BANKING PROBLEMS IN EUROPE

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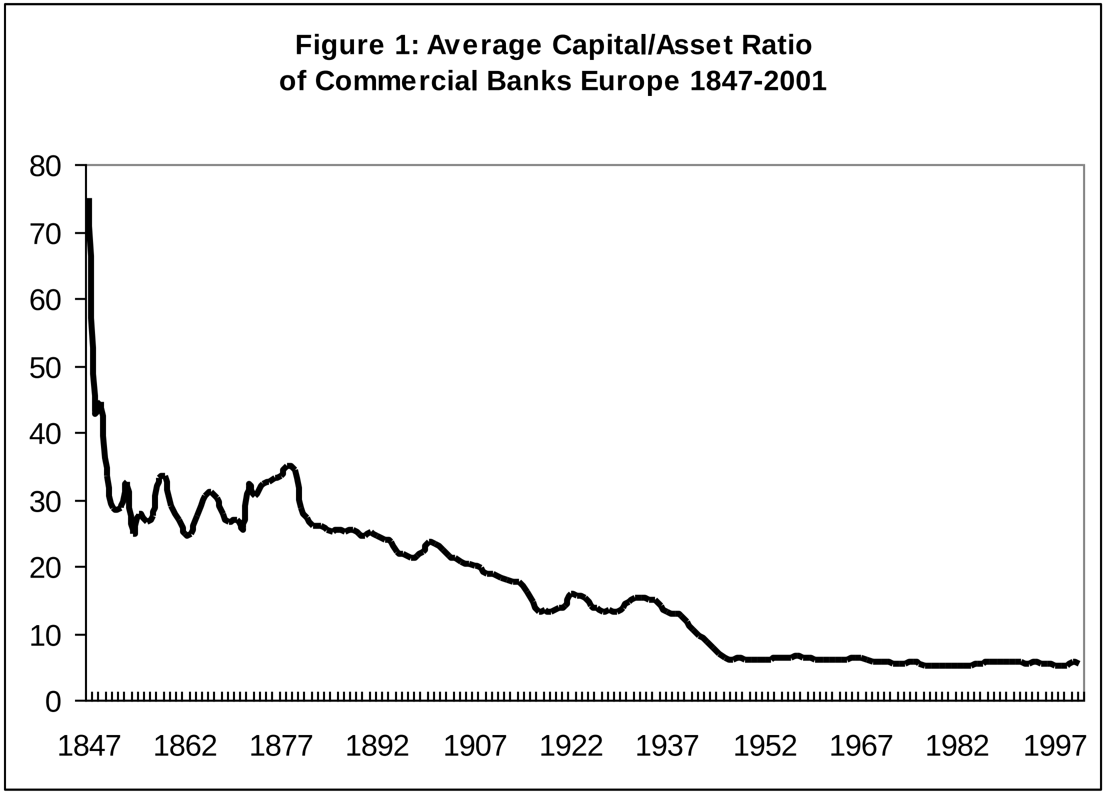
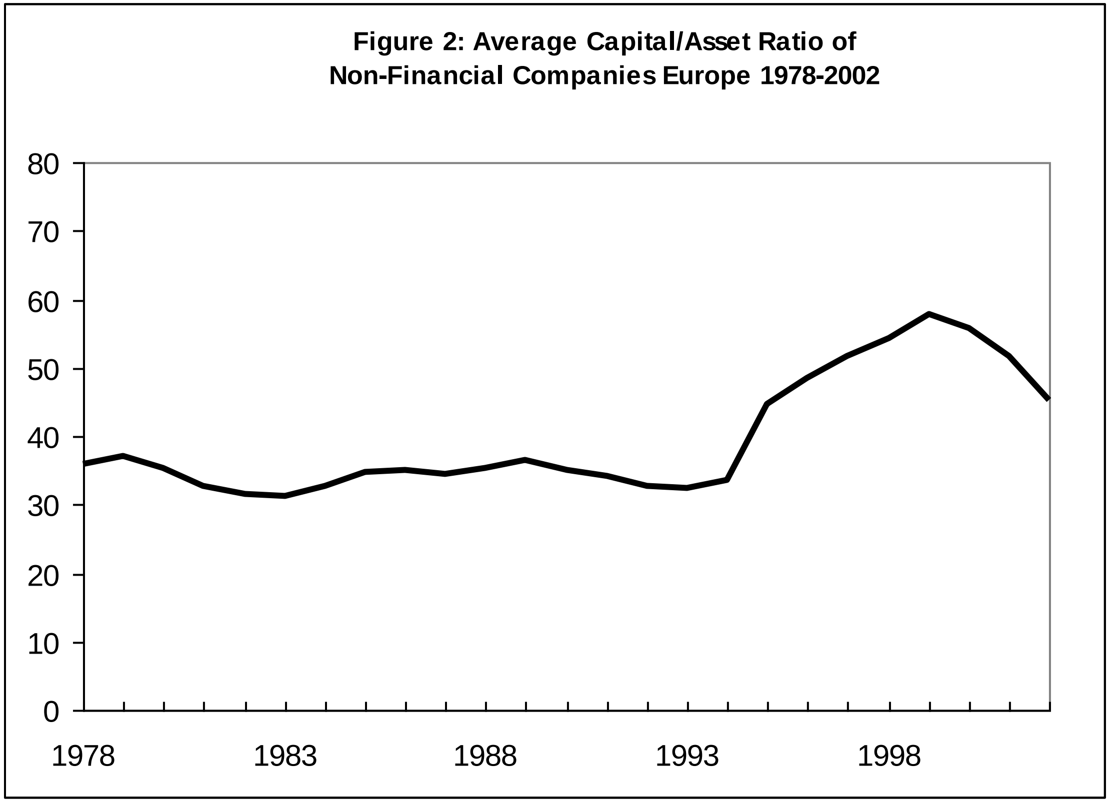
EVOLUTION OF BANK CAPITAL/ASSET RATIOS (1847-2001)



