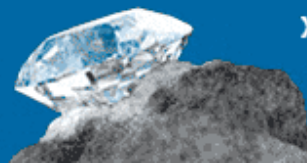


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FINANCIAL NEWS



Fixing Europe's banks comes first

Roy C Smith

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The welcome oversubscribed debut of the eurozone bond helped to narrow spreads in the peripheral countries for a while, but the success of the issue cannot hide the fact that Europe has not yet devised a credible plan for restructuring its ailing sovereign borrowers.

And this it cannot do until it first addresses the huge contingent liability from the banking sector that continues to threaten these borrowers.

The undercapitalisation of banks represents a major overhanging claim on the eurozone countries. It is an unknown that must be clarified before the problems of excessive sovereign indebtedness can be dealt with convincingly. The banks have to be fixed first, then the sovereigns.

The crisis of 2008 caused European governments to inject several hundred billion euros to shore up failing banks and to nationalise many of them. But the banks are still wobbly, despite having passed a recent unconvincing stress test, and need to undergo a serious market-based recapitalisation effort to recover their balance.

They are wobbly because even after all the government assistance, many banks are still undercapitalised. [Basel III](#) will require EU banks to raise more than €300bn to comply with various new capital requirements, including new “countercyclical capital buffers”, over the next four to eight years.

European banks are also weak because they are holders of substantial amounts of European sovereign debt, more than €600bn of which was issued by the endangered peripherals.

This exposure, which few banks carry at market value, represents a large additional write-off if the sovereign debt is to be restructured, which much of it surely will be.

Meanwhile, the ability of European banks to strengthen their finances has been weakened by their governments' efforts to scourge them with increased bank taxes, fees and other regulatory enhancements such as those adopted in the US, UK and Switzerland and soon expected in France and Germany.

“Too-big-to-fail” is now dead, regulators say, so banks (now absent implied sovereign guarantees) are paying much more to fund themselves in the markets. These actions have greatly undermined the banks’ ability to earn their way out of their troubles.

Most of the burden is with the top 50 or so banks on which regulators have good information, even if that information has been kept from the public. Many of these banks will require rights issues, asset sales and a generalised dose of further deleveraging to bring themselves into compliance with Basel III and whatever additional national enhancements may apply.

Realistic restructuring

Regulators have loaded up banks with heavier capitalisation requirements to keep them safe but, to make the requirements practicable, the compliance period has been stretched out to make recapitalisation more gradual.

Doing this, however, preserves the uncertainty of the overhang, leaves banks vulnerable to sudden market reversals prior to achieving their capitalisation goals and inhibits them from voluntarily taking haircuts to their sovereign loan positions so as to facilitate the restructuring of that debt. Much better would be an accelerated approach to a realistic restructuring of the banks.

One way is to exchange outstanding bank debt for a package consisting of a significantly lesser amount of new senior bonds, some contingent capital (or [CoCo](#)) bonds and some equity warrants. The package should have a market value a bit greater than the present market value of the outstanding debt so as to encourage acceptance.

Investors would receive three tradable securities representing different types of risk in a bank whose balance sheet had been strengthened by the exchange, which should increase the value and appeal of the securities after they are received.

Banks undertaking such exchanges would reduce senior debt, extend its maturity and put in place some otherwise difficult-to-sell CoCo bonds (which convert to common stock under stressful conditions).

Once the banks are substantially recapitalised, they can return to normal lending activity – necessary for EU economic recovery – and they will be able to participate in a similar recapitalisation exercise for sovereign debt.

Over-indebted sovereigns also need a market-based restructuring programme to reduce debt. They need to be able to make an offer to current debt-holders to exchange what they have for something of equal market value, but involving less debt.

As the debt of the peripheral countries now trades well below par value, the old debt-holders will have to take a haircut. After the exchange, however, there would be less debt outstanding, and its weighted average maturity would be extended.

But, if an exchange offer is to be successful, the new less-debt package offered has to be attractive enough to debt-holders for them to make the trade.

This would be the case if the new bonds were the modern equivalent of Brady Bonds, in which zero-coupon US treasury bonds were acquired by sovereigns and used as collateral for their new bonds.

Brady Bonds were a big success when they were issued to restructure \$300bn of distressed debt of 18 sovereign countries in the 1990s. If these bonds were issued by the European Central Bank, under arrangements with the European Financial Stability Facility, they could be called “Trichet

Bonds”, as I proposed in an earlier column.

For it to work, however, the banks exchanging the old loans have to be able to absorb the write-offs that such an exchange would require. For this to happen, the banks have to be restructured first. The sooner EU officials and bank regulators use their considerable powers to make this happen, the better.

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