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Phone: 202-861-0791 • Fax: 202-861-0790
www.international-economy.com
editor@international-economy.com

BY KLAUS C. ENGELEN

# Das Empire Strikes Back II*

*German finance and industry experts argue that the new European Banking Authority's one-size-fits-all regulatory approach threatens to deepen the eurozone crisis.*

As Germany's politicians crusade in vain for the introduction of a global financial transaction tax and wage a futile popular war against the big rating agencies, they have at the same time been very efficiently transferring greater regulatory and legislative power over financial markets to the newly established European system of financial supervision, according to the prevailing view of the German banking sector. The beneficiaries of "the biggest sell-off" in terms of regulatory and legislative sovereignty since World War II are the European supervisory authorities, according to veterans in Germany's financial service industry and former regulators.

These European supervisory authorities for banking, securities, and insurance have different locations, with the European Banking Authority based in London, the European Securities and Markets Authority in Paris, and the European Insurance and Occupational Pension Authority in Frankfurt. They replace the former "Level 3 Committees," and are designed to create a single rulebook for financial supervision and align supervisory practices with macroprudential supervision through the newly established European Systemic Risk Board.

### MOVING INTO THE TRENCHES

Large segments of the German banking community—with the savings banks and cooperative banks in front—are hitting the trenches to fight what they see as destructive transgressions that are threatening to eliminate much of the diversity and strength of the three-pillar German banking system. Much of the German angst is centered on

*Klaus C. Engelen is a contributing editor for both* Handelsblatt *and* TIE.

*In the Winter 2004 issue of *TIE,* Mr. Engelen's article "Das Empire Strikes Back" examined the struggle of German banks against U.S.-based rating agencies.

**Angela Merkel** *and* **Wolfgang Schäuble**

## Down on the Banks

Large parts of the German banking industry feel betrayed by Berlin's coalition government. Chancellor Angela Merkel and Finance Minister Wolfgang Schäuble are selling out the vital interests of a diverse and unique German banking system to Brussels bureaucrats and to a new power elite of European regulators.

Schäuble has been at cross purposes with the German banking community since taking office in 2009. "In his disgust and in revenge on banks as culprits of the financial crisis, no other German finance minister has been so eager to transfer regulatory power to Brussels without caring much about the long-term consequences for the three-pillar German banking system and how Germany is represented in the regulatory agencies," complains a top German banker.

*—K. Engelen*

the European Banking Authority and the forthcoming 150 to 170 new "binding technical standards" it will issue without input from German policymakers to adjust for the specifics of German banking. Diversity in the German (and the European) banking sector has been one of the key factors mitigating systemic risk during the recent financial crisis. This is even more true when taking into account that it is mainly small- and medium-sized banks who provide the effective diversification in the banking system.

Many in the German banking industry feel betrayed by Berlin's coalition government. There is fear that under the pressures of dealing both with rescuing some large banks and an escalating sovereign debt crisis, Chancellor Angela Merkel—always watching her standing in the polls—with her "Europa über alles" CDU party warrior Wolfgang Schäuble as finance minister—are selling out the vital interests of the German banking system. There is also the specter of a powerless German regulator holding the short end of the stick on a dramatically changed European stage. This contrasts with the strength of the German industrial sector in recent years, and does not at all reflect Germany's role in the European Union.

### COLLATERAL DAMAGE

The European Banking Authority's stress testing in the fall of 2011 for the EU-wide bank recapitalization effort has dramatized the sector's new dependence on arbitrary rule-making at the EU level, with enormous collateral damage in terms of the worsening financial crisis. Although European leaders sent the EBA on a bank recapitalization mission in October 2011, the agency under its Italian chairman Andrea Enria made a mess of the effort for seventy-one surveyed banks, unsettling markets and worsening the crisis. This raises the question of why the newly established European Systemic Risk Board did not perceive the systemic risks of forcing Europe's major banks into dumping Italian, Spanish, and other sovereign bonds on depressed markets in order to meet a recapitalization target, speeding their deleveraging by reducing their lending levels.