EVOLUTION OF NON-FINANCIAL CAPITAL /ASSET RATIOS (1978-2002)



REDUCTION IN BANK CAPITAL/ASSET RATIOS

- **Moral hazard in the banking system due to existence of explicit and implicit guarantees (too big to fail)**
- **Perverse incentives for taking more risk and reducing bank capital**
- **Bond holders have no incentive for proper risk monitoring and disciplining of the bank**
- **Short-term bonus schemes**

MORAL HAZARD IN THE EUROZONE

- **Moral hazard in the eurozone due to perception of guarantees and bail outs (notwithstanding no bail out clause of Maastricht treaty)**
- **Bond holders perceive the riskiness of a German bond as about equal to a Greek bond**
- **Ministers of Finance had an incentive to create an image of risk equality and diminish Germany's anchor role**

EUROZONE: THE FIRST DECADE

- Violation of the Growth and Stability Pact
- High budget deficits and debt levels
- Lack of enforcement of structural reforms on labour and product markets
- Weak starting position when financial crisis emerged as from 2007
- June 29, 2012: government leaders create ESM and ESM direct bank recapitalisation instrument (breaking the vicious loop between banks and sovereigns)

EUROPEAN CENTRAL BANK

- July 26, 2012: Draghi states “whatever it takes to preserve the euro”
- September 6, 2012: Draghi’s “audacious gamble” with “outright monetary transactions”
- Unlimited buying scheme of existing bonds of problem countries IF they meet ESM conditionality
- Strict and effective conditionality in terms of budget cuts and economic reforms
- Spain and Italy have to apply for help, better sooner than later

EUROZONE COUNCIL 14 DECEMBER 2012

- **First step of European banking union:**

  ECB will start acting as supervisor for banks with assets of more than 30 billion euro in 2014 ("single supervisory mechanism")
- **Second step of European banking union:**

  Single resolution mechanism, initially based on cooperation of national resolution authorities
- **Proposal to be drafted in 2013 for a European resolution authority to oversee the orderly winding down of insolvent lenders**

FROM ZOMBIE BANKS TO BANKING UNION

- Crisis management, recognition of losses on "legacy assets" of banks, will shape the future role and size of ESM, SRM and DGS
- Bail out by ESM or bail in by unsecured creditors
- In case most of the losses are imposed on unsecured creditors, the amounts of European taxpayers' money to be committed will be much lower

CREDIBLE STRESS TEST & BAIL IN

- Benink & Huizinga in FT (May 7, 2013):

  Credible stress test in order to determine for zombie banks their capital shortages (based on risky assets and loss of implicit state guarantees)
- Avoid Japanese-style inertia
- US model of issuing shares and direct recapitaliation of banks by governments may not be feasible in all cases
- Sort of Cyprus model may be needed: Dijsselbloem and Schäuble “template”?

DIRECT BANK RECAPITALISATION BY ESM

- **June 20, 2013: eurogroup provides framwework for direct bank recapitalisation**
- **Under certain conditions ESM can recapitalise banks (60bn out of 500bn ESM fund available)**
- **If tier one common equity ratio is below 4.5%, national member states will have to use their own money to recapitalise to 4.5%**
- **As from 4.5% capital ratio countries would contribute 20% of the recapitalisation amount**
- **Still ongoing discussion on legacy assets**

RECOVERY AND RESOLUTION DIRECTIVE

- June 27, 2013: EU finance ministers agree on rules to force losses on creditors in failed banks
- From 2018 bail-in of shareholders, bondholders and some depositors
- Insured deposits under 100,000 euros are exempt and uninsured deposits of individuals and small companies are given preferential status
- Minimum bail-in of 8% of total liabilities before resolution funds can be used

RECOVERY AND RESOLUTION DIRECTIVE (cont.)

- **National flexibility: after implementation of minimum bail-in countries can dip into resolution funds or state resources to recapitalise the bank and shield other creditors**
- **Intervention is capped at 5% of total liabilities and contingent on approval by the European Commission**
- **Before 2018 and applicable to ECB stress test in 2014: improvisation and application of new state aid rules (wipe out shareholders and junior creditors)**