Waiting for the big one

Where do Europe's money-market jitters sit on the financial Richter scale?

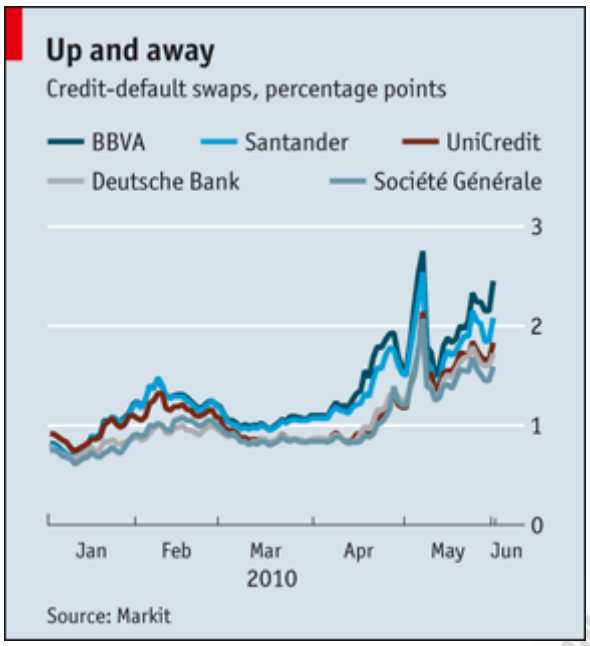
IF YOU live in San Francisco you get used to the tremors. In banking, however, every shake and jerk still feels like it might herald another devastating earthquake. Investors are nervous and regulators are too. Monitoring risk in the financial system was once a job for officials thought to be too dull for monetary policy. Now financial seismology is where it's all at.

When all three of the most-watched gauges of stability in banking deteriorate, as they did in Europe in the last week of May, there is naturally a rush to sound the alarm. Nerves had already been frayed by the Bank of Spain's seizure of CajaSur, a savings bank, on May 22nd (despite the central bank's efforts to telegraph this for months). Ratings downgrades of assets guaranteed by Spain's central bank didn't help either.

The first of these unsettling gauges is the rate at which banks are willing to lend to one another, known as LIBOR (London Interbank Offered Rate). As of June 2nd the three-month dollar LIBOR rate had more than doubled to above 0.5%, a level last seen a year ago, after lounging comfortably for months at about 0.25%. It continues to edge up, albeit at a slowing pace. Futures markets suggest that it may yet double again before the end of the year. Analysts at Citigroup reckon that LIBOR could triple to 1.5% over coming months as markets price in the risk that banks may suffer losses on some of their holdings of government bonds.

The second alarm is the widening in the spread between LIBOR and the relatively risk-free interest rate known as OIS (overnight indexed swap). In May it tripled to above 0.3 percentage points, suggesting that banks are hoarding cash rather than making it available on the interbank market. A rise in either LIBOR or its spread over OIS is unsettling. When both go up together they suggest that the delicate strands of trust that underpin the financial system are again beginning to fray.

The final signal is in the credit-default swaps (CDS) market, a measure of the price paid to insure debt issued. CDS spreads on even the biggest banks have also surged in recent days (see chart), indicating the risk of default, while low, has risen. For a few smaller European banks these spreads are at scary levels.



So far these are tremors, not quakes. Both LIBOR and the OIS spread would have to rise by about ten times before reaching the levels they did when Lehman collapsed. And although CDS spreads are rising, they remain lower than they were before the bail-out of Greece was announced. The financial system has been strained, but it has not broken down.

That partly reflects the extraordinary help that the European Central Bank and other central banks are still offering. The ECB is providing at least €800 billion in loans to banks, much of it in exchange for slightly soiled government bonds and other dubious assets. Even as central bankers worldwide talk of withdrawing the special liquidity programmes put in place during the crisis, this amount has been creeping up from nearer €700 billion at the beginning of the year, according to Alastair Ryan, an analyst at UBS.

Southern discomfort

Just how dependent firms in southern Europe are is hotly debated. One executive at a rival big bank nearer the North Sea than the Mediterranean laughs at the idea that Spain's big firms can fund themselves without support. Spanish officials, though, insist their banks have not tapped more than their normal share of ECB borrowing, and that the big two firms are able to raise money from markets at a sensible price. They dismiss the rumours as ridiculous.

Part of the funding jitters reflects the remote but higher risk that the government of a big European economy, such as Spain, might default. This would be a calamity for European banks. But the nervousness also reflects the widespread belief that European banks have been slow to recognise losses on private-sector assets.

The numbers are certainly large. The ECB recently estimated that euro-zone banks would take €123 billion of charges against loans this year. However, it reckoned this might be partly offset by profits from securities whose prices are recovering. And, in any case, that figure needs to be put in the context of a very big banking industry, with a lot of underlying profits, especially when compared with America's. In 2009 euro-zone banks absorbed similar bad-debt costs to those expected this year while still making a net profit, and thus replenishing capital.

Yet it's hard to ignore the worries of the past two weeks. Some banks are becoming dangerously addicted to the medicine the ECB has been administering. They can easily borrow from the ecb and then invest the proceeds in higher-yielding government bonds. Mr Ryan of UBS, reckons this "carry trade" may account for as much as 40% of the profits posted by some

smaller Spanish banks and 20% at bigger ones. Banks have also reduced the maturity profile of their own borrowing, rather than paying higher rates for safer longer-term funds. When all banks make the same decision this is a form of collective madness because it makes the system vulnerable to market disruptions. Moody's, a ratings agency, notes that the average lifespan of new bank debt has fallen to its lowest level in at least 30 years.

Most of all, even if the system is solvent, individual firms might not be—as the implosion of some of Spain's savings banks highlights. Europe has dodged a big crisis this spring but still needs to put in place resolution regimes for failing banks, wean firms off volatile short-term funding and publish stress tests on individual banks (as America did, giving confidence a powerful boost). Until it does, it will be hard to ignore even the slightest tremor.

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