(BN) European Banking Regulator Imperiled by Zombie Banks in Ger many

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European Banking Regulator Imperiled by Zombie Banks in Germany
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By Yalman Onaran

July 30 (Bloomberg) -- Germany's regulator balked last year when the European Banking Authority conducted stress tests on financial firms, objecting to the agency's definition of capital and allowing one state-owned lender to withhold some results.

The refusal to go along with the European Union regulator reflects an aversion by governments to ceding control to a central authority that may doom talks about creating a banking union and thwart plans to shift the burden of bailing out Spanish and Irish lenders to other euro-area nations.

"Germany didn't let the EBA dictate any terms to its troubled banks, why would it now hand over controls to a new regulator?" said Nicholas Spiro, managing director of Spiro Sovereign Strategy Ltd., a London consulting firm specializing in sovereign-credit risk. "The prospects of a new central authority are shaky at best."

EU leaders agreed in June to use common funds to inject cash directly into banks once a new regulator is established.

Until then, Spain will be on the hook for as much as 100 billion euros ($123 billion) it may need to borrow to recapitalize its banks. That means increasing the public debt level, already strained by budget deficits, a second recession in four years and regional governments strapped for cash.

First Step

Establishing a central regulator with true supervisory powers is the first step toward creating a European banking union, which also would feature a joint deposit-insurance fund and a mechanism for dismantling failed firms. The idea, discussed since the start of the sovereign-debt crisis, depends on 17 nations agreeing on who's going to pay for banks' losses.

That won't be easy. When German Finance Minister Wolfgang Schaeuble sought approval from parliament for a Spanish bailout this month, he said Spain would remain liable for any money it borrows to rescue its banks.

Six days after the June 28-29 summit where the agreement was reached, the German newspaper Frankfurter Allgemeine Zeitung published a letter signed by 172 economists criticizing the decision to support banks directly after setting up a central supervisor. That amounts to the first step toward a banking union that will make taxpayers in some European nations responsible for the "enormous losses" faced by banks in other countries, the economists warned.

German Chancellor Angela Merkel has called repeatedly for nations to give up more sovereignty as a prerequisite for using common funds for bank bailouts or jointly issuing euro bonds, even as her own officials have resisted central authority.

Resisting Regulation

Even Spain, which stands to benefit most from a banking union, has resisted external regulation of its firms. The Bank of Spain, which supervises Spanish lenders, clashed with the EBA over last year's stress tests, according to a person familiar with the discussions who asked not to be named

because the talks were private. It said “no Spanish bank needs to increase its capital” the same day that the EU agency said five of the country’s lenders needed to raise more capital.

Spain’s opposition might soften now that it has asked the EU for as much as 100 billion euros to fix its banking system, Spiro said. Still, the survival of Prime Minister Mariano Rajoy’s government may be threatened by such compromises and the austerity measures imposed on the country, he said.

European Commission President Jose Manuel Barroso is facing a self-imposed September deadline to unveil a blueprint for a euro-area bank supervisor. Leaders of the monetary union asked the EU’s Council of Ministers to act on Barroso’s proposal by the end of the year. The commitment to an accelerated timetable initially fueled market optimism that Spain could shift some of its debt burden to the European Stability Mechanism, boosting the price of Spanish bonds.

Spanish Bonds

The euphoria lasted only three days as Schaeuble and other European officials cast doubt on the commitment to transfer liability from member states to the EU. Last week the yield on Spanish 10-year government bonds jumped to record levels, exceeding 7 percent, before falling back below that after comments by European Central Bank President Mario Draghi led to speculation that the ECB would buy Spanish and Italian bonds.

The EBA, established in 2011, was designed to provide better oversight than the coordinating committee of national bank regulators it replaced. Still, the London-based agency doesn’t have the power to tell those supervisors what to do or to close failed lenders.

‘Big Fight’

While acknowledging the EBA’s ineffectiveness in getting national regulators to give up power, a senior European official involved in the discussions said some governments now agree that that attitude has to change. There are two camps within the euro zone, one pushing for a swift overhaul, the other seeing it as a longer-term goal, the official said, asking not to be identified because the talks are private.

“Giving up national rights will be a big fight, but the politicians now realize there might be no other way to resolve the banking problem,” said Dirk Schoenmaker, dean of the Duisenberg School of Finance in Amsterdam. “So they might eventually get there kicking and screaming.”

The screaming by German banks was heard quickly after EU President Herman Van Rompuy released a 10-year road map in June calling for common deposit insurance.

