DEBATE

Alessandro Merli, Frankfurt Correspondent, *Il Sole 24 Ore*

Mr von Oesterreich, are you convinced by Mr Coeuré's argument that there will be no mutualisation of losses? It should be noted, and I do not know if it is commonly known, that Germany spent more money on helping its banks after the crisis than even Spain in terms of percentage of GDP. According to the IMF, Germany spent twice as much as Spain to help its banks. Germany will say it is their money and they will do what they want with it.

Constantin von Oesterreich, Chairman of the Management Board, HSH Nordbank

Obviously, I subscribe to the Central Bank's view on this occasion, because the banking industry is an important part of all our future, especially for Germany, so we are in principle in full agreement. Germany did everything to stabilise its banking industry, and I am happy to report that the last tranche of aid was paid last week, so the agency now has no more debt outstanding to the system. This means we are heading in the right direction overall.

Alessandro Merli, Frankfurt Correspondent, *Il Sole 24 Ore*

This exercise is supposed to last for about 12 months. The ECB will take several steps; they will look at the general risk of the banks, evaluate their balance sheets in the asset quality review, and then do the stress tests. Twelve months is a very long time for markets and can create a lot of uncertainty for banks in terms of risk of short-term deleveraging. Things may get better in the long term, in that we may have a more stable and better supervised banking system. Is there a risk of more deleveraging and heightened volatility in the next 12 months, which may threaten the recovery?

Benoit Coeuré, Member, Executive Board, European Central Bank

While it is true that 12 months is a long time for financial markets, they are very forward-looking, so anything that happens over the next 12 months is already in their plans. A lot of what Philipp has described, money coming back into peripheral countries and non-Euro investors buying bonds issued by banks, including in southern Europe, which we have seen in the last few months, is in anticipation of the banking union. They will not react on 14 November 2014; they are taking decisions today, and rightly so.

We have a deleveraging trend in the European economy already, and certainly in the banking sector, and this is accelerated to some extent by the banking union and the asset quality review and stress tests. The sooner the better, because once it is done, it will free up the capacity of banks to lend to the economy. Banks should have the ability to restructure their balance sheets, to shed some portfolios of not-very-well-performing loans. Today there is no price in many places because there is too much uncertainty, and that is precisely the purpose of the asset quality review, to create trust around the price of the assets. Then there will be a market, and banks can then rearrange their balance sheets and create room to lend to profitable projects in the economy. This really serves a positive purpose, which is to help restart growth.

Alessandro Merli, Frankfurt Correspondent, *Il Sole 24 Ore*

Mr von Oesterreich, what is your view on that? Will your institution deleverage, or do you see much deleveraging going on in the next 12 months that may worsen credit provision?

Constantin von Oesterreich, Chairman of the Management Board, HSH Nordbank

The larger banks are concerned, and they have already known about this topic for a long time and are working it out very extensively. I do not see much fear there, and other non-core financial institutions are stepping in, like the shadow banking system or insurance companies. Therefore, as far as I can see, there is no shortage of money supply where the industry is concerned; obviously I am speaking more for Germany than for other countries.

Alessandro Merli, Frankfurt Correspondent, *Il Sole 24 Ore*

Philipp, you alluded to the US experience earlier. The US did it the reverse way to what the Europeans are doing now; they first had the money there, and as Mario Draghi once said, just by magic the needs corresponded exactly to the money that was put in place, so everything worked out. The Eurozone is still unclear about the backstop. There are some proposals on how the fund should be arranged fiscally speaking. How do you see this ending? Will the Eurozone, even though it did the reverse process, end up like the US or like Japan?

Philipp Hildebrand, Vice Chairman, BlackRock, former Chairman of the Swiss National Bank (SNB)

Let me put it this way; it has taken a very long time to get to where we are today. I keep reminding people that we are about to start year six after the crisis, which is quite extraordinary when you think about it. There is no reason this should have taken so long, but that is history. Europe is a unique construct, and our American friends often have difficulty understanding its complexity. Frankly, if we ended up in a Japanese situation, that would be an unforgiveable mistake given where we are today. There is no reason to end up in that type of environment, provided that this show can be kept on the road, so to speak. I think that this entire banking union exercise is absolutely crucial for the next year, because it will lay the foundation for growth to come back.

If we had a clearly committed European backstop that would enhance confidence in the entire process. I would simply say, at this point, that I am not sure the money was really there in the US at the time.

Alessandro Merli, Frankfurt Correspondent, *Il Sole 24 Ore*

It was announced.

