EUROPEAN SHADOW FINANCIAL REGULATORY COMMITTEE

Statement No. 35

Tilburg, 27 June 2012

Escalating Crisis in the Eurozone: Time for Urgent Action

Since 2010 the crisis in the eurozone has been developing towards unprecedented levels. Notwithstanding the rescue packages for Greece, Ireland and Portugal, the creation of the European Financial Stability Facility, and the planned start of the European Stability Mechanism (ESM) as of July 2012, the eurozone crisis seems to be escalating at an alarming pace.

On June 26th the President of the European Council published the report "Towards a Genuine Economic and Monetary Union", as input for the European Council meeting on June 28-29. Although the report, in our view, contains valuable proposals on how to move towards a European banking, budgetary and economic union over the next decade, it does not propose short-term measures on how to contain the current market upheaval.

In this statement the European Shadow Financial Regulatory Committee (ESFRC) recommends that the European Council should take urgent decisions in the following two areas:

- The recapitalization of problem banks should be allowed to be done directly by the ESM.
- Countries facing punitive interest rates, such as Spain and Italy, should be allowed to issue and sell new debt directly to the ESM.

Our recommendations are aimed at trying to bridge the current stalemate in the discussion in which several northern European countries are concerned about the potentially perverse incentive effects and moral hazard associated with direct bank recapitalizations and direct lending to countries by European taxpayers.[1]

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[1] These recommendations are a natural follow-up to statements which the ESFRC has been issuing since 1998, especially "Dealing with Problem Banks in Europe" (Statement No. 1, June 1998), "EMU, the ECB and Financial Supervision" (Statement No. 2, October 1998), and "Reforming Banking Supervision in Europe" (Statement No. 23, November 2005). All ESFRC statements are available at www.esfrc.eu and www.ceps.eu.

Recapitalizing problem banks while imposing losses on shareholders and unsecured creditors

The recent announcement by eurozone leaders that they are willing to provide an amount of up to 100 billion euros to the Spanish government, which Spain can use for the recapitalization of its problem banks, has not received a positive market response. On the contrary, the loan will add to the government debt ratio of Spain, thereby worsening Spain's financial predicament. Consequenty, interest rates on Spain's sovereign debt have moved towards unsustainably high levels.

The ESFRC recommends that the ESM should be allowed to inject capital directly into the Spanish banking system and problem banks in other eurozone countries. In this context, it is important that risks to the eurozone taxpayer are limited, losses on the loans of problem banks are recognized, and that moral hazard is mitigated. Therefore, we also advocate that the ESM, as part of a conditionality linked to the recapitalization, obtains the mandate of imposing losses on the shareholders and unsecured creditors of problem banks. In order to be able to impose such losses several countries, including Spain, will have to adopt special bank insolvency laws through emergency legislation.

The ESM should be granted the maximum possible autonomy and may be assisted by staff from the European Banking Authority, national banking supervisors and the European Central Bank but it is essential that the ESM has the overall authority and responsibility to link the conditions of granting the recapitalization of a particular bank to the imposition of losses to shareholders and unsecured creditors of that particular bank. The preceding will maximize the negotiation power of the ESM during its discussions with the management, shareholders and unsecured creditors of the problem bank searching for recapitalization.

Guaranteeing sovereign debt with a flexible risk premium as incentive mechanism

Investors are looking for credible actions and signals by the eurozone leaders to shore up the sovereign debt markets of Spain and Italy. The current high interest yields on the debt of these countries are unsustainably high. Given the fact that both countries need to refinance hundreds of billions of euros in the near future they are prone to a rapidly worsening financial situation.

The ESFRC recommends that those eurozone countries facing punitive interest rate levels should be allowed to issue and sell new debt directly to the ESM. The ESM should charge a modest risk premium, substantially lower than demanded by the market, as part of the interest rate. At the same time, the ESM should also be able to grant, ex post, a refund of part of the risk premium after a country has met explicit targets with respect to the reduction of budget deficits and the implementation of economic reforms. Ex post reduction of the charged risk premium and interest rate for countries implementing budget cuts and economic reforms could play the role of a powerful incentive mechanism.

The conditions defined by the fiscal compact adopted by 25 EU countries in December 2011, and monitored by the European Commission, could provide to be an important anchor point. The fiscal compact is not only aimed at imposing budgetary discipline on countries but is also envisaged to provide general macro surveillance, including the implementation of adequate economic reforms. The ESFRC recommends strong enforcement of the fiscal compact. Without such a strong enforcement there is no credible road map to a sustainable long-run solution for problem countries.