Applied Economics Quarterly Vol. 60. N° 2 (2014)
Duncker & Humblot GmbH, 12165 Berlin

Banking and Public Finance as a European Challenge

By Hannes Rehm*

Abstract

In response to the European financial crisis and recession that began in 2007, the monetary union member states, the major central banks, and the ECB itself embarked upon an unprecedented effort to stabilize and inject liquidity into financial markets. The result of these activities is the European sovereign debt crisis as well as a portfolio structure in the banking industry that is characterized by a high percentage of credit to the public sector. This situation has been exacerbated by the special regulatory privileges granted for such assets.

This paper proposes a strategy to reduce the dominance of public debt in the banking sector and to coordinate the bank restructuring process. The approach includes the option of setting up a European framework for national asset management vehicles. The core idea of this approach is to create national "bad banks" to hold distressed assets and make the "deleveraged" banking institutions fit for the future.

JEL Keywords: European Banking Union, European Sovereign Debt Crisis, European Banking Sector Restructuring

JEL Classifications: E42, E52, E58

1. The Entanglement of Public Finances and the Banking Industry

Financial markets need an overarching framework that guarantees the stability of the system. In contrast to other areas of the economy, in the banking industry, shocks do not remain isolated. Economic and financial history leading up to the most recent financial crisis has shown that, due to the high degree of global interconnectedness, difficulties with one bank can rapidly infect the entire system. The uncontrollable social and political upheavals that result can stretch far beyond the banking sector. What is more, because of the strain this creates on national financial systems, the state's ability to stabilize the financial sector is severely limited. Massive state interventions have been used to counter the effects of the recent economic and the financial crisis. The result of this major effort is a third crisis: a public finance crisis.

* Dr. Hannes Rehm, President of the Hannover Chamber of Commerce and Industry, Schiffgraben 49, 30175 Hannover. praesident@hannover.ihk.de

This leaves banks and the state in the same situation as before: Indeed, they are two sides of the same coin. And this coin—which actually ought to stand for the smooth and efficient functioning of our system—no longer has the public's trust. The involuntary symbiosis between banks and the state is potentially disastrous. It leads to the stability of public finance being heavily dependent on the stability of the banking sector. Or to put it in different terms: the national governments have made themselves dependent on the banks. This is questionable from a public policy perspective. The state is no longer free; it has to consider the interests of the banks.

Against this backdrop, Europe stands at a turning point.[1] Continental Europe has been hit by a threefold crisis—a financial market crisis, an overall economic crisis, and a crisis of public finances. Politicians and central banks have taken extraordinary measures to gain time to correct the distortions. The member states' contributions to rescuing banks and stabilizing the economy in the euro area have caused government debt to rise further. It is debatable to what extent the sovereign debt crisis was the result of permissive budgetary policy in the individual countries or the use of funds to rescue banks. What beyond debate is that up to the present, it has been mainly taxpayers who have funded the bank bailouts.[2] The result of these interventions is a high share of government financing by banks and by the European Central Bank (ECB). The ECB's low interest rate policy has created additional incentives for banks in the countries in crisis to refinance their debt at favorable terms using central bank funds to invest in domestic government loans. We will return to this topic later (see Section III.). The share of government debt held by banks domiciled in the bond-issuing countries increased significantly in 2013, especially in Spain and Italy, where it reached 68 percent.[3] In total, EU banks held around 1.7 billion in government bonds at the end of 2013.

2. On the Role of the European Central Bank (ECB)

First, on the ECB's role in this situation: In May 2010, the ECB began buying government bonds from Greece, Portugal, and Ireland in order to prevent a rise in their interest rates and to ensure their capital market viability. To this end, the ECB bought around 210 billion euros in government bonds up to the end of 2012 that have since declined in value to 140 billion euros. It is debatable whether this measure was motivated more by monetary or by fiscal policy considerations. In any

[1] See Friedrich Heinemann: "Die Europäische Schuldenkrise: Ursachen und Lösungsstrategien," in: Jahrbericht für Wirtschaftswissenschaften 2012 (1), 18 ff.; ibid.: "Zwischen 'Kernschmelze' und 'Fass ohne Boden' – Zum Dissens deutscher Ökonomen in der Schuldenkrise," in: Zeitschrift für Politik 2013 (2), 206 ff.

[2] See Hans-Jürgen Dübel: "The Capital Structure of Banks and Practice of Bank Restructuring," Center for Financial Studies, University of Frankfurt/M., Oct. 8, 2013.

[3] See Deutsche Bundesbank: "Zur Entwicklung der Bestände heimischer Staatsanleihen der Banken im Euro-Raum," in: Monatsbericht November 2013, 33 ff.

المنارة للاستشارات

case, at that point in time, the ECB could credibly argue that there were no other European instruments of crisis management available.

