

Unedited Rush Transcript

Moody's Investor Service–PIIE Sovereign Economic Panel  
The European Union: Challenged and Poised for Change

Session 1: The EU financial system on the eve of the single supervisory mechanism

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Panelists:

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Adam Posen: I'd now like to call up the next panel, which my colleague Jacob Kirkegaard will be chairing.

Jacob Kirkegaard: All right, let's proceed in the program, which is already tight. The next panel is going to be about the European financial system today on the eve of the launch of the single supervisory mechanism. Now, everyone has a PowerPoint, which means that I think everyone will be able to see, even though we're already set up here. So that is good.

And I'm happy to say that we have an absolutely stellar panel to discuss this issue. Because the first panelist is Karolina Ekholm; who will be probably known to most of you as the now former deputy governor of the Riks [inaudible 00:01:01] in Sweden, but has recently joined the new government as State Secretary in the Ministry of Finance. And before that, before joining the Riks [inaudible 00:01:10], also had a distinguished career in Swedish academia and did European and International academia.

In the middle, we have Michael Foley who is the managing director from Moody's Global Financial Institutions Practice, but for this particular purpose, it is also incredibly relevant to note that Michael has a distinguished career as a banking supervisor with the Federal Reserve where he was the senior associate director responsible for large banking supervision during the financial crisis and only returned to Moody's in 2012.

And then finally, we have Ajai Chopra who is now fortunately with us here at the Peterson Institute, but was of course the former deputy director of the IMF's European Department. And, at least in this building is universally credited with singlehandedly rescuing the Irish economy.

Each panelist has about 10 minutes for their presentation and I believe everyone has a PowerPoint. Okay, only two PowerPoints, even better, but Karolina, without further ado, I think it's probably easier if we—

Karolina Ekholm: If I stay [inaudible 00:02:24].

Jacob Kirkegaard: If you stay up there and we should ....

Karolina Ekholm: I should—it—is this the?

Jacob Kirkegaard: Yes, that is.

Karolina Ekholm: Well, thank you and thank you so much for the invitation. And, because I switched job very recently, there's been a flurry of activities the last day or so to remove all the logos of the Swedish Central Bank from my slides and also making sure that I don't preempt any position that the new Swedish government may want to take vis à vis the European banking union.

So, as was clear here, we do have a new government and I think they haven't really put down their foot yet regarding where they want to stand in terms of the membership in the banking union. So, I'm not going to stand here and make some stark revelation regarding what the Swedish position is likely to be, but I can give you some more general views on the plans for a European banking union from a non-Euro country perspective.

And, my starting point is very much where Marco Buti's presentation or the focus of Marco Buti's presentation namely that there isn't really any sign of a clear recovery in the Euro area if we look at more the general economic development. So my graph here shows GDP in levels and its index so it takes the value of hundred the last quarter of 2007 before the financial crisis.

So the red curve is the Euro area and it has been pretty flat the last few years. Of course, there are differences within the Euro area, so I've also put Germany in this graph and Germany has, of course, done much better than the crisis country in the European periphery. But still, even Germany is showing signs of weaknesses more recently.

And of course, there are many different reasons why the development has been so weak, but I would think that one factor at least, important factor, is remaining weaknesses in the European banking sector. And of course,

in Europe, banks are very important for credit intermediation, much more important than here in the United States.

So this diagram shows—well, the blue bar shows quarter one capital ratios. It's the medium for a large number of banks that are going to fall under ECB supervision. So, on the positive side, you see that there's been sort of an increased capital ratios in these banks and that is partly related to the banks having taken in more capital, but of course also, partly related to some process where they—we have shared assets.

Now, the red bar show you profitability in terms of return on equity. And, there, the development is of course not so positive, very weak profitability and decline in profitability. And, to a large extent, the decline in profitability is related to poorly performing assets in these banks. And, there's a lot of uncertainty regarding the European banking sector also when it comes to where exactly these poorly performing assets are located.

And I think one important aspect of the process leading up to the creation of the single supervisor mechanism located at the European Central Bank is the fact that all of this has to go—you have to go through the banks now. So, there has been this exercise and comprehensive assessment going through the quality of assets in the European banks carrying out a stress test.

And I see this is an opportunity to restore confidence in the European banking sector because there's been a number of stress test carried out before, but I think unlike the ones or the main one in the US, they weren't really perceived as very credible. But this time, the ECB has very strong incentives to really find the weaknesses, where the weaknesses are, or to deal with them because they don't really want to take all the supervision of the banks that aren't really viable even at the outset.

And, as I've noted on this slide, at least according to a survey made by Goldman Sachs, the perception in the market is that this exercise is likely to be credible, but it remains to be seen. We will see very shortly since the results are going to be presented at the end of this month.