The stress testing was condemned by Jochen Sanio, then president of Germany's Federal Financial Supervisory Authority—BaFin—as "the EBA acting without proper legitimacy in setting controversial rules that define bank capital." In BaFin's annual report, Sanio put it on record that the EBA had "without legal authority…or legitimacy" ignored phase-out periods for such capital that were agreed as part of Basel III global bank regulations."

Heinrich Haasis, outgoing president of the Association of German Savings Banks (DSGV), accused the London regulators of "arbitrary rulemaking unsettling markets" in the German business weekly *Wirtschaftswoche*. He expressed outrage that the EBA "in a surprise assault" on the banks discarded the Basel III core capital rules that were negotiated over many years. This type of destructive regulation, warned Haasis, apparently was designed to speed up the formation of "a banking system according to Anglo-Saxon design." Sanio and Haasis were echoed by Michael Kemmer, managing director of Germany's commercial banking association, the BdB, representing such large private banks as Deutsche Bank and Commerzbank, when he pointed out that "the tests have caused market uncertainty and have procyclical effects" and that "by the frequent changes of criteria for the tests in a process that has been tiring and chaotic, EBA has lost credibility."

For the thirteen larger German banks surveyed for a possible capital shortfall (criticized as "trial with maximum error"), and also for the Berlin government and German regulators, the EBA's stress testing process became a nightmare. Initial estimates were that German

credit institutions would have to meet a combined capital shortfall of €5.6 billion to bring their core Tier 1 ratio to 9 percent by June 30, 2012.

In the process of stress testing—due to changing calculations of trading book risks and offsetting options for fair value gains and losses for credit claims on exposures to European Economic Area countries—the combined capital shortfall for surveyed German banks shot up to an alarming level of €36 billion (with €16 billion for Deutsche Bank alone.) When Sabine Lautenschläger, vice president of the German Bundesbank, and Raimund Röseler, head of banking supervision at BaFin, finally presented the results, the numbers turned out to be smaller. The EBA put the combined shortfall for six of the banks at €13.1 billion with 65 percent of the national capital shortfall attributable to two institutions—Commerzbank with a recapitalization requirement of €5.3 billion and Deutsche Bank with a requirement of €3.2 billion.

## Trap of Procyclicality?

The EBA has certainly deepened the European sovereign debt crisis. It totally misjudged the consequences of the last stress test. Banks were virtually forced to dump Italian, Spanish, and other European sovereign bonds and thus escalate the euro crisis to a point where only the ECB's two-stage €1 trillion long-term refinancing operation three-year flooding of the banks with capital could stabilize sovereign European debt markets.

*—K. Engelen*

### DEFENDING GERMANY'S BANKS

As fallout, segments of the German banking system—in particular the savings and cooperative banks—are now regaining the political support they lost in the initial reaction to the financial crisis, when the EBA and the other supervisory authorities were established. Large portions of Germany's political establishment, the media, and policymakers had supported transferring powers to independent European regulators with pan-European regulatory harmonization, more convergence, and a single rulebook. But reacting to growing concerns about regulatory transgressions, Germany's ruling CDU/CSU coalition has begun to pressure Merkel to use German clout in Brussels to defend the German banking system more vigorously.

In a parliamentary resolution presented on the occasion of the fourth CDU/CSU Congress in March 2012, the governing parties warned that through delegated acts, the ESAs are given powers that go beyond binding technical standards to "also make substantial, political, strategic, and structural decisions within the regulatory framework, powers that are preserved to those EU organs that have the needed democratic legitimacy." The CDU/CSU legislators asked the Merkel government to ensure, for example, that when the ESAs issue binding technical standards, they shall not imply strategic decisions or policy choices and their content shall be delimited by the legislative acts on which they are based. A hotly contested issue remains how much further—when implementing Basel III core capital rules—the EBA could go in its binding technical standards imposing final definitions on the Tier 1 criteria.

