BY KLAUS C. ENGELEN

Stress Test *Blues*

The trials and tribulations of European banks.

One thing has been clear since the European Central Bank was empowered as top supervisor for eurozone banks at the June 2012 EU summit. Before the ECB would assume responsibility as the euro area's lead bank supervisor in November of this year, a comprehensive health check of bank balance sheets and a tough stress test in cooperation with the London-based European Banking Authority would be needed.

So it was timely for *The Economist* at the beginning of this year to look at the euro area's negative legacy regarding bank stress tests. In an article titled "Setting the exam," it reminded its readers, "Stress tests have had an inglorious history in Europe since they were introduced in the wake of the financial crisis along with new institutions such as the much-scolded EBA, which has the job of harmonizing bank regulations and coordinating national supervisors across the 28-country EU."

A July 2011 Bloomberg news report on the market reaction to the 2011 EBA stress test results, "EU bank stress tests missing sovereign defaults fail to convince analysts," captures the European Banking Authority's spectacular failure. "The European banking stress test is unlikely to provide much in terms of assurance to the markets … Concerns about contagion of the sovereign debt crisis into core Europe have taken center stage." Dexia, for example, the Franco-Belgian bank that had required state aid in 2008, passed the EBA's stress tests in the

---

Klaus Engelen is a contributing editor for both Handelsblatt *and* TIE.

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E.
Suite 200
Washington, D.C. 20002
Phone: 202-861-0791
Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

Policymakers have gambled that economic recovery would raise the profitability of financial institutions. It's now clear that this strategy failed.

summer of 2011, but three months later had to be rescued in another bail-out operation by the French and Belgian governments.

To put the 2014 EBA/ECB stress test in perspective, leading experts such as Harald Benink, Harry Huizinga, Daniel C. Hardy, and Heiko Hesse argue that unlike the United States, Europe failed to recapitalize its biggest banks following the financial crisis of 2007–2009. Instead, policymakers have gambled that economic recovery would raise the profitability of financial institutions, enabling them to increase their capital buffers over time. It's now clear that this strategy failed. Without such recapitalization, there is the danger that economic stagnation will continue over a long period, putting Europe on a course toward Japanese-style inertia and the proliferation of zombie banks.

Ever since Dutch Finance Minister and Eurogroup President Jeroen Dijsselbloem, backed by German Finance Minister Wolfgang Schäuble, shifted eurozone bank rescue policy in the direction of resolution without using taxpayer money in the case of Cyprus, the need for credible bail-in rules and a new push for cleaning up bank balance sheets has become obvious. The chaotic Cyprus rescue marked a low point in the governance of the ECB and the European System of Central Banks, since the Eurosystem kept Laiki, the country's second-largest financial institution, above water with Emergency Liquidity Assistance loans to the tune of €9.4 billion, although Laiki was bankrupt for more than a year.

But the ECB as lead bank supervisor, along with major euro area governments, is pushing in the direction of precautionary bank recapitalization, showing that the eurozone's pro-bailout interests are still very powerful. Whether the EU Commission as guardian of strict state aid rules can make a difference remains to be seen.

ENTER THE NEW EUROPEAN BANK SUPERVISOR

To put it mildly, the ECB's launch as the eurozone's lead bank supervisor was bumpy. In the driver's seat is Danièle Nouy, a former veteran French bank supervisor, who chairs the Supervisory Board of the single supervisory mechanism at the ECB. She and her new team need to cooperate closely with the London European Banking Authority regulators in the framework of the ECB's

Tough Road Ahead

The ECB's launch as the eurozone's lead bank supervisor was bumpy. In the driver's seat is Danièle Nouy, a former veteran French bank supervisor, who chairs the supervisory board of the single supervisory mechanism at the ECB. She and her new team need to cooperate closely with the London European Banking Authority regulators in the framework of the ECB's "comprehensive assessment" that includes an asset quality review, a stress test, and a supervisory risk assessment. According to the ECB, it is "the largest such exercise ever undertaken in terms of the numbers of banks, their overall size, and geographical reach."

After decades as a bank supervisor, Nouy seems to be aware of the reputational risk a failed health check of bank balance sheets and another stress test debacle pose in the build-up phase of European banking union. "We know that we have a single opportunity to establish our credibility," she confessed in a recent *Financial Times* interview. She has good reason to fear that the ECB will further damage its credibility by taking on the mammoth task of pan-European bank supervision in a rush and without prior supervisory experience.