Now, from a Swedish perspective, I would say that the characteristics of the Swedish financial sector is such that there are—large membership in the banking union maybe quite beneficial. So this diagram shows you bank assets in relation to GDP and here, it's bank group so it also includes assets held by foreign subsidiaries. So you see that Sweden has very large banks in relation to the size of the economy and a lot of it is related to operations outside Sweden.

But because of this very large financial sector and the fact that a lot of these activities are in Europe, in the Euro area, I think that, in principle, Sweden is one of those countries that could have a lot to benefit from an integrated regulatory framework for the banks. But the way the banking union is being constructed, creates some political obstacles to membership for a non-Euro country.

So, one obstacle is that because the single supervisor mechanism is located at the ECB, non-Euro countries don't have a seat at the table where the formal decisions are being taken, which is the governing council of the ECB. So that's one issue.

Another one that I've noted on this slide is that it's a little bit unclear—so there's a single resolution fund that is going to be built up by taking in fees from the banks, but it remains a little bit unclear whether this fund is going to be sufficient to provide proper insurance for a country such as Sweden with our large banks.

So, those are some of the obstacles. And, the outgoing government, the previous government, because of these obstacles, has sort of chose to take a wait and see approach to the issue of membership. Still, it's going to be the case that Swedish banks will fall under supervision by the ECB because of their operations outside Sweden, because there are these criteria based on size of assets or whether there is the most important banks in membership countries.

So, three out of our four large banks are going to be on this SSM supervision in one way or another. So that's a challenge for a country that will remain outside the SSM, at least at the outset. Now, another, I think, issue is that the way bank resolution is being set up seems extremely complicated. So there's a picture here that you probably won't see the details of and it's not meant to be. You may have seen it in other contexts.

It's something that German politician who is a member of the European parliament made in order to try to illustrate how resolution is supposed to work, all the steps involved and all the different parties involved in trying to resolve or restructure a bank with problems. And, it's actually said somewhere in this picture something about, "And this is supposed to be done over a weekend seriously?" And also, if you have very large banks like we have lots of foreign activities, cross border activities, this is also a source of concern. Is this really going to work in terms of resolution?

And finally, I would say that it also, as you probably know an important part of the framework for resolution or restructuring is that there's going to be bail-in of creditors. And, I think there's a fear in Sweden that a bail-in would involve large contagion risks. And this pie chart shows you the

asset share of our large banks and so, the colors except the green one is the four large banks and so you see our four large banks hold more than 75% of banking assets in Sweden.

So there is a concern that if one of these banks get into problems and there's bail-in of creditors given that these banks are—they look quite similar, they have quite similar exposures, that this is going to lead to terrible contagion processes that makes all the banks for—to end in problems.

So, I think all of these are our concerns that has made the previous government to want to wait and see a little bit. So, in short, strong banks are needed for economic recovery in Europe. The comparative assessment with the credible asset quality reviews are preconditioned for regained confidence I would say. And, although the benefit from participating in banking union is likely to be high in the Swedish case, it seems likely that we will stay outside for the time being. We will still be affected because our banks would fall under the supervision of the ECB and we think that bail-in can be a challenge and we're pretty sure that resolution will be. Thank you.

Jacob Kirkegaard: Thank you very much Karolina. Michael?

Michael Foley: Yeah.

So, I think I've [inaudible 00:14:44] excellent. I'm going to start just by referring back to the title of this session today, which I thought was very interesting: Challenge and Poised for Change. I've been involved as a bank analyst or a supervisor in the banking sector for some 25 years. I've had the, I guess, pleasure of living through the Texas bank crisis, New England real estate, the SNL Crisis, a number of emerging market crisis and some pretty spectacular one off bank failures.

But I don't think anything has approached the stress that we've seen in the banking system over the last several years post-Lehman. And, when I think about the AQR in the comprehensive stress test underway right now or even the CCAR, compared to what the banks have actually had to go through in terms of real-life stress test, it just kind of pales by comparison.

But, having thought about the changes that have come out of prior crises and having thought about the fact that "too big to fail" has been on the agenda many times in the past but there's been very little progress towards actually ending it, I think we truly have seen more fundamental, more profound, more long-lasting change coming out of this crisis by far than any prior crisis we've been through. And I think that that's true in terms of a significant limitation on activities that banks can engage in, regulatory

requirements and standards around liquidity and capital that are going to be embedded and, I think, long-lasting.

I think a fundamental step change in terms of requirements from a regulatory standpoint and around internal risk management. And again, I think it's going to be long-lasting. And perhaps most importantly around resolution. We're recovering resolution. We've gone beyond talking about it. There's political will at this point and most importantly, there are legislative frameworks that are being put in place.

So, just to give you a sense of a—the magnitude of the change and I'll speak in rating space, I'm most comfortable with that. Prior to Lehman, the average rating in North America for banks was AA2. This was a very highly rated industry. The average rating in Europe was also AA2. Today, the average bank rating in North America has come down to A1, so that's a two-notch differential, which over this amount of time from a historical standard is a pretty significant move. In Europe, in the non-Euro area banks, the average is now A2, so a three-notch move. And in the Euro area, the average rating is now BAA1, five notches lower than we were prior to Lehman.

