“Euro area banks in a deepening monetary union” - speech by Rolf Strauch

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Ladies and gentlemen,

Thank you very much for inviting me to this conference. I would like to congratulate the European Banking Institute with what is already the third Global Annual Conference on Banking Regulation. The research from your institute is a very welcome contribution to the debate about the banking sector in the monetary union.

Today, I would like to start with looking at the economic performance of the euro area. It is doing very well at the moment. However, things on the banking side are looking less favourable. Some banks are still struggling under the weight of problems they racked up during the crisis. These problems need to be further tackled for Europe to deepen the monetary union and complete the Banking Union. There is wide political consensus now that we should decide on the next steps, and Europe is facing a unique opportunity to make itself less vulnerable when the next crisis hits. In what follows, I will explain how we can best use that opportunity.

Some 10 years after the start of the global financial crisis and – subsequently – the euro debt crisis, Europe shows strong economic growth, with positive growth rates in all euro area countries. Figures from the European Commission two weeks ago showed GDP growth of 0.7% and 0.6% quarter-on-quarter in the two last quarters of 2017, and momentum should remain robust in early 2018. Unemployment is falling and public finances are on a sounder footing. The strong recovery, which we have experienced, could not have taken place without the comprehensive policy package that the euro area put in place as a response to the crisis. A set of crucial innovations was made that would have been unthinkable only a few years earlier.

The Banking Union is one obvious example. Its two pillars, the Single Supervisory Mechanism and the Single Resolution Mechanism, launched 6 years ago, have been put in place successfully, and protects taxpayers from future financial crises.

My own institution, the ESM, was set up as a lender of last resort for euro area countries. Together with its predecessor EFSF, it has disbursed a total of € 273 bn in loans to five countries: Ireland, Greece, Portugal, Spain and Cyprus. Four out of these five are now success stories. Greece can be the next success story of the ESM, if it continues to implement the reforms that it has agreed to. Its recent successful fund raisings in the market are a good step forward in exiting Greece’s third programme in August.

Now that Europe has entered a period of calm, we should take the opportunity to better prepare the euro area for a next crisis. Politically and economically, this is the right time. At the end of last year, Europe’s leaders mandated work on a concrete agenda to deepen the monetary union further. The first element is to complete the Banking Union and the second is to develop the ESM by broadening its mandate as the crisis resolution mechanism. President Tusk asked the finance ministers to work first on these two areas because convergence of views is the greatest. Then there is a third topic, which is the fiscal governance and common fiscal resources where there is a higher divergence of views. The aim is to come to more definitive conclusions on the first two topics by June.

Let me look at the banking sector**.** Since the inception of the crisis and with the implementation of the Banking Union, a lot has been done to make the euro area banking sector financially far more robust. In several countries, particularly those that had an ESM programme, the banking sector underwent a marked restructuring and consolidation. Banks have almost doubled their regulatory capital ratios by injecting almost €700 billion of fresh capital since the onset of the financial crisis. And leverage, liquidity and net stable funding ratios for banks are even above the requirements for the existing EU regulation for both the EU and at the national level. Non-performing loans accumulated over the crisis are now declining. Since December 2014, when the non-performing loan stock reached the peak, the amount of distressed loans has decreased by 20% and the pace is accelerating.

Yet, a lot of work has still to be done. The banking sector is lagging behind compared to the strong economy. Non-performing loans are still too high and burdening the banking system, hurting profitability, especially in Greece and Cyprus. The pace of workout should increase further. This will also require a change in practices.

For almost a decade now, the European banking sector has been consistently outperformed by their peers in the United States. Investors and equity analysts clearly consider European banks less attractive than the US ones. They criticize rigidities in Europe in adapting to the low interest rate environment by repricing deposits and compensating for lower interest income. And they see that US banks are faster to reduce costs and deliver higher returns.

Completing the Banking Union would be one step to fix this situation. The Banking Union should lead to a bigger market where banks can effectively run their business and it should prepare us for the structural changes, which the banking sector will have to face over the coming years. And compared to the steps already taken and the progress achieved, the remaining steps are limited. This is not the completion of a halfway built house, but rather fixing the roof to protect everyone.