The more protective stance by German policymakers can be traced to the impact of politically explosive surveys of "EBA transgressions of competences" by major banking associations that are circulating in the ministries and among lawmakers. They document how binding technical standards will be implemented directly into national law without German lawmakers having a chance to adjust them to national circumstances.

The resolution demands that the government should ensure that the ESAs impose their regulatory mandate in a way that will not diminish the diversity of the German and European banking landscape, in particular with respect to servicing the small- and medium-sized business sectors. Instead of shifting such regulatory powers to the supervisory authorities, the proper legislative bodies—the EU Commission, the EU Council, and the EU Parliament—should remain authorized to make such decisions on the basis of democratic legitimacy.

### REGULATION WITHOUT REPRESENTATION

When European leaders upgraded the former Committee of European Banking Supervisors, Committee of European Securities Regulators, and Committee of European Insurance

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*The EBA "in a surprise assault" on the banks discarded the Basel III core capital rules that were negotiated over many years.*

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# Germany's New Euro Crisis Fire Brigade

As Germany enters the third year of the euro crisis, Chancellor Angela Merkel has lost most of the top officials who helped her stem the 2008–09 banking crisis that jolted Berlin at the end of her "Grand Coalition" with the Social Democrats.

Her chief economic advisor, Jens Weidmann, became president of the Bundesbank in May 2011, after his predecessor Axel Weber decided not to serve out his tenure and thereby give up his candidacy to head the European Central Bank. And after Jürgen Stark—in protest against ECB securities purchases—followed Weber, resigning early in September 2011 as ECB chief economist, Berlin sent Jörg Asmussen, long-time deputy finance minister, to the ECB's Executive Board beginning January 2012.

**Some seasoned observers question why Merkel and Schäuble chose two insurance industry experts—Steffen and König—and Röller, an academic in competition policy, for the three key positions handling the banking and sovereign debt crisis both domestically and internationally.**

**No wonder Germany's stressed financial market community doubts whether the new "fire brigade" will live up to the enormous challenges it faces.**

In fall 2009, when the Christian Democrats and their Bavarian sister party, the Christian Social Union, won the national elections and took the Free Democrats into a conservative-liberal coalition, Merkel put veteran CDU stalwart Wolfgang Schäuble in charge of the finance ministry. The fact that Merkel and Schäuble kept SPD finance secretary Asmussen and other top finance officials was indicative of the fact that the Social Democrats had held the finance ministry for more than a decade. Asmussen's role was even enlarged as the chancellor's "sherpa" to prepare the G-7 and G-20 summits.

Schäuble filled Asmussen's heavy-duty position with Thomas Steffen, formerly Germany's chief insurance supervisor as director of BaFin, who also chaired the Committee of European Insurance and Occupational Pensions Supervisors from 2007–09. Steffen was called back to the finance ministry as head of the European department, becoming Schäuble's key negotiator in Brussels, in particular on the building of the euro rescue walls. Before joining BaFin, Steffen had moved up the finance ministry ladder in the 1990s. It helped that he had studied law in France and the United Kingdom before joining the finance ministry.

Instead of calling an experienced banking and capital markets expert with crisis management experience as her chief economic advisor, Merkel selected Lars-Hendrik Röller, an academic in the field of competition policy and regulation. The son of the former head of the now-defunct Dresdner Bank AG, Merkel's new chief economic advisor and "sherpa" for the G-7 and G-20 summits studied and taught at several U.S. universities, held economist positions at the EU Commission, and taught at the business school INSEAD. He was president of the European School of Management and Technology in Berlin before moving to the chancellery.

Other veteran officials of the German finance ministry had to be replaced, such as Rolf Wenzel, who was responsible for dealings with the International Monetary Fund and banking and financial markets. Wenzel took over the presidency of the Council of Europe Development Bank in January 2012. Levin Holle, his successor, comes from the outside, specifically the Boston Consulting Group, where he headed the Berlin office. A seasoned senior economist from the ECB, Ludger Schuknecht, who had specialized in EU fiscal studies, took over the ministry's policy department.

