WHO'S EXPOSED TO GREECE?

In the wake of the 2008 Financial Crisis, there was a political push in both the US and Europe to head off the next crisis by easing leverage ratios down for major banks. After all, the "crisis" in 2008 wasn't hedge-fund failures. The systemic fears came from the possibility of major banks falling like dominoes.

Now that Greek Prime Minister Tsipras has upset the credit apple-cart in Europe, it's a good time to ask: are we safer than last time around?

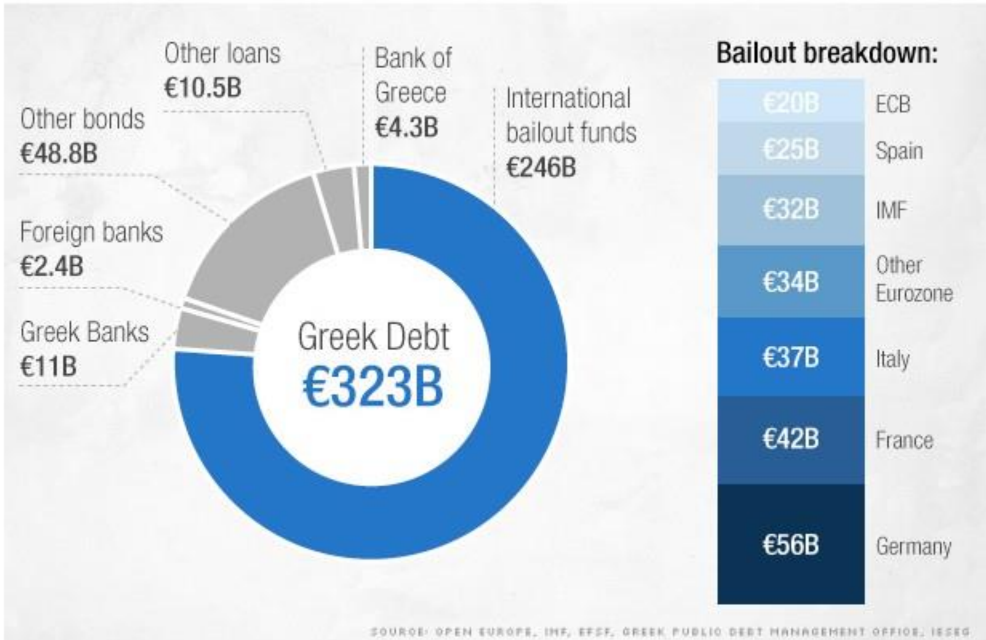
The immediate question is who's still exposed to Greece, specifically. But the more important question is figuring out what kind of systemic risk is coursing through world financial markets after the post-2008 efforts.

What Greece is giving us, fundamentally, is a real-world "stress test" of the post-2008 financial order. After all, the real fear in the Greek story isn't really to do with Greece alone. The wider risk is that, if the Euro is a revolving door, then trillions in assets go from denomination in a currency run by ex-Bundesbankers to a currency run by inflationist money-printers.

This repricing of assets is just the kind of thing that can potentially set off a domino-effect in our world of assets backing each other in daisy chains, and this is precisely what happened in 2008: the problem wasn't US mortgages per se, although they did represent a lot of money.

The real "crisis" was that those mortgages had been bundled into "asset-backed securities" (ABS) that were backing a whole lot of other transactions. When those ABS devalued, the collateral devaluation rippled through the credit system.

So, first, let's look at Greece itself.



Most Greek debt, at this point, is owed to other governments. This means it's systemically benign; it just gets tossed in with the trillions of existing debt. Long-term it's a problem, like all government debt, but short-term it's not.

Governments can eat debt all day long, and actually world governments are dramatically under-debted, in terms of what they can carry without unsettling markets. To illustrate, in order for the US to reach Japanese levels of debt owed to the public (http://www.bloombergview.com/articles/2014-09-24/japan-s-debt-trap), the American government could pile on another $10 trillion in debt. Possibly more, since Japan's debt hasn't yet sparked a bond-market feeding frenzy, suggesting they could easily go higher still. Similarly, for EU governments to reach Japanese levels of debt owed to the public they could also another $10 trillion. So the US and Europe are, altogether, at least $20 trillion below their credit limit.

Now, I'm not advocating such levels of debt, of course. It's a crime to impoverish hard-working taxpayers for the benefit of cronies. But the point here is that there is no systemic risk from Greece reneging on its inter-government debts.

