Fixing Europe’s banks

Cleaning the Augean stables

The ECB starts the Herculean task of repairing Europe’s banks

CONSTRUCTION cranes tower over the angular glass facets of the new headquarters being built in Frankfurt for the European Central Bank (ECB). Yet by the time the building is finished its acres of office space (twice as much as in its present downtown digs) will be too small to accommodate the expanding remit of the ECB. This week it lifted its shovels to begin the new task of cleaning euro- zone banks’ balance-sheets of their bad loans.

Its first step will be to try to get a measure of just how much bad debt there is through a close examination of the assets. On October 23rd it gave some details of how it will do this in an “asset- quality review” and what standards it will expect banks to meet. These revealed something of the fierce arguments that have taken place recently within the ECB and the compromises it has had to swallow. The ECB needs to be tough on banks to restore confidence—yet not too tough. If it reveals capital shortfalls so large that filling them would destroy the public finances of struggling countries then it may undermine confidence rather than restore it.

Its response has been to set reasonably hard standards, while giving banks time to comply and itself some flexibility on future hard decisions. The main yardstick imposed is a core-capital ratio of 8%, which is higher than in current regulations. Yet it will give banks an unspecified time in which to get there. The ECB also dodged some unresolved issues such as the actual riskiness of banks’ holdings of government debt and the divergence in banks’ own calculations of the riskiness of specific assets.

The biggest contribution to confidence would be the imposition of some common rules across the region for non-performing loans (NPLs). There is wide diversity at the moment, less in the definitions than in how regulators deal with “forbearance”—that is, banks easing terms for struggling borrowers to avoid recording loans as non-performing. Forbearance discourages banks from selling or restructuring bad debts for fear of crystallising losses and eating into their own capital. Standardised rules across the euro zone would probably reduce NPLs in Italy and raise them in Germany and Portugal (see chart).

Estimates vary on how much additional capital banks will have to raise to meet these new standards and to set aside in bad-debt provisions; some analysts predict about !50 billion ($69 billion). Yet this would be just to fill existing balance-sheet holes. A planned stress-test of banks could indicate significantly larger capital shortfalls. It is due to take place next year and will probably examine banks’ ability to weather an economic downturn. It may also consider the impact of a shock to the price of various countries’ sovereign debt. Back-of-the-envelope calculations suggest that this could easily double the capital shortfall if sluggish economies keep adding to the heap of bad loans and the slump in banks' earnings.

One unanswered question is how these capital holes will be filled. Private-equity markets may shoulder some of the burden, but badly busted banks may need help from governments. Before they can get this they may be forced to "bail in" their bondholders under stringent new rules agreed upon by the European Union. In principle this makes perfect sense, since taxpayers should be called on only as a last resort. Yet the new rules have prompted an unusually public row between Brussels and the ECB's president, Mario Draghi, who frets that private-debt markets will be spooked if regulators impose losses on bondholders just because higher capital standards are introduced.

An alternative source of capital, which Mr Draghi would prefer to use as a backstop, is Europe's bail- out fund, the European Stability Mechanism (ESM). But Germany insists that governments should be responsible for their own banks and that they may turn to the ESM only if their finances are insufficient. Germany's stance, if it prevails, risks perpetuating the link between weak banks and governments, which Europe had hoped to sever through a banking union.

Despite the many uncertainties that remain, the ECB's plan seems likely to help restore confidence in peripheral banks and lower their borrowing costs. The hope is that it will encourage banks to face reality and sell or restructure bad loans. This in turn would free them to lend to growing businesses while helping to reduce the debt burden faced by zombie firms—those that are profitable but weighed down by borrowings. If it achieves both, Mr Draghi will be able to relax in his new tower.