HCP NOTES

That Was Then, This is Now

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Comparing the European Debt Crisis to the Credit Crisis

Europe's current sovereign debt crisis bears many similarities to the recent U.S. Credit Crisis. Both crises involve(d) two roughly $14 trillion dollar economies weakened under the weight of too much leverage, particularly within the financial system. Both have seen central bankers provide unprecedented monetary accommodation as they struggle for ways to support economic growth. What's more, bank stocks have acted in both cases as a daily barometer of investor confidence.

However, what is happening in Europe is not a repeat of the Credit Crisis, and there are three primary differences. First, the potential losses facing Europe are nowhere near as large as those of the Credit Crisis. Second, the Credit Crisis was, at its core, an exceptionally severe banking crisis. By contrast, the crisis in Europe is multi-dimensional, with a sovereign debt crisis having the potential to cause a banking crisis. Third, the need to achieve consensus among many countries, each with their own political priorities and motivations, makes the European crisis harder to resolve, and its outcome more difficult to predict. In addition, its complex geopolitical implications introduce severe tail risk.

Potential Losses Facing Europe are Nowhere Near those of the Credit Crisis

The first and most important difference between the two crises is the relative size of the potential losses from "toxic" assets. During the Credit Crisis, the market struggled to value an unfathomable $15 trillion of real estate mortgages (both whole loans and securitizations), unable to discern how much was toxic as real estate prices were collapsing. Eventually, the crisis's monumental scale, and the ubiquitous nature of these assets (which were owned directly or indirectly around the world), froze the global credit market and contributed to a global recession.

By contrast, the level of "toxic" assets or sovereign debt exposures in Europe is much smaller. The sovereign debt for Greece, Portugal and Ireland total less than US$1.0 trillion. This rises to approximately $4.5 trillion if fellow GIIPS countries, Spain and Italy, are included. While obviously very large, this is just over a quarter of the exposures of the Credit Crisis.

To put the enormous size of the Credit Crisis into further perspective, there were failing banks that were not central to the crisis with loan books larger than the entire debt of the most troubled European countries, namely Wachovia (Greece), Washington Mutual (Portugal), and National City (Ireland).

For more information on any of HCP's funds, please contact:

Patrick Sommerville
Managing Director, Business Development
416-941-9250
psommerville@hamilton-capital.com

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Even worse, entering the Credit Crisis, the U.S. financial system was extremely vulnerable to shocks, as most toxic assets were held by giant and highly levered financial intermediaries that lacked the crucial capital to absorb looming losses. At the extreme were Fannie Mae and Freddie Mac, which held or guaranteed a staggering US$4.5 trillion of residential and multifamily loans and had an effective leverage ratio of an astonishing 70x[1]. The U.S. banks held another US$5 trillion of real estate loans (with leverage exceeding 25x)[2]. There were no less than six financial intermediaries central to the Credit Crisis, that had assets in excess of a trillion dollars (and that does not even include Lehman Brothers or Bear Stearns, which together had assets in excess of a trillion).

The severity of the Credit Crisis was also greatly amplified by the role of the five global publicly traded investment banks[3]. Although these firms had "only" a few hundred billion dollars of "toxic" assets on their $5 trillion-plus balance sheets, a devastating combination of high leverage ratios (approximately 30x), mark-to-market accounting, and overnight funding nearly caused the collapse of the entire financial system, bringing the crisis to its penultimate moment with the failure of Lehman Brothers[4].

Though Europe's economies are in aggregate roughly the same size as that of the U.S., the amount of "toxic" assets in the banking system is much smaller. For example, according to the European Banking Authority, the amount of GIIPS sovereign debt held by the 34 largest banks is under $500 billion (supported by leverage of approximately 22x)[5]. Of great importance, excluding the much larger Italy and Spain, these amounts decline to a very manageable US$135 billion, underscoring why policymakers are focussed on containing the crisis within the peripheral countries.

There are two reasons why these exposures are so much lower. First, the U.S. residential mortgage market is one of the largest fixed income markets in the world at over $10 trillion, and these loans are highly concentrated in the financial system. Second, and even more importantly, an increasing percentage of sovereign debt has effectively been nationalized as the European crisis has progressed, with the International Monetary Fund (IMF), the European Financial Stability Fund (EFSF), the European Central Bank (ECB), and other sovereigns having made most new country loans, and/or bought debt in the private market.

Multi-Dimensional Crisis vs. Pure Banking Crisis

At its core, the Credit Crisis was a banking crisis, making the path to resolution relatively straightforward. Specifically, losses in commercial and residential mortgages had to be recognized as incurred. Unfortunately, these losses were so enormous that by early 2009, exploding defaults amid plummeting real estate prices caused one in seven banks/thrifts (by assets) to fail or be acquired in distress; Bank of America and Citigroup to need government rescues; and the GSEs, Fannie Mae and Freddie Mac, to

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[1] Leverage ratio is measured as tangible assets divided by tangible common equity. At the beginning of 2007, the tangible common equity of Fannie Mae and Freddie Mac totaled just over $60 billion. By the beginning of 2008, the combined leverage ratio began to increase further, due first to rising OCI losses, then credit losses, which together eventually caused the GSEs' tangible common equity to fall below zero. Nevertheless, with government support, they continued to grow their mortgage exposures. However, as they have been effectively nationalized, their losses continue to be borne by U.S. taxpayers.

[2] The remaining $5.0 trillion of exposures were predominantly in securitization vehicles (as agency MBS), and held throughout the fixed income markets, including in bank securities portfolios.

[3] Bear Stearns, Lehman Brothers, Merrill Lynch, Goldman Sachs, Morgan Stanley.

