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Banks can't dodge the EU sovereign debt crisis

Hamish Risk
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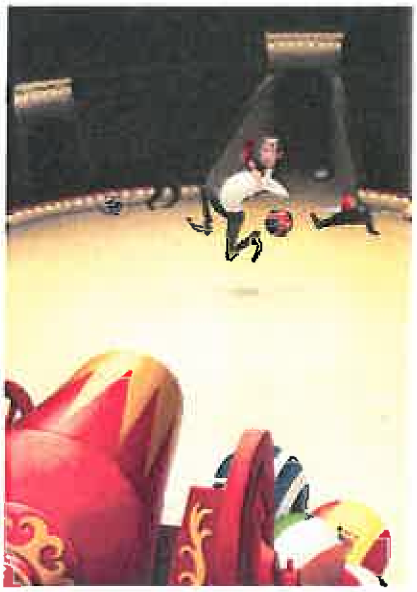
Just when Europe's big banks have begun to repair their balance sheets and return to profitability, along comes the European sovereign debt debacle. With huge stockpiles of government bonds on their books, can the region's banks avert a second catastrophe? Hamish Risk reports.

European sovereign bond market faces big test in 2010



WHEN YOUR POPULARITY among investors plummets faster than you can say "Tiger Woods sponsorship deals", you know you have a problem. That seems to be the case for European banks. Bank of America Merrill Lynch's benchmark February investor survey revealed that the banking sector's popularity plummeted by the biggest-ever margin since the poll began in 2001.
It is the most negative investors have been on banks since March last year, and the largest conviction underweight position for any sector in seven months. Not the sort of news you want to hear when you have €500 billion to refinance this year.

It is a reflection of how interconnected the finances of banks and governments are in Europe. Not only do banks face risks to profitability via slowing loan growth and worsening asset quality as austerity plans to rein in bloated deficits are implemented, but more directly banks face big losses on the government bonds they hold on their balance sheets. To make matters more troublesome, funding costs are also on the rise, particularly for southern European banks. Yet they can hardly be accused of being reckless for investing in so-called risk-free debt. Indeed, it may very well be the governments of Europe and the capital regulators that have planted the seeds of this new banking crisis.

Since the European Union was formed, its banks have been encouraged by governments and regulators to bolster their balance sheets with liquid assets, sovereign bonds being the asset of choice. In return, capital regulators assigned the same zero-risk weighting to those assets, whether they be Greek bonds or German bonds.

"When governments look at themselves in the mirror they will realize they have an enormous responsibility, and they will have to honour that for their banking system," says Graham Bishop, an independent consultant on European financial affairs. "Even now there are proposals out there to encourage the banking system to put its most liquid assets into the worst possible government debt. And that's stupid to say the least."

At the union's foundation 20 years ago Bishop, in his capacity as Salomon Brothers' adviser on EU financial affairs, argued strongly to European authorities that zero-risk weightings were an outmoded concept within a monetary union. If a sovereign state didn't have the ability to print its own money, it lost the capability to pay its debts by printing money rather than raising taxes. He recalls that it was an issue European politicians found too difficult to confront. Now the chickens have come home to roost.

The Mediterranean menace

So far this year, Greek bonds have lost investors 3.4% on an annualized basis, as yields have risen 180 basis points. Portugal's benchmark 10-year bond yield has risen about 30bp, and was as high as 80bp. Now investors nervously await a decision by EU finance ministers on March 16 after Greece provides more details on how it plans to cut its ballooning deficit from 12.7% of GDP in 2009 to 3% of GDP by 2012. The plan will likely include increasing value-added tax rates, taxes on energy products and further cuts to government expenditure. Next in line is Portugal (see Portugal tries to show how it's different, **Euromoney**, March 2010), where Moody's has assigned a negative outlook to its Aa2 rating. It too faces robust measures to strengthen the economy and adjust its public finances, and could face further ratings downgrades, although its outstanding debt is much less than in either Spain or Greece. However, there is a fine line to be walked for policymakers between curbing Europe's most profligate members and sending the region into recession.

