The Economist

Recapitalising Europe's banks

Cushion calculations

Policymakers agree that banks need more capital. Little else is clear

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WILDFIRES can sometimes only be stopped by the act of lighting a second blaze to create a firebreak. Europe's policymakers seem finally to be edging towards similarly extreme measures. On October 9th Angela Merkel and Nicolas Sarkozy pledged to strengthen Europe's financial system as part of their response to the euro zone's debt crisis. That may well force cash-strapped governments to pump capital into banks to insulate them from the risk of government defaults.

There is little time to waste: Europe's banks are being squeezed to death. On October 10th France and Belgium dismembered Dexia, a long-troubled lender. Also that day, Austria's Erste Bank said it would post a loss because of write-downs on, among other things, contracts it had sold that would require it to pay up if peripheral euro-zone economies were to default.

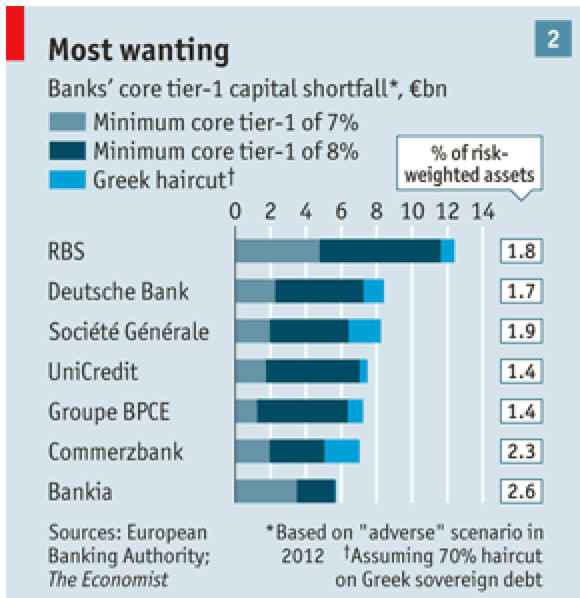
Mrs Merkel and Mr Sarkozy did not say how recapitalisation will proceed; more details are promised in time for a G20 summit on November 3rd. But it seems that the plan is for the European Banking Authority (EBA), the EU's banking regulator, to rerun its July stress tests. Capital shortfalls would presumably be filled by private funds, if possible; by national governments or the European Financial Stability Facility (EFSF), the euro zone's bail-out fund, if not.

The July tests were laughable. They simulated a European recession but not a Greek default. They also set a relatively low pass mark, saying that no bank should be allowed to let its core-capital ratio drop below 5% by the end of 2012. The rumour-mill is now whirring as to what another set of stress tests will look for.

One option would be to test the impact on banks of several euro-zone sovereign defaults by writing down the value of government bonds using market prices. But that is politically unpalatable: European leaders do not like the idea of testing for a wave of defaults they insist will not happen. Instead, regulators are said to be considering a write-down on Greek debt and an increase in the minimum pass mark to absorb any further shocks.

The Economist has done some rudimentary calculations to work out the effects of such changes. Assuming that regulators test for a recovery rate of 30% on Greek debt and apply the EBA's "adverse" economic scenario for 2012, then European banks would have a capital shortfall of about €90 billion ($124 billion) if the minimum pass mark for core capital is raised to 7%. A more demanding minimum of 8% would make more sense given jitters in markets. That would raise the amount of capital required to around €150 billion (see chart 1), although less reassuringly, Dexia would still have passed even this target.

There is talk of regulators applying a 9% minimum, which would raise the capital shortfall to €248 billion. But that could leave France, Germany, Spain, Greece and Britain each having to pump close to €40 billion into their banks. If that strains national exchequers and places greater demands on the EFSF, it would reduce the amount of money left to support sovereign bonds in countries such as Italy.



If regulators were to settle on 8%, Greek banks would be hardest hit. But the British, Spanish, German and French banking systems would still need €18 billion-26 billion each. The burden of recapitalisation would fall disproportionately on a few, very large and relatively thinly-capitalised banks. Those with the biggest shortfalls (apart from Greek banks) would be Royal Bank of Scotland (RBS), Deutsche Bank and Société Générale (see chart 2). Some banks may have to raise capital worth between a quarter and half of their current market values (although the actual amounts may well be smaller because of mitigating steps they have already taken).

The case of RBS, a British bank that was nationalised during the financial crisis, highlights some of the difficulties that recapitalisation will entail. Britain may find itself being ordered by a European banking regulator to inject yet more capital into the bank, despite its negligible exposure to Greece and other peripheral countries, because of stress tests designed to shore up the financial system in the euro-zone. Unlike countries in the euro zone that would be able to tap the EFSF, Britain would have to shoulder this burden alone.

Many lenders are squealing that more capital is not needed. Credit markets suggest otherwise. Credit-default-swap spreads on European bank bonds are in almost all cases higher for banks that have less capital. Recapitalising the banks will not be popular and does not solve the root problem of sovereign indebtedness. It is needed all the same.