A Question *of* Money

And who pays to rescue Europe's over-indebted banks.

By Hans-Werner Sinn

A year ago, the German Finance Minister Wolfgang Schäuble gave me a good telling-off. Why? Because I had issued a warning that, with the European banking union, politicians were preparing to shift the losses from write-downs of Europe's over-indebted banks to the taxpayers to protect the banks' creditors. At the time Schäuble scorned this idea, but now he is getting a bit hot under the collar himself as the liability spiral set in motion is getting out of control. Schäuble describes the Commission's most recent proposals as violating the Maastricht Treaty. Whether that be true or not, he is certainly right to be worried.

The bank debts of the six crisis-afflicted countries—Greece, Ireland, Portugal, Spain, Italy, and Cyprus (GIPSIC)—amount to €9 trillion, while the bank assets are slightly higher. This represents two-and-a-half times the total of these countries' government debts. Many GIPSIC banks are crippled and on the verge of bankruptcy. For the last five years of the crisis they have been kept afloat with huge special loans (measured by their Target balances) issued by the European Central Bank that peaked at €1 trillion. These special loans were only poorly collateralized, leading the president of the Bundesbank to voice a stern warning.

The semi-official and official estimates of banks' toxic claims are growing steadily and are now estimated at over €500 billion in the GIPSIC countries. Private estimates are even higher. In recent weeks, a new internal estimate by the Italian central bank pegged the figure at €250 billion in Italy. In view of the Italian banking system's aggregate equity capital of €382 billion, which is just enough to comply with regulatory requirements, this is an alarming amount.

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It is good that the Commission has now backed down from its position of just a year ago, whereby it insisted that there should be no bail-in, or that creditors should not bear any of the losses, until 2018. This position, which was sharply criticized at the time in two almost identical appeals by 480 German economists, has now been abandoned. The sums to be potentially written off are so huge that the financial firepower of the taxpayer can barely cover them—quite apart from the fact that there is no reason why investors should be absolved of their investment risks. In this respect Cyprus marked a turning point, as the creditors of the banks concerned were not fully protected. The bailout funds of the Community and the ECB were not enough to cover the losses in this case, even although they collectively exceeded the annual national product of Cyprus.

The European Union is now proposing a pecking order for the distribution of losses. Equity capital naturally tops the list, followed by hybrid capital and other subordinate forms of borrowed capital. If that is insufficient, the domiciling country will have to take responsibility for 4.5 percent of the total of risk-weighted assets. This, however, sounds better than it is. First, the 4.5 percent are, in reality, usually no more than 2 percent of the total assets, because many critical assets, and especially government bonds, are not, or only partially, included in the total of risk-weighted assets. Second, the domiciling country does not have to contribute anything if this would push it to the verge of bankruptcy. Third, European Stability Mechanism funding is definitely foreseen to compensate for higher losses, contributing 80 percent while the domiciling country contributes 20 percent. Fourth, the ESM should not only assume the losses stemming from the bank's new investments, but also from old ones accumulated prior to the establishment of the banking union. Fifth, politicians have torpedoed the pecking order with a long list of exceptions that protect bank creditors and reads like a wish-list under a Christmas tree.

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All secured loans, for example, are excluded, regardless of the quality of the collateral provided. This covers all of the ECB loans, including those that are only collateralized with government bonds that have been given junk status by the rating agencies. Short-term inter-bank loans and deposits of up to €100,000 are also excluded, which corresponds to double the assets of the median household in Europe's biggest economy.

The banks will now try to restructure their creditor base so that they are left practically exclusively with protected creditors. The ESM would then ultimately have no other choice but to foot the entire bill. The Community should protect itself against such a scenario by imposing rules on the minimum amount of liable capital. But no such rules have been introduced. Instead, each individual country is free to decide this amount at will. In the end, it is not really a question of rationality and efficiency. It is about money, a serious amount of money. ◆

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Tongue Lashing

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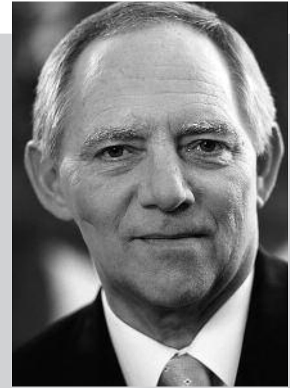

Wolfgang Schäuble