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Debtors' Prism: Who Has Europe's Loans?

By **JACK EWING**

FRANKFURT

IT'S a \$2.6 trillion mystery.

That's the amount that foreign banks and other financial companies have lent to public and private institutions in Greece, Spain and Portugal, three countries so mired in economic troubles that analysts and investors assume that a significant portion of that mountain of debt may never be repaid.

The problem is, alas, that no one — not investors, not regulators, not even bankers themselves — knows exactly which banks are sitting on the biggest stockpiles of rotting loans within that pile. And doubt, as it always does during economic crises, has made Europe's already vulnerable financial system occasionally appear to seize up. Early last month, in an indication of just how dangerous the situation had become, European banks — which appear to hold more than half of that \$2.6 trillion in debt — nearly stopped lending money to one another.

Now, with government resources strained and confidence in European economies eroding, some analysts say the Continent's banks have to come clean with a transparent and rigorous accounting of their woes. Until then, they say, nobody will be able to wrestle effectively with Europe's mounting problems.

"The marketplace knows very little about where the real risks are parked," says [Nicolas](#)

Véron, an economist at Bruegel, a research organization in Brussels. “That is exactly the problem. As long as there is no semblance of clarity, trust will not return to the banking system.”

Limited disclosure and possibly spotty accounting have been long-voiced concerns of analysts who follow European banks. Though most large publicly listed banks have offered information about their exposure — [Deutsche Bank](#) in Frankfurt says it holds 500 million euros in Greek government bonds and no Spanish or Portuguese sovereign debt — there has been little disclosure from the hundreds of smaller mortgage lenders, state-owned banks and thrift institutions that dominate banking in countries like Germany and Spain.

Depfa, a German bank that is now based in Dublin, is one of the few second-tier European banking institutions that have offered detailed disclosures about their financial wherewithal, and its stark troubles may be emblematic of those still hidden on other banks' books.

Despite boasting as recently as two years ago of its “very conservative lending practices,” Depfa, which caters primarily to governments, has flirted with disaster. It narrowly avoided collapsing in late 2008 until the German government bailed it out, and today its books are still laden with risk.

DEPFA and its parent, [Hypo Real Estate Holding](#), a property lender outside Munich, have 80.4 billion euros in public-sector debt from Greece, Spain, Portugal, Ireland and Italy. The amount was first disclosed in March but did not draw much attention outside Germany until last month, when investors decided to finally try to tally how much cross-border lending had gone on in Europe.

Before Greece's problems spilled into the open this year, investors paid little heed to how much lending European banks had done outside their own countries — so it came as a surprise how vulnerable they were to economies as weak as those of Greece and Portugal.

“Everybody knew there was a lot of debt out there,” said Nick Matthews, senior European economist at [Royal Bank of Scotland](#) and one of the authors of the report that tallied up Greek, Spanish and Portuguese debt. “But I think the extent of the exposure was a lot higher than most people had originally thought.”

Concern has quickly spread beyond just the sovereign bonds issued by the three countries as well as by Italy and Ireland, which are also seriously indebted. Private-sector debt in the troubled countries is also becoming an issue, because when governments pay more for

financing, so do their domestic companies. Recession, along with higher interest payments, could lead to a surge in corporate defaults, the [European Central Bank](#) warned in a [report](#) on May 31.

Hypo Real Estate has hundreds of millions in shaky real estate loans on its books, as well as toxic assets linked to the subprime crisis in the United States. In the first quarter, it set aside an additional 260 million euros to cover potential loan losses, bringing the total to 3.9 billion euros. But that amount is a drop in the bucket, a mere 1.6 percent of Hypo's total loan portfolio. Hypo has not yet set aside anything for money lent to governments in Greece and other troubled countries, arguing that the [European Union](#) rescue plan makes defaults unlikely.

The European Central Bank estimates that the Continent's largest banks will book 123 billion euros (\$150 billion) for bad loans this year, and an additional 105 billion euros next year, though the sums will be partly offset by gains in other holdings.

Analysts at the [Royal Bank of Scotland](#) estimate that of the 2.2 trillion euros that European banks and other institutions outside Greece, Spain and Portugal may have lent to those countries, about 567 billion euros is government debt, about 534 billion euros are loans to nonbanking companies in the private sector, and about 1 trillion euros are loans to other banks. While the crisis originated in Greece, much more was borrowed by Spain and its private sector — 1.5 trillion euros, compared with Greece's 338 billion.

Beyond such sweeping estimates, however, little other detailed information is publicly known about those loans, which are equivalent to 22 percent of European G.D.P. And the inscrutability of the problem, as serious as it is, is spawning spoofs, at least outside [the euro](#) zone. A pair of popular Australian comedians, John Clarke and Bryan Dawe, who have created a series of sketches about various aspects of the [financial crisis](#), recently turned their attention to the bad-debt problem in Europe. After grilling Mr. Clarke about the debt crisis in a [mock quiz show](#), Mr. Dawe tells Mr. Clarke that his prize is that he has lost a million dollars. "Well done," says Mr. Dawe. "That's an extraordinary performance."

On a more serious front, [Timothy F. Geithner](#), the [United States Treasury](#) secretary, visited Europe at the end of May and called on European leaders to review their banks' portfolios, as American regulators did last year, to separate healthy banks from those that need intensive care.

