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Bolstering bank capital is elusive target

By Alex Barker in Brussels, Sharlene Goff in London and Hugh Carnegy in Paris

The need to bolster bank capital is perhaps the most settled part of Europe's proposed antidote to the sovereign debt crisis. But translating this big political decision into practice remains fraught with difficulties.

Finance ministers last weekend agreed that Europe's banks must meet a higher, 9 per cent threshold for their core tier one capital ratios – a measure of financial strength – after revaluing their sovereign bond holdings at market rates.

On the recapitalisation, this is where clear agreement ends. Key technical details are still unresolved, there are disputes over presentation and, most importantly, some countries harbour serious worries about the adequacy of state backstops.

Another outstanding concern is how banks reach the higher capital levels and whether the temptation to shrink their way out of trouble will starve the real economy of credit, putting further pressure on Europe's faltering economy.

These problems are stoking tensions between the economically strong and those weaker countries – such as Spain and Italy – that bear a heavier recapitalisation burden, yet fear they will lack the resources to pay for it.

However senior officials involved with the process are adamant that no corners can be cut if Europe's banking system is to win back its credibility. "The Europeans have to do it well, they have to do it consistently in a co-ordinated fashion and without missing the targets," said a senior non-EU official.

In its latest estimates the European Banking Authority identifies a capital shortfall of €108bn, a gap banks will be given until June to close, using their own resources, fresh private capital or state support.

But even this shortfall remains fluid. It is a moving target that is dependent on what snapshot of time is chosen to price sovereign debt. Some countries are concerned that an effort to update the model, using data from September, may further increase the deficit they need to fill.

The big political sticking point remains state support. This is less of a problem for France and Germany, whose banks are expected to reach the new capital thresholds under their own steam.

But Italy and Spain, among others, fear that exposing a capital black hole without a clear plan to fill it will put further pressure on their sovereign bonds, thereby increasing the capital shortfall for their banks.

As a last resort, nations that cannot fund the recapitalisation can turn to the European Financial Stability Facility. But these loans still go to banks via the state, meaning they still raise the debts of the government, weakening its position in bond markets.

"The credibility of plans to bolster the banking system lies in allowing the EFSF to provide capital and bond guarantees to weak banks directly circumventing the troubled countries they are located in," said said Sony Kapoor of the Re-Define economic think tank. "This is the only way of breaking the vicious sovereign-bank loop."

So the great hope is that many banks will raise funds independently. But this carries its own risks.

Banks face difficulties selling assets in the current climate without triggering large losses. Rights issues are also unattractive at today's beleagured share prices. So they are expected to make some headway by simply allowing loans to roll off.

European leaders will give national regulators the job of policing banks to ensure the recapitalisation does not choke off funds to the "real economy". But they have limited clout and the deleveraging poses a significant challenge.

Morgan Stanley predicts that EU banks will shrink their collective balance sheet by €2,000bn over the next 15 months, potentially cutting back on areas such as trade finance, leasing, and banking in Eastern Europe.

One safeguard was a EBA-backed plan to offer state guarantees for bank bonds, with the aim of unclogging funding markets and giving banks more confidence to lend. But again differences between weak and strong economies complicated matters.

So far ministers have only agreed to coordinate national guarantee schemes, rather than use the EFSF to underwrite bank bonds directly. This reliance on national funds poses a familiar problem: do troubled sovereigns have the resources to stand behind their banks?

Additional reporting: Brooke Masters in London