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Scrambling on eve of E.U. summit

BRUSSELS

Banks playing hardball on Greek debt losses as ministers cancel meeting

BY STEPHEN CASTLE AND JACK EWING

New ways of tempting banks to write off about half the value of their Greek bonds were being discussed Tuesday as debt crisis talks went down to the wire, prompting the cancellation of one meeting scheduled ahead of Wednesday's crucial summit meeting of European leaders.

With less than 24 hours before government heads were to meet in Brussels to forge a solution to the crisis, banking representatives and European officials were locked in a high-wire negotiation over the losses banks should accept.

The banks have played hardball and threatened that the write off of the debts they are being asked to accept — of about 55 percent — could result in a default or similar financial shock, something European officials are desperate to avert.

That has prompted a search for so-called complementary measures that might help to sweeten the pie for the bankers.

Italy, meanwhile, has come increasingly under the spotlight as investors doubt the government's commitment to reduce curb the country's €1.9 trillion, or $2.6 trillion, debt.

European Union leaders want the Italian prime minister, Silvio Berlusconi, to present firm plans on growth and debt reduction in time for the meeting.

Italian news agencies reported late Tuesday that Mr. Berlusconi had reached an accord with the Northern League, his principal coalition partner. The league's leader, Umberto Bossi, said earlier in the day that Mr. Berlusconi's government could fall over the issue of aising the standard retirement age to 7 from 65, a move Mr. Bossi opposed.

With the clock ticking, a senior German official, Jörg Asmussen, and a rench counterpart, Ramon Fernandez, pined intensive discussions with the anks in Brussels.

Under one of about five plans being ebated, Greek bonds might be swapped for those of much lower face value issued by the euro zone's bailout fund, according to two officials briefed on talks, who said the idea might make a write-down more attractive for the banks.

To add to the mood of anxiety, a meeting of E.U. finance ministers that was to precede the second gathering in a week of European leaders was abruptly canceled on Tuesday.

In an e-mailed statement, Kacper Chmielewski, a spokesman for the Polish government, which holds the bloc's rotating presidency, said the finance ministers' meeting, set for Wednesday, had been called off.

Though that was a recognition that the deal with the banks will not be ready by Wednesday morning, it did not mean that agreement was impossible later Wednesday, diplomats and officials said.

The meeting of E.U. leaders will still take place and "work on the comprehensive package of measures to curb the sovereign debt crisis" will continue there, the Polish statement said.

Those measures include a recapitalization of European banks and an expansion of the firepower of the euro zone's €440 billion bailout fund, probably to more than €1 trillion.

This will probably be achieved through two methods that are likely to run alongside each other. The rescue fund, known as the European Financial Stability Facility, is expected to offer insurance against a portion of the losses on bond purchases. A separate mechanism is expected to be set up to purchase

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JOHN THYS/AFP

BACKING FOR BERLUSCONI GROWTH PLAN
The Italian prime minister stitched together political support for the plan demanded by his E.U. peers. *PAGE 3*

E.U. crisis talks go down to the wire

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bonds, drawing in funds from the International Monetary Fund and other investors from the emerging world.

Though France is reluctant to bring other powers, like China, into the heart of the euro zone, it is likely to have to overcome its reservations because of the gravity of the situation.

Though officials expect the European Central Bank to play a role in bond buying, at least in the short term until a new system is established, Germany is resisting any firm reference by leaders to this as part of the deal.

In one vivid illustration of the urgent need for a deal, the Athens News Agency reported that from late August until the end of the first two weeks of October consumer deposits in Greek banks decreased by 4.9 percent, worth about €9.5 billion.

No package of proposals will add up unless the banks write down large amounts of debt, however. "It is important to have clarity on private sector involvement," Amadeu Altafaj Tardio, a European Commission spokesman on economic and monetary affairs, said in Brussels, "all the issues are interlinked."

The statement of the Polish presidency came just hours after an earlier declaration stating that the meeting of E.U. finance ministers would go ahead and increased the impression of confusion in decision-making

Diplomats and officials said that the announcement had less to do with the substance of the negotiations and more to do with internal politics of the 27-country Union, of which only 17 states are members of the euro currency zone.

