Peterson Institute for International Economics

Policy Brief

NUMBER PB09-13 JUNE 2009

A Solution for Europe's Banking Problem

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Note: The authors are grateful to all who reviewed prior drafts of this policy brief and thank Marc Hinterschweiger and Martín Saldías Zambrana for excellent research assistance.

Since mid-2007, public authorities in the European Union have broadly met the challenge of ensuring a functional degree of liquidity and preventing financial meltdown. The Eurosystem has even been ahead of the curve compared with the Federal Reserve and the Bank of England in discounting early on a wide variety of assets to a range of counterparties. However, despite unprecedented central bank intervention, extensive government guarantees since October 2008, and macroeconomic assistance (with the International Monetary Fund) to the European Union's weakest member states, the underlying state of continental Europe's banking industry remains very fragile.[1]

The health of banks means a lot to the European economy. The European Union is far more reliant than the United States on bank credit (figure 1) and on bank intermediation of savings. As of 2007, 34 percent of EU household financial assets were currency and deposits (27 percent in the United Kingdom, 37.5 percent in the euro area), mostly bank-held, compared with less than 15 percent in the United States.[2] Banks also represent a larger share of the overall corporate landscape in the European Union. By mid-2007, they represented no less than 24 percent of the aggregate market value of European listed companies among the world's largest 500, compared with only 16 percent in the United States (by March 31, 2009, these proportions had halved to 12 and 8 percent, respectively).[3]

Healing the banking system is therefore crucial for sustained recovery in Europe. Lingering banking fragility would result in recurrent disruption or misallocation of bank credit and would have a sizable negative impact on economic activity, depressing investment. Monetary policy and asset guarantee measures, which steepen the yield curve and increase banks' margins, would play to the detriment of savers, depressing consumption. Ongoing fragility will not just depress aggregate demand through these two channels but also harm European trend productivity growth by skipping some investment and R&D cycles, misallocating capital to lower-return projects, and wasting human capital by consigning some workers to long-term unemployment (Posen 2009 and Pisani-Ferry and van Pottelsberghe 2009). Conversely, there is, at least in this crisis, no convincing evidence that continental Europe's reliance on banks has delivered more financial stability than the more securitized finance of the United States and the United Kingdom.

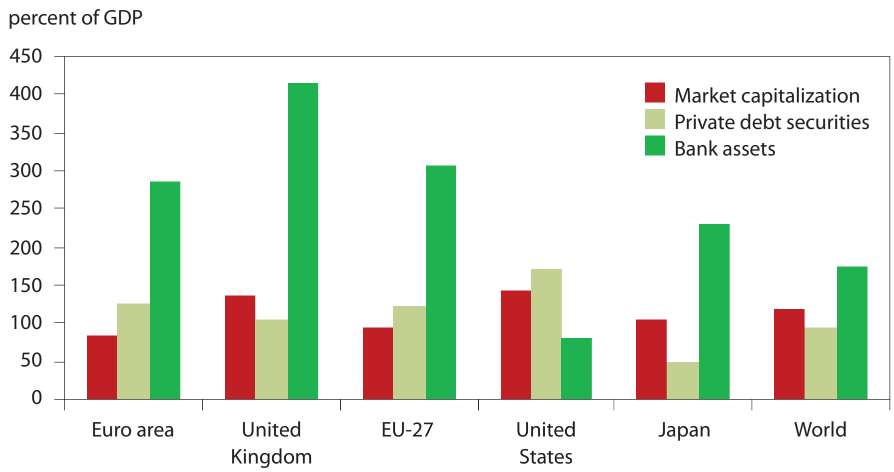
How big is Europe's banking problem? There is not enough

