Draghi's German *Nightmare*

BY KLAUS C. ENGELEN

And tensions could worsen.

The German Constitutional Court may have put the brakes on Mario Draghi's OMT bond-buying program on the grounds that the European Central Bank is grossly over-stepping its mandate.

However, since the ECB will assume the role as lead bank supervisor for the euro area in November 2014, the occupants of Frankfurt's Eurotower become more powerful by the day.

Earlier this year we learned that Draghi, president of the ECB, is so obsessed with the limits of the ECB's powers that he dreams about monetary policy—though always within the ECB mandate. His surprising (and fitting) revelation comes from an exclusive interview at the World Economic Forum when Philipp Hildebrand, former governor of the Swiss National Bank and now vice chairman of BlackRock, asked Draghi whether he dreamed about monetary policy in Italian or German.

Draghi's nightmares featuring "pervasive German angst" about the ECB overstepping its monetary mandate and the prospect of the upcoming ruling of the German constitutional court on the ECB's Outright Monetary Transaction program may have entered the Davos session, judging from how he answered Hildebrand's somewhat mischievous question. "It is hard to say in which language I dream, but the objective always is price sta-

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Philipp M. Hildebrand *(left), vice chairman, BlackRock, and ECB President* **Mario Draghi** *at the 2014 World Economic Forum in Davos, Switzerland.*

bility, that's our mandate, everything we've done so far is in the mandate," was Draghi's response. The unlimited but conditional OMT bond-buying program that Draghi announced in the summer of 2012 is widely credited with having calmed the markets and saved the integrity of monetary union.

As Europe's most important crisis manager, the former economics professor, financial official, investment banker, and Bank of Italy governor has much more to worry about than overstepping the ECB mandate.

After all, the monstrous mega-project of becoming the euro area's lead bank supervisor, the emerging ECB role in the eurozone's bank resolution program, and the ECB's entanglement in ongoing euro area rescue operations are mindboggling challenges that can cause a lot of nightmares for those responsible.

GERMANY'S EUROSKEPTICS FEEL VINDICATED

Some of Draghi's bad dreams in German might have been justified, since it did not take long for some of his premonitions became a bitter reality.

On February 7, 2014, the German constitutional court, in forty tightly printed pages, issued a harsh judgment: "There are important reasons to assume that [OMT] exceeds the European Central Bank's monetary policy mandate and thus infringes the powers of the member states and … violates the prohibition of monetary financing of the budget." Monetary financing of government debt is prohibited under Article 123 of the European Treaty. This is also the position of the Bundesbank, Germany's central bank. The judges said that they were inclined "to regard the OMT decision as an *ultra vires* act"—meaning "beyond the powers"—implying that this creates an obligation for German authorities to refrain from implementing it.

With a majority of six judges—two judges dissented—the German constitutional court in effect rejected Draghi's "whatever it takes" OMT program as a blatant violation of German constitutional law. But the court in Karlsruhe passed the case to the European Court of Justice for clarifications on a long list of issues relating to the ECB mandate and the OMT bond-buying program. Although the German constitutional court never before passed a case to the Luxembourg judges, Karlsruhe did not give the case away, insisting that it would come up with the final verdict. As Ambrose Evans-Pritchard wrote in the British newspaper *Telegraph,* "It referred the case to the European Court instead, but only after having pre-judged the issue in lacerating terms that effectively bind German institutions." Udo di Fabio, a former judge at the German constitutional court who participated in major rulings on the euro, argued that "the court is deliberately fencing in the European Court of Justice, constraining its room for maneuver by issuing its own prior judgment."

The German constitutional court ruling comes at a time when the ECB is causing revolt among German savers and pensioners because of its zero interest rate policy intended to keep Southern zombie banks afloat.

Jens Weidmann

Buba Isolated

With a hefty dose of hypocrisy, German Chancellor Angela Merkel and her Finance Minister Wolfgang Schäuble justified the unlimited OMT bond-buying pledge as a monetary policy decision by independent ECB central bankers. This left the Bundesbank under President Jens Weidmann—which took the position that OMT was a blatant violation of the German constitution and in breach of EU law—in not-so-splendid isolation.

—K. Engelen

Transferring the case for clarification to the European Court of Justice raised hopes that the European Union's highest court would look more favorably at OMT. Whether the Luxembourg court will use the fast track to get a ruling this year or whether it will come up with a ruling much later is not yet clear.

By keeping the case for a final judgment, the Karlsruhe judges made clear that they would stick to their key objections but would be willing to incorporate changes in the OMT program that would make it compatible with EU law.

For Clemens Fuest, head of Germany's ZEW institute, the Karlsruhe verdict "is a massive attack on Europe's rescue strategy." Hans Redeker from Morgan Stanley told the *Telegraph* that the German constitutional court "had crippled the ECB" since they have "taken away the ECB's weaponry, and greatly increased the hurdle for a future program of quantitative easing." And Ebrahim Rahbari from Citicorp argued that "Although the European Court may eventually validate OMT, it cannot deviate far from the German verdict without provoking a political backlash."

Marcel Fratzscher, president of the German Institute for Economic Research (DIW), sees the German constitutional court ruling as "Germany's pyrrhic victory" since limiting the ECB's ability to address the interdependence of sovereigns and banks could put stronger pressure on eurozone policymakers to confront banking problems directly. The ECB's coming asset quality review and stress tests of the major euro area banks could be the last chance to repair Europe's banking system and avoid a Japanese-style long-term economic drag from the financial system.