"Governments will have to stand by the moral hazard they have recklessly created. They were warned 20 years ago"

Graham Bishop

"If you get too much of a fiscal tightening all across the eurozone at the same time it would present a real risk to the European recovery," says Michael Krautzberger, head of euro fixed income at BlackRock. "European banks hold a substantial amount of Greek assets and therefore the crisis cannot be allowed to get out of control."

At the end of the third quarter of 2009, there was $1.3 trillion in Spanish, Portuguese and Greek debt outstanding. UK and continental European banks are the most exposed to the three countries, accounting for 92% of total foreign bank exposure to public and private sector borrowers, of which around 20% is government debt, or $265 billion. Within that, German and French banks account for almost half the total bank exposure, according to BCA Research. Government debt is about 8% of the European banking sector's asset base and in some cases more, notes JPMorgan. In some countries, such as Greece and Spain, that level has risen significantly since the ECB introduced special liquidity schemes in the wake of the banking crisis.

Most of these bonds are typically held on so-called treasury trading books within banks, which were reluctant to discuss their exposures with **Euromoney**. However, the head of risk at one leading European bank told **Euromoney** that the hedging of sovereign debt price risk was almost non-existent and that that was typical of all European banks, because the cost of risk management using credit default swaps was prohibitively expensive. Some hedging was taking place using interest rate swaps to shorten the duration of the positions, he added.

The banker also noted that, despite the risks European banks are holding, they remain the most likely buyers of Greek bonds, given that Greek banks only hold €40 billion out of €300 billion of outstanding debt, and that pension funds and insurance companies remain overweight and are less willing to participate in future deals.

Graham Bishop argues that, if a country is going to be in the excessive deficit procedure, it should stop being zero risk-weighted and face penalties for failing to behave properly. Given the real risk of a sovereign default in the region, he says it will become harder and harder for finance ministers to tell the banking sector it can lend governments money and book it as zero risk.

"Governments will have to stand by the moral hazard they have recklessly created," he says. "They were warned 20 years ago."

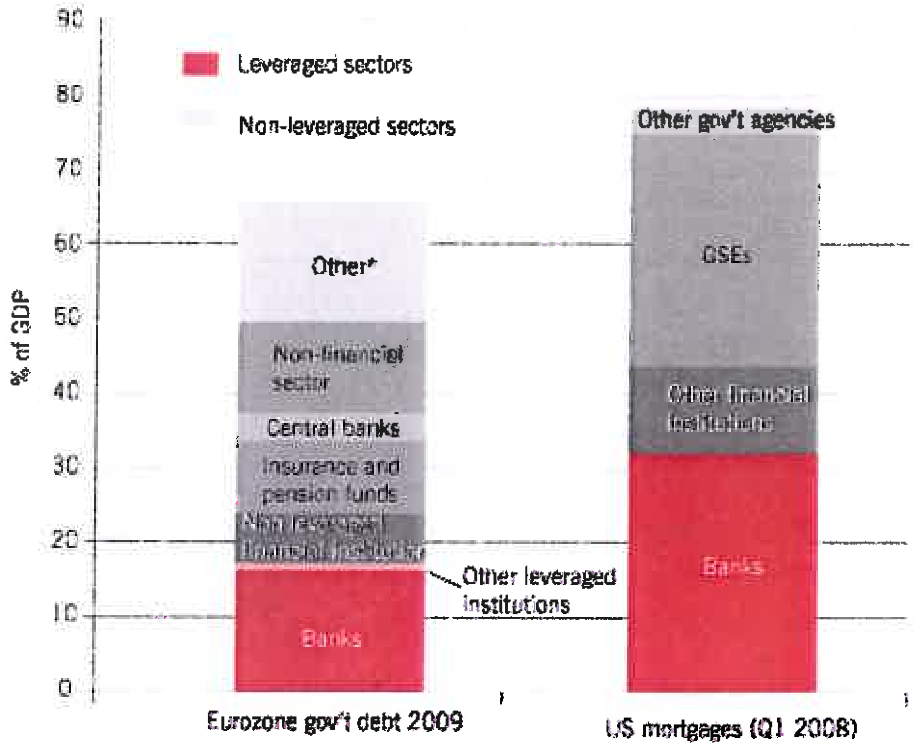
Not as bad as the last one

So what is the unrealized cost of that moral hazard and is it Europe's very own version of the sub-prime crisis?