The ECB's Outright Monetary Transactions (OMT) program of September 2012 was designed explicitly with monetary policy in mind. Under the OMT program, the ECB makes purchases in secondary sovereign bond markets of bonds issued by euro-area member states. According to the ECB, the program's aim is to ensure the proper transmission of monetary policy and to preserve the singleness of monetary policy in the euro area. In this program, government bonds are only bought from monetary union member states that have gone through a macroeconomic adjustment program and are in full compliance with the terms of conditionality set by the OMT. Up to now, no European government bonds have been offered to the ECB for sale in this program. The ECB takes credit for having stabilized the markets simply by having announced the program.

One might well ask to what extent this program is legitimated by the statutes of the ECB: If the ECB's bond purchases are indeed motivated by monetary policy considerations, the ECB could buy a representative portfolio of all member states' government bonds or also private bonds. But it is not doing this: it is buying only bonds in case of emergency from crisis-hit member states.

On February 7, 2014, the Second Senate of the Federal Constitutional Court ruled on the cases brought before it, but also submitted several questions to the Court of Justice of the European Union for a preliminary ruling. According to the Senate, there are important reasons to assume that the OTM program exceeds the European Central Bank's monetary policy mandate, thereby infringing the powers of the member states, and that it violates the prohibition of monetary financing of the budget.[4]

The key sentence in the ruling is: "The OMT Decision does not appear to be covered by the mandate of the European Central Bank."[5] The ECB's goal in this program is to eliminate the interest rate spreads on government bonds of selected member states. The mandate of the European Central Bank is limited in the Treaties to the field of monetary policy.[6] It is only authorized to support the general economic policies in the Union (Art. 119 sec. 2; Art. 127 sec. 1 sentence 2 TEUV; Art. 2 sentence 2 ESCB Statute). It is not, however, authorized to pursue its own economic policy. Furthermore, the Court points out that the ECB is forbidden from purchasing government bonds directly from the emitting member states. This prohibition cannot be circumvented by functionally equivalent measures. If the purchase of government bonds were admissible every time the monetary policy transmission mechanism is disrupted, this would—according to the Court's argumentation—amount to granting the European Central Bank the power to remedy any deterioration of the credit rating of a euro member state through the purchase of that state's government

4 Federal Constitutional Court: Press Release 9/2014, February 7, 2014.

5 Ibid, p. 3.

6 See http://www.bundesverfassungsgericht.de/pressemitteilungen/bvg14-009en.html.

المنارة للاستشارات

bonds. This would largely suspend the prohibition of agreements that could disrupt free competition in the EU's internal market.

In its statement, the Federal Constitutional Court also described how the OMT program would have to be designed to be in conformity with European primary law:

- The purchased government bonds must exclude debt haircuts that would affect public creditors, which must be given seniority;
- Interferences with price formation on the markets should be avoided whenever possible,
- Government bonds of selected member states may not be purchased up to unlimited amounts.

What remains uncertain is the position of the Court of Justice of the European Union on these proposed adaptations.

For the topic at hand, this discussion and its outcomes are important because they revolve around the question of whether and to what extent the ECB is now pursuing not only monetary but also fiscal policy.[7]

3. The Importance of the Long-Term Refinancing Operations Program

The same question applies to the ECB's quantitatively significant refinancing measure, the Long Term Refinancing Operation (LTRO)—although to different aspects of this program's design. The LTRO, a 1,000 billion euro loan program, was launched in 2011 to provide cheap loans that were due to be repaid within three years. Around 500 billion euros of this have been paid back so far. The program is set to end in 2014. The ECB has already announced that the program will continue. It is noteworthy that a significant portion of the aforementioned increase in loans to states coincides with this program.[8]

In defense of this approach, the ECB notes that it was unable to make the necessary progress with classic instrument of reducing key interest rates. The interest rate cuts in fall of 2011 and summer pf 2012 did cause bank interest rates to decline in Germany, but not in southern European countries and France. In Italy and Spain, banks increased interest rates even further. According to the ECB, the markets were fragmented and the monetary policy transformation mechanism was disrupted. The ECB used the same argument to justify a further program announced in September 2014 to purchase asset-backed securities and additional liquidity supports. These

[7] See "Zeitgespräch: Bundesverfassungsgericht und Krisenpolitik-Stellungnahme der Ökonomen" with contributions by Kai A. Konrad / Clemens Fuest / Harald Uhlig / Marcel Fratzscher / Hans Werner Sinn, in: Wirtschaftsdienst 2013 (7), 431 ff.

[8] See Deutsche Bundesbank: "Zur Entwicklung der Bestände heimischer Staatsanleihen der Banken im Euro-Raum," in: Monatsbericht, November 2013.

are tied to additional lending by banks in the 18 euro states; the interest rate is fixed at 0.15 % for the entire four-year term and is independent of market interest rates.

