European Shadow Financial Regulatory Committee

(www.esfrc.eu)

Allocation of Losses of Banks and Sovereigns in Europe

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In this statement the European Shadow Financial Regulatory Committee (ESFRC) addresses the need for prompt recognition and predictable allocation of losses in banking and sovereign debt crises. The EU has so far failed in its management of losses associated with the legacy of the recent financial crisis, thereby causing that crises in several countries have become unnecessarily severe and prolonged.

First of all, the credibility of newly implemented recovery and resolution procedures for banks must be strengthened. The ESFRC also recommends that the ESM should play a more prominent role as the fiscal backstop in resolution and recapitalization rather than national authorities in order to reduce political influences on resolution decisions and prevent further increases in government debt levels.

Legacy problems of banks are often symptoms of deeper institutional or structural weaknesses. Institutional and structural reforms on the national level are required to enhance the credibility of the formal rules for resolution of banks.

The legacy problems generated by the build-up of government debt should be addressed with clear allocation of responsibilities. Mutualization across EU or euro zone members is often proposed. An alternative is debt restructuring but this must be accompanied by conditionality with respect to growth enhancing structural reforms.

Nations, banks and corporations in Europe have suffered substantial losses since the beginning of the Great Recession in 2008 and throughout the sovereign debt crisis that began in 2010. Only during the last couple of years has economic growth provided some relief particularly for banks with large amounts of non-performing loans and for countries in the Southern euro zone, which have achieved primary surpluses on their government budgets after many years of austerity. The long drawn-out period of crisis management in the euro zone is a clear indication that EU wide and national mechanisms for allocation of losses generated by nations' inability to service their debts, and by declining asset values in banks and corporations, have not functioned in an effective manner.

It is not surprising that holders of sovereign, bank and corporate debt try to avoid the realization of losses if at all possible. For example, the early handling of the Greek crisis had as one objective to prevent the realization of losses for holders of Greek bonds including banks. Banks' creditors have been protected by bailouts and corporations in several countries have been allowed to survive too long as a result of weak bankruptcy laws. This type of forbearance towards governments, banks and corporations delays the necessary recognition of losses that often mount higher as a result of delayed loss recognition. There is little doubt that the euro zone crisis has dragged out longer than necessary and that zombie banks have been a burden to the economic recovery in Europe.

The EU has made an important attempt to address the loss allocation issue for banks with the Bank Recovery and Resolution Directive (BRRD) and the Single Resolution Mechanism (SRM) for the euro zone countries. Much work remains to be done, however. It is necessary to improve on the loss recognition and allocation mechanism to be able to manage future structural changes in both the financial and the non-financial sectors. Furthermore, the legacy of high government debt levels and non-performing loans in banks must be dealt with.

The ESFRC has addressed the issue of loss recognition and allocation in a number of statements during the 20 years of its existence. The very first statement in 1998 had the title "Dealing with Problem Banks in Europe" and recommended the implementation of special insolvency procedures for banks with the objective of quickly allocating losses to some bank creditors while minimizing the systemic effects of a bank's failure. These ideas have been reflected in the BRRD and the SRM. More recent statements have commented on problems with the SRM as well as the allocation of losses on sovereign debt. We return to these issues below.

The urgency of dealing with these issues is illustrated by the high debt to GDP ratios in the EU; the average level of national debt relative to GDP in the EU is over 80 percent and in the euro zone even close to 90 percent. Seven countries exceed this mark with a maximum of 177 percent (at the end of Q3/2017). The average level of non-performing loans relative to total loans is still above 4 percent in spite of a decline since the peak in early 2016. The differences between and within countries are great. The ratios in Greece, Cyprus, Portugal, and Italy are 46.7, 32.1, 14.6 and 12.1 percent, respectively, and in many countries highly concentrated in systemically important banks.

Efficient allocation of losses in banks

Weaknesses of the European resolution procedures

The start of the Single Supervisory Mechanism (SSM) in November 2014 was compromised by the fact that the legacy losses associated with the banking and sovereign crises were not dealt with adequately. One reason is that there was and is no political agreement on who is primarily responsible for the recapitalization of problem banks: should it be done through a bail-in, by imposing losses on unsecured debt holders, or through a bail-out with the use of national or European taxpayers' money?

In its first statement in June 1998 the ESFRC emphasized the importance of allowing banks to fail at the expense of important groups of creditors. As the ESFRC pointed out in a statement[1] commenting on the Single Resolution Mechanism (SRM) in November 2014, just after the ECB became the supervisor of the largest banks in the euro zone, weaknesses remain with respect to the credibility of the bail-in rules.

One weakness lies in the transition of a distressed bank from the ECB as a supervisor to the resolution board. The Bank Recovery and Resolution Directive (BRRD) and the SRM state that the transition from early intervention under the authority of a supervisory authority takes place when an entity is deemed to be "failing or likely to fail." The main criterion for this event is that "extraordinary public financial support is required." Under the SRM for euro-zone countries a resolution scheme adopted by the Single Resolution Board (SRB) can be implemented only if there are no objections from the European Council and the European Commission.

Another weakness lies in the systemic risk exception that allows substantial leeway in keeping a failing bank outside the resolution mechanism on the grounds that the prospects of bail-ins may have systemic consequences. This exception opens the door to publicly funded recapitalization with weaker bail-in conditions than those specified in the BRRD.