—K. Engelen

Danièle Nouy, *Chair of the Supervisory Board of the single supervisory mechanism at the ECB.*

German Chancellor
Angela Merkel

No Meddling

Chancellor Angela Merkel is not hiding her apprehension with respect to establishing the first pillar of the ambitious European integration project.

Speaking at a Berlin conference of Germany's cooperative banks about the challenges of the ECB health checks for the large euro area banks, Merkel warned, should politicians interfere, "the reputation of the ECB as an oversight authority will be damaged before it starts." In her view, it is "very important to regain the confidence of international markets in the European banking system."

—*K. Engelen*

"comprehensive assessment" that includes an asset quality review, a stress test, and a supervisory risk assessment. According to the ECB, it is "the largest such exercise ever undertaken in terms of the numbers of banks, their overall size, and geographical reach." As the ECB announced in its October 2013 note, "Given the unprecedented scale of the exercise that will involve some 130 credit institutions in 18 Member States, covering approximately 85 percent of euro area bank assets, a system-wide approach is necessary. The ECB will conduct the exercise, detailing its design and strategy, monitoring its execution in close cooperation with the NCAs." (In official ECB terminology, all national bank supervisory authorities—whether operating under the helm of central banks or standing alone as in the case of Germany's Federal Financial Supervisory Authority—are called "national competent authorities.")

In a further step, on March 11, 2014, the ECB published its manual for the asset quality review. It contains the applicable methodology and provides guidance for the NCAs and their third-party support in carrying out the exercise as part of the comprehensive assessment. In October 2014, the results of the asset quality review will be released together with the results of the stress test conducted by the ECB in cooperation with the European Banking Authority. Subject to the comprehensive assessment are the major European banks that will fall under the ECB's supervision in the future.

"The banking union," argues Nouy in an upbeat mood, as she recently addressed the traditional Economic Conference of the National Bank of Austria in Vienna, "is testimony to what Europe can achieve when it sets its mind to it, and by working together the ECB and the national competent authorities can meet their remaining challenges. … And by 'we', I mean all of us together: staff from the ECB and from the NCAs."

ONE SHOT TO ESTABLISH CREDIBILITY

After decades as a bank supervisor, Nouy seems to be aware of the reputational risk a failed health check of bank balance sheets and another stress test debacle pose in the build-up phase of European banking union. "We know that we have a single opportunity to establish our credibility," she confessed in a recent *Financial Times* interview. She has good reason to fear that the ECB will further damage its credibility by taking on the mammoth task of pan-European bank supervision in a rush and without prior supervisory experience.

Concerns about possible failures and setbacks in establishing bank supervision at the ECB level have also reached the top levels of the German government. Chancellor Angela Merkel is not hiding her apprehension with respect to establishing the first pillar of the ambitious European integration project.

Speaking at a Berlin conference of Germany's cooperative banks about the challenges of the ECB health checks for the large euro area banks, Merkel warned, should politicians interfere, "the reputation of the ECB as an oversight authority will be damaged before it starts." In her view, it is "very important to

Since the ECB is paying much higher salaries and can offer considerable tax benefits, lower-paid national bank supervisors are tempted to apply for jobs.

regain the confidence of international markets in the European banking system."

Contrasting with apprehension from Nouy and Merkel are the threats of ECB President Mario Draghi that, "Officials won't hesitate to fail banks in its stress test" since "banks do need to fail" to prove the credibility of the exercise. Draghi expressed this warning in an interview with Bloomberg last October. "If they do have to fail, they have to fail. There's no question about it."

At the Eurotower site in Frankfurt, where the pan-European bank supervision authority is in a somewhat chaotic construction stage, an expanding press contingent has been doling out doubtful progress reports. Nouy and her newly formed single supervisory mechanism team cannot hide their problem: they have to set up a new organization of supervision from scratch and have only a few months to get the SSM operational. And they face an ever more frustrated banking community that, so far, is not openly revolting for fear that their complaints could damage their banks' standing in the markets.

