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Toward the European Banking Union: Achievements and Challenges

Europe has made significant achievements over the past five years. Since the start of the crisis in 2008, we have come a long way and the political will of the actors has been strong enough to defend the integrity of the euro area, which, in terms of economic fundamentals and institutional set-up, is today on a sounder footing than before. Also, the regulatory landscape has been revised substantially. We have taken major steps forward, the banking union being one of them.

Nonetheless, some challenges still lie ahead. The first and most immediate one is to rebuild confidence in euro area banks. To this end, the comprehensive assessment conducted by the ECB and the national competent authorities (NCAs) will play a key role. The goal of the comprehensive assessment is to foster transparency of banks' balance sheets, to repair them where needed and, consequently, to foster confidence in the banks, thereby unlocking a needed revival of credit to the euro area economy.

The comprehensive assessment is based on two important pillars: an asset quality review (AQR) and a stress test. The AQR covers EUR 3.72 trillion of risk-weighted assets (RWA), representing 58% of total credit RWA in the scope of the exercise and involving some 135,000 credit files. The stress test will provide a forward-looking view of banks' shock absorption under stress. The results of these closely interlinked elements will be published in October 2014. The SSM is now proceeding with the actual execution of the AQR (Phase 2), which will be completed by the end of July 2014. Regarding the stress test, the ECB is closely cooperating with the European Banking Authority (EBA). The capital thresholds for the baseline and adverse scenarios are 8% and 5.5% Common Equity Tier 1 respectively. The end result will be more demanding than in previous exercises. Banks will be given six to nine months to address possible capital shortfalls.

The second immediate challenge is to complete the SSM preparatory work before assuming supervisory responsibilities on 4 November. Much work has been done and several milestones have been reached, most recently the Framework Regulation that lays down the rules ensuring the smooth functioning of the SSM. At the same time, good progress is being made in finalising our supervisory model and recruiting supervisors in time. We have received over 8,000 applications and we are hiring the best of the best.

Long- term challenges are also being dealt with. The goals are to perform supervision with a truly European view, to ensure the effectiveness of the Supervisory Board, to foster convergence of supervisory practices and to integrate local supervisory best practices to the benefit of all SSM members.

The banking union is testimony to what Europe can achieve when it sets its mind to it, and by working together the ECB and the NCAs can meet their remaining challenges.

Ladies and gentlemen,
Thank you for inviting me here to this conference.

The topic of this session – *Toward a European Banking Union: Transitional Issues* – is well chosen at this point in time. We stand today in a transitional (and very busy) period, before the historical moment when the European Union will for the first time have a single European supervisor – the Single Supervisory Mechanism (SSM) – for the banks in the euro area and in any other Member State that wishes to join. As Chair of the Supervisory Board of the SSM, it is my pleasure to explain what we are trying to achieve.

Today, Vîtor Constâncio has already elaborated on banking union, with a focus on the Single Resolution Mechanism and on financial integration.

I would like to concentrate on two other aspects.

First, I will briefly remind you of Europe's significant achievements over the past five years. I believe this will put into perspective how far we have come in such a relatively short time.

As Chair of the SSM Supervisory Board, my goal is for the SSM to be a robust and effective supervisor, contributing to the safety and soundness of banks in the SSM area. Such an SSM will support financial integration, financial stability and economic growth. In order to achieve this goal, the SSM will need to overcome some challenges.

Second, I will take a forward-looking view and discuss the challenges that remain for the SSM.

Our Achievements

Since the start of the crisis in 2008, we have come a long way forward in a relatively short time. Indeed, the political will of all actors involved since the start of the crisis has been strong enough to defend the integrity of the euro area. Many had underestimated this will.

Remember that barely two years ago, at the peak of the crisis, there were fears about a break-up of the euro area and markets were pricing in this risk.

Today, however, the euro area is – in terms of economic fundamentals and institutional set-up – on a sounder footing than before.

In the public sector, gradual and continuous deleveraging has taken hold. The euro area has the lowest budget deficits and debt levels of the large advanced economies in the world. Moreover, the divergence within the euro area has been reduced.

