ECONOMIC RESEARCH & CORPORATE DEVELOPMENT

Financial Market Outlook

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Heading for the next banking crisis?

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HEADING FOR THE NEXT BANKING CRISIS?

Executive summary

- Banks are plagued by the "Greek factor": Fears of further write-downs on government debt weighs heavily on European banks.
- Consequences for banks: No liquidity crisis – the ECB acts as back-stop liquidity mechanism – but elevated funding costs for term debt and capital: profit squeeze inevitable.
- Consequences for the economy: As banks' balance sheets have already improved considerably (more capital and deposits, less inter-banking business), a full-blown credit crunch is not on the cards but credit supply remains feeble – like demand from over-indebted private households and cash-rich companies.
- Consequences for policymakers: Despite fresh calls for renewed support for banks such as guarantees or public re-capitalization, such a strategy is not very promising; a better and more efficient way to stabilize the banking system is to finally curb the sovereign debt crisis.

1. Indicators point to rising stress

Two worries are engulfing European banks:

- Interbank lending is starting to freeze up again
- Investors are shunning banks

Indicators of the potential for another interbank lending freeze are many: growing use of the ECB's overnight deposit facility, higher borrowing from the ECB by peripheral banks, less buying of European banks' commercial paper by US money market funds and, last but not least, a rising Euribor-OIS spread.

That investors are turning away from banks is reflected in falling stock prices, rising interest rates and CDS spreads, and falling debt issuance.

The fear is that these funding constraints could spark another credit crunch – with a devastating impact on the rest of the economy, similar to the situation after Lehman's collapse.

2. This time is different

Are these fears justified? No and yes. A replay of the Lehman disaster is not on the cards, but the long-term challenges for the banks seem even bigger.

To the first point: It cannot be denied that banks from peripheral countries face difficulties in the interbank market. But it no longer matters. Even if interbank lending freezes up again as

banks refuse to lend to each other, there will always be enough funding – from the ECB. A pragmatic ECB has taken over the role of the interbank market. It can even displace US money market funds and provide dollar liquidity to European banks, if necessary.

In fact, stress indicators like the higher use of the ECB's overnight deposit facility are not flagging up a liquidity shortage but signaling that there is *too much* liquidity. Of course, this is the intended consequence of the ECB's liquidity measures. Even the rising Euribor-OIS spread is proof of *too much* liquidity: The spread has not risen because of higher Euribor rates (this would indeed be a sign of banks desperately seeking short-term funding) but because of falling OIS rates. In other words: What we are seeing is no longer the illness of the banking system itself but rather the impact of the medicine that the ECB is administering. But, of course, the fact that the ECB is forced to apply its medicine in such big doses is an indication that something is amiss in the European banking system.

That brings us to the second point. Investors have a reason to turn away from banks. This has less to do with the deteriorating economic outlook but more with the "Greek factor". Since Lehman, the golden rule of finance markets had been: Creditors have nothing to fear. There will always be a bail-out, with taxpayers' money. Even the holders of senior debt of the hapless Irish banks did not lose a cent. But since July 21, the latest eurozone summit, the rules of the game have changed. Now, politicians talk of "bail-ins" which means the participation of creditors in rescue operations. The new mantra is: there could always be a write-down.

Unfortunately, banks are by definition the biggest group of creditors for any debtor, private or public. It speaks for itself that the ECB, as the guardian of financial stability in the eurozone, fought tooth and nail to ward off the new rule. Without much success. As a consequence, the drawn-out process of normalization in the banking sector, which led to the re-opening of short- and long-term funding markets, has been brought to an abrupt halt.

3. Change in the banking sector

From a banker's perspective, this is a hugely disappointing development because banks had indeed used the years since Lehman to tidy up their balance sheets. The progress seen is pretty remarkable. Not so much in terms of size – balance sheets declined by only 2.6%, although the drop as a percentage of GDP is more impressive, from around 350% to 335% – but in terms of composition. Looking at the balance sheet developments of eurozone banks (see following charts and appendix), four general trends stand out:

First, activities between financial institutions have been sharply reduced, on the assets as well as on the liabilities side. This reverses the trend before the financial crisis when assets, such as mortgage loans, were used and reused many times over to create new trading and hedging opportunities, balance sheets mushroomed, and the financial sector more or less decoupled from the real economy.