Others say that if such reviews do not occur, the banking sector in Europe could be crippled

and the broader economy — dependent on loans for business expansions and job growth — could stall. And if that happens, says [Edward Yardeni](#), president of Yardeni Research, the Continent's banks could find themselves sinking even further because “European governments won't be in a position to help them again.”

LENDING practices at Depfa may have seemed conservative before its 2008 meltdown, but its business model had always been based on a precarious assumption: borrowing at short-term rates to finance long-term lending, often for huge infrastructure projects.

From its base in Dublin, where it moved from Germany in 2002 for tax reasons, Depfa helped raise money for the Millau Viaduct, the huge bridge in France; for refinancing the Eurotunnel between France and Britain; and for an expansion of the Capital Beltway in suburban Virginia. Depfa was also a big player in the United States in other ways, like lending to the [Metropolitan Transportation Authority](#) in New York and to schools in Wisconsin.

Before the current crisis, Depfa was proud of its engagement in Mediterranean Europe. In its [2007 annual report](#), the company boasted of helping to raise 200 million euros for Portugal's public water supplier and 100 million euros for public transit in the city of Porto. In Spain, it helped cities such as Jerez refinance their debt and helped raise money for public television stations in Valencia and Catalonia as well as raise 90 million euros for a toll road in Galicia. And in Greece, Depfa raised 265 million euros for the government-owned railway and in 2007 told shareholders of a newly won mandate: providing credit advice to the city of Athens.

Depfa said it performed a rigorous analysis of the creditworthiness of its customers, including a 22-grade internal rating system in addition to outside ratings. More than a third of its buyers earned the top AAA rating, the bank said in 2008, while more than 90 percent were A or better.

The public infrastructure projects in which Depfa specialized were considered low-risk, and typically generated low interest payments. Yet because long-term interest rates were typically higher than short-term rates, Depfa could collect the difference, however modest, in profit.

To outsiders, Depfa still looked like a growth story even after the subprime crisis began in the United States. Hypo Real Estate, which focused on real estate lending, acquired Depfa in 2007. After the acquisition, Depfa kept its name and its base in Dublin.

But when the United States economy reached the precipice in September 2008, banks suddenly refused to make short-term loans to one another, blowing a hole in Depfa's financing and leaving it with a loss for the year of 5.5 billion euros and dependent on the German government for a bailout.

As Hypo's [2008 annual report](#) said of Depfa: "The business model has proved not to be robust in a crisis."

Even with Depfa's myriad travails, most investors weren't aware of the extent of its cross-border problems until it disclosed them this year.

The question now hanging over Europe is how many other banks have problems similar to Depfa's, but haven't disclosed them.

On May 7, the cost of insuring against credit losses on European banks reached levels higher than in the aftermath of the [Lehman Brothers](#) collapse in the United States. Officials at the European Central Bank warned that risk premiums were soaring to levels that threatened their ability to carry out their fundamental role of controlling interest rates.

Three days later, European Union governments joined with the [International Monetary Fund](#) to offer nearly \$1 trillion in loan guarantees to Europe's banks. At the same time, the European Central Bank began buying government bonds for the first time ever to prevent a sell-off of Greek, Spanish and other sovereign debt.

The measures, widely regarded as a de facto bank rescue, restored some calm to the markets, but critics said that the aid merely bought time without reducing overall debt load. Europe's major stock indexes and the euro have continued to fall as investors remain dubious about the ability of Greece and perhaps other countries to repay their debts.

Even so, figuring out which banks may be most exposed to those countries largely remains a guessing game.

Regulators in each country know what assets their domestic banks hold, but have been reluctant to share that information across borders. Lucas D. Papademos, vice president of the European Central Bank, which gets an indication of banks' health based on which ones draw heavily on its emergency credit lines, said at a news conference Monday that a small number of banks were "overreliant" on that funding.

But Mr. Papademos, who retired last Tuesday at the end of his term, wouldn't be more

specific. He said European banks would undertake a vigorous round of [stress tests](#) by July.

It's obvious that Greek and Spanish banks hold large amounts of their own government's bonds. Spanish banks hold 120 billion euros in sovereign debt, according to the Spanish central bank. But a central bank spokesman said that those holdings were not a problem because, thanks to the European Union's rescue plan, the prices of Spanish bonds have recovered.

Guessing also falls heavily on public and quasipublic institutions like the German Landesbanks, which are owned by German states sometimes in conjunction with local savings banks. Five of Germany's nine Landesbanks required federal or state government support after they loaded up on assets that later turned radioactive, ranging from subprime loans in the United States to investments in Icelandic banks that failed.

According to the Royal Bank of Scotland study, banks in France have the largest exposure to debt from Greece, Spain and Portugal, with 229 billion euros; German banks are second, with 226 billion euros. British and Dutch banks are next, at about 100 billion euros each, with American banks at 54 billion euros and Italian banks at 31 billion euros.

"Banks continue to not trust each other," says Jörg Rocholl, a professor at the European School of Management and Technology in Berlin. "They know other banks are sick, but they don't know which ones."

DEPFA and Hypo Real Estate, meanwhile, face continued setbacks as they try to steer back to health. Hypo reported a pretax loss for the group of 324 million euros in the first quarter, down from 406 million euros a year earlier.

At the end of May, the German government raised its guarantees for Hypo to 103.5 billion euros from 93.4 billion. Some analysts say they think the bank may need more aid in the future.

"I don't think it's over yet," says Robert Mazzuoli, an analyst at Landesbank Baden-Württemberg in Stuttgart.

Raphael Minder contributed reporting from Madrid.