Since the ECB is paying much higher salaries and can offer considerable tax benefits, lower-paid national bank supervisors are tempted to apply for jobs at the Eurotower. Filling about eight hundred positions in bank supervision plus about two hundred in support services, such as information technology, statistics, and legal, seems manageable, says a German bank supervisor. So it doesn't come as a surprise when Nouy assures: "Good progress is being made in finalizing our supervisory model and recruiting supervisors in time. We received over eight thousand applications and we are hiring the best of the best."

But the question is whether the new SSM organization that is still operating on seconded staff from the NCAs and relies for much of the preparatory work on a highly controversial "internal consultant firm," namely Oliver Wyman, will be functioning in November.

Veteran bank supervisors doubt that such a bank supervisory apparatus built from scratch can be fully operational in such a short time.

ECB President **Mario Draghi** *on banks in the stress test: "If they do have to fail, they have to fail. There's no question about it."*

Veteran bank supervisors doubt that such a bank supervisory apparatus built from scratch can be fully operational in such a short time. At the recent German Banking Congress in Berlin, Jens Weidmann, president of the Bundesbank, reminded a highly skeptical German audience including central bankers and supervisors that transferring bank supervision from the national to the European level, setting up supervision for systemically important large banks, and organizing a balance sheet check is a project comparable in its complexity with the introduction of the euro that took almost a decade. And all this should be "rolled out at seven times the speed?" Weidmann asked.

A BALANCE SHEET CHECK OF UNPRECEDENTED DIMENSIONS

In Nouy's Vienna speech, in order to illustrate the scope and the comprehensiveness of the asset quality review, she gave the following figures: "A total of around 760 banking book portfolios have been selected from the 128 banks in scope for a detailed examination. The asset quality review covers €3.72 trillion of risk-weighted assets, representing 58 percent of the total credit risk-weighted assets 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 asset quality review."

As the ECB noted in February, "The capital adequacy threshold for the baseline scenario will be 8 percent Common Equity Tier 1 capital, whereas—as communicated by the European Banking Authority—a threshold of 5.5 percent CET1 will apply in the case of the adverse scenario. The baseline threshold is identical to the minimum threshold being applied in the asset quality review. If a bank's capital falls below the predefined threshold at the end of the stress test horizon, remedial action must be taken. The definition of CET1

Continued on page 59

Continued from page 41

capital used for the stress test will be that applicable at the end of the horizon on 31 December 2016."

On April 29, 2014, the European Banking Authority published its methodology and macroeconomic scenarios for the 2014 EU-wide stress test. "While the extensive process of banks' balance sheet repair is already underway," says the EBA, "the 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 into EU banks' exposures." Banks will be given six to nine months to address possible capital shortfalls.

NO WELCOME MAT FROM THE GERMAN HOSTS

Taking a closer look at the Single Supervisory Mechanism, *Handelsblatt* in mid-March offered a devastating assessment, calling on Mario Draghi to take charge "if he doesn't want to damage his credibility." Talking to insiders, bank supervisors, auditors, accountants, and consultants, they found "a lack of qualified personnel, lack of orientation, lack of concepts, lack of standards, lack of communication." They titled the cover story "Out of Control," arguing that "the ECB is not sufficiently prepared as bank supervisor."

They found that the ECB's bank supervisory section "is a bank supervision without bank supervisors," with top personnel but lacking the specialists doing the necessary analysis. The SSM receives masses of data that are not compatible, and thus difficult to evaluate. There is a problem with reliable definitions, for instance with respect to non-performing loans. Stefan Winter, who heads the Association of Foreign Banks in Germany, was quoted as warning, "The ECB will have a problem with communicating its asset quality review and stress test results, since publicly listed banks are forced to immediately publish pertinent market information." Therefore, *Handelsblatt* concluded, "ECB President Draghi has reason to fear that Nouy's 'one try to establish our credibility' will go wrong. The consequences would be fatal."

Such public criticism hasn't come from the twenty-four German financial institutions which are part of the 128 systemically important banks under review, which represent around 65 percent of the German banking sector. "Bank managements under the asset quality review and the EBA stress test are keeping their mouths shut but are speaking through their actions as the stunning recent capital increase of Deutsche Bank demonstrates," says a former top German bank supervisor.