At a time of great pressure from a protracted global banking crisis which evolved

**Jörg Asmussen**
*Long-time deputy finance minister, now new ECB Executive Board member.*

**Thomas Steffen**
*New negotiator in Brussels.*

**Lars-Hendrik Röller**
*New G-20 sherpa.*

**Levin Holle**
*To interface with the IMF.*

**Sabine Lautenschläger**
*New deputy president of the Bundesbank.*

**Raimund Röseler**
*New top banking supervisor.*

**Elke König**
*New president of BaFin.*

into a sovereign solvency battle reaching the core of the eurozone, Germany's policymakers are also struggling to adjust to the new European system of financial supervisors. By naming Sabine Lautenschläger, Germany's top banking supervisor at BaFin, as deputy president of the Bundesbank, the Berlin coalition sent a gender signal and also made sure that the Bundesbank and BaFin as national watchdogs would work closely together as more supervision and regulatory powers shift to the European authorities. Lautenschläger's position as top banking supervisor was filled by Raimund Röseler, who worked in the private sector with HypoVereinsbank before joining BaFin.

The beginning of this year also marked the end of the Sanio era in German banking supervision. For decades, Jochen Sanio represented Germany in the European and international regulatory and supervisory bodies negotiating Basel I, Basel II, and Basel III. As a young lawyer, Sanio had joined the predecessor banking watchdog BAKred in 1974, the year of the Herstatt bank failure that shook global foreign exchange markets and caused major losses for international banks. After serving as vice president and then president of BAKred, when BaFin was established as financial supervisor for banking, securities markets, and insurance in 2002, Sanio became its president, acting as key crisis manager in a decade of never-ending banking and financial market turmoil.

He is succeeded by Elke König, who was a member of the International Accounting Standards Board and previously served as chief financial officer of Hannover Rückversicherung AG.

Some seasoned observers question why Merkel and Schäuble chose two insurance industry experts—Steffen as deputy finance minister and König as BaFin president—and Röller, an academic in competition policy, for the three key positions handling the banking and sovereign debt crisis both domestically and internationally.

No wonder Germany's stressed financial market community doubts whether the new "fire brigade" will live up to the enormous challenges it faces.

*—K. Engelen*

and Occupational Pensions Supervisors into independent EU agencies and cooperation platforms within a European System of Financial Supervisors, key spokesmen for the financial industry called on the Berlin government to make sure that Germany as the largest and most diversified financial sector in the European Union would be adequately represented in the personnel pool. But with Germany's top officials absorbed in the management of the financial crisis, the strategic challenge of securing adequate German representation in the management and staff of the authorities was dismally neglected. To banking critics this was not surprising, since Finance Minister Schäuble has been at cross purposes with the German banking community since taking office in 2009. "In his disgust and in revenge on banks as culprits of the financial crisis, no other German finance minister has been so eager to transfer regulatory power to Brussels without caring much about the long-term consequences for the German banking system," complains a top German banker.

Consider that in major votes of EBA bodies—like voting on stress tests—most of the twenty-seven supervisors come from countries without larger, systemically relevant banks, but still can swing the tide. Since the authorities began their operation in January 2011, not just Germany's banking and finance communities but also the political establishment are beginning to realize how much regulators from other countries are calling the shots. With no representative in the European Insurance and Occupational Pensions Authority's management, Germany has only Raimund Röseler, BaFin's executive director for bank supervision, and Karl-Burkhard Caspari, BaFin's executive director for securities markets, on the boards of the European Banking Authority and European Securities and Markets Authority respectively.

### EBA STRESS "LEAVES FEARS FOR THE FUTURE"

Disgusted with how the EBA handled the recent recapitalization, Jochen Sanio of BaFin was not alone when warning that the bungled EBA stress test "leaves fears for the future."

As Matthew Elderfield, the EBA's alternate chairman and deputy governor of the Central Bank of Ireland, conceded at the CDU/CSU Congress: As the banks are in the process of meeting the EBA's aggregate €115 billion capital requirement, "perhaps the safest course of action, then, is for a breathing space in terms of further initiatives on the capital front. The EBA's decision to postpone its next stress test exercise into 2013 is therefore a sensible development."

