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The beginning of the end game

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Daniel Gros & Stefano Micossi*

The US financial system is being nationalised piece by piece. With the AIG operation the US government has taken control of its biggest insurance company just two weeks after it had to save Fannie and Freddie, by far the world's largest mortgage underwriters. It is likely that a number of medium-sized regional banks heavily exposed to the real estate market will soon have to be saved as well. The remaining US banks not yet formally nationalised depend on a number of generous 'temporary' facilities operated by the Federal Reserve.

It is fitting that the first institutions to be formally nationalised in this crisis were not banks in the traditional sense, but institutions (Fannie and Freddie, AIG), which were supposed to play only a supporting role in the financial system.

Formally, the AIG operation is composed of two separate elements: the Federal Reserve of New York has been "authorized to lend" AIG up to US$ 85 billion. At the same time, however, the US Treasury is taking control of AIG, of which it will own 80%, thereby immediately changing its management. The Federal Reserve is thus providing financing to the US government. The punitive terms (850 bps above LIBOR) agreed for the loan to AIG are irrelevant as any interest payments would merely go from the left to the right hand pocket of the government.

But at the same time the balance sheet of the Federal Reserve has now been loaded with so many assets of dubious value that the Fed itself may soon no longer be solvent; hence the Fed's request for a recapitalisation by the Treasury. This means that the US Central Bank has lost its independence, since it now survives on a life-line from the US government.

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* Daniel Gros is Director of CEPS and Stefano Micossi is Director of ASSONIME and a board member of CEPS.

An independent central bank committed only to the goal of price stability used to be considered an essential cornerstone of a modern macroeconomic stability-oriented policy framework. In the US this is giving way to a situation in which the Central Bank ended up in the pockets of the finance ministry, while frantically trying to re-establish normal operating conditions in financial markets. Will Europe be far behind?

The near miss of AIG also provides an illustration of the nature of the links between global financial markets. One key link has so far been risk-sharing. European (and other) financial institutions held a large share of the assets based on US residential mortgages and thus shared in the losses that arose when the US housing market turned sour. This type of risk-sharing is exactly what financial globalisation should be able to provide. The US banking system would be in an even worse shape had all the losses from US sub prime-based securities been concentrated in the US.

But the AIG case shows the importance of another link across financial markets, namely massive regulatory arbitrage. The K-10 annex of AIG's last annual report reveals that AIG had written coverage for over US$ 300 billion of credit insurance for European banks. The comment by AIG itself on these positions is: "…. for the purpose of providing them with regulatory capital relief rather than risk mitigation in exchange for a minimum guaranteed fee". AIG thus helped to organise regulatory arbitrage on a gigantic scale. A formal default of AIG would have had a devastating impact on banks in Europe. This explains why AIG's problems had sent shock waves through the share prices of European banks. For the time being the US Treasury has saved, *inter alia*, the European banking system, but given that AIG is to be liquidated European banks now have to scramble to find other ways of obtaining the 'regulatory capital relief' they appear to need urgently.

So far European banks have been spared the convulsions that are ravaging the US financial system. This is surprising because some of the major European banks have leverage ratios (often over 30, in some cases close to 50) that must, under current market conditions, be considered a disaster in waiting. The experience over the last year has shown that given the automatic feedback loops in a system of mark to market and ratings, any slight doubt about the solvency or liquidity situation of such highly leveraged institutions (see Figure 1) can lead to their demise in a matter of days.

The European Central Bank and European regulators are living on borrowed time.

Figure 1. European banks ranked by total assets (€ million)

Bank	**Total Assets June 2008**	**Total Assets end 2007**	**Market Capitalisation Oct 2008 (Billion)**	**Leverage Ratio June 2008**	**Leverage Ratio end 2007**
HSBC	2,546,678	2,354,266	140.9	20.1	18.4
RBS	2,463,214	2,579,194	37.2	18.8	20.8
Deutsche Bank	1,990,740	2,020,349	24.4	59.1	52.5
BNP Paribas	1,817,193	1,694,454	59.1	36.1	31.5
Barclay's Bank	1,726,187	1,665,652	37	61.3	52.7
Credit Agricole	1,464,822	1,414,223	32.3	40.5	34.8
ING Group	1,369,947	1,312,510	33.8	48.8	35.3
UBS	1,292,081	1,370,820	42.1	46.9	63.9
Societe Generale	1,075,925	1,071,762	37.5	30.3	39.3
UniCredit	1,059,767	1,021,504	37.7	19.0	17.7
Fortis	974,343	871,179	12.9	33.3	26.4
Credit Suisse	764,828	820,762	34.6	33.4	31.5
Commerzbank	615,223	616,474	8.5	39.9	38.2
Dexia	613,708	604,564	9.8	64.4	41.6
Intesa Sanpaolo*	572,902	572,902	48.2	11.1	11.1
BBV Argentaria	504,990	502,204	43.4	20.1	18.6
Lloyd's TSB	464,876	479,185	19.8	34.1	31.0
Hypo Real Estate Holding	395,422	400,174	1.1	83.0	65.9
KBC	377,351	355,597	21.9	24.4	20.5
Standard Chartered	251,287	224,092	25.1	19.5	15.8
Deutsche Postbank*	202,991	202,991	4.8	38.2	38.2
Banco Popular	108,928	107,169	10.3	16.6	17.2

* Interim 2008 data not available