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Europe wary as Lehman specter rises for its banks

LONDON

Big lenders are struggling to secure dollar-based loans from U.S. firms

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Remember the collapse of Lehman Brothers? Europeans certainly do.

As a divided Europe struggles to contain its sovereign debt crisis, the greatest fear is that one of the major European banks might fail, setting off another fi-

NEWS ANALYSIS

nancial panic like the one that engulfed the global economy after Lehman filed for bankruptcy in September 2008. European policy makers say they are determined to avoid such a catastrophe and that they are prepared to back up their effort to prevent any major bank from failing with hundreds of billions of euros of government support if necessary.

But as large European banks are having a harder and harder time securing dollar-based loans from U.S. financial institutions, questions persist about their ability to ride out the crisis.

Despite an aggressive bond-buying program by the European Central Bank and short-term borrowing rates that are around 1 percent, many of the big European banks have suffered as their lenders have cut credit lines and hedge funds have sold short their shares, or bet that they will decline in value.

Government leaders and bank executives themselves insist that recent stress tests and the enhanced powers given to Europe's main sovereign debt bailout fund, which still needs to be approved by euro zone parliaments and will not be operational until October at the earliest, will be enough to guarantee the health of its banking system.

But Europe's unwillingness to do what governments in the United States and Britain did — make weak banks take government money whether they like it or not — is being questioned by policy makers in the United States and large investors.

''This crisis has the potential to be a lot worse than Lehman Brothers,'' said George Soros, the hedge fund investor, citing the lack of an authoritative pan-European body to handle a banking crisis of this severity.

''That is why the problem is so serious,'' he continued. ''You need a crisis to create the political will for Europe to create such an authority, but there is still no understanding as to what the authority will do.''

In recent weeks, American money market funds, long a reliable funding source for capital-starved European banks, have sharply cut back on their exposure — starting in Spain and Italy but now turning to France — and the result has been a sharp retrenchment in dollar lending by European banks.

One hedge fund trader said that on Monday, as bank stocks across the region fell, a cash-rich client was refused a midsize dollar loan from a major Euro-

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Can Europe's banks ride out crisis?

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pean bank and offered a lesser amount in euros.

This trader declined to identify the bank in question.

The 10 biggest money market funds in the United States cut their exposure to European banks by a further 9 percent in July, or $30 billion, after a reduction of 20 percent in June, the Institute of International Finance said in a report issued Monday.

While the institute said that Spanish and Italian banks suffered the most, the dollar lines for French banks had also been cut significantly.

French banks have continued to come under pressure despite the government's efforts to protect them. The authorities imposed a temporary ban on short-selling last month after shares in Société Générale, a systemically important bank considered too big to fail, tumbled on rumors it might be insolvent. The bank vigorously denied the talk, and the French stock market regulator jumped in to investigate the source of the rumors.

But Société Générale's shares are still sliding amid concern that it, like BNP Paribas and other major French banks, is having trouble raising dollars to finance its American and other dollar-based operations. Indeed, most European banks are now transferring euros to their U.S. operations, according to two French bankers who spoke on condition of anonymity because of the sensitivity of the situation.

Société Générale recently reported that its dollar-based loans used to support short-term funding needs had fallen to 40 percent from 49 percent between the end of June and mid-August.

Société Générale has also come under pressure, particularly from U.S. hedge funds betting that its shares will go lower, after the bank opened lines of credit with those funds earlier this summer, said a French banker with knowledge of the situation who was not authorized to speak publicly about the matter. That move raised suspicion the bank had trouble obtaining funding.

Executives at the bank say the market's fears are unfounded. The bank's chief executive, Frédéric Oudéa, has described as ''fantasy'' the rumors that Société Générale was having trouble raising money.

The bank is solvent and has very strong capital ratios, both French bankers said, but it is running into a communication challenge deflecting rumors about its health, a problem reflected in its declining share price. The shares closed down 6 percent Tuesday at €18.92, or $26.50. Three months ago the shares were at €40.

In any case, the French government is adamant about protecting its banks, which are seen as integral players in the functioning of the French economy. President Nicolas Sarkozy and the financial watchdogs of France are monitoring the situation closely.

''When you buy into a French bank, you are basically buying into the French state because the government would never let Société Générale, BNP, Crédit Agricole or any other major bank go under,'' the second French banker said. What is more, French banks, like any other European banks, are able to obtain funding from the European Central Bank if necessary.

The current problem is a crisis of confidence that is not necessarily reflected in the French banks' fundamentals, both French bankers argued. Although the major French banks are well capitalized, American clients of money managers and investment funds are unnerved by rumors about French banks' health and their difficulty in raising dollar funding, they said.

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Meanwhile, while the recent focus has been on French banks, the problems in Spain were highlighted Tuesday when one of the largest Spanish savings banks, Caja de Ahorros del Mediterráneo, reported a sharp increase in bad loans to 19 percent of overall lending from 9 percent at the end of last year.

Still, the huge stockpile of euros that banks have stashed away at the European Central bank at rock-bottom interest rates — it hit a recent of €166 billion Monday evening — suggests that banks have plenty of cash to draw on.

But bankers and analysts say that, perversely, this pile of cash only compounds anxiety in the market as it is evidence that banks prefer to earn under one percent on their money at the E.C.B. rather than run the risk of lending to each other, even though the returns are much greater.

The risk now is that Europe's resistance to recapitalizing its banks could turn its debt drama involving Greece and other countries into an even broader banking crisis, since much of the capital held by banks is in loans to European governments.

Daniel Gros, director of the Center for European Policy Studies in Brussels, had a blunt explanation for why European governments have so far refused to recapitalize their banks.

''They don't have the money and they are in the pockets of their bankers,'' Mr. Gros said.

Policy makers in the United States and Britain, where compulsory bank recapitalizations played a crucial role in calming the markets in 2008, have long urged Europe to do the same.

Most recently, Christine Lagarde, the managing director of the International Monetary Fund, proposed that Europe's main bailout vehicle, the European Financial Stability Facility, inject money directly into banks.

It was a radical proposition that in many ways hit at the crucial flaw of the euro zone: monetary policy may be unified, but fiscal and banking policy continues to be carried out by 17 disparate nations.

European officials dismissed Ms. Lagarde's proposal. ''It's a nonstarter,'' a senior European Commission official said. ''For that to happen the E.F.S.F. would have to become a supranational body.''

Deutsche Bank's departing chief executive, Josef Ackerman, perhaps the most influential European bank executive, said during a speech this week that such a move would be a mistake. At the same time, he conceded that many banks in the region could not survive if forced to take major losses on their government debt.

At a banking conference in Frankfurt on Tuesday, the chief executives of Société Générale and UniCredit, the large Italian lender that has also been punished by investors, minced few words in describing how their profits would suffer in the years ahead.

''We are all convinced that profitability of banks will be lower,'' said Mr. Oudéa of Société Générale.

Federico Ghizzoni, the chief of UniCredit, while conceding that ''liquidity was an important topic,'' said investors were exaggerating the danger from banks' holdings of government debt.

UniCredit's holdings of Italian government bonds, which Mr. Ghizzoni put at €38 billion, represent less than 4 percent of the bank's assets, he said.

Liz Alderman reported from Paris. Jack Ewing contributed reporting from Frankfurt.