As to the implications for Germany of transferring national bank supervision to the European level, a former top bank supervisor notes, "National competent authorities such as BaFin have lost most of their courage and power already; the transfer of sovereignty, however, will not stop there. It will especially relate to national parliaments and governments to regulate and supervise their banks. Conflicts are not really expected since the legal basis is by and large irreversible. It's clear that the national competent authorities are no longer in the driver seat, but are involved under ECB leadership."

THE STRESS TEST IS ANOTHER MATTER FOR GERMAN BANKS

For many banks, the year 2014 brings—along with near-zero interest rates and therefore not very healthy margins and a somewhat improving economic outlook—a lot of stress because of the broad-based EU stress test exercise. At a recent *Handelsblatt* conference on the future of Germany's savings bank sector, Georg Fahrenschon, president of the German Savings Banks Association, blasted the new European banking union project because it puts the German savings bank sector under a "regulatory tsunami" and threatens a redirection of its deposit protection funds to safe banks in other eurozone countries. Germany's 431 savings banks, with 15,600 branches, more than €1 trillion in total assets, employing 250,000, and serving fifty million clients have a lot of political clout. For Fahrenschon, some of the stress test parameters that banks need to reach "are beyond comprehension, for instance with respect to future German housing prices."

Not So Fast

Jens Weidmann, president of the Bundesbank, reminded a highly skeptical German audience including central bankers and supervisors that transferring bank supervision from the national to the European level, setting up supervision for systemically important large banks, and organizing a balance sheet check is a project comparable in its complexity with the introduction of the euro that took almost a decade. And all this should be "rolled out at seven times the speed?" Weidmann asked.

—*K. Engelen*

Bundesbank President
Jens Weidmann

Germans Are Also at Fault

Martin Hellwig, co-author of *The Bankers' New Clothes,* defends the banking union approach. He blames Germany's politicians for past failures. Hellwig is a fellow of the Max Planck Institute and an advisor to the European Systemic Risk Board.

In Hellwig's view, the stress tests of 2010 and 2011 weren't worth much. The European Banking Authority is less at fault than the national supervisory authorities, starting with BaFin, Germany's Federal Financial Supervisory Authority. National supervisors are under pressure from politicians, and they have avoided timely recapitalization because recapitalization would mean taking a loss on bad loans.

In this respect, Germany led an effort to cover up the failings of both the Landesbanks and former politicians with respect to Landesbanks. Peer Steinbrück was not only the Federal Minister of Finance from 2005 to 2009. He also was minister of economy, then finance minister, then head of the state of North Rhine-Westphalia from 1998 until 2005. Steinbrück negotiated the agreement under which WestLB was able to issue an additional €30 billion in debt against state guarantees. A large part of these funds were used for investments into toxic securities.

For those becoming upset with the ECB's democratic deficit, Hellwig point out, "It should be of interest that the present North Rhine-Westphalia government, when asked by the opposition Free Democrats about the participation of Steinbrück in the decisions of WestLB, blocked the information with the argument that such decisions are business matters not subject to disclosures."

One should not overlook that, "This is the first Asset Quality Review and simultaneously the first stress test in which national supervisory authorities operate independently and can make their own determinations." Says Hellwig, "The question is whether this will suffice to stop the misuse of supervision for the purposes of national governments. If one wants to keep governments from avoiding bank stabilization in order to use the weakness of banks to obtain direct access to the central bank's printing presses, this is necessary."

Hellwig would have preferred to avoid a banking union. "I am not convinced banking union will function. But what is sure: If the banking union doesn't work, we shall over time move to a politically dominated system—a regime *à la Italia* 1980s—or the eurozone will break apart." In his view, "The breakup of the financial system in the peripheral Member States of the euro area will cause problems. Much more in Europe could break up." He admits that "developments in recent years are subject to a lot of criticism, especially on the European stage. However, one should not put national institutions on a pedestal—the federal government, BaFin, and the Bundesbank—since they played a considerable role in what went wrong. If BaFin had intervened in 2007 in the cases of Hypo Real Estate, IKB, and Sachsen LB, German rescue costs would have been much lower, for example."

National supervisors are under pressure from politicians, and they have avoided timely recapitalization because recapitalization would mean taking a loss on bad loans.

