

COUNCIL *on* FOREIGN RELATIONS

Center for Geoeconomic Studies

POLICY INNOVATION MEMORANDUM NO. #42

Date: February 24, 2014
From: Benn Steil and Dinah Walker
Re: Restoring Financial Stability in the Eurozone:
Lessons From the U.S. Financial Crisis

The European Stability Mechanism's (ESM) bank recapitalization instrument was designed to break the vicious circle tying financially weak eurozone governments to financially weak banks. It cannot, however, actually be used until the ESM board of governors amends the ESM treaty and Germany amends its own ESM implementation law forbidding direct recapitalization. These two actions should be taken *before* the European Central Bank (ECB) releases the results of its important ongoing eurozone bank stress tests; failure to sequence this correctly threatens to undermine the credibility of the tests, and thereby the ECB's efforts to stimulate the resumption of the flow of credit to eurozone businesses and households. It also risks reigniting fears among investors internationally that the most heavily indebted eurozone governments may see their finances deteriorate further owing to the need to commit yet more resources to bailing out their banks. The example of the 2009 U.S. bank stress tests suggests that having adequate funds precommitted to bank recapitalization is essential to their success, and that such success is itself critical to promoting economic recovery.

THE PROBLEM

Eurozone policymakers are struggling simultaneously to strengthen the balance sheets of banks and governments, but each is dragging down the other: banks facing large loan losses are increasing their already outsize exposure to eurozone sovereign debt, which falls in value as fears rise that the governments will be called on to bail them out. Each is therefore weakened by financial exposure to the other.

One of the chief economic challenges facing the eurozone is that action taken by the ECB to stimulate lending to the private sector is being rendered ineffective by the weak condition of the banking sector. Cheaper ECB borrowing rates for banks have encouraged them to lend more to their governments, but not to businesses and consumers. Particularly

in Italy, Spain, Portugal, and Greece, the ECB is now largely powerless to lower the interest rates that matter most to economic growth.

European banks have been trying to repair their balance sheets by raising capital, but uncertainty over the quality of the assets they hold makes such capital expensive. Many eurozone bank stocks trade at less than book value, which means that investors believe the banks are overstating the value of their assets. Rather than raise capital, therefore, banks have resorted to cutting back on their lending. This further weakens the eurozone economy by reducing the supply of credit available to the private sector.

THE ECB'S FLAWED SOLUTION

The ECB hopes to restore market confidence in the financial condition of eurozone banks by conducting a “comprehensive assessment,” including a stress test, of 130 of the largest ones, representing 85 percent of eurozone banking assets. The strong ones will be certified, while the weak ones will be obliged to recapitalize themselves.

Eurozone authorities have conducted stress tests before, but with little to show for it. In 2011, the European Banking Authority (EBA) conducted what was promoted as a stringent test of eurozone bank health. Dexia, the large Franco-Belgian lender, passed with flying colors, only to require a government bailout just a few months later. The stress test assumed much lower losses on sovereign debt in the event of a restructuring than the market and ignored the risks arising from dependence on short-term funding—both of which were factors in precipitating Dexia's downfall. In 2012, Spain conducted a much-heralded test with similarly conspicuous flaws, among which were ignoring large bank exposures to risky foreign assets (such as Portuguese debt) and assuming an “adverse scenario” in which unemployment was no worse than it was when the test was conducted. The ECB aims to do better, but its planned test suffers from another flaw that plagued both the EBA and Spanish tests: no credible mechanism to ensure that banks judged to need more capital are actually able to secure it.

The Council of the European Union has laid out three steps a bank must take, in turn, to raise capital if the ECB's assessment reveals a shortfall. First, tap the private markets. Second, if more capital is needed, apply for public funds from its home-state government. Third, if a shortfall remains after the national backstop has been exhausted, seek funds from the supranational European Stability Mechanism. The ESM was established in 2012 as a permanent successor to the European Financial Stability Fund, which had been created in 2010 to address the sovereign debt crisis.

The problem with this rubric is that neither national governments nor the ESM is an effective backstop for institutions unable to raise sufficient capital in private markets. Securing capital from already highly indebted national governments increases their indebtedness and makes the debt that they have issued, and that their banks hold, less valuable, thereby increasing the banks' capital shortfall. The ESM, the capital provider of last resort, is currently only permitted to recapitalize banks *indirectly*, through loans to national governments. This provision does nothing to rectify the problem just identified—that if a government is already highly indebted it is not in a position to recapitalize banks with yet more borrowed funds.

Since bank capital shortfalls identified by the ECB may not be rectifiable through the three mechanisms available, there is, in short, no reason why the markets should be comforted by the new testing regime. Weak banks are, in fact, apt to be weakened further by being revealed as such. Since investors know that the ECB knows this, they will also put no credence in declarations that a given bank has passed its tests and is therefore adequately capitalized.

THE FIX

The problem is, fortunately, remediable. The ESM's board of governors has agreed on the main provisions of a reform to the ESM to allow direct bank recapitalization, rather than recapitalization through the sovereign, once the ECB has assumed supervisory responsibility for eurozone banks, which should happen in November. German law implementing the ESM expressly forbids the ESM from assuming direct bank financial risk; the November 2013 coalition agreement between the German CDU/CSU and SPD parties, however, included a provision supporting the ESM making available up to 60 billion euros in funds for bank recapitalization. Amendment of the law in the Bundestag later this year, therefore, is likely. German finance minister Wolfgang Schäuble has indicated that once this amendment is made he will be in a position to vote for the necessary reforms within the ESM board.

The direct recapitalization instrument was created specifically to break the link between the weak balance sheets of governments and banks—a link that the methods of capital infusion currently available only serve to reinforce. The ECB stress test results should, therefore, be published only after the ESM has been legally empowered to recapitalize eurozone banks directly with sufficient funds.

The experience of the U.S. government's treatment of the country's own weakened financial system in 2008 and 2009 supports this proposal. The U.S. federal banking supervisors' stress tests of 2009 were a success—indeed, a turning point in the financial crisis—owing to the market perception that they were tough and credible. The supervisors could, critically, afford to be tough, as funds from the Troubled Asset Relief Program (TARP) were by that time available through the Capital Assistance Program (CAP) to recapitalize banks deemed to have a shortfall. There was, therefore, no reason for the supervisors to give weak banks passing grades owing to fears that failing them might spook investors and counterparties: the market knew that government funds were available as the ultimate backstop.

The CAP did not, in the end, actually provide any capital to banks following the stress tests; all those deemed needing capital were able to raise it privately (with the exception of the General Motors Acceptance Corporation, or GMAC, which was recapitalized through the Automotive Industry Financing Program). Knowledge that the CAP backstop was available was instrumental in encouraging private investors to step forward; German parliamentarians should take some comfort from this.

Europe cannot afford the damage to market credibility that would be occasioned by flawed ECB bank stress tests. This could trigger a cut off of market funding both to financially suspect eurozone banks and to heavily debt-burdened governments faced with unaffordable new bailout liabilities, leading to renewed fears of a eurozone breakup. It is therefore vital that these tests be conducted in the same way as the U.S. stress tests were in 2009—with sufficient public funds made available in advance to recapitalize banks that fall short.

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