So, there's been a fairly significant structural change in terms of how I think the market, how the rating agencies view banks. And again, I don't think that's a short-term phenomenon. If we were here having this discussion two years ago, I think we would have been talking about acute stress in the banking system. Even a year ago, we were very focused not so much on core Europe at that point, but on a number of the banking systems in the periphery, systems that had either gone through recapitalization. We're in the process of going through recapitalization or we're threatened through recapitalization.

And, I think as we stand here today, much of the tail risks that we had focused on has been reduced and many of the banking systems have, at least from a financial strength standpoint, stabilized. I think that's been obvious in the core European banking systems, but increasing I think it's evident in some of the peripheral countries as well.

For example, from a sovereign standpoint, we've upgraded the ratings of a number of peripheral countries while growth has not been robust, we've moved from, in many of these countries, a significant recession in some cases such as Italy, a triple dip recession to at least a point where we're seeing stability in the potential for growth in the near term. Asset quality liquidity across the board is much stronger funding issues that were a real threat to the banking system have receded pretty dramatically with the help of the ECB.

Asset quality is the one area where we continue to see a significant overhang. But the difference there is quite stark between the core European countries and many of the peripheral countries and I'll come back to that in a moment.

Having said that, I think one of the biggest challenges that the banks are facing going forward is growth, and the lack of growth or the very modest growth. And we've seen, I think through the second quarter, essentially flat growth this year expectations in Europe for about 1% growth and that significantly raises the degree of difficulty for banks that will have to work through a very significant overhang of problem assets over the coming years.

And compounding that because of the low-rate environment while there are some benefits from that in terms of borrower's capability to repay. So benefits from our funding cost standpoint, margins have been continually squeezed, profitability is quite thin. So the ability of banks to deal with ongoing credit cost has been again fairly challenged.

This just pictorially shows some of the progression in Moody's ratings. The green portion of the bars are the elements of the rating that are effectively the standalone financial strength. You'll see that since 2008 to today, the significant change in our ratings has been primarily driven by financial strength. And across most of Europe today, we have stable outlooks on banks in terms of financial strength. There are some exceptions; Italy is one exception where two-thirds of our banks still have negative outlooks in terms of their underlying financial strength, but for the most part, our view has stabilized in many of these systems.

The yellow bar is the area that we're focused on right now and that's the portion of the rating that's attributed to systemic support. And there have been a number of changes that have come out to this crisis. I think potentially the most significant, the most long-lasting, is around the movement to actually end "too big to fail". And as I mentioned it before, while there's been discussion around this, what we now have is very specific legislation in the US around Dodd-Frank and very specific legislation that will become into force in Europe in terms of the BRD. And a political will to put in place a framework where there will be much less flexibility going forward for receivers, for regulators to support banks even if they think it would be appropriate to do so from a financial stability or contagion risk standpoint.

As it stands today, the yellow bars are still quite large for senior unsecured debt. Support for subordinated ranks for hybrids has essentially disappeared over the last three to four years. But we are having to go back and look at the support that's embedded in our European ratings. Two-

thirds of European banks still have some systemic support built in for senior unsecured debt. It equals three notches, equivalent of three notches, which is very material in core Europe, and a little over one notch in peripheral Europe. So that is a key focus for us going forward.

I'll speak to some of the underlying fundamentals and I'll be relatively brief here. I'm just referring to some of the trends where there's unambiguous progress. The numbers here I think are self-evident and pretty compelling. A tangible comment equity risk-weighted assets increasing from just over 7% to close to 13%. Problem loans relative to equity plus loan loss reserves that have been quite stable for most of the core European banking systems and actually improving in a number of those systems including the UK.

Quite a bit of a dichotomy with the peripheral European countries here though as you can see, that problem loans have been increasing at a pace that has outstripped their ability to reserve for those loans to generate capital to offset potential losses. We have seen a flattening of that in a number of systems in 2014. So we may be seeing a bit of an inflection point for some systems. There are other systems; Italy being one example, Cyprus being a more extreme example, where you continue to see significant inflow of new nonperformers that aren't being offset by reserves or capital.

It's worth just noting for a moment, liquidity and funding because as we went through the crisis, this was the most significant factor in determining whether banks were viable or not viable. And today, we're in a dramatically different situation. European banks are far less reliant on a market funding. They have much stronger liquidity. Even in the periphery, the banks have the leverage, they've improved their deposit funding. The ECB has gone a long way towards addressing the near term pressure.

So, this was a key driver of our rating considerations two years ago, three years ago. It's basically come off the table as a concern. Certainly, that can reverse going forward. To some extent, we view the regulatory enhancements around the LCR, the NSFR as being helpful and making sure that the banks continue to have a more conservative approach to liquidity and funding.

