

**Ανακεφαλαιοποίηση Ευρωπαϊκών Τραπεζών –
Οι Επιλογές της Ευρωζώνης και Πρόταση για ένα
Ευρωπαϊκό Κεφάλαιο για την Αγορά και Αναδιάρθρωση
Τραπεζικών Χρεών**

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Πανεπιστήμιο του Εδιμβούργου**

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AN IMBALANCED MONETARY UNION AND FOUR INTERLOCKING CRISES

- ❖ Predominantly a banking crisis which leads to public bailouts/bailins
- ❖ Competitiveness crisis which is not simply translated to loss of fiscal revenue and widening fiscal deficits and debt accumulations (Greece, Portugal, Spain)
- ❖ It also leads to massive payment imbalances within the Eurozone (Germany, Finland, the Netherlands vs the European south), and surpluses had to be invested and were invested in real estate bubbles in Ireland and Spain and to finance budget deficits – as a result most of EU public debt is intra-EU
- ❖ Accumulating public debt to the point of unsustainability: sovereign debt crisis

Lack of Institutions to absorb shocks

- ❖ Crises will happen and institutions should be in place to absorb the shocks
- ❖ No central debt issuance facility
- ❖ No fiscal transfers
- ❖ The ECB had no Treaty mandate(and still has not) to act as a shock absorber in Euro area sovereign debt markets

For the common banking market

- ❖ No unified bank supervision
- ❖ No fiscal burden sharing for bank rescues
- ❖ No European scheme guaranteeing deposits (which would have stemmed the deposit hemorrhaging of Greek, Spanish, and Italian banks)

Why no institutions?

Just an issue of political expedience and unwillingness?

❖ **A string of disastrous intellectual fallacies**

- ❖ Financial markets are efficient and can absorb shocks through market discipline and interest rates
- ❖ The era of great moderation – Jackson Hole consensus
- ❖ Optimal currency areas given factor mobility
- ❖ Current account imbalances do not count because they do not trigger a run on the currency as in the case of countries with own currency where both foreign and domestic capital is withdrawn from the economy

In Reality

- ❖ Financial markets are prone to crisis and market discipline can break down either as a result of fads, herding and panics or due to existence of too-big-to-fail banks
- ❖ The era of great moderation – Jackson Hole consensus [is not (always) working]: it facilitated the formation of asset bubbles
- ❖ Current account imbalances count even within a currency union
- ❖ A confidence run on the ailing member state's banking system is inevitable, as is its amplification to the monetary union, since the member state is kept afloat through central bank liquidity injections

What's 'the elephant in the room'?

- ❖ The banking system in the euro area – as a share of the overall economy was over 300% in 2007 (compare with 100% in the United States).
- ❖ Moreover, firms in the euro area rely more on the banking system for financing than American firms (who use capital markets directly), making the health of the banking system particularly important for the European economy.
- ❖ ‘...[T]he largest individual banks in the U.S. and Europe are roughly the same size, and thus the largest euro-area banks are roughly the same share of euro area GDP as the U.S. banks are of U.S. GDP, but this implies the largest euro area banks are a much larger share of any individual national economy in the euro area.’ [Shambough 2012]
- ❖ Finally, ‘what goes round, comes round’, surpluses are inevitably recycled one nation’s credit is another nation’s debt –i.e., it was (mostly) German banks using German savers’ money to finance the real estate booms of the South and in Ireland, and those banks are as exposed to the crisis as any other banking system in Europe.

Possible forms of EMU bank recapitalization

- ❖ The states – impossible due to current levels of sovereign indebtedness
- ❖ ESM as providers of liquidity and recapitalization
- ❖ Bailin = ESM
- ❖ A European TARP – Is it possible without a
- ❖ Pan-European fiscal backstop?

ESM – not Enough Money

- ❖ The ESM provides financial assistance to euro area Member States experiencing or threatened by financing difficulties.
- ❖ The ESM raises funds by issuing money market instruments as well as medium and long-term debt with maturities of up to 30 years.
- ❖ ESM issuance is backed by a paid-in capital of €80 billion and the irrevocable and unconditional obligation of ESM Member States to provide their contribution to ESM's authorised capital stock of of €700 billion.

ESM + Bailin

❖ Bailing in individual banks is a terrific way to battle moral hazard and minimize public costs,

❖ BUT

❖ Bailin is divisive: North vs South

❖ The ESM is no TARP

❖ Further falls in asset prices followed by further calls for bank recapitalization will remain a marked concern

Bailin

- ❖ It can trigger a bondholder panic
- ❖ Bailing in entire financial systems, as would the case in the EU (e.g., Cyprus, and in the future Greece? Spain?) is tantamount to destroying essential economic infrastructure!
- ❖ Intermediation of credit is largely dependent on large deposits and long-term bank finance on bond holders, if their confidence is shattered the banking system suffers with lasting consequences
- ❖ Bail in can make bank funding and thus bank lending more expensive, leading big borrowers to the shadow banking sector creating major problems in the future

Charles Goodhart's View on Bail-in

- ❖ Exemptions of favoured creditors are likely to be so extensive that hair-cuts on those remaining to be bailed in are likely to be large.
- ❖ Thus, the burden will be shifted from the taxpayer to pension funds, charities etc., an outcome that is as unfair as a public bailout
- ❖ Governance issues: the unknown creditors now become the majority shareholders of the bailed in banking institution
- ❖ Contagion ' but we didn't see it in Cypurs
- ❖ Conclusion: we still need a fiscal backstop!

