CORE
Metadata, citation and similar papers at core.ac.uk
Provided by Research Papers in Economics

Not a Good Fit: The European Banking Authority's New Capital Requirements and the EFSF

Hans Peter Grüner and
Daniel Patrick Müller*

Introduction

At present, Europe pursues four different approaches to contain the debt crisis. First, countries with excessive ratios of debt to GDP are to implement policy reforms that – in the medium term – should reduce their debts. Second, a leveraged version of the European Financial Stability Fund (EFSF) has been set up. It is supposed to provide liquidity to Italy and Spain for at least a few months should their refinancing conditions deteriorate further. Third, the European banking authority (EBA) is pushing banks to increase their capital ratios as early as 2012. Fourth, the ECB is continuing to buy government bonds on the secondary market in order to lower their interest rates and maintain their liquidity.

The first measure can only yield positive results in the medium term. The other three measures are intended to prevent a severe banking crisis in the short run. In principle, each of these three measures is suited to prevent the worst consequences of a complete drying out of GIIPS sovereign debt markets. A leveraged EFSF could provide liquidity to Italy and Spain for some time while those countries work on their credibility. The same holds for the ECB's interventions on the secondary market. A substantially higher equity endowment of banks would instead help to avoid the worst consequences of possible debt restructuring programmes.

However, authorities currently attempt to undertake all three measures at the same time. In this paper we argue that the attempts to lever the EFSF do not agree with the new capital requirements of the European Banking Authority (EBA). The most likely outcome will be that the ECB will have to significantly increase its activities on the secondary market for government debt or that the European states have to increase their contributions to the EFSF.

The EBA's plans

At the European summit of 26 October 2011 it was decided to leave it to the European Banking Authority to draft a text for an initiative to raise capital requirements in the EU. The EBA released its recommendations on 8 December 2011.

The new capital requirements are the following. First, those institutes which are affected by the initiative should achieve a core tier 1 capital ratio of nine percent by June 2012. Second, additional capital buffers have to be introduced to cope with possible losses from exposures to government debt in the eurozone. The size of these buffers is determined by banks' exposure to central and local governments of the European Economic Area (EEA) countries. The difference between market prices and the current balance sheet valuations determines the required additional capital buffer. To avoid banks' immediate sell-off of government bonds, the capital buffer is to be calculated on the basis of September 2011 data (European Banking Authority 2011a).

As almost all major banks are exposed to eurozone sovereign risk, the overall minimum capital ratio – according to this new regulation – will be above 9 percent. In October 2011 the EBA estimated that an additional 106.4 billion euros will be needed to fulfill the new core tier 1 capital quota. The additional capital buffers were estimated to add up to 40.6 billion euros (European Banking Authority 2011b). However, these were just initial EBA estimates. The final numbers and additional data were initially expected to be released in mid-November. It was then later announced that the data will be published by the end of November. In December the data was finally

* University of Mannheim. We thank Alexander Naydenov for his research assistance.

released with an overall shortfall of 114.7 billion euros and a capital buffer of 39.4 billion euros (European Banking Authority 2011d).[1]

According to the EBA, the new requirements shall mainly be achieved by an increase of equity endowments and the reinvestment of profits. Accordingly, the EBA is appealing to banks to reduce dividend and bonus payments.

The EBA additionally requires banks to seek approval by their national supervisory authorities of their plans on how to fulfill the new capital requirements as of 20 January 2012. The national supervisors shall in turn consult with the EBA (European Banking Authority 2011a). This procedure shall prevent extensive deleveraging. Hence, national supervisory authorities are likely to only approve plans if they believe that these will not restrict the national credit supply too much.

Incentive problems of the capital initiative may increase spreads

The EBA's preferred solution is that banks acquire the new capital on the financial markets. However, the current state of the market situation may make this difficult. There is a limited willingness to invest in assets that are tied to default risks in the GIIPS countries. The EBA's critical position with respect to dividend payments is another potential obstacle for banks to get access to new capital.

The required capital buffers will lead to a great demand for new capital by banks with high GIIPS exposures. The GIIPS countries themselves will have to compete with European banks for that capital. This will make it more difficult for those countries to raise credit.