The meeting of all E.U. finance ministers was intended to sign off on a package of measures that are intertwined but only some of which, most notably bank recapitalization, involve all 27 countries.

"It's clear that the whole package won't be ready by Wednesday morning so there is little point in going ahead" said one European diplomat speaking on condition of anonymity because of the sensitivity of the issue. "It's unfortunate handling by the Polish president, and bad news because the markets have tanked. But in my book there is no reason why the cancelation of the meeting should stand in the way of the summit of eurozone leaders."

The office of the German chancellor, Angela Merkel, said that her plans had not changed and that, after a speech to the Parliament at midday Wednesday, she would travel to Brussels for the summit meeting.

While political leaders fumbled toward a solution, analysts and bankers began to contemplate the consequences if there is an agreement to sharply cut the Greek debt load and require banks to raise their reserves.

TIM BRAKEMEIER/EPA

Chancellor Angela Merkel of Germany in Berlin on Tuesday for a meeting with Christian Democrats on euro rescue efforts.

A reduction of 50 percent to 60 percent in the value of Greek bonds would be hard to dress up as anything but a default, analysts said. The resulting "credit event" would activate insurance that investors have bought on Greek debt, known as credit-default swaps. There is incomplete information on which banks may have issued the swaps and could be vulnerable to losses, creating an extra element of risk.

Among policy makers and analysts, there is palpable nervousness that there could be dire consequences that are impossible to predict.

"We have created a world that is noncomputable because it is too complex," said Fredmund Malik, chairman of Malik Management, a consulting firm in St. Gallen, Switzerland.

Under one of several plans being debated, Greek bonds might be swapped for those of much lower face value issued by the euro zone's bailout fund.

Some consequences are predictable. Greek banks would require major aid to absorb the losses on their holdings of their government's debt, which Barclays Capital estimates at €45 billion to €50 billion. The Greek banks would also need emergency cash to continue operating.

"Launching a hard restructuring without the adequate backstop could be too risky from a financial stability perspective," Antonio Garcia Pascual, an analyst at Barclays Capital, wrote in a research report Tuesday.

There is also a question of what happens with the European Central Bank's substantial holdings of Greek bonds, which have an estimated face value of about €45 billion. Jean-Claude Trichet, president of the E.C.B., has said that the central bank will not participate in any voluntary debt relief for Greece, known as private sector involvement, because it is not part of the private sector.

Still, any insistence by the E.C.B. that it should be exempt from the pain of a debt devaluation could be controversial. The central bank might insist that its holdings be transferred to the European bailout fund, Mr. Pascual wrote.

The E.C.B. began buying bonds from Greece and other countries on open markets last year, via the network of national central banks known as the Eurosystem. The E.C.B. does not disclose the size of its Greek holdings or the prices it paid, but Greek debt was already trading at a substantial discount to its face value when the E.C.B. began intervening in bond markets in May 2010. That means the E.C.B.'s actual losses would be limited.

Meanwhile, bankers are deeply unhappy about plans to make them raise their reserves so that they could absorb the shock if Greece defaults. Some have complained that they are being asked to meet regulatory standards that were not supposed to take effect for many more years.

"What banks would have had by 2019 they want to see in six months, at a time when capital markets are closed," said Herbert Stepic, chief executive of Raiffeisen Bank International in Vienna. That could pressure banks to reduce lending not only in Western Europe but in Eastern Europe where Raiffeisen is particularly active, increasing stress on economies there, he said by telephone.

Stefan Krause, the chief financial officer of Deutsche Bank, said Tuesday that the bank could raise capital if needed without resorting to government help. But Deutsche and other banks might need to reduce the amount of money they have at risk, and withhold dividend payments to shareholders. Bankers complain that the pressure to raise capital will force them to restrict lending and hurt the European economy.

The euro fell on the news of the cancellation of the finance ministers' meeting. It was trading at $1.3921 at midafternoon in New York, down from the day's high of $1.3960 and from the late New York rate Monday of $1.3929. Stock markets in Europe and on Wall Street, which were already retreating Tuesday, slipped further.

Jack Ewing reported from Frankfurt. Contributing reporting were Liz Alderman in Paris and Elisabetta Povoledo in Rome.