What this argument fails to recognize is that the real problem is on another level. The euro area member states have the same currency but are not equally competitive. To correct this differential, prices would have to sink in the Latin European countries, from Greece to France, or they would have to rise in Germany and other countries. This shows that the solution to the dilemma cannot be achieved through monetary policy alone. There are two preconditions for a solution: structural changes in the southern European countries to make them more competitive, and a restructuring of the banks domiciled there to make them more competitive as well.[9] In addition, the interest rate differences between the members of the euro area are not evidence of a lack of integration but the expression of a structural framework that is based on individual responsibility.[10]

If some European countries' banking systems can in fact be described as lacking creditworthiness, this has more to do with the large share of government bonds held by the banks in these countries, their insufficient equity capital, non-performing assets, and lack of cost-efficiency. The proportion of "non-performing loans" in the banks' credit portfolios strains their trust in each another as well as the solvency of their partners and the system itself.[11] This is exacerbated European banks' lending to newly industrializing countries that are suffering from severe structural problems, which has now reached over 4 billion euros according to the Bank for International Settlements (BIS).[12]

Die ECB is attempting to use monetary policy to ease liquidity tensions, but without addressing their root causes. Indeed, the low-interest rate policy of the ECB allows what appears to be risk-free investment in and trade with government bonds, which are refinanced at relatively high interest rates and low margins and can, if necessary, be submitted to the ECB as collateral. These options were expanded through the broadened definition of eligible collateral for Eurosystem credit operations, the lowering of the minimum credit rating for eligible assets, the limitation of the obligatory haircut on bonds taken on the Eurosystem's balance sheet, and the increased lending limits.[13] This is also one reason why other borrowers are left out in the cold in a particular form of "crowding out." This is probably due above all to the possibility of using government bonds as collateral in refinancing operations

9 See Deutsche Bundesbank: "Anpassungsprozesse in den Ländern der Wirtschafts- und Währungsunion," in: Monatsbericht, January 2014, 13 ff.

10 See ibid., 83.

11 See Table 2.2 "Bonitätsindikatoren der Banken ausgewählter Euro-Länder," in: Deutsche Bundesbank: Finanzstabilitätsbericht 2013, 28.

12 See Friedrich Doll / Gustav Caesar: "Bumerang aus Übersee," in: Wirtschaftswoche 2014 (9), 105 ff.

13 See ECB: Chronik der geldpolitischen Maßnahmen des Eurosystems, in: Monatsbericht, 2011, I. ff.

المنارة للاستشارات

and earning interest through "carry trades," as well as to the low weighting of the bonds in the context of the overall increased regulatory equity requirements.

On the one hand, this has allowed banks to pay back part of the liquidity obtained from the three-year LTROs or to refinance by reducing of other holdings on the assets side of their balance sheets, or by reducing private sector loans. In Spain, Italy, and Portugal, the decline in private sector loans made up around 90% of the reduction in refinancing.[14] It is also for this reason that the low interest rate policy is proving unable to achieve its aims. On the other hand, the share of government loans that are being held by domestic banks is 99% in Italy, 97% in Greece, 94% in Spain, and 73% in Germany. The share of government bonds in liable bank equity is 188% in Greece, 103% in Spain, 113% in Italy, and 165% in Germany. Studies show that banks with low assets and investments hold relatively large portions of their portfolio in public equities.[15] The low interest rate policy has developed into a significant aid to government financing.

4. On the ECB's Understanding of its Role

How does this relate to the topic at hand? The ECB is using its policies in two ways: functionally and conceptually. The ECB is taking on the liabilities from increased government debt and deficits onto its own balance sheets. The expectation of low interest rates has now become a promise and thus an invitation to continue this inefficiency in fiscal policy.[16] In its policies, the ECB has vastly underestimated the political dynamic that has emerged from sluggish reform efforts in Greece, Italy and France fostered by low interest rates, tendencies toward speculation on credit markets, and the forces set in motion by fiscally liberal, government debt-fueled capitalism. To put it in even starker terms, one could say that the low interest rate policy is actually helping the hopelessly entangled private-public government bank complex of mutually supporting creditors and debtors. "In this respect, the security of the system is like a viscious circle: the national governments are supported by the banks, the banks are supported by the central banks, and the central banks are supported by the national governments."[17] All this is not an engine for sustained, substantial progress in Europe. To the contrary: in the long run, it will place the idea of European idea under extreme mental as well as political and economic stress.

---

14 See Deutsche Bundesbank: "Zur Entwicklung der Bestände heimischer Staatsanleihen der Banken im Euro-Raum," in: Monatsbericht, November 2013, 34.

15 See Claudia Buch / Michael Koetter / Jana Ohls: "Banks and Sovereign Risk: A Granular View," Deutsche Bundesbank Discussion Paper, No 29/2013, August 2013.

16 See Beate Sauer: "Gefährdet der Ankauf von Staatsanleihen die Unabhängigkeit der ECB," in: Credit and Capital Markets, 2013 (1), 29 ff., esp. p. 49.