Banks have the option to reduce their country-specific risks by selling government bonds. According to the currently announced regulation, this would not change the size of the required capital buffer. However, selling GIIPS bonds should enable banks to get access to groups of more risk-averse investors.

Some of the recent measures and announcements of EU leaders have been characterized by a very short time horizon. The EBA seems to continue this trend. The news agency Reuters reports that there have been discussions within the EBA about changes to the terms of the capitalization initiative (Reuters 2011b). Furthermore, according to banking circles, the data templates, used for the determination of the final capital shortfalls, requested information on additional risks that was not part of the previous queries. Therefore, banks cannot preclude the possibility that the rules will be adjusted once again along the way. In the end, the current amount (and not the value of September 2011) of sovereign exposures could be used as a reference for the shortfall of bank capital. This creates additional incentives for the banks to divest themselves of government bonds.

Limits of governmental capital injections

The question of the proper origin of new capital for the banking system was already discussed during the negotiations on the revision of the Basel capital requirements (Basel III). The fear to overwhelm the markets by too fast an introduction of new rules led to a gradual implementation of the requirements over a period of five to ten years (Basel Committee on Banking Supervision 2011).

The currently planned capitalization of the European banks differs from that approach. Although it may be argued that the capital market would have expected the banks to strengthen their capital base faster in any case, it is questionable whether the markets would have forced such a quick introduction by mid-2012. According to a Citigroup study, the European banks have already raised new capital of more than 270 billion euros since the end of 2008 (Citigroup Inc. 2011). Therefore, the banks are likely to need new sources of capital for a further private sector capitalization.

As an alternative, EU governments could provide part of the missing capital. Some proponents of this approach refer to the governmental capital injection of American banks after the collapse of Lehman Brothers in 2008. However, one key difference between the EBA capitalization and the US recapitalization is that the latter was carried out at a time when the US public debt was not yet in the focus of financial markets. Against this background, it may be difficult for some countries to fund the missing shortfall of capital. As an *ultimo ratio* the funds of the EFSF could be used for this. However, this would mean that

[1] The sovereign buffer does not fully contribute to the shortfall if the banks have already free capital above 9 percent core tier 1 ratio.

less capital were available to guarantee new government bonds.

If there is not enough private capital available in the markets and if the resources of the EFSF are not to be exhausted for bank capitalization, the affected banks will ultimately have to scale back their lending business. This would reduce the risk-weighted assets and thus reduce the EBA capital shortfall. National supervisors are primarily required to safeguard their national financial systems. Hence, one may assume that banks will reduce their lending, especially outside their home markets. This would lead to a certain re-nationalization of capital markets. The shortage of the supply of credit could also affect the real economy because of the risk of a credit crunch. As a result, the capital buffer in particular could have a pro-cyclical effect. The purpose of such a buffer should be that banks can make use of it in times of crisis to enable them to continue to lend. For that purpose it has to be established in advance of a crisis.

The 'voluntary' renunciation of private creditors and hedging strategies

The so-called voluntary renunciation by banks as holders (creditors) of Greek government bonds causes additional difficulties. From the perspective of the banks it will be difficult to understand that banks, which hold Greek government bonds and hedged this position through a credit default swap (CDS), do not get any compensation, because they are giving up their claims against Greece voluntarily. Why should banks believe in a possible insurance approach of the EFSF if the legal occurrence of a clear credit event is prevented? In the end, a similar approach might be used for other countries and the 20 to 30 percent coverage would not be paid because the insured event (the official default of the country) has not occurred.

In addition, it may be attractive for the banks to divest themselves of sovereign bonds, as these bonds are worth more in the hands of non-private investors. When this consideration is shared by many banks, this will further reduce the market price of the bonds. One can argue that, in the case of Greece, the divestment of sovereign bonds from the banks' balance sheets would make a haircut less problematic. Nevertheless, the case of Greece could constitute a precedent in the view of the banks, which could help to explain the current sales of Italian bonds.

Analogously, one can explain a reluctance of the banks when it comes to sign newly issued government bonds. There is a risk that the issuers could change the conditions of the bonds afterwards. This risk may discourage banks from continuing to operate public finance business at its current level.