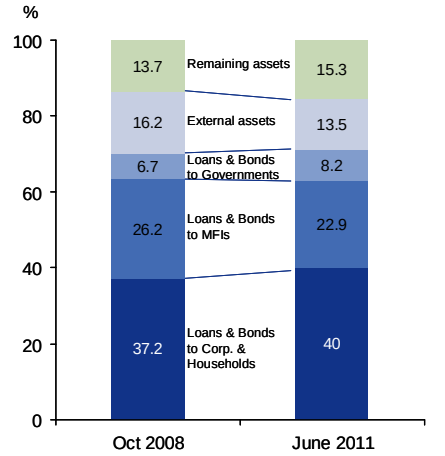
Second, external assets and liabilities (i.e. cross-border business to non-euro area residents) have been slashed. This refers to a large degree to US activities, particularly to (indirect) exposures to the US mortgage market.

Third, banks are "reconnecting" again with the real economy. The focus of business is shifting back towards the more traditional banking practice of attracting deposits and acquiring, holding and monitoring loans from the real economy, i.e. companies, private households, and the state.

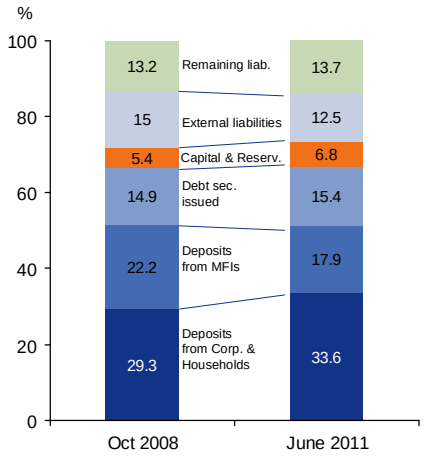
Fourth, balance sheets have been strengthened as banks have increased their capital and reserves: Since Lehmann, this liability class has grown by 23%. This is evidence of the deleveraging process which has (until now) not so much resulted in shrinking overall balance sheets but first and foremost in higher capital ratios.

Euro area MFIs: Balance sheets

Assets
Asset classes in % of total assets



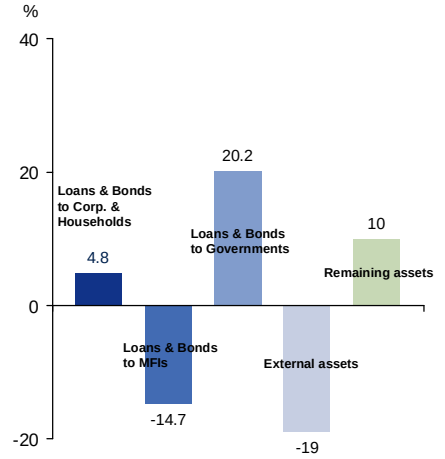
Liabilities
Liability classes in % of total liabilities



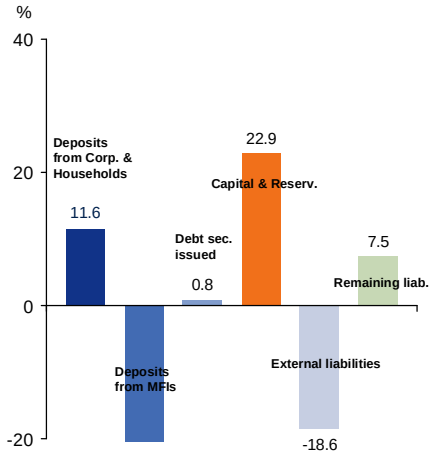
Sources: ECB, own calculations.

Euro area MFIs: Balance sheets

Assets
Growth of assets classes from Oct 2008 to June 2001, in %



Liabilities
Growth of liability classes from Oct 2008 to June 2001, in %



Sources: ECB, own calculations.

