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# Stress Test for Europe's Banks, and Its Politics

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**Lorcan Roche Kelly**

## Dexia's failure clarifies Europe's mind on banks -- now we wait for Slovakia's EFSF vote.

Markets reacted positively to this weekend's meeting between German Chancellor Angela Merkel and French President Nicolas Sarkozy, and the restructuring of troubled Belgian/French bank Dexia. But the drama in Europe seemingly never ends. Today markets hang on Slovakia's ratification of the European Financial Stability Facility (EFSF).

On the Merkel/Sarkozy meeting:

- Merkel and Sarkozy set a deadline of the end of October to reach agreement on a comprehensive solution to current instability in the Euro area. This solution would include the recapitalization of banks, if necessary.
- Unfortunately, the press conference after the meeting was heavy on promises, but light on specifics. The comprehensive package is due to be announced before the G20 summit in Cannes on November 3.
- This is not to completely dismiss the advances made over the weekend -- Merkel's commitment to do "whatever is necessary" to recapitalize banks, and Sarkozy's admission that it is necessary, are certainly positive, and markets very much took them that way. We are particularly encouraged to see this *bilateral* move by Merkel and Sarkozy, which we interpret is another step toward Germany and France working together to overtly set the pace for the rest of Europe (see "Two-Tier Europe is Born" August 17, 2011).
- But this needs to get real -- the market half-life of Euro area political promises is getting shorter with each unfulfilled statement.
- Already, the July 21 second Greek bailout (see "Whatever It Takes" July 22, 2011) seems to be dead in the water. The expansion of the EFSF to increase its effective lending capacity to €440bn is now not seen as being large enough, with European leaders openly talking about the need to "maximize the effectiveness of" -- that is, to *leverage* -- the facility (see "Europe Fails, US Stocks Flail" October 4, 2011).

On Slovakia and the EFSF:

**Update to strategic view**

**EUROPE MACRO, EUROPE FINANCIAL STOCKS:** Dexia's failure and a bilateral meeting of Merkel and Sarkozy indicate that Europe is finally beginning to get serious about bank recapitalization, including what promise to be more rigorous stress tests. Today, we await a political drama to play out in Slovakia over its ratification of the EFSF. While ratification is certain, timing is not clear.

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- The expansion of the EFSF has the world looking to Slovakia, the last of 17 Euro area nations to vote on ratification. The fractured coalition government there is due to vote on the expanded package today. But it seems that we may have to endure a repeat of Slovenia's EFSF situation before we get ratification. One of the governing parties is refusing to vote in favor of the package. While the large opposition party does support the EFSF -- so ratification is certain, eventually -- it seems likely that it will fail on the first vote. If it does fail, the President may have to allow a new government to form to allow the bill to be passed.
- In Slovenia, this process took a matter of days with the EFSF ratified before a new government was even formed. In Slovakia, the situation is less clear -- Slovak constitutional experts are hard to find -- but reports suggest that even if the first vote fails, another may be called in the coming days.
- Herman Van Rompuy, President of the European Council, yesterday moved the date of the next Euro area and European Union leaders summit forward by five days to Sunday October 23. The release said the change would allow time to "finalise our comprehensive strategy on the Euro area sovereign debt crisis" but the change in timing does also allow Slovakia time to sort out its internal political wrangling.

On Dexia:

- Ironically, a large bank failure -- just the thing that was supposed to immerse Europe in credit market contagion -- seems to have been the catalyst for relief.
- Dexia is being restructured by the French and Belgian governments. At the same time, Proton Bank in Greece was nationalized and Erste Bank in Austria reported large write-downs on foreign currency lending to Hungary.
- Dexia had already been bailed out in 2008, when it was caught with large exposure to US sub-prime and municipal debt. At the time it was the largest foreign borrower from the Fed's discount window and was also responsible for the National Bank of Belgium engaging in Emergency Liquidity Assistance (ELA) to provide funds to the bank (see "Understanding ELA: Emergency Liquidity Assistance" July 15, 2011).
- As part of Dexia's response to the 2008 situation it reclassified €100 billion of trading assets as loans, so it did not have to mark them to market. However, this accounting trick only stored up problems for Dexia. The ECB, the provider of liquidity to banks when they cannot get access to market funding, takes market value into account when calculating haircuts for repo operations. So as Dexia lost short-term funding, it lacked the assets to obtain alternate funding from the ECB.
- Liquidity conditions have tightened across Europe. The rise in the use of the ECB's deposit facility (see chart on next page) shows that lenders would rather park money in the ECB than provide it to

