Moritz Schularick, University of Bonn, schularick@uni-bonn.de

Sascha Steffen, Frankfurt School, S.Steffen@fs.de

March 15, 2020

A Protective Shield for Europe's Banks

The 2008-2009 global financial crisis was a financial crisis that turned into an economic crisis. **The current crisis is an economic crisis that could turn into a financial crisis**. Importantly, it did not originate in the banking system that was overleveraged with bankers making bad decisions, or in the household sector that, too, was overleveraged. Instead, the virus and the unprecedented response governments are taking to contain its spreading, has an immediate impact on the real economy through the simultaneous occurrence of both demand and supply shocks. Liquidity quickly evaporates in financial markets. We are facing a **global sudden stop of economic activity** of unknown duration. The reality about the coming disruptions in the U.S. economy still has to sink in and the coming weeks will be very challenging in global financial markets.

This sudden stop poses a **major financial stability challenge** that remains under-appreciated. Even if we support businesses through the recession (the German liquidity program was a very important step), the strain on corporate profits, asset prices, and risk aversion will feed through to banks' balance sheets across the Eurozone in a major way. After a decade of low interest rates, there are significant parts of the market where valuations are stretched and prices will fall substantially. Private equity, leveraged loans, and EM corporate debt come to mind: credit risk will spike, covenants will be breached and recovery values will be severely impaired. Importantly, we are facing historic levels of corporate leverage that is to a large extend funded by non-bank financial institutions, and the behavior of these investors during crises remains untested.

The **share prices of Eurozone banks have already dropped by 40-50%** and are trading back at the lows of the crisis. The cost of default protection is rising. When bank stock prices sell off, leverage ratios (relative to the market value of capital) explode and tolerance for risk at banks goes down. Most banks are trading at fractions of their book value owing to weak balance sheets and weak profitability. We have learned in the past crisis that **what counts is not what regulators or central banks think about banking sector stability, what counts is the market perception of it**. We must avoid a doubling down of liquidity withdrawals from both borrowers and short-term investors of banks that turns a liquidity into a solvency crisis.

The potential financial stability implications of the Corona virus must be addressed proactively and decisively. **The market must not doubt the willingness and ability of the ECB and, foremost, Eurozone governments (even the fiscally weak ones) to safeguard financial stability.**

The ECB can help overcome liquidity pressures and it has announced important measures such as long-term liquidity operations as well as asset purchases both the sovereign and corporate sector directly. The credibility of ECB and the "central bank put" should not be put into question.

But going into this economic crisis with a fragile banking system risks making the crisis worse by adding lingering financial stability risks and slowing the eventual recovery. Once we are past the peak of the virus, we need a healthy banking system to restore economic activity and avoid a long-term output gap. This crisis, the stop in economic activity paired with high corporate leverage, low bank profitability and low credit provisions will put bank capitalization to a stress test. The longer economic activity is disrupted, the worse it will get. Supervisors can provide some capital relief, but this will likely be insufficient in a severe downturn, and a **recapitalization of the banking sector of the Eurozone might be inevitable**.

We need to avoid repeating past mistakes. Liquidity guarantees of undercapitalized banks from governments are counterproductive and might even sow the seeds for future crises. As recapitalizations is limited by a country's fiscal capacity, this has to be an effort on the Eurozone level with **European resources**. This also helps avoiding another **doom loop.** The doom-loop between weak sovereigns and weak banks was probably the single most important factor why Europe was less successful than the U.S. in fighting the 2008 crisis. Joint crises in banking and sovereign debt markets is extremely costly economically.

Current arrangements are not up to the task and need modification to address and avoid a financial crisis. The European Stability Mechanism (ESM) should be the main vehicle that spans the **protective shield for all Eurozone banks**. The **ESM** has an unused tool to directly recapitalize banks. However, the total amount available for this instrument is limited to **€60 billion** (compared to assets of Eurozone banks of €25 trillion and tier-1 capital of about €1 trillion). This tool is **too small** to effectively shield the entire European banking sector from the fall-out of a global sudden stop of 2008 proportions.

We need a larger **protective shield for Eurozone banks** – a bigger **recapitalization fund** to be used for Eurozone banks in trouble if needed. The sheer existence of such a fund would make it **less likely that banking sector stress arises**, in particular in the fiscally weaker member states. How large should this protective shield be and how should it be deployed? We can apply some lessons from past crises.

Be bold, be early. Acting early, boldly and proactively ultimately saves money. In the European crisis, a repeated mistake was that policy action took too long to be agreed to and was too limited in scope initially and insufficient to tip the market from the bad equilibrium to the good one. This time, we should announce the increase of funds early and boldly using joint resources.

This means that we need to commit an amount for potential recapitalization of the European banks that is convincingly large. We propose tripling the ESM money currently available to **at least 200 billion Euros**. This corresponds to about **20% of the tangible equity** and about **50% of the current market capitalization of Eurozone banks** and thus could absorb substantial losses. Importantly, we make sure these funds are available before the acute banking stress arises so that negotiations don't take place while the house is burning. Importantly, **these funds should be the first line of defence and not only be used after national resources are exhausted.**

The deployment of the funds will have to be proactive and governance professional: in case of acute systemic banking sector stress, a **proactive recapitalization of the Eurozone banking system** might become necessary. As for implementation on a European level, **this means that the ESM should take stakes in the largest banks of all countries**, even some healthy ones, to **avoid stigma** for the weaker ones and to **avoid contagion**. This is not the moment to discuss moral hazard but some conditionality needs to be attached.

In the 2008-2009 financial crisis, a big difference between the U.S. response to banking sector bail-outs and the European ones was that in the TARP program the U.S. forced even presumably healthy and reluctant banks to take government money. This avoided stigma for the weak ones and stabilized the system. The equity stakes can always be sold later, potentially with a profit as the U.S. example shows. If banks turn out to be non-viable, this can also be addressed later.

If there is no acute crisis, but lingering fears about the capital position, the best way of action to determine how much capital banks need is a **credible stress test**. The European track record here is bad, and the underlying economic assumptions will have to be harsh to convince the market. In the current environment, the only credible **stress test scenario** we can think of is a **repeat of the 2008 recession in terms of depth and length of the recession**, coupled with a substantial fall in equity and house prices. None of the previous stress tests have been even close to this scenario.