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EUROPE • FINANCE

Bank capital is Europe's big problem

The transmission mechanism of the euro area monetary policy is not working properly, as interest rates charged by the banking system vary widely across countries. This hurts small businesses in particular, as they have to rely on bank credit much more than large companies which can issue debt in the capital market. As a result, countries which are implementing fiscal restriction cannot fully benefit from the monetary policy easing implemented by the ECB. Under these conditions the adjustment risks being self-defeating.

Several proposals are being considered to improve the financing conditions for SMEs. Some concern the ECB, which could purchase securities in the markets that are backed by bank loans to SMEs. The risk for the ECB could be absorbed through guarantees, involving either the member states or the EIB, which would be involved in the packaging of the securities.

This type of proposal entails several problems and its effectiveness would depend on a series of assumptions. One problem is the price at which the securities are purchased, which under current conditions would most probably entail the recognition of losses by the banks. This would impact negatively on banks' capital and thereby would reduce the room for further increasing credit to SMEs. The result would be opposite to the desired one.

Aside from this issue, it is unclear whether banks would use the liquidity received from the ECB for additional loans to SMEs or for other purposes, like investing in government bonds, which have a lower risk weight and thus use up less capital or even to reduce leverage. In both cases the income position of the banks would improve and this could reduce the overall cost of credit for the marginal borrower, but the overall impact is likely to be limited.

All in all, the transmission mechanism of monetary policy seems to be

impaired not because of a problem related to the liquidity of banks' assets but rather to the uncertainty concerning banks' ability to absorb losses, given the effects of the ongoing recession, which might be further aggravated by the credit crunch. In other words, the issue is solvency, not liquidity. Banks' capital may appear adequate in a benign scenario, but is insufficient to address worse cases, especially in light of the uncertainty surrounding economic conditions and the valuation of banks' exposure.

Under these circumstances, it's rational for bank managers to reduce the flow of credit to the riskier clients, including SMEs, especially if banks supervisors encourage them to increase risk provisions. The only way to break the vicious circle is to increase banks' capital. This has been recommended for quite some time, including by the ECB. This can be achieved in two ways.

First, by raising capital in the markets. This solution can succeed only if investors are convinced that this is the last capital increase, i.e. that it will be sufficient to face the worse of all possible scenarios. This would require a drastic exercise of loss recognitions which tends to be opposed both by managers, as it would provide an indication of their past failures, and by shareholders, as the value of their past investments would be diluted. Past experience with stress tests has made it difficult to find investors willing to put fresh capital in European banks.

Second, put public money into banks, in a preventive way, and raise core tier one capital to such a high level to convince the markets that they would be safe even in the worse of all scenarios, and reducing the incentive for bank managers to deleverage. This solution is also opposed by bank managers, who fear Government interference, by private shareholders, who do not want to be diluted, and also by the public at large, who dislikes that taxpayers' money is used once again to bail out banks and bankers, who have been responsible for the crisis.

A further constraint is the state of public finances of those countries where such action is required. The European Stability Mechanism could nevertheless be used, as done in the Spanish case.

This solution is politically very difficult to implement, and tends to be delayed until it becomes inevitable to avoid financial collapse, as shown by the US experience after the failure of Lehman brothers. Only when Congress realized that the stability of the US financial system was at stake, in the Fall of 2008, did it accept to vote in favor of the TARP, and the Treasury was able to join forces with the Federal Reserve to use the proceeds to strengthen the capital position of the major US banks, against their own will, and to prevent a credit crunch.

Unless a similar avenue is taken in Europe, the scenario may look more and more like the Japanese lost decade, in which the restructuring of the banking

system was continuously delayed, producing a protracted deflationary environment. Avoiding such a scenario may require tough decisions which are politically costly. Not taking these decisions, however, may be even more costly, including for taxpayers.