Yves Mersch: Interview in *Het Financieele Dagblad*

Interview with Mr Yves Mersch, Member of the Executive Board of the European Central Bank, in *Het Financieele Dagblad*, conducted by Mr Oene van der Wal and Mr Rik Winkel and published on 12 September 2013.

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Any signs of fragmentation diminishing?

Certainly. It is visible in the sovereign spreads. There is less divergence. The number of banks accessing markets is going up. But there is still a long way to go. We think establishing a complete banking union would help along that way.

Will there be a new round of 3-year LTRO's?

There is a difference between banks that otherwise have trouble attracting money and banks asking for ECB-financing. At the same time we see improved access for banks to markets in southern Europe, their own funding and that of their sovereigns becoming less problematic.

So a new round of 3-year LTRO's might not be necessary?

Possibly. All options are open and we have a very extensive toolbox. We still have to monitor the situation very closely. But as a central bank we are not with our back against the wall. The message to the markets is: we will do everything that is needed to execute our monetary policy objective with conventional and unconventional measures.

Isn't the monetary environment in the world much too loose?

Opinions differ. I hear complaints from emerging markets, sometimes from banks, in some countries also from politicians. But I would not say that our accommodative policy is inefficient or toothless. We can observe that in the broader economy and in the balance sheets of banks in different countries. Low rates are not always beneficial for banks.

So the policy will not change until all balance sheets have been sanitised?

We are determined to use forward guidance (the message that rates will be kept low for an extended period of time) to overcome the shortcomings in the transmission of monetary policy resulting also from fragmentation. We will do this as long as necessary. But we will not wait for the slowest boat to reach the harbour.

Banking union is the magic bullet to end fragmentation?

It is an important element, because it entails not only supervision but also an orderly resolution of insolvent banks. I cannot tell you exactly when it will be over. Unfortunately, we don't have a stop button to push.

Are you optimistic about competitiveness?

Yes, we see progress in all programme countries. It's visible in trade balances and real price adjustments. It vindicates economic theory. Ireland will soon be able to raise money on its own. Spain will probably not need more support for its banks. We will see in six months whether Portugal needs a follow-up programme. Although the decisions of the Constitutional Court there remain an unknown.

What makes you so optimistic about Spain?

Unemployment is no longer going up; the current account is in surplus. We see at least a bottoming out, a turnaround.

You don't mention Greece?

The Eurogroup currently discusses whether there is a financing gap and whether a third programme is needed. Obviously, it does not help to ask for debt restructuring. But at the same time we are far away from the size of the first two support programmes. Some mention a single digit figure. It is important that Greece reaches a primary surplus in the first quarter next year, on an annual basis.

What do you make of the Netherlands?

It set a good example. It got into a difficult situation and reached a national consensus on how to get out of it while sticking to the European rules. I am not happy it got into the bad situation in the first place. But it is important that it did not follow the example of some bigger neighbours in 2003 and 2004.

But it is set to miss the 3% -threshold again in 2015?

The rules allow for some flexibility. That is ok in a crisis.

The ECB will take up supervision from next year and will review the books beforehand. Do you already know exactly which bank will fall under your remit?

No bank will be completely absent from our radar. The most important ones with assets of at least €30 billion will be supervised directly. We will also look at the size in relation to GDP, but we will cover at least three banks from each euro area country. The final list will only be made up when the new Supervisory Board takes up its duties next year. In the sample of banks subject to the comprehensive assessment we built in some safety margin of 10%, because balance sheet totals can fluctuate. So, not all the banks that are assessed will necessarily end up being directly supervised by us. Other banks will remain under national supervision. Not with the amount of national discretion we see at present, but according to harmonized standards and rules. A Dutch bank will be scrutinized in the same way as a Greek bank will be scrutinized.

What do you mean by national discretion?

Supervision has its fashions too. Like skirt length going up or down, supervisory practices go back and forth between quality and quantity. In the mix sometimes one thing dominates, sometimes the other thing.

Is that a difference between Northern and Southern Europe?

