STOCK MARKET REVIEW

Is the European banking crisis returning?

PORTUGUESE BANK BANCO ESPIRITO SANTO'S (BES) HEADQUARTERS IN LISBON. PORTUGAL'S ESPIRITO SANTO FAMILY IS RACING TO FIND A WAY TO REPAY €847 MILLION IN MATURING DEBT. *PHOTO:RAFAEL MARCHANTE/REUTERS*

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Last Thursday, fears over the health of one of Portugal's largest banks triggered a sharp decline across international equity markets especially in the banking sector. Meanwhile, yields on Portuguese government bonds rose reflecting declining prices.

The developments in Portugal also triggered a decline in government bond prices of the other peripheral eurozone nations such as Italy, Spain, Greece and Cyprus. On the other hand, amid a renewed flight to quality, German bond prices increased with yields dropping to their lowest level in 14 months. Many international commentators argued that this reaction very much resembled the contagion witnessed a few years ago at the height of the eurozone sovereign crisis.

So what sparked the equity market sell-off and contagion in the bond markets of periphery countries?

Until recently, Banco Espirito Santo (BES), which was set up 94 years ago, was Portugal's largest private sector bank. Remarkably, BES was the only one of the top banks in Portugal that did not require a government injection during the country's sovereign debt crisis. The majority shareholder was the Espirito Santo family via two companies, a holding company Espirito Santo International (ESI) and Espirito Santo Financial Group (ESFG), a banking and insurance company based in Luxembourg. ESI owns 25 per cent of BES and ESFG holds a stake of another 26 per cent. ESI also has a majority shareholding in a major fund manager in Portugal.

Early last week, ESFG announced that ESI was experiencing "material difficulties" after it failed to pay the interest on some of its short-term debt instruments. The problems had started surfacing last May when the Bank of Portugal ordered an audit of BES, ESI and ESFG following concerns that ESI was struggling. The auditors discovered accounting irregularities at ESI and BES admitted that ESI was in serious financial difficulties.

Following the news of ESI's difficulties in paying the interest on its debt, the speculation on the possible exposure of BES and ESFG to ESI led to a suspension of the equities of both companies on the Lisbon stock exchange last week. However, shortly before the suspension last Thursday, the share price of BES had already lost 19 per cent at the start of the day. Meanwhile, international rating agency Moody's immediately downgraded the bank's credit rating by three notches to Caa2 – a rating representing a default situation.

In a bid to quell market speculation about its €1.15 billion exposure to the other companies of the Espirito Santo family, BES issued a press release late Thursday evening explaining that it had €2.1 billion in excess capital beyond the minimum regulatory requirements. The press release also noted that "the potential losses resulting from the exposure to the Espirito Santo Group do not compromise the bank's compliance with the regulatory capital requirements".

Despite the assurances from BES as well as those of the government and the Bank of Portugal that BES is ring-fenced from the problems of the Espirito Santo Group and that its solvency is not at risk, investors feared that the full extent of BES's exposure to the Espirito Santo Group may not have yet been fully disclosed. Some commentators estimated that the exposures could leave BES with a capital shortfall of up to €3 billion. Portugal's Prime Minister also confirmed that Portuguese taxpayers would not be called in to bail out failing banks, making it clear there would be no state support for BES.

Portugal's banking problems had an immediate negative effect on the Portuguese government's borrowing costs and this could complicate the country's ability to recover from their sovereign debt crisis. In fact, 10-year yields, which had dropped to almost 3 per cent in recent weeks from over 13 per cent in February 2012, jumped to 4 per cent last week on the news surrounding BES. Likewise, government bond yields of the other eurozone periphery nations had also declined steadily from their very high levels at the peak of the crisis (a clear signal that the market became more comfortable with the creditworthiness of such countries). However, last week's developments in Portugal confirmed the weak health of some of the banks in the periphery countries and the difficulties when dealing with struggling financial institutions – a clear signal that the debt crisis is not yet over.

A further rise in yields on Portuguese government bonds may compromise the country's efforts to tap the bond markets regularly in the coming years to fund a series of bond redemptions. This has already led some international commentators to speculate that eventually Portugal will need to restructure its debt to be able to come out of its debt spiral. The government's finances are stretched, as debt levels jumped from 94 per cent to 129 per cent of GDP over the past three years partly due to the severe austerity measures undertaken as part of the EU and IMF rescue package. A debt restructuring programme will inevitably imply losses for holders of Portuguese government bonds.

PEOPLE WALK IN FRONT OF THE MAIN OFFICE OF BULGARIA'S CORPORATE COMMERCIAL BANK IN SOFIA. BULGARIA WILL STRIP CORPORATE COMMERCIAL BANK (CORPBANK) OF ITS LICENCE AND ALERT PROSECUTORS TO POSSIBLE MALPRACTICE AT THE LENDER, THE CENTRAL BANK SAID. *PHOTO: REUTERS/STRINGER*

Apart from the developments in Portugal, renewed anxiety across financial markets was also caused by the publication of some weak data from the two largest eurozone economies and a bank run in Bulgaria. Recent statistics indicate that the German economic recovery appears to be slowing while France could slip back into recession. Meanwhile, last month there was a bank run at the Bulgarian fourth-largest bank, Corporate Commercial Bank (Corpbank), after media reports indicated that its top shareholder was involved in some suspicious business deals. The bank run, which drained Corpbank's deposits by more than 20 per cent in a few days, spread quickly to another bank and the government intervened with a protective credit line of $2.3 billion. After a number of initiatives failed to keep the bank in operation, earlier this week it was announced that Corpbank will cease to operate – another stark reminder of the problems that still exist in some parts of the banking sector.

The most recent developments in Portugal and the weaker economic data elsewhere could lead to the European Central Bank adopting quantitative easing (QE), i.e. money printing in a similar way to what happened in both the US and the UK. Such a decision by the ECB would be further proof of the economic problems still evident in Europe. QE is certainly more difficult in a monetary union with fragmented financial markets than in the US or the UK, where the central banks used QE partly to help the housing market and the corporate sector. While some economists argue that without QE, the eurozone economy will most probably get stuck in a long period of low growth and ultra-low inflation, others believe that QE may have negative consequences on financial stability due to asset bubbles that this may create. In fact, the QE by the Federal Reserve and the Bank of England led to increasingly buoyant equity and bond markets across the globe as these two major central banks injected the financial system with huge levels of liquidity.

The events of recent weeks and the impact on both equity and bond markets again highlights the importance for investors to keep the element of risk in perspective and not to follow the 'herd instinct'. Equity and bond markets are bound to become increasingly volatile following their strong rally over recent years. Investors should therefore continue to seek professional advice periodically to ensure that their investment portfolios are constantly positioned to reflect their risk appetite and financial objectives.