Philipp Hildebrand, Vice Chairman, BlackRock, former Chairman of the Swiss National Bank (SNB)

It was announced, and we could have a long discussion to see whether the money was really available there and then. When you hear this backstop discussion in a European context though, people overlook that there is still a fair amount of money which has been committed, passed in the national budget and is still available in the various stabilisation funds. For instance, Greece has EUR11 billion in its stabilisation fund, and Spain has even more; a number of countries have capacity left in their funds, and obviously the big countries like Germany certainly have budget capacity if it were to become necessary. Therefore, there is money in Europe; it is not as clean or as neat as it would be if we had a European backstop, but there is some money left.

Secondly, one should not over-dramatise the problem. The worst estimate I have seen of the capital shortfall is EUR200 billion, so the ranges are somewhere between EUR30-200 billion. Let us take the wildly pessimistic number that was put out by one of the Big Four Audit Firms; even that number represents 1.3% of the collective European banking balance sheet, so let us not turn this into a story of the entire banking system in Europe being insolvent. EUR200 billion would be a very big number, and frankly I doubt that is the right number, but even if it were, it is not beyond the fiscal capacity of the Eurozone, if you look at the countries that still have capacity and at the money that is already earmarked in the various stabilisation funds.

There are elements of a European backstop in place already today; you have the ESM, and from the way I read it you have significant progress on the bank resolution fund. That is not something which has been fully priced into the market yet, and if the leaders can deliver next weekend, that is a very important next step in the so-called mutualisation of the banking system, in the deeper integration of the Eurozone.

Would it be nice to have a big European backstop? Yes, of course it would be, but I do not think the fact that we do not have one perfectly set up and clean means that this problem is insurmountable.

Alessandro Merli, Frankfurt Correspondent, *Il Sole 24 Ore*

You mentioned the vicious circle between sovereigns and banks, and there has been some recent discussion about the way sovereign bonds in bank balance sheets should be treated, not so much in the AQR but in the street tests, and there is a need for some clarity there.

Benoit Coeuré, Member, Executive Board, European Central Bank

I am happy to provide the clarity on that aspect. Regarding the capital shortfall, I am not going to comment on the numbers, which I don't know yet, but there is sometimes a perception in the market that any capital shortfall arising from asset quality review and stress tests would have to be covered by governments. This is no longer the case; the world has changed. There will be a very clear watershed of capital coverage. Banks should first raise capital in the market, and the vast majority of European banks can raise capital in the market, so shareholders will not be happy – that is life – but they will raise capital in the market. Then, if there is any need for public money, there will be bail-in of some categories of investors under the new competition guidelines issued in July by the European Commission; again, this is not money that will come from the taxpayer. Therefore, the taxpayer is really the last resort contributor, and, as Philipp said, there is a European backstop, which is the ESM. We did it in Spain, and it worked very well, so it could be done if needed for other countries. However, the backstop is really a last resort.

Alessandro Merli, Frankfurt Correspondent, *Il Sole 24 Ore*

The Spanish actually needed much less money.

Benoit Coeuré, Member, Executive Board, European Central Bank

Yes, they used much less money than initially planned, less than half of what was appropriated by the Eurogroup. Coming now to sovereign exposure, there is sometimes confusion between the asset quality review and the stress test. The asset quality review is really an accounting exercise; it is an audit that has to be done differently from the past, but it is a snapshot of the balance sheets and levels of regulatory capital. It has to be done under current rules, and the European rule is CRD4. Basel III does not necessarily force zero exposure on sovereigns, but this what the EU has chosen to do in CRD4 and as a European supervisor, the ECB has no choice but to enforce European law as it is. This is a supervisory exercise, not a lawmaking exercise.

Then there will of course be a stress test, and the stress test is about scenarios which have to apply to all items of the balance sheet, including exposure to sovereigns. The stress test is really the right place to have that discussion.

Alessandro Merli, Frankfurt Correspondent, *Il Sole 24 Ore*

I thought I understood something about the crisis in the European banks, especially the Spanish banks. When I opened a copy of *El Pais* one day, there was a picture of a chairman of one of the banks that failed, and he was the local bishop. I thought that something must be wrong here; if the bishop is running the bank, no wonder the bank failed. I am saying this because we have this interaction between banking and politics in many European countries. One of the clearest cases of mismanagement was in one of the banks in my own country, Monte dei Paschi di Siena, which also happens to be the oldest bank in the world, where there was so much interference from local politics that eventually it was run very badly. There were instances of that in Germany as well, where many of the appointments were not done on the basis of competence.