No. In all countries we have seen changes towards more quality or quantity. On top of that there is an enormous amount of options and exceptions in the European guidelines. Every article has formulations that open up possibilities of a deviation from the rules. This has led to divergence and absence of a level playing field. Even in the present capital requirements directive (in CRD IV) more than a hundred deviations are possible. The future Supervisory Board is obliged to publish within six months a complete set of harmonized rules and procedures. A public consultation on this framework regulation is also foreseen.

And until then?

While the competences are still with the national authorities, a so-called "Comprehensive Balance Sheet Assessment" is done. Of course we do not want to buy a cat in the bag. At the moment, we still have all sorts of accounting differences, in valuations, in the treatment of non-performing loans, etc. But we want balance sheets to be comparable, sound and repaired. The assessment takes place in three stages. First we determine, together with the national authorities, the riskiest portfolios per country and bank. Then we will thoroughly analyse the samples in a point-in-time analysis. That is the asset quality review. Then we have the stress test, which we do together with the EBA (European Banking Authority). That stress test takes care of the "dynamic element".

And what about banks from outside the euro area?

We cover 85% of the balance sheet total of banks in the euro area. Non-European banks that are active in the euro area through large subsidiaries are screened on their European activity, although we cannot access their main headquarters.

And at the end you know per bank how much capital is missing?

At the end you have one figure. The question is what you do with that figure. That's why we keep on stressing all the time that credible backstops need to be put in place in time. We want to create certainty, transparency and credibility. That in itself will already help banks to attract capital. But they might not be able to attract everything they need from the markets. That's why extra backstops are necessary. The first one that comes to mind is a national backstop because we're dealing with legacy burdens. Some countries however do not even have a national resolution system. And there are countries that have limited means. Should we then jeopardise the whole exercise, an exercise which is supposed to restore confidence in the system?

Germany is very clear about this…

The banking union is also about democracy. The voters say: we do not want to save the banks for a second time with taxpayer money. And that's why we also need a bail-in system where it is first and foremost the banks' shareholders and creditors that foot the bill. We should not wait until the bail-in instruments are available in 2018. The Commission can already impose it now when state aid is given. Everything is linked: bail-in is important but also bail-out. But a European bail-out – now only possible via an indirect bank recap through the ESM – only comes as the last line of defence and is rather hypothetical. But because of its availability it will provide an element of certainty to the markets and that's why it's important. In such a case, the European emergency fund ESM can lend indirectly to a country for a bail-out.

Direct recapitalisation is not available?

That is only possible if supervision by the ECB has started. The problem of indirect recapitalisation is that the debt of the country in question would increase. Not every country can afford this. However, the European Commission has already said that countries can increase their deficit for this purpose without being sanctioned. This is a step in the right direction.

Are the national authorities cooperating?

The relations are excellent. The motivation is very big. And the capacity to deliver results is there. We will continue to use the expertise of national authorities.

And the banking sector, is there resistance there?

It would be strange if there wasn't. Some banks are afraid of the eyes of strangers. But that is exactly what this is about: breaking the sometimes too cosy relations between national supervisors and banks. That's what we want to do. For that reason we will have multinational supervisory teams. Banks will be checked by the ECB and by experts from third countries. But around half of the teams will still be national.

Do you expect unpleasant surprises?

I am too old to exclude that. But don't forget that the banks in the programme countries have already been assessed extensively. From that perspective we should expect only few surprises. However, some portfolios are very complicated and require specific expertise. Take for example the shipping sector. Then there is the question of how you value non-liquid assets. Those are difficult discussions. But we have a European perspective in the Asset Quality Review. The biggest surprise could come from the number of assets that has been classified incorrectly. They will then have to be revalued.

Will the ECB in case of capital shortfalls wait till the end of the review or try to work out a solution right away?

The supervisory role of the ECB sets in only in one year's time. What you see is that banks are already anticipating and cleaning up their balance sheets.

How firm will this exercise be compared to the two previous ones by the EBA?

You refer to the Stress Test, the third stage of the Comprehensive assessment. We are discussing this with the EBA. We have already decided what the buffer requirements are for the second stage, the asset Quality Review. They are pretty tough. Banks need to have 4.5% in common equity tier one (CET1). We added a capital conversation buffer of 2.5%. For significant banks 1% is added. Then we are at 8%, which is in substance comparable to the old capital definition.