No, say Goldman Sachs economists Ben Broadbent and Nick Kojucharov. They argue that European banks are less exposed to government bonds than their US counterparts were to the mortgage market. European government bonds constitute 65% of the EU's GDP, whereas the US mortgage market was 80% of GDP in mid-2007. In addition, the banks' market share of government debt is just 25%, compared with the 40% share of the US mortgage market accounted for by domestic banks, according to Broadbent and Kojucharov. Finally, eurozone banks' exposure to domestic sovereigns is around half the face value of the mortgage assets that sat on US banks' balance sheets in 2008.

Both leverage and size of asset base is lower for eurozone than for US sub-prime

*Includes holdings by rest of world and unaccounted sectors



Source: Eurostat, ECB, Goldman Sachs

Broadbent and Kojucharov have attempted to construct a projection – which they warn is far from definitive – in which European banks suffer a similar scale of losses to US banks. They calculate that it would take the default of nearly half the non-German eurozone government debt to equal the hit to US banks' balance sheets.

Investors say such an outcome is highly unlikely, given the lessons learned from the sub-prime crisis. As one puts it, in Donald Rumsfeld speak, we're now in the world of "known unknowns, rather than unknown unknowns".

"The European Union realizes it needs to extinguish the fire early," says BlackRock's Krautzberger. "If you ask any European official what was the biggest mistake in the past crisis they will say letting Lehman default, because that started the domino effect, and for that reason there is a consensus that they have to help."

Another London fund manager sums up the story of European banking sector of the past few years. "There's been an horrendous car crash, the driver is critically injured, close to death, half his family are dead, he's in the hospital bed, but they've now got him out of intensive care," he says. "He's doing not bad, breathing a bit better, and so they've switched off a few machines. But they've switched off one machine too early, and now he's gasping for breath and so they've had to put him back on the machine again."

The risks of liquidity withdrawal

W hat form the banking resuscitation will take isn't clear, given that some of the liquidity programmes and government guarantees imposed by European governments and the European Central Bank begin to roll off this year. The ECB's long-term refinancing operations, which have effectively allowed banks to borrow at 1% and lend to European governments, say five-year bonds, at rates ranging from 2% for Germany and 6.35% for Greece, is set to expire at the end of 2010.

"They're caught between a rock and a hard place. The problem is a lot of the private sector assets have been transferred to the public sector, which is trying to fund those assets. Additionally, governments are having to digest other assets, as bank liquidity programmes mature"

Gregor MacIntosh, Standard Life Investments

The withdrawal of the liquidity facilities threatens to destabilize the banking system again, although most market participants agree that the ECB is aware of this and there is scope to extend the facilities.

"They're caught between a rock and a hard place," says Gregor MacIntosh, head of rates at Standard Life Investments in Edinburgh. "The problem is a lot of the private sector assets have been transferred to the public sector, which is trying to fund those assets. Additionally, governments are having to digest other assets, as bank liquidity programmes mature."

But there is a mismatch in the timing of the funding requirements. With banks still delevering their balance sheets and growth likely to be muted and fragile for some time, national budget deficits are going to remain very high for many years. Hence governments are effectively looking for a new marginal buyer of their large debt requirements, says MacIntosh.

"Further withdrawal of the liquidity will be driven by the underlying market environment at the time," he says. "The ECB is likely to be more pragmatic in future, so if it's very obvious that peripherals are having difficulty accessing the markets, then I think they'll slow the speed of this liquidity withdrawal."

