Worries rise about fate of banks in Italy and Spain

PARIS

With record purchases of government bonds, risks to lenders resurface

BY LIZ ALDERMAN

Only a few months ago, banks around the world were scrambling to unload piles of European government bonds that had turned toxic as the Continent's sovereign debt crisis flared.

While the fever has cooled since then, warning lights are blinking again in Spain and Italy — the two countries considered most susceptible to a second round of problems — amid signs that banks there are once more loading up on the sovereign debt of their governments.

New data show that Spanish and Italian banks have been buying such debt in record amounts after the European Central Bank lent financial institutions huge sums at unusually low interest rates in the hope that the banks would buy more bonds from their own governments to tamp down national borrowing costs. Those costs had earlier approached the high levels that had forced Greece to take a bailout.

The central bank lent approximately €1 trillion, or $1.31 trillion, to more than 800 European banks from November to February. At the same time, Spanish and Italian banks increased their holdings of government securities, especially from their own countries, by €68 billion and €54 billion, respectively.

But while the purchases pushed down national borrowing costs and helped Spain and Italy avoid asking their European partners for a financial lifeline as Greece did, the effect has been to raise new risks by tying the health of the banks to the fate of their governments.

The action has caught the attention of analysts. Last week, a number of banks, including Société Générale, Barclays and Credit Suisse, telegraphed their concerns. In a note to clients, Société Générale wrote that the connection "between bank risk and sovereign risk has increased." As Spain and Italy grapple with downturns amid deep spending cuts and tax increases designed to cut high deficits, "a further deterioration of the fundamental news would prove particularly toxic, now that banks have increased their exposure," the note said.

Spain is the speediest in moving out of the eye of the storm. With unemployment near 24 percent and youth unemployment at 50.5 percent, the government of Prime Minister Mariano Rajoy faces challenges after he introduced sharp budget cuts. The country is facing its second deep recession in three years.

At the same time, banks are not lending much into the broader economy.

"Banks are lending to their governments, but not apparently to businesses," Credit Suisse wrote in a note. Spanish banks are already holding loads of toxic mortgages after the nation's housing boom went bust.

While government bond holdings make up only 6 percent to 7 percent of Italian and Spanish banks' balance sheets — down from 8 percent a decade

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A general strike in Málaga, Spain, to protest a government labor law overhaul that would make it easier to fire workers. The country has an unemployment rate near 24 percent and a youth unemployment rate above 50 percent.

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ago — risk could swirl again if investors believe the crisis may get a second wind.

Laurent Fransolet, head of European fixed-income market strategy at Barclays Capital, said investor sentiment had become more fragile and could deteriorate quickly. Markets are shedding the optimism of the last couple of months, and the mood is moving back toward pessimism, he said.

Conditions are not as bad in the euro zone as they were just a few months ago. Prime Minister Mario Monti of Italy has calmed market worries by implementing a €30 billion austerity plan to cut a debt load of 120 percent of gross domestic product. Some economists say that they now expect the overall euro zone to enter a mild recession, instead of the deep one they feared, especially now that the U.S. economy is showing signs of an upswing.

Last month, Ben S. Bernanke, the U.S. Federal Reserve chairman, and Timothy F. Geithner, the U.S. Treasury secretary, told Congress that the European economies at the center of the crisis had made significant progress.

But analysts say governments must still urgently convince investors that the policies being adopted to strengthen the euro currency union, and to improve competitiveness and deficit problems, are the right ones.

Stocks in Europe and on Wall Street fell late last week amid renewed concern about Europe's debt crisis as Spain failed to find buyers for around a quarter of its 10-year bond offering. Yields on the bonds were 5.74 percent at the end of last week, fanned also by concerns that a new austerity program may hobble the economy. They had fallen to as low as 4.6 percent in January, when banks used the low-cost central bank loans to buy government bonds.

But domestic banks will not buy nearly as many sovereign bonds when the European Central Bank's lending program stops. The Federal Reserve and the Bank of England, which last year flooded their banks and markets with money to stabilize the upheaval from Europe, are also trying to wean financial institutions from those funds.

Meanwhile, foreign investors — whether the Chinese government or overseas banks — have stayed away recently from Italian and Spanish bonds. Banks in France and Germany are also thought to be buying, though not large amounts. While both countries have already sold most of the bonds they had offered for the year, the question is who will buy when more are issued.

Further episodes like the bobbled Spanish bond auction could deepen fears about the country and send yields yet higher, though perhaps not above the 6.7 percent Spain paid at the height of the crisis.

Should that happen, problems would ripple again through Italian and Spanish banks and in Europe's banking sector, even among banks that shed billion of euros worth of Italian and Spanish debt but still hold some on their books.

"It's definitely concerning," Michelle Bradley, an analyst in London on the European interest rate strategy team at Credit Suisse, said of the government bond holdings concentrated in Spanish and Italian bank coffers. "We have only to look at the Greek banking system to see how it played out there."

In Greece, most banks were relatively sound and not suffering from the same problems as in countries like Ireland, where a real estate bust and profligate lending decimated the banking system and the national economy. But the Greek government's continued stumbling on the economy and in negotiating bailouts with its European partners ravaged Greek bond holdings.

"In Greece, it was government troubles that passed through the banking sector, rather than the other way around," Ms. Bradley said.

Meanwhile, as the link between the governments and their banking sector strengthens, so do the worries. "We've seen through the crisis that this has been negative," Ms. Bradley said.