European Banks Hit the Pause That Refreshes

The End of Good News Is Not Bad News

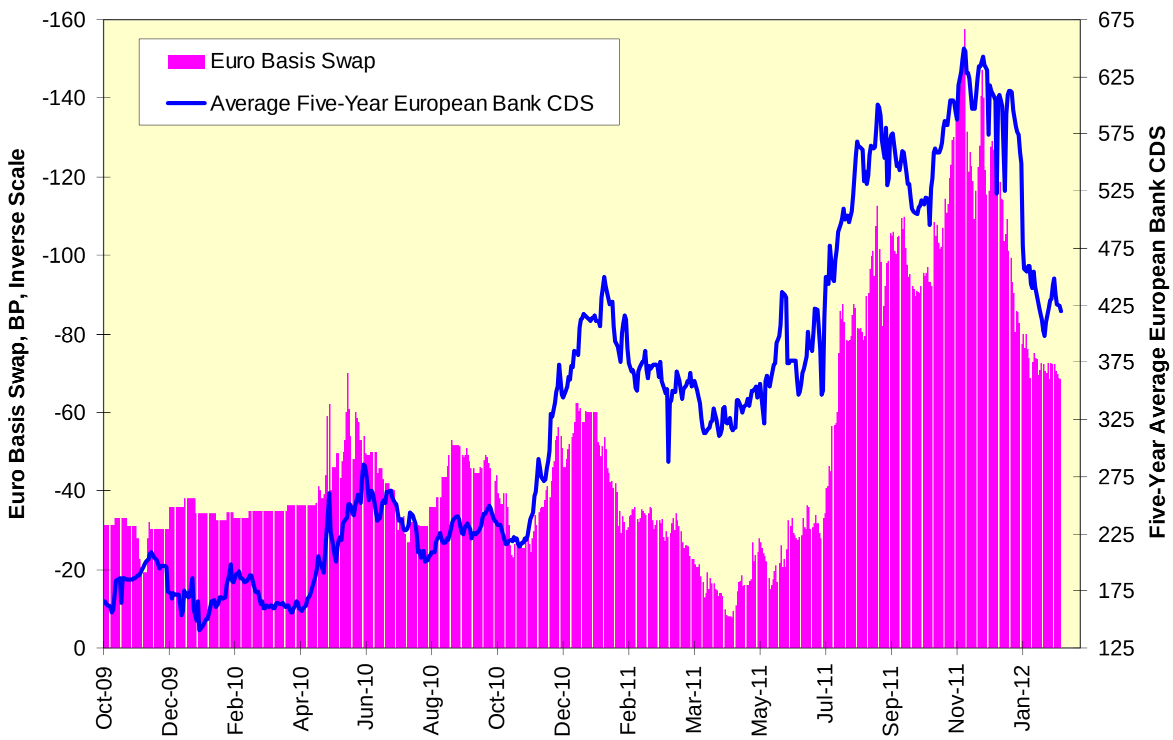
All things European have a certain *savoir faire*, as my German friends say. Even their fiascoes have more style than ours; really, did you ever see Hank Paulson sweep into a room a la Christine Lagarde, and what fashion magazine cannot get enough of Angela Merkel?

But just as the good of U.S. of A had to do in World Wars I and II, it has had to come riding to the rescue in the form of currency swap lines. The Federal Reserve swaps dollars for euros at a fixed exchange rate, the European Central Bank makes those dollars available to the European banking system and, in a stunning tribute to the "Momma raised stupid children" school of public policy, those banks were supposed to take the money and buy sovereign debt therewith. That they have resisted the temptation while being clobbered with haircuts on their Greek debt tells me there is hope in this world yet.

Basis Swap

The key risk measure for European commercial banks, the gallant crew inclusive of Société Générale (GLE), Deutsche Bank (DBK), Banco Bilbao Vizcaya Argenta (BBVA) and many others to numerous to mention, has been the euro basis swap, the difference between three-month floating rates on the euro and dollar. As many European banks' deposit bases are in euros while a percentage of their loans outstanding are in dollars, a wider basis swap is deadly. This is why the currency swaps at the end of November 2011 that drove the basis swaps lower were effective in reducing the average five-year CDS costs for European banks.

EUR Basis Swap And Bank CDS Pausing In Normalization



Right now, the contraction in basis swaps has stalled as have the reduction in CDS costs and in the narrowing of the European LIBOR – OIS spread. In addition, the tendency of European banks to deposit the funds arising from the currency swaps and the ECB's long-term refunding operation at the ECB itself remains. Remember, they were supposed to take that money and – wink, wink – buy sovereign bonds therewith.

I think this is all a pause. The banks were distracted over the past few weeks by the latest Greek bailout. Once this is somewhat in the rearview mirror for another few months, the massive monetary expansion of Japan and the lowered reserve requirements in China will find their way into the global banking system in general and into the higher-rate European banking system in particular. That will lead to basis swap contraction, a lowering of CDS costs and LIBOR-OIS spreads and eventually to money coming off deposit at the ECB and landing in risky assets. That will be bullish.