The european banks riskier than the us finance essay

Finance, Banks

Many bank regulators and researchers for long have tried to analyse bank-risk. Some of the theoretical and empirical studies state that bank-risk depends on a number of factors like moral hazard provided by mispriced deposit insurance, ownership structure, risk preferences, leverage, agency problems between management and shareholders and regulatory actions. Many of these results are meaningful as well as conflicting in some ways or the other for example many theories suggest that the increase in moral hazards of deposit insurance would increase the risk positions of banks as the capital declines. But in practice such widespread risk shifting behaviours by banks (Duan, Moreau, and Sealey 1992) or thrifts (Benston and Carhill, 1991) are not observed. An efficient bank with a backing of superior technology has more flexibility when it comes to taking risks then less efficient banks (Simon Kwan and Robert A. Eisenbeis, 1997). On the other hand, an efficient bank which already has a higher market valuation than less efficient ones may restrain from taking any risks to protect its franchise value. In contrast to the established US relationships, there is not much of a positive relationship between bank-risk taking and inefficiency. Inefficient European banks tend to keep more capital and take on less risk. In recent years, European banks have become highly integrated and there has been increase in the level of liberalisation which has led to increased product and service deregulation. This in turn is increasing the competition among banks and emphasising the increase in better efficiency of banks. Some argue that this increase in competition has caused incentives leading to increased risk taking behaviour among banks. Regulators have attempted to counterbalance these incentives by providing capital adequacy a more

prominent role in the banking regulatory process. Hence due to regulatory and market pressures, many European banks have been pressured to increase their capitalisation. Often relationships between bank's capital and its efficiency yield conflicting results. One of the main reasons for this is that most of the hypotheses are non-exclusive. One of the possibilities is also that agency cost and information asymmetry problems can have a major impact on trade-offs between bank capital and risk (Jensen, 1986; Berger, 1995). This is considered to be one of the major reasons why some banks react to increased capital requirements by taking on more risks while some may reduce leverage (Yener Altunbas, Santiago Carbo, Edward P. M. Gardener and Philip Molyneux, 2007). As shown below, figure 1 has been taken from Y. Altunbas et al (2010, p122). It shows the expected default frequency from 1999 to 2008. It shows that the lower pressure on the balance sheet of banks also reflected a decrease in the expected default frequency. It was like this until the reversal in 2007 and more clearly in 2008. This shows that the credit risk management was very much lenient prior to 2007-2008 economic turmoil. The figure below shows that from 1999-2001, more credit risks were taken by the US banks as compared to the Euro area. So the default frequency was high in the US till such times. Figure 1: Expected default frequency (1-year ahead, averages). Source: Moody's KMV. However, from 2002-2007, Euro area seems to be more risky as the default rate in the Euro area till such times seems to be more high and during this time US seems to be taking very less risk. From 2007 onwards there seems to be a herculean rise in the amount of risks taken by the US banks. Euro area banks have also been taking risks during this time but a bit less as compared to the US

counterparts. This is the time when the 2007-2008 economic turmoil took place. Securitisation is a process in which the banks bundle their individual bank loans and other financial assets together and then sell them onto the secondary markets. So, securitisation is a measure against risk. That is, it helps to reduce bank risks. So, by analysing the amount of securitisations taken by the US and the European banks can give us an idea about which banks from these respective areas take more measures against risks or which of the banks are riskier. The US mortgage backed securities accounted to USD 4 trillion at the end of 2006 which was contributed by agencies such as the Federal National Mortgage Association, known as Fannie Mae, and the Federal Home Loan Mortgage Corporation or Freddie Mac. When both agency and non-agency issues are considered then the mortgage related securities accounted for USD 6. 5 trillion during this period. This represented the largest fixed income market in the world. The US corporate bond market accounted for USD 5. 4 trillion and the treasury segment accounted to USD 4. 3 trillion. In the Euro area, the development of the securitisation market was a gradual process and it was not triggered by the introduction of any such government agencies. Figure 2: Total euro-denominated asset-backed securities issuance (millions of euros, annual gross flows and numbers, 6-month moving averages of monthly data), note: Broad sample includes all euro-denominated activity and non-euro-area European originators issuing in euro.(Source: European Commission)The above figure 2 was taken from Y. Altunbas et al (2009, p 997). The above figure shows that the growth in securitisation in the Euro area started from the end of 1990s. It grew rapidly from 2004 to late 2007 and then again declined afterwards. In 2006, the

annual net flow of asset backed securities (ABS) was around one-fifth of bank loans given to households and non-financial corporations during that year. The reasons for this growth in securitisations from 1999 until the recent crisis are attributed to three main reasons. (a) the rise in demand from investors, (b) technological and financial innovation and (c) the introduction of euros. ABS was responsible for the increasing number of investments by institutional investors seeking to buy assets that had good rating and provided for an extra yield over government bonds (Rajan, 2006). Sometimes many of these securities are specially created in order to provide a tailor-made, risk-return trade-offs that can be segmented by rating, asset class, sector and country of origination which can thus be used for tapping broader investor baseSecurities help banks in taking risks. One advantage of this is that when the economy or the market is down then the banks can also prevent themselves from taking risks which can prevent them from major losses (Yener Altunbas, Leonardo Gambacorta, David Marques-Ibanez, 2009). It is an important point to be noted that most of the banks in US might have heavily relied upon securitisation market and therefore might have reduced monitoring and screening on their loan portfolios (Parlour and Plantin, 2007). Also some argue that the securitized loans are less informationally sensitive than loans held by banks (Drucker and Puri, 2007). Some also argue that those banks which achieved profits were those that undertook highest amount of risk prior to the crisis (Yener Altunbas, Leonardo Gambacorta, David Marques-Ibanez, working paper series no. 1166, 2010). Country CodeTOTAL ASSETStotal loanstotal depositsLoan Loss Prov / Net I0000nt Rev (%)FR53120122513996395380560 60. 51BE81135929884851183555 7.

69GB10047815280105639942043141. 53SE653279566626320722-33. 72AT186314499820513836552191 5. 67DE21941354122840521654223619422 6. 5LU24706464896782034727147 0. 49DK10106347535512860872731. 22PT622044544727565582. 67ES5964417973355194 20. 05US118140575607700197029868330327. 79NL567347235083234103949. 83IT172067286104482151. 36GR959271138214131. 36FI560329094729241. 77IE1134439234720399891137. 05Summary of European-US 0207 excel balance sheet from 2002-2007Now I will analyse the European-US 0207 excel balance sheet. After analysing, I found out that from 2002-2007, the total assets for Finland was lowest at USD 5603 million. In Europe, Germany had the maximum assets of USD 21941354 million followed by UK with an asset of USD 10047815 million from 2002-2007. US tops the total assets list with total assets of USD 118140575 million. Loans made by US is maximum which is USD 60770019 million. In Europe, loans made by Germany is highest at USD 12284052 million followed by UK at USD 2801056 million and then France at USD 2513996 million. Total deposits by US are USD 70298683 million. In Europe, the highest deposits are of Germany which is USD 16542236 million followed by UK which is USD 3994204 million and then France which is USD 3953805 million. The deposits are liabilities. So, it shows that US has the maximum liabilities and maximum loans. So US has taken more risks than the European banks and the total loan loss incurred in US is 30327. 79%. This shows that the number of bad loans made by US was also very high which further brings them onto the

riskier side. Thus, I would like to conclude by saying that US banks are more riskier than their European competitors from 2002-2007.