[4] Although it was only #4 in the global rankings, Lehman Brothers had over $700 billion in assets.

[5] Excludes trading exposures, which are marked-to-market.

be nationalized[6]. These steps were augmented by government guarantees of a myriad of debt instruments critical to maintaining functioning credit markets.

The result was a large-scale, system-wide nationalization of losses. This was accomplished in three ways: FDIC loss sharing of failed banks, the conservatorship of the GSEs, and taxpayer-provided capital (including TARP).

By contrast, the crisis in Europe is multi-dimensional, with excessive sovereign debt that, if unresolved, could cause a banking crisis (with possible geopolitical implications). As a result, the first and most important path to resolution is fiscal consolidation among the GIIPS countries in order to regain market confidence and preserve/re-establish the ability to service long-term debts through the public markets. An inability to accomplish such a fundamental objective *in advance* of bank recapitalizations could trigger a banking crisis.

To forestall this potential outcome, policymakers are trying to agree on forced recapitalizations. This comes in addition to the nearly $200 billion in capital raised by the top 34 European banks since April 2010 (although nearly half of that was raised by the U.K. banks). The banks have also been proactively reducing their sovereign debt exposures through write-downs and public market sales, and growing capital via balance sheet shrinkage and rising earnings.

Also of crucial importance, since the European crisis emerged nearly two years ago, the banks have been taking the critical step of building liquidity. This is vital since over 50% of continental bank funding comes from the less stable institutional market, making the system uniquely vulnerable to a liquidity crisis[7].

While these steps have not been nearly enough to restore market confidence, they have not been insignificant either.

Political Dimension Makes Outcome in Europe More Difficult to Predict

The significant political dimension of the European crisis makes its resolution harder to achieve and the outcome more difficult to predict. In the Credit Crisis, one government was needed and able to make the (difficult) decisions to nationalize losses, force system-wide bank recapitalization, and be the capital provider of last resort.

In Europe, seventeen countries must agree collectively, and then individually ratify their decisions, making policy consensus extremely difficult and the pace of implementation glacial. Unfortunately, allowing the crisis to build for so long may even result in it spreading beyond the GIIPS countries, most notably to Belgium, which has more debt than Portugal (and is experiencing serious political instability).

Making the situation in Europe more complex is the geopolitical implications, including the fate of the European Union (EU), and the Euro currency. The EU's lack of fiscal integration is threatening to destroy the entire currency union, introducing

[6] The GSEs were placed into conservatorship in September 2008. This total also does not include the more than 300 other banks that failed after 2008, which had total assets of $222 billion.

[7] The U.S. banking system is primarily deposit funded, and, as a result, liquidity risk was theoretically lower during the Credit Crisis. Nevertheless, the regulators were very quick to deal with potential liquidity-driven failures to ensure they did not add to the severity of the crisis (IndyMac and National City being the best examples).

unpredictable and potentially extraordinarily severe tail risk. No one knows what the impact would be if a country tried to leave, or was ejected from, the union.

That said, losses must be recognized eventually. And except for Greece's rapidly approaching and inevitable default, the "when", "who", and "how much" are still unclear, since they will be significantly impacted by political considerations.

The "when" could be influenced by any expansion of the EFSF. This giant fund, which was set up to buy debt of those countries unable to access the public markets, could continue to rollover existing sovereign debt, or finance (or insure) new debt, postponing the recognition of losses for an extended period of time. It could also be used to recapitalize the banks, a step policymakers could take immediately to downgrade the seriousness of the crisis.

As for the "who", countries could ultimately agree to share future losses through debt forgiveness. The IMF could make further loan commitments. The ECB, which may need to be recapitalized itself, could continue to print money to buy sovereign debt to help keep countries' financing costs lower (as it has recently for Italy and Spain) and to buy them more time to enact austerity programs and recapitalize the banks.

Together, these political and central bank decisions will influence "how much" losses will be incurred by the banking system and likely the severity of any resulting recession. In the meantime, European governments are essentially playing a high stakes game of chicken with the markets as they seek to enact the least painful austerity measures possible, while still retaining access to the debt markets.

Conclusion: The Fate of Spain and Italy Will Determine the Severity of the Crisis

So, how does this end? The epicentre of the Credit Crisis was the U.S. financial system, which was faced with overwhelming losses and insufficient capital to cope. Consequently, after almost two excruciating years, the market got a genuine confidence-restoring solution with the stress tests and the resulting mandatory bank recapitalizations.

The complexity of the European crisis makes a similar one-dimensional solution less likely. The epicentre of this crisis is (several) over-levered countries that are struggling to fund their ongoing debt commitments, the potential write-down of which could precipitate a banking crisis.

The good news is that – with resolve – a banking crisis can be avoided, since forced recapitalizations are within policymakers' means as capital provider of last resort. If enacted, a "European TARP" would significantly reduce the negative implications of this crisis to the global (and specifically, the North American) markets and economies.

The bad news is that regardless of any happens to the EFSF that may be announced in the next few weeks, any long-lasting solution must include the GIIPS countries doing the hard work of eliminating their structural deficits and getting their debt under control. Unfortunately, this will be painful and likely a drag on global growth for years.

That said, the most important factor determining the ultimate severity of the crisis will be policymakers' ability to ring-fence Spain and Italy to give them time to implement fiscal consolidation and regain the market's confidence. If this is done successfully, the crisis will be more benign. If not, the seriousness of the crisis will rise dramatically (and likely include some liquidity-driven bank failures), casting an ominous shadow on the fate of the Euro.

Whether policymakers can find permanent structural solutions and avoid policy errors before the markets force them remains an open question.

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