Says Hellwig, "The weakness of German banks in 2010 caused by the lack of a clean-up in 2008–2009 was the reason that Germany moved to support the rescue of Greece with the state aid of other countries. When in 2012 the haircut on Greek sovereign debt came, German banks were already off the hook. Some had passed their Greek debt to the Federal Agency for Financial Market Stabilization, others sold their Greek holdings to Greek banks. After such a history, one cannot write about banks in the European Union anymore as if more European financial integration is the problem."

—K. Engelen

"German banks should generally be in a solid position, but it will depend on the definition and intensity of stress," says Gerhard Hofmann, former department head of bank supervision at the Bundesbank and now managing board member of the National Association of German Cooperative Banks. "You can stress every bank to death. Therefore, the comprehensive assessment will also be a credibility test for the ECB itself. As we know, the European Banking Authority was not that successful in conducting stress tests, and was criticized by politicians across Europe. Asset quality review and stress tests are creating enormous complexity and a very high administrative burden for banks with huge data requirements, with new concepts, for instance deviation from standard procedures and accounting standards. The substantial influence of Oliver Wyman on a public sector exercise is without precedence."

As to the likely result of the asset quality review for German banks, Hofmann expects, "The asset quality review should basically not reveal major deficiencies, as German banks' accounts were audited before by internationally recognized accounting firms such as KPMG, Price Waterhouse, and others. To the extent that the ECB is applying its own methods which deviate from generally accepted accounting standards, adjustments may be necessary in banks' capital positions, but most likely not so much in their annual accounts. Overall, the balance sheets of German banks should be fine."

But Martin Hellwig of the Max Planck Institute, who co-authored the bestseller *The Bankers' New Clothes: What's Wrong With Banking and What to Do About It,* in an interview with *Deutsche Wirtschafts Nachrichten,* still sees "big risk" in the banks that are examined under the asset quality review or stress tested by the European Banking Authority. For German banks he sees, for example, major problems with maritime loans. Hellwig, who demands much higher capitalization levels for banks, predicts that "governments still will have to use taxpayer money to bail out banks."

There are also reports that the German authorities are trying to get waivers for certain banks on parts of their property portfolios. "This may reflect the concern about the massive funding mismatch of extremely long-term fixed-rate housing finance in Germany (average duration is 11.5 years), which could create a double whammy—when rates rise, the value of loans in portfolios drops, and falling housing prices may increase credit risk. Both combined create significant solvency risk for lenders," argues Berlin-based capital markets specialist Achim Dübel.

According to the latest IMF Article IV consultation, the German banking sector gets mixed grades. "The banking sector keeps downsizing through the disposal of legacy assets, thus building up capital buffers, but requires continued close monitoring. Capital-building efforts should continue while the ECB's Comprehensive Assessment is in progress, and supervisors are in active dialogue with assessed banks about their capital plans. While asset quality is generally not a problem, the Comprehensive Assessment will help bring clarity about the health of banks still holding sizable portfolios of hard-to-value legacy assets. In addition, supervisors should continue pressing to ensure that all large banks comfortably meet forthcoming minimum standards on leverage ratios. Close cooperation and coordination within SSM joint supervisory teams will be important in this context."

LEVEL PLAYING FIELD QUESTIONED

In contrast to most other eurozone countries, actual or suspected competitive distortions in the implementation of the asset quality review and stress test exercise are a hot issue in Germany. Concern is voiced not only from the banking sector that is under examination, but also from the official side, including the Bundesbank in its role as co-national bank supervisor.

The Bundesbank's move to block Italy's plans to boost its banks' capital position by legislating a substantial upward valuation of their stakes in the Bank of Italy dramatizes how the asset quality review and stress test are threatened by the lack of a level playing field.

Actual or suspected competitive distortions in the implementation of the asset quality review and stress test exercise are a hot issue in Germany.

As Frankfurt's *Börsen-Zeitung* found out, the Bundesbank intervened with the ECB and the Italian authorities to make sure that a new law giving a windfall to Unicredit, Intesa Sanpaolo, and other financial institutions to strengthen their capital base by a substantial upward revaluation of their stake in the Bank of Italy would not distort the ongoing asset quality review and

stress test. Through a new law, stakes in the Italian central bank valued at a minuscule €156,000 held by banks would be revalued to €7.5 billion on a pretax basis to use to beef up bank capital, for instance by €1.4 billion in the case of Unicredit and €2.5 billion for Intesa Sanpaolo. What the Bundesbank achieved was that the revaluation of the banks' stakes could not be used for the year 2013, the baseline for the asset quality review and stress tests. However, these positive revaluations will have a favorable effect after the comprehensive assessment and thus undermine the level playing field.

