

Sabine Lautenschläger: Interview with *Deutschlandfunk*

Interview by Ms Sabine Lautenschläger, Member of the Executive Board of the European Central Bank, with *Deutschlandfunk*, conducted on 4 September and aired on 7 September 2014.

* * *

Ms Lautenschläger, you are a member of the six-person Executive Board of the European Central Bank. In a few weeks, the ECB will be entering what is practically a new era. You are taking over supervision of the most important European banks. That is a balance sheet of more than €21 trillion. The question is, therefore, are you up to the task? Are you ready for take-off?

We are ready to start, or we will be ready to start in November. We have taken on quite an astonishing number of highly qualified staff. So far, there are 28 nations represented here.

So, how many people will be working there in the new supervision function?

We will have 800 supervisors plus an additional 250 staff who will provide the support. These are colleagues carrying out legal work and colleagues involved in IT or recruitment. Altogether, that makes 1,050.

And how easy was it to fill the positions? Did you have a lot of applications?

Almost 20,000, I heard last week. That's something I'm very proud of. We appear to be very attractive – which I can understand. It's a great job. And we had applications not only from bank supervisors from lots of countries, but also from employees in accountancy firms, management consultants and a very large number of bankers.

How does it work in practice? How are the banks monitored? Are banks scrutinised by teams of people from various countries, or how do you do it?

It depends to some extent on what kind of bank it is. It is divided into two parts. We will directly supervise 120 credit institutions in the euro area, for which there are these mixed teams of supervisors. Altogether, that represents 80% of the aggregated balance sheet of the banks in the euro area. That's already quite a lot. And then there is the indirect supervision. That is around 3,500 credit institutions, representing the remaining 20% of the aggregated balance sheet of the banks in the euro area. And we will set the supervisory standards for this, so that there is uniform supervision. However, the supervision itself – the decisions etc. – will be carried out by the national supervisory authorities.

The financial centre of Frankfurt is actually a bit of a male bastion. If you look out of the window here, in the towers – Deutsche Bank, Commerzbank – the men have the final say. But in banking supervision there are an astonishingly large number of women. For example, Danièle Nouy, the new chief bank supervisor, Elke König, the President of the Federal Financial Supervisory Authority (BaFin), and, of course, you yourself. Are women better at keeping an eye on banks?

Yes, well, I would say it's a tough job, and that's something to which we are suited.

So, would the financial crisis not have happened with women charge ?

Lautenschläger: That's a tough question. I don't like thinking in such boxes. There are men who are risk-takers and there are women who are risk-takers, and there are also much less risky business activities that both men and women pursue. So, please, don't think in terms of pigeon holes.

However, you once said you could imagine that, with the start of the new banking supervision, there could also be a new European supervisory culture?

Yes.

What are we to understand by that?

That that is what I would like to hope. That is what I expect. And we have been working towards it for months.

So, what's new about this culture?

Well, this supervisory culture will at last bring together the experience, the knowledge, of 19 different supervisory authorities – in fact it's actually 28 when you consider that we currently have 28 countries represented among our staff. It will at last incorporate the lessons of the crisis. It will ensure that, through a fusion of these different traditions, we create better supervision using the best practices that we will devise from these different supervisory cultures. And this supervisory culture will most certainly be able to assert itself. It will be in direct contact with the credit institutions, very close to the bank, challenging the bank in its valuations and detecting risks at an early stage, and then also taking action. It will not simply collect and evaluate information, but will also go on to do something.

So, how well prepared are the large European banks for this supervision? We hear that Deutsche Bank has already obtained a lot of capital and so on. What would you say? Are they well prepared?

Well, the capital has more to do with whether one is prepared for the health check. In that regard, I would say that some have done their homework. Since July 2013, more than €140 billion has been added in additional capital or by reducing business etc. That is quite a sum. But supervision is not just this health check. Instead, it concerns the fact that, as a bank, I would have to adjust to a new supervisor. What supervisory culture does it have? How tough is it? How seriously does it take certain things? How quickly will it actually want to see deficiencies corrected etc? And that is what the banks are preparing themselves for. And, finally, it also concerns the fact that banks are now going to have to do everything in English and not in German.

While we're discussing the health check – this time it's a bit different than in the past. You are first conducting an inspection of the banks' balance sheets. Why?

