The EU Banking System Is In Big Trouble

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The EU banking system is in big trouble. Many of the Union's largest banks are sitting on hundreds of billions of euros in dodgy sovereign bonds and non performing real estate loans. But writing down their losses will deplete their capital and force them to restructure their debt. So the banks are concealing their losses through accounting sleight-of-hand and by borrowing money from the European Central Bank. This has helped to hide the rot at the heart of the system.

Presently, 170 banks are having difficulty accessing the wholesale markets where they get their funding,. Financial institutions are wary of lending to each other because they're not sure who is solvent or not. It's a question of trust.

ECB chief Jean-Claude Trichet has tried to keep the problems under wraps, but markets aren't easily fooled. Stress gauges, like euribor, have been rising for the last two months. Investors smell a rat. They know the banks are playing hide-n-seek with downgraded assets and they know that Trichet is helping them out.

A week ago, stocks rallied on news that EU banks would repay most of the €442bn one-year emergency loan from the ECB. The news was mainly a publicity stunt designed to hide what was really going on. Yes, the banks borrowed significantly less that analysts had predicted (another €132bn), but just two days later, 78 banks borrowed another €111bn. The additional loans makes it look like Trichet cooked up the whole thing to trick investors.

EU banks were engaged in the same high-risk activities as their counterparts in the US. They were playing fast and loose on speculative trades that were ramped up with maximum leverage. Bankers raked in hundreds of billions in salaries and bonuses before the bubble burst. Now the securities and bonds they purchased have plunged in value, so they've turned to the ECB for a bailout. Sound familiar?

Trichet is a banking industry rep, much like Geithner and Bernanke. His job is to maintain the political and economic power of the banks and to dump the losses onto the public. Presently, the ECB provides "limitless" loans to underwater banks so they can maintain the appearance of solvency. Trichet has lowered rates to 1 percent, provided a safe haven for overnight deposits, and begun an aggressive bond purchasing program (Quantitative Easing) which keeps prices of sovereign bonds artificially high. Valuations on bank assets are supported by a central authority and do not reflect true market pricing.

The wholesale-funding market (repo) has not shut down. Banks can still exchange their sovereign bonds and real estate securities for short-term loans. It merely requires that they take a haircut on the value of their collateral, which would then have to be recorded as a loss leaving them capital impaired. This is how markets work, but the banks are not required to play by the rules.

From Bloomberg News: “European lenders had $2.29 trillion at risk in Greece, Italy, Portugal and Spain at the end of 2009, including loans to governments, according to the Bank for International Settlements…German banks’ writedowns on loans and securities will probably reach $314 billion by the end of 2010, with state-owned lenders and savings banks facing the bulk of the losses, the International Monetary Fund said in a report in April.”

See? The ECB is not buying Greek bonds because of a “sovereign debt crisis”. They are buying them so the banks won’t lose money. The “sovereign debt crisis” meme is all public relations hype. If it becomes too expensive to fund government operations, Greece can leave the EU and return to the drachma which would give it greater flexibility to settle its debts. That would increase demand for Greek exports and improve tourism. This is the best solution for Greece. So, where’s the crisis?

If Greece, Portugal and Spain, leave the EU and restructure their debt, banks in Germany and France will default and bondholders will lose their shirts. In other words, the investors, who took a risk, will lose money—which is how the system is supposed to work.

Bloomberg again: “The region’s banks have written down a proportionately lower percentage of their assets than their U.S. counterparts. U.S. banks will have written down 7 percent of their assets by the end of 2010 and euro-area banks 3 percent, according to the IMF. European banks still haven’t shown analysts they have completed their writedowns.” (Bloomberg)

So, the banks are underwater, but nothing has been done to fix the problem. Where are the regulators?

On Tuesday, euribor hit a 10-month high. The pressure is building despite Trichet’s emergency programs. ECB bank lending is nearly €800bn while overnight deposits are roughly €240bn. Trichet is willing to drag the EU through 10 or 15 years of subpar growth and high unemployment (like Japan) to keep a handful of bankers and bondholders from accepting their losses. If things get bad enough, Trichet might invoke the “nuclear option”, that is, allow a major bank to implode “Lehman-style” so he can extort hundreds of billions of euros from the EU member states. It’s been done before; just ask Bernanke or Paulson.

The “Stress Test” Fraud

The bank stress tests in the US were organized by the Treasury as a “confidence-building” measure. They allowed the banks to use their own internal-models to determine the value of complex securities. The same rule will apply to EU banks. The Daily Telegraph reports that some of the banks will actually test themselves. As least that removes any doubt about the results.

From Bloomberg News — “European stress tests on 91 of the region’s biggest banks drew criticism from analysts who said regulators are underestimating probable losses on Greek and Spanish government bonds. The tests are designed to assess how banks will be able to absorb losses on loans and government bonds, the Committee of European Banking Supervisors said yesterday. Regulators have told lenders the tests may assume a loss of about 17 percent on Greek government debt, 3 percent on Spanish bonds and none on German debt, said two people briefed on the talks who declined to be identified because the details are private.

Credit markets are pricing in losses of about 60 percent on Greek bonds should the government default, more than three times the level said to be assumed by CEBS. Derivatives known as recovery swaps are trading at rates that imply investors would get back about 40 percent in a Greek default or restructuring." (Bloomberg)

The tests are a joke. The banks will continue to use accounting-rule changes and other gimmickry to obfuscate their losses. Trichet will use the tests to step up his bond purchasing program (QE) which will transfer the banks losses onto the member states. Many of the banks are insolvent and need restructuring. But they are in no real danger, because they still have a stranglehold on the process.

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