

# Euro Area Can Make Progress—Even Without an Unlimited Fiscal Backstop

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The European Parliament is scheduled to establish a single supervisory mechanism (SSM) for banks this week, setting in motion the timetable for the European Central Bank (ECB) to assume responsibility for supervising most euro area banking assets by the fall of 2014. Notwithstanding such progress, some commentators dismiss this step as useless without a supranational euro area fiscal backstop to provide public money in an emergency to shore up bank capital, restore private market confidence, and stem a future systemic crisis. Without unlimited access to such support, critics say that a future systemic banking crisis might not be contained, making the system more vulnerable to self-fulfilling market panics and forestalling a cleanup of the banking sector.

Are these concerns justified? Fortunately for Europe, in the eyes of this author, the answer is no. A fiscal backstop would be desirable, but progress toward stabilizing the regional financial system and restoring growth can be achieved without one for now.

The timetable following the European Parliament's action this week is as follows. The ECB will immediately begin preparing its upcoming asset quality review (AQR) and subsequent bank stress test in collaboration with the European Banking Authority (EBA) and an external private sector partner that is still to be determined. The AQR and stress test are to be completed within the next 12 months. Meanwhile, negotiations will (hopefully) accelerate between member states and the European Parliament over the design of the envisioned Single Resolution Mechanism (SRM) to oversee bank liquidations with an industry-funded resolution fund. As discussed previously on *RealTime*, reaching political agreement on the SRM will not be easy. The euro area, however, must move toward an integration of banking regulations if it wants to return to sustained economic growth. It can be argued that without the introduction of eurobonds, backed by the full faith and credit of the euro area, no real progress towards financial stability in the banking union is possible. But that overstates the case. Eurobonds have many merits, but they could not be implemented without revising the EU Treaty, which European voters would resist. The need to reform the banking sector is urgent, on the other hand.

## **Why an Unlimited Fiscal Backstop Is Unnecessary**

Systemic banking crises strike once every few decades, usually alleviated by a sovereign government rescue. Lacking a single government, the euro area would in theory be handicapped in a crisis. But assuming that a fiscal backstop would prevent banking crises from occurring is misguided. Each new crisis requires a distinct political settlement to distribute financial losses between private creditors and taxpayers, as occurred in the United States and Britain during the most recent crisis. Specifying a backstop in advance of a crisis is thus unwarranted. It is premised on the assumption that euro area policymakers will not agree on action in a future crisis. In fact, future systemic banking crises are best dealt with by the elected leaders of the time. Some comfort should be taken

from the proven ability of euro area leaders to reach required compromises in the current crisis. Future elected euro area leaders will not likely allow a systemic banking crisis to destroy the common currency and their national economies. Their job will moreover be easier because, in a future environment overseen by the ECB, national regulators will not be targets for blame in the event of banking losses, making bank recapitalization by regional authorities more politically palatable. Nonperforming loans from the era when banks were under national supervisor regulation—known as “legacy assets”—will by definition largely disappear when these banks come under the new ECB supervision.

Doesn't the absence of an unlimited fiscal backstop make systemic banking crises more likely? Perhaps. But a great many other factors contribute to banking crises—for example, quality of banking supervision, technology and innovation in the financial sector, societal transparency, and corruption levels. Indeed, the absence of a fiscal backstop might make private actors more risk conscious. Requiring that the euro area be equipped with all the fiscal tools of an integrated sovereign state, as advocated by some, is excessive and a barrier to required expeditious progress.

Is an unlimited euro area fiscal backstop necessary to credibly deal with the banking crisis in Europe? Again, not necessarily. There is a direct inverse relationship between imposing costs on bank shareholders and creditors and the need to draw on a public fiscal backstop at the national or euro area level. New state aid rules, in force since August, already dictate that losses be imposed on shareholders and junior bondholders, making recourse to public sources of capital less likely for troubled banks. The ultimate scope for “bailing in” senior unsecured bondholders in the euro area, i.e., imposing losses on them, remains to be completed. But as discussed earlier on *RealTime*, such rules would have lowered the costs of the euro area's biggest banking failures to date—Bankia, Anglo-Irish, etc.

### **Upcoming Stress Tests Are Crucial to Saving the System**

Because of these factors, the ECB/EBA stress test due next year will be conducted in a different regulatory environment than has been the case to date, diminishing the potential call for public funds.

