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Principles for Re-Capitalising Europe's Banks

NOTE

Abstract

Mario Draghi has acknowledged that there is a "fog of uncertainty" surrounding Europe's banks and the upcoming comprehensive assessment should help to dispel it. To be credible these tests need to uncover capital shortfalls at a significant number of banks and these shortfalls must then be made up quickly. This paper argues that before public money is used to bail out insolvent banks, senior bond liabilities should be written down or converted to equity. Similarly, the Commission's new state aid guidelines are correct in insisting on conversion of subordinated debt to equity as a condition for state investment in banks that are declared solvent but cannot raise private funds. If states are unable to recapitalise their banks, there is a strong shared public interest argument for using ESM to recapitalise banks. Protection of deposits of households and SMEs should be a priority but non-deposit liabilities should be bailed in before ESM participates.

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EXECUTIVE SUMMARY

- Europe's banking sector is objectively under-capitalised, both relative to the tougher capital standards required by Basel 3 and relative to what is necessary to re-assure creditors that their investments with banks throughout Europe are safe despite the likely problems in coming years with bad loans.

- Bank balance sheets are difficult for potential creditors to assess and bank executives of weak banks are incentivised to act in a way that may run counter to the good of the economy or the banking sector as a whole. For these reasons, the upcoming comprehensive assessment of the banking sector, followed by mandated recapitalising, is an essential step in strengthening Europe's banks and pulling the economy out of its slump.

- Public money should only be considered for the purposes of bank recapitalisation when all options that do not threaten financial instability have been exhausted.

- In the case where a bank is clearly insolvent, liabilities to bond-holders should be written down or converted to equity. This includes senior bonds. The current European policy of delaying bail-in of senior bonds until 2018 is counter-productive and may cost the European governments a lot of money.

- Where a bank is declared solvent but is unable to raise funds to reach the capital ratios required by regulators, the EU's new state aid rules are correct to insist on conversion of subordinated debt to equity as a condition for state aid. ECB President Mario Draghi has objected to this rule on the grounds that it could damage subordinated debt markets. An alternative viewpoint is that subordinated debt is better replaced with contingent capital which automatically converts when a bank falls below a specific capital threshold.

- When a member state is not able to recapitalise its banks, there are strong European public interest arguments for using the ESM to do this task. While ESM investments should be structured so as to protect the taxpayer as far as possible, there is also a strong common public interest in maintaining financial stability in the euro area.

- Despite the limited reaction elsewhere in the euro area, the approach taken in Cyprus of writing down deposits and then imposing capital controls should be avoided if at all possible. While depositors appear to have viewed these actions as a one-off event, their application elsewhere would likely to be highly damaging to financial stability.

- At a minimum, deposits of households and SMEs should be protected as a matter of priority in line with the hierarchy of creditors set out in the draft recovery and resolution directive.

1. INTRODUCTION

Problems with Europe's banks have played a crucial role in restraining growth in the years since the onset of the global financial crisis. Europe's banking sector is objectively under-capitalised, both relative to the tougher capital standards required by Basel 3 and relative to what is necessary to re-assure creditors that their investments with banks throughout Europe are safe despite the likely problems in coming years with bad loans.

In an ideal world, problems related to under-capitalised banks could be sorted out by the private sector. Banks that were insolvent would negotiate with creditors to be re-capitalised via writing down their liabilities while banks that were solvent but needed more capital would obtain new equity investments at a market rate from private sector investors. Alas, we don't live in an ideal world and the banking sector is riddled with informational problems that make this sector function in a completely different way to the markets of simple neoclassical theory. These problems mean that governments need to play an active involvement in regulating the banking sector and, on occasion, it may be necessary to use public money to maintain the stability of this sector.

In June 2012, the euro area's leaders agreed in principle for the first time that, potentially, the public money used to recapitalise banks could come from a joint European source in the form of the European Stabilisation Mechanism (ESM). As a precursor to this being possible, it was agreed that the ECB should take over as the supervisor of the euro area's banks and that it should perform an intensive round of balance sheet assessments and stress tests.

To be credible these tests need to uncover capital shortfalls at a significant number of banks and these shortfalls must then be made up quickly and without damaging financial stability. This raises an important debate about how public money should (and should not) be used to recapitalise banks. This debate is a complex one and there often are tensions between the key goals of protecting financial stability and preventing taxpayers from making losses.

