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European banks' toxic debts risk overwhelming EU governments

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The toxic debts of European banks risk overwhelming a number of EU governments and may pose a "systemic" danger to the broader EU banking system, according a confidential memo prepared by the European Commission.

"Estimates of total expected asset write-downs suggest that the budgetary costs of asset relief could be very large both in absolute terms and relative to GDP in member states," said the document, prepared for a closed-door meeting of EU finance ministers.

"For some member states, it may be the case that asset relief for banks is no longer an option, due to their existing budgetary constraints and/or the size of their banks' balance sheet relative to GDP. The extent of any risks to the EU banking system as a whole from an inadequate response in these member states needs to be considered, particularly in the case of cross-border banks".

While no country was mentioned, the obvious candidates are Ireland, Luxembourg, Belgium, the Netherlands, Austria, Sweden, and Britain — and non-EU member Switzerland — which all have oversized banking sectors. EU banks hold balance sheet assets of €41.2 trillion (£36.9 trillion).

Brussels refused to comment on the paper, but it is clear that officials are concerned about default risk in the weaker states where interest spreads on government bonds are flashing warning signs. The International Monetary Fund has questioned the lack of a proper lender of last resort in the eurozone. The European Central Bank is not allowed to bail out individual states, yet national goverments do not control the monetary levers.

The IMF says European and British banks have 75pc as much exposure to US toxic debt as American banks themselves, yet they have been much slower to take their punishment. Write-downs have been $738bn in the US: just $294bn in Europe.

Global banks have so far written down half the $2,200bn losses estimted by the IMF. On top of this, EU banks have $1,600bn of exposure to Eastern Europe — increasingly viewed as Europe's subprime debacle, and EU corporate debts are 95pc of GDP compared to 50pc in the US, a mounting concern as default rates surge.

The EU document also highlighted the "real danger of a subsidy race between member states" if countries start to undercut each other in the way they value toxic debts in their `bad bank' rescue programmes. This could be used as a means of covert state aid, undermining the unity of the EU single market.

It could also lead to an explosion of budget deficits, already threatening to hit 12pc of GDP in Ireland next year and almost 10pc in Spain and Britain.

"It is essential that government support through asset relief should not be on a scale that raises concern about over-indebtedness or financing problems. Such considerations are particularly important in the current context of widening budget deficits, rising public debt levels and challenges in sovereign bond issuance," it said.

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