Force-feeding Capital to European Banks

There can be little doubt that the European sovereign debt crisis has finally drawn the full attention of Europe's leaders. After following events from a more than discrete distance, it is starting to look as if a consensus is evolving around three principles:

1) Greater write-down of Greek debt

2) More realistic stress tests of Europe's banks with a view to requiring them to reach 9-10% equity capital to risk-weighted assets over a fairly short period of time

3) Using the EFSF as a guarantor of first loss on sovereign debt, in effect increasing its firepower to €2 trillion or more.

The European Banking Authority's (EBA) last stress tests identified only €2.5 billion in capital shortfall for the entire region, a ludicrously low figure that lost them great credibility. Mike Cembalest, JPMorgan's Private Bank CIO, memorably commented that the number was so low he thought the results were being released by country alphabetically starting with Andorra. At the same time the IMF's estimate of the needed additional capital was €100-200 billion.

However, there is a problem with forcing banks to raise additional capital. They may instead decide to shrink their balance sheets instead, a prospect noted in the FT today. Issuing equity at 0.5 X book value is scarcely an attractive proposition and selling assets must be a realistic alternative. But that could well lead to a sharp slowdown in lending, further hampering the EU region's efforts to avoid (or emerge from) recession.

George Soros floats an interesting suggestion that governments should first unconditionally guarantee their banks to stabilize them, following up with recapitalization later when their share prices have presumably recovered.

While it’s positive that constructive solutions are now receiving consideration, holders of risky assets can still benefit from being short the Euro. The € continues to be the focal point of the global slowdown. We are long ProShares UltraShort Euro (EUO) as a hedge against other types of long equity risk in our hedge fund. The risk of a complete disaster is receding, but the solutions don’t look to be positive for European growth.

Disclosure: Author is long EUO