Since the German court intends to stick to its core objections, the interim verdict strengthens the euroskeptics, especially the anti-euro Alternative für Deutschland party. Bernd Lucke, head of the AfD, sees the ruling as "wise and highly effective." He argues that "If the ECJ rejects the arguments of the German constitutional court, we would be in a position of direct confrontation. It would boost all the anti-euro forces in Germany in the core argument that the European Union is breaking fundamental EU laws. The ECJ is thus in a dilemma."

Wolfgang Münchau, editorialist for the *Financial Times* and *Spiegel Online,* argues that "the OMT is effectively suspended as a result of this ruling—not so much for formal legal but for political reasons. The whole point about the OMT was to send a signal to the markets that the whole force of the system would support the euro."

Hans-Werner Sinn, president of Ifo Institute, argues in a Project Syndicate piece under the headline "Outright Monetary Infraction": "The Constitutional Court is not asking the ECJ to decide whether the OMT scheme is compatible with EU primary law, but

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rather to limit the program in ways that make it compatible with EU treaties." Sinn is of the opinion that the German constitutional court ruling effectively suspends OMT, as the ECB will not dare launch it in view of the legal controversy. For the Ifo president, "[T]he ECB's market-calming gimmick of shifting default risk from clever investors to trusting taxpayers worked. The OMT scheme amounts to free insurance against a default by southern eurozone countries, thereby subsidizing the return of private capital flows to places where they were squandered before. But that is not enough to legitimize the program."

As the German constitutional court stated in the preliminary verdict: *pari passu* for secondary market purchases for the OMT would definitely amount to a breach of the monetary financing prohibition enshrined in the EU treaties.

And how did the Eurotower react to the blow from the German court? The ECB stuck to Draghi's mantra that "the OMT program falls within its mandate." From the office of German Chancellor Angela Merkel came the statement that the Karlsruhe judgment "was an intermediate step in a very complex legal process." Investors reacted calmly to the news from Karlsruhe as most market actors seemed to think the European court will wink OMT through when the time comes.

GERMANY'S OMT SCHISM CONTINUES

Draghi's pledge to rescue European monetary union "whatever it takes," that is, with all the ECB's defensive central bank arsenal, was welcomed by euro area governments, EU leaders, and by the Eurogroup of finance ministers. So far, the OMT bond-buying program has never been used. It served as insurance coverage for euro area sovereign debt markets. With OMT, the ECB has in place a backstop scheme for Spanish or Italian bonds if Europe's debt crisis flares up again.

This was also the prevailing stance within the old and new German coalition governments under Merkel. With a hefty dose of hypocrisy, Merkel and her Finance Minister Wolfgang Schäuble justified the unlimited OMT bond-buying pledge as a monetary policy decision by independent ECB central bankers. This left the Bundesbank under President Jens Weidmann—which took the position that OMT was a blatant violation of the German constitution and in breach of EU law—in not-so-splendid isolation.

As one of the few euroskeptic members of the Bundestag, Frank Schäffler, whose liberal Free Democrats were coalition partners of Merkel, openly sided with the Bundesbank. Schäffler accused the Merkel government and his legislative colleagues of acting as accomplices in a blatant breach of German and EU laws. "While ignoring the European Central Bank overstepping its mandate, the German government and the German legislators were proclaiming the high principal of central bank independence and were happy to leave the task of saving the euro to the ECB," says Schäffler.

Draghi, president of the ECB, is so obsessed with the limits of the ECB's powers that he dreams about monetary policy, though always within the ECB mandate.

Where the German government failed and what the Bundesbank couldn't do, was done by several

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groups defending the German Constitution and EU law. They organized a petition filed by 37,000 German citizens before the German constitutional court questioning OMT's legality.

To put the controversy about the case in perspective, one has to recall that successive German governments have avoided politically difficult decisions dealing with banking troubles since the summer 2007 and also during the euro sovereign debt crisis beginning in the spring of 2010. When German banks and their clients were caught with toxic mortgage investments during the U.S. subprime crisis and the bankruptcy of Lehman Brothers in September 2008, the coalition government under Merkel opted for a bailout of the whole financial sector at taxpayers' expense.

And when the eurozone sovereign debt crisis hit German banks starting with Greece in spring 2010, they couldn't avoid hefty losses by participating in the deep (voluntary) haircuts as part of the "private sector involvement" in an unprecedented coordinated rescue operation. This rescue was organized through a committee—the Troika—in which the European Commission, the ECB, and the International Monetary Fund coordinated their efforts.

Since then, German banks have profited from the supportive ECB lending facilities, especially its extremely low interest rates. Letting the ECB do the main job of keeping struggling banks above water in the euro area—especially by sticking to its bank bailout strategy—was considered by Berlin's chief crisis manager, Finance Minister Schäuble, as a safe way to limit Germany's fiscal burden.

This fits when looking at the controversial issue of the ECB overstepping its mandate. While the German constitutional court claimed in its preliminary verdict that the ECB had acted on its own and not in support of fiscal or economic policy, Achim Dübel of the financial market research firm Finpolconsult sees things differently.

"This is not quite correct," he argues. The OMT bond-buying program "was tacitly agreed on in August 2012 between Draghi and Schäuble on the island of Sylt where the German finance minister was

The ECB's governing board is dominated by Club Med debtor states on a one-country, one-vote, basis.

vacationing." Says Dübel, "This happened in the wake of the Greek government bond haircuts, when protection was urgently needed for Spanish sovereign bonds after Schäuble had forced Spain to absorb her banking crisis costs domestically in July 2012."