17 Malte Krueger: "Ein Drei-Punkte-Plan zur Reform der Geldpolitik," in: Credit and Capital Markets, 2013 (4), 421 ff., esp. p. 434.

للاستشارات المنارة

For some time now, the "Draghi put" of summer 2012 ("… whatever it takes") has been affecting markets.[18] The interpretation is: If necessary, the ECB will buy sovereign debt. Investors speculate, and when times get tough, they issue Eurobonds—all in all, it is a safe "put." This behavior has two consequences: First, investors move up on the bond maturity curve to gain higher yields under a normal yield curve. Second, they move down the credit curve, that is, they enter into higher risks by buying poorer credit risks. One therefore has to ask, for example, if Spain's economic condition really does jutify the historic low interest rate or if these are first signals of excesses.

Another aspect of the dangerous entanglement of the government finance crisis and the bank crisis can be discussed under the heading of "fiscal repression."[19] The German Bundesbank addressed this issue in some detail in its September 2013 monthly report.[20] Measures of financial repression imply a decline in the nominal interest rate that a particular government would pay in the absence of such measures, that is, under competitive conditions. The reduced burden on public finances in the area of "interest payments" created by this low-interest policy leads to redistribution between citizens and the government. Behind the public sector as the creditor, there are individual recipients of the interest who, faced with a lack of alternatives, lend the money to the government but receive much less real interest in return. In sum, over the course of time, real private capital gains are reduced to the benefit of the government interest income. The consulting firm McKinsey[21] calculated that the the low interest rate policy already saved the governments of the USA, Great Britain, and the Euro area 1.6 trillion dollars between 2007 and 2012. This stands in stark contrast to the 360 billion dollar loss to private households.

As an intermediate conclusion, one can state the following: Through these infringements, or stretching, of European law, the euro area has maneuvered itself into a very difficult situation. The "infringements" refer to the violation of the "no bail-out rule" under Art. 125 TFEU and the "stretching" of European law to the interpretation of Art. 123 TFEU regarding monetary government financing. In view of the institutionalized "bail-outs"—first, through the European Stability Mechanism (ESM), second through the OMT program—it has become impossible to credibly communicate the need for fiscal and structural cutbacks to the public in

---

18 See http://go.bloomberg.com/euro-crisis/2012-02-08/the-draghi-put-effect/.

19 See Deutsche Bundesbank: "Die Entwicklung staatlicher Zinsausgaben in der Europäischen Währungsunion," in: Monatsbericht, September 2013, 59 ff.

20 See Carmen M. Reinhart / M. Belen Sbrancia: "The Liquidation of Government Debt," Bank for International Settlements Working Papier, 363, Nov. 2011; Carmen M. Reinhart / Jacob Funk Kirkegaard / M. Belen Sbrancia: "Financial Repression Redux," in: Finance and Development, June 2011 and the "Zeitgespräch: Finanzielle Repression – ein Instrument zur Bewältigung der Krisenfolgen?", in: Wirtschaftsdienst, 2013 (11), 731 ff. with articles by Stefan Homburg / Bernhard Herz / Alexander Erler / Thomas Mayer / Arne Heise / Ulrike Neyer.

21 See McKinsey Global Institute: "QE and ultra-low interest rates: Distributional Effects and Risks," New York 2013.

المنارة للاستشارات

the creditor states. Instead, the over-indebted countries are relying on the ESM and the ECB.

5. Possible Approaches to Resolve the Government Financial and Banking Crisis

What needs to be done to resolve the entanglement of the government financial crisis and the banking crisis?

First, public budgets need to be restructured. This entails a dual task: in the short term, budgets will need to be consolidated, not merely as an expression of willingness to cut spending but as as sign that budgets will be restructured sustainably to reduce the burdens on future generations.[22] Public finances will have to be restructured to expand each country's capacity for economic growth. There are now even some indications of success, at least in Ireland, Spain, and to a lesser extent in Portugal, but not in Italy or Greece.

Efforts to deal with the European government debt crisis through institutional measures were brought to an end with the fiscal pact adopted in mid-2012: the European Stability Mechanism (ESM). Without going into too much detail, what is important about it here is the following: the key component of the fiscal pact is the requirement of at least nearly structurally balanced government budget. The fact that France already failed to meet these criteria in 2012, the year the pact was signed, as well as in 2013 gives an impression of how these rules will be dealt with in the future.

One can assume that national debt brakes will be institutionalized since this is the precondition for the use of tools provided for in the ESM. As a binding fiscal rule, this mechanism cannot, however, be enforced in its current form by the European Court of Justice. Taking matters to the European Court of Justice would have no chance of success. The Court dismissed an action in 2008 based on the "no bailout" clause in the Maastricht Treaty with the argument that it does not forbid EU states from helping one another. Above all, the criteria for budget discipline are not well defined: the limits of government debt are based on the "government's annual structural budget balance." This is defined as the "annual cyclically adjusted balance net of one-off and temporary measures."[23] Thus, the escape routes are programmed in. A rule like this ultimately justifies the economic development as an exceptional situation justifying additional government debt.