In this paper, I first discuss the economic principles underlying the need for a set of government-mandated, strict and honest assessment of the European banking sector, followed by a process of mandatory re-capitalisation of weak banks. I then focus on the potential role the public sector should play in re-capitalising banks focusing on the public interest arguments for this role as well as on how governments should behave towards bank creditors during this process. Finally, I discuss the arguments for the use of the European Stabilisation Mechanism to re-capitalise banks under certain conditions.

2. WHY STRESS TESTS AND RECAPITALISATION?

Before considering the questions of how recapitalisation of European banks should work, it is worth briefly outlining why the current process of government-mandated balance sheet assessments and stress tests is required.

Whenever a government intervention in the economy is considered, it is useful to consider the market failures that warrant such a policy. In the case of stress tests and recapitalisation requirements, the market failures relate to two different areas: First, the informational problems associated with the opaque nature of bank balance sheets and second, the negative externalities that the actions of weak banks inflict on the rest of the economy.

2.1. Information Problems: Opaque Balance Sheets

If the valuation of bank assets was a simple business and creditors could easily assess a bank's solvency then there would be little need for banking regulation or stress tests. Losses on assets would be seen by all and banks would either be forced to raise new private sector capital or, if the losses implied insolvency, to inflict losses on creditors.

In reality, bank balance sheets are extremely difficult to assess. Actual and potential creditors seeking to establish the soundness of a bank have to consider a range of difficult issues.

- In assessing the quality of a bank's loan book, you can read its occasional reports and find data on the fraction of loans classified as performing or non-performing. In practice, however, banks can differ in the ways they report non-performing loans (NPLs). For example, loans can be prevented from moving into non-performing status by restructuring agreements that do not change the underlying credit quality. Further complicating matters when assessing European banks is the fact that regulatory requirements for reporting NPLs differ across European countries.[1]

- Even if a bank's reporting of its NPLs could be trusted, it is still difficult for outsiders to assess the likely losses on a portfolio of bad loans. Weak banks tend to be cautious about booking provisions on these loans and the amounts booked often depend on highly subjective opinions about the value of the collateral underlying loans.

- Banks generally provide limited information on their liquid financial assets. For example, while they will generally report their holdings of sovereign bonds, they are often reluctant to report the exact details of these holdings, i.e. whose sovereign bonds they own and their maturity. Big international banks also tend to have very large and complex derivative positions that carry risk that is almost impossible to assess on the basis of their published reports.

- Investors often rely on a bank's reported capital ratios to assess their underlying solvency. These ratios, however, depend on a myriad of complex discretionary decisions and regulatory standards. Both the definitions of various types of capital as well as the denominator in capital ratio calculations (risk-weighted assets) depend on more factors than most investors can feasibly assess. For example, details of the Internal Ratings Based models used to generate estimates of risk-weighted assets are not made available to the public (and might not be of much use to most people even if they were). As Andy Haldane (2012) has noted, Basel risk-based capital ratios appear to have had little power in predicting past bank failures.

[1] See Barisitz (2013) for a summary of the issues relating to definitions of non-performing loans.

2.2. Problems Caused by Under-Capitalised or Failing Banks

These information problems – which mean that bankers tend to have a much better understanding of their asset quality than outside creditors – can lead to a wide range of bad economic outcomes.

For example, bankers who know their bank is failing but are not reporting the true figures have an incentive to "gamble for resurrection" by seeking out highly risky investments with a potentially high upside. History is littered with stories of bank executives engaging in highly risky or even illegal behaviour in order to save their bank or else prevent the public from seeing its true state. These actions can end up having a serious impact on the bank's creditors by raising the total amount of losses and may also cost the taxpayer if the bank's creditors are bailed out because of deposit insurance or other guarantees.

Banks that are in a weak position but are not quite failing can also cause problems for the economy. The executives in these banks will also have an incentive to hide their bank's true position to prevent creditors from worrying and pulling their funds from the bank. In addition, the bank's shareholders often do not have a good understanding of underlying asset quality and are likely to wish to remove executives who "come clean" and admit that the bank needs a fresh infusion of equity. Capital raising of this type tends to be unpopular with shareholders who often (perhaps wrongly) view it as diluting the future flow of dividends they are likely to receive.

Given these pressures, management at weak banks may seek to increase their capital ratio by reducing the denominator in the capital ratio formula, i.e. by cutting risk-weighted-assets. This reduces the amount of credit available in the economy and re-allocates bank assets towards supposedly "risk-free" assets like sovereign bonds and away from assets with higher risk weights such as loans to small businesses.