In Dübel's view, the ECB's protection was thus a *quid pro quo:* "It saved Germany immediate substantial fiscal costs from direct recapitalizations of Spanish banks, as initially agreed on at the June 2012 EU summit by Chancellor Merkel." Merkel's summit concession to finance direct bank recapitalizations, says Dübel, "was premature and dead on arrival in Berlin since it would have likely let private creditors in Spain off the hook."

"Because of the legal doubts, Schäuble remained under cover and never publicly endorsed the ECB's OMT bond-buying pledge while smartly enjoying the fiscal savings," says Dübel.

According to Dübel, "Schäuble's next step should have been to formulate an explicit fiscal policy that would put a floor under sovereign bond prices, and thus convert a *de facto* into a *de jure* partial insurance policy. Yet, instead of affording investors such minimal protections—essentially

Amateurs at Work

Nicolas Veron

Nicolas Veron of Bruegel and the Peterson Institute notes the ECB's comprehensive assessment of eurozone banks is a "market-sensitive process," described by the ECB itself as "the largest such exercise ever undertaken in terms of the number of banks, their overall size, and geographical reach." He also draws attention to "the lack of prior supervisory experience at the ECB."

—*K. Engelen*

Draghi is claiming a key role in planning and constructing the Single Resolution Mechanism and the European Deposit Insurance System.

to avoid a Greek-style write-down on sovereign bonds—Schäuble pushed through collective action clauses in the European rescue fund ESM. This threatens investors in euro sovereign bonds who face a potential repetition of the Greek sovereign bond disaster," warns Dübel. "By early 2014, the result has been that while the eurozone has agreed on partial insurance in banking—deposits up €100,000 are now backed with the new Single Resolution Mechanism while other debt can be bailed in—no such move has been made to protect sovereign finance or enable bail-in, depending on which side of the protection limit you sit. While losing now-legal support, Draghi's OMT bond-buying program has lost little of its economic necessity."

Dübel is of the opinion that this awkward situation for investors promises to unnecessarily extend the European sovereign crisis. "If the German constitutional court judgment has any benefit, it could therefore be what forces Schäuble to finally start acting in the direction of partial insurance on sovereign finance, too."

DRAGHI STRIKES AT "PERVERSE GERMAN ANGST"

The German constitutional court ruling comes at a time when the ECB is causing revolt among German savers and pensioners because of its zero interest rate policy intended to keep Southern zombie banks afloat.

Since the ECB cut its main interest rate to 0.25 percent in November 2013—and two German members of the ECB's twenty-three member governing council led a six-man revolt against this unexpected move—the strained relationship of the ECB leadership with the euro area's largest member country has exploded.

The divisions within the ECB set in motion a broad and resentful debate in Germany about how the ECB's zero interest rate is robbing savers in the North to finance banks in the South. For years, taxpayer anxieties about ECB policy of buying the government bonds of crisis-stricken countries have been running deep.

The spectacular resignations of Axel Weber, former president of the Bundesbank, and ECB chief economist Jürgen Stark are not forgotten. The ECB's big wealth report showing that private wealth levels of households in major debt-stricken peripheral euro area countries are much higher than in Germany left their imprints.

More and more German savers and pensioners perceive the Club Med-dominated ECB as an EU institution through which wealth is transferred from North to South. Some are calling the ECB the new "European Wealth of Nations Single Redistribution Mechanism."

For its critics, the ECB's governing board is dominated by Club Med debtor states on a one-country, one-vote, basis. In an interview with Germany's *Bild,* Hans-Werner Sinn, president of Ifo and one of Germany's leading economists, accused Draghi of "cutting the rate to help borrowers in the south who could not otherwise get low-priced loans." And in an editorial, *Wirtschaftswoche* blasted the ECB's benchmark lending rate move as a "*diktat* from a new Banca d'Italia."

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This German uproar must have riled Draghi very much. He shot back against the "perverse angst" displayed by Germans over ECB policies.

"Let me react towards what is a nationalistic undertone in some of our countries whereby we [are

said to] act against the interests of some countries and in defense of our own countries," said Draghi in his press conference on November 21, 2013. "We are not German, neither French nor Spaniards nor Italian, we are Europeans and we are acting for the eurozone as a whole."

The *Financial Times* reported Draghi's press conference rebuke with the prediction: "The Italian ECB president's comment could exacerbate tensions in Germany, where official support for the central bank's policy is at odds with many savers' fears about the impact of ultra-low interest rates."

Shortly afterwards, in an interview with *Der Spiegel,* Draghi vented his frustration with German anxiety. "Each time it was said, for goodness sake, this Italian is ruining Germany. There was this perverse angst that things were turning bad, but the opposite has happened: inflation is low and uncertainty reduced."

As Draghi gets in ever-deeper trouble with large parts of the German population, there is not much help from those in Berlin who sit at the levers of power. Schäuble, speaking at the European Banking Congress in Frankfurt in November of last year, gave the impression of venting frustration about how the ECB under Draghi has been overstepping the mandate. In the shadow of the Eurotower, he reminded Draghi that "the European Central Bank's independence is based on its limited mandate." He added, "Monetary policy, as the ECB underlines again and again, cannot create sustainable growth. It can buy time for reforms but it cannot solve the fundamental problems." What Schäuble didn't say was that the failure of the eurozone governments to live up to their responsibilities on the fiscal side of the eurozone rescue efforts—for instance, in pushing for faster bank restructurings with more bail-ins—keeps shifting the task of calming markets to the Eurotower central bankers.