“More integration in Europe can’t purely be built on a redistribution of funds at the cost of German taxpayers and savers,” the association of German savings banks said in a statement the same day.

Deposit Insurance

To guarantee the 11 trillion euros of deposits in euro-area banks, lenders would need to pay fees equivalent to 20 percent of their profits for the next five years, Barclays Plc analysts estimated last month. The common insurance fund could be smaller and cost less if it covers only 100,000 euros per depositor, the current EU-wide insurance threshold, according to Schoenmaker.

The establishment of central supervision and joint deposit insurance are the relatively easier parts of creating a banking union, Schoenmaker said. More difficult is agreeing on who pays for the resolution of failed lenders and who decides to shut them, he said. While the ECB can provide more cash to keep such banks going, the money to recapitalize them has to come from governments, Schoenmaker said.

"You need a tough guy with final authority, at a safe distance from politicians, to be the resolution mechanism,"
Schoenmaker said. "It's not clear if the ECB can play that role without decisions getting mired in politics."

Ireland, Spain

The ECB doesn't have a great track record forcing governments to shut insolvent banks, said Spiro, the sovereign- risk analyst. After Ireland's banks were bailed out in 2010, only two of the six biggest were ordered to close. The others have been kept alive after receiving about 30 billion euros from the government. Two years later they're mostly locked out of credit markets and rely on the ECB for financing.

Spain also failed to shut its weakest lenders, merging dozens of savings banks, or cajas, and supporting them with small capital injections. That didn't make them any more solvent. Bankia group, which became the country's third-largest lender when seven regional banks were combined, needed an additional 19 billion-euro bailout from the government in May.

"Merging 17 insolvent banking systems won't give you a solvent system, the way merging seven insolvent cajas into Bankia didn't work," said Gordon Kerr, founder of Cobden Partners, a London-based consulting firm that advises governments on banking crises. "When you have insolvent banks operating, you debase the whole financial system."

'Zombie Banks'

Germany too has resisted demands that it dismantle failed banks. It took four years for regulators to shut WestLB AG, a regional lender crippled by its U.S. subprime and other risky investments during the 2008 financial crisis, even as the European Commission's competition authority pressed for its closing. The commission last week accepted restructuring plans for two other banks that received state aid.

"Germany is the creator of zombie banks and has been protecting its zombies against the EBA or other EU institutions that have tried to dismantle them," said Peter Tchir, founder of New York-based TF Market Advisors, which advises hedge funds.
"Germany might not be acting so fast to give the reins to a new central authority."

Even if a central authority is created, getting governments to agree to pay to wind down failed banks in other countries will be a challenge, said Constantin Gurdgiev, a finance lecturer at Trinity College in Dublin.

"There's still no political will to pay for these bank losses, either Irish or Spanish, among the European countries that have some money," Gurdgiev said.

Underestimating Losses

The political will is hard to muster when it's impossible to know how big bank losses in Spain, Ireland and other euro- zone countries will be, according to Guntram Wolff, deputy director of Bruegel, a Brussels-based research institute. Irish losses have reached 21 percent of banks' total loans, exceeding even the worst-case scenarios the government imagined when it got a 68 billion-euro bailout in 2010.

"If Spanish bank losses are limited to 100 billion euros, that might be manageable, but what if they're at 200 billion?"
said Wolff. "We have all these insolvent banks that have to be resolved. And we don't know the true size of the problem."

Spain probably is overestimating its banks' potential earning power and underestimating their losses, said Karel Lannoo, chief executive officer of the Centre for European Policy Studies in

Brussels. His research organization has estimated Spanish lenders may lose as much as 380 billion euros.
"Their business model is bust already, and in a further deteriorating economy, there's no way they can make money,"
Lannoo said.

Too Big

The euro area will struggle to create a true banking union because the financial system is too big for the sovereign states to back, according to Alberto Gallo, head of European macro credit research at Royal Bank of Scotland Group Plc in London.
Banks' assets are three times the size of the region's gross domestic product, which means guaranteeing just 5 percent of liabilities would increase public debt by 15 percent, he said. Government debt levels already average 87 percent of GDP.
"The firepower left to guarantee banks is very little,"
Gallo said.
Even if the June summit decision is a sign that Germany, the Netherlands and other northern European countries are agreeing to share the burden of saving banks elsewhere, politicians are moving too slowly to keep up with markets, according to Gianluigi Cesano, a professor of economics at the University of Turin.
"Germany and others may be willing to move toward full integration, but they want to do it at their own pace," said Cesano. "But markets are moving much faster, and if you have free markets, you have to abide with their timing."

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