1. The United Kingdom faces a distinct situation, which is not specifically addressed in this policy brief.

2. Authors' calculations based on Eurostat and country flow-of-funds reports.

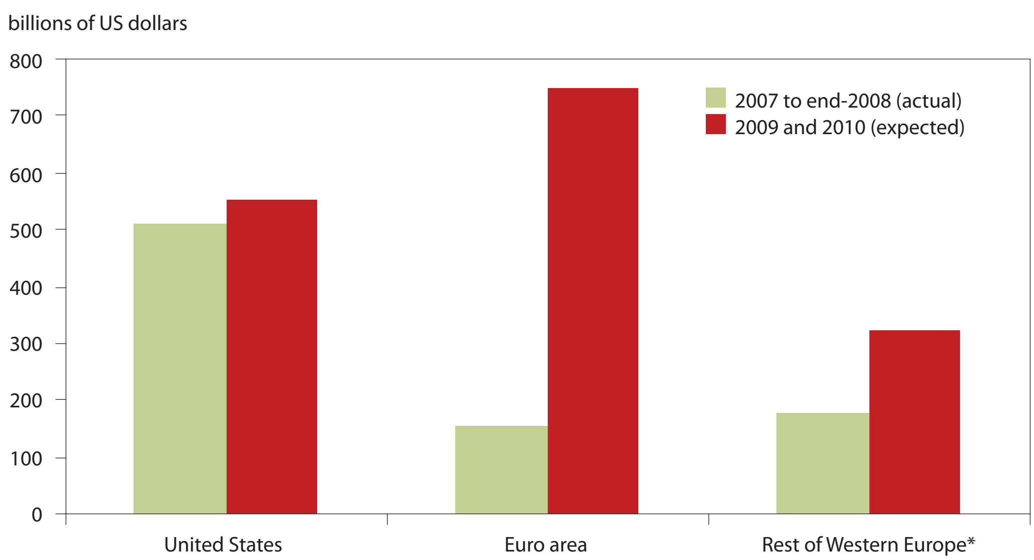
3. Authors' calculations based on FT Global 500 rankings.

Figure 1 Bank versus other sources of capital, end-2007



Source: IMF, *Global Financial Stability Report*, April 2009.

Figure 2 Bank writedowns, past and future



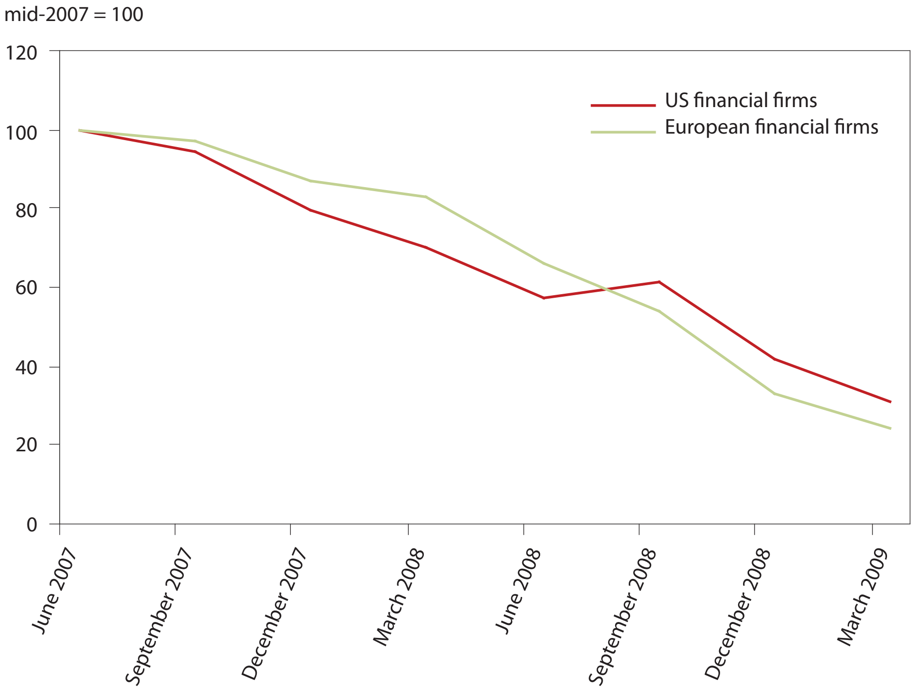
Source: IMF, *Global Financial Stability Report*, April 2009.