MORE TROUBLE WILL COME FROM BANKING UNION

In the great struggle over the eurozone's future, the June 2012 EU Summit's decision to make the ECB the pan-European lead bank supervisor, under the Single Supervisory Mechanism as the first pillar of a European banking union that also includes a Single Resolution Mechanism and a European Deposit Insurance System, was per-

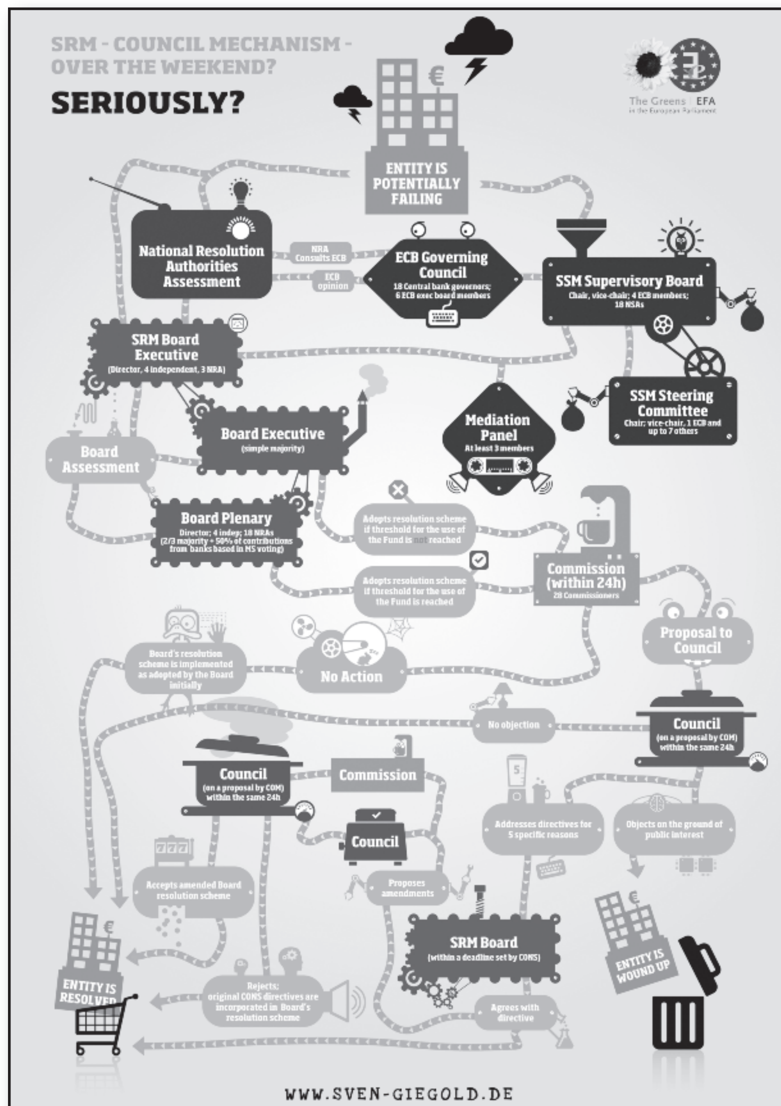
Don't Try This at Home

Whether the coming euro area resolution system will work remains in doubt. In an analysis under the headline "Don't try this at home," Silvia Merler, a Bruegel researcher, questions whether eurozone bank supervisors would be able, over a weekend, to cope with a large failing bank.

The decision to place a bank in resolution "would involve the Single Supervisory Mechanism Board (twenty-four members), the ECB Governing Council (twenty-four members), possibly the Single Supervisory Mechanism Mediation Panel (minimum three members) and Executive Boards (up to ten members), and the Board of the Single Resolution Mechanism (twenty-three members)." Merler continues, "Even if these two steps were to go smoothly—which seems hard to believe, given the high political sensitivity of the elements to be included in the resolution scheme—the next level could be a back-and-forth arguing between the Board and the Council (twenty-eight members) on a proposal by the EU Commission (twenty-eight members).

In line with the consensus view, Merler notes that the definition of when to take action is left deliberately vague, leaving the Single Resolution Mechanism board to make a judgement call based on a recommendation by the ECB as the bank supervisor. The board then takes a resolution decision, which could involve a number of instruments, such as the sale of the banks, a split-in, and bail-in. Once the board adopts the scheme, the EU Council can, on a recommendation from the EU Commission, object or request amendments. If there is disagreement, the haggling starts. The Council can raise objections on some of the key issues in the decision, for example whether the criteria for a resolution are met, or whether the tools are adequate. Then it goes to mediation, with the above mentioned bodies involved.

—*K. Engelen*



Sven Giegold, *member of the Green party in the European Parliament, posted this graphic showing how the Single Resolution Mechanism is supposed to resolve bankruptcies of banks over a weekend.*

ceived by most Germans as a victory by Club Med debtor countries, and a German defeat with unforeseen implications and without a sound legal basis.

As the ECB prepares to assume its new role as euro area's lead bank supervisor in November, Draghi is claiming a key role in planning and constructing the Single Resolution Mechanism and the European Deposit Insurance System. Already, the ECB exerts control over the euro area's major banks through its comprehensive assessment program that was announced in October 2013.

