Written by **Bruce Walker** on August 31, 2011

European Banks Water Down Greek Bond Losses

In banking, few values count more than consistency and integrity. The sovereign debt crisis in Europe, however, appears to have watered down those values in the case of some banks. The International Accounting Standards Board has stated that some European banks used the value provided by the Greek government in determining how much value Greek bonds should be counted in the assets of the bank. That would mean the bonds would be worth about 21% less than than the original valuation.

Those bonds on the open market, IASP Chairman Hans Hoogervost (above left) wrote in a letter to the European Securities Markets Authority — the organization responsible for regulating securities valuation — have much lower values than that. "This is a matter of great concern to us" the August 4th letter, which was made public on August 29th, warned. "It is hard to imagine that there are buyers willing to buy those bonds at the prices indicated by the valuation models being used."

IASB establishes the International Financial Reporting Standards, which are the standards that most European companies use. Hoogervost noted that going public with the August 4th letter was atypical but warranted in this case because of what he said were "visibly inconsistent application" of the accounting rules regarding these bank assets. IASB did not specifically name which banks engaged in this questionable practice, but the impact upon financial confidence is still certain to be significant. An auditor, citing confidentiality, noted regarding the standards used: "There was no consensus between regulators." The *Financial Times* was less charitable stating that Europe's financial institutions used "wildly divergent" approached to the writedown of Greek debt.

It appears certain that the Greek sovereign debt crisis, as well as the problems of the other PIIGS, are driving down the price of bank stocks in Europe. Although these stocks seemed to have been undervalued a few months ago, the stocks have been plummeting on the open market in the last month. Christine Lagarde, the Chief of the International Monetary Fund, is suggesting that some European banks were not sufficiently capitalized, meaning that the banks may not have enough money to weather the current financial storms. Louise Cooper, a market analyst for BCG Partners, described the quandary of investors recently in a note: "So which is it? One thing I can say for sure is that this sector is misspriced, but whether the European banks are way too cheap or way too expensive, I do not know. No wonder bank share prices are all over the place."

The European Securities and Markets Authority in a public statement advised that it was investigating the practices of European banks to determine whether banks used different practices in discounting Greek debt and whether the banks followed accepted accounting principles in how Greek debt was handled. The authority, however, observed that it was the duty of national regulatory authorities to make sure that the appropriate accounting practices were followed, which brings up the fact that the authority has little power to enforce its rules.

Many of the banks and insurance companies in Europe which owned significant amounts of Greek government bonds took their losses in the second quarter earnings statement. Since that time the Greek government has given banks the choice of rolling over or, instead, of swapping their bonds for new ones. The latter choice would result a 21 percent loss.The IFRS rules, though, provide different accounting standards for those bonds which firms plan to hold to maturity, and for bonds held to maturity the valuation should be current market value, and that value is much lower than the 21 percent discount used by many European banks.

Banking regulators in Europe are looking at ways to allow European banks to get credit for medium and long term funding. One idea floated by the European Banking Authority is to provide a guarantee for bank bonds that would require new powers for the EBA. There are already fissures within the European Union as a result of these proposals. BaFin, which is the German financial regulator, went to the unusual step of announcing its opinion: "The EBA has no powers under current European law to concern itself with these questions."

Other member nations are also skittish about granting new powers or pouring more money into systems that either appears to be in over their heads or which lack the mechanisms to insure integrity. What was at one point more an administrative matter within the European Union (albeit a high level administrative matter) has become an increasingly hot political issue.

The news from the European Union anymore seems always to be an underestimation of the scope of the problem and a willingness to conceal crucial information, like the writing off of bank assets, with no real consequence for acting irresponsibly. In January, the story broke that the Irish Central Bank simply began printing its own euros, a practice technically allowed (because notice was given) but surely malodorous in ethical financial systems. The 21% writedown of Greek bonds held by banks also does not pass the smell test: when Europeans stop trusting their banks, how far off can a meltdown be?