*Denmark, Sweden, United Kingdom, Iceland, Norway, and Switzerland.

transparency to provide an uncontroversial answer. International Monetary Fund (IMF) estimates anticipate big losses in euro area–headquartered banks (figure 2). A team of economists at Goldman Sachs have also independently come to a similar figure of €569 billion in as yet unrecognized losses (Broadbent et al. 2009). Even allowing for more optimistic scenarios, there is no escaping the great magnitude of the losses to come for continental Europe's banks, illustrated by the slightly steeper decline in the aggregate market value of large European listed banks compared with their US counterparts since the crisis started (figure 3). These losses portend bank insolvencies, since the projected losses are too large to be fully compensated for by future retained earnings, especially as they are likely to be very unevenly distributed among banks.

Figure 4 compares market indicators of liquidity and solvency risk. It illustrates the success of liquidity provision

Figure 3 Aggregate market capitalization of large listed financial firms



Source: FT Global 500 rankings; authors' calculations.

since the turmoil following the Lehman Brothers bankruptcy, but also the persistent perception of insolvency risk, even after the remarkable easing since March 2009. Major European banks cannot be considered in more robust condition now than in late 2008, and a number of them are likely to be either insolvent or seriously undercapitalized, though which banks are thus afflicted cannot be determined on the basis of currently available public information.

Healing the banking system is crucial for sustained recovery in Europe.

The magnitude of the problem, however, does not guarantee a prompt policy response. Elected officials typically find it hard to garner the political will to take tough measures to deal with banking difficulties when forbearance is an easier short-term option. The inaction of the US government during the 1980s savings and loan (S&L) crisis, and the Japanese government during the 1990s, illustrate this difficulty (Mikitani and Posen 2000). In continental Europe, the centrality of banking and the high number of people it employs make the situation more acute.

Nor are market pressures likely to prompt proactive policy action. Current state guarantees remove pressure on weaker institutions from depositors. Central banks' liquidity provision has saved the macroeconomy but has also eroded discipline. The perceived availability of generous government bailouts, at least for the first few banks to face problems, also relieves equity market pressure. Furthermore, politically induced moves away from "fair-value" accounting shift the scrutiny from individual bank balance sheets to the entire financial system, which brings a far more damaging air of uncertainty. European policymakers have so far insufficiently acknowledged the resulting challenge.

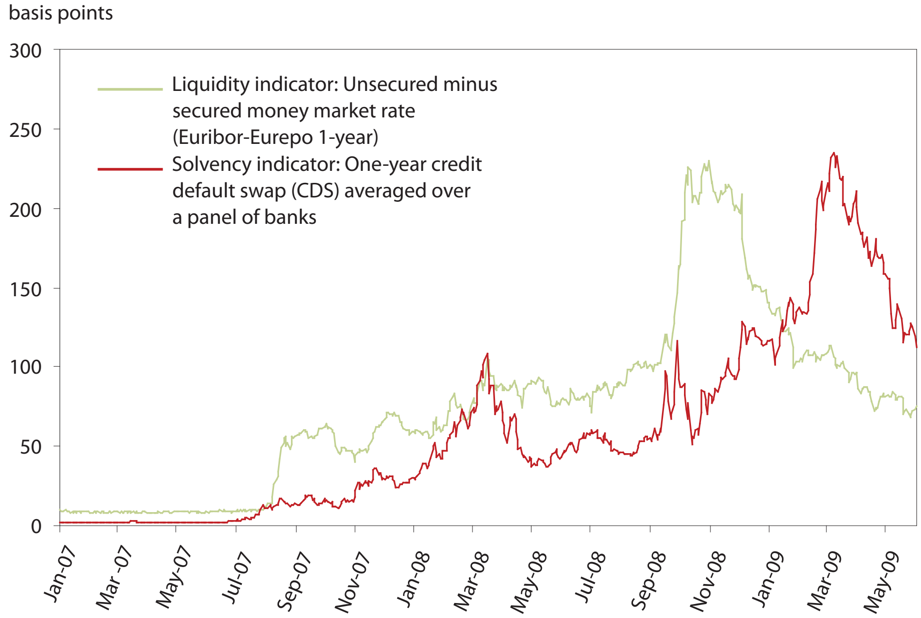
THE NEED FOR A EUROPEAN APPROACH TO TRIAGE AND RESOLUTION

Systemic banking crises are especially difficult to address, because they cast doubt on all banks simultaneously. Yet policymakers prefer that general drag to having to close specific banks. Failure to confront the problem, though, only aggravates the crisis. A key aim is to allow the marketplace to differentiate among banks and to regain trust in those sound enough to continue their operations without major change, while unsustainable banks are duly restructured.[4]