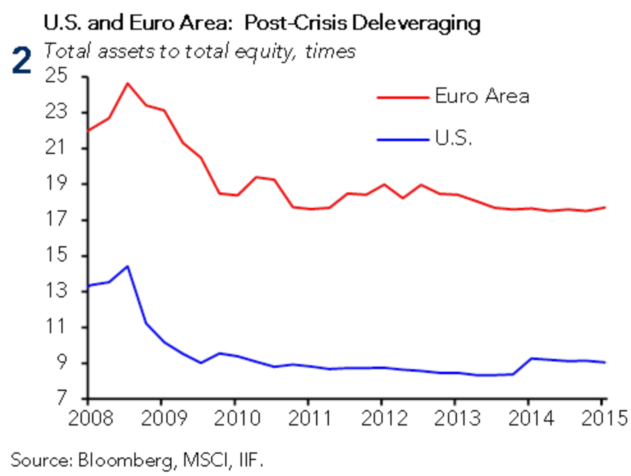
This leaves about 50 billion Euros owed to the private sector. Some of these holders are speculators -- hedge funds and private equity that bought cheap Greek debt as a lottery ticket. Love them or hate them, speculators are not systemic risk; whatever capital was committed to such pools can be lost without anybody dumpster-diving for dinner. In 2008, for example, hedge fund collapses were frequent, and never newsworthy in terms of systemic risk.

The final slice of external debt is about two billion euros owed to banks outside Greece. This is a trivial sum, and it would be shocking if any major foreign bank had trouble with their slice of that debt.

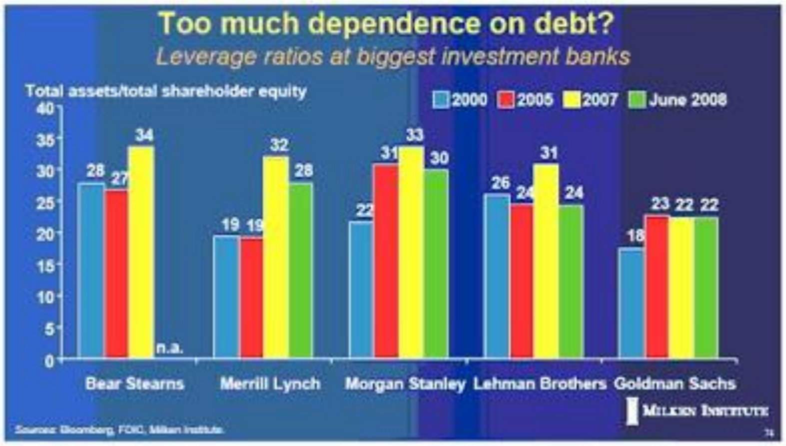
So, putting aside the domestic carnage on Greek banks, pensions, and so on, the wider systemic risk is, if we believe these figures, minor. The major unknown here is whether the debt is where they think it is -- is it “rehypothecated” (re-lent) as collateral on other speculations.

Next up, let’s widen the question to systemic risk in the financial system. This has, unsurprisingly, not been fixed by the post-2008 reforms. Bank concentration, the source of the “too big to fail” problem in 2008 remains elevated -- in the US actually higher than 2007, as the investment banks were bailed out by commercial banks, themselves bailed out in a daisy chain ending, as always, with taxpayers.

But the most important number for systemic bank risk is the leverage ratio. The ratio of loans to equity of banks. Here, things have gotten better in the US, less so in Europe.



Since 2008 US leverage ratios have come down from 13 to 9, a one-third reduction. In the Eurozone, though, they have only come down from 22 to 18. A 20% drop, yes, but leaving Eurozone banks about 50% more leveraged than US banks were going in to 2008. And, indeed, leaving the average Eurozone bank at about 2/3 the leverage of the major US investment banks going into 2008.



Now, in normal times, these leverage ratios don't matter much. The US system at 13 times leverage was perfectly sound until the mortgage problems clustered. So, in normal times, the US at 13 or Europe at 19 are perfectly sustainable. And they will be so long as a large class of assets don't drop all at once.

And that's where the risk comes in. At their current leverage ratios, European banks may have trouble if doubts about the Euro discount a wide range of Euro-denominated assets all at once. This would act analogously to the mortgage-backed securities, where the real problem wasn't the assets per se -- this would cause losses but wouldn't crash the system. Instead, the fact that a wide range of assets all lost value at the same time is what introduced existential risk into the entire financial system.

So it really boils down to whether the current crisis devalues Euro-denominated assets, and how able are Eurozone banks to absorb those devaluations. If they are not, the third question becomes how willing Eurozone governments and the European Central Bank will be to bail out any Eurozone banks that fail under the repricing, possibly via nationalization.

So what are the odds? I think slim given the perfect sequence that must occur in order for the European financial system to collapse. Possible? Yes. But we'd have to see a systemic discounting of Euro assets, followed by singularly incompetent risk management by a large number of banks, followed by a complete unwillingness of European bureaucrats to socialize the losses. We may well see one of these three -- losses in Euro assets, bank failures or nationalization. But I don't think it's likely. If only because Brussels has a history of buying its way out of trouble, and that \$10 trillion gap between Eurozone and Japanese debt will buy Brussels' way out of even a severe financial crisis.

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