As regards institutional set-up, we have taken major steps forward. We now have a stronger Stability and Growth Pact and the so-called fiscal compact. The Macroeconomic Imbalances Procedure (MIP) was introduced to enable macroeconomic imbalances to be identified and corrected at an earlier stage. We improved the effectiveness of European crisis management with the agreement on the European Financial Stability Facility and the European Stability Mechanism. We have established the European Supervisory Authorities (EBA, ESMA, EIOPA) as well as the European Systemic Risk Board (ESRB). Last but not least, we are of course working hard on the implementation of banking union. I will come back to this topic shortly when I look ahead.

In addition to the complete overhaul of the institutional set-up, the regulatory landscape has also been revised substantially.

Basel III and the Capital Requirements Regulation and Directive (CRR/CRD IV), which implement Basel III in Europe, introduced new requirements on the level and quality of capital, new rules on liquidity and leverage and instruments for macroprudential supervision. In December last year, political agreement was reached on the Bank Recovery and Resolution Directive (BRRD) and the recast Deposit Guarantee Systems Directive (DGSD). Both these directives will ensure a harmonised framework across the EU for resolution and deposit guarantees and are a prerequisite for the Single Resolution Mechanism.

Although we have come a long way forward in a short period of time, we are not there yet.

Let me therefore turn to the challenges that lie ahead. I will first discuss the challenges facing the SSM in the short term, before looking at the longer term.

The Challenges Ahead – Short Term

Our first and more immediate challenge is to help rebuild confidence in the balance sheet of SSM area banks. To this end, we are performing a comprehensive assessment. And by "we" I mean all of us together: staff from the ECB and from national competent authorities (NCAs) such as the OeNB and the Austrian Financial Market Authority.

As the comprehensive assessment is an essential element of the preparations for the SSM, please allow me to go into it in detail and explain the latest state of play.

The goal of the comprehensive assessment is threefold. First, to foster transparency of banks' balance sheets. Second, to repair balance sheets, where needed, by identifying and implementing necessary corrective measures. Third, to consequently foster confidence in the banks, thereby unlocking a needed revival of credit to the euro area economy.

The comprehensive assessment is built on two important pillars:

The first is an asset quality review (AQR), during which we review the quality of a banks' assets as per 31 December 2013. The assessment will be based on a capital benchmark of 8% Common Equity Tier 1.

To illustrate the scope and the comprehensiveness of the AQR, let me recall some figures. A total of around 760 banking book portfolios have been selected from the 128 banks in scope for a detailed examination. The AQR covers EUR 3.72 trillion of risk-weighted assets (RWA), representing 58% of the total credit RWA of all banks in the scope of the exercise. The examination will involve the review of approximately 135,000 credit files. In total, more than 6.000 supervisors, external auditing staff, consultants and independent specialist appraisers are working on the AQR. Quite impressive figures in my opinion!

The second pillar is a stress test, aimed at examining the resilience of banks' balance sheets to stress scenarios. The stress test will provide a forward-looking view of banks' shock-absorption capacity under stress. This exercise will follow the approach agreed with the EBA.

These elements are closely interlinked and will ensure a rigorous, independent and centralised comprehensive assessment. The results will be published in October 2014, shortly before the SSM is due to assume its operational responsibility.

Let me now turn to the state of play regarding the asset quality review.

Phase 1, the selection of asset portfolios to be reviewed for the asset quality review, has been completed.

We are currently in Phase 2, which is the actual execution of the AQR. It includes data integrity validation, sampling, on-site review of files, collateral valuation and recalculation of provisions and risk-weighted assets.

The AQR is all about transparency. In this spirit, the ECB published the AQR Phase 2 manual on 11 March 2014. The full details of the different building blocks of the AQR are now available online for everyone to see. As the manual runs to around 280 pages, we held conferences with NCAs and auditors to fully explain the methodology and templates. By providing full disclosure of the AQR methodology, the ECB has further increased the credibility of the exercise and shown its rigour.

Phase 2 of the AQR is now well under way and will be completed by the end of July 2014, when the results of the AQR will feed into the stress test.

All in all, we are on track for the AQR. Disclosure of the results (together with the stress test results) is planned for October 2014.

As regards the stress test, the ECB is cooperating closely with the European Banking Authority (EBA).