4. Banks' Achilles' heel

But the process of "banking normalization" has a snag. Europe's banks – as before them Japanese banks in a similar situation – piled into supposedly safe assets: government bonds and loans (a process that was also directly encouraged by new banking regulations). As a consequence, exposure to sovereign debtors jumped by 20%. This is now backfiring. With investors casting doubt on the solvency of some eurozone members, they automatically also start to question the viability of banks, for two reasons: banks are holders of large amounts of government debt and banks' ratings are usually linked closely to that of their own sovereign. The ramifications for banks are – similar to the situation of the affected sovereigns – elevated funding costs.

The timing could not be worse. According to the ECB, the share of term debt to be rolled over by end-2012 is around 30% of the debt outstanding. Moreover, new Basel requirements for capital and stable funding will require banks to raise fresh capital and issue more medium-to-long term debt.[1] After Lehman, when banks also needed fresh capital and stable funding, public money – from guarantees to capital injections – was plentiful, queuing up to plug the holes. Not so this time. Government coffers are empty, new rounds of large-scale bank bail-outs with taxpayers' money are unlikely, except for the most egregious cases like Greek banks. Any calls for new Europe-wide blank guarantees of bank term debt defy the political reality.

5. How to help the banks without money

So, is there nothing policymakers can do to help the banks, except for the ECB flooding the banking sector with liquidity?

In a sense, today's state of affairs is a mirror-image of the situation after Lehman. Then, losses resulting from the subprime and securitization debacle were a done deal; but what was unclear was the exposure of each bank to these toxic assets. Today, write-downs on government debt are far from clear (except for the case of Greek bonds) but the exposure of each bank to these assets is there for all to see, thanks to the last round of the European banking stress test.

Then, governments' task was to make sure that banks could withstand the losses. Not knowing which banks were most exposed, they offered a wide range of public support to all of them. Today, such a policy would be futile. A default of, say, Italy would be financial Armageddon. Bolstering capital buffers to hold out against such a shockwave would be like re-arranging the deckchairs on the Titanic.

Governments should instead remove the risk that such an outcome could ever happen. In other words, they have to quash the probability of sovereign default in the eurozone, eliminate the Greek factor and return to the status quo ante. That requires an efficient crisis management mechanism to stop contagion. Only then, will investors' distrust towards banks be lifted.

[1] According to the IIF, the higher amount of capital required could be more than two trillion dollars; new liquidity ratio requirements under the net stable funding ratio could amount to more than three trillion dollars of medium-and long-term debt. Both figures are global estimates.

There are already some ideas on the table how policymakers could put the EMU back on a stable footing, ranging from the ominous Eurobonds over a larger, bank-like EFSF to our proposal of a European Sovereign Insurance Scheme (ESIM). However, taking the track record of the first 18 months of the euro crisis as a gauge, unfortunately, the assumption seems realistic that Europe's policymakers will continue to muddle through rather than take the bull by the horns and enact bold decisions.

The implication for banks: The headwind of mistrust will continue to blow strongly for the time being. Given their exposure to government debt, there is no easy way out. Banks have to bite the bullet and accept higher funding costs. A profit squeeze seems unavoidable. In fact, banks have already launched big cost-cutting efforts, slashing their workforce and announcing mass layoffs.

6. Implications for the economy

Of course, banks will try to ease their funding constraints by reducing their balance sheets which are still very large. This could impact the supply of credit for the real economy; for a start, lending conditions are set to become tighter again. But a full-blown credit crunch is not in the making. Two arguments speak against it:

- Only 40% of eurozone banks' total assets are loans to the real economy (excl. the state); 84% of them are financed by deposits. If banks want to shrink their balance sheet, they have plenty of other assets which are riskier and / or have lower margins.

- Funding constraints in the market for term debt and capital have only a slow-moving impact on lending decisions. As there is no sudden ebbing away of liquidity there is also no abrupt halt in the credit supply.

