Europe's High Finance 'Faces Stiff Headwind'

by Lothar Komp

The worst meltdown of global financial asset prices since the 1930s, record numbers of corporate and sovereign defaults, and an *implosion* of investment banking undertakings—like initial public offerings (IPOs) and mergers—are devastating the world's largest financial institutions, and not least in Europe.

Already during the Summer of 2002, the European insurance sector was at the center of global financial worries, as about 30% of its huge reserves had been invested on the collapsing stock markets. In Britain, life insurance firms dramatically increased their penalty fees for early cancellations of contracts, trying to prevent panicking customers from taking their money out. In Germany, the association of life insurance firms established an emergency fund that could bail out one of their members in case of insolvency. Swiss Life, the largest insurance company in Switzerland, has lost about 80% of its stock price this year as, on top of overall market weakness, it had to restate its figures twice due to "accounting errors." Swiss Reinsurance, the world's second-largest reinsurer, in late August reported a 91% fall in profits for the first half of the year. Swiss Re explained, that the decline was neither caused by Sept. 11 nor by natural disasters, including the recent flooding in Central and Eastern Europe, but by the worldwide stock market crash. Two weeks earlier, Crédit Suisse Group, Switzerland's second-largest bank, reported a much bigger than expected loss, as it had to inject 1.7 billion Swiss francs into its troubled life insurance subsidiary Winterthur. In early October, Crédit Suisse Group again had to rescue Winterthur once again.

By mid-September, after the German DAX stock market index had fallen to 3,200 points, compared to about 8,000 points in March 2000, the German insurance giant Allianz, as well as other German insurance firms, hit the "panic button," selling off much of their stock portfolio in order to limit losses. By doing so, the insurance firms further accelerated the stock market decline. By the end of September, the German stock market closed its worst quarter since 1959, with a loss of 37%, which came on top of steep losses in the preceding nine quarters.

German Banking Crisis

Suddenly the issue of a "German banking crisis" entered the headlines of financial media. In the last week of September, the risk premiums on the debt of German banks exploded, as the creditworthiness of the German banking sector is being questioned by international markets. German banks have a particular exposure to the corporate sector, now hit by record-high bankruptcies, and the country's financial institutions—apart from their traditional holdings of domestic industrial stocks—entered the global stock market bubble relatively late in the game; that is, they often bought at bubble prices.

One of the triggers for the sudden eruption of fears concerning the German banking sector, had been rumors about considerable losses by Commerzbank in the credit derivatives business. The rumors were spread by the Merrill Lynch Europe headquarters in London, and were accompanied by a Merrill Lynch report on German banks entitled, "Turning Japanese," a reference to the enormous amount of bad loans in the Japanese banking system.

Within days, German bank stocks were crashing in a way even exceeding the dimensions of the Autumn 1998 Long Term Capital Management (LTCM) hedge-fund crisis. The total market losses of German banks within the last two and a half years are high enough to resemble those of some former "New Economy" high-rollers. Commerzbank stocks fell from 44 euros in 2000 to 5.3 euros on Oct. 8, 2002, the lowest price in 20 years, and a collapse of 88%. The market capitalization of Commerzbank in the same period sank from 24 to 3 billion euros. The other financial titles in the DAX-30 also faced huge losses: Bayerische HypoVereinsbank (–84%), Deutsche Bank (–64%), Allianz/Dresdner Bank (–83%), Münchener Rück (–75%), MLP (–96%). The entire market capitalization of these six firms crashed from 330 billion euros in 2000 to just 71 billion euros in early October 2002.

Extreme nervousness behind the scenes was revealed by an unusual number of statements by German banking supervisors and bank representatives. Frankfurt bankers accused City of London competitors of deliberately spreading "evil rumors." Commerzbank admitted that it will have to set aside more money than planned for bad loans. Commerzbank chief executive officer Klaus-Peter Müller gave interviews, claiming that "we have our problems under control," and urging that "no one should be questioning the existence of the bank." He nevertheless confirmed that banks are right now "facing the stiffest headwind in 30 or 40 years."

Four top bankers—Otmar Issing, European Central Bank chief economist; Edgar Meister of the Bundesbank directorate; Karl-Burkhard Caspari, vice president of the German financial supervisory agency BaFin; and Rolf E. Breuer, supervisory board chairman of Deutsche Bank and current president of the German banking association—all came out vigorously denying liquidity problems among large German banks. However, Issing had to admit that the situation of the German banking sector, at least on the stock markets, is indeed "dramatic." Already at the beginning of 2002, Bankgesellschaft Berlin was rescued from going bankrupt by a 21 billion euro state guarantee.