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Beware hidden costs as banks eye ‘Grexit’

By Gillian Tett - **May 24, 2012 6:46 pm**

Earlier this month, I asked the leaders of a group of US-based companies what – if anything – they were doing to prepare for “Grexit”, or a possible exit of Greece from the eurozone. The responses from the manufacturers were rather vague.

The bankers, however, were alarmingly precise: amid all the speculation about Grexit, they told me, banks are increasingly reordering their European exposure along national lines, in terms of asset-liability matching (ALM), just in case the region splits apart. Thus, if a bank has loans to Spanish borrowers, say, it is trying to cover these with funding from Spain, rather than from Germany. Similarly, when it comes to hedging derivatives and foreign exchange deals, or measuring their risk, Italian counterparties are treated differently from Finnish counterparties, say.

The halcyon days of banks looking on the eurozone as a single currency bloc are over; cross-border risk matters. To put it another way, while pundits engage in an abstract debate about a possible break-up, fracture has already arrived for many banks’ risk management departments, at least when it comes to ALM in their eurozone books.

It is difficult to overstate the significance of this, or the potential hidden costs. As a report from the European Central Bank last month notes*, until 2007 the eurozone seemed to be on a glide path towards steadily rising levels of financial integration, which was delivering big economic benefits, by cutting the cost of capital.

But since then, the ECB says, progress has gone into reverse, since “the financial crisis has led to a marked deterioration in European financial integration”; and since late 2011 “the integration of the euro area financial system [has] deteriorated further.” The most visible sign of this, extensively quantified in the ECB report, is that spreads have jumped between sovereign bonds, and the funding costs of different sets of national banks. Cross-border interbank lending has shrunk, too.

But ALM trends are equally important. Sadly, nobody seems to have tried to quantify the scale of this shift; risk managers tend to be very secretive about their internal practices and some have only started to reorganise their books quite recently. But the banking world is full of anecdotes about how European and US banks are trying to match their lenders and borrowers within national borders – and the growing headaches this poses.

Consider a tale I just heard from one global bank. This entity has big loans to Italian companies and public sector bodies, but a much smaller Italian funding base, creating a gap of more than €10bn. Until last year, this bank’s risk managers never worried, since this bank has plenty of deposits from elsewhere in the eurozone. Moreover, it used to raise money easily in wholesale markets. But since 2007, wholesale funding costs have surged. And while the bank could build a bigger Italian deposit base, this would be costly, since other banks are also competing for deposits.

ALM fragmentation thus means the bank must either slash its loans, run a lossmaking retail bank, or be very creative.

In theory, the ECB could offset this private sector fragmentation with cross-border smoothing across the eurozone system; this is what the longer-term refinancing operations are supposed to achieve. Yet, as Gene Frieda of Moore Capital observed in a column on these pages, hints of fragmentation are even emerging in the LTRO; these days the ECB is increasingly demanding that when loans are extended to banks in troubled areas, this is done by their local national central bank, backed by local collateral. Hidden ringfencing is the flavour of the day even in central banking terms.

If you wanted to be optimistic, you could argue that this trend has benefits; such ringfencing might cushion the blow if – heaven forbid – the eurozone broke apart, since it forces managers to confront the issues before, not after, the fact. But the problem is the issue that deeply worries the ECB, that such fracture undoes much of the good created by the eurozone.

And this could have nasty economic implications. Last month the International Monetary Fund warned that eurozone banks were likely to embark on massive deleveraging over the following 18 months, to the tune of $2.6tn. But that projection assumed the eurozone remained a single bloc; if fracture keeps deepening, deleveraging will rise. Anybody who wants to explain to voters – or politicians – why it pays to keep the eurozone, in other words, better learn about banks' ALM practices. Better still, it would be canny for the ECB – or anyone else – to try to quantify the impact of these hidden ALM shifts.

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