The EBA published the stress test methodology and the scenarios on 29 April 2014. While the extensive process of banks' balance sheet repair is already under way, the stress test, designed to assess banks' resilience to hypothetical external shocks, will identify remaining vulnerabilities in the EU banking sector and will provide a high level of transparency on EU banks' exposures. The capital thresholds for the baseline and adverse scenarios will be 8% and 5.5% Common Equity Tier 1, respectively.

The common methodology and underlying assumptions cover a wide range of risks including credit and market risks, exposures towards securitisation, sovereign and funding risks. To ensure consistency, the methodology is restrictive and rests on a number of key constraints. These include a static balance sheet assumption during the stress test horizon of three years, which precludes any defensive actions by banks. The methodology defines prescribed approaches to market risk and securitisation, and a series of caps and floors on net interest income, risk-weighted assets and net trading income. Other key components of the methodology are a sovereign shock that impacts banks' entire balance sheets, including exposures held in the available-for-sale portfolio via the internationally agreed gradual phase-out of prudential filters, and a shock to banks' funding costs that pass through to the asset and liability side in a conservative asymmetric fashion.

The adverse scenario, designed by the ESRB, reflects the systemic risks that are currently assessed as the most pertinent threats to the stability of the EU banking sector. Allow me to highlight four particular risks that demonstrate the severity of the stress test.

First, an increase in global bond yields amplified by an abrupt reversal in risk assessment, especially towards emerging market economies; second, a further deterioration of credit quality in countries with feeble demand; third, a stalling of policy reforms jeopardising confidence in the sustainability of public finances; and fourth, the lack of necessary bank balance sheet repair to maintain affordable market funding.

The stress test for the banks subject to the comprehensive assessment will incorporate the results from the AQR. Banks with a capital shortfall arising from either the baseline or adverse scenario relative to agreed benchmarks or identified in the AQR will be required to strengthen their capital buffers. The end result will hence be more demanding than in previous exercises.

Banks will be expected to raise capital to cover a capital shortfall arising from the AQR or baseline scenario within six months. For capital shortfalls arising from the adverse scenario, banks will have nine months to raise capital, on the basis of an agreed capital plan, so long as regulatory minima are respected. The periods of six or nine months will start from the release of the comprehensive assessment results in October 2014.

The bank's capital plans should show that they will first draw on private sources of funding to strengthen their capital positions so as to meet the required targets, including retained earnings, reduced bonus payments, new issuances of common equity, suitably strong contingent capital, and sales of selected assets at market prices or reductions of RWAs associated with restructuring plans agreed with the European Commission.

Recapitalisation measures to cover any shortfalls detected should rely on capital instruments of the highest quality, unless the shortfalls are reduced through other means. Shortfalls revealed by the AQR and the baseline stress test scenario may only be covered by Common Equity Tier 1 (CET1) capital instruments. The use of Additional Tier 1 (AT1) capital instruments to cover shortfalls arising from the adverse stress test scenario is limited, and depends on the trigger point of conversion or write-down.

Helping rebuild confidence in the SSM banks' balance sheets is not the only short-term challenge. *The second challenge is to complete the SSM preparatory work before assuming supervisory responsibilities on 4 November 2014.* Much work has already been done to ensure we will be ready.

The latest milestone we reached in this respect is the finalisation and publication of the SSM Framework Regulation on 25 April. The purpose of the Framework Regulation is to lay down the main rules which will ensure the smooth functioning of the SSM. In this context, it sets out the procedures governing the cooperation between the ECB and NCAs and the methodology for the assessment of the significance of institutions.

Much remains to be done, however. Let me mention two major milestones ahead.

First, we need to finalise our supervisory model. Our supervisory model is reflected in the draft Supervisory Manual of the SSM. The manual covers issues such as the methodology for the Supervisory Review and Evaluation Process (SREP), off-site and on-site reviews, risk assessments and model validations. Through the supervisory manual we will ensure that the same supervisory standards will be applied across banking union – and indeed, through harmonisation with the European Banking Authority, across the EU as a whole. The Supervisory Manual is an internal SSM staff document, but we intend to derive a public version from it, entitled *"Guide to supervisory practices and methodologies in the SSM"*.

