LUISS SCHOOL OF EUROPEAN POLITICAL ECONOMY

POLICY BRIEF – JULY 21, 2016

EUROZONE STABILITY STILL UNDER THE THREAT OF A "BAD SHOCK"

Stefano Micossi

On 25 June, *VoxEU* published "Making the Eurozone more resilient: What is needed now and what can wait," an article supported by an impressive list of 'Resiliency Authors' (RA). It argues that the Eurozone now has an adequate financial architecture for coping with another "bad shock" and that what needs to be done "mostly [is] to make sure that the rules in place can be enforced."[1] I feel that this view may prove optimistic and, more importantly, that careless implementation of existing rules may become the very source of a new bad shock. Let me explain why.

Is the glass half-full or half empty?

The RA share the view that the Eurozone has not resolved the problem of risk-sharing that lay at the root of the sovereign debt crisis of 2010-12; they recognize that the European Stability Mechanism (ESM) is too small to provide sufficient resources in the event of a shock hitting the sovereign debt of a large country such as Italy and that its decision-making procedures would not ensure the prompt action needed to stop a financial market rout. They also observe that the Single Resolution Fund (SRF) may prove too small to confront a major shock hitting a large cross-border bank or an important segment of a national banking system, but they maintain that, if necessary, the ESM would be allowed to step in. Furthermore, they consider the lack of cross-border deposit insurance, the as yet unrealized European Deposit Insurance Scheme (EDIS), as something to be fixed over time, but not an urgent problem. In sum, the

[1] The case in point, in their view, is Italy, on the twin counts that large amounts of non-performing loans (NPL) are carried in the banks' books at prices substantially above market prices and that the government "has proven very reluctant" to apply bail-in rules.

Stefano Micossi is Director General of Assonime, Chair of the LUISS School of European Political Economy, and a member of the Board of CEPS in Brussels and Cassa Depositi e Prestiti (CDP) in Rome. This commentary is an English version of an article prepared for www.voxeu.org, the policy portal for the Center for Economic Policy Research (CEPR).

glass, in their view, is half-full, and they insist that what we have is sufficient for ruling out a new bad shock.

I would rather see the glass as half-empty. I fear that the combination of extensive economic and financial fragility in some member states and large segments of the banking system, on one hand, and an incomplete institutional set up on the other, create sufficient opportunities and incentives for financial investors to test the system's resiliency; they may only be waiting for some trigger to coordinate expectations, before launching an attack (and the aftershocks of Brexit could very well provide that trigger). Should this happen, a new bad shock similar to the one in 2010-2011 could occur.

Why financial stability in the Eurozone cannot be taken for granted

I see three main reasons why the Eurozone remains exposed to a new shock bad enough to endanger its survival. First of all, the reemergence of severe stress in the Eurozone financial markets is likely to lead to the same acrimonious and publicly-voiced disagreements on the source of the shock and its remedies, as was the case when the Greek public sector woes first came fully to light in 2010. In this regard, failure to agree on working risk-sharing arrangements for sovereign and banking risks reflects fundamentally different, and indeed incompatible, views on how to bring about lasting financial stability to the Eurozone. The latest manifestation of this is the recent decision by the Economic and Financial Affairs Council (Ecofin) to freeze "political" negotiations on EDIS until "sufficient progress has been made on measures for risk reduction"; furthermore, any such negotiation will resume in the framework of an inter-governmental agreement, requiring unanimity and no longer conforming to normal Community decision making under Article 114 (the legal basis for the internal market legislation). I view this decision as an official declaration that the sovereign-bank doom loop may restart at any time.