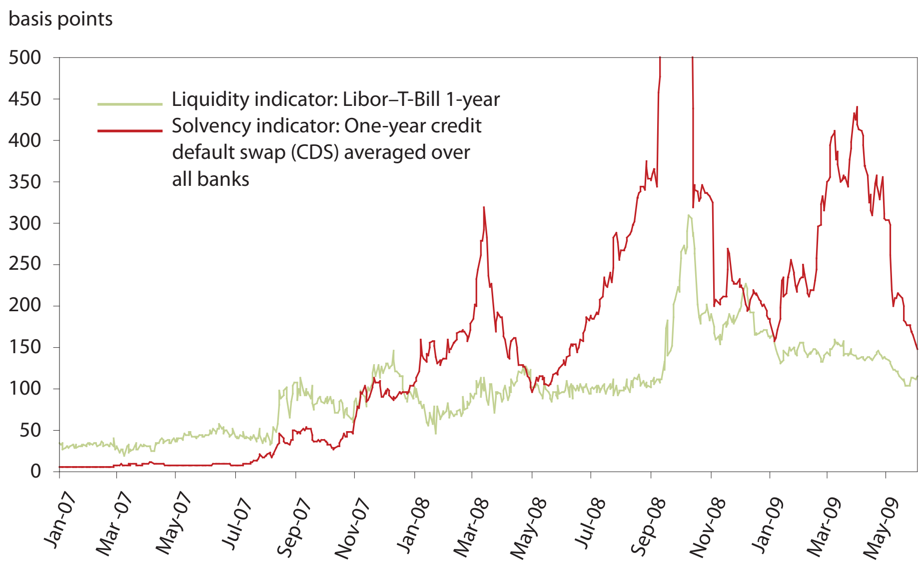
4. Adam Posen, "A Proven Framework to End the US Banking Crisis Including Some Temporary Nationalizations," testimony before the US Congress, Washington, February 26, 2009.

Figure 4 Market assessment of liquidity and solvency risk

a. Banks headquartered in the euro area



b. Banks headquartered in the United States



Sources: Datastream; European Banking Federation; British Banking Association, series ending June 2, 2009. Methodology based on Eisenschmidt and Tapking (2009).

Triage[5] necessarily involves a system-wide assessment of the solidity and long-term viability of all or most key banks on a comparative basis using a consistent methodology. In times of crisis, accounting information as appears in the banks' published financial statements is of limited use, because the usual incentives for issuers to provide high-quality disclosure are weakened. Triage cannot be spontaneous and market-driven and has to be a specific process initiated by public authorities to deliver the required reliability and comparability.

None of the major banking crises of the last few decades in developed economies has been ultimately overcome without something akin to a triage process, and the later it comes, the greater the economic cost of the crisis. In the United States in 1989, it took the form of an overhauled regulatory framework and a Resolution Trust Corporation (RTC) to restructure failed S&L associations. Sweden in 1993 created a Bank Support Authority (BSA) to assess banks' assets and take over ownership of those found insolvent.[6] In Japan, the Financial Services Agency in 2002–03 launched "special inspections" of the major banks, and harsh measures imposed on undercapitalized banks eventually led to recovery. By contrast, approaches that focused on the state buying assets deemed "toxic" from banks still in private ownership played a marginal role, if any (see, for example, Hoshi and Kashyap 2007). The term "bad banks" sometimes used to describe such approaches can be misleading, as those "bad banks" set up in Sweden in 1992–93 involved no transfer of assets to the state in situations where there had not been prior full nationalization.[7]

Major European banks cannot be considered in more robust condition now than in late 2008, and a number of them are likely to be either insolvent or seriously undercapitalized....

Triage has not started in continental Europe. On the basis of general principles agreed to in October 2008 and under the control of the European Commission's Directorate-General for Competition, member states have injected capital into many banking groups. The De Larosière Report to the European Commission (February 2009) called for consistent crisis management but focused on mid- to long-term institutional responses. In May 2009 the Committee of European Banking Supervisors (CEBS) announced that tests would be conducted in each EU member state on the basis of "common scenarios and guidelines,"[8] but specified that "this is not a stress test to identify individual banks" and that "the outcomes [would remain] confidential," meaning no effective triage process. By comparison, the US stress tests completed in early May 2009 have given markets a means of improving their understanding of the respective strengths and vulnerabilities of major US banks.

