

Crisis Management Tools for the Euro Area

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Europe's universal banks were supposed to be immune to the fallout from the sub prime crisis. But we are now discovering that any financial institution is vulnerable if its leverage is too high. The key issue for Europe is not only that its largest banks are vulnerable because they have high leverage, but that they have grown too big to be saved by any single government.

The rescue of Fortis, the Belgo-Dutch banking and insurance group, illustrates vividly the difficulties of raising adequate defences against a fully fledged banking crisis in the eurozone.

There was no European solution because the European Central Bank can only provide liquidity against collateral to keep the money market functioning, but has no powers to resolve a solvency crisis. In the absence of a European Treasury this can only be done by national authorities. But national authorities are responsible to their taxpayers and are thus reluctant to pay for the rescue of banks abroad. In the case of Fortis it was relatively easy to cut the bank into three pieces, but this would be more difficult with other large EU banking groups.

One problem is that large European banks typically have subsidiaries – separate legal entities with separate balance sheets – in each country where they operate. At the same time, asset and liability management is centralised, as are cash and liquidity reserves, which at times of stress will be ordered back to the parent, with subsidiaries receiving in exchange paper which would be worthless in case of insolvency. When failure comes and governments step in, burden-sharing among national treasuries and issues of equal treatment of creditors and depositors in different countries are bound to be controversial, delaying decisions.

In the case of Fortis, three governments – Belgium, the Netherlands and Luxembourg – were called in to inject capital for the subsidiaries in their countries. This is a harbinger of the balkanisation of the EU banking system that might spread unless decisive action is taken immediately. Two steps need to be taken.

First, a new European statute of EU-chartered banks should be established for banks in the Union/eurozone with significant operations in more than one member state. These banks would be subject to fully consolidated capital requirements and supervision, with access to ECB liquidity support in the event of a crisis. By the same Act, a new supervisory authority would be created in Frankfurt – preferably at the ECB or otherwise separate but legally obliged to fully co-operate with the ECB in all its activities.

Second, a contingency fund for organising rescue operations at the EU level should be created at the European investment bank (EIB). The EIB already is a public agency and issues guaranteed bonds to finance its operations; its Board of Governors is made up of the ministers of finance of the member states. This rescue fund could therefore be operative within weeks. One need only empower the EIB to take up equity stakes in financial institutions under well circumscribed circumstances and to issue (guaranteed) bonds as required.

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One could go further and allow the European authorities to act preventatively to stop contagion, or at least make it less likely, by forcing the highly leveraged EU banks with significant cross-border operations to recapitalise themselves or accept public funds. For instance, a capital injection of €280bn would be sufficient to reduce the leverage ratio of the 10 largest eurozone banks from the current value of 33 to below 20 – which would underpin confidence and thus reduce the risk of massive liquidity withdrawals by depositors. The investment could be unwound once distress conditions in financial markets started to ease.

Of course, support by the EIB must have strings attached to preserve the value of the public investment and to make sure those who mismanaged pay for the consequences. Thus, the price (for preferred shares) should be such as to protect the value of the investment, and management should be changed.

We are living in extraordinary times: policymakers in Europe cannot continue to muddle through. The implementation of these simple proposals would put them ahead of events in the unfolding crisis. Being behind the curve is extremely costly, as the US has discovered.