While these actions of private sector bank executives may be rational and maximising from their own narrow perspective, they can do severe damage to the wider economy and the banking sector as a whole. As stressed in Andrew Crockett's (2000) famous speech and formalised in academic papers such as Adrian and Shin (2010), negative shocks to the economy become exacerbated when banks react by restricting credit. The negative effects on the economy of tightening credit can act to further worsen asset quality and deepen an economic slump. Crockett argued that governments should aim to preventing these kinds of outcomes via what is now known as *macro-prudential policy*. The upcoming round of balance sheet assessments and mandated re-capitalisation is a good example of sensible macro-prudential policy. It may not be popular with individual banks but it will act to strengthen the banking sector as a whole.

2.3. Europe's Banks: Clarity Required

Many of the negative factors associated with weak banking systems are evident in Europe today. With the euro area economy in a slump now for over half a decade, investors understand that there must be serious problems with asset quality at European banks. However, given the opaque nature of bank balance sheets, it can be difficult to assess the size of the problems at any individual bank or indeed the scale of problems affecting banks in different countries.

For example, it is well known that Ireland's banking crisis cost the state over €60 billion while UK-owned banks also incurred additional large losses in the Irish market. Spain is a much larger economy than Ireland (its GDP is about six times bigger). Like Ireland, Spain has gone through a major property boom and bust though, unlike Ireland, house prices in

Spain are still falling. This might lead the casual observer to expect the recapitalisation requirements of the Spanish banks would be far larger than those at Irish banks. However, the detailed report produced by Oliver Wyman (2012) suggested that recapitalisation requirements for Spanish banks should not be larger than €60 billion.

From an outside perspective, it is hard to know what to make of these estimates. On the one hand, it may be that Oliver Wyman are correct and Ireland's bankers just turned out to be much more reckless than their Spanish counterparts.[2] On the other hand, Oliver Wyman's would hardly be the first publicly-commissioned report to downplay the true extent of difficulties affecting a banking sector. The all-time prize in this regard goes to Price Waterhouse Coopers, who produced a report on Anglo Irish Bank in early 2009 which declared that "*Under the PwC highest stress scenario, Anglo's core equity and tier 1 ratios are projected to exceed regulatory minima (Tier 1 – 4%) at 30 September 2010*."[3] The capital hole in the bank ended up being over €30 billion and by September 2010 the bank was a major factor in the country's inability to borrow on sovereign debt markets.

Given the significant uncertainties about asset quality at various European banks, many creditors have decided to simply avoid providing funds to any banks that are deemed as potentially risky. Deposit flight from Europe's periphery has largely ceased, thanks mainly to Mario Draghi's "whatever it takes" assurances reducing concerns about the break-up of the euro. However, concerns about credit risk at banks remain and many banks in Spain, Portugal, Ireland and elsewhere are still heavily reliant on the Eurosystem to fund their operations. With this supply of funds not seen by investors as a reliable long-term source of stable funding, these banks are still under severe pressure to deleverage and this is weakening the supply of credit in countries that are already suffering from fiscal contraction and problems with private debt burdens.

For these reasons, it is essential that Europe's banks be exposed to a wide-ranging, independent and credible set of balance sheet assessments and stress tests. The European Banking Authority (EBA) has undertaken stress tests of this type before but it is widely accepted that these tests were insufficiently tough or rigorous. The new assessments under the centralised authority of the ECB have the potential to bring far greater clarity than these previous stress tests. In particular, the application of common techniques for earmarking NPLs and for provisions will be helpful in improving transparency -- "lifting the fog" as Mario Draghi has put it.

As noted above, however, to be credible these tests need to uncover capital shortfalls at a significant number of banks and these shortfalls must then be made up quickly. Only once transparency in relation to bad loans has been improved and banks have been recapitalised are we likely to see a return of trust in Europe's banks.

Of course, even stress tests run by an independent authority are not perfect. The technical challenge for the ECB in assessing the balance sheets of so many different banks is considerable. And the ECB may feel under pressure to "take it easy" on banks given concerns about whether there are adequate backstops in place to supply recapitalisation funds. Still, even with these caveats, the signs are good that the upcoming tests promise to be more serious and useful in promoting transparency than previous exercises.