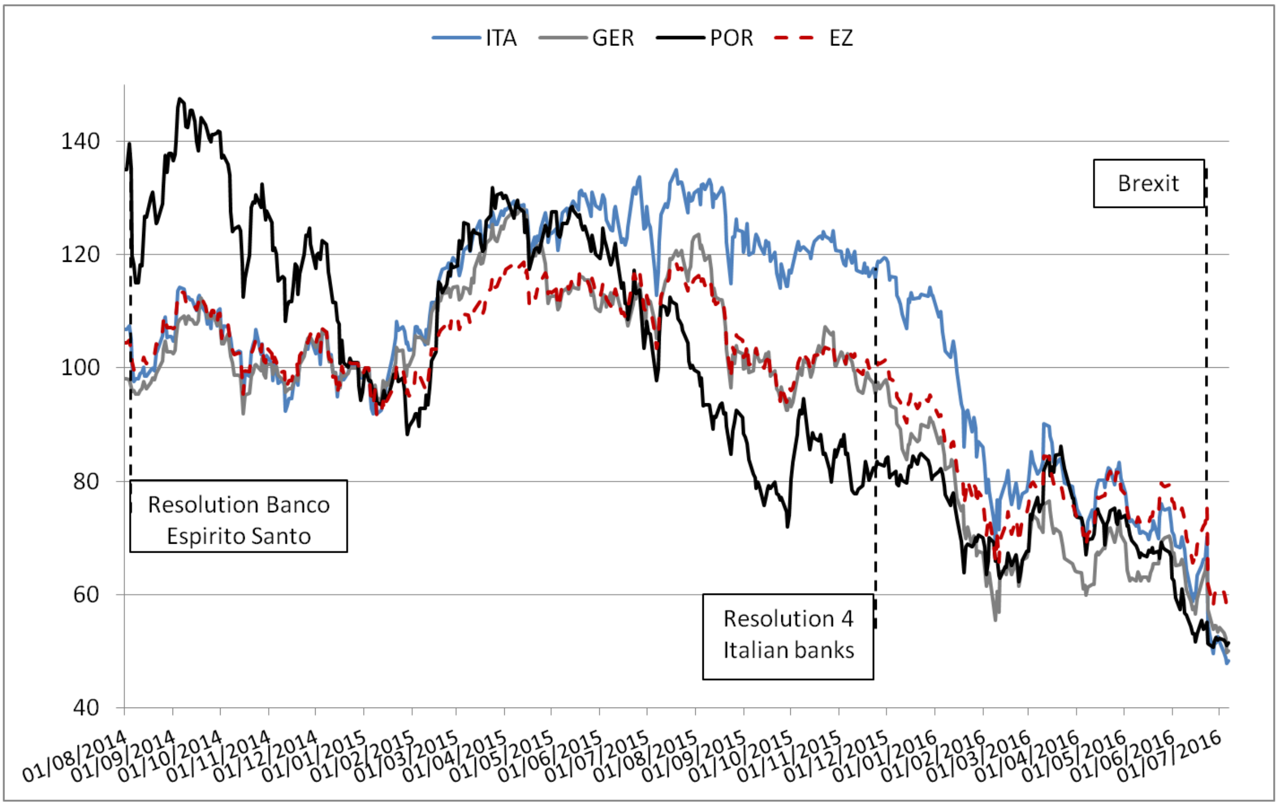
It is also unclear if the task of meeting a new bad shock can be left solely in the hands of the European Central Bank (ECB), as has happened thus far. For one, a repeat of the 2014 Outright Monetary Transactions (OMT) hocus-pocus to stabilize the sovereign debt market of a member state under attack, without any real interventions, would probably not work. However, real market interventions can only be initiated after the country under consideration signs up for an economic programme with the ESM entailing "strict and effective conditionality", i.e., another intergovernmental negotiation,[2] possibly highly divisive and potentially too slow to allow the necessary swift action by the ECB. Similarly, much of the goodwill of the ECB with German policymakers has been consumed to justify quantitative easing, perhaps entailing a reduced ability for the ECB to make "unlimited" resources available for the stabilization of financial markets in the periphery. Investors would, of course, recognize the predicament of the central bank. In this regard, an ominous sign following the Brexit referendum has been the peripheral sovereigns' risk premia over the Bund returning to levels not seen since the start of quantitative easing.

Finally, the reason why a bad shock cannot be ruled out is that the Eurozone is still plagued by severe imbalances in its banking and financial system. According to the International Monetary Fund's (IMF) latest Global Financial Stability Report, one in three banks in the

[2] This can take the form of a full macroeconomic adjustment programme or, under certain conditions, a 'precautionary' programme. The possibility of a precautionary programme may offer a way out, but it requires the government's willingness to sign a memorandum of understanding (MOU) on adjustment measures with the ESM well before the country's back is against the wall, something only farsighted politicians may be willing to do.

Eurozone must confront severe challenges due to legacy issues (€900 billion of NPLs and an unspecified amount of toxic assets) and the need to revise business models to respond to a distinctly modified economic environment and adapt to taxing regulatory changes. Let me note in passing that the Italian banking system only makes up about a third of the bad loans and is virtually clear of other toxic assets. As bank stocks often trade at heavy discounts from book value, raising fresh capital in the market can be prohibitively expensive, raising the cost of capital well above the banks' ability to remunerate it. This aggregate fragility has come to the fore after the British referendum, with bank stocks sinking to new lows across European markets (Figure 1).

