

German bank loss only the start

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The disclosure by the bailed-out German bank IKB that its losses for the year could total as much as €700 million (\$US954 million) is unlikely to be the last of such announcements as the impact of the subprime credit crunch spreads across European markets.

The board of IKB, which was bailed out at the beginning of August by a consortium of banks amid warnings that its failure could see the worst German financial crisis since 1931, said a “one-time balance sheet adjustment” was needed for a “fresh start.” The estimated loss represents a turn around of more than \$1 billion for the bank, which reported a profit of €179.6 million (\$244.6 million) in the 12 months to the end of March.

Under the terms of the bail-out, the state-owned KfW and an association of German banks agreed to cover as much as €3.5 billion of potential losses at IKB and its affiliate Rhineland Funding, which had invested in asset-backed debts, including US subprime mortgages. KfW assumed all of IKB’s €8.1 billion worth of obligations to Rhineland.

The massive losses suffered by IKB as well as those incurred by the state-owned bank SachsenLB may only be the start. This week Fitch Ratings reported that European banks were trying to reveal as little as possible about their exposure to the US subprime crisis. It warned that this reluctance to come clean over subprime exposure might be feeding nervousness in the markets about which banks and financial institutions hold what risks.

“One of the marked features of the current circumstances is the opacity of information,” Fitch said in a statement last Friday. “Without a better understanding of where the risks currently lie, many market participants are simply standing on the sidelines.”

Remarks about the “opacity of information” will no doubt strike some observers as a bit rich, given the role

played by Fitch and the other credit-rating agencies, including Standard and Poor’s and Moody’s, in providing high, investment-grade ratings to bundles of financial assets that included risky subprime mortgages. If China is to be taken to task for supplying toxic toys to the American market, it is argued, then should not the credit-rating agencies be held to account for unloading “toxic” debt on to European banks and financial institutions.

Last Thursday German Chancellor Angela Merkel said credit rating agencies should be included among participants in financial markets that require close public scrutiny. At the G8 summit in June, Merkel attempted to initiate moves for international oversight of hedge funds, but was rebuffed after opposition from the US and Britain. But the question of international regulation could be put back on the agenda at the meeting of G8 finance ministers in October.

French President Nicolas Sarkozy is among those who have hit out at the role of the US credit rating agencies in the subprime crisis. In a speech last month, he warned that financial crises would recur “if the leaders of major countries fail to take resolute concerted action to foster transparency and regulation of international markets.”

An article in the *International Herald Tribune* published on August 28 pointed to increased calls for an “international overview” of US markets. “We need an international approach, and the United States needs to be a part of it,” Peter Bofinger, a member of the German government’s economics advisory board, told the newspaper.

In the face of expected American opposition, Bofinger issued a pointed reminder about the implications of growing US indebtedness. “America depends on the rest of the world to finance its debt,” he said. “If our institutions stopped buying their financial products, it would hurt.”

Christian de Boissieu, the head of the French Council of Economic Analysis, which advises the prime minister, said hedge funds should be subject to stricter rules about disclosing their exposure to risk. He is also calling for a global register of all hedge funds and for complex securities to be scrutinised before being authorised for banking portfolios.

But such action may be a case of too little too late as the seriousness of the present crisis becomes more apparent. Despite emergency action by the US Federal Reserve Board, large parts of the commercial paper market, the source of short-term liquidity for corporations and financial institutions, remain paralysed. The volume of these loans has declined by \$244 billion in the past three weeks, reflecting the lack of confidence sparked by the subprime crisis. This contraction of 11 percent was the greatest in seven years, according to Fed data.

Moreover, there are doubts over whether action by the Fed to increase liquidity can prevent the housing slump from impacting on the rest of the US economy. As *Financial Times* columnist Wolfgang Munchau noted, if the subprime mortgage exceeds the value of a house and the mortgage repayments exceed income then interest rate cuts will be of no avail.

And there are further problems ahead. “We should remember,” he continued, “that the sub-prime market is not the only unstable subsection of the credit market. Once US consumption slows, we should prepare for a crisis in credit cards and car finance CDOs (collateralised debt obligations). And once corporate bankruptcies start to rise again as the cycle turns down, both in the US and Europe, we will probably hear about problems with collateralised loan obligations. The credit market is very deep and offers significant potential for contagion.”

Concerns over the state of financial markets and the economy more generally have not been eased by anything coming from the Fed’s annual symposium held at Jackson Hole over the weekend.

A Bloomberg report noted that the participants, including bankers and academics, left the gathering in a more pessimistic mood than when they arrived.

“I came to Jackson Hole thinking there would be no recession, but I’m leaving thinking we could well have one,” Susan Wachter, a professor at the University of Pennsylvania’s Wharton School told the news agency.

According to Ethan Harris, chief US economist at Lehman Brothers, there were “no optimists” at the gathering. “There’s a pretty strong consensus that this has gotten a lot more serious.”



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