Back-Door Bank Runs in Europe Have Started

He then went on to explain that there are only three sources of funding available to a bank: its customers lending it capital through checking and savings accounts, the issuing of long-term bonds which it sells to bond investors, and short-term financing provided mostly through money market funds. If any of these sources dries up, it puts the bank almost immediately into a precarious financial position. He said that the day before the world's central banks stepped in to make short-term money more available was "frightening:"

> Even though I've been saying this has been coming, last week was truly frightening with the banking system about to fall into the abyss. Had the central banks not stepped in it would have been a Lehman moment.
>
> Sadly, they haven't solved the problem. They have bought time and whether that time is one or two weeks or maybe a month, we will soon find out.

Belgium's largest bank, Dexia, with some 35,000 employees and nearly $25 billion of "core shareholders' equity" at the end of last year appeared to have recovered from its near-death experience in 2008 when it required a $10 billion bailout. On July 15, 2011 the European Banking Authority applied a "stress test" to the bank's finances, and it passed with flying colors. The authority reported that its safest asset — Tier 1 Capital — was 12.1 percent, and would fall to 10.4 percent only under the test's "adverse scenario," making it one of Europe's safest banks.

On October 10 the bank failed, and had to be purchased by the Belgian government.

Dexia was the trigger event that started the run on the European banks. Paul Krugman of the *New York Times* answered a hypothetical question in his column on November 1:

> The question I'm trying to answer right now is how the final act will be played. At this point I'd guess soaring rates on Italian debt leading to a gigantic bank run…. This then leads to emergency bank closing(s)…

On November 21, the Fixed Income Research Unit of Credit Suisse had this to say:

> We seem to have entered the last days of the euro as we currently know it…. Some extraordinary things will almost certainly need to happen … to prevent the progressive closure of all the euro zone sovereign bond markets, potentially accompanied by escalating runs on even the strongest banks.

David Rosenberg, senior economist and strategist at Gluskin Sheff, wrote that same day that "banks are shedding their assets. Investors are increasingly reluctant to lend to either sovereigns or financial institutions…. Lenders are finding it difficult to finance their day-to-day operations with short-term funding. This is a lot like 2008…"

Two days later, *The Economist* wrote that a back-door run on European banks had begun in earnest. This is not the typical visible bank run with depositors lined up at the front doors waiting to withdraw their funds. Instead, as *The Economist* noted, “billions of euros are flooding out of Europe’s banking system through [the back door of] bond and money markets.” It started just after Dexia failed. In the third quarter bonds issued by European banks were just 15 percent of the amount they sold over the same period in the last two years.

Short-term financing started drying up too. American money market fund managers became aware of the increasing risks and began pulling their investors’ money out. According to *The Economist*, those funds have pulled almost two-thirds of their money out of French banks, and more than 40 percent of their funds from all European banks. Interbank borrowing costs are reflecting the increasing need for day-to-day funds as three-month rates are now the highest since 2009.

An analyst for Citi Group wrote that corporations also have started withdrawing excess balances from banks in Spain, Italy, France, and Belgium. This is forcing banks to begin to act like pawn brokers, putting up real assets as collateral for loans. The president of UniCredit, an Italian bank, for instance, has asked the European Central Bank to broaden its range of “acceptable assets” against which it will lend. And an increasing number of banks are now engaging in “liquidity swaps” where banks borrow an asset that the ECB will accept as collateral in exchange for one that it won’t accept, and paying a hefty premium for the privilege.

Banks are reducing their lending to finance trade and fund aircraft leases as well in order to preserve cash. But that only slows down the bleeding and buys the banks precious little time.

The blogger at the *Economic Collapse Blog* has confirmed that the back-door runs on European banks have begun:

> Right now we are seeing the beginning of a credit crunch that is shaping up to be very reminiscent of what we saw back in 2008. Investors and big corporations are pulling huge amounts of money out of European banks…. Nobody wants to lend to these banks. We could potentially see dozens of “Lehman Brothers moments” in Europe…

All of which is entirely predictable. The banks loaned money to credit-challenged sovereign states, hoping that at least they would be able to service the debt by making interest payments. Now, as credit is drying up and interest rates are soaring, the European economies are slowing down. This so-called “death spiral” can only end badly with the back door runs continuing until bank failures ultimately stop the bleeding.

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