Box 11

GOVERNMENT MEASURES TO SUPPORT BANKING SYSTEMS IN THE EURO AREA

This box summarises the measures taken by euro area governments to support the banking sector and discusses their implementation and effectiveness.

Following the bankruptcy of Lehman Brothers in September 2008, financial market stress intensified sharply. After the summit of the EU Heads of State or Government in Paris in October 2008, EU governments implemented support measures to alleviate strains on their banking systems. These measures complement the extensive liquidity support that has been provided by the ECB and have been implemented in accordance with specific guidance from ECB and the European Commission.[1]

1 The recommendations can be downloaded from the following websites: http://www.ecb.int/pub/pdf/other/recommendations_on_guaranteesen.pdf (Recommendations of the Governing Council of the European Central Bank on government guarantees for bank debt), www.ecb.int/pub/pdf/other/recommendations_on_pricing_for_recapitalisationsen.pdf (Recommendations of the Governing Council of the European Central Bank on the pricing of recapitalisations), and http://www.ecb.int/pub/pdf/other/guidingprinciplesbankassetsupportschemesen.pdf (Eurosystem guiding principles for bank asset support schemes).

The main objectives of the public support schemes are to (i) safeguard financial stability; (ii) restore the provision of credit and lending to the economy; (iii) promote a timely return to normal market conditions; (iv) restore the long-term viability of the banking sector; and (v) contain the impact on public finances and preserve taxpayers' interests. In practice, the government support schemes introduced thus far fall into one of three main categories: (i) guarantees for bank liabilities; (ii) re-capitalisation measures; and (iii) measures to provide relief from legacy assets. The main characteristics of these schemes, most of which have been made available to banks on a voluntary basis, can be summarised as follows.[2]

- *Guarantees for bank liabilities*. In accordance with the agreement reached at the Paris summit, euro area governments raised the coverage of their deposit insurance schemes to the new maximum of €50,000 per deposit account, with some governments extending the guarantees even further. In addition, many countries started to extend government guarantees to cover newly issued bank debt securities. These guarantees were provided either on an ad hoc basis or within national schemes, with pre-announced commitments of the total amounts made available for banks.

- *Capital injections*. Several governments also provided Tier 1 capital to banks. Capital injections have mostly been made through the acquisition of preference shares or other hybrid instruments which fulfil the conditions for Tier 1 capital. Some countries have considered the provision of capital through the acquisition of ordinary shares.

- *Asset support schemes*. Some countries have set up asset support schemes. These can take the form of asset removal schemes (transferring the assets to a separate institution) or asset insurance schemes (keeping the assets on the banks' balance sheets). Some initiatives can be categorised as hybrid schemes, in that they involve asset transfers, financed through guaranteed public sector loans, and sophisticated risk-sharing arrangements between the governments and the participating banks.

A summary of the measures is given in the table below. The numbers outside parenthesis show the volume of the schemes as implemented by the cut-off date of this FSR, while the numbers in parenthesis show the full amounts to which governments have committed. Regarding the implementation of these measures, some conclusions can already be drawn. The take-up rate is generally low across

2 This is in contrast to some of the schemes announced in the United States where, for example, the recapitalisation measures have more often been compulsory.

Summary of rescue measures in Europe

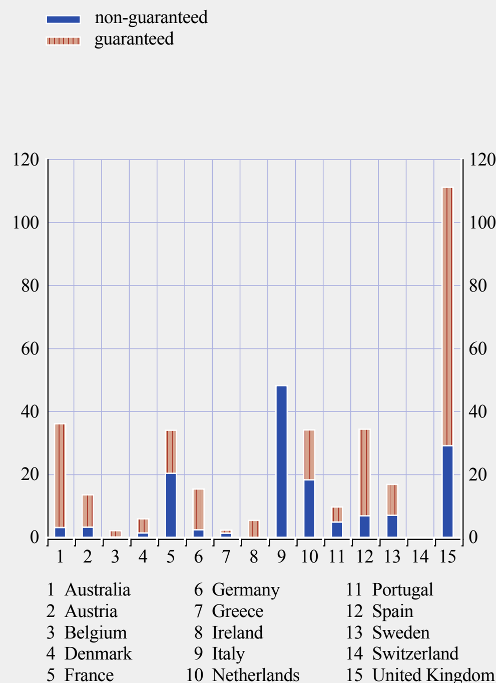
(EUR billions unless stated otherwise)