The same skepticism regarding the disciplinary effect is called for in view of the so-called "European Semester" and especially regarding the "Six-Pack" and "Two-Pack" legislation to coordinate economic and fiscal policy. The German Ministry of

[22] See Hannes Rehm: "Wohin geht Europa – institutioneller Wandel oder Umverteilung?", in: Zeitschrift für das gesamte Kreditwesen, 2013 (6), 285 ff.

[23] For both definitions see http://ec.europa.eu/economy_finance/economic_governance/sgp/glossary_en.htm.

للاستشارات

Economics had this to say: “Only when everyone takes the jointly agreed goals and procedures seriously will Europe regain credibility.”[24] Yet learning from experience seems to be difficult: the government debt crisis did not arise because there are no legal limits, but because they are ignored. Paul Kirchhoff points out that stability always means a return to legality.[25] This is not the European consensus. Rather, the hope is that after setting some basic rules, the rest—that is, the definition of more precise regulations that are necessary for implementation—will take place later, and the political decisions this will require can be put off indefinitely by relying on the credit and financing potential of other members.[26]

This expectation always underlies the repeatedly articulated demand that the European community keep the emission of eurobonds as an option. This discussion is only conducted at all because EU states (still) have hopes of obtaining low-cost refinancing given that around one-third of them have a triple-A rating (Germany, Austria, Finland). This overlooks the fact that the accompanying quota liability could even challenge the creditworthiness of this “springboard” itself. The German Council of Economic Experts’ proposal to establish a European debt repayment fund is equally founded on hopes. Their model only functions when the debtors settle their debts once and for all at a given point in time, that is, if they respect the legal framework of the construct. Yet precisely this faithfulness in adherence to European agreements has been lacking up to now.[27]

This leads us to the crux of the fiscal union: the necessary symmetry between monitoring and accountability. In this context, it should be noted that the general authorization in the ESM statutes provided for by Art. 21 of the ESM By-Laws, the ESM has the possibility for refinancing on the capital markets and in the ECB. To the extent that a direct recapitalization of banks by the ESM is contained in the concept of the European banking union (see section VII below), the ESM and the banks would be protected from all monitoring.[28]

---

[24] Bundesministerium für Wirtschaft und Technologie: “Wirtschaftspolitische Koordinierung in Europa – ein Fundament für den Euro – Verfahren müssen konsequent angewandt werden, in: Monatsbericht, December, 2013, 19 ff. See also the critical evaluation of previous steps taken by the ECB (Monatsbericht, March 2014, 7).

[25] Paul Kirchhoff: “Deutschland im Schuldensog,” Munich, 2012, 87.

[26] See Friedrich Heinemann / Mathias Jopp: “Wege aus der europäischen Schuldenkrise,” Institut für Europäische Politik, Februar 2012; Friedrich Heinemann / Marc-Daniel Moessinger / Steffen Osterloh: “Feigenblatt oder fiskalische Zeitenwende?”, in: Integration, 2012, 167 ff.; Deutsche Bundesbank: “Jüngste Entscheidungen des Ecofin-Rates zu den Defizitverfahren der Länder im Euro-Raum,” Monatsbericht, August 2013, 71 ff.

[27] The preconditions for these instruments, in particular the symmetry between control and accountability, can only be achieved with European constitutional rules. (See Deutsche Bundesbank: “Zur gemeinschaftlichen Haftung für Staatsschulden und zum Vorschlag eines Schuldentilgungsfonds,” in: Monatsbericht, June 2012, 8 ff.)

[28] See Markus C. Kerber: “Der Europäische Stabilitätsmechanismus ist eine Hydra,” in: Wirtschaftsdienst, 2013, (7), S. 456.

المنارة للاستشارات

On balance, it must be emphasized that one should not invest excessively high hopes in a thoroughgoing consolidation of public budgets and an accompanying repayment of government debt in general and in the banking sector in particular. It is possible that at some point, an escape route will be sought in one-off capital levies,[29] which would certainly be within the realm of possibility for the peripheral countries judging from the empirical findings on the wealth situation of private households.[30] Alternatively, serious consideration might be given to government bankruptcy law[31] as a means to achieve sustainable budget restructuring.

