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Guaranteeing the Guarantors

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Peripheral banks are struggling to tap markets, but a supranational guarantee scheme is not the easy solution it might appear to be.

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Peripheral banks struggling to fund in wholesale markets could benefit from a guarantee at supranational level, Morgan Stanley analysts have suggested. The idea carries a lot of merit. Given the negative feedback loop between Europe's banks and governments, a guarantee from the Portuguese, Irish — arguably even the Spanish — sovereigns would do little to help banks in these countries find demand or attractive pricing for a new issue.

On top of that, adding to the existing government guarantee programmes in these countries is likely to increase investors' wariness of the sovereigns.

With most peripheral banks already locked out of senior unsecured and close to maxing out their limits for covered bonds, the biggest source of liquidity for many is central bank repos, which have a maximum six month term. Morgan Stanley is not alone in warning of a lending crunch in Southern Europe if the region's banks remain locked out of wholesale markets.

A programme of guarantees for senior unsecured debt from the European Financial Stability Fund seems like an attractively simple solution to a crisis of confidence in the periphery's banks — and a way to keep lending flowing to the local economies.

The obvious reason against the idea is that the EFSF's ability to mop up all of Europe's debt woes will be weakened with every new liability it takes on — whether it be actual lending, or just a guarantee. That will only accelerate as those guarantees move further down the credit curve. And offering to help all banks would be unwise: Spain took another into administration only last month.

If European leaders decide that the prospect of another recession in the periphery justifies restarting bank debt guarantee schemes, a supranational programme needs to be carefully thought out. The fees and conditions attached would need to be strict enough to avoid banks borrowing more than needed — while at the same time avoiding singling out any others as too big to fail. And attention must be given to where the guarantor's claim would sit in the credit waterfall if an institution did go bust.

There are a lot of elements at play, but in the end the costs — skewed incentives and increased risk at the European level — may outweigh the benefits of escaping a couple of quarters of negative growth.

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