

Box 12

GOVERNMENT MEASURES TO SUPPORT BANKING SYSTEMS IN THE EURO AREA

In response to the intensification of the financial crisis in autumn 2008, euro area governments implemented coordinated measures in support of financial sectors. These measures consisted mainly of guarantees for bank liabilities, capital injections and asset support schemes. These measures, together with the sizeable macroeconomic policy stimuli and the extensive liquidity support provided by the ECB, were successful in restoring confidence in the euro area financial system and in improving its resilience. This box describes the state of the government support measures and the progress that has been made in exiting from these measures.¹ It should be added that the progressive intensification of market concerns about sovereign credit risks within the euro area in April and early May 2010 also put pressure on the operating environment of banks. In some countries, these developments led to an increase in government support rather than to its withdrawal.²

Given the highly integrated financial system, there is agreement among EU Member States to coordinate their exit strategies from financial sector support. A coordinated approach would help to avoid adverse cross-border spillover effects and preserve a level playing field. However, this does not necessarily entail a synchronised implementation of exits. The EU's coordinated strategy is based on: (i) adequate incentives to return to a competitive market; (ii) ex ante exchanges of information between governments on the intentions to phase out; (iii) transparency towards the public and the financial sector; and (iv) an assessment of the stability of the financial system.

1 The European Financial Stabilisation Mechanism, announced on 9 May 2010 and directed to provide support to euro area governments rather than financial sectors, is not covered in this box.

2 For instance, as part of the economic stabilisation programme in Greece, a Financial Stability Fund will be established with the task to provide capital support to banks. In addition, the Greek government increased the volume of its government guarantee scheme from €15 billion to €30 billion.

The EU Member States also agreed to start the exit by ceasing to grant government guarantees. Banks in most countries have indeed relied less on government-guaranteed bond issues, and the issuance of long-term debt without such guarantees has picked up (see Chart A). Some countries have already closed their guarantee schemes for bank debt.³ So far, the closure has not put visible strains on the sector. Furthermore, the potential for a market-based exit is built into the remaining schemes with a fixed price for the government guarantee: improving market conditions raise the relative cost of issuing government-guaranteed bonds in comparison with issuing non-guaranteed bonds. The incentive to exit may be increased further by raising the guarantee fee.

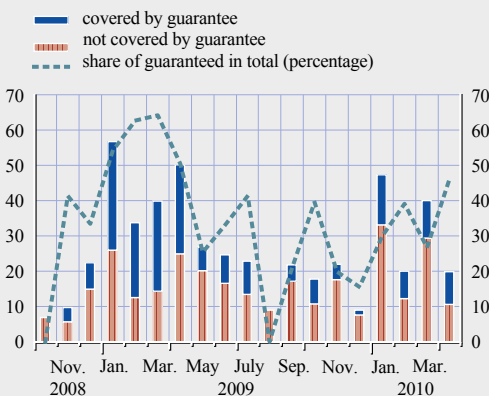
Where the exit from capital assistance is concerned, some banks have already paid back government capital, indicating that the incentives set by governments to induce early repayment have been effective.⁴ There are several alternative and generally complementary options available for banks to raise equity in order to return capital to the government. The main strategy is to raise capital in private markets. This strategy has been complemented by retaining earnings, selling business units, deleveraging and converting Tier 2-type capital of private investors into ordinary shares. Other banks will find it harder to reimburse the government. In fact, the incentive to repay early may prove largely ineffective in the case of banks that cannot raise capital in private markets or retain earnings. For these banks, the options to achieve repayment are more limited and repayment will need considerably more time. It should also be noted that banks that finance repayment by deleveraging may reduce their lending activities, thereby contributing to possible credit constraints for the real economy. In addition, governments can also pursue exits proactively through the sale of their stakes. However, this requires a sufficient increase in stock prices to protect the taxpayers' interests, and markets that are capable of absorbing the large government stakes.

3 In the euro area, Italy and France have terminated their schemes, and the Netherlands has increased the pricing as of 1 January 2010. Currently, eleven schemes are still open.

4 Banks typically pay a significant coupon on their preferred shares. The expensive pricing should encourage an early exit by the banks. This incentive is often further strengthened by step-up and redemption clauses.

Chart A Gross issuance of senior bank bonds in the euro area

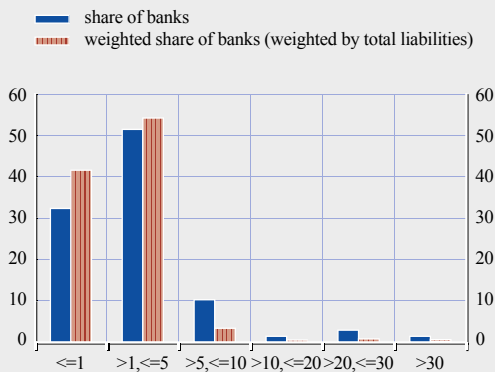
(Oct. 2008 – Apr. 2010; EUR billions)



Sources: Dealogic and ECB calculations.

Chart B Euro area banks' dependence on government-guaranteed debt

(Mar. 2010; percentage)



Sources: Bloomberg, Bankscope, European Commission and ECB calculations.

Notes: The sample consists of euro area banks which have outstanding government-guaranteed debt as of March 2010, but which are not under restructuring by the European Commission. The x-axis refers to the share of government-guaranteed debt in total liabilities.

Asset support measures have been used heterogeneously across countries, and have only recently been implemented in a number of cases. For instance, the Irish National Asset Management Agency (NAMA) bought a first tranche of loans with a nominal value of €16 billion in spring 2010.⁵ NAMA plans to purchase a total of €81 billion of loans by the end of 2010. As asset support is granted for the life of the underlying assets, asset support measures are generally self-liquidating. It should be noted, however, that owing to the long maturity of the underlying assets, asset support measures will be in place for a considerable period of time.⁶

Apart from heterogeneity across countries, the picture within the banking sector is also differentiated, and the overall picture of improved access to funding by the euro area banking sector disguises the emergence of polarisation in the banking sector. On the one hand, as mentioned above, many banks have recovered well after the financial crisis and have already exited from government support or will, in all likelihood, (soon) be able to manage without public support. On the other hand, some banks could have become “chronically” dependent on government support (see Chart B) and some may also be disproportionately reliant on central bank funding. For this group of banks, fundamental restructuring, derisking and, where necessary, downsizing of balance sheets will be needed in order to confirm their long-term viability when public support is no longer available. Restructuring is already underway for some large banks in the euro area, in some cases forcing banks to shrink their balance sheets by as much as 40% or more from their peak size.

5 NAMA paid €8.5 billion for the loans, representing an average discount of 47%.

6 In principle, asset support measures can be terminated prior to the maturity of the underlying assets. In the case of asset removal measures, the asset manager – be it a private investor (e.g. under the Public-Private Investment Program in the United States) or a public agency (e.g. the NAMA in Ireland) – can sell the assets when market prices improve. In the case of asset insurance measures, where the assets are ring-fenced and stay on the financial institution’s balance sheet, the financial institution can terminate the guarantee arrangement.