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In most ways the excess borrowing by, and lending to, European sovereign nations was no different than it was to US sub prime households. In both cases loans were made to folks that never had the means to pay them back. And these loans were made in the first place because regulatory arbitrage allowed stealth leverage of the lending on the balance sheets of financial institutions for many years. This levered lending generated short term spikes in both bank profits and most importantly executive compensation - however, the days of excess spread collection and big commercial bank bonuses are now long gone. We are only left with the long term social costs associated with this malevolent behavior.

While there are obvious similarities in the two debtors, there is one VERY important difference - that is concentration. What do I mean by that? Well specifically, there are only a handful of insolvent sovereign European borrowers, while there are millions of bankrupt subprime households. This has been THE key factor in understanding how the differing policy responses to the two debt crisis have evolved.

In the case of US mortgage borrowers, there was no easy way to construct a government bailout for millions of individual households - there was too much dispersion and heterogeneity. Instead the defaults ran quickly through the system in 2008 - forcing insolvency, deleveraging and eventually a systemic shutdown of the financial system. As the regulators FINALLY woke up to the gravity of the situation in October, they reacted with a wholesale socialization of the commercial banking system - TLGP wrapped bank debt and TARP injected equity capital. From then on it has been a long hard road to recovery, and the scars from this excessive lending are still firmly entrenched in both household and banking sector balance sheets. Even three years later, we are trying to construct some form of household debt service burden relief (ie refi.gov) in order to find a way to put the economy on a sustainable track to recovery. And of course Dodd-Frank and the FHFA are trying to make sure the money center commercial banks both pay for their past sins and are never allowed to sin this way again! More on that below, but first let's contrast this with the European debt crisis evolution.

In Europe, the subprime borrowers were sovereign nations. As the markets came to grips with this reality, countries were continuously shut out from the private sector capital markets. The regulators and politicians of course never fully understood the gravity of the situation and continuously fought market repricing through liquidity adds and then piecemeal bailouts. In many ways the US regulators dragged their feet as well, but they were forced into "getting it" when the uncontrolled default ripped the banks apart. Thus far the Europeans have been able to stave off default because there were only 3 borrowers to prop up - Portugal, Ireland and Greece. The Europeans were able to do something the Americans were not - that is "buy time" for their banking system. And why could they do this - because of the concentrated nature of the lending. In Europe, there were only 3 large subprime borrowers (at least so far), so it was easy to front them their unsustainable payments - for a while. But time is running out. Of couse, the lenders (ie the banks) have always been dead men walking!

At the moment, the European policy makers – after much market prodding - have finally come to grips with the gravity of their situation. And having seen the US bailout movie, they know all too well what happens when a default of this caliber rips through the financial system. The reason the EFSF was created in the first place was so that there could be some form of a European TARP when the piper finally had to be paid and the defaults were let loose. Certainly many had hoped the EFSF could be set up as a US style TARPing mechanism (like our friend Chrissy Lagarde suggests). The problem of course is that there are 17 Nancy Pelosis and 17 Hank Paulsons in the negotiation process. And while the Germans are likely to approve an expanded TARP like structure on 29-Sep, it increasingly looks like it may be too little too late. The departure of Stark, the German court ruling on future bailouts/Eurobonds, the statements by the German economy minister and the latest German political polls all suggest that Germany is NOT interested a full scale TARPing and TLPGing process across Europe. They somehow think they will be better off with each country going at it alone.

The bottom line is that it looks like a Lehman like event is about to be unleashed on Europe WITHOUT an effective TARP like structure fully in place. Now maybe, just maybe, they can do what the US did and build one on the fly - wiping out a few institutions and then using an expanded EFSF/Eurobond structure to prevent systemic collapse. But politically that is increasingly feeling like a long shot. Rather it looks like we will get 17 TARPs - one for each country. That is going to require a US style socialization of each banking system - with many WAMUs, Wachovias, AIGs and IndyMacs along the way. The road map for Europe is still 2008 in the US, with the end game a country by country socialization of their commercial banks. The fact is that the Germans are NOT going to pay for pan European structure to recap French and Italian banks - even though it is probably a more cost effective solution for both the German banks and taxpayers.

Where the losses WILL occur is at the ECB, where the Germans are on the hook for the largest percentage of the damage. And these will not just be SMP losses and portfolio losses. It will also be repo losses associated with failed NON-GERMAN banks. Of course in the PIG nations, the ability to create a TARP is a non-starter - they cannot raise any euro funding. The most likely scenario for these countries is full bank nationalization followed by exit and currency reintroduction. Bring on the Drachma TARP!! The losses to the remaining union members from repo and sovereign debt write downs at the ECB will be massive (this is likely the primary reason why Stark left). It will require significant increases in public sector debt and tax collection for remaining members. And for the Germans this will probably be a more costly path. Nonetheless, politics are the driver not economics. There is a reason why German CDS is 90bps and USA CDS is 50bps – Bunds are not a safe haven in this world – and there is no place in Europe that will be immune from this dislocation. Expect a massive policy response in Europe and a move towards financial market nationlaization that will make the US experience look like a walk in the park. Picking winners and losers will be VERY HARD but let's look at a few weak spots – SocGen 12b in market cap (-70% this year) with assets of 1.13 trillion BNP 31b in market cap (-55% this year) with assets of 2 trillion Unicredito 13b in market cap (-70% this year) with assets of 1 trillion Intesa 14b in market cap (-70% this year) with assets of 700b

Compare this with the USA where we have -

JPM 125b in market cap with assets of 2.1 trillion BAC 70b in market cap with assets of 2.2 trillion

Importantly, France GDP is only 2 trillion and in bank balance sheets are some 400% of that number. The banks are dead men walking with massive leverage to both home country income as well as assets. The governments are about to take charge and Europe as a whole is about to embark on a sloppy financial market socialization process that has been held back for nearly 2 years by 3 bailouts. The weak links will not be able to raise enough Euros/wipe out enough private sector equity to get this done, so there will be EMU members that need to exit and use a reintroduced currency for this process. We put a Greek drachma on the front cover of our Global Fixed Income Monthly 20 months ago for a reason.