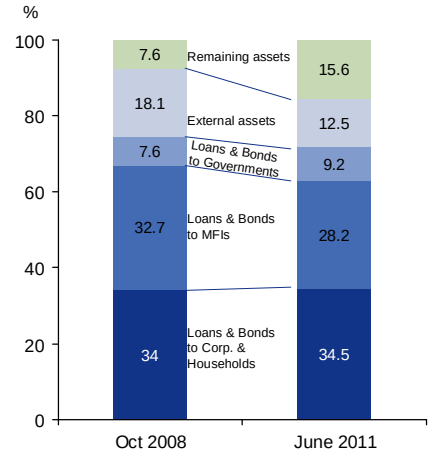
Nonetheless, the role of banks will tend to place a drag on the economy. But against the backdrop of the "New Normal" this matters less than in former times. No one is hoping for a credit-fueled boom any longer. On the contrary, with private households having to repair their own overstretched balance sheets and many companies sitting on big cash piles, demand for credit will remain subdued for the time being. As the latest recovery was not driven by bank credit but rather by fiscal stimuli the next downswing will not be triggered by less bank credit but rather by public belt-tightening and uncertainty over the outcome of the euro sovereign debt crisis.

The bottom line: After Lehman, governments around the world did a terrific job in supporting banks, leading to an astonishingly quick recovery of banks (also in terms of profits and bonuses). This time around, the ineffective efforts to solve the euro crisis let the banks down. Now, they have to bear the brunt. At least, with the ECB acting as a back-stop funding mechanism, credit supply to the real economy is not in jeopardy. Banking woes add to the bleak economic outlook but they are not the main culprit. A larger scale banking crisis must be avoided. That will require decisive action by policymakers to finally curb the sovereign crisis.

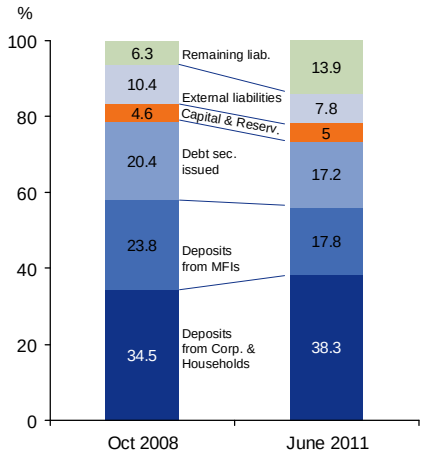
Appendix : Balance sheets of German banks

German MFIs: Balance sheets

Assets
Asset classes in % of total assets



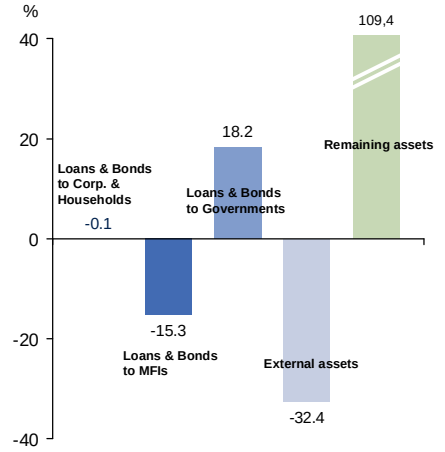
Liabilities
Liability classes in % of total liabilities



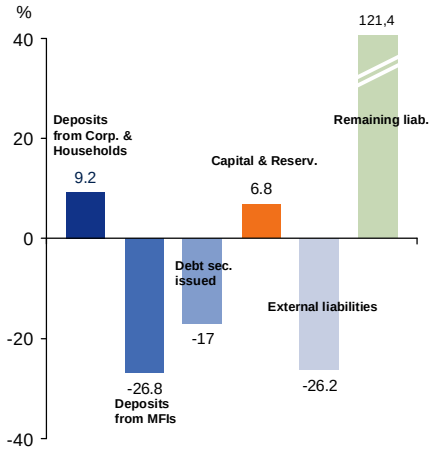
Sources: ECB, own calculations.

German MFIs: Balance sheets

Assets
Growth of assets classes from Oct 2008 to June 2001, in %



Liabilities
Growth of liability classes from Oct 2008 to June 2001, in %



Sources: ECB, own calculations.

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