I'll spend just a minute on profitability because from a credit standpoint, this is perhaps the issue that we're most focused on over the medium to long-term. And what we have seen is that certainly the market does not expect banks to earn the type of returns that they earned pre-crisis. And many banks have readjusted their expectations and communicated lower ROE targets to the market. But the fact is that many banks still are not running their current cost of capital. That's a situation that can persist for



some period of time, but the longer that goes on, the more pressures that will post for the management.

So they've taken a number of steps in Europe. They've taken these steps in the US as well in terms of focusing on core businesses, exiting geographies and lines of business where earnings were weaker, where risks were higher, but they're also having to deal with higher costs. Higher costs for compliance, litigation and fines and those are going to be, I think, persisting cost going forward.

So the concerns we have around this is behavior going forward for the banks and that's kind of highlighted a bit in the red box here. And, historically, if you go back through prior banking cycles, I think the suggestions of bankers have the shortest memory on record, but there is a tendency if banks are unable to earn an appropriate return to look for revenue growth. And banks are very frustrated today. I think they believe they have enough capacity, funding access liquidity to book quality loans. There's intense competition including in the peripheral countries for bankable credits spreads out relatively tight given the economic conditions overall. The banks are still finding it quite difficult to generate revenue growth as they're seeing runoff in a very large nonperforming portfolio.

So there have been a number of efforts to reduce cost and take other steps. But as it stands right now, perhaps, the biggest challenge is growth going forward. And, the chart here I think is just a little bit longer time horizon, but similar to what we've seen already today. And clearly, in prior cycles, the recovery has been stronger, it's been more pronounced, it's been more sustained. And in Europe in particular, what we've seen is a fairly modest bump up and then a trickle down in terms of economic growth and uncertainty in terms of the direction going forward.

And I'll just compare that to the US a bit whereas was noted today, the recovery in the US has not been as robust as might have been the case given the severity of the downturn, but there has now been enough growth for a long enough period and that's sustained in the expectation of sustained growth. It has been sufficient enough to allow for underlying asset prices to firm up for banks to understand what the likely lost content is. And from a reserve standpoint, that's been evident in credit cost that are now more in line with what we would have seen pre-crisis than at any point since.

So, the longer that that growth factor is I guess an overhang in European banks, the more likely that instead of us being a one, two, three or time horizon in terms of working through problems, it becomes a much longer, a much more protracted problem.

So, I think I'll leave it with that. If we have time for questions, it might come—it might be interesting to come back and talk about resolution as well. But, let's move on.

Jacob Kirkegaard: Thank you very much Michael. Ajai.

Ajai Chopra: Thank you.

Thank you. It's a pleasure to be here with this distinguished company. The outside, I also—I just want to do a shout out to Nicholas Véron who's a colleague here at Peterson. He's the resident expert on banking issues, especially on Europe, and I had benefitted greatly from discussions with him and his writings, but the views here are my own, not to be ascribed to him.

So what I'm going to do is I'll first start very briefly on how I see the problems in the banking system in the Eurozone and I'll focus primarily on the Eurozone, not the EU. And then, I'm going to discuss three aspects of how these problems are being addressed: the AQR, the move towards banking union. But one thing that hasn't been mentioned that I do want to touch on is the importance of repairing private sector balance sheets. Now, these are of course vast topics. I know I stand between you and lunch so I'll sort of be quite selective in what I cover.

I think on the problems the previous speaker noted Marco Buti have touched on them, but just to recap a couple of points and add a couple. I mean, first, banks in the Euro area have been very slow in dealing with unviable banks excepting the most egregious cases. We've also heard about investor uncertainty about the true condition of banks. We've already heard about a very weak income and profitability of these banks, which of course also then constraining their ability to supply credit so we've been seeing growth of lending to the private sector being a negative territory. Yes, there is a demand element, but there's a very substantial supply element over here, too. And the GFSR from the IMF that got released yesterday has some very nice analysis on this.

Second financial market are still fragmented. Marco Buti had a nice slide on that so I don't have to go into the specifications over there. The third point problem that I'd highlight is that sovereign and bank links remain very tight. A home bias of in Sovereign Debt Portfolios held by banks and still quite significant, and if anything it might have increased.

The fourth issue is that there's still a very significant corporate and household debt overhang, which is the counterpart of what's happening in the banks. And then, Michael Foley just also emphasized the macroeconomic risks. Banks don't operate in a vacuum. They operate in a

particular microeconomic environment and the macroeconomic environment that they face is one of low inflation, very weak growth and very high public and private debt.

Now, having pointed to these problems I think it's also important to point out that the market environment has benign, and that this is also something that Michael Foley mentioned, so that systemic threats have receded, spreads have tightened, bank funding conditions have improved. But I think history also does tells us that markets can overshoot fundamentals.