Such episodes are causing bad blood, related to what insiders call a "euro area cheat list" that is getting longer and covers complex issues and developments that are shielded behind an opaque curtain.

Eurozone governments are working behind the scenes on what some call "political fudges" to make sure that several systemically important "zombie banks" pass the asset quality review and stress test requirements. Take the recent case of Dexia. According to *Reuters* on May 22, "Belgian officials could soon conclude talks with the EU and Eurozone financial regulators that might see France and Belgium avoid having to pour more public money into crippled bank Dexia if it fails an EU stress test on its balance sheet. Sources familiar with the process told Reuters that talks on 'special treatment' in the tests for publicly owned Franco-Belgian Dexia have intensified and are nearing their end."

Another possible or actual source of distortion in the ongoing exercise is the use of deferred tax assets to boost bank capital. Here the focus is on banks in Italy and Spain.

German banks have a relatively higher portion of long-term sovereign bonds on their books, while banks in the periphery in Spain and Italy have more short-term sovereign bonds. Based on the bad experience with the 2011 stress test—especially with the European Banking Authority's "sovereign buffer" requirement—German bankers see the risk of different treatment. This is even more true as the safe-haven character of Bunds is virtually neglected by assuming a similar loss experience as Italian government bonds. Thus, a ten-year German government bond is assumed to lose a hefty 16 percent under the stress conditions predefined by the ECB and the European Banking Authority.

Analyst Achim Dübel considers capital quality a litmus test for the credibility of the exercise. "Europe still doesn't have in place the equivalent of the U.S. Federal Deposit Insurance Corporation that would push politically for recapitalizations with cash obtained through issuing shares. The more cash is raised for the bank, the more credible is the recapitalization. Former FDIC Chairwoman Sheila Bair has vividly described her conflicts with the Federal Reserve and other U.S. regulators on this point in the context of the large banks exiting TARP."

Dübel continues, "The absence of a vested interest in Europe on behalf of taxpayers and depositors explains why murky deals are currently being proposed that essentially only alter asset valuations and thus create capital out of thin air. The hope is that with the incoming Single Resolution Mechanism, a vested interest comparable to the FDIC will be created in Europe. As long as this is not the case, the ECB should go out of its way to demand the highest capital quality possible for the exercise."

The chaotic Cyprus rescue marked a low point in the governance of the ECB.

Since we drew attention to the competitive distortion among the eighteen members of the eurozone relating to the role of third parties such as accounting firms, consultants, or national bank supervisory authorities that are hired to carry out examinations in the asset quality review and stress test (*TIE,* Winter 2014), not much has happened in terms of more transparency provided by the ECB and the NCAs. The questions with respect to governance, competition, and costs have been left unanswered. In the case of German financial institutions, major public accounting firms are mandated to carry out the balance sheet auditing, which is very costly. Banks in other euro area countries will be examined by NCAs, which may be less costly, and may be questionable as to the audit quality. "As far as we can tell, different third parties (or no third parties at all) are being used in the ongoing ECB comprehensive assessment," warns Gerhard Hofmann of the National Association of German Cooperative Banks. At least the ECB is not transparent on this important aspect. It seems that it is not even ruled out that the NCAs themselves would check their own banks' books, which may create serious conflicts of interest and less reliable results, compared to a situation where the use of external auditors, such as the big four accounting firms, is mandated by NCAs.

We also criticized the ECB governance problems shown by the hiring of the international consultancy Oliver Wyman, a subsidiary of the U.S. Marsh &

McLennan conglomerate, to provide "independent advice on the methodology, assisting in the design and implementation of the execution, including the implementation of quality assurance."

As we noted, this means that the most important assessment of about 85 percent of euro area bank assets cannot be carried out by a European consultancy. We continue to question how those responsible at the ECB can be sure that the data from the mega-exercise will not be used by the Wall Street "masters of the universe" such as BlackRock or Goldman Sachs.

