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BANKING CRISIS YET AGAIN AND HOW TO FIX IT

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ALMOST OUT OF THE BLUE, a combination of diverse factors has elicited a run on bank stocks and junior and senior debt, raising the specter of a renewed systemic bank crisis within the European Union. The policy response cannot come from the ECB but, instead, must consist of regulatory responses capable of dispelling the uncertainty over future prudential capital requirements, relaxing the rules on state aid *cum* bail in that had ignited the crisis.

Of course, financial instability has multiple roots, from the slowdown of the Chinese economy, to the dire straits of the emerging countries, the fall in oil and commodity prices and its repercussions on the health of the financial system, and fresh fears (probably overplayed) of a new recession in advanced economies. However, the banking system, notably in Europe, suffers from specific weaknesses that have played an important role in the investors' rout and are in part policy-induced. Bank profitability has taken a hard and durable hit from higher capital requirements imposed in response to the 2008 financial crisis, and there is still considerable uncertainty as to the impact of the ongoing review of risk-weighting models by Basel supervisors on regulatory capital. Quantitative easing and negative deposit rates at the ECB are squeezing returns even further, leaving thinner margins for meeting internally rising capital requirements over the coming years, which promises more share issues in capital markets. The equity of some large banks appear barely able to satisfy current prudential requirements, thus leaving insufficient room to restructure the stockpile of non-performing loans (NPLs, some 900 billion, out of which about 350 billion are held by Italian banks) and potential losses from large level-three (toxic) assets and derivative positions (especially in German and Swiss banks). This further feeds fears of bail in of bank creditors in case of large write offs eventually requiring injections of state funds.

This is the environment in which the new EU regulations governing state aid to banks (as of summer 2013) and the resolution of banks in crisis (as of 1 January 2016) went into effect. These regulations require banks in need of state aid to first write down capital held by outstanding bondholders and other creditors for an amount up to 8% of the bank's total liabilities (bail in). The new rules were to apply not only to newly issued bonds, but also to bonds already in circulation. For the latter, this entailed changing their risk profiles relative to

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what they had been when first sold to investors in the market. This is a highly questionable decision that has contributed importantly to recent turmoil.

The shock has been especially hard=felt Italy. The Bank of Italy, as the national resolution authority, placed four small local banks in resolution last November. All totaled, they made up only 1% of bank deposits. The stock value and junior bonds for these banks were wiped out, inflicting significant losses on a plethora of small investors, many of whom had bought these securities at the issuing banks' advice. The impact on bank stock and the bond market was magnified by spreading and unfounded fears that other banks might have to incur large losses due to their need to unwind large holdings of NPL, possibly leading to more creditors' bail in. It should be recalled, in this context, that, following the financial crisis, Italian banks issued around €67 billion of junior bonds, of which over half are held by retail investors. While these banks were, for the most part, solid, many savers grew anxious and started to offload their bonds. In some cases, depositors raced to withdraw deposits. A similar event happened in Portugal with the resolution of Banco Espirito Santo and the creation of Novo Banco, which also entailed a controversial decision to transfer senior Novo Bank bond issues to the bad bank, thus making them subject to bail in.

Slowly, in an atmosphere of growing international financial tensions, the shock has spread to other European markets, embroiling larger establishments such as Deutsche Bank, Commerzbank, Credit Suisse, Standard Chartered, and Barclays.

There is little doubt, in my view, that we are facing a systemic shock, in which, as happened before with the Eurozone sovereign bond crisis in 2010-12, a serious error in European policy has destabilized financial markets. As was the case then, markets are unlikely to calm down on their own, meaning that there is a risk this instability may spread, imperiling the banking system as a whole. In 2012, the problem was resolved when the European Central Bank stepped in with its Outright Monetary Transactions program (OMT), which stabilized the market for sovereign bonds. Today, an intervention cannot come from the ECB, which is already buying up €60 billion in public bonds per month, and whose interventions may indeed have the effect of aggravating the banks' dismal profitability.

What is needed is a joint act by European governments to convince financial investors that bank liabilities are secure. As was done in 2008, the European governments must offer a public guarantee for bank liabilities, temporarily suspending European regulations governing state aid and, above all, the bail in provisions. As in 2008, banks should also be allowed to obtain a public back stop to cover the potential losses from securitizing and restructuring their NPLs and level-three assets. The Treaty of Lisbon, which governs the workings of the EU, explicitly allows (in Article 107) the Commission to declare state aid "compatible" with the Treaty in the face of especially turbulent economic conditions.

As has been suggested by Gene Frieda of Moore Europe Capital Management, it would also help if European regulators allowed banks presenting credible business plans to improve profitability, by rationalizing their business models and cleansing their balance sheets, more time to meet final capital targets, as has been done in the US and the UK but not in Continental Europe.