The voluntary renunciation has also an effect on potential private investors in banks. In making their investment decision they will now focus on the gross positions against the GIIPS-countries on the banks' balance sheets. The consideration of net positions would be affected by the risk that hedging strategies could be worthless if the credit events do not occur officially.

The EBA capitalization would not be enough in case of an Italian default

At present it does not appear that the European governments are willing to prepare for a haircut of Italy or Spain. But at the same time the provisions of the EBA speak a different language, as the capital buffers are calculated based on the exposure to sovereign debt from these and other countries. This is not a good signal for investors.

Moreover, the EBA's estimated aggregate capital shortfall in Europe of about 100 billion euros (provisional numbers) would not be enough to cover significant losses. In a scenario of a further dramatic worsening of the European debt crisis it is likely that this capitalization is not sufficient to prevent a systemic banking crisis. This is because the buffer would not react to the falling asset market prices due to an escalation of the situation.

It is extremely difficult to determine the aggregate losses of the banking system and thus the recapitalization that would be required for restoring the capital base in a situation with several simultaneous haircuts in the periphery of the eurozone.[2] One reason for these difficulties is that the ownership of government bonds changes continuously. Another reason is that in such an extreme situation the feedback effects form the real sector back to the banking system are difficult to estimate.

The IMF estimates a magnitude of approximately 200 billion euros for the losses of European banks in

[2] When the state recapitalizes a distressed bank, the losses of the bank are in general larger than the losses of the state because the state receives assets in exchange of at least part of its investment (see also Hau and Lucke 2011).

the event of a more severe debt crisis. Another 100 billion euros of losses could arise due to spillover effects within the banking system (IMF 2011). In similar scenarios, Credit Suisse expects a capital shortfall of 220 billion euros (Credit Suisse 2011), while Goldman Sachs expects 298 billion euros (Reuters 2011a).[3]

If there is a political request for an increase of bank capital, it should be sufficiently large to avoid bank failures, even if the debt crisis leads to haircuts in more than one country. The previous figures indicate that the approach of the EBA is half-hearted.

Every year, international bonds and notes with a volume of about 2–2.5 trillion euros are issued in the eurozone. The total volume of government bond issues is much smaller. Against this background it is clear that the additional capital demand that would be triggered by an appropriate recapitalization of the European banks is substantial. Whether raising this amount is possible in times of a recession and a general economic and banking crisis is an open question.

Clear signals are needed

It makes a difference whether regulators ask banks to increase their capital before a crisis or during a crisis. In the absence of a crisis this policy is useful to strengthen investor confidence in the banking system. However, to demand an increase of banks' capital during a crisis may signal a high risk of significant write-downs and may trigger additional assets sales.

Investors' reluctance to co-finance the EFSF indicates that a leveraged EFSF will only work if investors can expect Europe's governments to definitely avoid a haircut in Italy and Spain. If, instead, the EU governments send an unclear signal by leveraging the EFSF and simultaneously increasing banks' capital requirements, banks' investors will not rule out further haircuts for country in the eurozone. Accordingly, investors may find an investment in the EFSF too risky.

European leaders have to state clearly why an increase in banks' capital is desired at this time. They have to identify the countries for which a default is ruled out and those for which a default cannot be ruled out. The EBA's statements regarding this point are not suited to resolve the current uncertainty in this matter.[4] It is also not clear why a capital buffer, which is not needed, should actually reassure investors. Moreover, the currently demanded capitalization would not be enough to cover the losses which would obtain if Italy, Spain, Portugal, Greece and Ireland would all be subject to a haircut.

One should not try to simultaneously prepare the EFSF for a large-scale support program for Italy and to prepare banks for a possible Italian default. This policy may be one of the reasons why risk premia for Italy have increased substantially in October and November 2011.

It is also necessary for the EBA to make its capital requirements transparent and reliable in order to avoid additional adverse effects. At this stage, the EBA, the national governments and the national regulators can still make an effort to reduce the short-term burden imposed on their banks by the EBA's recent recommendations. Europe should definitely exclude an Italian default and give the Italian government time to implement further policy reforms. The ECB can contribute to the functioning of the EFSF by continuing not to rule out further interventions in the secondary market.