The BRRD allows the use of public funding for a precautionary recapitalization as an alternative to resolution when the bank complies with capital requirements but, nevertheless, requires recapitalization that cannot be obtained in private markets. The precautionary recapitalization in the euro zone requires the approval of the ECB as well as that of the European Commission. The former has power to impose conditions for liquidity support while the latter must approve any state aid within the EU. Systemic risk considerations are important in this context.

The preceding weakness of the resolution mechanism is illustrated by recent cases in Italy where Banca Monte dei Paschi di Siena and the Veneto banks had excessive bail out components financed by Italian taxpayers. Not only did these partial bail-outs undermine the credibility of the SRM, they also created a further challenge to the sustainability of Italy's fiscal position. These Italian cases are very different from the recent case with Banco Popular in Spain, which was rescued through a sale to Banco Santander without having to resort to support by taxpayers.

The ambiguity concerning the burden sharing for losses in distressed banks is often the cause of political conflicts and, thereby, of long delays in the recognition and allocation of losses. These delays worsen the damage generated by the original event that gave rise to the rescue operation.

[1] Statement No. 39, "Complexity and Credibility in the Single Resolution Mechanism," London, November 10, 2014 (www.esfrc.eu/previous statements).

National vs European fiscal backstop

In the Monte dei Paschi case the Italian government provides the fiscal backstop. If, on the other hand, an EU authority like the European Stability Mechanism (ESM) would provide the backstop, it would be likely to offer less forbearance than the Italian government. The ESM would be free from national influence activities in its determination of the need for public funding. It would be able to provide a backstop based on concern for systemic risk alone. Our argument is that a fiscal backstop on the European level will be able to impose more discipline on the fiscal costs of bank bailouts.

The ESFRC recommends that the ESM should play a more prominent role as the fiscal backstop in resolution and recapitalization rather than national authorities in order to reduce political influences on resolution decisions and prevent further increases in government debt levels. Such a role of the ESM would strengthen the credibility of bail-ins of unsecured debt holders. In case where small investors have purchased junior debt instruments of banks based on false promises, the authorities may choose to compensate the investors up to the maximum of the deposit insurance guarantee.

The future of legacy problems

Legacy problems are many times symptoms of deeper institutional or structural weaknesses. For example, it is possible that the non-performing loan problem in the Italian case will appear again after some time unless governance structures and competitive conditions in the Italian banking system can be improved. In this case, it would be a mistake from both a European and a national perspective to focus exclusively on the short-term solution to the problem. Institutional and structural reforms on the national level are required to enhance the credibility of the procedures for resolution of distressed banks.

In this connection we want to emphasize the role of general bankruptcy law for non-financial firms as well. In Italy, as well as in other southern euro zone countries, bankruptcy procedures are slow and the burden sharing between debtors and creditors imposed by the court systems is often unpredictable. These weaknesses of bankruptcy laws and their implementation have no doubt contributed to the build-up of non-performing loans and may do so in the future as well.

The unresolved business of unsustainable government debt in Europe

There is not even an approximate number for what level of government debt relative to GDP may be considered sustainable. Italy’s debt ratio was above 100 percent already when the euro was introduced in 1999 and Belgium’s debt ratio was even higher. Belgium has not had a debt crisis and Italy’s ratio was not considered a problem before the Greek crisis erupted in 2010.

Clearly, GDP growth and expected future growth rates are critical for the sustainability of a particular level of debt. Another factor is the ability of a country to create inflation in order to reduce the burden of debt. Any country with its own central bank can do this while member states in the euro zone cannot. Therefore, these states face a more strict constraint on the sustainable debt level. They must be able to generate economic growth in order to maintain or reduce the level of debt.

Herein lies the problem for a country like Italy as well as for other euro zone states, in particular, for Greece. These countries may find themselves in a trap where attempts to increase economic growth are stymied by the burden of interest payments while the political situation prevents substantial structural reforms that would allow the countries to escape from the trap.

If a euro zone country is unable to implement structural reforms for political reasons one way out is debt reduction. Debt reduction imperils banks with large holdings of government debt. The situation is made worse if the banks are already settled with large non-performing loans as in Italy. In addition, other euro zone countries may be unwilling to provide the necessary relief.

In spite of these problems the EU is not without power to alleviate the legacy of government debt and to provide incentives for structural reforms as well as for improved fiscal discipline in the future. The emphasis in the European debate has focused on *mutualization of sovereign debt*. The disadvantage of this solution is that it may create a 'moral hazard problem' that reduces fiscal discipline in the future. To come to grips with this problem, the ESFRC proposed in a statement[2] that *debt relief* – and not only provision of new loans – for Greece should be made conditional on structural reforms. A more general application of such conditionality could provide stronger incentives for structural reforms in member states with weak economic growth.

To be more specific we propose that the European Stability Mechanism (ESM) should take the primary responsibility for the sovereign debt of the countries facing difficulties serving their debts. The ESM is well situated to specify and enforce a schedule of debt relief conditional on specific reforms of a country's ability to adjust its economic structure and enhance its competitiveness. Debt relief must be linked to the implementation of reforms rather than to realized economic growth since the time delay between reforms and effect on growth can be long, uncertain and difficult to identify. There is naturally a risk to the European taxpayers in this proposal but conditions for debt relief become explicit and predictable. Furthermore, the moral hazard problem associated with mutualization will be alleviated.

[2] Statement No. 40, "Escalating Crisis in the Euro Zone: The Case for Conditional Debt Relief for Greece," Frankfurt, June 29, 2015 (www.esfrc.eu/previous statements).