European Shadow Financial Regulatory Committee

(www.esfrc.eu)

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Statement No. 45

10 Years after Lehman:
Is Europe heading towards a New Financial Crisis?

Summary

In this statement the European Shadow Financial Regulatory Committee (ESFRC) recommends that the European Stability Mechanism (ESM), already in place, should play a more active role in mitigating the risk of a new financial crisis in Europe. Specifically, we advocate that countries facing sovereign debt problems work together with the ESM on a package of economic reforms that may allow debt relief. The current escalating confidence crisis facing Italy could be more effectively resolved by such involvement of the ESM. Also, we recommend that the ESM should play a prominent role in the recapitalization of problem banks in order to reduce the non-performing loans (NPLs), which are still substantial in some euro zone countries, notably Greece and Italy.

Explicit and implicit risk sharing in the euro

Key financial risks in the euro area have been suppressed for five years as a result of large scale quantitative easing by the ECB. The key question regarding the euro zone financial sector is whether stability can be retained as and when QE is removed.

We address several partly interrelated risks that were identified already during the financial crisis of 2010-13:

- Macro financial imbalances within and between nations
- High levels of Non-performing loans (NPLs) and insufficient capitalisation in some European banking systems.
- The doom loop: high levels of national concentration of sovereign debt in banks' portfolios
- Lack of credible bank resolution and rehabilitation procedures
- Risk of contagion between interconnected financial systems in Europe.

Although some reforms have been implemented fundamental issues remain unresolved as illustrated by the current banking problems in Greece and Italy. Furthermore, these risks are also connected to risks outside the financial sector. The most important of these are the real economic and political fragilities still present in the euro zone, notably the current confidence crisis with respect to Italy.

Integration in the euro zone as the result of the introduction of the single market and the single currency have led to an unprecedented level of economic interconnectedness, which means that every member state's economy could be exposed to extremely high costs were the euro zone to disintegrate as result of a national shock not being managed effectively and addressed on the European level. The disruption that is expected in the case of a no-deal Brexit would be a pale shadow of disruptions generated by a dissolution of the euro zone. The dissolution of the monetary union could well have major political and geostrategic consequences for all member states including those in the North and the East of the EU. This risk is seldom taken into account by policy makers in surplus countries, which are trying to boil down the problem to a reduction of risks in the debtor countries.

Even economic risks are already more shared than policy makers are willing to admit. One example is the way the Target 2 mechanism works to provide liquidity to countries that are losing capital. Making risk-sharing more explicit and visible need not increase the risk level and may indeed serve to facilitate mechanisms for reducing moral hazard, including national adjustment programs and their conditionality.

The unresolved business of unsustainable government debt in Europe

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 countries in the euro zone cannot. Therefore, these countries 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. Problem 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 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[1] that *debt relief* should be made conditional on structural reforms. Such conditionality would 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. A case in point is Italy.

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 can be alleviated.

Currently, the ESM is well endowed with actual and potential funding and has at its disposal a rich financial assistance toolkit, including primary and secondary market purchases of securities. However, its decisions take time, are subject to politically inspired veto powers and their conditionality depend on bilateral dealings between individual problem countries and the Commission. A more autonomous and, not least, more accountable management should be able to manage crises with greater speed and discretionary power to directly impose conditions on individual governments. The actions of the EMS could also relieve the ECB of some active supervision. In addition, the ECB would not have to bear the burden of liquidity expansion for long periods during a crisis.

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 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.

[1] 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).

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 that imposes losses on unsecured debt holders, or through a bail-out with the use of national or European taxpayers' money?

As the ESFRC pointed out in a statement[2] 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, doubts exist about the extent to which the bail-in rules will be applied in practice.

One problem 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 Bank Recovery and Resolution Directive (BRRD).

Another problem is that the BRRD allows the use of public funding for a precautionary recapitalization as an alternative to resolution if the bank complies with capital requirements but, nevertheless, requires recapitalization that cannot be obtained in private markets.

The preceding problems with respect to the resolution mechanism are illustrated by recent cases in Italy where the bondholders of the Banca Monte dei Paschi di Siena and the Veneto banks obtained substantial bail-outs by Italian taxpayers. Not only did these 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.

In the Monte dei Paschi case the Italian government provided the fiscal backstop. The ESFRC recommends that an EU authority like the European Stability Mechanism (ESM) should provide the backstop. The ESM is less likely to offer 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 also be able to act based on concern for systemic risk alone.

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.

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