As you probably know, most of the steps for the completion of the Banking Union were already recognised in the Roadmap in the June 2016 Council Conclusions. A key point was that countries will only be prepared to share risks in each other’s banking systems when problems dating back to the crisis have been solved. I fully support this agenda. The two elements in completing the Banking Union on the agenda are a backstop for the Single Resolution Fund and a common deposit insurance.

The Single Resolution Fund has slowly been building up its war chest since its inception. However, if it wants to be credible in the eyes of the financial markets, it needs to be prepared for any eventuality. Technical work on the design of the backstop has already advanced. It has already been agreed that the common backstop to the Single Resolution Fund has to be introduced at the latest by 2023, though political leaders could also decide to do so earlier. The European Commission proposes its introduction for 2019. The so-called Five Presidents Report in 2015 referred to the ESM as the backstop for the SRF, noting that it should be fiscally neutral in the medium term – that means eventually all costs have to be covered by the banking sector. I can assure you that – if agreed - the ESM is ready to take up its role as backstop to the SRF.

The second point to complete the Banking Union is a European Deposit Insurance Scheme, or EDIS. Trust in deposit insurance is a key prerequisite of financial stability. Therefore, we need to create an EDIS to provide an equal level of protection for bank deposits in the euro area and increase the resilience of the Banking Union against future financial crises. I know that it might be difficult at the moment to reach an agreement. The level of trust between member states is low, not only because NPLs are still high in some countries, but also because the national deposit guarantee schemes are not yet fully funded in some countries.

In my view, this doesn't mean we should simply sit and wait for things to happen. There is good momentum now that problems of the crisis are behind us, mitigated by new policy initiatives. Further steps are in the making and can be advanced, some even before June this year.

In the past years, bank regulation has been tightened in step with global rules, and Europe's framework for resolution and restructuring of troubled banks has been adopted to shield taxpayers from any future bank bail-outs. This regulation is currently under review to reflect the lessons learned over the past years. This review could be concluded, which would address some of the conditions mentioned in the Roadmap. Moreover, an EU action plan for non-performing loans was adopted as an additional element, not mentioned in the Roadmap. The European Commission is expected to further follow up with a comprehensive package of specific proposals how to foster NPL markets, how to manage them more efficiently and ensure adequate provisioning in spring.

Further, the Single Supervisory Mechanism (SSM) is developing a path for the reduction of the stock of NPLs in all banks under its remit over the coming years. Outlining a credible path will put further pressure on banks to deal with crisis legacies and can reassure the concerns from some euro area countries.

Another step to reduce risk is for the Single Resolution Board (SRB) to define the level of bail-in securities that every bank needs to hold on its books by the end of this year. These shock absorbers are of key importance particularly in the case of globally systemic banks. The SRB has committed to set the adequate targets of shock absorbers for all banks by end of 2018 at the latest, but much work has already been done.

All these steps will lead to a measureable further improvement of the risks in the banking sector. Showing tangible progress will increase the confidence that the banking sector is on the right track when moving forward with the completion of the Banking Union and the common backstop and EDIS.

There is also a more fundamental issue on the political agenda. The Roadmap referred to a debate on how to tackle sovereign risk in bank balance sheets. In December 2017, the Basel Committee clarified that there is no consensus on introducing risk weights on sovereign exposures at the international level. Now, policy makers have to decide whether they want to move ahead without that common view. Clearly, nobody wants such a regulation to cause any disruption. From our perspective, a recent proposal to introduce concentration charges on sovereign bonds is one useful option that would promote the diversification of portfolios and therefore reduce the dangerous linkages between banks and sovereigns. At the same time, it would not undermine the profitability of banks and not put them at a disadvantage internationally.

As we move along in completing the Banking Union, we will also be able to remove remaining obstacles for banks to operate efficiently across countries. This requires that capital and liquidity regulations apply to banking groups as a whole. At the same time, host countries need to be reassured that subsidiaries are well protected. The subsidiaries of banking groups are oftentimes of systemic importance in host countries and the rules should ensure that subsidiaries are sufficiently safe and that a failure does not have fiscal consequences for the host sovereign. Therefore, an agreement on the home-host issue, that strikes the right balance between free movement of capital and liquidity and national supervision of subsidiaries, is key for completing the Banking Union as well. The discussion around an appropriate home-host balance and the common deposit guarantee scheme consequently should be made in parallel.