So how are these problems being addressed? I think there's already been several mentions of the AQR and I think when these results are announced in a few weeks, the press and analysts will try to instantly come up with a verdict on whether they're successful or credible and they'll end up focusing on the aggregate capital requirement. In my view, that's not the way to look at this and the truth is going to be—is that it's going to take quite some time before we can judge because success of this exercise will depend very much on the rigor of a bank repair rather than just having a big capital hole.

I think Miss Ekholm already talked about the reputational issues for the ECB and their incentives. But, I feel that there could also be a tendency for forbearance in order to avoid any market instability right now especially given that there isn't a common Euro area backstop to protect market confidence. And it's also possible that because of just inexperience, that the ECB will miss some material asset quality problems in the process of this exercise. They still have to rely on that [inaudible 00:31:39] national supervisors.

But, there have been positive developments. I mean, a lot of focus has been on the fact that banks have been raising capital. They have been recognizing bad loans, but I think there's been—very recently, there was one other event that happened that has been less noticed. There is an Austrian bank, Austria Volksbank that's already started the wind down process. I mean, essentially, it was clear that this bank would not pass the stress test. It had been bailed out in the past by the Austrian government. The Austrian government decided it's not going to put any more capital into this bank. So, the wind down process has started ahead of the AQR and stress test results. I would hope that we'd see more of these, but let's see. If we did see more of these, I think that would be quite a significant development.

In a blog post a few months ago, Nicholas Véron and I used the catchy phrase that what Europe needs to do as a part of this exercise is “kill the zombies and heal the wounded”. And here are the zombies here are the zombie banks and the wounded here and wounded banks. So, the basic

point is, to maximize prospects for success of the AQR, it will be essential to identify the banks that are not viable and that should be closed in an orderly manner and those that can be made viable with corrective measures.

Just a few words on the bail-in regime, I think this has been mentioned. My view is that bail-in of unsecured senior bonds to reduce the cost of resolving zombie banks would be the right thing to do. It would reduce the resolution cost, it would increase financial discipline, it would reduce moral hazard. Now, having said that, I don't think this is going to happen in this exercise. The BRRD does not come into full effect until 2016 and the ECB, I think, will be reluctant to do anything that might cause tension and bank funding markets, rather I do think we will see write down of shareholder equity, as well as hybrid instruments, subordinated debt as happened in the case of Banko Espírito Santo.

Now, I very much take the point that there is a danger of a contagion if senior debt is written down, but the point I'd make over here is that it would be quite unfortunate, I think, if protecting senior debt markets in the Eurozone comes at the expense of putting the burden on taxpayers and individual countries as well.

Two quick additional aspects on these stress tests. One is they don't include a deflation shock ... even in countries where the risk of deflation is particularly high. So weak assumptions about stress tests is going to make it more difficult for the ECB to establish trust that the banks are sound.

The second problem that I see is that the genuine concerns about risk waiting and also about the definition of capital in the Euro area, in the EU actually, and I think studies do show that our risk-based tier one capital are not a good predictor of default, while simple unrated leverage ratios are much better. Now, one good thing is that the disclosure, as a part of the stress test, will include a leverage ratio. But I think it would be much better if this leverage ratio was not just based on CET1, but rather was based on tangible common equity, which then takes out goodwill, it takes out deferred tax credits, it takes out minority interests because this is what really has the lost absorbency.

Now, on banking union, my bottom line is that what's been achieved since the launch of banking union in the middle of 2012 to two years ago has been very important and in some respects, even quite radical. It's a big change in the institutional structure, but I think it's a misnomer to call it a banking union as yet because it does not break this vicious cycle between banks and sovereigns. The most concrete improvement is the launch of the SSM, the Single Supervisory Mechanism because a key benefit of the

SSM is that it will increase the tangibility of liquidity within cross-border groups, which will help reduce financial fragmentation.

But, some of the other elements, the single resolution mechanisms, it has already been pointed out as to how cumbersome that is, but also, it's not really a single resolution mechanism because it's still subject to national resolution authorities and who have divergent resolution regimes. So I would question the notion as to whether it really is single and also the single resolution fund will have very limited capacity and it will take a long time to build.

On direct bank recap, there has been political agreement to have such an instrument, but I think the likelihood of it being use are very low because the conditions that have been applied are very, very stringent. So, I don't see that as a real instrument as yet for the Euro area. But more fundamentally, deposit insurance will remain a national—will remain purely national in the absence of any move to a fiscal union or move to a Euro bond so there's no common fiscal backstop.

And, what this ends up meaning is that if there is a crisis, it's not clear what will happen if the SRF and national deposits schemes are insufficient to deal with it. This also ends up raising some anomalies because what we—as far as I can tell, the provision of emergency liquidity assistance is still going to be based on national central banks rather than—once you have the SSM, it would have been logical that all lender last resort would move to the ECB, but as far as I can tell, that's not going to happen.

So the result is that banks and sovereigns are remained joined at the hip and as long as banks are not independent of their domicile and of their sovereign, banking markets will not be fully integrated.