Could triage be done successfully in Europe on a country-by-country basis? There are certainly strong political forces against a supranational approach. National governments (and ultimately, taxpayers) have to pay for the upfront costs of any recapitalization. Bank supervision is also presently primarily national. Bank shareholders and management tend to make their case for bailouts to national politicians, whether as multinationals claiming to boost the country's image or as local banks purporting to provide capital on favorable terms to local communities and projects. The increasingly fervent discussion over financial nationalism of late reflects these incentives. Finally, governments' antipathy to fiscal federalism makes collaboration on banking crisis resolution a reflexively unappealing prospect, as was clear when appeals for an "EU bank fund" were rejected in the dramatic early days of October 2008.[9]

However, Europe's current banking problem must be tackled cross-nationally for two key reasons, both linked to the advanced (albeit far from complete[10]) cross-border integration of Europe's financial systems, as figure 5 illustrates.

First, only centralized balance sheet assessment and stress testing can effectively restore trust. Not only must standards conform in principle to "harmonized parameters" (IMF 2009) but also their implementation must be uniform in practice. Given the incentives, decentralized implementation is a recipe for gaming of the system and ultimately ineffectiveness. Under the seemingly patriotic imperative to protect local "champions," national authorities would be too lenient on "their" banks in order to support them in the competition with peers from neighboring countries. A supervisory race to the bottom would ensue. But a proper triage process must include a willingness to put an unflattering spotlight on banks found too weak and apply the same discount to identical distressed assets irrespective of country of issuer (the same considerations also justify continued vigilance by the Directorate-General for Competition).

5. Analogous to the medical term used to describe the process of prioritizing casualties for treatment in an emergency situation based on the severity of their conditions.

6. Urban Bäckström, "The Swedish Experience," speech at the Federal Reserve Symposium in Jackson Hole, August 1997, available at www.riksbank.se.

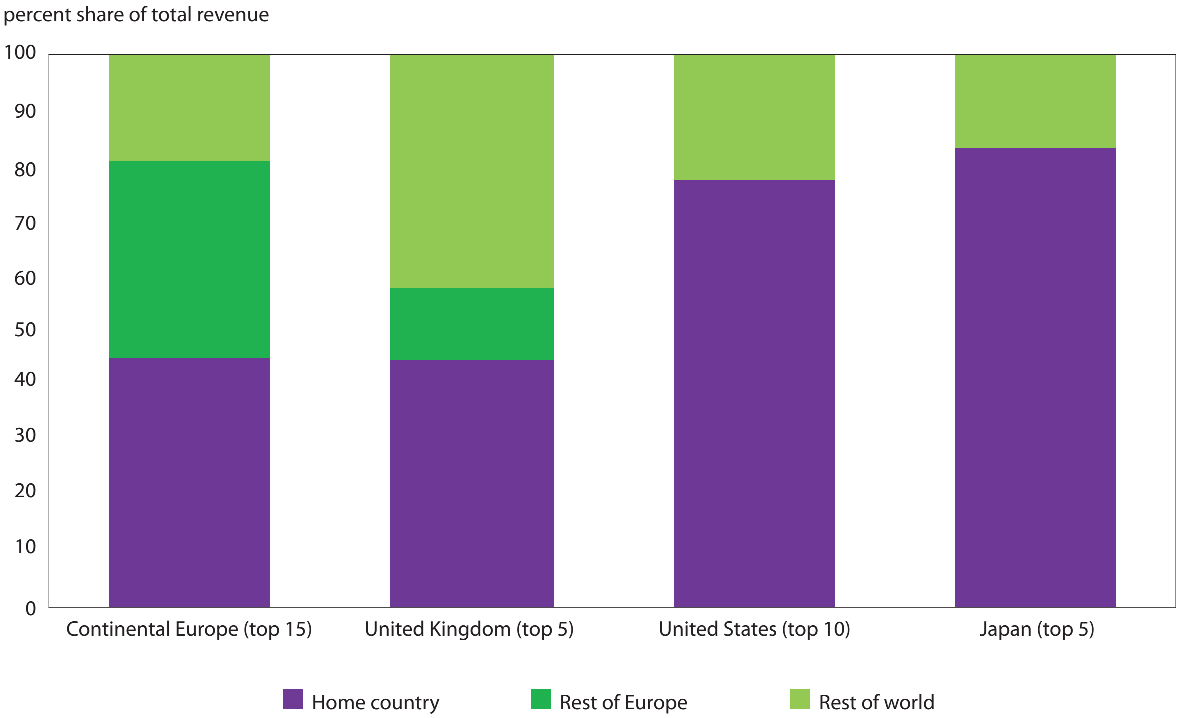
7. Leif Pagrotsky, "Sweden May Not Be a Model," *Euro Intelligence*, February 12, 2009, www.eurointelligence.com.

