Yves Mersch: Interview in *Frankfurter Allgemeiner Zeitung*

Interview with Mr Yves Mersch, Member of the Executive Board of the European Central Bank, in *Frankfurter Allgemeiner Zeitung*, published on 14 October 2013.

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Mr Mersch, you are responsible for setting up banking supervision at the ECB. That is a huge task. Are you looking forward to it, or do you also have some concerns about whether it will all work out?

In the course of my life, I've regularly been involved in such pioneering projects. It's gratifying when one can look back afterwards and see that it has been successful. Presently, there are of course moments when we have some concerns about the future.

You don't have much time. The first acid test, the comprehensive balance sheet assessment, will be held as part of the preparations. Will the process be less rigorous for being swift?

We had a longer run-up period when we were setting up the monetary union. When I was involved in founding Banque centrale du Luxembourg in 1998, the run-up period was even shorter, but the current task is far greater. However, we have the advantage of an excellent cooperation with the national central banks and supervisory authorities. And we can also build on the experiences of the European Banking Authority (EBA)….

..which were not altogether positive, however...

I don't want to make an assessment, but we have learned from them. First and foremost, communication will be essential. Last week, at a meeting with the heads of the national supervisory authorities, we agreed on key cornerstones, including core elements of the comprehensive balance sheet assessment.

And how will it proceed?

This plan must first be approved by the ECB's Governing Council. You will be let in on all the details on 23 October: what form the balance sheet assessment will take; how it ties in with the portfolio selection, which we will examine in more detail; and how the balance sheet assessment in turn relates to the subsequent stress tests. It should all lead to a single result, that will be published in October next year.

What benchmark will this single result represent?

We are not primarily aiming to quantify a capital gap. The main purpose of sifting through the banks' balance sheets is to restore international market confidence in them. The balance sheet assessment will hence be carried out in accordance with uniform guidelines. All institutions will be examined by the same methods. That is why we also have external consultants on board. Moreover, the supervisory teams in the countries will be linked to each other.

The benchmark will not be a capital gap, the capital requirement? What else will it be?

We will have a benchmark for the balance sheet assessment. That will be derived from European regulations, the Capital Requirements Regulation/Capital Requirements Directive IV (CRR/CRD IV).

Those are the technical names. What do they refer to?

The main issue is the definition of capital that a bank is required to keep on deposit. That is set down in the CRD IV.

…which is based on the Basel III guidelines .

It contains a minimum percentage of common equity capital that banks, under Basel III, must keep in proportion to their risk-weighted assets. It also states that banks must maintain a capital conservation buffer as a further cushion against risks. And since we are dealing with the most important banks in all Member States, the "significant credit institutions" require an extra buffer to reflect this significance in a European context. If you add that up, you arrive at the benchmark that we will use for orientation.

In the final analysis, the most interesting point is the gap between a banks' capital adequacy requirement and the capital that it has available.

We must apply uniform rules in Europe. It may emerge that a bank does not have adequate reserves or has not made sufficient provisions. That gap may need to be filled with capital, but it may also be removed through balance sheet shrinking.

How?

The situation will improve if we restore confidence: a bank will find it easier to raise funds in the market if there is transparency and certainty about its balance sheet.

It will be difficult if many banks turn to the markets all at once.

Most bankers are forward-looking and are already looking for capital. If private capital does not suffice, then the European guidelines state that the shortfall must be made up through a bail-in, with shareholders and creditors bearing losses. The state may not provide any funds before a bail-in has been carried out. Before any public money flows, however, a decision must have been taken on whether a bank is viable or not. A bank that is only able to keep afloat with sustained public support does not belong in our concept of a market economy. If the bank, or perhaps just one part of it, does have a chance of survival, public funds may be used as the third line of defence; first at national level, and then – as an ultimate line of defence – at international level. If a country is unable to cope, a European safety net would be the last option. So we have a cascade of backstops.

Many taxpayers in Germany already fear that, in the last instance through a European safety net, their money, too, will be used to rescue banks.

The European backstop is the absolute final stage. If a country does not provide the funds, it must enter into an aid programme. The need to activate the European safety net, the last backstop, will not readily arise.

But you understand that many taxpayers are concerned.

People in some countries are more nervous than in others. In the "creditor countries", people now feel that they are being made to pay up. We need to take these fears seriously, while not failing to appreciate that the interest rates in these countries have been lowered by the crisis and the flow of capital from the stressed countries. That facilitates investment.

The low interest rates are not welcome to savers in Germany.

No, they are not welcome to savers.

Savers would at least like a real return on their savings.

Real rates come from the real economy. Long-term real interest rates will increase again when the European economy has re-established a sustainable dynamic.

Getting back to banking supervision in the hands of the ECB. Surely that will lead to dilemmas and conflicts of interest if, say, the supervisors ascertain the number of sovereign bonds held by troubled banks. An increase in interest rates could put pressure on the prices of these bonds and thereby on the banks. The ECB would have a conflict and could postpone an interest rate increase that may be warranted from a monetary perspective.

It would be naïve to deny that conflicts might arise in some cases. But in 90% of cases, the interests of financial stability are identical to those of price stability. To be clear: in the 10%, 5% or 1% of cases in which a conflict arises, our price stability objective will take precedence in line with our mandate.

The intention is to publish the test results of the balance sheet assessment next October. Isn't there a danger that provisional results regarding capital gaps might leak out in advance and unsettle the markets.

That is true, that's why we want to consistently manage the process through effective communication. We want to prevent people from drawing the wrong conclusions from partial or inaccurate results. Publication of the final results is the only approach that makes sense. Constant reports on the status quo are of little value. However, a bank's business model will also be accorded great significance in a dynamic stress test, which will follow the rather static balance sheet assessment.

The main promise of euro area policy-makers is that taxpayers will no longer have to foot the bill for ailing banks.

Some politicians say no more taxpayers' money will flow at all. That seems very optimistic to me, but I am not a politician. It will be our task to minimise the likelihood that banks run into difficulties in the first place.

The policy-makers' argument is that there should be no bail-out in future, but rather a bail-in. But these rules do not take effect until 2018. What will happen in the meantime?

For the interim period the Commission has drawn up rules for national state aid, which also follow the principle of bail-in. Besides, the European Parliament is doing all it can to advance the resolution rules governing the bail-in. In addition, individual countries may bring these forward independently.

The bank resolution fund should also bear the costs of resolving banks. But this fund, which should be financed by banks' contributions, so far only exists on paper. The ECB and the EU Commission have suggested that the European Stability Mechanism (ESM) crisis fund might provide a loan. Does that mean taxpayers may end up paying for bank crises after all?

A credit line is conceivable; it would give security. However, that should certainly not be a permanent loan: it may only be interim financing that will not cost taxpayers anything in the long run. The credit should be extended on market terms; that might even be a good deal for taxpayers.

If it is such a good deal, why can't other funding sources be found in the market?

That option is also contained in the Commission's proposal. If the ESM provides a credit line, the ESM rules would have to be changed. In Germany that would require parliamentary approval, in other countries that would not be necessarily be the case.

A final question on international monetary policy. In Janet Yellen, the US Federal Reserve will have a Chairperson who is known as a "dove" and who will probably pursue an accommodative monetary policy for some time to come. Are you pleased that you will hence not come under pressure from across the Atlantic to tighten monetary policy any time soon?

I doubt that Ms Yellen fits into all the slots that people put her in. At the Fed, too, decisions are taken by a committee. Ms Yellen is highly experienced and has an excellent professional and academic background. The good cooperation with the ECB will be continued. We, as the ECB, will fulfil our mandate in line with our established strategy for the euro area.