	Capital injections		Liability guarantees		Asset support		Total commitment
	Within schemes	Outside schemes	Guaranteed issuance of bonds	Other guarantees, loans	Within schemes	Outside schemes	as % GDP
Europe	103.4 (251)	56.6	543.7 (2,136)	236.8 (-)	585.4 (877)	26.2	27.3
EU	99.4 (247)	56.6	543.7 (2,096)	236.8 (-)	544.2 (836)	26.2	27.9
Euro area	59.1 (172)	54.1	396.8 (1,677)	235 (-)	23.7 (198)	26.2	23.7

Sources: National authorities, Bloomberg and ECB calculations.
Notes: Data are cumulative since October 2008. Numbers in brackets show total commitments for each measure. Some of the measures may not have been used despite having been announced. Usage of guarantees includes issued bonds but not guaranteed interbank loans. Capital injections outside schemes are support measures used without a scheme having been explicitly set up.

Chart A Cumulative volume of gross issuance of bank bonds in Europe

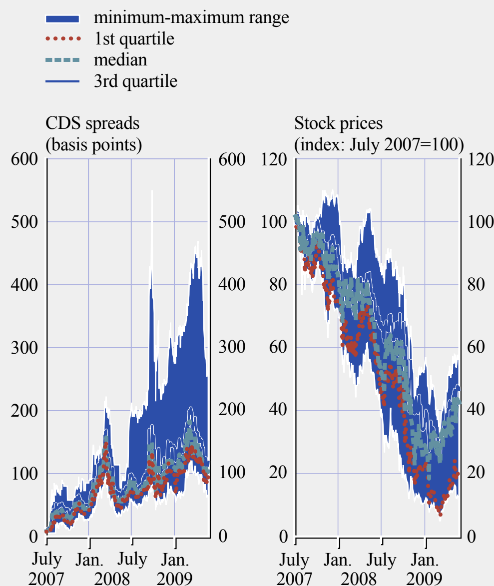
(Oct. 2008 – May 2009; EUR billions)



Sources: Dealogic and ECB calculations.

Chart B Distribution of five-year senior CDS spreads and stock prices for euro area large and complex banking groups

(July 2007 – May 2009)



Sources: Thomson Financial Datastream and ECB calculations.

all measures, but there are substantial variations: the use of recapitalisation measures has been relatively widespread, while the issuance of bank bonds with government guarantees has been considerably lower, albeit with an increasing take-up rate over the last few months.

However, as the issuance of non-guaranteed bank bonds remains limited in most countries, the use of guaranteed bonds is likely to have been indispensable in providing banks with access to medium-term funding when needed (Chart A). Reasons for the slow take-up rate include the occasionally relatively high liquidity premium on guaranteed bank debt over government debt, possible stigma effects (i.e. resorting to government assistance may be perceived as a signal of bank weakness), conditions that are sometimes attached to such guarantees (such as restrictions on remuneration), decreased medium-term funding needs owing to ongoing deleveraging by banks, and the general slowdown in demand for credit. Overall, while it is clear that the measures were successful in averting a further escalation of the crisis in late 2008, in spite of recent improvements, investor sentiment towards the banking sector remains rather negative, as evidenced by the still elevated levels of interbank money market spreads and banks' CDS spreads, as well as low (albeit rising recently) bank stock prices (Chart B).

The various measures to support the financial sector are expected to have only a small direct impact on government deficits in the short to medium term. The impact on government debt largely depends on the borrowing requirements of the government to finance the rescue operations. However, potential fiscal risks are sizeable for all countries that have established a guarantee scheme as it may negatively affect market perceptions' about the creditworthiness of the respective governments.

The impact of the measures on the provision of credit to the non-financial sector is more complex to assess, especially when it comes to separating possible credit supply restrictions from the observed decline in demand for loans. At the current juncture, credit to the private sector continues to be on a downward trend: year-on-year credit growth has decreased further, and monthly flows have even become negative in the first quarter of 2009. Banks that have tightened their lending standards have done so mostly in reaction to the deteriorating economic outlook, but also in response to continued funding pressures, notwithstanding the government support, hence indicating that some loan supply constraints cannot be ruled out at present.