[2] Though, of course, Oliver Wyman did award Anglo Irish Bank its "best performing large cap bank" prize in 2006, noting "A centralized loan approval process has helped the bank maintain high asset quality and minimize the risks of portfolio concentration." See http://ftalphaville.ft.com/2011/02/11/485311/worlds-best-bank-2006-vintage/

[3] This report is still publicly available on the Irish Department of Finance website at http://www.finance.gov.ie/documents/publications/other/2009/anglopwc.pdf

3. WHEN AND HOW TO USE PUBLIC MONEY?

While there is widespread agreement now that the upcoming comprehensive assessment should play an important role in highlighting weaknesses in the European banking sector, there is far less agreement about how these weaknesses should be addressed. In particular, the role that should be played by governments and private creditors in recapitalising banks is a subject of great controversy.

Here, I consider the potential role of public funds in recapitalising banks in two different cases: One in which a bank has been found to be insolvent and the other in which a bank is found to be solvent but weakly capitalised. In both cases, I assume that the state in which the bank operates has the capacity to provide the initial investment without causing strain on the public finances. I return to this issue in the next section.

3.1. Insolvent Banks

Consider the first case, in which a bank is found to be clearly insolvent, with its assets falling well short of its liabilities. For now, I am going to assume these banks have sufficient non-deposit liabilities so that writing off these liabilities would restore solvency.

In this case, the new European Commission's state aid guidelines introduced in July correctly insist that equity must be written off and subordinated debt either written down or converted to equity (depending on the extent of the negative capital position). These guidelines are the minimum possible level of protection that should be afforded to the public purse when consideration is given to assisting failing banks: Those who provided funds to banks in the full knowledge that those funds would be at risk should the bank fail must lose out when the bank does indeed become insolvent.

Where cases of bank insolvency become more serious is when capital shortfalls cannot be made up by writing off equity and subordinated debt. In relation to these situations, the current position in relation to European guidelines is unclear. The European Council has agreed a draft Bank Recovery and Resolution Directive (BRRD)[4] which sets out a clear hierarchy for the treatment of liabilities when banks are put into resolution. Most importantly, it states that "*eligible deposits from natural persons and micro, small and medium-sized enterprises shall have a higher priority ranking than the claims of ordinary unsecured, non-preferred creditors*".

This suggests that, in principle, European leaders are willing to restructure senior unsecured bonds to restore banks to solvency. This can be done via some combination of writing down senior bonds and conversion of some part of the bonds to equity: Insolvent banks can be restored to solvency via write-downs of senior debt while privately-owned equity can be provided by converting some of the remaining debt to equity.

There remains some confusion in public debate in some countries about how this kind of bail-in would operate given that most senior bonds rank equal with deposits via "pari passu" clauses. These clauses, however, only apply to the treatment of claims in a liquidation. There is nothing that prevents governments from overseeing a process in which both senior bonds and deposits receive haircuts but the deposits are "topped up" by the state after they have been transferred to a separate institution.

The current state of play in relation to bail-in on senior debt, however, is that the BRRD only envisages the bail-in tool being applied from 2018 onwards. The argument put

[4] http://register.consilium.europa.eu/pdf/en/13/st11/st11148-re01.en13.pdf

forward in the draft directive is that this approach is necessary "to reassure investors and market counterparties and to minimise its impact."

My assessment is that argument for delays in the application of the bail-in tool are flawed. Financial markets need to be clear in the future about the risks that they are taking when investment money with banks. The only way to provide assurances that these risks are low is to restructure banks so that they are very well capitalised. Write-downs and bail-in of senior bonds at failing banks will, in many cases, be sufficient to achieve this outcome. Using public funds to bail out senior bond holders over the next few years could also re-capitalise banks but would be no more effective at doing so, would cost the public money and could set a bad precedent with investors wondering whether bail-in of senior bonds actually would occur at all from 2018 onwards.

One argument against bailing in senior debt is that it could have financial stability implications. Bailed-in debt could belong to other financial institutions and contribute to their failure which could lead to financial instability. Ultimately these arguments have to be assessed on a case-by-case basis but, in general, any knock-on impact should be dealt with directly by stabilising the affected institutions rather than requiring governments to provide the funds to avoid bond write-downs.

The use of bail-in tools should allow many insolvent European banks to be restored to solvency without requiring public funds for recapitalisation. If, however, public funds are still required to meet regulatory capital requirements so that a bank ends up with a mixture of public and private forms of equity, then public equity investments should be structured in a way that reduces risk for the public and incentivizes early retirement of the public equity. For example, publicly acquired equity could come with warrants that would see the government obtain a higher stake in the bank if its shares are still in existence after a particular time period has elapsed.