8. Statement on Stress Testing Exercise, May 12, 2009, www.c-ebs.org.

9. See, for example, the "Open Letter to European Leaders on Europe's Banking Crisis: A Call to Action," October 1, 2008, available at www.voxeu.org.

10. See Gropp and Kashyap (2009).

Figure 5 Average internationalization of large banks



Source: 2008 revenue based on Worldscope data, company reports, SEC filings, and authors' assumptions. For two banks in the continental European sample the distribution was based on assets, for lack of disclosure of revenue.

Second, the high risk of cross-border bank insolvency requires a supranational approach to crisis management, as the addition of ad hoc national measures has been proven inadequate to handle such situations. This risk was generally not a major concern in past financial crises, because the degree of cross-border banking integration remained limited. The systemic banking crises in Spain (started 1977), the United States (1988), Finland, Norway, and Sweden (1991), and Japan (1997) were essentially national in scope.[11] Otherwise, only three significant multinational banks have failed since 1970. While the failure of Herstatt Bank (1974) led to the formation of the Basel Committee on Banking Supervision and upgrading of settlement systems, those of BCCI (1991) and Barings (1995) did not result in significant international reform, in spite of serious dysfunction of cross-border cooperation. But the risk landscape has now been profoundly affected by financial and banking integration (Véron 2007).

Post-Lehman, normal insolvency proceedings cannot be envisaged for systemically important banks. Thus, ad hoc, out-of-court solutions must be devised to manage failures. As cases such as Fortis or Hypo Real Estate have illustrated, this is a challenge irrespective of the cross-border dimension; among EU countries, only Italy and the United Kingdom have a special insolvency regime for banks. For a multinational bank, any home government–led resolution would create a high risk of unfair treatment of nondomestic stakeholders, as in the case of Iceland, which in 2008 nationalized banks and froze the accounts of foreign clients, who were more numerous than its total population. Similarly, home country–led resolution of a Western European bank with large operations in Central and Eastern Europe may create a politically disruptive discrepancy between home and host countries. Another option, the joint management of the ailing bank by several countries concerned, is also impractical. This is what Belgium, Luxembourg, and the Netherlands attempted with Fortis when it was considered unviable in late September 2008, but cooperation collapsed after a few days due to incompatible domestic political pressures. Moreover, any future cases may be more difficult to handle than Fortis, which had quality assets and operated in countries with long experience of mutual cooperation.

Also, pooling the management of distressed assets and bank

11. These are all the systemic crises in developed economies since 1970, based on Laeven and Valencia (2008).

shares and securities in public ownership at the European level is the only way to have true price discovery and sufficiently deep, liquid markets for such securities, thus preparing the ground for eventual exit.

Triage and resolution therefore have to be centralized at the supranational level. Otherwise it will not work. Policymakers have so far refused to acknowledge this reality. This is not just due to Britain's sovereignism, France's economic nationalism, the Czech Republic's Euroskepticism, or Germany's politicized banking system and ongoing election campaign. The difficulty is compounded by deep institutional mismatch, as none of the existing supranational institutions in the European Union is well suited to the task. The European Commission's Directorate-General for Competition has played a key role in developments so far, but its mandate is about competition, not financial stability. More generally, the Commission does not currently have the operational or political capacity to take over the triage task; neither does the European Investment Bank. For the European Central Bank (ECB), banking triage would arguably be incompatible with the independence needed for its monetary policy mission and would certainly be outside its staff's primary responsibilities. Existing bank-specific "colleges" of supervisors do not provide the required central authority. CEBS has very few staff, and its current governance is ill-suited to the public responsibility that triage would entail (and the authority suggested by the De Larosière Report to replace it will take a long time to establish). Existing global entities, including the Financial Stability Board, are even less suited to the triage task.

