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# **A Lack of Lending at European Banks Increases the Fear of Stagnation**

By **JACK EWING**

FRANKFURT — This was supposed to be the month that European banks went back to debt markets to refill their coffers. It is not working out that way.

On the contrary, debt issuance by banks has slowed to a trickle at the same time that short-term interbank lending is drying up. The financing drought raises questions about whether banks will have enough money to refinance their own long-term debt and still meet demand for loans.

Less lending could further depress growth in Europe, which is already teetering on the edge of recession. “The euro zone economy has stalled and as the recent financial stresses feed into the real economy, it is likely to get worse still,” analysts at HSBC wrote in a note to clients on Thursday. A release of data showed that pessimism among manufacturers had reached levels not seen since the 2009 recession.

The fund-raising problems at banks stem directly from the sovereign debt crisis, which is having an insidious effect in a few ways.

Not surprisingly, investors are wary of banks that could suffer losses if Greece defaults on its debt, as seems increasingly likely. But the crisis has also raised doubts about the underlying health of the European banking system and whether governments would be able to step in to rescue their banks if there were another financial catastrophe.

“Banks certainly do not have enough capital in relation to their government bonds,”

said Dorothea Schäfer, an expert in financial markets at the German Institute for Economic Research in Berlin. She has calculated that the 10 largest German banks would need to raise 127 billion euros (\$171 billion) to bring their capital reserves to 5 percent of gross assets — a level she considers barely adequate.

“That could substantially heighten trust, I would even say would bring it back,” Ms. Schäfer said. But raising that additional capital would be politically perilous because it would probably require another taxpayer-financed bailout. Many of the banks that need capital are already owned by government entities and, because they are not listed on stock markets, cannot sell shares to increase their capital.

The banking industry is also fighting requirements that would require them to keep more ample reserves, which would cut into profits.

According to the standard used by regulators, banks are much better capitalized than they were in 2008. Banks in Europe had so-called core Tier 1 capital — the most durable form of reserves — equal to 10.6 percent of their assets at the end of June, according to calculations by analysts at Nomura. That compares with a previous low of 6.4 percent.

For that reason, some analysts say that the alarm about bank financing is overblown.

“I don’t think we’re overly concerned yet,” said Jon Peace, a banking analyst at Nomura. But he added, “Definitely we are watching the data week by week.”

He said that banks in Northern Europe, where government debt is less of a problem, were having an easier time raising money.

Ms. Schäfer said, though, that current measures of capital reserves were “useless” because they did not capture the risk from holdings of government bonds, which the [International Monetary Fund](#) this week estimated at 300 billion euros for European banks.

Regulations still treat European government debt as if it were risk-free, though it obviously is not. As a result, banks are not required to set aside extra capital to cushion against a government default. And holdings of government bonds are excluded from the calculation of capital ratios.

Sophisticated investors are aware of these shortcomings, which helps explain the

drop in debt issuance recently. Since July, sales of bonds and other debt instruments have plummeted 85 percent compared with sales in the period a year earlier, according to Dealogic, a data provider in London.

“A lot of money has been lost,” said Kenneth Rogoff, a Harvard professor and former chief economist at the I.M.F., during an appearance in Frankfurt on Thursday. Greek default is inevitable, said Mr. Rogoff, author of a history of sovereign defaults. “Banks and governments may not have put it in their books,” he said of the losses, “but it’s gone.”

Though September is not yet over, it is clear that issuance will be well below levels from earlier this year, denying banks one of their main sources of financing. Through Thursday, Dealogic recorded a meager 2.6 billion euros in debt issues. That compares with 6.2 billion euros for all of August and 65.5 billion euros in January, the most active month for bond issues this year.

The plunge in bond issues by banks is happening at the same time that European financial institutions are having trouble borrowing from one another at reasonable rates on the open market. As a result, bank borrowing from the [European Central Bank](#) — the lender of last resort for euro zone banks — surged again this week.

In another measure of banks’ suspicion of one another’s creditworthiness, a closely watched measure of interbank stress, known as the Euribor-OIS spread, rose to its highest level since March 2009, according to Bloomberg data. The cost for European banks for financing in dollars rose to near the highest level in almost three years.

It is the nature of the interbank market that just a whisper of doubt about a bank’s solvency can be enough to keep lenders away, and lead them to the central bank loan window.

“Nobody really wants to lend to anybody where there is the slightest doubt,” said one banker in Frankfurt involved in fixed-income markets, who spoke on the condition of anonymity to avoid offending clients. “Any counterparty where the market suspects underlying problems will have trouble finding liquidity from sources other than the E.C.B.”

In what investors take as a particularly bad sign, a small number of banks have also been borrowing emergency dollars from the central bank. That raises questions about

whether some large European banks are having trouble refinancing assets in the United States, a problem disturbingly reminiscent of the 2008 financial crisis.

Shares of French banks have been hit particularly hard because of perceptions that they are not prepared for potential losses on their holdings of Greek debt. Last week, the French bank BNP Paribas denied a report in *The Wall Street Journal* that it had run into problems obtaining dollars on the market. The central bank closely guards the identity of borrowers.

Regulations allow banks to ignore market movements in the prices of sovereign bonds, classifying the bonds as long-term holdings and pretending that governments will always pay the promised interest and principal.

But those bonds may still represent a continuing liability to banks, and another source of market nervousness.

Many banks may have borrowed money in the short term to buy the bonds in the first place — for example, taking out a three-month loan to buy a bond that matures in 10 years. This is a common practice known as maturity transformation. In good times, banks can profit from the difference between short-term and long-term interest rates. But it means that banks must continually refinance the original purchase price of the bond. Without financing, or enough capital to absorb the loss, a bank can go broke.

Those bonds are worth less today in another way. Government debt is the most common asset banks use as a collateral to obtain loans in the so-called repo market, which is another crucial source of financing. But lenders have become less willing to accept European bonds except at a discount to their face value, if at all.

Use of Greek, Portuguese and Irish bonds as collateral in the repo market fell by half in the second half of 2010 compared with the amount in the period a year earlier, as markets imposed steep discounts, according to a study by Michael Davies and Tim Ng at the Bank for International Settlements in Basel, Switzerland.

Adding yet another layer of uncertainty, the debt crisis has undermined the longstanding assumption that governments will step in if their domestic banks get in trouble. Lenders have begun to wonder if countries like Italy — which already has one of the world's highest debt burdens as a percentage of its economy — would even be able to.

In the B.I.S. study, which was published this week, Mr. Davies and Mr. Ng warned: “Sovereign credit risk and its implications now pose a significant and urgent challenge to banks.”