Figure 1: Bank stock indexes of selected Eurozone countries (02/01/2015=100)



Note: Index Eurozone (EZ) = Euro stoxx Banks; Index Italy (ITA) = FTSE Italia All Share Banks; Index Portugal (POR) = PSI Financials Gross Return; Index Germany (GER) = DAX Banks.
Source: www.investing.com.

The rules on burden-sharing and bail-in for state aid to banks

The new rules on state aid and the Bank Recovery and Resolution Directive (BRRD)[3] require shareholders and creditors to share the cost of any public intervention to shore up a bank's capital, but they provide the leeway necessary to suspend burden-sharing when financial stability maybe at risk.[4] This risk is more intense when extensive weaknesses plague the banking system.

[3] Commission Guidelines on state aid to banks of July 2013 and Directive 2014/59 of 15 May 2014.

[4] In its 2013 Communication on the application of Article 107(3)(b) of the Treaty on the Functioning of the European Union (TFEU) in the banking sector (the Banking Communication), the European Commission stated that, whenever there is a capital shortfall, it will require that any state aid be preceded by all possible measures to minimise the cost of remedying that shortfall, including capital raising by the bank, burden-sharing by

In such circumstances, expectations on the use of burden-sharing and the bail-in tool by competition and resolution authorities directly affect the risk of capital instruments in the banking sector and, if not properly governed, may actually become a source of instability, rather than shoring up the system.

Figure 1 presents data on the evolution of banking stocks in Germany, Italy, Portugal, as well as the Eurozone average.[5] As shown, with the exception of Portugal, quantitative easing had a galvanizing effect on banking stocks throughout 2015. In Portugal, during the course of 2014, the authorities decided, in the context of the resolution of the Portuguese Banco Espirito Santo, to apply burden-sharing to certain unsecured bonds held by institutional investors. The decision led to the collapse of Portuguese banking stocks; the senior unsecured bond market seized up not only for Portuguese borrowers, but also for all but the largest banks throughout the Eurozone. Similarly, Figure 1 shows especially depressed stock prices for Italian banks emerging after the resolution of four local banks in November 2015. It should also be noted that, in the charted period, the stock index of German banks behaved no better than the Italian index—a signal that bank weakness maybe a systemic feature of the Eurozone banking system, as clearly reflected in the concomitant fall of the overall Eurozone bank index.

In sum

Two conclusions are worth reiterating. First, maintaining that the Eurozone is no longer exposed to a bad shock seems utterly imprudent, given the lack of adequate risk-sharing arrangements. Second, existing rules in EU law do not require the application of burden-sharing when it is liable to damage financial stability. Indeed, the current financial conditions in the Eurozone seem to require great caution when applying burden-sharing.

The idea that the Eurozone would be made more stable by ruthless application of burden-sharing without due consideration to the current economic and financial conditions of the banking system seems ill-thought and, indeed, quite dangerous.

shareholders and subordinated creditors, and measures aimed at avoiding the outflow of funds from the bank. However, the Banking Communication provides for an 'exception rule' whereby burden-sharing can be derogated when implementing such measures would endanger financial stability or lead to disproportionate results (point 45). The Bank Recovery and Resolution Directive (BRRD), like the 2013 Communication, aims to prevent moral hazard by making the bailout of banks virtually impossible and providing that any extraordinary public financial support will normally entail at least some bail-in of shareholders and creditors, in accordance with the order of their priority claims under normal insolvency proceedings. However, under Article 32 (4), temporary "precautionary" recapitalizations fulfilling certain conditions–that is, when the institution concerned is solvent and the injection of funds or purchase of capital instruments takes place "at prices and on terms that do not confer an advantage upon the institution"–are permitted without activating the bail-in instrument when they are adopted to remedy a serious disturbance to the economy of a member state and to preserve financial stability.

[5] The indexes have been calculated with basis 2 January 2015=100 to highlight the initial impact of quantitative easing by the ECB.

References

Council of the European Union – ECOFIN (2016), *Council Conclusions on a roadmap to complete the Banking Union*, Brussels, 16 June.

IMF (2016), *Global Financial Stability Report: Potent policies for a successful normalization*, April.

Micossi S., G. Bruzzone and M. Cassella (2016), *Fine-tuning the use of bail-in to promote a stronger EU financial system*, CEPS Special Report No. 136, April.

Resiliency Authors (2016), *Making the Eurozone more resilient: what is needed now and what can wait?*, Voxeu.org, 25 June.