Triage necessarily involves a system-wide assessment of the solidity and long-term viability of all or most key banks on a comparative basis using a consistent methodology.

A new instrument is needed. This is not unprecedented. European-level evaluation of private entities for safety or impact is accepted in many areas, such as environmental or consumer regulation, even where there are implications at the national level for expenditure. The absence of funding at the European level for the requirements of judgments made supranationally (beyond the trivial salaries and operations of the supervisors) is not a barrier to making those judgments. If anything, the case for doing so is stronger in an integrated financial market, where the problems of one nation's banks can rapidly spill over into another or all nations' economies. What may look costly as an on-budget mandate to national governments to spend money is actually much less costly than allowing the banking fragility to continue to drag down and distort all of Europe's economies. And there is an additional risk of damaging market fragmentation if the current policy paralysis continues.

HOW TO DO IT: A TEMPORARY EUROPEAN BANK "TREUHAND"

We propose the creation of a temporary supranational agency or Treuhand[12] for a limited period of, say, five years. Ideally this agency may be established by all EU countries jointly, but it is more realistic to rely only on the endorsement and support of those member states where the headquarters of most banks active in the entire European Union are located. "Critical mass" would arguably entail the participation of Austria, Belgium, France, Germany, Italy, the Netherlands, and possibly Spain and Sweden, but not necessarily the United Kingdom as large British banks have only limited presence in other EU countries. Whether Switzerland may become an affiliate member could be discussed.

Functionally, this structure parallels that of the previously mentioned US RTC and Swedish BSA. It is also designed to respect the subsidiarity principle and minimize political obstacles. Political qualms cannot be permitted to keep Europe in a lost decade as occurred in Japan. Crucially, the proposal does not require EU-level treaty provisions or binding steps towards fiscal federalism. The Treuhand would have three clearly defined tasks. First, it would evaluate the capital adequacy of major banks on a consistent European basis. The definition of "major," or systemic, would combine measures of size and cross-border activity. Not all European banks need be so scrutinized, but conversely, cross-border effects can occur for any very large bank irrespective of its observed cross-border activity (thus American bank failures still hit European economies). This could encompass between 30 and 50 financial groups, for which the Treuhand would conduct comprehensive balance sheet assessments as the basis for the triage process, with the support of national authorities. It would publish the results in a consistent manner, without privileging or protecting particular banks or national interests. The US stress test experience has proved that such publication need not have disruptive market effects.

Second, it would catalyze the recapitalization, or other

12. For Treuhandanstalt, a fiduciary entity in German. The word was used for the agency that restructured and sold the former Democratic Republic's state-owned businesses from 1990 to 1994. The German press has also referred to Finanzmarktstabilisierungsanstalt, an agency established in late 2008 in the context of the banking crisis, as "Bankentreuhand."

restructuring, of the weaker banks. The announcement of triage results would trigger market pressure on weaker banks, unlike the current situation where opaqueness hampers market discipline. By giving an accurate sense of which banks need what amount of fresh capital on a consistent basis, the Treuhand would induce the changes needed in national government behavior: In keeping with the best traditions of European-level inducements to better economic policy by member states, national governments would have to accept transparency about the state of their banking systems in the best interest of their countries. During that period, the weaker banks would continue to benefit from the same guarantees, generally from the home country, as they currently rely on.

A new EU supervisory architecture is needed. But Europe's banking fragility calls for measures to be implemented in the next 12 months, such as this policy brief's Treuhand proposal.