Nobody now disputes, even on the official side, that the EBA totally misjudged the consequences of the last stress test. Banks were virtually forced to dump sovereign bonds and

## The ESRB: Asleep at the Switch

When monetary historians write up the euro sovereign debt and banking crisis, they will probably point to the failed start of the European Systemic Risk Board established after the crisis to detect and mitigate systemic risks.

At the height of the crisis in October 2011, when European leaders decided on a radical bank recapitalization program for the member states and gave the task of stress testing seventy-one large banks to the European Banking Authority, the central bank-dominated ESRB was caught asleep at the switch. At the time, Jean-Claude Trichet, president of the European Central Bank, was its chairman.

By stipulating that Europe's major banks would have to reach a core Tier 1 capital ratio of at least 9 percent with a "sovereign buffer" (core capital would be assessed net of valuation losses on European Economic Area sovereign exposure incurred by end-September 2011) by June 2012, the huge systemic risk of procyclicality was apparent.

Had the leadership of the ESRB, chaired since November 2011 by new ECB President Mario Draghi, forgotten the declaration of the G-20 Washington summit of 2008, when leaders called for the development of recommendations to mitigate procyclicality, including the review of valuation and leverage, bank capital, executive compensation, and provisioning practices? Javier Suarez and Rafael Repullo from the Bank of Spain's Center for Monetary and Financial Studies recently published a paper, "The Procyclical Effects of Bank Capital Regulation," and cannot understand why the ESRB stayed on the sidelines in such an ambitious capital raising effort where the procyclical mega-risks for the eurozone were so obvious.

This spectacular failure of the new risk board brings to mind how Willem Buiter, shortly before joining Citicorp as chief economist in November 2009, put down the ESRB because it was "overweight central bankers." Bankers, politicians, supervisors, regulators, and also central bankers have credibility problems as watchdogs of systemic risk. As Buiter points out: "The ECB, the Euro system NCBs, and the rest of the EU NCBs have not exactly covered themselves with glory in the area of macro-prudential supervision and regulation during the past decade. Like the Fed, they failed to foresee the financial crisis let alone to prevent it. Like the Fed, the ECB and most other EU central banks contributed over a period of many years to the unsustainable credit and asset market boom and bubble that turned to bust starting in August 2007. … In Germany, the Bundesbank failed to diagnose the deep rot in most of the Landesbanken, and the excessive leverage of its main cross-border banks; in Spain, the Banco de España, despite being widely admired for its pioneering of dynamic provisioning, failed to recognize the wildly excessive exposure of its regional cajas to the construction industry, developers, and the housing market generally. The Banque de France missed an epochal fraud at Société Générale. The Dutch central bank missed the ball completely with the ABN-Amro take-over and the subsequent collapse of Fortis. The litany of central bank failure is endless."

*—K. Engelen*

thus escalate the euro crisis to a point where only the ECB's €1 trillion long-term refinancing operation three-year flooding of the banks with capital could stabilize sovereign European debt markets.

A highly placed German regulator sees some blessings in disguise when he observes: "Due to the recapitalization program, Europe's major banks are on the way to having more than €100 billion in core capital." But this has been achieved by dramatically changing the rules, industry analysts argue. Although sovereign bonds carry a zero risk weight, the EBA changed that in practice to deduct book losses from capital. Such a capital charge (under Pillar 2) is very high, and the uncertainty of future price fluctuations in bonds made it very risky for banks to own sovereign bonds. Overall European crisis management was hugely undermined by an independent European regulator. In this way, the EBA has certainly deepened the European sovereign debt crisis.

At the same time, the EBA has damaged its own reputation. American regulators are seen as highly professional in their stress-testing exercises. This applies to both the design and implementation of such exercises as well as to the communication of results. As a consequence, U.S. stress tests conveyed by and large the notion that regulators were in control of the situation and helped calm the markets. The EBA, on the contrary, has performed much worse on all these criteria. Both the next stress test in 2013 and the quality of binding technical standards to be worked out this year will therefore be a test of the EBA itself. The EBA will have to live up to high expectations by policymakers and financial markets. Credibility is easily lost, but hard to regain.

