The Route Back to Credit

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Originally published in French in *La Tribune*, 17 December 2008

The machinery of credit is increasingly clogged, in France and elsewhere.

The response of the French government has been to mobilise prefects and to create a new job of 'credit mediator', entrusted to René Ricol. The pressure thus placed on banks may unblock some situations. But it cannot by itself bring credit conditions back to normal.

The problem is not so much banks' bad faith. It is rather that creditors are petrified at the thought that they might fail to meet mid-term commitments.

In a crisis, undercapitalised banks do not lend. Experience from the Japanese crisis even suggests that, in a grim economic environment, banks must be overcapitalised to get credit moving again.

Unfortunately, banks' financial statements are of little help in assessing the challenge.

International accounting standards and their implementation in Europe still give too much leeway for banks to hide the bad news. For all the arguments about procyclicality, a fast cleaning up of balance sheets would be in the public interest. From that perspective, the changes hastily made to IFRS standards in mid-October are unhelpful.

More important still, capital ratios based on current financials paint too optimistic a picture, because banks expect their equity to absorb additional losses next year on existing assets.

Such future losses cannot yet be booked in the financial statements, but their assumption is made reasonable by the current economic dislocation. Even bold government stimulus programmes will not halt a sharp increase in payment defaults.

As former Japanese central banker Teizo Taya was quoted in the Financial Times of 23 October, 'I don't think we can expect [US and European] banks to lend. They are going to be too busy writing off bad loans. What has to happen will happen'.

A Morgan Stanley study of 6 November estimated the total capital injection needs of Europe's banks at €83 billion, on top of the €117 billion already raised in 2008 at that date. Bad news has continued to hit since then, thus only increasing the need for new equity.

Where are these vital billions going to come from? Rights issues are unappealing given the depressed share prices. Most sovereign wealth funds, which had plugged the gap last year, are still reeling from their paper losses.

Banks which have remained strong enough, such as Santander which recently raised new equity at the cost of a steep price discount, may withstand the shock without considering radical moves. For the others – many of them – there remain essentially only three options.

First, some ailing banks will need to be bought up by others, as Alliance & Leicester in the UK was by Santander in October.

In France as in many other European countries, domestic consolidation is well advanced. In such countries, if competition is to be maintained, the most promising consolidation scenarios are cross-border.

For this to happen, governments would need to accept two things: to keep their protectionist instincts in check (France's François Fillon felt compelled to declare in January, after the Kerviel shock, that Société Générale would in all scenarios 'remain a great French bank'); and to thrash out a credible framework for supervision of pan-european banks, which does not currently exist.

Second, in some cases private equity investors should be allowed in. Politicians are deeply suspicious of such funds and most often see them as mere asset-strippers. But they could be a catalyst for the changes in strategy, organisation and culture which some poorly managed banks desperately need. And many funds still have deep pockets.

The takeover of a major bank by a private equity fund is no science fiction. There is currently at least one such project concerning Bank of Ireland. And similar deals were carried off successfully in Japan and elsewhere following the Asian crisis.

Third, if all else fails, governments will have to dig deep themselves, beyond the preferred shares presently used in France. Such instruments can be counted as capital for regulatory purposes. But they remain hybrids of debt and equity, unsuited for the most pressing capital needs – unless they are figleafs for disguised subsidies, which would violate not only EU rules on state aid but also the taxpayers' interest.

Whether leading financiers like it or not, it may soon be necessary to break the taboo of government acquisition of banks' common stock. The UK has already done so. Its continental neighbours would be well advised to follow suit in some instances.

Cross-border consolidation, private equity investment, nationalisations: these three options would require governments to cast aside their erstwhile prejudices, and a tough job of explaining the change of approach to the public.

But this may well be the price to pay, if credit is to come back within a reasonable timeframe.

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Andrew Fielding's help in translating from the French is gratefully acknowledged.