Based on its system-wide insight, the Treuhand would broker negotiations among individual states to share the burden of recapitalization in cases where outside investors would not provide the required funds. The combination of market pressure and governments' existing commitment not to allow a disorderly bankruptcy should result in eventual restructuring agreements. These may involve the home country but also host governments, irrespective of whether they are Treuhand founders or even outside the European Union. The Treuhand will greatly enhance the chances of such agreements by being a trusted third party, by providing centralization of information, and by being able to provide a commonly accepted reference for the price of any assets to be transferred into government ownership and the economic value of banking franchises and operations. Financial expenses associated with each restructuring would be negotiated among countries, thus avoiding politically unpalatable fiscal federalism.

This addresses the coordination failures that have long been identified as obstacles to efficient cross-border bank resolution (Freixas 2004). The respective banks' home countries will have little choice but to make agreements work, especially when the announcements by the Treuhand identify the banks at risk, and when the shares of those banks are primarily held in the home country, if not by the home government. If coordinated across the major European banks, this will not simply be a matter of one-off operations but of various countries giving and taking across the range of banks in question. The initial efforts to rescue Fortis and Dexia show that case-by-case burden-sharing agreements can be found under pressure. The restructuring may also include a haircut on claims held by "old" creditors (before the state guarantees extended in 2008–09), which would save government money.

Third, the Treuhand would become the trustee that holds bank equity and other assets purchased by national governments in the restructurings on account for them. This trusteeship would save on costs and has a strong precedent in the US RTC when dealing with state and local-level institutions. It would prevent national politicians from micromanaging bank lending decisions or strategies, while retaining clear accountability to public owners. It would ensure sound governance of any banks brought under public ownership. Moreover, it would prevent the destructive games otherwise likely to emerge when it is time to sell off the publicly held assets, when national governments would have an incentive to time their sales so as to grab demand before other governments went to market, even if the sales might be premature, thus driving down returns to taxpayers and possibly prompting market instability. Conversely, the Treuhand could sequence and synchronize sales of assets, thus deepening markets and improving price discovery, possibly through contracts with private asset managers.

In legal terms, the participating countries would sign a binding Founding Agreement,[13] which would govern the temporary establishment of the Treuhand, including its legal form and place of incorporation. Other member states could join at a later stage. The Treuhand would be governed by a compact board, accountable to participating governments and parliaments, and liaising with EU institutions and council formations such as Ecofin and the Eurogroup. It would be subject to high standards of transparency. The board would appoint a chief executive, with significant power over the recruitment, compensation, and management of staff in order to meet the challenge of building a large, highly skilled organization in a very short period of time. Operating expenses, trivial compared with the public costs that may arise in recapitalizations, would be covered by an ex ante commitment of participating countries during the Treuhand's expected lifetime, with allocation among countries through a no-nonsense formula such as the ECB's capital key. The Founding Agreement would also commit participating countries quickly to pass enabling national legislation to give the Treuhand direct authority over relevant financial firms to execute the tasks outlined above. If decision-making is swift, it is not impossible to imagine the Treuhand being in place before the end of 2009.[14]

13. Most likely an international treaty—but this of course would be much easier to achieve than an EU treaty, because of fewer participants and no unanimity requirement.

14. As an example, the more complex UK Banking Act 2009 was adopted in only six months.

TOWARD A SUSTAINABLE EU FINANCIAL FRAMEWORK

This proposal is short-term and does not by itself provide a sustainable policy framework for an integrated EU financial system. The De Larosière Report provides a basis for this debate, but more is needed. Otherwise, financial fragmentation may be irresistible, with negative economic consequences for all stakeholders.

In a recent speech, the head of Japan's Financial Services Agency remarked that "[a] relevant suggestion from Japan's experience [of the 1990s] is the need to implement short-term measures and medium-term re-design of the regulatory framework in a simultaneous and balanced manner. [...] On the one hand, if the policies lean too much toward crisis management, it could cause moral hazard or distort the system in the longer run. On the other hand, hasty implementation of medium-term measures could rather exacerbate the situation and make crisis management even more difficult."[15]

This wise advice merits heeding. A new EU supervisory architecture is needed. But Europe's banking fragility also calls for measures to be implemented in the next 12 months, such as this policy brief's Treuhand proposal. The banking crisis is an acid test for the European Union. It is not too late to pass it successfully.

15. Takafumi Sato, "Putting the current financial crisis in perspective," speech to the Asia Financial Forum in Okinawa, January 30, 2009.

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