Without going into too much detail, one note should be made: countries like the USA, New Zealand, and Switzerland have in place, and enforce, bankruptcy laws for regional public authorities at the municipal level. These are based on the concept of a fiscal policy that is designed to promote competitive federalism and exclude the possibility of "bail-outs" of higher levels. This also has a sustained impact on markets, which anticipate the possible outcomes, both on the question of "whether" and of "how" (the spreads). It would scarcely harm the euro and would even tend to benefit it if individual overindebted member states declared insolvency. What would happen then—that creditors would take on part of the insolvency costs—can only be achieved in a very complicated way, through a change in European treaties. This raises a question: Would government bankruptcy with sweeping debt cuts that would be borne by all creditors have been the better alternative for Greece and one that would have promised the country's sustained recovery? The answer is yes, but with some caveats. The country's restructuring would have been easier, but in light of the government's high indebtedness to its banks and foreign credit institutions, this would have triggered a new banking crisis—a good example of the hopeless situation resulting from the entanglement of the banking and financial crisis.[32]

6. The Importance of Regulatory Privileges Over Public-Sector Credit

How are banks behaving? All the attempts to use the aforementioned possibilities of ECB policy as a business model in recent years have taught banks a number of

29 See Deutsche Bundesbank: "Einmalige Vermögensabgabe als Instrument zur Lösung nationaler Solvenzkrisen im bestehenden EWU-Rahmen?," in: Monatsbericht, January 2014, 52 ff.

30 See Stefan Bach: "Vermögensabgaben – ein Beitrag zur Sanierung der Staatsfinanzen in Europa," in: DIW Wochenbericht, 2012 (28).

31 See Wissenschaftlicher Beirat beim Bundesministerium für Wirtschaft und Technologie: "Überschuldung und Staatsinsolvenz in der Europäischen Union," Expert Report, September 26, 2010, Berlin 2010; Sachverständigenrat: "Stabile Architektur für Europa – Handlungsbedarf im Inland," Jahresgutachten 2012/2013, November 2012, Ziff. 160 and the recent proposal by the Committee on International Economic Policy and Reform: Revisiting Sovereign Bankruptcy, Brookings Institution, Washington D.C. 2014.

32 See Jörg Rocholl: "Eigentum und Haftung zusammenbringen," in: DIW-Vierteljahreshefte zur Wirtschaftsforschung, 2013 (2), 149 ff.

المنارة للاستشارات

lessons. The "Sovereign Credit Risk" has gained in importance on the market for government bonds from the member states of the EU. The debt cut in Greece has clearly demonstrated to investors the significance of government credit default risk. In 2011, for a nominal 100 euros in old Greek government bonds, creditors received 15 euros in short-term EFSF bonds and 31.50 euros in new long-term Greek government bonds. Concerns about Greek government finances caused risk premia to reach their highest levels to date just before the debt cut. These experiences induced banks to at least partly shift to calculating the transfer risk (i.e. the potential loss due to currency conversion restrictions imposed by a foreign government) and the government default risks into their country debt ratings. Indicators include the current account balance, foreign debt, monetary reserves, government debt, and budget deficit. The key factor is "Loss Given Default (LGD)", that is, the answer to the question: How high would a bank's expected losses be relative to the remaining amount of financing if a government defaulted on its debt? Base on the country ratings and the LGD, the strategic country limit would normally be calculated with the possibility for early indexing of concentration risks.

These internal reactions by banks are, however, just a bare minimum and not a complete and adequate response to the problem. The problem itself is characterized by the fact that because of the aforementioned developments, concentration risks in government bond investments have emerged on many banks' balances that are significantly above the upper limits for major loans to individual creditors. This upper limit is 25% in the EU for loans to non-government entities at 25% of a bank's liable equity capital.

These developments have been driven by the 0 percent risk weighting applied to bank loans to central governments, central banks, and other public entities when backed by equity capital. This creates considerable incentives for loans to public entities. Although experience has shown that government securities are no longer without risk, bank regulation policies continue to use a 0 percent risk weighting, even in the "Basel III" approach and in the "Solvency II" rules for public sector credit in the insurance industry. Public-sector borrowers do not only create privileges for themselves through their exemption from the requirement to provide capital backing; they have also garnered significant advantages over other issuers in the refinancing requirements and in the insurance supervision rules of Basel III. This is true for the privilege of trustee security status (*Mündelsicherheit*, § 1807 BGB) and for Article 2 of the German investment regulations (*Anlageverordnung*) for insurance companies.

The complex relationship between government debt and debt refinancing by banks cannot be disentangled overnight, but only gradually. Attention should be given to the following key points:

First: Governments need banks as investors but not just domestic banks. There can be no renationalization of government bonds in markets within the euro area.

Second: Banks must hold a certain amount of goverment bonds in their portfolio for liquidity management.

المنارة للاستشارات

Third: Banks should be urged to invest excess liquidity in the real economy rather than in government bonds.

Fourth: Banks should not enter into cluster risks with government bonds in their own currency, in order to not run into survival problems in the case of debt cuts.

Based on these considerations, the Managing Director of the Commerzbank, Martin Blessing, made the proposal at the beginning of this year that banks should gradually provide capital backing for government bonds starting in 2019.[33] The capital requirements should be in foreign currency for all government bonds in order to correspond to the currency risk. Within the euro area, banks should only be exempted from their capital requirements up to a large loan ceiling of 25% of liable equity capital for the particular country.