The Single Supervisory Mechanism regulation enables the ECB to obtain all the relevant information from the national bank supervisory authorities—called national competent authorities—of the participating member states that it needs to carry out a comprehensive assessment of the relevant credit institutions. The exercise will comprise a supervisory review, an asset quality review, and a stress test. As the ECB stipulates: "The integrated outcome of the comprehensive assessment may lead to a range of follow-up actions, possibly including requirements for changes in a bank's provisions and capital."

As Nicolas Veron of Bruegel and the Peterson Institute notes, this "market-sensitive process" is described by the ECB itself as "the largest such exercise ever undertaken in terms of the number of banks, their overall size, and geographical reach." He also draws attention to "the lack of prior supervisory experience at the ECB."

The asset quality review will be based on balance sheets as of the end of 2013. The ECB will use an 8 percent threshold for the minimum capital requirement, corresponding to the 7 percent reference of the Basel III Accord (4.5 percent so-called core equity tier one capital plus a 2.5 percent so-called conservation buffer), plus a 1 percent surcharge as all banks are considered of systemic importance.

In its October 2013 note, the ECB explained that "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." At the time, the ECB welcomed the news that euro area banks have raised around €225 billion of fresh capital and a further €275 billion has been injected by governments, an equivalent of more than 5 percent of euro area GDP.

The ECB is hiring about one thousand bank supervisors and support staff under the new supervisory structure, including the Supervisory Board, formed by a chair and vice chair, representatives of the national supervisory authorities, plus four ECB representatives, and a Mediation Panel consisting of one representative from each participating member state. As a result, Germany's banking supervisors—the Federal Financial Supervisory Authority (BaFin) and the Bundesbank—are losing a large part of their control, power, and influence, which causes deep resentments.

Key building blocks of the new ECB bank supervision such as the promised Chinese wall—strict separation between monetary policy and bank supervision—are questioned and cause uncertainty. "There cannot be a 'Chinese wall' between supervision and monetary policy in the ECB because several members of the Supervisory Board must be chosen from the Governing Council which is responsible for monetary policy," argues Roland Vaubel, who teaches economics at the University of Mannheim. He questions Schäuble's view that under the Single Supervisory Mechanism, the final decision rests with the Mediation panel. Since the reconciliation committee may not contain a majority of (or indeed any) representatives of the ECB Governing Council, this is illegal, says Vaubel. And he makes the point that "According to Article 263 of the Treaty of the European Union, acts of the ECB may be reviewed by the Court of Justice of the European Union. This includes banking supervision. If the act is addressed to a natural or legal person, such as a bank, or if the act is of direct and individual concern to it, the bank is entitled to institute proceedings against the ECB."

Most German insiders are concerned that the wide-ranging activities of the ECB—from its decision-making processes, its role in the Troika rescue operations, and most importantly in the coming bank supervision and bank resolution structures—are perversely politicized in a way that could not have happened with the truly independent Bundesbank. This is an irony. A major reason for EU leaders to transfer national bank supervisory authority to the European level was that the recent financial crisis showed that national supervisory authorities were too politicized.

Successive German governments have avoided politically difficult decisions dealing with banking troubles.

The new lead bank supervisor can operate with even less accountability and control than national supervisory authorities.

This explains the deep concerns in the German financial sector and beyond that the ECB as the new lead bank supervisor can operate with even less accountability and control than national supervisory authorities. Insiders question the decision-making structures under the supervisory mechanism—the Supervisory Board and the Mediation panel. In their view, the fact that the Supervisory Board has to report to the European Parliament and has yielded to the European Parliament a confirmation role doesn't make much difference.

What worries many are the breathtaking mass conflicts of interest in the new supervisory structures at the supranational and national levels. They expect that these will undermine the efficiency of the three-pillar European banking union, open new channels of debt and risk mutualization, be highly divisive, and eventually cause a political backlash against more European integration.

Only the European Parliament has been drawing public attention to the alarming failures in governance, transparency, and accountability by those responsible in Frankfurt's Eurotower.

The ECB's response to the questionnaire of the European Parliament, dated November 21, 2013, give relevant insights and should be considered required reading.

The response evaluates the structure, the role, and operations in the Troika's actions in euro area

program countries. As an example of a system that is out of control, the ECB's governing council did not object to the Cyprus central bank using emergency liquidity assistance funds to keep the insolvent Laiki bank in business.

There are also concerns that the ECB's lack of bank supervisory experience and tradition will be compensated for by new waves of bureaucratic requirements imposed on the banks from the supranational level. "It will take half a decade to catch up with the supervisory experience of other important bank supervisory authorities," warns a bank supervision and regulation consultant.

As the realization sinks in that the ECB is the most powerful European institution, deciding the financial fate of debt-laden member states and their banking systems without any democratic legitimation or accountability, Germany's representation in the Eurotower decision-making structures comes into focus (see box).

GETTING THE ASSET QUALITY REVIEW AND STRESS TEST RIGHT

Draghi and his colleagues have understandably used their power and influence on member state governments to secure adequate backstops should banks not meet the asset quality review and stress test requirements. He is trying hard to avoid the failures of the previous stress tests during the regime of the European Banking Authority under its Italian president, Andrea Enria. The ECB leadership from Draghi down to the newly appointed chair of the Supervisory Board of the new Single Supervisory Mechanism, Danièle Nouy, have been sounding harsh warnings to the euro area banking community. Nouy, who headed the French Prudential Supervision and Resolution Authority, was put forward for the chair of ECB's Supervisory Board right from the beginning.