### THE EBA: INDEPENDENCE AND ACCOUNTABILITY?

"We have a serious problem with the EBA's independence and accountability," says a politically well-connected veteran regulator now in private industry. "Those regulators have powers to work out binding technical standards which need the endorsement of the EU Commission. Nevertheless, the Commission does not seem to take responsibility for the actions of the EBA in general. The question arises: To

which European body is the EBA accountable at all? So far, at least, no one takes ownership. In modern democracies this is hardly acceptable. The EBA should have clear lines of accountability *vis-à-vis* the European Parliament and the public at large." This insider sees an urgent need to rebalance the EBA's power. "Giving the EBA quasi-rulesetting powers (through the Commission) and allowing it to conduct stress tests without real accountability means a double shift in power: National parliaments have more or less lost all their influence on the European rulemaking process and the executive branch of European government (the Commission) has gained huge additional power. Members of the European Parliament like the idea of Europeanization of supervision and regulation. This strengthens European institutions in general and weakens national governments."

However, this shift in power creates a growing disconnect. The decision that a bank needs higher capital would in most cases be taken in London by the EBA, whereas the implementation remains a national task. This can lead to dire consequences, such as national governments having to recapitalize banks using taxpayers' money. It may even lead to cross-border payments if banks in a country such as Greece are unable to meet their capital needs and the government itself is also insolvent. Who then pays the bill? Typically, the eurozone must contribute, which means Germany, France, and to some extent Italy pay for stress test-induced bailouts of banks elsewhere in the eurozone."

But Deutsche Bank's international expert for financial market supervision, Bernhard Speyer, took a more sanguine view of the new European supervisory authority structures when he wrote in a recent study: "As regards the reform of micro-prudential supervision, the establishment of the ESAs is undoubtedly another step in the evolutionary approach that started with the Lamfalussy Process. But it still leaves the supervisory framework in an uneasy halfway house between national and supra-national structures for financial supervision. This construction reflects that the structure, which took effect at the start of the year, is a hard-fought compromise between the European Parliament and the Commission, who wanted stronger powers for the EU-level institutions and transfer of direct supervisory powers over at least the largest financial institutions in the EU to them, and the (majority of) the Council, which wanted to preserve the influence of national supervisors."

*The question arises: To which European body is the EBA accountable at all?*

On the basis of the earlier EBA stress test, Speyer correctly pointed to the problem of how the EBA could get into big trouble in stress test exercises: "[T]his leaves the European supervisory authorities caught between high expectations on the one hand and limited powers and the head winds from national supervisors on the other. As a result, the new structure of micro-prudential supervision constitutes an uneasy arrangement if handled well—the integrated structure of national and EU-level institutions could be tantamount to a pooling of the strengths of both levels. It is at least equally likely, however, that conflicts over competences will be frequent, making supervision less effective."

Against this background, Speyer—like many others—welcomes that the EU regulation establishing the European system of financial supervisors stipulates that the entire structure be reviewed after three years. But what Speyer, who represents Germany's remaining globally operating bank, leaves out is the fear of large segments of Germany's savings bank and cooperative bank sectors that, through a steady flow of binding technical standards emanating from the supervisory authorities, in particular the EBA, Germany's banking landscape might change drastically—and not for the better in terms of bank services for retail customers, for small- and medium-sized companies, and for the larger society. ◆

## Competence Gap?

**Andrea Enria**

Although the European leaders sent the EBA on a bank recapitalization mission on October 26, 2011, the agency under its Italian chairman Andrea Enria made a mess of the recapitalization effort for seventy-one surveyed banks, unsettling markets and thus worsening the crisis. This raises the question of why the newly established European Systemic Risk Board did not perceive the systemic risks of forcing Europe's major banks into dumping Italian, Spanish, and other sovereign bonds on depressed markets in order to meet a recapitalization target, speeding their deleveraging by reducing their lending levels.

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