Well, the stress tests which we have seen so far were applied to the valuations made by the banks themselves for their operations, that is to say for the individual contracts, for the individual transactions. I would put a question mark over whether those valuations were occasionally a bit too positive, whether, ultimately, the starting position to which the stress was applied – assuming more or less that an economic crisis was developing and looking at how the value of these transactions developed – was too positive. Therefore, this time, we have looked at the most significant, most risky transactions of the banks and gained an impression of the valuation standards. We have also valued individual transactions ourselves in order to see where we might have to reduce the valuation of individual transactions and then apply stress to this reduced value.

Will banks fail?

I cannot tell you that yet. We are right in the middle of the quality assurance. And, I'm afraid, much as I really like Deutschlandfunk, I have no insider knowledge for you.

But there is a study which says that, of the 130 banks, there are nine or ten that probably won't manage it?

Well, of course, the studies don't have our insights. And I am not going to pass them on.

But, speaking generally, without mentioning individual banks or figures, how good are the German banks?

I'm not going to tell you that either. You can ask me as many times as you like. We will announce the results in the second half of October this year, and then we'll see what's going on in the German banks and in the other banks.

Let us assume that the results have been published and there are a couple of banks that have failed. What would you do then? Provide capital in next to no time?

Well, if banks actually see a need for capital in the asset quality review or in the stress test, meaning that, in the end, they fail to meet our benchmark of 5.5% in the stress test – or, more specifically, in the adverse stress test – and of 8% in ...

You will have to explain “adverse stress test”, if we’re going to use the term.

Oh, sorry. “Adverse” means using a special, very tough scenario of an economic slump. Now, if they no longer meet this 5.5% capital ratio – or, more specifically, core capital ratio – or the 8% core capital ratio in the less tough stress scenario or the asset quality review, then the credit institutions will have two weeks to present a capital plan to us. This capital plan must provide us with a fully credible explanation of how, over the next six months or nine months respectively, they intend to close these gaps in their capital. That means that each bank has a further six or nine months to meet the capital requirement.

So, can we, as taxpayers or as investors, be sure that, when you take over the supervision, there will be no more bank crashes, no more episodes like the one at Espirito Santo – the Portuguese bank which got into difficulties this summer? Can we be sure that there will be no more bank crashes?

I will, of course, not comment on individual banks. I am also of the opinion that it must be obvious that a bank can be wound up. To put it plainly, imagine what it would be like if we have 4,000 banks in the euro area and not one is allowed somehow to go down the drain economically.

But, Ms Lautenschläger, isn’t there a fault in the system there? We don’t have bank resolution regime yet. It is on the way, but it does not exist yet. If a bank had to be wound up in the next few months, the framework does not exist yet, does it?

In Germany, there is a framework under the German Bank Restructuring Act.

But in Germany, all the banks will pass the test, won’t they?

I have not said anything about which banks from which countries might possibly not pass the test! And you won’t get me to do so either!

Okay.

No, in Germany we have a Bank Restructuring Act. Many other countries also have bank restructuring laws. Some countries don’t, and then the national insolvency law applies. So, a bank can indeed be wound up. However, it is our aim that a bank should be wound up in an orderly fashion, without affecting financial stability. That is, of course, the point of the European bank restructuring law that you, I believe, were alluding to. That will not in fact be in place until 2016. Nonetheless, for me it is very important to make it clear that individual banks must be able to leave the market. Otherwise, we would not have a proper market, because we would never ultimately remove banks from the market that do not have a sound business model. However, you asked me whether we were more secure overall. I would, of course, like to answer that. I believe that we will provide better supervision. That means that we will, of course, make our contribution to ensuring financial stability. However, that does not mean that one bank or another will not leave the market.

Generally speaking, have the banks become more humble? At the moment, they (the banks) have a lot on their plates with stress tests, penalties, regulation. You have been involved with banks for the whole of your professional career – has anything changed?

I would not equate it with humility, but I would perhaps mention the word “cautiousness” or a greater awareness of the lack of understanding in the society. There is quite clearly also greater awareness that the rules have become very much tighter, that countries, regulators and supervisors have finally become much more critical, and that the framework overall has

been found to be too loose, too soft, and that we are now tightening all the reins – and rightly so.