Last point is on repairing private sector balance sheets. It's all very well to recapitalize banks, but this, on its own, will not get investment and credit flowing because repair of these stretch private balance sheets is also essential. And I think we saw this in Ireland in spades where the banks did get recapitalized in 2011, but it took two years to getting schemes to be able to deal with very large mortgage arrears.

So, I would stress that dealing with the corporate and household debt overhang is going to be a very important element of what needs to be done. Now of course, repairing private bank balance sheets is going to be much easier if inflation was at target, and preferably even above target, but I don't see that as something that's in prospect in the Eurozone. So, this means that the emphasis ends up being on getting the institutional framework right, national insolvency regimes, out-of-court settlements, creditor coordination, liquidation procedures, et cetera.

And of course, it's going to be important that firms in the future rely much more on equity and this then comes back to the point that's been touched on, but a single capital market, the capital market union and it's not just firms that should rely more in equity. Of course, banks should also rely much more in equity. Thank you.

Jacob Kirkegaard: Well, thank you very much Ajai. I thought this is—I always believe that there is a risk that any discussion that relates to the European financial system and especially the SSM is really at the risk of getting bucked down in a lot of details. I thought I would use my prerogative as chair to ask the first question, which is really a very broad, and ultimately I guess, political question.

Because one of the most striking things about the banking union and the SSM in general has always seems to me to be this remarkable audacious step that the Europeans are now engaging, which is really taking away control, day-to-day control over large banks away from national governments, which is essentially a step that, at least to my knowledge, hasn't been attempted by at least liberal market economy—liberal democracies, market economies before if you at least, if you ignore those who have essentially a foreknown banking sector.

And at the same time, I mean, I think Karolina, you mentioned that at least the previous British government has had some significant reservations about this issue. I think it's fair to say Michael that in the US, such a handover of national control over national banks will be impossible. But then on the other hand, Ajai, since you were involved in Ireland, it's fair to say that this was perhaps a case where loss of control over the national banking system by the national government should have proceeded a little quicker.

So, how do you see this, and this work and what are some of the potential pitfalls? It's open for anyone in the panel who wishes to. Yes?

Karoline Ekholm: Well, maybe I should just start to say something and I think and I've thought even long before the financial crisis that it would be a good idea to have a unified regulatory framework for the financial sector in Europe as part of European integration. And actually, many years ago I participated in writing a report about the Nordic-Baltic region where we proposed that maybe that particular region could go ahead and try to create a more—maybe not a fully-fledged banking union, but with integrated supervision. That wasn't very well received at that time I remember and the report is buried somewhere in someone's drawer or burnt, I don't know.

But I think in principle, it's this idea of having completely integrated financial markets and completely not fragmented supervision or regulation. Those things don't fit well together. But then of course, the momentum to do this comes from the crisis, so the Euro crisis, that's clear. But, so has many reforms that have sort of pushed European [inaudible 00:43:12] further has come from crisis as is very often pointed out. And well, I think this is an example of this.

Michael Foley: I guess as a former supervisor, I'd be the first to admit that supervision is not the solution to all of our problems and there's only so much that can be done. But I think as we move towards a world where there's going to be resolution where there's going to be bail-in on a more routine basis and we want to avoid market contagion and spillover effects from that. It's going to be important for investors to be able to make their own assessment in a reasonable assessment of risk amongst firms and position correctly and price correctly for that risk.

And I think one of the real challenges we've had as credit analysts at Moody's, and I'm sure others have had as well, is it's trying to really understand the depth of the issues, the depth of the problems as we've been looking at balance sheets over the last several years and, there are almost as many definitions of nonperforming loans as there are countries in Europe. There are nuances and looking at reporting of performing assets and real estate that's been taken back on balance sheet. We published three separate measures of asset quality for Spanish banks. We have a five-page report that tries to compare nonperforming loans in Italy versus in Spain.

So, from an investor standpoint, moving to consistent definitions around nonperforming loans, moving to consistent definitions around capital liquidity, being in a situation where forbearance is not going to be an uncertain situation down to each individual national supervisor, I think, is all quite possible and I also think the ECB I think is evidenced by their approach around the AQR and the stress test. They are very focused on establishing credibility. They are very focused on establishing, but they are going to take a prudent conservative approach to supervision.

And in the near term, that actually might not be particularly beneficial for creditors because it could result in some banks being moved along that otherwise might be able to muddle through. But I think in the longer term, it will make it easier for investors to distinguish between risks. And I think ultimately, that will be helpful for the market.

Ajai Chorpa: I think the previous speakers have covered all of the relevant points. Just one thing that I would add is, I think the crisis demonstrated very clearly that the institutional structures for the Eurozone were deficient. And, once

they made the decision to move towards the banking union, it was very clear that that would have to be underpinned by a single supervisor given the dangers of capture of national supervisors and also the fact that the quality of national supervision varied a great deal.