Draghi experienced considerable resistance from the German government, which had to protect its saving and cooperative banking sector interests.

Draghi is trying hard to avoid the failures of the previous stress tests.

Draghi offered this message when he attended the World Economic Forum in January: "The banks that should go, should go." He did not know whether any banks would need to be shut down following an honest appraisal of their financial health, "but if so the ECB and the eurozone are prepared to deal with the consequences," he warned in Davos.

In October 2013 under the heading "A Bank-Bailout Union—Public Backstops are another way of saying 'Germany pays'"—the *Wall Street Journal* pointed out the risks of the asset quality review and stress test exercise. "If the ECB assessment is too penetrating and reveals too many nasty surprises, then it risks inflaming crisis fears anew. Threading this needle will require the central bank to live up to official assurances that it can rise above the politics and deliver a credible review." According to the ECB, "For the success of the exercise, the *ex ante* availability of backstops is critical."

In his July 20, 2013, letter to Joaquín Almunia, vice president of the EU Commission, Draghi intervened on the treatment of subordinated debt in precautionary recapitalization. He called for avoiding an "improperly strict" interpretation of EU state aid rules when the European Commission polices any public support given to banks that struggle in the coming stress tests.

And when Bundesbank President Jens Weidmann urged the introduction of new regulations to require capital charges on sovereign bonds to break the so-called feedback loop between governments and private banks, Draghi put up the stop sign warning that the ECB's authority could be undermined even before it takes over banking supervision.

There are a lot of troubling questions voiced in the German banking community about the comprehensive assessment for the euro area's major banks.

Transition Nightmare

For large segments of the German finance community, the prospect of transfering banking supervision to the European level is causing nightmares. One dreadful specter is that in the new politicized European supervisory structures, bank controllers from mostly Club Med debtor countries, directed by France's top bank supervisor, Danièle Nouy, would supervise the three-pillar German banking sector. With this in mind, the German daily *Die Welt* nominated Nouy as a "menace to Germany."

Since the fateful June 2012 EU summit, it has been clear that putting the ECB's new Supervisory Board under a veteran French bank supervisor was part of the Club Med deal. Her retirement age of 63 didn't matter.

Nouy joined the Bank of France in 1974, specializing in bank supervision. As secretary general of the Basel Committee on Banking Supervision and by chairing the Committee of European Bank Supervisors, she raised her international profile.

The German government—during the final stretch of setting up the Supervisory Board in the Single Supervisory Mechanism—lost the chance to place their much younger experienced bank supervisor, Sabine Lautenschläger, 49, into the strategic position of vice chairman due to an unexpected resignation.

When Jens Weidmann followed Axel Weber as president of the Bundesbank in 2011, Lautenschläger, then head of banking supervision at the Federal Financial Supervisory Authority, was placed at his side as the Bundesbank's vice president. Then in mid-December of last year, Germany's representative on the ECB Executive Board, Jörg Asmussen, 47, resigned to become assistant labor secretary in Merkel's new coalition government. Lautenschläger, who was in charge of banking supervision at the Bundesbank, was asked to take Asmussen's place at the ECB.

A lawyer by training, Lautenschläger joined the predecessor banking supervision authority of BaFin in 1995 with a stellar career that included a stint as chief information officer under BaFin President Jochen Sanio. She went through the banking crisis in charge of large bank supervision at the side of Sanio, who for decades played an important role in bank regulation and supervision nationally and globally.

The two power ladies, Nouy and Lautenschläger, will in one stroke improve the gender balance at the top ranks of the ECB. They have one thing in common: They both experienced spectacular bank supervisory failures while they were on watch. Nouy confessed in the hearings before the European Parliament her failures in the case of the costly Dexia disaster. Lautenschläger experienced such cases as IKB, Hypo Real Estate, Sachsen LB, and Commerzbank, unprecedented supervisory failings that only could be corrected by mega-bailouts at taxpayer expense.

There will be a new bureaucratic layer at the European community level—highly paid and hungry for influence and power—and in smoldering conflict with national bank supervisors and regulators.

When major Italian banks—with the blessing of the Italian government—were able to increase the value of their stakes in the Bank of Italy thus creating new bank capital, this showed anything but a level playing field in the comprehensive assessment. Another competitive distortion in the asset quality review is the option, for instance for Italian banks, to beef up their core capital by including future tax credits.

Worry also centers on the eventual treatment of banks' euro sovereign debt holdings in the coming stress test. German banks under the comprehensive assessment have relatively more long-term sovereign bonds while banks in the periphery in Spain and Italy have more short-term sovereign bonds. Based on the bad experience in the 2011 stress tests, there is the risk of different treatment.

Furthermore, the role of "third parties" such as accounting firms, consultants, or national bank supervisory authorities that are hired to carry out the balance sheet examinations is questioned with respect governance, competition, and costs. 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

Danièle Nouy

Sabine Lautenschläger

Stefan Walter

As the Bruegel analysis shows, the powers of the supervisors on the European level may face a lot of limits. But in dealings with the systemically important directly supervised financial institutions and the thousands of smaller euro area banks, the new ECB bank supervisory operation will make a big difference. There will be a new bureaucratic layer at the European community level—highly paid and hungry for influence and power—and in smoldering conflict with national bank supervisors and regulators.