3.2. Solvent But Under-Capitalised Banks

Now consider the second case, in which a balance sheet assessment finds a bank solvent but with regulatory capital ratios that are below the level required by regulations. In many cases of this type, it may be possible for banks to find private sector investors willing to inject new equity into the bank, in which case there are no questions about public investment.

The tricky questions in this case relate to what happens when a solvent but under-capitalised bank is given the opportunity to raise private capital but fails to do so. The Commission's revised state aid rules from July require that subordinated debt be bailed-in prior to any state funds being used to add to the bank's recapitalisation.

Mario Draghi has argued against this approach of forced conversion of subordinated bonds in this case in which a bank is solvent but still falls below the capital ratios required by regulators. In a letter to Commissioner Almunia dated July 30 that has since been leaked, Draghi argued against this approach on the grounds that subordinated bonds should be an important instrument in building up the loss-absorption capacity of European banks and that this requirement could damage the market for these bonds.[5]

Draghi's letter argues adding a new source of credit risk ("precautionary recapitalisation after failing a stress test") would change the nature of subordinated debt and perhaps

[5] At the time of writing, a copy of this letter can be found at http://ep00.epimg.net/descargables/2013/10/21/e4c63829a1ef61f17a50533be5a2e3a9.pdf while a Financial Times report on the letter can be found at http://www.ft.com/intl/cms/s/0/13cc9614-397f-11e3-a3a4-00144feab7de.html

damage the market for such instruments. He notes also that this approach is inconsistent with the approach to bank resolution being developed in the draft BRRD. His letter also noted that bail-in of subordinated bonds may not be necessary for state investments in bank equity to be profitable. Indeed, the most obvious example of state investments in bank equity in recent years, the U.S. Troubled Asset Relief Program (TARP) has been a great success for American taxpayers. In total, the U.S. Treasury disbursed $245 billion to invest in bank equity. With almost all the original disbursement repaid, the Treasury has received $273 billion back for a return of over 11 percent.[6]

One could also argue that a failure to raise private capital during a period of financial strain may simply represent pressures within the private financial sector to deleverage, making governments the only body with the financial capacity to make large investments in bank equity.

These are important points but, on balance, my view is that the Commission's state aid rules are correct and that Mr. Draghi is not. Estimates of the solvency of a bank are always uncertain and dependent on highly subjective asset valuations. There are many examples of banks whose troubles were first revealed in accounts that showed they were solvent but weakly capitalised with losses of larger magnitudes only being revealed later. Even independent stress tests are unlikely to be an exception to the general rule that bad news tends to drip out slowly over time.

For these reasons, point estimates of solvency should be interpreted carefully if a bank fails to receive offers of equity investment at any reasonable cost from private sources. Considerable weight should be given to the view that the private sector has decided that there are further losses to come at this bank and that any equity investment would lose money.

Sub-ordinated bond holders may object to mandatory conversion of their investments into equity in these circumstances. However, if indeed a bank's assets turn out to be consistent with stress test valuations that show solvency, then the converted equity investment that these investors hold will retain its value. If, on the other hand, these valuations turn out to be overly optimistic, then it is only fair that losses are taken by private investors who knowingly invested their money under the risk that they could be wiped out if the bank became insolvent. If the government invests money before subordinated debt is converted, then public money will be first in line to be written off.

Mr. Draghi is correct that precautionary conversion of subordinated debt of this type is inconsistent with the current BRRD draft and with the legal contracts underlying these debt instruments. However, these arguments point towards revising the draft BRRD and towards the use of contingent capital (CoCo) bonds rather than subordinated bonds as a way to build up loss-absorption over and above core equity.

The reality is that very few banks are allowed reach the point where their published accounts show them to be insolvent. Regulators are aware of the ability of bankers to manipulate accounts and the long delays involved in the revelation of bad news. As such, it is generally best if they intervene at the point where a bank is solvent but under-capitalised. With the new SSM regime now in place, stress tests for European banks should be a regular event and recapitalisation requests of the type that will occur next year will continue to be a feature. Contingent bonds that are automatically converted to equity are a far cleaner solution to recapitalisation under these conditions than ad hoc conversions of

[6] Information on TARP is available at http://www.treasury.gov/initiatives/financial-stability/Pages/default.aspx

subordinated bonds. As such, banks and regulators should focus on promoting the sale of contingent capital bonds.