Jacob Kirkegaard: The floor is open. Our co-host.

Male Speaker: Thanks for that. I'd like to compliment all the members of the panel for remarkable presentations. If you allow me a question to both Mike and Karolina, one of the things that clearly differentiates the Euro area banking system from the US is one, it's the relative importance of banks in terms of financing, right? And then, so that's one of the reasons why Europeans seemed to be reluctant to kill zombies, right, because they are big, important and scary looking, right?

Now, could you perhaps talk a little about the trends in terms of what you might call deleveraging in the rural areas so this increase in nonbanking part of financing that we observe, would at least seem to observe. And not that it implies in terms of regulatory challenges, right, because that would be—we could characterize this as an increase of what can be, in some quarters, classified as a shadow banking system on a European scale, right? This, in principle, would be the less or lighter regulated part of financing and there are beyond positive arguably components of financial stability that could be related to that.

Karolina Ekholm: Okay, I [inaudible 00:47:26].

Jacob Kirkegaard: I think we should just go ahead and take this question and then we can take the answer.

Karolina Ekholm: I should.

Michael Foley: All right.

Karolina Ekholm: Okay. Well, I think you're right in observing that. I mean, there are these forces that will promote funding outside the banking system, which I think is probably a positive thing for Europe, that to have more sort of diverse sources of funding is probably a positive development. Then of course, to the extent that there's a buildup of a shadow banking sector that is sort of below the radar of the supervision. That is, of course, a less appealing development, but this is of course something that everyone is aware of. So I think monitoring shadow banking has become much more important in Europe now than it used to be.

And, in terms of market funding, I think it is clear everywhere, even in Sweden that hasn't really experienced much problems with its banks. I



mean, there was this initial problem early on in the crisis connected to their activities in the Baltic States. But even in Sweden, you can really see a pickup in market funding by corporates.

Michael Foley:

I think I'd just add that we've spent some time thinking on this and we've tried to look at the data that's available and I'm not sure that anything is definite, but if you think about alternative sources of funding, one of the most obvious is structured finance and the structure finance market in Europe has effectively seized up and it's actually been declining sequentially every year for the last three years. It's at a quite low level and while I think there are some laudable efforts underway to try and restart that market, there are some pretty significant regulatory barriers in place. And I don't think that those necessarily will be easily to deal with over the near term.

The potential for finance to come from outside of the banking system—and there are some indications of that happening. You see that in the fund sector where funds are being established to invest in assets that typically would have been on bank balance sheets—I think at this point, it's still effectively in its infancy and there are a number of characteristics of these efforts where they're still partnering with banks at either to get credit expertise, to tap into their relationships or more importantly, to tap into their balance sheets and funding if funding isn't available from structured finance and funding isn't available from the capital markets.

But, I think the one area where we seemed to have seen some actual momentum is in bond finance in the corporate sector. And it's been most obvious actually in the peripheral countries where there's been a—quite a significant uptake in first time issuers going through the bond markets and I'm talking about noninvestment grade issuers. The average rating has gone down several notches from what it might have been a couple of years ago, but the number of first time issuers are increasing.

And, I don't think that's necessarily—reflects the concern around credit quality. I think it reflects the deepening of the market in Europe and corporates being able to and/or finding way to access capital directly from the capital markets and a supply of fund for lower-rated credits that might have been the case in the past. And, I do think if you look the progression of the capital markets development of the US that that could be a significant trend if that persists.

Jacob Kirkegaard:

I think with the risk of eating a little bit of our lunch break, we have time for our last round of questions, that gentleman there and then the gentleman in the back, if you can go to the back mic, please.

Brad Dyslin: I'll make it quick. My name is Brad Dyslin, I'm with Aflac where I'm Global Head of Credit there. So naturally my question for you Michael, it seems clear the banks were overrated heading into the crisis. So now we're in this catch-up mode. But, how would you respond to the thesis that we've overdone it on the ratings front now and we've rattled off in this panel a lot of the strengths that do exist? We've got better capitalization, we've got better asset quality, dramatic increases in liquidity, the regulatory front is being unified. That all points to a stronger credit picture for most credit investors, yet, we've seen the ratings dropped, I think you said five levels for European banks on average.

So, could you just maybe address that, please? Thank you.

Jacob Kirkegaard: And, before you do that, let's take the question at the back, please.

Helge Berger: Well, thank you. Helge Berger with the IMF. And, I thought the banking union was also about [inaudible 00:52:13] should be the consensus that we need bail-in in the future. And—but then frankly, the panel left me confused. So, Karolina said this, the fact that we too have bail-in at the European level as an issue for the Swedish authorities and I can attest to that at least the previous government at least was worried.

Then, Ajai said, well, these regimes differ a lot across countries and all the [inaudible 00:52:39] to be and therefore, it's not that important what has been agreed upon. Maybe I'm misinterpreting you. And Michael, you were not even discussing it.