The underlying expectation is that in such a framework, banks will invest their liquidity up to the large loan ceiling in domestic bonds, for which they do not have to raise their equity capital. As soon as they have reached the large loan ceiling, they have three options:

- They can continue investing in domestic bonds, but would have to hold equity capital since it would now constitute a cluster risk.
- They can invest in loans to the real economy. Here too, they have to hold equity capital, but this is more appealing since the spreads for these trades are higher.
- The can invest in the government bonds of another country in the euro area, since these also do not have an equity capital requirement up to the large loan ceiling.

Over time, this would bring about a restructuring of government debt that would stabilize the euro area as a whole. The dependence of some individual banks on the credit quality of their governments would be reduced as well, as would the dependence of governments on their own banks. The size of the capital requirements should be staggered according to the credit rating of the issuing country and the term of the bonds. This procedure is already being used by the ECB today to calculate discounts on government bond loans in the euro area.

The introduction of new rules should be planned in advance and should take place at a point in time after the banking sector but also the euro area has stabilized. An introduction of these rules for fresh issues starting in 2018, that is, when the European Banking Union begins operation, would ensure that the banking sector but also the issuing states are able to adapt themselves to this change.

It is a welcome development that—independent of the aforementioned medium-term perspective—the ECB has announced, as the future European banking supervision body, that as part of the upcoming stress tests, the government bonds will be valued at market prices (at book value) and that additional capital backing for the

---

33 See Martin Blessing: “Die unheilige Allianz von Staaten und Banken beenden,” in: Handelsblatt, January 20, 2014, 23.

المنارة للاستشارات

default risk on securities should be required to be held in the banking book portfolios, that is, until the bonds reach maturity. Apparently the ECB is considering whether it will reveal the "prudential filters" it uses to adapt the valuation of government bonds to bond price volatility. This shows that progress is being made, despite all resistance even on the part of state issuers.

7. The Model of European "Bad Banks" as a Possible Solution to the "Skeletons in the Cupboard" of the European Banking System

One may still have hopes that in the planned banking union, the relationship between public finances and the banking banking industry will become less densely entangled than it is now. Unrestrained optimism, however, is not warranted.[34] In general, a significant amount of progress has been made. Yet major details remain to be fleshed out and are still the subject of heated debate. The compromises that were made in March 2014 between the Eurogroup and the European Parliament over how the resolution fund will be filled with financial means and the liquidation procedure itself give indications that the underlying material problems[35] will rapidly catch up with the participants. And it is not impossible that despite the planned "bail-ins" of property owners, creditors, and depositors, there will be a direct or at least indirect possibility for recapitalization of European banks by the ESM—a demand that the southern European countries and France continue to insist upon. Indeed: the final Directive published by the EU-Comission in June 2014 does not exclude a direct investment of the ESM as an element of banking restructuring in the future.

Perhaps discussion on this point could be carried out in a more politically effective way if, prior to the banking union, that is, in the years up to 2018, the elements that exacerbate the severity of banking crises, which also includes a portion of government bonds—in other words, the "inherited problems"—are removed from bank balance sheets.[36] This means that the respective governments will have to take responsibility for overcoming the "past" of their national banking industries, and that

[34] See Roland Vaubel: "Probleme der Bankenunion: Falsche Lehren aus der Krise," in: Credit and Capital Markets, 2013 (3), 281 ff.

[35] Tobias Tröger: "Der Einheitliche Aufsichtsmechanismus (SSM) – Allheilmittel oder quacksalberische Bankenregulierung? Eine kritische Bewertung der neuen Architektur für die Bankenaufsicht unter der Ägide der ECB," in: Zeitschrift für Bankrecht und Bankwirtschaft, 2013 (6), 373 ff.; Uwe H. Schneider: "Inconsistencies and unsolved Problems in the European Banking Union," in: Europäische Zeitschrift für Wirtschaftsrecht, 2013 (24), 452 ff.; Sabine Lautenschläger: "Wie ist das EU-Konzept zur Bankenunion zu bewerten?," in: Ifo-Schnelldienst, 2013 (1), 3 ff.; Silvia Merler, Guntram B. Wolff "Ending uncertainty – Recapitalisation of Banks Supervised by the SSM, in: Credit and Capital Markets, 2014 (2), 241 ff.

[36] See Hannes Rehm: "Europäische Staatsfinanz- und Bankenkrise – Laokoon oder klarer Schnitt?," in: Zeitschrift für das gesamte Kreditwesen, 2012 (14), 708 ff.

المنارة للاستشارات

they may need to count on the community for its help in the spirit of solidarity. The new European banking union should thus be a "fresh start".[37]

To this end, the banks should be given the possibility to remove the risky assets from their balance sheets and to subject them to a specific procedure for asset management or liquidation. The basic elements of such a procedure were created in Germany's "Bad Bank Law," the second amendment to the Financial Market Stabilization Act of 2009. The concept would therefore fit within the scope of the EU Directive.[38] Furthermore, such national resolution funds already exist in Spain and Ireland, and one is planned in Italy.