What information will these stress tests yield? Estimates of the banking losses in the euro area vary dramatically, but they often run into the trillions of euros. Trying to guess the additional capital requirements in the euro area banking system is futile without new common rules for what constitutes a “bad loan” and even bank capital itself in the euro area. But only a euro area banking system recognized as well-capitalized will dissipate counterparty risk perceptions, restore intra-bank wholesale lending, reduce Target2 imbalances, and reduce peripheral lending costs. The reduction in lending costs for the peripheral countries of Europe would be helpful in restoring their economic growth. As a result, euro area banks would need straightforward equity loss-absorbing capital levels beyond regulatory minimum levels to pass the stress tests. Euro area bank bond investors will demand a higher risk premium on junior and senior unsecured bank bonds, increasing the cost of capital for thinly capitalized euro area banks that lack adequate deposit based financing. Carrying out credible AQR/stress tests is therefore the most important economic policy challenge facing the euro area in the coming 12 to 18 months.

Even without the need for a full fiscal union, there are numerous things that euro area policymakers must achieve for the AQR/stress tests to be successful.

The ECB/EBA needs to establish a genuine regulatory “Single Rulebook” for what constitutes nonperforming loans, how to rate the quality of equity capital, and what constitutes a sufficiently stressful economic scenario. The ECB and the European Banking Authority must be willing to revoke the banking licenses of euro area banks that fall short of the prescriptions resulting from the AQR/stress test. European regulators must also establish an administrative regulatory apparatus that can crunch a phenomenal amount of data on the euro area banks. Finally, the euro area, the commission, and European Parliament need to complete design and implementation of the resolution mechanism to clarify what will happen to any euro area bank deemed non-viable.

If these prerequisites are met—admittedly a pretty big IF—an unlimited fiscal backstop would not be required to stabilize the euro area banking system. A credible AQR/stress test is possible without eurobonds and a fiscal union. Policymakers should focus on what is politically possible, not what some might call an ideal but unattainable solution. If tough and rigorous AQR/stress tests are carried out, each euro area bank will either pass or fail. Those that fail should be issued with a specific amount of required new capital. The tests should not target capital ratios, because doing so might encourage banks to shrink their balance sheets as the quickest path to solvency, aggravating credit access problems in the euro area.

The banking systems of Greece, Portugal, Ireland, Cyprus,<sup>1</sup> and Spain have all been restructured, and most have gotten sizable amounts of public capital. Most euro area banks deemed viable at present should be able to raise most new capital they might need from private markets. Yes, existing shareholders would protest to avoid significant dilution of their holdings, but would comply if necessary to save their banking license.

Should some troubled banks fail to raise new capital from private sources, the ECB and the European Commission would force losses on shareholders and junior bondholders before any senior unsecured bondholders and higher ranking creditors might potentially be affected, too. Only then would potential public funds become available—from national sources, or the European Stability Mechanism (ESM), which is backed by national sources.

Any euro area bank that not only failed the AQR/stress test, but was found to be non-viable would need to be liquidated, which is why the SRM rules have to be finished ahead of time. The euro area needs to be prepared for really bad news from the AQR/stress test. Even after bailing in creditors, banks would likely require a least some resolution funding from public euro area sources in the absence of a prefunded resolution fund like the Federal Deposit Insurance Corporation (FDIC) in the United States. This could again be from national sources and possibly the ESM. These sources could be reimbursed from future industry payments into a new resolution fund.

True, the ESM has only €60 billion earmarked for direct bank recapitalization purposes (and only for after the SSM takes over). The so-called “legacy assets” or nonperforming loans will end up on national euro area sovereign balance sheets. How large are those losses? Some say they may be trillions of euros. Perhaps so. But after hundreds of billions of euros in new capital have been injected into the banking system since 2008, are the banks in the euro area really beyond hope and condemned to zombie status for years to come? Yes, several remain thinly capitalized, with questionable business models, and exposed to large amounts of country-specific risk. But these banks could raise capital in

response to a direct order from the ECB/EBA. They would prefer not to, but once removed from traditional national regulators and political protection, they will have no choice.

Europe faces the opportunity to have the necessary institutions for a sounder banking system. The AQR/stress tests will be the first critical challenge. Authorities should work to insure the success of these tests and leave eurobonds, fiscal union, and unlimited backstops for the future.

## **Notes**

1. Cypriot banks didn't receive any public funds directly as part the country's Troika program, but were restructured through extensive bail-ins of bank creditors. The Cypriot government, however, will receive substantial funds from the Troika program for broader budget support, and the Cypriot banks continue to rely on extensive liquidity support from the ECB.