NBER: The European Crises—Banking Challenges

July 12, 2012

Donald Kohn

Senior Fellow

Brookings Institution

For my contribution to this panel, I’ve been asked to reflect on my experience as a policy maker dealing with banking challenges as it might apply to the Euro area. The most important and fundamental challenge is restoring confidence in banks and the flow of private capital into the banking system. We met with some success in bringing private capital into the banking system in the U.S. in 2009, and I will look at what we did to bring this about and reflect on European actions in this light.

**The U.S. Response**

It’s useful to start by recalling what didn’t work in the U.S. In the summer of 2008, Congress authorized infusions of capital and liquidity for Fannie Mae and Freddie Mac. The theory was that the availability of government backstops would restore confidence and make their very use unnecessary (Secretary Paulson’s “big bazooka”.) Before long, however, the government assistance had to be activated. The problems of these two GSEs were too deep for market confidence to be bolstered by a promise; and the possibility of government capital coming in actually scared off private equity capital, which saw itself at risk of substantial dilution by the government with uncertain governance consequences. So, just promising support often isn’t enough and can even be counterproductive.

In October 2008, following the passage of TARP, the government followed what was then the standard playbook—derived from earlier experience in Scandinavia and elsewhere-- for dealing with a banking crisis: inject capital; guarantee senior debt; make liquidity readily available at the central bank discount window; and ease monetary policy aggressively. These actions were helpful, but they were not comprehensive enough to restore confidence and end the adverse spiral of asset price declines, tightening credit, and sharply weakening spending. Private capital continued to shun banks and other financial institutions.

A final example of the government’s failure to restore confidence was Secretary Geithner’s first press conference, at which he laid out the key elements of the government’s approach to stabilizing the financial sector. Those steps were ultimately successful. However, expectations for the event were too high—and perhaps unable to be met, especially so early in the new administration. In part because it was so early, the Secretary was unable to give detailed plans for implementation, which undermined the credibility of the proposed steps and created uncertainty. Financial problems continued to mount, confidence fell further, and the economy slid even deeper into recession.

The key to turning the situation around was identifying all the problems and coming up with detailed and credible plans for dealing with them across their many dimensions. A critical aspect of restoring confidence is size; enough resources need to be made available to deal with issues, even if the needs turn out to be greater than is first estimated—it’s the tail risk that dominates the psyches of investors in a financial crisis.

The most fundamental problem was the direction of the economy. Efforts to stabilize the financial sector and attract private capital are unlikely to be successful if the economy is contracting rapidly, as it seemed to be in early 2009. Private capital is not going to come into banking if loan losses are growing substantially and difficult to predict and asset prices are falling. Activist and aggressive fiscal and monetary polices—a strategy for getting out of recession-- were necessary complements to various programs to stabilize the financial system.

Within the financial sector three problems were identified: funding liquidity for banks and other intermediaries; the solvency of banks and other systemically important institutions; and restarting buying and trading in key asset markets— for legacy assets on the books of the banks and also securitization markets to get new credit flowing.

*Liquidity.* In a crisis, the distinction between liquidity and solvency problems is not clear. A lack of liquidity causes fire sales of assets; declines in asset prices lower net worth and collateral values for borrowing, raise questions about viability, and result in lower credit ratings, which increase the demand for liquidity, and cause credit supplies to tighten. The proximate cause of the failure of a financial institution is almost always a drying up of funding, but concerns about solvency can underlie the reluctance to lend.

The central bank must take liquidity concerns off the table as best it can. It must stop the feedback loops keyed to liquidity, and afford itself and other authorities a basis for judging and dealing with underlying solvency issues. The Federal Reserve pulled out all the stops to supply liquidity in the fall of 2008 and early 2009. It lent to nonbanks as well as banks; it provided an intermediary function where markets were frozen—not only for interbank markets, but in nonbank markets like commercial paper. Its actions have often been characterized as market maker of last resort as well as lender of last resort. Valuing collateral in such a situation presents challenges. Market prices reflect panic selling rather than fundamental values. Bagehot is clear on this issue: central banks cannot chase those valuations down—they must value collateral as it would be in calmer markets. But what those underlying values might be is far from clear and central banks should be very careful about putting taxpayer money at risk.

*Solvency.* The public fisc cannot be the main source of long-term support for a dynamic banking system. While public capital injections can be useful to fend off collapse, private capital will reduce the need for pubic support and is the ultimate source of solvency in a market system. There are two ways to bring in private capital: One is to compel a capital infusion, say through forced conversions of debt for equity—the “bail in” by creditors now contemplated as part of saving or resolving a troubled institution; the second way to get private capital in, and the far better choice, is to attract that capital. This is what happened in the US and its success depended on a number of elements.

One such element was the ready, public, availability of information that allowed potential investors to judge the underlying condition of individual companies. In this regard, the publication of each institution’s performance in a credible stress test in the spring of 2009 was critical. In general, transparency in a crisis is hard because of the potential for the information to destabilize those institutions that are seen to be vulnerable, but it is essential in order to strengthen the less vulnerable that may be suffering from contagion brought on by a lack of information. To be transparent in a crisis you need a source of government capital to be available to those institutions that are not in good shape and can’t access markets.

Another element was incentives for current owners and managers to avoid public funding—for the institutions to raise private capital even at the expense of considerable dilution of existing shareholders. The cost of public funding in the US was perceived as high, not so much because of the dividend on the preferred shares, but more because of the nonprecuniary costs of public funds. These included intrusive regulation of compensation and close Treasury and Congressional oversight. And institutions were required to raise capital in private markets to retire government capital—and generally at $2 of private for $1 of repayment. This gained private validation of the ability of these institutions to survive and access markets and an extra margin of safety to assure that they would not need another infusion of government support.