Second and not least, we need to recruit supervisors. Many of them, in fact – approximately 800. We are also progressing well on this front. Most of the recruiting campaigns should be concluded before the summer break and the remaining ones soon after. We need the best of the best and our call for applications has been very successful so far. We have received over 8,000 SSM-specific applications, so there is no scarcity of talent from which to choose.

Successful applicants will have the opportunity to help build the SSM and to work in a challenging new environment. Austrian applicants will bring their own expertise and best practices to the SSM. This will be of benefit to all of us – the SSM, the OeNB and Austrian Financial Market Authority, and the Austrian and European financial sector.

Challenges Ahead – Long-Term

Our first long-term challenge is to perform supervision from a truly European perspective

Supervisors at the ECB will come from diverse backgrounds. But we are all "European" when we supervise a bank. The supervisory culture within the SSM should be European rather than national. With this objective in mind, the SSM Regulation contains provisions regarding independence. Supervisory Board members should act in the interest of the EU as a whole and not in their national interests. Similarly, the ECB has introduced Joint Supervisory Teams (JSTs), which will be responsible for the operational supervision of significant banks and will consist of supervisors from different countries. This will allow us to incorporate the existing local expertise at a central level, while at the same time ensuring a European view when supervising individual banks.

Second, we need to ensure that the Supervisory Board is effective

You will know that the Supervisory Board consists mainly of a large group of supervisors from the SSM area who act in the interest of the EU as a whole. And in the future, non-euro area Member States may also join the SSM. The governance structure of the SSM is therefore carefully designed, with a Supervisory Board which interacts with the ECB Governing Council.

National competent authorities (NCAs) will present this governance structure with multiple issues for decision and action, especially in times of stress. Decisions relating to supervision may considerably outnumber those relating to monetary policy.

I am very ambitious to meet this long-term challenge. I want to make the SSM function as a European institution, taking European decisions. I believe our accountability towards the European Parliament – the champion of European decision-making – will be helpful in this regard.

The third long-term challenge is to bring about a convergence of supervisory practices and approaches

Ideally, we would have fully harmonised EU regulations – there are still too many national options in CRD IV, meaning that the EU capital requirements regime may differ across Member States on a number of points. That is why I fully support the development of the single rulebook for the EU.

The SSM's Supervisory Manual I referred to earlier will be embedded in this single rulebook. It is my aspiration to make the SSM a benchmark for supervisors worldwide. This manual is therefore being developed on the basis of the best supervisory practices and processes of supervisors from the SSM Member States.

But ultimately, the Supervisory Manual must be more than words on a page. It needs to be implemented in all SSM countries to foster the necessary convergence of supervisory practices and we will make sure that happens. The manual will be subject to a continuous review process against internal evaluations, internationally accepted benchmarks and international regulatory developments.

Finally, I wish to mention *the long-term challenge relating to local supervisory best practices*. The SSM needs to integrate local supervision best practices to the benefit of all SSM members. As the SSM aspires to be a single best practice framework, we need to ensure that it fully incorporates the expertise of national supervisors in order to enhance the quality of supervision for the SSM area as a whole. We can all learn from each other, and local supervisory best practices should not be discarded *accidentally or unintentionally*.

I think we can learn from the strong role played by Austrian supervisors in assessing and mitigating risks stemming from Austrian banks granting foreign exchange loans to households. I understand that the end result was a restriction on issuing foreign exchange loans to retail customers. The SSM could draw on this experience when it comes to addressing unsustainable business models.

Conclusion

To conclude, let me take you back to 2009. To Wednesday 25 February 2009 to be exact, the day of publication of the "de Larosière Report", advocating the creation of a European System of Financial Supervision (ESFS) and a common framework for bank resolution. If de Larosière had then suggested having a *single* European supervisor and *single* European resolution authority – rather than the decentralised network of the ESFS he proposed in his report – the almost universal reaction would probably have been, "That is not realistic."

Five years after de Larosière and less than two years after Europe committed to building a genuine banking union, this is where we stand!

Europe has delivered on its banking

union promise. For those that criticise Europe for being slow in taking decisions, I think this is testimony to what Europe can achieve when it sets its mind to it.

I am therefore confident that – together – we can meet our remaining challenges and leave the transitional issues of banking union behind us. And I look forward to working with you – the OeNB and the Austrian Financial Market Authority in particular – when supervising the SSM area.

Thank you!