The ECB is now the supervisor and, at the same time, the central bank. Is there not a danger that this will somehow become mixed up?

On one hand, there are synergies to be gained. It is good as a supervisor to also have the knowledge that a central bank has, for example, about an economic environment, about the markets, about infrastructures such as payment services. In this area, therefore, there are synergies to be gained, simply by exchanging information. On the other hand, it is of course the case that, when you conduct monetary policy, you always have an eye on the banks as a transmission channel, and then conflicts of interest can, of course, be expected. Let us assume, for example, that you provide emergency liquidity assistance to banks and, at the same time, as banking supervisor, you ask yourself: “Is this bank still solvent?” That would, for example, be such a case. For this case, we have very clear rules. They were laid down for us by the European legislator, but we also impose them on ourselves. They concern the fact that, ultimately, the decision-making channels, right up to the Governing Council of the ECB, are kept fully separate. That means that the central bank side, with the exception of the Governing Council, does not know what is being decided or prepared on the banking supervision side, and the banking supervision side does not know what is being prepared on the central bank side.

That is why they sit in two towers so far apart from each other. One, the ECB, is located in the new tower in Frankfurt, and the supervision is located in the old tower.

Precisely. Yes, they are located in two different buildings. But there are also very clear decision-making channels which are separate from each other. On the central bank side, the Executive Board prepares the decisions. On the supervision side, these decisions are prepared by the Supervisory Board, which is composed of the representatives of the national supervisory authorities and representatives of the ECB who, with one exception, are not on the central bank side. But, to ensure that one side knows what the other side knows, there is one person who acts as a bridge between the two, and you are talking to her right now.

And we are very pleased about that, since we have you here with us for the “Interview of the week” at Deutschlandfunk – Sabine Lautenschläger, Member of the Executive Board of the European Central Bank. One of the sides was very active this week, and – to the surprise of many – initiated a cut in interest rates. The key rate is now only 0.05%. That surprised a lot of people. What is the reason for such a low interest rate?

Well, first of all, the low interest rates are justified. I know that very many of your listeners may not always be able to fully appreciate that. It is, however, the case that the economic growth we are seeing in the euro area as a whole is simply too modest not to want to give growth a boost through low interest rates. In addition, as you also know, we have very low rates of inflation. And that is another reason why these low interest rates are justified. The interest rate move to which you have just referred ensures, ultimately, that we have now arrived at the very bottom. That is, in view of the interest rate move, now the lower bound. And that was also the intention.

But others might say: “So, now they are at the bottom. Now there is nothing more they can do.” Is that not an admission that there is now nothing more that can be done? Is that not an admission of the powerlessness of the ECB?

That would be so if, in addition to interest rate adjustments, there were not also other measures which, ultimately, can be used to influence the rate of inflation and economic growth.

We will come to the other measures in a moment. Staying briefly on the subject of the low interest rates, because that is of real interest to many of our listeners who are looking at their savings and life insurance and saying: “What is the ECB doing? Is it

actually conducting monetary policy against me as a saver?" What would you say to them?

I would say that the ECB is not conducting monetary policy against your listeners as savers. I have a lot of understanding for the fact that savers are concerned. I am, by the way, also a saver. But I believe we must not think so short-term, but more middle and long-term. And you have to simply recognise that you can't save if you don't have a job. And if, at the end of the day, the economic environment is so weak that economic growth cannot be generated, then we at the ECB must consider how we can ensure that economic growth is generated and that inflation rises from the, as mentioned, very low inflation rate of 0.3%. How can we ensure that jobs are safe and remain or that new jobs are created? And not only for Germany, but for the euro area as a whole. We are not conducting monetary policy for Germany alone – that is a very important point! And with this interest rate cut, which is one measure among a package of measures – also a very important point –, another small input is ultimately being provided and the lower limit has been reached. Again, the low interest rates are, unfortunately, justified at this time. It is my conviction that they, of course, also entail risks, and therefore it is also my conviction that, if the conditions improve, then we should, of course, also allow interest rates to rise again.

So you can give people a little hope when they look at their savings books and their pensions that things will not remain as they are, that you will also become active again and raise interest rates?