This approach could be expanded to a European dimension in the following steps:

- First, the assets under discussion and the corresponding liabilities could be separated at book value as of a specific date from the bank's balance sheet and put into a national asset management vehicle. Precursors for such a vehicle exist in Spain, Italy, and Austria.
- The operator of this vehicle should be the country of domicile of the banks whose supervisory board pursues the approach, together with the emerging supervisory board of the ECB, following a standardized procedure.
- The refinancing of the transfered assets up to the selling date will be guaranteed by the respective state.
- Aid would then be provided through a European solidarity initiative such as the ESM, and not by the individual bank itself, focusing on capital market viability, rating, and the resulting government refinancing costs.
- Such a concept could help resolve ongoing discussions over the design of the future European Banking Union's bail-in tool, which is to include direct recapitalization by the ESM. This would leave the political responsibility for the restructuring of national banking systems—also with respect to European requirements—in the hands of the individual countries. They can then decide whether and to what extent the owners and creditors of the core banks are involved in the bearing the burdens of separation or to what extent changes of ownership are necessary.

All this can only serve as food for thought, and does not provide answers to a number of individual questions. For example, the transfer of assets and liabilities to

[37] See Nicolas Véron: "Tectonic Shifts – Banking Union is a long-term process that will dramatically reshape Europe's financial system," in: Finance and Development, 2014 (3), 17 ff., 19.

[38] See Europäische Kommission: "Vorschlag für eine Richtlinie des Europäischen Parlaments und des Rates zur Festlegung eines Rahmens für die Sanierung und Abwicklung von Kreditinstituten und Wertpapierfirmen," COM (2012) 280 final/2, Brüssel, June 12, 2012; Bernd Rudolph: "Defizite und Perspektiven der Bankenregulierung in der Europäischen Union," in: Kredit und Kapital, 2012 (4), 459.

المنارة للاستشارات

a settlement bank would be conditioned on the agreement of the debtors and creditors. Herre as well, there are conceivable solutions that have already been tested to some extent. Some of the bywords of this are "synthetic transfer", that is, the approach of only transforming the economic risk to the resolution framework (in the case of complications on the side of the debtor) or restructuring liabilities through debt equity swaps (in the case of complications, on the side of the creditor). The latter would make an immediate and direct contribution to recapitalizing the particular core bank.

Another question that still remains to be answered is whether such an approach should be designed for all or just for system-relevant banks which are "too-big-to-fail", or whether it should be limited to banks in the countries in crisis. Similarly, the criteria for separable assets and the means of transfering them to a liquidation vehicle. Setting these framework conditions will be one of the essential and objectively required conceptual tasks of a European banking authority.

Such an approach would not provide direct relief to government budgets and debt levels. This would remain the task of national-level fiscal policy. But it would prevent further public costs from arising due to continually putting off the necessary corrections, and it would slow down the disastrous spiral of bank bailouts that are posing a major burden on government budgets.

Above all, however, this would offer a means of redimensioning the European banking system: the core banks that would still remain after separating bad assets into a liquidation vehicle would be significantly more stable in regard to their profit situation and risk potential. Relieving the core capital from certain assets would help in their restructuring and would facilitate their orientation towards a sustainable business model, thereby also creating new options for credit lending. The renewed financial soundness of the slimmed-down, deleveraged banks would then improve their ratings and potential for refinancing. The bridge bank, for its part, would offer the advantage of potential and partial recovery of value of the currently stressed assets, and also government bonds, over time. It would render fire sales unnecessary and thus open up the opportunity to reduce otherwise necessary supports. Capital gains from the sale of the liquidation vehicle could reduce the need for aid provided in the framework of European solidarity initiatives.

Independent of individual questions that—as the German model shows—are possible to solve, this procedure would defuse a great deal of conflict potential in the run-up to the European Banking Union. Cleaning up the banking industry—of government debt in particular—does not rely on a complicated resolution mechanism; initially the responsibility and choice of design options would be placed in the hands of the national states, which can then seek European aid. It would also stop further erosion of European primary law by pedantic, unprincipled changes in the Community's secondary law.[39]

---

[39] See the article by the former constitutional judge Dieter Grimm: "Es geht um das Prinzip," in the FAZ, February 6, 2013, 28.

المنارة للاستشارات

Such an approach would significantly reduce the politically and psychologically explosive potential of efforts to achieve Europe-wide deposit protection and funding of a European resolution fund. It would then become evident that such funds are not the only means of addressing the impacts of high government debt, risk-friendly behavior, and moral hazard. But above all, what this approach would make clear is that Europeans have not entirely abandoned their commitment to think and act in terms of "Ordnungspolitik". This would be valuable in itself, for this certainty will ultimately serve as the foundation for the trust of markets and citizens in their political leadership.

Reproduced with permission of the copyright owner. Further reproduction prohibited without permission.

المنارة للاستشارات

www.manaraa.com