Also critical was clarity on the goals of the capital raising. At the end of the stress test, each institution was given a dollar amount of capital it needed to raise to repay government capital or avoid further infusions. The amount was based on comparing the post-stress capital ratio to a safe level, but the emphasis for the institutions was on the numerator of the capital ratio, not the ratio itself, so requirements could not be met by deleveraging, except for some special cases of disposal of noncore assets that had previously been agreed with regulators.

*Asset markets*. The U.S. authorities took several steps to restart trading in critical asset markets. They initiated public-private partnerships for the legacy assets on the books of the banks. That program never amounted to much in dollar terms, but the announcement of the program helped to firm prices for those assets, which was crucial to limiting losses and helping the banks begin to manage out of impaired positions. The second program was aimed at restarting securitization markets so credit to households and businesses would flow better outside the banking system. Under Talf, the Federal Reserve provided leverage by lending to private purchasers of securitization assets; the government took some of the default tail risk with Tarp. Both of these programs used small amounts of public capital to attract larger amounts of new private investment in important asset markets.

**The European Response**

I don’t want to hold up U.S. actions as the only right way to approach a banking crisis. Ultimately it was successful in restoring confidence and bringing in new private capital, but there were some false starts, and, in a number of respects, the circumstances in the U.S. in 2009 and Europe today differ both economically and politically. But it may be instructive to examine the European response to their banking and economic crisis in light of what was done over here.

 My first observation is for the need to attack all the problems on a broad front at the same time. The fiscal, banking, and competitiveness issues in the euro area are all interlinked. You can’t stabilize the banking system without solving the sovereign debt problems and vice versa. For many euro area banks, sovereign debt is the counterpart of the legacy real estate assets on the books of U.S. banks. Neither the banking or sovereign problems will be soluble without better plans for restarting growth and for restoring competitiveness in current account deficit countries without years of austerity and recession. This characterization isn’t entirely fair, but the European response to their serious problems has had a bit of a “whack a mole” quality to it. Issues arise in a particular area, a summit is called, and an announcement made about how that particular problem will be addressed. Over time, progress has been made on several fronts, but it has been slow and episodic, and the overall strategy for dealing across many areas and their interactions has not been made clear.

 Second, it is critical to avoid announcements of general plans without specifics and timelines. Such announcements create uncertainty rather than resolving it. And vague plans without consideration to all ramifications can have unintended consequences. We saw this very clearly in the market response to the initial announcement of the plan to recapitalize Spanish banks, which raised questions about the implications for private holders of Spanish sovereign debt. Somehow, private investors need to be drawn into investing in euro zone sovereign debt and banking equity and debt; a prerequisite for this would be an understanding of the standing of these investors after government support has been provided. Much has been made of the steps towards a “banking union”. But specifics about the elements and a timeline are lacking. How are supervision, deposit insurance, and resolution to be consolidated and the authority of national regulators to be reduced? What will be the source of funds to back up any insurance fund and handle resolutions and how will responsibility for past losses be split among the private sector holders of debt, the national authorities, and supra national sources of funds? Private capital will be reluctant to come in when so many elements of the structure of regulation and responsibility are unclear.

 The ECB has appropriately and constructively become more aggressive in backstopping the liquidity of euro area banks; its actions in creating the LTROs last fall and winter slowed a very dangerous deleveraging dynamic that had taken hold after new capital requirement ratios for banks had been announced. However, a portion of the additional liquidity was invested in sovereign debt, further strengthening the ties between banks and sovereigns, with adverse effects over time. This is another illustration of the difficulty of designing policies without unforeseen consequences. It would be good to be able to backstop the medium-term funding needs of the banks on an ongoing basis without strengthening those ties that other policy initiatives are attempting to loosen.

 The Europeans have been largely unsuccessful at attracting private capital to banks to relieve the pressure on sovereigns. One problem has been informational; the stress tests on European banks were not sufficiently tough, credible, and transparent for investors to feel they could differentiate the fundamentally sound institutions from those that would require government assistance or resolution. Credibility will require that the tests be controlled by the supra-national EBA or other supra-national institution like the ECB, with much less input from national authorities who can be suspected of protecting their national champions. As noted above, credible and transparent stress tests require a back up source of government capital available to stabilize weaker entities, and a source with enough capacity has been missing. Finally, the capital requirements coming out of the stress tests have been specified in ratios, not in euros of additional capital required, and that has fueled deleveraging and renationalization of euro area banking as banks retreated from cross-border lending.

 I recognize that dealing with the banking crisis is harder in the European context than it was in the U.S.—and that was no piece of cake. Addressing these issues—not only banking but debt sustainability, competitiveness, and growth--effectively will require nations to relinquish a good deal of sovereignty to create a real economic union to go along with the currency union, now that the adjustment mechanism of realigning exchange rates has been foregone and integrated product and financial markets have left the real and financial sectors of many countries exposed to problems in other individual countries. The formation of an effective economic union implies reforms to economic structures and governmental oversight in many of the countries but also ceding decision-making to supranational authorities who can credibly apply a euro-wide perspective and overcome national interests. And the adjustment and transition will require some sharing of the cost of past mistakes made by the private sector and national authorities in many countries. All this needs to occur within the context of a political system that was not built to support crisis decision-making and democratic accountability for significantly expanded powers at the supranational level. But clearly something fundamental needs to change if the banking and other crises are to be overcome. I hope the experience of the U.S. can be instructive in delineating some of the requirements.