at the height of the euro debt crisis when banking union was still in its infancy and bank resolution bodies were not yet in place.

Nicoletta will shortly give you more details on how the backstop works in practice. But first, I would like to explain the policymaking context of the ESM backstop as it has broader implications than simply making banks safer.

It is important to understand that the backstop is a milestone in the euro area banking union. And as such, it will contribute to the robustness and resilience of the Economic and Monetary Union as a whole.

While this is a major step towards completing banking union, further important reforms are needed to enhance the crisis management framework, allow for a more efficient allocation of resources across countries, and strengthen protection for all depositors.

Without a concerted effort to support banking union, we risk that the crisis will increase existing divergences and vulnerabilities across different national banking sectors.

This is why the banking union's three pillars need to evolve together and strengthen each other to foster confidence and promote stability. The recovery and resolution framework with the backstop is just one pillar.

It needs to be coupled with a mutualised European deposit insurance scheme to make savers confident that each deposited euro carries the same value, irrespective of where the bank and the customer are located within the banking union.

With EDIS, moreover, supervisory and resolution responsibility would better match financial liability: the deposit insurance would be provided at the same level as supervision and resolution. In addition, having a joint insurance is more efficient and

robust than having 19 national insurance systems. Overall, this would not only offer better protection but also ensure equal treatment and a level playing field.

At the same time, we need to encourage more efficient cross-border banking activities, including cross-border consolidation. The current push towards digitalisation facilitates the consolidation and upscaling of services. Cross-border consolidation will not only allow for efficiency gains but also strengthen private sector risk sharing. A better flow of financing across borders will make banks and our economies more robust to future shocks.

There are ongoing discussions at the European level on all these aspects and the Heads of State or Government have asked the Eurogroup to present a time plan for further progress by June this year.

To conclude, we see the introduction of the common backstop as an important milestone towards completing banking union. Nevertheless, we still need to strengthen the crisis management framework and gradually introduce EDIS to create the conditions for stronger integration and more stability in the longer term.

Thank you.

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