So, what about bail-in?

Jacob Kirkegaard: Well, Michael, if you want to take the first question first and then—

Michael Foley: Yeah. I think on the first question just in terms of rating level, we've spent a considerable amount of time looking through every dataset that we can find in terms of bank failures. And I think at this point, we probably have developed the most comprehensive dataset that's available looking at crisis in the US, crisis in emerging markets, crises in Europe and folks on the most recent crisis.

And, what's very obvious from that is this is a very cyclical industry. And while bank credit risk hasn't essentially existed historically. In fact, no investor, no bond investor in any major bank and a developed market lost money from the Great Depression through Lehman Brothers. That's been because of systemic support, but underlying that, in terms of banks that needed to be supportive or that otherwise would have failed, this is actually a very cyclical in history.

And, it really actually implies standalone ratings kind of in the BA range. Our standalone ratings are above that at this point. We're kind of in the BAA3 range. Part of that reflects our view that there have been some structural enhancements and changes that are long-lasting that should, over time, reduce the cyclical of banks or at least, reduce their—the likelihood of failure given a stronger capital liquidity. But this has been a cyclical in history. I don't think anything that we've seen is going to change that and we're trying to reflect that in the ratings appropriately going forward.

Jacob Kirkegaard: Karolina, Ajai, bail-ins.

Karolina Ekholm: Yes. So, let me clarify one thing about—this may be strange that I am not going to clarify the previous government's position regarding bail-in, but I think this is something that there isn't so much diversity in views within Sweden. I think the Swedish position very much comes from the experience from the Swedish banking crisis in the early 1990s. So I think what this really—reluctance or this skepticism against bail-in I think comes from—not from a wish to do bail-out in the sense of letting taxpayers foot the bill for the banks' sometimes reckless behavior.

I think the sort of consensus view or at least the view held by many in Sweden who were involved in dealing with the crisis in the early 1990s is that having the government sort of take over the banks and sort of recapitalize it, hold it for some time, run it professionally, just get rid of management and so forth. And of course, wipeout all the shareholders and then privatize and sell it with a profit for the taxpayers. That would be the Swedish model of dealing with the banking crisis. But, in that type of process, bail-in is ... a little bit difficult to see how it fits in.

Ajai Chopra: Okay, just to clarify to what I said, firstly, the bank recovery and resolution directive, which covers this issue of bail-in of senior creditors does not come into effect until 2016. And the fact that it's included in that directive I think is a good thing. Now there's a question of what happens in the interim given that AQR results are going to be announced now and some banks may go into resolution, so what will happen, what will the regime be? And the point that I made is that I think—in my view—that it's unlikely that there will be bail-in of senior creditors in these circumstances.

And one is the financial stability angle and that in the ECB is going to be concerned about that given the benign market conditions right now, which they're not going to want to rock the boat on that. But also, I think there's a danger of different practices in different countries and it will end up going to the lowest common denominator, which is just new—just focusing on subordinated debt and hybrid instruments and so on.

But I do think there's a broader point of principle. If there is a contagion risk—and I think that is a well taken point—I think it is unfair to put the burden on the taxpayer of an individual country in those circumstances. They're doing something for the common good at preventing contagion and I think there needs to be some compensation from that ideally through a common backstop.

Michael Foley: I'll be very brief and I'll just say I guess that if you were a sub debt holder and coop bank or SNS or [inaudible 00:57:46] or any number of Spanish banks that you know that bail-in is here, it's a reality. It would have been unthinkable perhaps five years ago to bail-in even sub-debt holders out of concerns around market impact that the market has. So I've done any number of instances where sub debt holders have been bailed-in. I think resolution is difficult to do. It's going to be even more difficult for very large cross-border firms, but if they need to be recapitalized, there's going to be a desire to think about where those funds come from.

So without making a judgment on whether that's the right or the wrong thing, I think with the framework that's put in place, there's a much greater likelihood going forward that there's going to be bail-in, not just on sub debt, which has become an accepted expectation, but of senior unsecured debt as well and, as folks in Cyprus found out, potentially deposits, uninsured deposits.

Jacob Kirkegaard: Well, on that note, given what the time is, I would like to thank you the panel very much for elaborating and illuminating what is the very complex area.

And, we are ready I believe for lunch and take over Adam.

Adam Posen: Well, thank you to Jacob, to Karolina, to Michael, to Ajai—I mean, there's a lot of other stuff going on this week, but I think everyone and right now, but I think everyone will agree who stayed here for this, the substantive quality of this panel was simply outstanding. And I'm truly grateful to our three participants and my dear colleague and chair for achieving that result. And, I look forward to promoting a video and presentations on this panel throughout the website and throughout our world because I think it's a great discussion.

But yes, it is my pleasure to invite you to be fed. Lunch is now and in about 15 minutes, we'll start again with Vitor Gaspar. Thank you.