Do you feel that European supervision will put an end to this mixture of banking and politics?

Constantin von Oesterreich, Chairman of the Management Board, HSH Nordbank

That is a very difficult question to answer. We have to find an equilibrium between supervision, external guidance, and running our business successfully. Currently, in the run-up to the balance sheet assessment and the stress tests, there is an overburdening of administrative work to be done from various parties, whether the local regulators or the European regulators, and if you are a state-owned bank your own government is obviously very interested in how things are going. What we are looking for at the end of the day is to have a clear-cut and very precise regime and that we can work successfully within this regime, and this year.

It is an important point to make in a policy forum that this should be done in a way that is good for the industry, and that obviously will also help the industry to recover fully at the end of the day and to be what it was in the past.

Alessandro Merli, Frankfurt Correspondent, *Il Sole 24 Ore*

Where do you see the European banking industry and its supervisory and regulatory side in five years' time, say, when the dust will have settled on this?

Benoit Coeuré, Member, Executive Board, European Central Bank

I am hesitant to even answer the question, because that is really a market process, so we should not prejudge what market forces will shape the industry. It is not only about supervision but also technology, which will be very important in the banking industry, including over the next five years, with e-banking, non-bank competitors, etc. Therefore, I will not be very prescriptive, as that is not my role here; I will say that I expect the financing of the European economy to evolve somehow away from the traditional continental European model and toward the Anglo-Saxon, the US, model, though not of course all the way, as it is not needed; it does not make sense in the European context. However, I would expect a little less bank financing and a little more of arm's-length financing through capital markets, including securitisation, and going a little more in that direction would make the system more resilient to shocks such as those we have seen in the current crisis, which have very much impacted banks.

Therefore, there will be more of a role for non-bank actors and a little more of the originate-and-distribute model for bank loans, which of course will create issues, because we know that the originate-and-distribute model has failed in the US in many respects, so this will have to be monitored very carefully. One of the big challenges, not really for bank supervision particularly but for financial supervision and financial conduct generally if we want to move in that direction, will be to monitor the ability of non-bank actors to assess and manage credit risk and follow loans over their life cycle.

Philipp Hildebrand, Vice Chairman, BlackRock, former Chairman of the Swiss National Bank (SNB)

I think that is basically right. Perhaps the one point I would add is that hopefully we will see consolidation, or further consolidation. This process is well underway in Greece and I would expect Germany to consolidate eventually, but that might take a little longer. The next year is crucial, because if this confidence game works it has to work over the course of the next year. Sadly, the contracting credit cycle will probably continue to be present for most of the year; hopefully the second derivative will change and the contraction will become less. However, and this is the bad part of the adjustment, we will continue to see some deleveraging, which will continue to weigh on credit, and therefore I expect growth to be fairly muted in Europe. That said, we have a global cycle which is on the uptick.

The other thing I am optimistic about for the next year or two – and something which is not appreciated enough yet – is that 2014 will be the story of a fantastic re-rating of the periphery in Europe. I do not think Anglo-Saxon investors have fully understood how significant the structural change has been in the south in Europe, primarily Spain, but even in Portugal and Greece. Therefore, from an investment perspective, we will hopefully see capital flow to the banks in the region that has been hurt the most.

Then I have this perhaps slightly idealistic hope; that France will realise that the south is now outperforming and suddenly looks much more competitive. The hope is that this can be an added motivation for France to implement the kinds of reforms that will be necessary to make the Eurozone truly lasting and stable, by having France return to being an unequivocally strong member of the Eurozone.

It is one thing to lose against Germany; many soccer teams from many countries are used to that. It is perhaps another thing when you start to lose against Spain, Greece, or Portugal, and that would be, in a way, a healthy process for the Eurozone as a whole.

Alessandro Merli, Frankfurt Correspondent, *Il Sole 24 Ore*

Regarding soccer, we have now got used to losing to the Spanish for the last several years.

Constantin von Oesterreich, Chairman of the Management Board, HSH Nordbank

Everything we are talking about now will be fully digested in five years' time, and I am absolutely convinced that the financial industry will have fully reinvented itself. We do not have the faintest clue today what we will look like then, but I am pretty sure that we will be in very good shape by then.

Alessandro Merli, Frankfurt Correspondent, *Il Sole 24 Ore*

The only thing I would take away is the words Philipp used at the very beginning, 'fragile optimism.' 'Fragile' is also a favourite word of Mario Draghi lately. I am not sure whether this panel would put the emphasis on the fragility or on the optimism, but maybe slightly more on the optimism given the view of the markets.