THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
888 16th Street, N.W., Suite 740
Washington, D.C. 20006
Phone: 202-861-0791 • Fax: 202-861-0790
www.international-economy.com

No Hope in a Storm

BY NICOLAS VÉRON

Why Europe is unprepared for the next banking crisis.

As shockwaves from America's subprime disaster continue to reverberate, there is growing doubt about Europe's ability to handle a financial crisis on a major scale. Severe lapses in bank regulation—in Germany, Britain, and perhaps France—have damaged the credibility of national systems of supervision. But this is only part of the problem. The European Union remains hopelessly ill-equipped to handle the crises that haven't yet happened: cross-border crises sparked by EU banks' increasing interdependence.

EU financial integration began in earnest in the 1980s, and the European Commission and European Council made great strides in financial-sector reform. Among the milestones were the decisions in 1986–88 to remove all restrictions on cross-border capital flows, and the launch in 1999 of a legislative action plan on financial services. The euro was introduced and quickly became the world's second currency, behind the dollar.

Perhaps less conspicuous, the European Union's decision to adopt International Financial Reporting Standards in 2000–02 triggered an extraordinary move toward the global harmonization of accounting rules. Meanwhile, the Commission's steadfast defense of competition in the banking sector—particularly in Portugal, Germany, Italy, and Poland—ended an era of protectionism in the guise of prudential control; this helped to spur cross-border financial integration to an extent unprecedented in developed economies.

These achievements came during a period of remarkable stability in Europe's financial markets. Even during the 1992–93 dark days of the European Monetary System, Europe looked like a safe haven in an unsettled financial world. Many countries outside the European Community suffered banking crises, including neighboring Norway, Sweden, Finland, and Turkey, as well as many East European nations during their transitions from communism.

By contrast, the most serious bank failures inside the European Community in the 1990s—including BCCI, Crédit Lyonnais, and Barings—had only a limited fiscal cost and a negligible impact on growth. Later, corporate governance scandals in Asia and then in the United States, notably after the dot-com bubble and the accounting debacles at Enron, WorldCom, and others, encouraged Europeans to think that the "old continent" had somehow preserved higher standards.

The subprime-induced storm ended that fair-weather complacency. From the point of view of public policy, three points can already be made in its wake.

First, the good news: the European Central Bank proved itself an efficient lender of last resort to Europe's financial system. When the crisis started in earnest in August 2007,

---

Nicolas Véron is a Research Fellow at Bruegel, the European economic think tank.

the ECB reacted quickly and intervened as long as the inter-bank market needed support. Banks in the eurozone and beyond all benefited. By contrast, the Bank of England's reluctance to provide liquidity—because of concerns about "moral hazard"—was a poor choice.

Second, however, national banking supervision in Europe fell far short of requirements and its overall credibility is now in question. German authorities have been deplorably tolerant of commercial bank involvement in complex asset-backed securities investments, which were kept off their balance sheets via so-called "conduit" operations in Ireland.

Even if the three German banks most stricken by the credit crunch—Sachsen LB, IKB, and West LB—had technically complied with capital adequacy requirements, their "conduits" represented high risk factors at around 30 percent, 20 percent, and 13 percent of their total assets, respectively. Much stronger supervision was needed.

In Britain, the Northern Rock meltdown highlighted problems with the three bodies responsible for financial stability: the Treasury, the Financial Services Authority, and the Bank of England. In France, doubts were cast on the risk controls at major investment banks—first Calyon, then Natixis, and then most dramatically in January 2008, Société Générale.

Finally, the current financial turmoil highlights a long-standing but urgent problem for Europe: the lack of credible arrangements for the management of cross-border banking crises. Until recently, most banks focused on their country of origin, so risks largely arose under national systems of supervision.

The current financial turmoil highlights a long-standing but urgent problem for Europe: the lack of credible arrangements for the management of cross-border banking crises.

But Europeans banks have now dramatically expanded their operations across the European Union. Ten years ago, non-domestic assets were barely one-sixth of the total European assets of the European Union's largest banks; the proportion today has grown to one-third. By contrast, the proportion of assets held outside the European Union is almost unchanged.

Cross-border mergers and acquisitions are likely to continue apace once the current market turbulence is over, further increasing the likelihood of a major cross-border banking crisis. Both economic theory and past experience show that scattered national regulators who face conflicting pressures cannot efficiently manage such crises. Without a framework for more centralized supervision of a limited number of major international banks, the cost of a future cross-border crisis involving one of them is likely to be larger than Europe's economy can afford.

There are therefore very good reasons to put discussion about new EU-level prudential institutions high on the policy agenda. The exact arrangements will have to be decided, but they must allow quicker and better-informed decision-making while respecting national fiscal prerogatives. A system built on a strictly limited mandate could be both more efficient and less controversial than some single, all-encompassing financial regulator. No doubt there will be difficult political and technical issues to resolve, but the current credit chaos has generated a fresh feeling of urgency. Even Britain, an enduring opponent of EU institutions for financial regulation, may decide that its own interests as Europe's financial hub would be better served by reform.

Walter Bagehot once famously said, "Money will not manage itself." The private sector cannot act alone to sort out the financial mess; it needs support from well-adapted public institutions. An up-to-date system of EU supervision is more crucial than ever if Europe's financial system is to serve its proper purpose. ◆

Supervision Needed, Please

National banking supervision in Europe fell far short of requirements and its overall credibility is now in question. German authorities have been deplorably tolerant of commercial bank involvement in complex asset-backed securities investments, which were kept off their balance sheets via so-called "conduit" operations in Ireland.

Even if the three German banks most stricken by the credit crunch—Sachsen LB, IKB, and West LB—had technically complied with capital adequacy requirements, their "conduits" represented high risk factors at around 30 percent, 20 percent, and 13 percent of their total assets, respectively. Much stronger supervision was needed.

—N. Véron