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Global

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Bank woes in Europe go beyond southern tier

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Major lenders in France
and Germany are also
exposed to shaky debt

BY JACK EWING
AND DAVID JOLLY

Five years after the financial crisis began, many banks throughout the euro zone are still in a weakened state, cut off from money markets because investors do not trust them, and effectively on life support from the European Central Bank.

While the talk has been mostly about Spain and Cyprus, European leaders meeting in Brussels on Thursday and Friday must confront broader problems in the banking system if they want to stabilize the euro zone, economists say.

What country could be next to face a banking crisis? It may not be one of the usual suspects. If the key elements are banks with exposure to declining economies, thin capital cushions and a government that would be stretched to finance a bailout, even France could be vulnerable.

Three of the four largest French banks had capital shortfalls even by the relatively lenient standards applied by European regulators, and the fourth has suffered a 27 percent share decline so

far this year because of its exposure to Greece.

Germany, considered the strongest economy in the euro zone, is still dealing with publicly owned landesbanks that made bad investments in boom times. Even Deutsche Bank, the country's largest, faced a downgrade by Moody's last week because of what the ratings agency said was too much dependence on trading revenue.

"The weakness is throughout the euro zone," said Marie Diron, an economist who advises the consulting firm Ernst & Young. "Restructuring of the banking sector really hasn't taken place to the same extent as in the United States."

The meeting in Brussels comes a few
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Europe's banking woes extend far beyond Greece and Spain

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days after Spain and Cyprus formally requested aid for their troubled banks.

But the usual north-south divide that characterizes these meetings may not be as clear-cut when banks are the issue. Germany and Austria also have many ailing banks that are exposed to stricken euro zone countries like Spain and Italy, though they have stronger economies and their governments are in a better position to provide aid.

Indeed, one reason Greece and other countries have debt troubles is because banks in Germany and France were all too willing to extend credit.

The talks in Brussels could lay the groundwork for a so-called banking union, with centralized bank regulation and deposit insurance. Proponents say that a central regulator, possibly the E.C.B., might be more willing than national regulators to require weak banks to confront their problems and make changes.

"It is huge progress that everyone now is talking about banking union when nobody was two months ago," said Nicolas Véron, a senior fellow at Bruegel, a research organization in Brussels. "There is no longer denial of one of the core components of the crisis."

But the and other analysts are skeptical that political leaders will be willing to expose their countries' financial institutions to greater scrutiny. Stress tests have so far failed to restore confidence in European banks because there is a perception that the national authorities tried to protect their own institutions.

"There has been a large political dimension," said Harald A. Benink, a professor of banking and finance at Tilburg University in the Netherlands.

Mr. Benink is chairman of the European Shadow Financial Regulatory Committee, a group of university professors who on Wednesday said that the European Stability Mechanism, a euro zone bailout fund, should be given power to recapitalize banks directly and negotiate restructuring plans. That approach would bypass politicians.

Euro zone banks were supposed to be

fixed by now. Last year, the European Banking Authority assessed whether banks had adequate financial buffers, and pressured those that did not to raise more capital. The deadline for the banks to comply is this week.

Many of the top names in European finance are on the list, including Germany's two biggest banks, Deutsche Bank and Commerzbank. Both lenders said they raised the required capital well before the deadline.

Three out of four of France's biggest banks also made the list: Société Générale, BNP Paribas and Groupe BPCE.

Executives of the banks maintain that they have made huge progress reducing risk, increasing capital and raising funds they can lend on to credit-strapped European businesses.

"I think it's fair to say we've made an effort to get ahead of the curve," said Lars Machenil, chief financial officer of BNP Paribas.

Société Générale "is more solid now than we were a year ago, in a world that is just as difficult as it was then," the bank's chief financial officer, Bertrand Badré, said. "We have ample liquidity and have no trouble funding ourselves."

Christophe Nijdam, a banking analyst at AlphaValue in Paris, agreed that the major French banks were in better shape than they were in the second half of 2011, when U.S. money market funds effectively cut them off from wholesale lending.

"They went on a fast diet, because they didn't have any choice," Mr. Nijdam said. "They were like a rabbit caught in the headlights, mesmerized by the liquidity crisis."

But financial indicators show that European banks remain under a cloud. The interbank market, in which banks lend excess cash to each other for short periods, is crippled because banks doubt each other's creditworthiness.

Lending to banks in the euro zone fell by \$364 billion, or 5.9 percent, at the end of 2011, the largest drop since the end of 2008, according to the Bank for International Settlements. In another sign that

banks are afraid to lend to each other, they have been parking near-record sums at the E.C.B., collecting a meager 0.25 percent return on the money.

On Tuesday, banks stashed €747 billion, or \$931 billion, at the E.C.B. That was below highs of over €800 billion earlier this year but still well above normal.

"Banks have basically stopped trusting each other," Mr. Véron of Bruegel said.

While countries like Greece and Spain often face criticism for a lack of prudence that got them into trouble and caused the euro zone crisis, French and German banks were the enablers. During the boom years before 2008 they made huge loans to countries in Southern Europe, and today many banks remain vulnerable to the problems of those countries.

Private and public borrowers in Spain still owed €115 billion to French banks at the end of 2011, according to the Bank for International Settlements. Italian borrowers owed €332 billion to French banks and Greek borrowers owed an additional €44 billion.

Crédit Agricole, the one French bank to get a clean bill of health from the European Banking Authority, has suffered a 27 percent plunge in its share price this year, much more than its peers, because investors worry about its exposure to Greece, where it has a large subsidiary.

Crédit Agricole and BNP Paribas both have large operations in Italy, another country contending with big debt and bank problems.

German banks are less exposed to Greece, but are owed €134 billion by Italian borrowers and €146 billion by Spanish customers.

Economists say that regulators need to conduct a rigorous triage to separate healthy banks from those that need to be restructured and those that are mortally wounded.

At the end of this week, WestLB, once Germany's third-largest bank, will

provide a rare example of an ailing bank that is being broken up.

Under pressure from E.U. competition authorities, the bank's toxic assets have been moved into a so-called bad bank, another part of the business has been sold and the remainder will continue to operate under the brand name Portigon.

More banks will probably have to undergo a similar process before the system is healthy again. But that will happen only if control is wrenched from the local authorities, said Xavier Vives, a professor of economics and finance at IESE Business School in Barcelona.

"What Europe has lacked is a clear line of authority," Mr. Vives said. "A crisis needs much faster and coherent reactions."

"The Spanish banking system," he said, "is not the only one which has problems."