



Perspectives by Ruth Lea

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The continuing Eurozone crisis: implications for Britain

Introduction

There are no signs that the Eurozone's sovereign debt crisis is being resolved. After the Irish bailout at the end of November 2010, speculation continues to mount that Portugal will be the next country in need of a bailout. And then there may be others. Even though outside the euro, the on-going crisis has major implications for the financial stability in the UK. But, before looking at these implications, it is helpful to look at the degree of exposure of Britain's banks, and indeed of other major EU countries, to other key Eurozone countries, including exposure to their sovereign debt.

British banks' exposure to key Eurozone countries

The Bank for International Settlements (BIS) produces quarterly data for the cross-border exposure of nations' reporting banks to the public and private sector debt of other nations. These data are imperfect in several ways. For a start, there are gaps in the data, they do not adequately distinguish between the different classes of loan exposures (whether, for example, they relate to sovereign debt, corporate lending or interbank lending) and they are inevitably out-of-date. The data that were released with the BIS's December 2010 *Quarterly Report* related to end-June.¹ But they are nevertheless revealing and should give a reasonable idea of which country's banking systems are exposed to which countries, including the Eurozone periphery.

As can be seen from table 1 and chart 1, German banks have the greatest overall exposure to Portugal, Ireland, Greece and Spain (the PIGS countries). German banks have exposures of \$181.6bn to Spain and \$138.6bn to Ireland, and nearly \$308bn to the PIGS in total. French banks are the next in line, with much less to Ireland but more to Greece. The UK is next in total with exposure to Ireland which is a little greater than Germany's, at \$148.5bn. The US banks are the next most exposed in absolute terms, though much less so in terms of the relative size of their economy. Dutch banks, at number 5, are disproportionately exposed given the relative size of their economy. (The Dutch economy is less than one fifth the size of Germany's.)

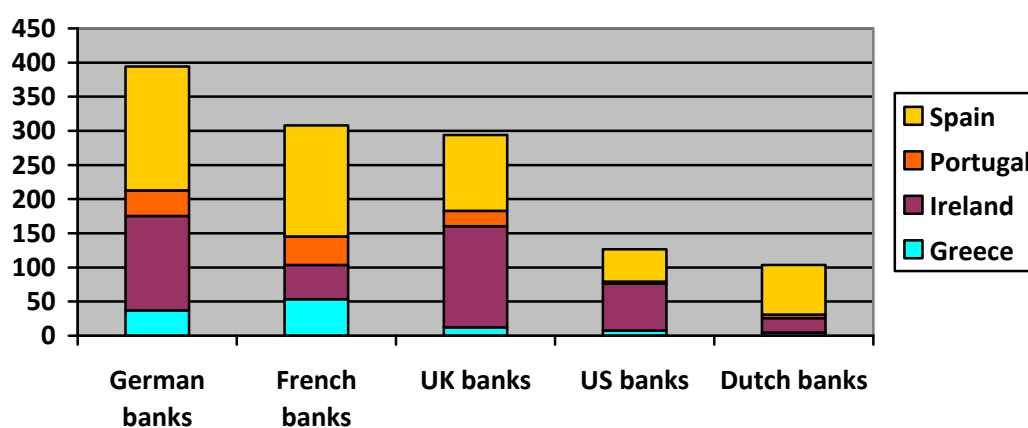
It should be noted that the BIS "cross-border" numbers reflect the operations of banks' subsidiaries. For Ireland this is particularly an issue for the UK. The BIS data not only reflect the (strictly) cross-border lending, but also the activities of RBS's Irish operations and to a lesser extent those of Lloyds.²

Table 1 Consolidated foreign claims of reporting banks, amounts outstanding – immediate borrower basis, \$bn

	Dutch banks	French banks	German banks	Greek banks	Irish banks	Italian banks	Port. banks	Spanish banks	UK banks	US banks
Exposure to...										
France	80.8	-	196.8	1.9	18.1	31.6	8.2	26.3	257.1	161.5
Germany	149.8	255.0	-	5.7	32.1	254.4	3.9	39.1	172.2	152.1
Greece	4.7	53.5	36.8	-	7.8	5.3	10.0	0.9	12.0	7.5
Ireland	21.2	50.1	138.6	0.5	-	15.3	19.4	14.0	148.5	68.7
Italy	43.2	418.9	153.7	0.5	40.9	-	3.4	32.6	66.8	32.5
Portugal	5.1	41.9	37.2	0.1	5.1	4.7	-	78.3	22.4	3.2
Spain	72.7	162.4	181.6	0.7	25.3	25.6	23.1	-	110.8	47.1
UK	135.4	327.7	462.1	19.7	209.0	44.0	7.7	386.4	-	572.7
PIGS, total	103.7	307.9	394.2	(1.3)	(38.2)	50.9	(52.5)	(93.2)	293.7	126.5