Well, things will remain as they are as long as the economic conditions remain unchanged. In our projections, inflation is too low over too long a period of time. And that is what we must respond to, because our mandate is price stability, and price stability means upwards as well as downwards. That means, if we have inflation that is too low, with all the dangers that I have already described to you, then we must also respond to that.

Is there, as a result of the cheap money, a threat of bubbles, for example in the property markets?

That is often mentioned as one of the risks. And, yes, there are such side effects. If we are talking about possible bubbles in the German property sector, I can tell you that so far we cannot detect any. Nor does the Deutsche Bundesbank see any. We can detect overheating here and there in certain areas in certain cities in Germany. However, a bubble is not generated through rising prices alone, but also through a simultaneous rise in credit growth, which, in the end, is what finances such bubbles and such overheating. And we cannot detect that. I would say that, until the middle of the year at least (I don't have the latest figures yet), credit growth in the property sector in Germany was not extraordinary, but, rather, at the lower end of the scale.

Turning away from Germany again and looking at Europe more widely, for many small and medium-sized enterprises, particularly in southern Europe, credit growth is unsatisfactory. For this reason, the ECB has now decided to purchase asset-backed securities (ABSs). This allows banks to clear their portfolios, i.e. what they have issued, from their balance sheets and to grant new loans again. That, I believe, is the basic idea of this measure. Has this any prospect of success? Many people say that there is no real market for these ABSs that are now going to be purchased, that the market is not large enough.

Now, first of all, there is a market. There is a market for the senior tranches, but there is also a market for the mezzanine tranches. However, the point is not only to show that we will purchase something that already exists, but to send a signal to the market that we will purchase certain securities over a certain period, so it makes sense to generate them, to produce them. Therefore, you have to look not only at the market that is already there, but also at what signal is being given out for future business activities.

In the United States, these ABSs were the fuel for the property crisis, so they carry a bit of a stigma. How do we get out of that?

I believe that we must be careful not to lump all securitisations together. There are securitisations which, ultimately, are simply a large pool of very transparent loans which can be easily evaluated, which are very simply structured, and which have been standardised, pooled and then securitised. I don't consider those particularly dangerous. In fact, I don't consider them dangerous at all, if they are simple and transparent in their structure and if individual valuations – for each individual loan – are available. What emerged in the United States and ultimately led to this contamination were extremely complex structures. In that case, there were securitisations of securitisations or “CDO-squared”. These securitisations were no longer transparent. The credit institutions and the investors no longer had any idea what they had bought in terms of individual loan values. Instead, at the end of the day, they simply assumed that diversification would keep the risk within limits. Moreover, and this is the significant factor with regard to US mortgage law, nobody really paid any attention to the fact that what we, for example, have in Germany in terms of collateral standards before such a mortgage loan can be granted, did not exist at all in the United States. Mortgage transactions were also not supervised.

Will the ECB go a step further? These are ABSs. Will the ECB at some time also purchase government bonds on a large scale? Will it begin a massive bond purchase programme?

We have decided on a package of measures, in particular that we will purchase ABSs, that we will purchase covered bonds, and that we have again reduced interest rates. At this time, I would prefer not to discuss future possibilities with you.

This week, the President of the ECB, Mr Draghi, also spoke of geopolitical risks that people will have to keep an eye on. Does this refer to the risks arising from the Ukraine crisis?

Precisely what he meant is something you will have to ask Mr Draghi, but I would assume so.

Can you see geopolitical risks?

Yes, of course. There is certainly a risk arising from the Ukraine crisis – a confidence risk relating to certain growth prospects. So far, it has not manifested itself in the economic indicators, but that it is, after all, a risk that could manifest itself at some time is undeniable.

The final question. You are extraordinarily active, and now there is also going to be a new ten euro note this month. Is everything going well with that? Last time, there were some problems with vending machines etc. It is now due on 23 September. Will it arrive?

I think it will arrive. I also hope that everyone is well prepared. We at the ECB have done our best. We informed people very early. We provided all the information to enable the vending machine producers or operators to modify their software. However, at the end of the day, we are dependent on the vending machine operators to actually send a mechanic to modify the software or do whatever he has to do to ensure that the ten euro note is recognised. After we have prepared everything, after we have provided all the information and knowledge, it is in the hands of, and is therefore the responsibility of, the vending machine operators. And I would just like to appeal to them right now.