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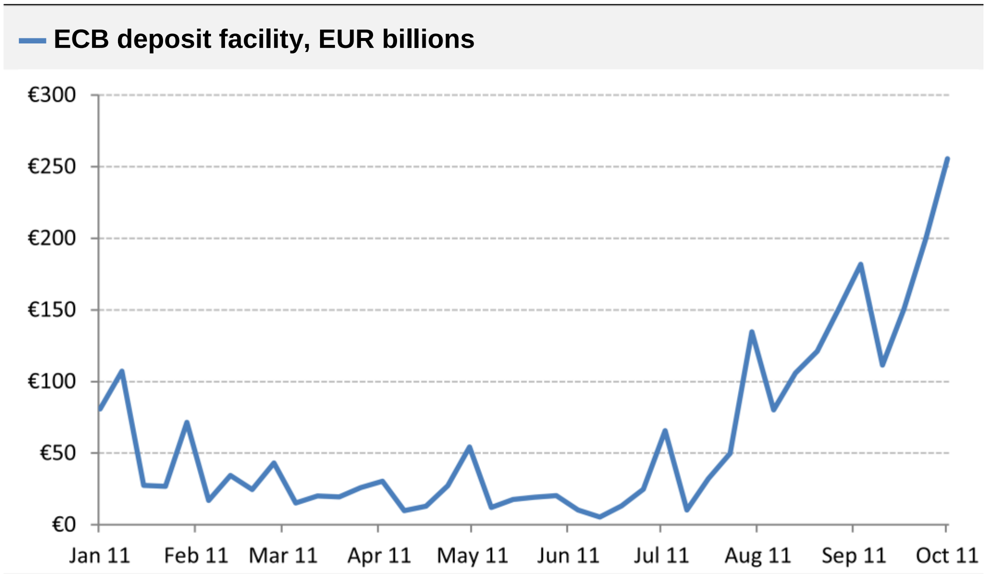

Source: ECB

the market. But this isn't a lethal problem in and of itself, as the ECB can finance banks in need of liquidity via its regular and longer-term refinancing operations.

- Dexia's problem is not really a liquidity problem, although it is being described that way. In fact it is a solvency problem, which had been hidden by Dexia's decision not to mark €100 billion of its loans to market. Without the current liquidity crunch in Europe, it may well have got away with it.
- The failure of Dexia is an embarrassment for the European Banking Authority (EBA) as the bank had passed the July 15 stress test with flying colors (again, see "Europe Fails, US Stocks Flail"). So, naturally, the EBAs response to this failure is another stress test.
- But this time the test will take greater account of sovereign -- particularly Greek -- exposures. If the bank recapitalizations announced by Merkel and Sarkozy are going to be viewed by the market as effective, a clear view of the problem is essential. While it may be a case of third time lucky for the stress tests, the new round will have to be credible, or the entire recapitalization plan may fail.

In the US 2009, the combination of rigorous and fully-disclosed bank stress tests, along with a commitment to help recapitalize banks that fail, restored market confidence and ended the banking crisis that catalyzed the Great Recession (see "The Stress Tests' Hidden Mickey" May 4, 2009). Now with something similar to that in prospect, stock markets are rallying and credit markets are calming across Europe.

- The consensus seems to have subtly shifted toward our view that there *is* a solution to Europe's woes, and that its politicians can stumble their way toward that solution. We were slightly early, but our contrarian call to take a gamble on European financial stocks near the worst of the crisis last month is beginning to pay off (see "CHooF!" September 6, 2011).

- But the path forward is paved with politics.
- There are several meetings of finance ministers due before the October 23 EU leaders summit. There is a meeting of the Eurogroup (the Euro area finance ministers) and Ecofin (all European Union finance ministers) due "ahead of the European Council" according Van Rompuy's press release. There is also a G20 finance ministers meeting due on October 14-15.
- So we can expect a lot of political noise in the coming weeks.

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**Bottom line**

Dexia's failure and a bilateral meeting of Merkel and Sarkozy indicate that Europe is finally beginning to get serious about bank recapitalization, including what promise to be more rigorous stress tests. Today, we await a political drama to play out in Slovakia over its ratification of the EFSF. While ratification is certain, timing is not clear.