"A key step in the formation of the new supervisory function at the ECB," notes Nouy, "is the appointment of the Director Generals."

The ECB nominated Stefan Walter, a former vice president of the New York Federal Reserve, to head one of the two Directorates General with direct supervision of significant banks. This is considered by German insiders as a "provocation poisoning the air."

Positioning the German-born Walter, who for five years served as secretary of the Basel Committee on Banking Supervision, is seen as a Draghi move to give the U.S. Federal Reserve, the U.S. Treasury, and Wall Street insider access to the process. "Walter would bring to the Eurotower twenty years of representing U.S. interests in the field of bank resolution and supervision," says a former German bank supervisor, "and he never stopped badmouthing the three-pillar German banking system."

From a German perspective, the other nominations were expected. Ramon Quintana, director general of banking supervision at the Bank of Spain, is to head the second Directorate General with direct supervision of significant banks. Jukka Vesala, currently the deputy director general at the Finnish Financial Supervisory Authority, will head the Directorate General responsible for the indirect supervision of all other banks in participating countries. Korbinian Ibel, currently head of group risk control and capital management at Commerzbank, will head the Directorate General providing horizontal and specialized services for the other three Directorates General. Since Ibel worked nearly seven years for Boston Consulting and three years for Accenture before joining Commerzbank, he might help to break the Oliver Wyman domination as ECB and SSM risk consultant.

—K. Engelen

area countries will be examined by national bank supervisors, which may less costly and may also be questionable as to the audit quality. "As far as we can tell, there is not a level playing field in the coming comprehensive assessment," warns a German banker involved in the matter.

Also seen as a governance problem is the fact that the ECB hired the international management 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 measures." This means that the most important assessment of about 85 percent of euro area bank assets cannot be carried out by a euro area consultancy. How can those responsible at the ECB 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, with the NSA listening in?

What should not be overlooked is that when euro area governments are pushing politically sensitive decisions from the national to the European community level, they may delay and not speed up the needed

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sorting out and recapitalization of the eurozone's zombie banks. Letting national bank supervisors start early enforcing the restructuring of banks with politically difficult bail-in rules to protect taxpayers—as was done in the United States and other countries—may have been a better way to recapitalize and strengthen euro area banking systems.

THE BANK RESOLUTION BATTLE RAGES ON

In the run-up to giving banking supervision responsibilities to the ECB, Draghi experienced considerable resistance from the German government, which had to protect its saving and cooperative banking sector interests. In the negotiations on the second pillar of banking union, the Single Resolution Mechanism and Fund, Draghi didn't get what he wanted because of German resistance. With German Finance Minister Schäuble as chief negotiator, Berlin dismissed Article 114 of the Treaty on the Functioning of the European Union as the legal basis for a bank resolution fund, opting for a "two-stage" approach starting with a network of national resolution funds in the euro area and—following the European Stability Mechanism model—called for a nongovernmental agreement through which resolution funds will be channeled. Berlin's main objectives were to minimize new debt mutualization channels through bank resolution and keep fiscal costs under control.

The European Commission proposed the Single Resolution Mechanism in the summer of last year, and it took until December to reach an EU Council compromise and a decision by euro area member states committing them to negotiate, and until March 2014 to reach an intergovernmental agreement on the single resolution fund.

How the eurozone governments will finance the resolution fund was at the center of month-long negotiations among the finance ministers. In a bitter struggle with the European Parliament—which rejected the intergovernmental council option—the Eurogroup eventually prevailed under the time constraints of the May European parliamentary elections and the compelling argument that for the Single Resolution Fund, no other legal basis is in sight.

The Single Resolution Mechanism is—so far—the most controversial building block of the European banking union project. When the EU Commission enthroned itself as the authority which will decide on bail-in and bank resolution measures for all banks, it met considerable opposition among EU members. Setting up a bank resolution fund raises difficult legal, political, and practical issues. There are strong differences in opinion on whether Article 114 of the Treaty on the Functioning of the European Union is a sufficiently robust legal basis for imposing losses through bail-in on shareholders and creditors among member states.

Last but not least, the idea that more stability in the European banking sector and a higher degree of safety for the taxpayer against official bail-outs shall be achieved by the Single Resolution Mechanism is not clear yet. The Single Resolution Mechanism will include a highly contested Single Resolution Fund of €55 billion. While the ECB and the European Parliament demand that the banks fill the fund in five years, the EU Council's proposal gives the banks ten years in view of their other needs in strengthening their capital base.

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Gerhard Hofmann, managing board member of the National Association of German Cooperative Banks, makes the point that "American or Asian banks will not be faced with such significant burdens. To impose 'fair' contributions of banks to the single

resolution fund can be a very demanding endeavor as the riskiness and systemic importance of individual banks will be hard to judge."

Hofmann, who for many years was in charge of the bank supervision department of the Bundesbank, questions that the Single Resolution Mechanism could be modeled after the U.S. Federal Deposit Insurance Corporation. Says Hofmann, "We do not have and will not be able to establish the United States of Europe within the foreseeable future, probably not even within one generation. On the contrary, when it comes to political union or fiscal union for the euro-zone countries, almost all member states show no appetite to give up their national sovereignty."

Like most of his colleagues, Hofmann questions whether "banking union can be a success and create lasting improvements in financial stability without fiscal union. Banks will be forced into mutualization schemes across the banking union countries. Banks will have to contribute to the costs of resolution for their competitors, and it seems an illusion that such a scheme which relies to a great extent on 'other people's money' would have no fiscal impact."