4. WHY SHARED FUNDS FOR RECAPITALISATION?

Thus far, I have discussed the case in which banks are re-capitalised by a government in the country in which the bank is based. This has ignored a crucial question: What happens if the government in this country is unable to provide these funds?

There may be a number of reasons why a government may not be able to recapitalise its banks:

- It may be that the banks are so clearly insolvent and the government is going to make such large losses that financial markets anticipate that the government is likely to experience a sovereign default if it proceeds with the recapitalisation. It may still be possible to proceed with the recapitalisation in this case through the use of non-market forms of debt issuance (for example, the promissory notes that the Irish government used to recapitalise Anglo Irish Bank in 2010) but most governments would be reluctant to go down this path.
- It may be unclear whether there will be large losses but if debt levels are already high, financial markets may be unwilling to take a risk on a government that could be heading for default if its investments in bank shares turn out badly.
- The government may be able to fund the recapitalisation and may expect it to provide a full return and markets may view the risk of default as slim but the country will end up violating European rules on public debt. These rules focus on the gross amount of government debt, so even if a country has accumulated assets (in the form of bank shares) that match this debt, it will still end up increasing its "headline" debt figures. Commissioner Rehn has written to finance ministers signalling that once-off accumulations of debt will not trigger escalation of excessive deficit procedures.[7] However, the effect of such debt issuance on headline debt levels may be enough to prevent governments from proceeding with recapitalisation plans.

Given that these circumstances can arise for an individual member state, what are the arguments for a shared recapitalisation using the ESM as a vehicle? The most obvious rationale – and the one that is clearly put forward in the agreed guidelines of 20 June 2013 relating to the use of the ESM for bank recapitalisation – is the maintenance of financial stability in the euro area.[8]

In particular, there is likely to be a common European public interest in limiting losses for depositors. A situation in which a bank inflicts large losses on depositors because a government does not have the ability to bail out creditors or recapitalise the bank could lead to fears across Europe that banks in any country with weak public finances may be unsafe.

Of course, the obvious response to this argument is that there were large write-downs of deposits in Cyprus earlier this year and this triggered almost no response from depositors in the rest of Europe. My sense is that this response was because people believed that Cyprus represented a "special case" that could not be repeated. In some ways, Cyprus was a special case: The level of insolvency of its banks was high and they had very little non-deposit funding to be bailed in. In addition, the level of publicity given to the involvement

[7] This letter is available here http://ec.europa.eu/commission_2010-2014/rehn/documents/finmins_public091013_en.pdf

[8] The guidelines for the use of ESM for recapitalisation purposes can be found online at http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/137569.pdf

of Russian depositors in the Cypriot banks led many people to conclude that there was a political element to the Cypriot bail-in that would not be repeated elsewhere.

These points, however, do not rule out situations arising over the next year in which deposits could be at risk because Europe's banks differ widely in the extent to which they may be hiding losses and in their dependence on non-deposit funding. As soon as depositors see one more case in which deposits are bailed in, they may view events in Cyprus as a template rather than as an exception. This could trigger substantial financial instability across Europe.

Furthermore, it would be unwise for euro area leaders to consider repeating the post-bail-in approach taken in Cyprus. The ECB's approach to the Cypriot banking crisis has effectively been opposite of the textbook approach of lending freely to solvent institutions. Large amounts of Eurosystem funding were provided in 2012 and early 2013 to Cypriot banks that the ECB knew were insolvent. After solvency was restored to Bank of Cyprus via deposit write-downs, it appears that the ECB then decided to limit its support for the bank, an approach that can be implemented because capital controls limit the extent to which deposits can be taken out of the bank. Again, this is perhaps viewed across Europe as a one-off event but the imposition of these controls in a second country could provoke significant concerns amongst depositors all across Europe.

For these reasons, I believe there is a common interest in the euro area in using the ESM to recapitalise banks when member states are incapable of doing so, with the top priority being the avoidance of deposit write-downs. At a minimum, deposits of households and SMEs should be protected as a matter of priority in line with the hierarchy set out in the draft recovery and resolution directive.

The idea of using ESM to recapitalise banks is unpopular in a number of European countries, most notably Germany. It should be remembered, however, that the ESM guidelines call for the EU Commission's state aid rules to be applied to any ESM-backed recapitalisation. While some cases may involve filling in solvency gaps in a way that will not return money, a well-designed policy of bailing in subordinated and senior bonds will be the best way to ensure that, where possible, ESM's investments in banks provide a shared return for European taxpayers as well as maintaining financial stability.

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