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FOCUS: European Banks Seen Shaky Bet On High Loan Defaults

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ZURICH (Dow Jones)--European bank shares have made solid gains in recent months because of improved operating conditions and as many players have largely cleansed themselves of the illiquid assets that dogged them at the peak the crisis.

But analysts warn that the 17% increase in the Stoxx Europe 600 bank index since the start of the year may not have priced in the coming impact of the recession on loan losses, which may also lead some banks to seek fresh capital.

At the depth of the crisis, banks such as HSBC Holding PLC (HBC) and Credit Suisse Group (CS) were seen by investors as a relatively safe havens against battered financial markets and are seen emerging in good shape.

"We now think that fourth-quarter 2008 likely marked the trough for these banks' trading operations and that first-quarter 2009 has seen the bottom for their investment banking, asset management, and wealth management businesses," said Scott Sprinzen, a credit analyst with Standard & Poors.

Bank shares have risen briskly, helped by a brightening outlook for Europe's largest investment banks in particular - which include Credit Suisse and Deutsche Bank AG (DB). Stock offerings, debt issues and equity derivatives are examples of activities that flourished in the second quarter, which banks are due to begin reporting later this month.

Across Europe, banks that are also considered to have pulled through the subprime and financial crisis with minimum damage include: French bank BNP Paribas SA (BNP.FR), Italy's Intesa Sanpaolo SpA (IST.MI), Spain's Banco Santander SA (STD), U.K.-based Standard Chartered PLC (STAN.LN), and Scandinavian banks such as Nordea Bank AB (NDA.SK).

Despite recent optimism, new clouds are seen gathering.

Some analysts say the outperformance of European banks compared with insurance companies in recent months could be reversed because of emerging factors in their respective markets. The Stoxx Europe 600 insurance index has fallen 11% since the start of the year.

"Firstly, bank stocks have performed much better than insurers in the first half, and second the issue of loan write-offs will hurt banks, but not so much insurance companies," said Stephane Dutu, Geneva-based portfolio manager with **Vernes & Associes**, which manages roughly $184 million in assets.

Standard & Poors analyst Scott Bugie sees provisions for credit losses soaring this year. In many European countries, the rate of domestic loan losses is set to double, he said.

Just Monday, meanwhile, Moody's Investors Service changed the outlook for Dutch banks to negative from stable, citing "deteriorating profitability and limited diversification." And in June, Moody's put the financial strength ratings of 21 Italian banks on review for possible downgrade, saying the industry's operating environment has deteriorated significantly.

There are also concerns that after raising an estimated $107 billion in Tier 1 capital, some European banks may have to line up for more cash, according to analysts at bond research firm Credit Sights.

Spain set up a EUR9 billion fund for emergency bank restructurings and funding, which was lauded by ratings agency Fitch. The fund will have "a lot of leeway" to use the funds in different ways, even going so far as to provide bridge financing for bank deals if they are deemed as an effective way of strengthening the Spanish financial system, Credit Sights said.

To be sure, the immediate outlook, particularly for investment banks, has brightened as several such as Credit Suisse and BNP Paribas are set to record what portfolio manager Dutu of **Vernes & Associes** termed a "fixed-income bonanza" in the second quarter, with companies increasingly turning to debt markets to replace loans from cash-strapped banks.

Besides loan losses, recent European bank share price gains don't take into account that Europe will emerge much more slowly - as much as one year later - from its recession than the U.S., where some banks such as J.P Morgan & Chase Inc. (JPM) have begun paying back government funds, Deutsche Bank's Matt Spick said.

Some banks which have managed without government cash, such as Credit Suisse, are also seeing constraints in how they may use their excess capital, which could also be reflected in the share price. While the bank has begun putting funds aside to pay a year-end dividend, analysts say the Swiss regulator would frown on a share buyback, another often-favored shareholder payout method.

French bank Societe Generale SA (GLE.FR) said Monday it expects to post a small profit in the second quarter as losses from credit default swaps and the reversal of earlier fair-value gains on its own debt weigh on an otherwise improved operating performance.

In the first quarter, the bank posted an unexpected net loss of EUR278 million because of write-downs and higher provisions.

Little over a week ago, Switzerland's UBS AG (UBS) warned that reversals of gains on its own debt and restructuring charges would push it to a second-quarter loss.

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