Source: BIS Quarterly Review, December 2010, table 9B, www.bis.org

Chart 1 Consolidated foreign claims of reporting banks, amounts outstanding – most exposed EU banks, \$bn



Source: BIS Quarterly Review, December 2010, table 9B, www.bis.org

In addition to the comments already made about the inadequacy of the data, it should be noted that the data are on “immediate borrower basis”. So, for example, whilst German banks’ exposure to Ireland is shown in the BIS figures at \$138bn, this is probably an over-estimate. German lending to Ireland is almost certainly inflated by the lending practices of Depfa (now part of Germany’s nationalised Hypo Real Estate), which routes much of its business through Dublin.³ That lending, in turn, flows through to the data for the Irish banks’ lending to other countries, and it is possible that Ireland’s high rankings in loans to Italy and Spain are largely Depfa-related.

The implications of British bank overall exposure to the struggling PIGS economies, in general, but Ireland, in particular, are very clear. It has been estimated that British banks face cumulative losses for the years 2008-13 of £12.2bn on Irish loans alone.⁴ Prospects for the Irish economy, and the British banks exposed to them, would arguably improve if the Ireland left the Eurozone and went for economic growth. But this is mere speculation at present.

Sovereign debt

Data on sovereign debt holdings were made available as a by-product of the EU's "stress test" exercise undertaken by the EU's Committee of European Banking Supervisors (CEBS) in July 2010.^{5,6} The fact that the stress test were woefully inadequate, the Irish banks were given a clean bill of health, is not relevant here. As part of the stress test exercise, 91 large international banks were asked to disclose their exposure to central and local government debt in 30 EEA countries. The main data are shown in table 2.⁷

Table 2 European banks' sovereign debt exposure, for July 2010 stress test exercise, €bn

	Dutch banks	French banks	German banks	Greek banks	Irish banks	Italian banks	Port. banks	Spanish banks	UK banks
Exposure to debt of:									
France	21.8	93.5	18.4	0.2	0.9	1.4	1.1	5.1	35.7
Germany	18.4	5.9	338.3	0.4	0.5	20.4	0	0.6	54.4
Greece	3.0	11.0	17.6	56.1	0.4	1.8	1.7	0.8	4.1
Ireland	0.5	2.4	12.3	0	5.3	0.3	0.8	0.1	5.4
Italy	9.8	47.1	73.6	0	0.7	164.0	1.2	9.4	9.7
Neths.	28.4	15.2	4.6	0	0.2	0.1	0.1	0.6	22.4
Portugal	2.0	4.6	10.0	0	0.3	0.3	13.7	6.5	2.4
Spain	2.2	6.3	34.3	0	0.4	1.4	0.4	201.2	5.9
UK	1.7	2.6	15.0	0	1.1	1.1	0	4.4	55.0
PIGS, total	7.7	24.3	74.2	56.1	6.4	3.8	16.6	208.6	17.8

Source: "European banks' sovereign debt exposure", *FT*, 21 November 2010.

Thus the Spanish banks held over €200bn of Spanish sovereign debt at the time of the stress tests. Apart from Spain, the most exposed banks to the sovereign debt of the PIGS countries were German and French respectively. British banks held a relatively modest amount, just €17.8bn, of which RBS held €4.8bn of Irish debt. Again it must be emphasised that these data are out-of-date and cannot account for the ECB's purchases of sovereign debt since summer.

Intensifying sovereign risk and Britain's financial stability

Given Britain's relatively small exposure to the PIGS sovereign debt, this suggests the impact on Britain's banks of the on-going Eurozone crisis could be quite modest. But the Bank of England in its latest *Financial Stability Report* identified the "contagion of sovereign concerns, interacting with and amplifying bank fragility in Europe" as a key risk, if not the most important risk, to the UK financial system.⁸

The Bank came to this conclusion having assessed the overall implications, direct and indirect, for UK financial stability, given intensifying sovereign risk. The implications were classified under three headings:

- Concerning capital and profitability:
 - There could be further losses on sovereign debt, but they should be manageable (the direct effects of holding sovereign debt).
 - If accompanied by weakening economic conditions, as likely, banks would experience higher-than-expected losses on lending to euro-area households and corporates (especially in Ireland and Spain).
 - The interconnectedness of the financial system provided a potential amplification mechanism for these credit risks. The credit conditions in France and Germany, "whose banking systems are more heavily exposed to the most affected economies" (see data above), could be damaged by intensifying

sovereign risk in these countries. This, in turn, could have knock-on effects for British banks which have major exposures to France and Germany.