The New Role of Central Banks

- ❖ From lender of last resort – lending liberally against good collateral at ‘punitive’ interest rates (Henry Thornton; Bagehot’s Lombard Street) to
- ❖ Market maker of last resort (MMLR) – lending liberally on the basis of any discounted collateral at a low rate with the central bank essentially acting, in the nearly certain absence of an active market, as a market maker for requisite collateral
- ❖ Exceeding Central Bank legal mandate?
- ❖ Possibly
- ❖ Unusual development?
- ❖ Some central banks have discounted for a long time bank customer commercial paper in order to boost money supply

Examples

- ❖ The European Central Bank's long-term refinancing operation (LTRO) is a process by which the ECB provides financing to Eurozone banks. The stated aim of the LTRO is to maintain a cushion of liquidity for banks holding illiquid assets. Maturities are between 6-36 months
- ❖ Fed's Long Term repo or refinancing operations post-2008 extended to also non-bank actors such as the Term Asset-Backed Securities Loan Facility or the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility.

A Proposal for a Euro-TARP

- ❖ ECB financed Special Purpose Vehicles to purchase for 5 years distressed Eurozone bank assets with reasonable haircuts c. 10-15% & profit/loss sharing arrangements in the event of upwards movement of prices.
- ❖ Banks invest no less than 10% of SPVs capital, which of course might lose in the long-run and this should add to the 10-15% loss to face value of the purchase price through the haircut
- ❖ Assets are transferred to the ESM after 5 years and any further losses do not encumber either the ECB or eurozone banks
- ❖ Thus, ECB losses, if any, are underwritten by ESM in the vicinity of (75%) and the original creditor up to 25%

Would it be Legal?

- ❖ First Treaty Prohibition, Art. 125 of the Treaty states:
- ❖ The Union shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of any Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. A Member State shall not be liable for or assume the commitments of central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of another Member State, without prejudice to mutual financial guarantees for the joint execution of a specific project. -

No Bail-Out

- ❖ **The Pringle case (Case C-370/12 Pringle), Court of Justice of the European Union, 27 November 2012**
- ❖ **CJEU first held that article 125 TFEU does not in principle prevent Member States from granting any form of financial assistance to another Member State, but that ‘the activation of financial assistance by means of a stability mechanism such as the ESM is not compatible with Article 125 TFEU unless it is indispensable for the safeguarding of the financial stability of the euro area as a whole and subject to strict conditions.’**
- ❖ **The CJEU continued:**
- ❖ **Article 125 TFEU does not prohibit the granting of financial assistance by one or more Member States to a Member State which remains responsible for its commitments to its creditors provided that the conditions attached to such assistance are such as to prompt that Member State to implement a sound budgetary policy.**
- ❖ -----
- ❖ **Also, no sovereign debt is cancelled.**

Second Barrier: Is it ‘Monetary Financing’?

- ❖ Article 123 of the current consolidated Treaty on the Functioning of the European Union states
- ❖ 1. Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as ‘national central banks’) in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States **shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments.**
- ❖ This is immediately followed by
- ❖ 2. Paragraph 1 shall not apply to publicly owned credit institutions which, in the context of the supply of reserves by central banks, shall be given the same treatment by national central banks and the European Central Bank as private credit institutions.

Is It ‘Monetary Financing’?

- ❖ It Depends on the Interpretation of Art 123!
- ❖ Is Draghi’s, very successful, albeit yet unutilized, Outright Monetary Transactions (OMT) ‘monetary financing’?
- ❖ **Official interpretation NO! because:** buying bonds on the secondary market — in other words not directly from the government
- ❖ **BUT, if so**
- ❖ **Why having ‘conditionality’ attached to OMT?**
- ❖ **Similarly an ECB-Euro TARP could be kept clear of Art. 123(1): Pringle case: CJEU talked about ‘purposive interpretation’**
- ❖ **Or the Art. 123(2) perhaps gives a much wider exemption for this sort of operations provided that the right structures are in place**

Advantages of an ECB-run Euro-TARP

- ❖ Winners and losers are chosen by the market
- ❖ ESM becomes a long-term Eurozone sovereign wealth fund but not a recapitalization tool
- ❖ ECB balance sheet does not remain bloated forever
- ❖ Freed up from bad assets and with losses on asset values capped, Eurozone banks are directly capitalized through today's excessively liquid capital markets

Any Precedents?

❖ Direct precedent

❖ Fed's Maiden Lane, LLC I, II, III, an spv used to purchase illiquid or distressed assets held by Bear Stearns (Maiden Lane I) and AIG (Maiden Lane II & III)

❖ Indirect precedent

❖ ECB's covered bonds purchase programmes (CBPP1 & 2)

❖ CBPP2 consists of direct ECB purchases of covered bonds for a total nominal amount of €40 billion.

❖ Purchases can be conducted in both the primary and the secondary markets.

❖ Purpose: to ease funding conditions for credit institutions and enterprises and encouraging credit institutions to maintain and expand lending to their clients.

Pros & Cons of an ECB-run Euro TARP

- ❖ State aid?
- ❖ It depends on how it's accounted
- ❖ No if it is rightly treated as ECB investment
- ❖ It's highly controversial
- ❖ And it's a gamble:
 - ❖ If Eurozone economies fail to recover, a Euro-TARP will have only postponed the inevitable break up