Chest pains

Europe's sovereign-debt crisis is constricting the flow of money to its banks.

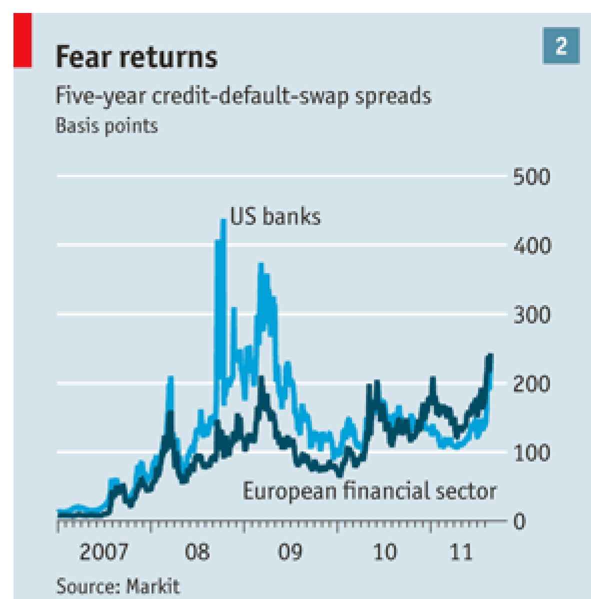
"I've never seen risk aversion this intense," says the chief executive of a large European bank. "It is unsustainable." His anxiety is understandable given the wild gyrations that rocked bond and commodity markets in early August and continued through the slow trading days of mid-August, when gold hit new highs and the yields on government bonds touched new lows in Britain and America.

Steep falls in stock prices this month have erased all the gains made over the past year. The hardest hit have been banks, with those in Europe getting the biggest clobbering. European bank shares have fallen by 25% this year, and have underperformed the wider markets and American bank stocks over the past two years (see chart 1). Banks in France are down by 33% since the start of 2011, those in Italy by 37%. Many banks now trade at a deep discount to the value of their assets. Barclays, for instance, has a market value that is less than half the worth of its assets. European banks are not unique in this regard. Bank of America, whose share price has slumped by almost half this year, is now valued at about one-third of its assets.

Such deep discounts present something of a mystery. They suggest that investors are either worried about the sustainability of banks' earnings as economies slow or that they do not trust the value that banks ascribe to their assets. A sign of investor scepticism is that the cost of insuring against banks defaulting on their debt has surged (see chart 2).

Worries about earnings are part of the explanation. Investment-banking revenues collapsed in the second quarter as trading activity slowed down. Ahead lie new rules forcing banks to set aside more capital against losses in their trading businesses. The economic outlook is also darkening. This week a flurry of downbeat indicators suggested that Europe's economy is continuing to slow. Bad loans in big European countries have been remarkably low over the past two years, yet many investors fret that they will rise in a downturn.

Concern over banks' profits, however, is not the full story. A more compelling reason for the slump in bank shares can be found by peering into the markets that banks use to fund themselves. For it is in these markets that the life is being squeezed out of Europe's banks. As a whole, the region's banks are not in crisis. Yet pockets of deep stress have emerged in funding markets. If these are not eased, bank earnings and capital as well as the prospects for a wider economic recovery may be at risk.



A closely watched indicator of the health of interbank markets is the spread that banks pay over a risk-free one (the interbank-OIS spread). This is now at its widest for more than two years. Another sign of mounting fear is that banks are hoarding again. The cash they have on deposit at the European Central Bank (ECB) has shot up to

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€126 billion ($182 billion), about three times as high as its average so far this year.

A further warning is the extent to which some banks now rely on the ECB for their funding. Until recently the main "addicts" have been banks from small countries on Europe's troubled periphery. These were shunned by investors no matter how prudent they might have been because of the risk that their governments might default. But, worryingly, banks from bigger economies are now also turning to the ECB for help. In July Italian banks doubled their withdrawals (though these are worth only about 2% of Italian banks' total liabilities), while Spanish and French banks also borrowed more. One reason is that American money-market funds are warily shifting their money out of Europe. Fitch, a ratings agency, reckons that they cut their lending to European banks by almost 10% in July. Since May their exposure has dropped by one-fifth.

Halting the slow-motion run in the funding markets will prove difficult. "Money-market funds say it's easier just to say to clients that 'we haven't any exposure to Europe' than to try to explain the differences," says a central banker. Indeed banks themselves are having to respond to similar concerns. Two big British banks, Barclays and Royal Bank of Scotland, recently put Italy on a list of countries (others include Greece, Portugal and Spain) for which they give a detailed breakdown about how much they are owed. "If they were doing it now France would be on that list," says a fund manager. "They wouldn't be doing it if investors weren't worried about it."

Despite the stresses in funding markets, Europe's main banks are in no immediate danger. Temporary shortages of cash in short-term money markets can be readily filled by the ECB. And most banks are in a relatively healthy position as far as their longer-term (typically a year or more) funding is concerned, for this year at any rate: many sold enough bonds in the first quarter of 2011 to see them through the rest of it. Analysts at Morgan Stanley reckon that as a whole European banks have sold 90% of this year's required funding.

Rolled over

Two worries remain, however. The first is that in short-term funding markets banks are having to borrow for ever shorter periods. Fitch says that whereas in June more than half of French banks' borrowings from money-market funds was for periods of 61 days or longer, by the end of July only one-third was, while 20% had to be rolled over within seven days or fewer. "What has disappeared is funding from three to 12 months," says a central banker. "It is the oil that keeps the engine going."

As funding terms become shorter, banks are forced to roll over greater amounts of debt each day, making the entire financial system riskier. Higher funding costs are also squeezing banks' profit margins in the more vulnerable economies. European banks are responding by reducing costs—Bloomberg reckons that they are cutting over 40,000 jobs—as well as by trying to increase deposits. One way out of the mess may be to exploit low share prices to buy deposit-rich retail banks.

But the likeliest response of stressed banks will be to reduce lending. "Funding is as big a constraint on lending as capital is," notes Huw van Steenis, an analyst at Morgan Stanley. "Unchecked, this could lead to a grinding credit crunch in the southern euro zone." Just as with chest pains, the malaise afflicting Europe's banks should not be left untreated.

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