Trade Deal Could Stick U.S. With EU's Bank Bomb

By Simon Johnson - Jun 18, 2013

With grand rhetoric, Group of Eight leaders this week seized upon the prospect of a deal between the U.S. and Europe that would reduce or eliminate tariffs and other trade barriers. David Cameron, the U.K. prime minister, called it "the biggest bilateral trade deal in history" and "a once-in-a-generation prize" that "we are determined to seize."

But would the proposed trans-Atlantic trade agreement really be a prize, or would it more closely resemble a poisoned chalice for the U.S.?

I think the latter is more likely. The European economy is a mess, with big unanswered questions about how sovereign debt will be handled and whether a strong fiscal union will be built in the euro-currency area. The periphery countries are struggling to recover, and even the two biggest economies, France and Germany, seem likely to show unimpressive growth in the near term.

Italy will continue to have a great deal of public debt and very little growth for the foreseeable future (see this 2012 paper by Bill Cline of the Peterson Institute for International Economics). Keeping interest rates low rarely works as a strategy over the business cycle -- unless you are prepared to accept substantial inflation. Does any of the Italian debt become a joint obligation of other euro-area members at some point? It is very hard to see through the murk.

The biggest danger, however, is the European banking system.

Undercapitalized Banks

The U.S. financial system suffers from large banks operating globally that are funded with too little equity, relative to their debts (and relative to their balance sheets). The most complex U.S. financial institutions are undercapitalized, posing a significant macroeconomic risk as the credit cycle unfolds.

Executives at these banks try to allay such concerns by pointing out that they have more capital than their European competitors. That is correct.

In a recent report, Fred Cannon, the director of research at KBW Inc., compares the capital levels at large banks in the U.S. and Europe, with an emphasis on leverage ratios, by looking at loss-absorbing equity capital compared with total assets, without any risk-weighting. (He has graciously allowed free access to his report, for this week only.)

This approach is appealing because risk weights have proved mistaken in every crisis, most recently in the fiscal dislocations of the euro area. Euro-area government debt is regarded by regulators as zero or very low risk weight. That assumption is dubious at best; future historians will probably view it as ludicrous.

Comparing leverage ratios across different accounting regimes involves making assumptions. Cannon provides a consistent approach to banks' exposure by including all over-the-counter derivatives. This is entirely reasonable because it implicitly assumes there is risk in gross derivative positions even when some bets are offset by so-called master netting agreements with counterparties.

Cannon will probably get a lot of pushback for his approach, because it has a significant impact on the size of U.S. banks' balance sheets by making their total assets and liabilities larger and their equity levels smaller. But his calculation is a valid attempt to bridge the difference between the generally accepted accounting principles in use in the U.S. and the International

Financial Reporting Standards practiced in Europe.

Failure Risk

In a public discussion recently, a senior financial-services executive insisted that netting agreements never fail. The assertion was undermined by the fact that his company once held the view that U.S. housing prices never fall, that AAA-rated collateralized debt obligations are always a safe bet and that there is no default risk in euro-area sovereign debt.

In addition, net exposures mask the risk of runs and potential insolvency; as my colleague John Parsons has explained, gross exposures can tell us a great deal about vulnerability and therefore systemic risk.

Using the leverage ratio as defined under the international bank capital and liquidity rules known as Basel III, Cannon calculates that Goldman Sachs Group Inc. (GS) has equity worth 4.6 percent of total assets, while JPMorgan Chase & Co. (JPM) stands at 4.5 percent, and Morgan Stanley (MS) (with the most leverage of the big eight U.S. banks) is at 3.8 percent.

The slightly good news in recent months is that regulators, both at the Federal Deposit Insurance Corp. and the Federal Reserve's Board of Governors, have indicated that they would like to increase the amount of loss-absorbing equity at U.S. banks, as calculated on a leverage ratio basis. Sheila Bair, the former chairman of the FDIC, has long called for a leverage ratio of at least 8 percent for big U.S. banks. (I'm a member of the Systemic Risk Council created by Bair after she left public office.)

Whatever your view of the right level of loss-absorbing equity capital in the U.S., the European numbers are alarming. Deutsche Bank AG (DBK) does worst, with a Basel III leverage ratio of 2 percent (up only slightly after recent capital raising), while Societe Generale SA (GLE) is at 2.7 percent, and BNP Paribas is at 3.3 percent. (Their Basel III Tier 1 common equity

ratios are much closer to the U.S. levels thanks to risk-weighting calculations that are deeply flawed.)

Barclays Plc (BARC) is hardly better, with a leverage ratio of 2.9 percent, though Anat Admati and Martin Hellwig's book, "The Bankers' New Clothes," which argues for higher equity requirements, has been well received in some official circles in the U.K. But the U.K.'s European partners reject the idea of higher levels, and the web of European treaty commitments makes any change difficult.

To the French and German governments, very low levels of bank equity are a feature of their financial systems, not a bug. This, of course, is a recipe for distortions, instability and, most likely, repeated disaster.

Should the U.S. be tied more closely to the European economy under such circumstances? The benefits seem dubious -- trade analysis doesn't include assessments of how further integration would increase U.S. volatility, or who bears the brunt of credit crunches when they occur.

And it would be a very bad idea for the U.S.-Europe negotiations to include financial services in any significant form, as the industry is strongly requesting.

The Europeans' policy on financial regulation is a millstone. It shouldn't also be tied around the neck of the U.S. economy.