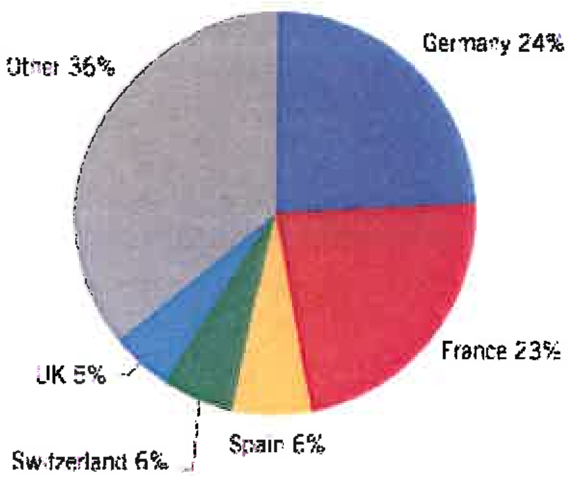
Who made Moody's king?

For Greece, however, there are more immediate concerns. Moody's says that, should the government's austerity implementation fall just short of the promised levels, it will downgrade Greece's rating one notch to A3 in the coming months. But the real kicker comes if Greece achieves only partial implementation of the plan, in which case Moody's says it will cut the rating another two notches to Baa1.

If that happened, Greece would fall below the threshold that makes its debt eligible for collateral at the ECB, when it raises the threshold from Baa3 to A3, at the beginning of next year. Some analysts say the ECB's collateral requirement criteria – particularly its reliance on the ratings agencies, which has now made Moody's the de facto determinant of eligibility for Greece (following downgrades by the two other agencies) – is clearly inappropriate and could lead to a change in the criteria.

Mediterranean Menace

European bank exposure breakdown ($billion)



As of 2009 Q3, includes claims on private and public sectors

Source: BIS

Authorities won't want to change the rules mid-crisis, however, because it would look as if they are reacting to Moody's. Yet that might be exactly what they'll end up having to do later this year, because it remains inconceivable that a sovereign member could lose eligibility.

Moody's concurs. "If the ECB, having lowered the bar, returns collateral arrangements to their pre-crisis state at the end of 2010, and if Moody's lowers Greece's rating below A3, banks wouldn't be able to buy Greek debt and hand it back the ECB," says Pierre Cailleteau, head of sovereign ratings at Moody's. "This is an unrealistic situation that is highly unlikely to happen. Why would the ECB, after having lowered the bar to help the banks, raise the bar and precipitate a systemic crisis in a eurozone member?"

"If we had thought that such a scenario was realistic, then Greece's sovereign bond rating would be several notches lower than it is now to reflect the increase in liquidity risk," says Cailleteau.

Falling prices in the southern European bond markets are likely to hit bank trading books and available-for-sale books (AFS) in the first quarter unless valuations recover, says Francesca Tondi of JPMorgan in London. Bonds held in trading books will likely have a negative impact on profit and loss straightaway, while those classified as AFS or held-to-maturity will only affect banks' bottom lines if there is a credit event such as a default, or a permanent impairment, whereby a negative valuation adjustment is made if the market price remains low for a sustained period, is required, she says.

Still, banks' exposure to the sovereign crisis goes beyond the valuation of bond portfolios. The widening of sovereign credit default swaps has led to a widening of CDS spreads for banks across Europe and a resulting increase in bank funding costs.

Although higher funding costs have yet to kick in for some of the big European banks, Spanish and Portuguese institutions have already been punished. In January, Spain's two biggest banks, Santander and BBVA, issued three-year floating rate notes at between 42bp and 45bp over three-month Euribor. Those same bonds were trading at 85bp and 75bp respectively by mid-February. In Portugal, Banco Comercial Português issued a two-year bond at 72bp over mid-swaps in January; a month later, it was trading at 176bp.

The bank funding time bomb

The contagion that has spread through the southern European banking sector has stunted what is an important year for bank funding, not just because financing has become more expensive, but because of the negative feedback loop into the government bond market.