Ladies and gentlemen, I have laid out steps to complete the Banking Union. I am convinced that together, they would foster financial integration, boost economic risk-sharing through the private sector and make the economy more resilient.
Let me now turn to the future role of the ESM. There is no crisis on the horizon now, and the current period of economic prosperity means the time is also exactly right to think about how the ESM can contribute to making the euro area less vulnerable when the next crisis does hit.

In five years, the ESM has developed into a strong, independent, efficient organization. It has shown not only that it can execute its main financial task of raising money and paying it out. It also has a proven ability to provide economic, financial and policy advice, for example through our debt sustainability analysis and the early warning system. And of course you are aware of our role in monitoring the implementation of the Greek programme.

A stronger, more powerful ESM is of course not a goal in itself. But – like completing the Banking Union – it can be an element to make the monetary union more robust. And it gives Europe the opportunity to take on more responsibility to solve its own problems.

In 2010 Europe couldn’t have done without the firepower of the IMF. But that has now changed. The ESM has sufficient lending capacity and its own know-how. In short, the ESM has matured and it makes sense to broaden its mandate so that it can become Europe’s crisis resolution mechanism. Then, designing, negotiating and monitoring a financial support programme would become a joint task of the European Commission and the ESM.

Another new task for the ESM, which I mentioned before, could be the backstop for the SRF.

When I look a bit further ahead, the ESM could also play a role if euro area countries were to define a sovereign debt restructuring framework to make settlements with private creditors more transparent. The ESM could provide the debt sustainability analysis and organise negotiations between creditors and the debtor.

To conclude my remarks about the future role of the ESM, let me say that I'm fully in favour of integrating it into the EU Treaty. The model we foresee at the ESM is along the lines of the European Investment Bank, a body with its own capital and accountable to its shareholders. For this to happen the ESM Treaty and the EU Treaty would need to change, however.

Let me now briefly discuss my third, and final topic. This is the further fiscal integration in the monetary union. First of all we need to simplify the fiscal rules. These were easy enough to understand in the Maastricht Treaty, but have become too complex and hard to understand, even for experts.

Also the plan to create the role of a euro area finance minister has merit. Obviously, this function would need have enough competences related to existing or new functions in the fiscal area in order for it to be a meaningful contribution.
Besides these two ideas, a wide range of plans is floating around. Let me give you a short overview. One is to create an annual EU budget to fund public goods in areas that countries can best solve working together, such as defence, climate change and border control.

Another idea, which we think could contribute to the resilience of the euro area, is a stabilisation function to tackle asymmetric shocks in a country or a region. This function would have to be set up without permanent transfers or debt mutualisation. Examples in the US, such as rainy day funds or a complementary unemployment insurance, show how this can work. Alternatively, the stabilisation function could work with shorter-term ESM loans. These would have a lighter conditionality than regular ESM programmes, and could also be used to stabilise investment, or reward structural reforms.

Another proposal for a stabilisation tool is a euro area budget aimed at equalising investment in countries during business cycles. This would exist in conjunction with investments that already happen from the EIB, the EU structural funds, and the Juncker plan.

This wide range of ideas shows the debate about more integration in Europe has gained some real momentum. We seem willing and able to make some meaningful change, whether you look at the Banking Union, deepening the monetary union or strengthening the fiscal framework. Economics and politics have created a chance to make monetary union more robust that we should not squander.

Let me come to a conclusion. The current performance of the euro area is impressive. On the banking side, things are looking less bright. Banks are still struggling under the weight of problems dating back to the crisis years. There is no reason for panic: we know where these problems came from and we can handle them. But these problems are standing in the way of the much-needed trust to complete the Banking Union to further deepen the monetary union. So if there is one message that I would like to leave you with, it is that reducing the risks which still exist in the financial sector should be our top priority. This will enable us to complete the Banking Union and develop the mandate of the ESM, two important steps that will make Europe ready for the moment the next crisis hits.

Thank you for your attention.

Photo credit: Sandra Hauer

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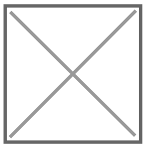

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