More stress ahead

It will take more than stress tests to resolve European banks' funding problems.

THE empty condos may have been in Florida and the mortgages that financed them repackaged on Wall Street, but it was banks in Europe that got hit first by the subprime crisis. On August 9th 2007 the European Central Bank (ECB), not the Federal Reserve, stunned the financial world by making the first giant emergency loan to banks. Europe's banking system relied more than any other on fickle borrowing markets that had dried up. Whatever the merits of their recent stress tests, that ongoing flaw explains why Europe's banks may still battle to finance themselves.

Some firms are still being stigmatised, and have to borrow from the ECB even as American rivals have been weaned off public money. The unspoken assumption of the regulators' stress tests, the results of which were announced on July 23rd, is that this is due to "one-off" problems: the risk that some governments in the euro zone might go bust and the perception that the murkier bits of the system, particularly unlisted banks in Spain and Germany, are hiding their risks. If reassured that banks have enough capital and are not fibbing, the logic goes, investors will start lending freely to them again. After all, the stress tests in America in 2009 helped restore confidence there.

Judged on this basis, the tests get half marks (see article). They do not prove that banks could withstand another severe shock. The worst-case scenario envisions that banks' capital ratio falls by only one percentage point, to 9%. Yet typically banking crises eat up some four percentage points in net losses; America's tests assumed a three-point hit over two years. On the plus side, the tests have at least led to lots of new disclosure, which should reassure investors that there are no ticking bombs at individual firms.

Even confident investors, however, may balk at how much debt they will soon be asked to buy. Euro-zone and British firms have €3.3 trillion of bonds to refinance by 2015, three times more than America's banks. That reflects in part the European banks' greater size, but also the fact that many countries have more loans than local deposits and some banks' habit of owning dollar-denominated assets without gathering dollar deposits to fund them. In the boom it was easy to fill the gap by tapping American money-market funds or securitisation markets. But they won't recover their appetite any time soon. Making matters worse, some banks are now competing against their governments, which need to sell piles of debt too.

Please, sir, can I have a lot more?

How firms cope with this funding crunch depends partly on their government's muscle. Germany's medium-sized banks, for example, are weak and have big refinancing needs, but can still borrow at very low rates because investors reckon the state has the strength to back them. Now that the draft "Basel 3" rules on banks' funding have also just been watered down, these firms may be able to carry on much as before.

That luxury does not exist in countries with weaker public finances (such as Spain) or with supersized banking systems too (Britain). There, banks with big funding gaps could just pray that markets recover and until then rely on central banks and state guarantees to roll over their debts. But this is not a permanent fix. The sheer size of their needs would soon test the generosity of the authorities—and make a mockery of politicians' claims to have fixed too-big-to-fail finance.

Instead these firms must prepare to stand on their own feet. This may require them to raise even more capital, whatever the stress tests and their regulators say. Switzerland's big banks

have mixed records and a relatively puny government behind them but can still borrow cheaply, in part because they have exceptionally high solvency ratios. Banks in overstretched countries are also likely to face price wars to attract depositors from each other (as is already happening in Spain) and from other savings products such as life insurance. Those firms with big enough buffers to absorb the hit to profits will win.

Even so, some firms with large funding gaps may prove unviable—they will have to shrink, sell out or break themselves up. Europe's banking system is still built for a bull market that isn't coming back. The stress tests are just a small step in sorting that out.

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