The French Connection

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Ioanna Antonopoulou 2011-9-19

By Dr Bernard H. Casey

When I reported on the second bail-out package – which is now rapidly unravelling – I pointed out that this involved bond holders taking a 21% "hair-cut". I also suggested that this might be rather generous. The yields than available indicated that a hair-cut in the order of 40-50% might be more appropriate.

Others had agreed. These included the accountants. The International Accounting Standards Board, end August, expressed concern that not only were European financial institutions taking wildly different approaches to how they valued the Greek sovereign debt they had on their books. What is more, some were valuing it far too highly.

Marking to what?

The argument was whether the banks should mark to market or mark to model. The former is what it says – the value of debt should be valued at what it would be worth if it were sold today. (Note that the stress tests of European banks, at least in the first round, had been criticised for allowing banks to value such debts at face value, because they claimed to be holding them to maturity rather than on their trading books.) The question was, what were they worth if sold today? Some said that because there was scarcely any trading of Greek debt, there was no market price to mark to. The alternative, to mark to model, allowed the banks to use their own valuation techniques based upon their own evaluation of worth. (Remember that models had been used to rate a whole lot of toxic products, and they had been criticised both for their lack of transparency and their contribution to the initial financial crisis.) Even ESMA – the new European Bank regulator – decided to investigate.

The extent of French bank exposure to Greece is difficult to determine. Some banks, especially German ones, are reported to have been unwinding their holdings in recent months. In total, French banks have about €53bn in the form of both public and private Greek debt on their books – making them the biggest holder by far – German banks come second worth about €36bn. Of the French banks, Crédit Agricole seems to have some €27bn holdings of Greek debt (€0.9bn in sovereign debt), Société Générale 6.6bn (€1.9bn in sovereign debt), and BNP-Paribas some €8.5bn (€5.bn).

Writing down and downgrading

Estimates of write-downs that were being made by different banks were produced by external commentators. Thus, whilst HSBC had written down its Greek holdings by 53%, of the above-named French banks, BNP had written down only by 23% and SocGen by 22%. BNP claimed that what it did was in accordance with the terms of the second bail-out. SocGen claimed that its mark to model approach had led to an even more penalising result than would have been the case if it had marked to market.

Not that the rest of the world was so sanguine. French bank share prices have been plummeting. From a high of some €52 in late February, CA's share price had fallen to €35 by mid-August and was down by half to little more than €17 this week as the bail-out package was subject to ever more doubts and talks about organised or unorganised default intensified. It felt sufficiently anxious that, on Monday (12-9-11) it organised a €4bn supplementary capitalisation. Soc Gen's and BNP's prices fell by about 37% over the last two weeks.

Today (14-9-11), Moody's cut both CA's and SocGens's credit rating by one notch and placed BNP on credit watch. In making its decision, Moody's factored in a hair-cut closer to 60%.

Analysts suggest that there is pressure for the banks to recapitalise, although the banks themselves claim that they are more than strong enough and that the downgrade was but "small".

Being on your Garde

There is a further French connection. In one of her first public statements on taking up her new role at the IMF, Christine Lagarde suggested that (some) European governments might need to slow down their fiscal consolidation if this was harming growth. She also argued that the real danger to Europe was that of under-capitalised banks. This is the same Christine Lagarde who served as Finance Minister in France where she spent her time trying to impress the rest of the world that French banks – CA, SocGen and BNP – were all sound.

Clearly some connections are not made when they ought to be, and some people have an interest in obscuring them when it is to their advantage. But it was because some people and some institutions were doing just this that we got into the state that we are in. In the meantime, we'd better make sure that we have booked some more appointments with our hairdressers. I understand that something called a "Twist" is all the rage in France at the moment. I thought that was what the Fed was trying to do with the yield curve. But that is yet another connection, and so another story.