What we could not imagine at the time was that as the Oliver Wyman consultants accumulate their exclusive insights as the ECB's "internal adviser" on the establishment of the SSM and the comprehensive assessment, the British Oliver Wyman partners have been producing a battle plan for the main City of London lobby group on "muscular defenses" against the new eurozone regulatory architecture. A central bank with the added mandate of bank supervision should not ignore the fact that asset managers pay a lot of money to obtain information through consultancies.

STATE AID THROUGH THE BACKDOOR?

The somewhat heroic statements of German Chancellor Merkel defending the ECB's independence in the asset quality review, and ECB President Draghi telling the eurozone's banks that he is ready to let some of them fail, stand in remarkable contrast to both past state aid practices and current proposals.

Taxpayers' increasing fatigue with bailouts not only led to the Bank Recovery and Resolution Directive, finalized in December 2013, that substantially limits the options for government subsidies to bank creditors. It also prompted the European Commission to demand in August 2013 that henceforth, junior bond creditors of banks should always be bailed in before a government intervention. This prompted ECB head Draghi to introduce the compromise concept of a public "precautionary" recapitalization, to be applied to a "solvent" bank with a capital need determined under a "hypothetical stress test scenario." Could this be an attempt to reintroduce bailouts through the backdoor, if watering down capital quality is impossible?

"The ECB risks diminishing its credibility through promoting this concept," comments analyst Dübel. "The concept of bank solvency used under Basel relies on a 'hypothetical stress test scenario'—assumptions over the shape of the future loss distribution of assets. Capital is to be held for a large part of those distributions, in particular beyond the level of expected loss and certainly beyond the level of actual loss realizations."

"Applying harsher stress test parameters, as the ECB does, therefore simply means assuming higher variances and larger tails of the loss distribution. So either the new assumptions are unreasonably harsh, in which case they should be dropped, or a bank that violates the resulting higher capital requirements is insolvent," continues Dübel.

This blurring of the capital concept on which the Basel process has forged agreement over nearly a generation seems politically motivated. In particular, regional (savings and cooperative) banks have often insufficient junior debt outstanding for a bail-in, and regulators have failed to standardize the bail-in conditions of existing and new junior debt issued sufficiently in order to permit a seamless process. Often, politically connected capital owners in the regional banks fear dilution. It is no coincidence that Draghi's push came in the middle of a heated debate over junior bond bail-in in the case of Italy's Monte dei Paschi di Siena.

"If eurozone leaders and the ECB had found the political courage of Swiss regulators and mandated a sufficiently large buffer of bail-in-able junior debt on their regional banks, either contractually or with sufficient Roman law guidance, the concept would have never seen daylight and a lot of confusion would have been avoided," says Dübel.

Eurozone governments are working on what some call "political fudges" to make sure that several systemically important "zombie banks" pass the asset quality review and stress test requirements.

With respect to Berlin's true policy stance on the asset quality review and bank resolution, Dübel notes, "Even after pushing Spain and Cyprus for bail-in and with great fanfare supporting the European Bank

Recovery and Resolution Directive, Germany and other European countries remain slow in adjusting their own legal framework. The current German bank restructuring law of 2010 *de facto* will never apply to the Landesbanken, the largest group of problem banks. The reason is that government itself as the owner of the banks through the law has numerous means at its disposal to preempt a transfer of control to the regulator through 'restructuring'. Only when the regulator is in control under the 'reorganization', kicking in after 'restructuring' has failed, is the regulator permitted under the law to order a bail-in of creditors. Finally, pre-restructuring bail-in is a concept that is unlikely to take hold. Consider the case of HSH Nordbank, which just received a topping up of state asset guarantees in her ship finance portfolio to avoid using its large volumes of subordinated debt for increasing the capital base."

DATA SECURITY

The topic of data security has recently gained prominence. As a Reuters report noted recently: "It would be an insider trader's dream to know ahead of time which of Europe's banks will fail or need more capital, and all that data will be stored somewhere in cyberspace as the European Central Bank assesses the eurozone's top banks. The chances of a leak are multiplied by the thousands of consultants who will work on data for the ECB's Comprehensive Assessment of the currency bloc's most important 128 banks. … 'It (data security) is of enormous concern,' said Dan Keeble, a London-based partner at Deloitte. 'Aside from the fact that much of the information required to conduct the asset quality review is commercially sensitive to individual banks, details of the conclusions regarding the asset quality review have the potential to be market influencing, and could damage financial stability.'" ◆