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OPINION

A Wrinkle in Europe's QE Effort

A plan to bolster financial stability may undermine the ECB's stimulus plan.

By Marcello Minenna

The European Central Bank is trying to stimulate growth by launching an aggressive sovereign-bond purchase program to encourage greater lending. Amid all the debate about whether this quantitative easing will work, commentators have been slow to recognize major barriers other European agencies are erecting against effective transmission of the ECB's monetary policy.

A clear example of the challenge comes in the form of a "request for information" sent in March by the European Commission's Directorate-General for Competition sent to governments of smaller eurozone countries related to an arcane accounting issue. During the crises that started in 2008, banks in these peripheral economies racked up as much as €110 billion ($118.93 billion) in so-called deferred tax assets (DTAs). These represent tax credits the banks accumulated for their losses during the crises that can be used to reduce their tax bills as they return to profitability in the future.

Because these tax benefits only take effect if and when a bank earns a profit, they are normally not included in calculations of the Tier 1 capital that's supposed to cushion the institution in the event of crisis. However, an EU regulation issued in 2013 allowed banks in peripheral economies to include these tax benefits in their Tier 1 capital so long as governments converted deferred tax assets into refundable tax credits that governments would reimburse to banks even if the institutions never earn enough profit to use their deferred tax assets in the traditional way.

These refundable credits represent a claim for a tax-refund payment from the government, although the laws don't allow banks to make that claim right away. The point was to allow easier recapitalization of the banks without needing to raise more capital via markets or immediate government cash injections. As of 2013, deferred-tax credits amounted to more than 10% of the Tier 1 capital of Italian and Portuguese banks; 20% at Spanish banks; and well above 40% at Greek banks.

The European Commission appears now to be concerned that such credits amount to illegal state support for the banks. That may be true. The laws that created the refundable credits provide explicit guarantees of state support under certain conditions. In Spain, for example, the government will refund the value of outstanding credits after 18 years if profits in the interim have not been sufficient to use up deferred-tax assets.

But enforcing the rules against state support here undermines the ECB's monetary policies. If banks are no longer allowed to include deferred tax credits in their Tier 1 capital, they will need to raise more capital in some other way. That could include retained earnings or new rounds of capital-raising. Or banks could meet regulatory capital requirements by not expanding their lending so as to keep their capital reserves aligned with the balance sheets they have now—not the expanded balance sheets the ECB wants them to have.

Nor is this the only example. For now, EU regulations allow banks to classify all government bonds as zero-risk. That will no longer be allowed under the global Basel III guidelines being phased in by the European Systemic Risk Board, a regulatory branch of the ECB. Instead, banks will have to adjust the risk assessments of their government bond holdings in line with a sovereign's risk of default.

Peripheral banks in particular tend to hold large reserves of their own countries' bonds. In 2014, more than 90% of the government bonds held by Italian banks were Rome's debts, and Greek banks held a similar proportion of Greek government debts. For Portugal and Spain, it was 80%. Since these all are soon to be deemed riskier, they face a new round of recapitalization or a forced reduction in their holdings of their sovereigns' debts.

This is compounded by other Basel III components. The president of the ECB Single Supervision Mechanism, Danièle Nouy, has publicly encouraged banks to deleverage their positions in government bonds. Basel III guidelines suggest that no issuer constitute more than 25% of an institution's bond portfolio. Meeting that guideline would require a massive portfolio rebalancing as peripheral banks sell their own countries' debt to buy other governments' bonds.

Rough estimates suggest Spanish and Italian banks each would need to sell off some €200 billion of their sovereigns' bonds, while for Portugal and Greece it would be €20 billion. Because the yields on the "safer" bonds they buy would be lower—indeed, even negative in some cases in the current environment—this rebalancing would dent profitability and therefore make it even harder for banks to lend the way

Una grinza nel piano europeo di quantitative easing

the ECB wants them to.

Policy makers can choose a financial system in which banks are encouraged to take risks for the sake of stimulating economic growth. Or they can choose a financial system in which tighter prudential regulations force banks to bolster their capital reserves and take fewer risks. At the moment, European leaders are trying to choose both, and the combination is sure to have unintended consequences.

Mr. Minenna is adjunct professor in quantitative finance at the Bocconi University of Milan.