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After the bank stress tests, ECB backroom tension lingers.

By Klaus C. Engelen

The surprisingly positive outcome of the ECB's health check for German banks may be something of a reprieve for the strained relations between Germany and the ever-more-powerful European Central Bank under its controversial Italian president, Mario Draghi. But for the ECB, the real stress and tests are yet to come for the supervisor tasked with making hard decisions with far-reaching consequences for member states, their governments, and their financial sectors.

Berlin's political leaders had not expected that Germany's banks would come out at the top of the health check ahead of the launch of unified banking supervision in the euro area. On the one side was the common view that with the ECB empowered as top eurozone bank supervisor, a comprehensive health check of bank balance sheets and a tough stress test in cooperation with the London-based European Banking Authority would be needed.

On the other side was apprehension that the ECB could bungle this major challenge on the way to much deeper financial integration. And—with a short list of German potential problem banks circulating—there was apprehension that the highly fragmented German banking system could come out as loser. Such worries led German supervisors to force Landesbanks with major shipping loan portfolios such as HSH Nordbank to substantially increase their capital. BaFin and the Bundesbank point to the fact that German banks had strengthened their balance sheets by €14 billion in preparation for the asset quality review and stress test exercises.

As it turned out, only one of Germany's twenty-five banks failed the test of capital strength under the ECB's "adverse scenario," and none fell short after 2014 capital boosts were taken into account. Only Münchener Hypothekenbank missed the requirements for the region's systemically important 130 banks at the December 2013 cut-off date. By raising €408 million this year, the special lender is off the hook.

Italy's banking system—for years supervised by Banca d'Italia chief Draghi—turned out to be the biggest loser. This may explain why Draghi didn't show up to present the ECB's health check results himself.

Some German Draghi watchers express a bit of *schadenfreude* that Italy's banking system—for years supervised by Banca d'Italia chief Draghi—turned out to be the biggest loser. With nine of the twenty-five failing banks and four of the fourteen banks still short of capital, Italy's central bank supervisors are not looking good. This may explain why Draghi didn't show up on October 26 to present the ECB's health check results himself, but left the job to his vice president, Vítor Constâncio.

As to the deteriorating relationship between Germany and the ECB—a theme we covered at length in the Winter 2014 issue—a Reuters report on the visit of ECB board member for international relations, Benoît Cœuré, to the Berlin chancellery a few days before the health check results were announced shows that things are getting worse. Draghi had sent Cœuré to Berlin with a plea that the constant bashing of the ECB president stop. But Cœuré failed to receive assurances.

"Benoît Cœuré received a fairly cold response when he visited Merkel's office recently, having been told that the chancellor has no control over the debate, even though she would not join in the Draghi-bashing in Germany," said the report. The article cited sources saying that "Merkel felt betrayed by Draghi's speech at a central banking conference in Jackson Hole," as it questioned the agreed fiscal policy stance. The Reuters report also

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gives graphic details about the personal relationship between Bundesbank head Jens Weidmann and Draghi, which has totally broken down to the extent that they avoid each other.

Analyzing the Reuters report, the widely read Eurointelligence daily briefing concludes: "It is our view that this dispute lies at the heart of the European policy conflict, and its resolution will have huge implications for the future of the eurozone."

How long and how fiercely the Bundesbank under Weidmann has been opposing the governance erosion under the Draghi ECB, despite being progressively marginalized by a Club Med debtor majority, was brought to light on October 17, when the *New York Times* published excerpts of its so-far secret minutes. Unlike the Federal Reserve and the Bank of England, which release the minutes of rate-setting meetings in a matter of weeks, the ECB decrees that its internal deliberations must be kept secret for thirty years.

Apparently the ECB was shocked enough to release a blistering denial claiming "full consensus" in the governing council on the need to get assurances from the Central Bank of Cyprus that this bank was solvent (see box).

The *New York Times* was able to get governing council minutes dating from May 2012 to January 2013. During this time, Weidmann not only was opposing ECB-backed rescues of the French-Belgian lender Dexia and smaller banks in Ireland, Greece, and Spain, but was waging a major fight in the case of Cyprus Popular Bank (Laiki Bank), which was kept solvent by the misuse of emergency liquidity assistance loans provided by the Central Bank of Cyprus. As the *New York Times* reports: "In January 2013, just two months before the Cyprus rescue package, Mr. Weidmann repeated his complaint that the ECB was putting itself at risk in propping up Cyprus Popular Bank," questioning "whether the Cyprus central bank … was trying to play down the bank's problems in order to keep it alive." The ECB, warned Weidmann, was violating a core tenet, that banks on the verge of failure should not be bailed out with additional loans. "It was not the governing council's job to keep afloat banks that were awaiting recapitalization and were not currently solvent," as Weidmann is quoted in the ECB minutes.

European leaders are planting the seeds of another crisis.

Alerted by our sources—in particular the team led by Achim Dübel that listens to central bank, EC community, and finance ministry experts—we followed the Cyprus banking story. That was months before the chaotic March 2013 €10 billion Eurogroup/Troika rescue deal. For those who have put together the facts and available information from the actors in the Cyprus drama (See "From Deauville to Cyprus," in the *TIE* Spring 2013 issue), the ECB press release is not only a big lie, but an insult and outright scary in the sense of what this EU institution is up to. As to what the now-published ECB minutes reveal, we went much deeper into the mess of what happened in Cyprus and in the Eurosystem in terms of governance breakdown.

"[T]he way the troika of Eurogroup finance ministers, the European Central Bank, and the International Monetary Fund managed the rescue of the outsized Cyprus offshore banking center will be useful as a case study to document the extremely fragile state of European monetary union at that point in time. The handling of the crisis puts big question marks around the June 2012 EU summit council resolution to transfer banking supervision to the European Central Bank—to a European institution acting as the euro area's financier of first resort for banks that lack access to market funding. This huge conflict of interest between supervising and funding large and small eurozone zombie banks and pursuing monetary policies oriented toward price stability is ignored by Europe's democratically elected leaders." As we previously wrote, "Draghi has ignored the most important finding that an objective analysis of the European Central Bank's role in the run-up to the Cyprus banking disaster would bring to light." The key message is that European leaders are planting the seeds of another crisis. ◆

PRESS RELEASE

17 October 2014 - Statement on *New York Times* articles

The ECB neither provides nor approves emergency liquidity assistance. It is the national central bank, in this case the Central Bank of Cyprus, that provides ELA to an institution that it judges to be solvent at its own risks and under its own terms and conditions. The ECB can object on monetary policy grounds; in order to do so at least two thirds of the Governing Council must see the provision of emergency liquidity as interfering with the tasks and objectives of euro area monetary policy.

In this specific case there was full consensus in the Governing Council on the need to get assurances from the Central Bank of Cyprus that this bank was solvent. This was confirmed explicitly by the Central Bank of Cyprus, which also confirmed the proper valuation of collateral after an intense dialogue between it and the ECB.

The ECB was not the supervisor and fully relied on the assessment of the Central Bank of Cyprus. Therefore to draw conclusions about the ECB's future banking supervision role on the basis of ELA to Cyprus is tendentious.

— *European Central Bank*