- Concerning funding:
 - Heightened sovereign risk in Europe could potentially affect domestic and foreign currency conditions for UK and other major European banks, as occurred in April 2010.
- Concerning the provision of financial services:
 - Heightened strain in European banking systems could also affect the provision of financial services to the UK economy more generally. There was a risk that a shock in some euro-area countries (more specifically Spain, given the importance of Santander) could lead to a retrenchment in the provision of UK financial services by foreign lenders.

The Bank summed up the Eurozone's threat to British financial stability as follows:

- "Direct UK bank exposure to European sovereign debt is relatively low. The main credit risks to UK banks stem from the possibility of losses on lending to euro-area households and companies, should sovereign and banking concerns spill-over to weaker-than-expected growth in the euro area. Heightened sovereign risk in Europe could also expose UK banks to funding risks and the UK economy to the withdrawal of lending by foreign banks".⁹

The threat of default

We have discussed the on-going Eurozone crisis so far without mentioning sovereign default. But the chance of default, especially in Greece and Ireland, remains firmly on the markets' agenda, despite the bailouts. According to credit default swaps data Greece has a 60% probability of defaulting on its bonds over the next 5 years.^{10, 11} Greece has the distinction of being considered the most likely country to default on its bonds, ahead of Venezuela.

Under these circumstances, it is unsurprising that some observers are starting to think "outside the box". One idea is a Eurozone equivalent of the "Brady bonds" that were devised to deal with Latin American debt crisis of the 1980s. Although there are major differences between the two crises, there are some striking similarities. Firstly, debts were issued in a currency over which borrowing countries had no control: the \$ for the Latin American countries and the € for Greece and Ireland. Secondly, the debt crises followed a period of easy credit. Thirdly, both debt crises coincided with a global recession deemed to be the "worst since the Great Depression". And, fourthly, default on the sovereign debts would have/will significantly damage the banks. When the Latin America crisis emerged in the early 1980s, the initial response was to let growth solve the problems. Suffice to say that it did not – and growth will certainly not solve the problems of Greece and Ireland as they struggle with vicious austerity packages over the next few years.

After a period of muddling through, Latin American sovereign debt was restructured thorough the creation of "Brady bonds" in 1989. Banks were offered the opportunity to swap their claims on the (insolvent) Latin American countries with tradeable "Brady bonds" that were backed by US Treasuries as collateral. Meanwhile the debtor countries committed to a series of economic reforms. The net effect was that over the following years the debts were written down to levels which were manageable for both debtors and creditors. It has been suggested that Eurozone "Brady bonds" could function in a similar way backed by the European Financial Stability Facility.¹² Given the high probability of default in the Eurozone, the notion of Eurozone "Brady bonds" has its attractions. The idea may or may not fly.

But given this high probability of default, were the hugely expensive bailouts a waste of time? The answer is almost certainly no. Even though they are unlikely to avert eventual default they have bought time. In May 2010 there was a risk that fears of a Greek default could have plunged Greece into chaos, precipitated a bond crisis and sparked a new banking catastrophe. This could have been the European equivalent of the collapse of Lehman

Brothers in September 2008, which was followed by a heart attack in the global financial system. The European economy is now in better shape – or at least parts of it are, including a resurgent Germany. Banks have had time to build up capital and sell some of their holdings of peripheral sovereign bonds to the ECB. The dangers of default have diminished.

Indeed some voices are now calling for restructuring now, starting with Greece and possibly also Ireland and Portugal, because, whilst the dangers of restructuring have diminished, the costs of delay are rising.¹³ In the words of Macbeth “If it were done when ‘tis done, then ‘twere well it were done quickly”. Given the politics surrounding the Eurozone, we would be very surprised to see such decisive action.

References

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8. Bank of England, *Financial Stability Report*, December 2010.
9. Bank of England, *Financial Stability Report*, December 2010.
10. “Europe’s woes put debt restructuring back on the agenda”, *FT*, 11 January 2011.
11. Incidentally, we may hope that the EU’s new “stress test” exercise will, apart from being generally more exacting than the previous one, take into account the possibility of default. The EU’s new European Banking Authority (EMA) is conducting the tests which are expected to be completed by the end of May.
12. “Eurozone can learn grim Latin lessons”, *FT*, 22 December 2010.
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