Global Financial Stability: Insights from Europe - speech by Rolf Strauch

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(*Please check against delivery*)

Ladies and gentlemen,

It is a pleasure to be with you today. The tenth anniversary of the collapse of Lehman Brothers provides us with an opportunity to look back and reflect on our response to the crisis and the progress we made since then. The European financial landscape has significantly changed over the last years and we find ourselves at a turning point.

During the global financial crisis, the euro area banking system was damaged, and interbank lending dried up. Europe was then hit by a second shock – a sovereign debt crisis. Problems in banks brought sovereigns into trouble, and vice versa. A negative feedback loop between banks and sovereigns emerged – the much-discussed bank-sovereign nexus – which had to be addressed.

Europe came up with a robust answer to protect the European Monetary Union (EMU). This led to two quantum leaps: the creation of the ESM as a crisis resolution mechanism for sovereigns, and the setting up of the Banking Union.

The ESM supported five countries – Ireland, Portugal, Spain, Cyprus and Greece. All countries have successfully exited their programmes. Greece was the last to do so. This constituted an enormous effort in terms of European solidarity – the ESM and EFSF provided almost €204 billion in support over the course of crisis years. But it was also a major effort by the Greek people. There is still much to be done. But we can see that the reforms are already bearing fruit. The country is returning to positive growth and there is a primary surplus in the budget. Now it is important that Greece continues the reforms, to sustain investor trust, secure market access and fully stand on its own feet again.

A lot has also been achieved in making the euro area banking sector safer. Euro area bank supervision and bank resolution were moved to the central level through the creation of the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). European supervision of national banks reduces political influence and increases the sharing of information.

Thanks to these measures, the euro area has left the crisis largely behind. Growth is substantially above long-term potential and some imbalances that arose prior to the crisis were overcome. Overall, public sector deficits and debt are improving. But there are still risks out there. Growth can be expected to slow down, as is normal in the course of the cycle. This slowdown may be accelerated if the current trade conflicts sharpen or emerging markets run into difficulties. A number of challenges also remain for the euro area banking sector.

In all of the programmes, strengthening the banking sector was an important part of the recovery. But the clean-up process takes time, and some banks still face legacy problems from the crisis. Many banks in Europe are earning less than their cost of equity, which has led them to take higher risks in mortgage markets and on stock markets in search for higher yields.

At the same time, another risk emerges: shadow banking, which the Global Financial Stability Report also points to. As banks pulled out of riskier businesses after the financial crisis, insurance companies and pension funds stepped in to swell the shadow-banking system to about 40% of the EU’s entire financial system and a full 82% of the size of the banking sector. This poses a challenge for regulation. We need more data on this sector to be able to better understand spill-over effects on the banking sector.

The speed of technological innovation is often seen as another challenge to the financial system. However, banks can turn this into an opportunity to jump into a more digitalized world and improve online services. The use of technology can help reduce the number of branches and therefore increase banks' operating efficiency.

Finally, recent money laundering scandals in some countries revealed potential gaps in the EU's supervisory framework, specifically regarding sharing critical information. The failure and difficulties some European banks experienced present challenges for the control of the financial stability risks.

These are some of the challenges Europe's banking sector is facing. They are challenges that, ultimately, only the banks themselves can address. On the policy side, we can complement their efforts by completing the Banking Union. In addition, euro area countries are discussing means to enhance the mandate of the ESM to make the euro area more robust to weather future crises. Let me turn to these two areas on which the Eurogroup is currently working. Hopefully euro area Heads of State or Government will take a further decision at their summit foreseen for December this year.

There are two concrete elements on the agenda for completing the Banking Union: a backstop for the Single Resolution Fund (SRF) and a European Deposit Insurance Scheme.

The financial firepower of the SRF is slowly being built up. However, if it wants to be credible in the eyes of the financial markets, it needs to be prepared for any eventuality. To this end, technical work on the design of the backstop is advancing. In June, a broad agreement was reached for the ESM to become this common backstop. This should be in place at the latest by 2024. If agreed, the ESM may take up its role as backstop earlier as well.

The second point to complete the Banking Union is a common deposit insurance for Europe. During the crisis, such an insurance would have helped to reduce ESM programmes. Therefore, we need to create an insurance to provide an equal level of protection for bank deposits – that means for savers – in the euro area and increase the resilience of Europe's banks against future financial crises.

I know that it is difficult at the moment to reach an agreement on the last steps of completing Banking Union. The level of trust between countries is low, often in view of the non-performing loans still being high in some countries, and because banks have not yet fully implemented all measures to make resolutions possible in the future without creating liabilities for others. The increased pressure on banks from the ECB and the European Commission with measures to avoid the build-up of future NPLs is certainly a necessary progress to advance on the Banking Union agenda.

Finally, let me say a few words about the future strengthening of the ESM, which is also on the agenda. A more powerful ESM is not a goal in itself, but it can be an element to make the monetary union more robust. During the crisis, the ESM has developed from an institute whose main function it was to disburse cash into a centre of know-how in areas such as market access and debt sustainability. That has lent it the reputation needed to broaden its mandate.

Four new tasks are being considered. In the first place, the backstop to the SRF, which I already mentioned. Then, the ESM will get a more prominent role in designing, negotiating and monitoring future support programmes, together with the European Commission.

Policy makers are also reviewing the lending toolkit of the ESM. We have six instruments at our disposal, but only two have ever been used. In particular, we want to make our precautionary credit line more effective in preventing the need for a full programme, but without attaching stigma. Fourthly, there may be a future role for the ESM to mediate negotiations between private creditors in case of a sovereign debt restructuring, along the lines of the London Club.

Conclusion

Ladies and gentlemen, as we look back at the crisis a decade after the collapse of one of Wall Street’s most prominent institutions, I believe Europe has made a robust effort to recover from the crisis. We have made progress that would have been unthinkable only a few years ago. That is not to say that the work is done. Completing the Banking Union and strengthening the mandate of the ESM are two additional important steps to prepare Europe for when the next financial crisis hits.

Thank you for your attention.

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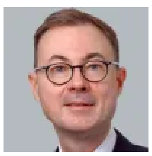

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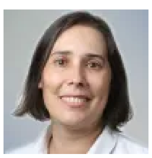

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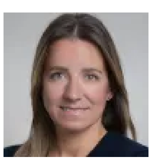

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