"Unless we see increased activity in the covered bond and securitization markets, or more appetite for senior unsecured debt – particularly for the second- and third-tier banks in each country – the outlook is bleak"

Allegra Berman, UBS

"This is potentially a time bomb, as financials have been very important investors in their own domestic government bond markets," says Allegra Berman, global head of SSA fixed income at UBS in London. "Unless we see increased activity in the covered bond and securitization markets, or more appetite for senior unsecured debt – particularly for the second- and third-tier banks in each country – the outlook is bleak. The more financials suffer, the more the government bond markets are also likely to suffer, if banks become less supportive in their own domestic government bond paper."

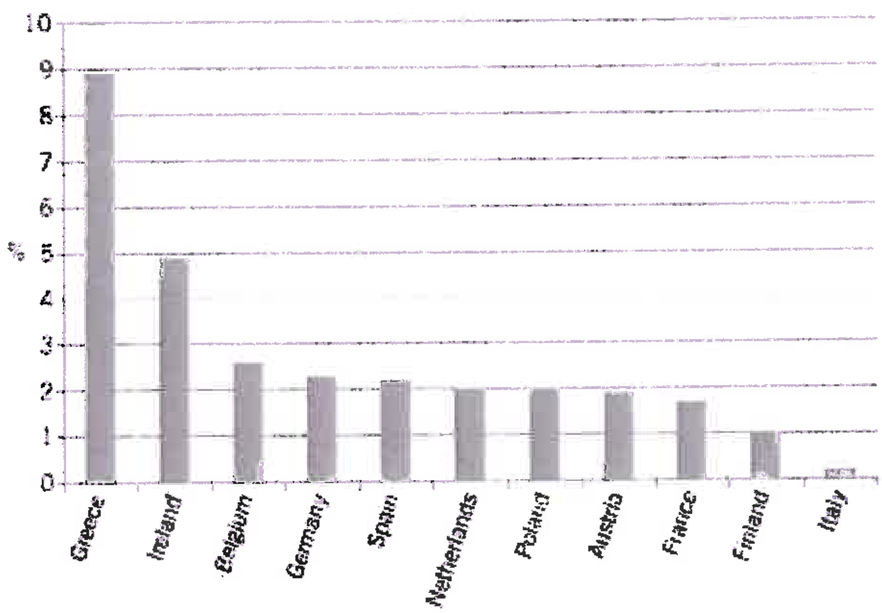
As for covered bonds, volumes have been light in the first few months of the year, with the market closed for most of the peripheral countries, meaning just €38 billion had been issued in the first seven weeks of 2010. It's not a good omen, given that 2010 was supposed to be the year of the covered bond. Forecasters predicted €150 billion of new issuance, after the market slowed last year as it became crowded out by the issuance of government-guaranteed bank debt. And time is running out in terms of any support from the ECB, whose €60 billion covered bond purchase scheme expires in June. As *Euromoney* went to press, €23 billion remained available on the scheme.

Standard & Poor's has revised its covered bond rating methodology by rejigging how it links the bonds' ratings with those of their issuers. That means sovereign jitters could start to seep into covered bonds, say analysts.

Add to that more than €50 billion of subordinated bank debt that matures this year and another $480 billion of senior unsecured debt, and banks face significant challenges in accessing capital markets on economic terms, at a time when there's a mountain of government-guaranteed paper maturing in the third quarter.

European banks rely on ECB

The risks of liquidity withdrawal as % of total bank assets (Oct 2009)



Source: Thomson Reuters Datastream, Credit Suisse, Spanish government

"Obviously we have seen a very substantial amount of government-guaranteed bank issuance and a lot of that matures in the third quarter this year," says Berman. "The worry for financials is that if the covered bond market does not open in a more meaningful way in terms of the volumes and maturities available, and for a wider range of names in more jurisdictions, it's really just the tip of the iceberg."

That raises the question: if the furore over southern European government debt continues and governments don't extend the programme of bank debt guarantees, will banks in the troubled jurisdictions be able to access the capital markets? Already the signs look ominous.

European sovereign bond market faces big test in 2010