In Hofmann's view, there are other larger implications. "It is quite evident that the Single Supervisory Mechanism may have a significant impact on the fiscal position of countries' participation in the banking union, as the ECB may end up with losses from lending to weak banks when their home country is defaulting at the same time. These examples seemed extreme before the crises in some countries in southern Europe."

When the European Parliament revolted against the German government's position, only to accept a resolution fund with a nongovernmental agreement, Achim Dübel of Finpolconsult made the point: "I have a hard time understanding the logic of the European Parliament's argument. On the technical level, there is no 'federal' budget in Europe to provide for the fiscal backstop required for the bank-sponsored fund to be created under the Single Resolution Mechanism, the Single Resolution Fund. With national parliaments and governments being asked to sponsor possible backstops (plus other possible costs) of bank resolution, having the direct decision-making line from the national level to the Single Resolution Mechanism is a *sine qua non*."

Dübel continues, "How would the obviously far more material European Parliament involvement that is asked for here, without providing much detail, then address its concern about the already complex decision-making processes? It would be just another complicating add-on. The European Parliament would be consistent if it asked for a transfer of the fiscal backstop capacity, including the ability to authorize debt issuance should a predetermined amount be insufficient, to the European level. This would be a quite decisive step towards fiscal union. This is something worth discussing going forward."

Looking at the policy level, Dübel argues, "Please note that the entire idea of the Single Resolution Mechanism is to empower the fiscal side versus the monetary policy side that so far has dominated the European banking crisis, with disastrous results for bank creditors and national fiscal policy. Those interested should look at the case of Laiki in Cyprus, where the ECB provided almost €10 billion in ELA loans and the fiscal side only became involved at the last minute in the face of dire alternatives that led to a catastrophic event for the European bank investor market. If people do not understand the need for early and decisive action from the empirics of this case, they do not understand finance."

Dübel concludes, "The European Parliament's threat to block the intergovernmental agreement enabling the fiscal side to move faster seems to go hand-in-glove with the efforts of some in the banking sector and investor community to hand over crisis management if possible entirely to the ECB, the sugar daddy of the banks. Is that the European Parliament's intention? Or is the posturing that we see part of the self-delusion that apparently some in the European

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Parliament harbor, namely that they could somehow ride the tiger of the ECB during a banking crisis and intervene into misguided lending programs to insolvent banks? All facts on hand show that the European Parliament is unable do this job." He adds, "The banking union project requires an architecture of checks and balances. The creation of the Single Resolution Mechanism—a precursor in my view to a European FDIC—is important in order to contain the bank-central bank cartel that has maximized Europe's banking crisis costs."

There are some somber conclusions. First, the ECB's leadership decided to ignore the findings of the German constitutional court by stating, "The ECB took note of the German court decision and stood by its (OMT) measures," letting ECB board member Yves Mersch, who is in charge of legal services of the bank, add "The court's decision did not affect the plan's credibility."

Second, the prevailing attitude of market actors was—if one looks at sovereign bond yields or credit default swaps—one of benign neglect. Whether markets will take the ECB's legal problems more seriously in the future should the euro sovereign debt crisis return remains to be seen.

Third, this doesn't change the fact that on the issue of OMT bond-buying, the ECB is on a collision course with its largest member country with unforeseen legal, political, and economic consequences. In case the European Court of Justice doesn't come up with OMT amendments, euroskeptical parties could profit from a political backlash.

Most market actors seemed to think the European court will wink OMT through when the time comes.

Fourth, as the European Parliament investigation has shown, the role of the ECB (and the European System of Central Banks) in the Troika rescue operations tends to delay needed bank restructurings by sticking to bail-outs as long as possible. The ECB thereby prevents the return of market interest rates and an efficient allocation of capital that are essential to the eurozone regaining its international competitiveness and improving its economic growth prospects.

The bank resolution structures will be extremely complex.

Fifth, based on the forthcoming compromises, the bank resolution structures will be extremely complex, with European burden-sharing evolving over a very long transition period. Under pressures from Germany, national governments will maintain a major role and retain the overwhelming responsibility in the resolution process. Therefore, the June 2012 EU summit leaders' pledge to "break the vicious circle of banks and sovereigns" won't be realized for the foreseeable future.

Sixth, by assuming the task of lead bank supervisor under the Single Supervisory Mechanism regulation—thereby closely chaining itself to the Single Resolution Mechanism and thus the EU Commission and the EU Council—the ECB will become part of a huge European Gosplan system with considerable fiscal intervention powers but without democratic accountability.

Seventh, as lead bank supervisor for about 85 percent of euro area bank assets, the ECB is on the way to beginning an unprecedented regulatory trial-and-error exercise with unknown economic consequences. Never before has banking supervision from seventeen national authorities been concentrated into one supranational body in just a few months on a questionable legal basis. Starting from scratch with newly assembled supervisory staff from many jurisdiction has considerable risks. The largest banking area in the world is *de facto* used as a supranational Single Supervisory Mechanism training ground. This way the ECB will become the most powerful EU institution, but will face major conflicts with national supervisory authorities and possibly a wave of lawsuits from private sector investors and intermediaries before the European Court of Justice. All this will worsen the ECB's reputational risks.

Finally, growing strains and stresses in the ECB's relations with its largest creditor member country—Germany—are not boding well for the euro and the functioning of European banking union. Draghi's nightmares with the Germans may get worse. ◆