Summary

The eurozone's governments have to decide whether they want to provide liquidity to Italy through the EFSF or whether they prefer to prepare the European banking system for an Italian default. Doing both at the same time is difficult and may further increase the risk premia of Italy's bonds.

References

Acharya, V., D. Schoenmaker and S. Steffen (2011), *How Much Capital Do European Banks Need? Some Estimates,* VoxEU.org, http://www.voxeu.org/index.php?q=node/7316.

[3] According to calculations that are based on assumptions in Hau and Lucke (2011), Müller (2011) arrives at even higher aggregate losses of the European banking industry of up to 500 billion euros in the case of a simultaneous default of all GIIPS states. However, this value is based on the relatively high indirect losses in the banking system (25 percent of the tier 1 capital) that were assumed in Hau and Lucke (2011). States' recapitalization losses are much smaller (65 billion euros). This value does not take into account state-owned bad banks that create additional direct losses. Acharia *et al.* (2011) derive capital requirements of a similar order of magnitude.

[4] The objective of the capital exercise is to create an exceptional and temporary capital buffer to address current market concerns over sovereign risk. This buffer would explicitly not be designed to cover losses in sovereigns but to provide a reassurance to markets about banks' ability to withstand a range of shocks and still maintain adequate capital (European Banking Authority 2011a).

Basel Committee on Banking Supervision (2011), *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems,* revised version of June 2011, http://www.bis.org/publ/bcbs189.pdf.

Citigroup Inc. (2011), *Venus & Mars, Banks Stocks and Spreads in Europe and US,* 26 August.

Credit Suisse (2011), *EBA Stress Test – Take 3,* http://doc.research-and-analytics.csfb.com/docView?language=ENG&format=PDF&document_id=918847321&source_id=em&serialid=5aCOyM1THVKLOV%2FRSh1P9EjxoqdNzuVuY%2FGGOxiEj28%3D.

Müller, D. (2011), *Kritische Würdigung des Hau und Lucke Szenarios einer obligatorischen Rekapitalisierung der Banken als Alternative zum Rettungsschirm,* http://gruener.vwl.uni-mannheim.de/fileadmin/user_upload/gruener/Hau-Lucke-Kritik_20111019Vorab-Papier__2_.pdf.

European Banking Authority (2011a), *The EBA Details the EU Measures to Restore Confidence in the Banking Sector, Methodological Note,* http://www.eba.europa.eu/cebs/media/aboutus/News%20and%20Communications/Sovereign-capital-shortfall_Methodology-FINAL.pdf.

European Banking Authority (2011b), *The EBA Details the EU Measures to Restore Confidence in the Banking Sector, Press Release,* 26 October, http://www.eba.europa.eu/News--Communications/Year/2011/The-EBA-details-the-EU-measures-to-restore-confide.aspx.

European Banking Authority (2011c), *The EBA Details the EU Measures to Restore Confidence in the Banking Sector, Question & Answers*, http://www.eba.europa.eu/cebs/media/aboutus/News%20and%20Communications/Q-A-FINAL_2.pdf.

European Banking Authority (2011d), *Results of Bank Recapitalization Plan,* http://stress-test.eba.europa.eu/capitalexercise/Presenting%20the%20results%20of%20the%20recapitalisation%20exercise.pdf.

Hau, H. and B. Lucke (2011), "Die Alternative zum Rettungsschirm. Zwangs-Rekapitalisierung gefährdeter Banken", *Frankfurter Allgemeine Zeitung*, 16 September, http://www.faz.net/aktuell/wirtschaft/zwangs-rekapitalisierung-gefaehrdeter-banken-die-alternative-zum-rettungsschirm-11227409.html.

IMF (2011), *Global Financial Stability Report, Grappling with Crisis Legacies,* IMF, Washington DC, http://www.imf.org/external/pubs/ft/gfsr/2011/02/pdf/text.pdf.

Reuters (2011a), *Goldman Sachs Says 50 European Banks Could Fail EBA Stress Tests,* 14 October, http://uk.reuters.com/article/2011/10/14/uk-eurobanks-research-goldman-idUKTRE79D1XX20111014.

Reuters (2011b), *Aufseher streiten wieder um Banken-Rekapitalisierung,* 18 November, http://de.reuters.com/article/companiesNews/idDEBEE7AH07B20111118.