

## Could the European Debt Crisis Cause a U.S. bank to Fail?

Time.com

September 28, 2011

Depending on how you look at it, U.S. banks could lose as much as \$1 trillion if the current money troubles in Europe were to lead to a full blown financial crisis. Or they could close to nothing. It depends on who you believe. Understanding why there is a difference of opinion is at the heart of knowing whether U.S. banks are really in trouble.

For right now, the point may be moot. In the past few days the news out of Europe has been looking a little better. Greece said again that it has no plans to default and will make good on its debt. And Germany's Chancellor Angela Merkel has pledged that her nation - the strongest financially in the European Union - plans to fully support Greece. Michael Sivy over at our sister blog [Moneyland](#) believes the sell off in European stocks may have been overblown and has some investment ideas on how to benefit when the market rebounds.

(Photos: [Riots Spread Across England](#))

But for a while there, and perhaps again, investors seemed really worried about the affect a European crisis could have on U.S. banks. Shares of the biggest banks have been falling for the past month or so on worries of European troubles, though to be fair the weak U.S. economy, legal woes and downgrade of U.S. government debt hasn't helped the banks either. Some argued that a crisis in Europe could significantly hammer U.S. banks and lead us back into our own financial crisis. Is this possible? Or was the sell off just another sign of lingering PTSD from the 2008 financial crisis? It's not really clear. But what is clear is that the European crisis and how it is affecting U.S. banks is another sign of why Dodd-Frank regulations don't go far enough to protect us from future financial crises. Here's why:

Early on, as the European debt crisis began to develop, a number of banks reported that they had little or no exposure to the sovereign debt problems in Europe. The Federal Reserve echoed that sentiment. In mid-July Ben Bernanke sent a letter to Congress saying the exposure of U.S. banks to Ireland, Portugal and Greece was "quite small." That seemed to satisfy the market for a little while. But in the past few weeks, the market began to doubt just how protected U.S. banks were. U.S. banks, relatively, don't hold a lot of sovereign bonds that they could lose money on. But European banks do. And U.S. banks do a lot of trading with European banks. So the thinking goes that if a European bank were to fail, some U.S. banks might be exposed to big losses if the bets they had made with that bank, particularly the ones that would go up should there be a crisis, could not be paid out.

(MORE: [The End of Europe](#))

Enter the controversy over Morgan Stanley. Last week, as the worries about France and its banks - Societe Generale is widely rumored to be in need of a bailout - the blog [Zero Hedge](#) wrote a [story](#) that Morgan Stanley could lose as much as \$30 billion on the trades it has made with French banks, or about \$2 billion more than the bank's current market cap. The blog got its data from a government source called the Federal Financial Institutions Examination Council that tracks all the cross boarder exposure of all the major banks. So the \$30 billion losses estimate seemed legit. The problem: Morgan Stanley says its exposure to French banks is essentially zero. And analysts seem to agree.

How could that be? Well, it's complicated. The government data gives the total exposure banks have to foreign financial institutions. It doesn't include hedges. Banks often take out insurance against trades they bank with other banks, just in case something like a default happens. What's more, bank sometimes collect collateral from the banks they trade with to at least partially cover the financial bets they make with other banks - kind of like a margin account. Morgan Stanley is essentially saying, yes we have \$30 billion in bets with French banks, but all of those bet are laid off or covered by money we have already collected.

End of story. Not quite. As Zero Hedge [points out](#), hedges, like credit default swaps, are only as good as banks you make them with:

Ah yes, collateral and hedges, which, lest we recall incorrectly, did miracles when Lehman blew up and the very fabric of net hedging offset was threatened when the viability of the initiator in the "gross" CDS chain was put into question (thank you AIG). Naturally, if and when the 3 Big French banks go down, everyone will be perfectly normal and have no problem netting of hedges.

The term for all this is called counterparty risk. If you sign up for a hedge with a bank that goes under, than you are really not hedged at all. So where does that leave us?

To figure this all out I called up David Kelly of Quantifi, which specializes in assessing counterparty risk. He says it is kind of like a Cat in the Hat problem. To get the pink ring off the tub you have to splash it on the wall. He says the problem is we really can't tell how big a problem this is unless we know how much of the risk Morgan has is covered by collateral and how much is covered by CDS contracts, and who those contracts are with.

And that brings us to Dodd-Frank. The financial reform bill was supposed to make financial crises less likely to happen. But it doesn't do that much to stop this problem. The financial reporting of banks remains opaque. So when a problem like what's going on in Europe right now pops up, it's really impossible for investors to know just how big a bank's losses might be. So investors panic, and problems ensue.

Just how worried should investors be about the U.S. banks' exposure in Europe? It's hard to say, but my guess is not very. Counterparty risk is probably not as big as a problem as Zero Hedge and others make it out to be. For instance, at the time Lehman failed there was talk that other banks could lose as much as \$400 billion because of the bets they had placed with Lehman. The actual losses ended up being a little more than \$5 billion. Yes, some of the losses were capped because the government bailed out AIG and others. A European financial crisis, though, would probably involve some bailouts as well. But again, the fact that we are having this debate at all shows that the issues that led up to the financial crisis of 2008, really haven't been resolved.

Copyright © 2011 Time Inc.

Source: <http://curiouscapitalist.blogs.time.com/2011/09/28/could-the-european-debt-crisis-cause-a-u-s-bank-to-fail/?iid=tsmodule>