The banking crisis in Europe

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The financial and banking crisis in Europe started before 2009, and is still ongoing, as illustrated by recent developments in Greece and other countries. The news flow about it has been deafening, especially since September 2008 and throughout the year 2009, making it often difficult to distinguish essential shifts from side issues. Here we attempt to provide an account of the key features of the crisis so far, concentrating on banking aspects, and even though it is obviously too early to weigh its overall impact on the EU policy framework.

Summarized chronology

The conventional start for the financial crisis is the seizing up of markets for asset-backed securities in early August 2007, as investors started to realize the extent of the US subprime property bubble. This most negatively impacted banks which had heavily relied on off-balance sheet vehicles such as asset-backed commercial paper (ABCP) conduits or special investment vehicles for their funding. One spectacular effect was the collapse of two mid-sized German banks with large Irish-domiciled ABCP conduits, IKB and SachsenLB, which had to be bailed out by state-owned German banking entities in late August 2007; many large financial-services firms in both the US and Europe experienced large paper losses following heavy write-downs of asset-backed securities which they held either on- or off-balance-sheet. The European Central Bank (ECB) reacted swiftly by providing massive amounts of liquidity and was emulated shortly afterwards by the US federal reserve. In the UK, the Bank of England (BoE) tried to resist this orientation, invoking moral hazard arguments, but this precipitated a bank run on Northern Rock in September 2007, after which the BoE essentially aligned its liquidity policy stance with the ECB.

In the fall 2007 and winter 2007-08, unprecedented investments by Asian and Middle Eastern sovereign wealth funds to shore up the equity base of ailing financial giants failed to halt the deterioration of market conditions and increase in volatility, illustrated by a multi-billion loss at France’s Société Générale in early 2008 following its failure to adequately control a reckless trader. This phase reached a temporary climax in March 2008, when Bear Stearns had to be bailed out by the US federal government. However, a lull followed in the late spring and early summer 2008, and it seemed for a moment that the crisis may have no material adverse impact on economic growth and employment in the EU.

Of course, this outlook changed following the nationalization of Fannie Mae and Freddie Mac in early September, the collapse of Lehman Brothers shortly afterwards, and the ensuing weeks of unprecedented financial disruption. Initially centered on the US, and secondarily on the UK where the government endorsed the shotgun merger of Lloyds TSB and Halifax Bank of Scotland (HBOS) on September 17, the wave of market panic fully reached Europe in the weekend of September 27-28, 2009, when the governments of Belgium, the Netherlands, Luxembourg and France had to orchestrate a public bailout of two large Brussels-headquartered banks, Fortis and Dexia. In the days that followed, Iceland’s major banks were put into receivership, and online savings accounts they had sold abroad were frozen, in the UK on the basis of the Anti-terrorism, Crime and Security Act of 2001, giving rise to a still ongoing dispute between the two countries. Meanwhile, the Dutch government unilaterally nationalized the operations of Fortis on its territory, after which that bank’s operations in Belgium and Luxembourg were sold to BNP Paribas in a legally tortuous process, as the Belgian government could not rely on a special resolution regime for failed banks. As the fear of banks run spread, several member states lifted the cap on deposit guarantees on their territory, without coordination and in at least one case (Ireland) initially reserving unlimited deposit guarantee to domestic banks only, a decision which was subsequently reversed following intervention by the European Commission to ensure equal treatment of foreign-owned banks.
On October 8, the British government announced a comprehensive plan combining bank recapitalization, guarantees and liquidity provision to ensure that no systemically important financial institution would become insolvent. This approach was then unanimously adopted by euro area countries at a crucial meeting in Paris on October 12, which arguably marked the end of the most acute phase of panic even though stock prices continued to decline for months afterwards. On October 15, the same approach was adopted by all 27 countries of the EU. Meanwhile on October 13, the UK government announced an equity recapitalization of Royal Bank of Scotland (RBS), Lloyds and HBOS, thus becoming the controlling shareholder in a large part of the UK banking industry. In the following weeks and months, many member states also conducted recapitalization through a mix of subordinated debt, nonvoting preferred stock, and in a few cases, common voting equity.

In 2009 and early 2010, no similarly large changes have been brought to the banking market structure. National authorities conducted stress tests on systemically important bank under coordination by the Committee of European Banking Supervisors (CEBS), but, unlike in the US in May 2009, no specific results of these tests or even their scope were publicly disclosed. The EU adopted changes to its Capital Requirements Directive, forcing the retention of 5% of securitized exposure by securitization originators.

Meanwhile, the EU initiated an ambitious overhaul of its supervisory architecture: in late 2008 the Commission’s President, José Manuel Barroso, formed a high-level group chaired by French former central banker and International Monetary Fund managing director Jacques de Larosière, which delivered a report in February 2009 (European Commission, 2009a) whose main recommendations were unanimously approved by the European Council of heads of state and government on June 19, 2009. This reform package includes the creation of a European Systemic Risk Board (ESRB), tasked with steering macro prudential policy and in which the ECB shall play a leading role; and the establishment of three European Supervisory Authorities replacing the so-called Lamfalussy level-3 committees established in 2001-04, with autonomous legal personality and budget, extensive tasks including the formation of a single European rulebook, binding powers in certain situations, and formal decision-making by a Supervisory Board voting under simple or qualified majority rule depending on issues. The corresponding implementing legislation is still under discussion at the time of writing, the proclaimed aim at the time of writing being a formal establishment of these new bodies by the end of 2010.

Immediate policy lessons

The ongoing financial crisis is the first major test of the powerful dynamic of EU banking integration that had developed over the 1990s and early 2000s. The previous systemic crises in what is now the EU had all been of an essentially national nature, with limited cross-border spillovers, even when they occurred almost simultaneously in the former Communist countries of Central and Eastern Europe or in Scandinavia; meanwhile, cross-border banking crises, such as those of Herstatt Bank in 1974, Bank of Commerce and Credit International (BCCI) in 1990-91, or Barings in 1995, were not systemic. By contrast, the banking developments in Europe since mid-2007 have a very significant cross-border component, mirroring the extent of banking integration described in the previous section. While these developments are still unfolding, a number of policy lessons can already be identified.

• The European Central Bank has been an effective lender of last resort, taking bold and rapid measures since the very beginning of the crisis to ensure liquidity in the banking system, with impact arguably extending beyond the perimeter of the euro area. This has significantly enhanced the credibility of this youngest of the world’s major central banks.

• EU competition policy and especially the control of state aid by DG COMP, the European Commission’s competition policy arm, have stood firm under difficult circumstances and effectively played their intended role as enforcers of a fair economic environment within the single market. This action has engendered significant friction between the Commission and member states but ultimately the Commission has appeared to win the argument in key cases, including by forcing financial firms that had received state aid, such as RBS in the UK, ING in the Netherlands or WestLB in Germany, to restructure and trim down their balance sheets substantially.

• The notion that market integration could be achieved through liberalisation without a strong regulatory stance at EU level now appears unsustainable, in spite of having been at the core of EU financial reform in the previous phase (see for example Jabko, 2006). Especially after the high point of turmoil in September-October 2008, an orientation towards more hands-on regulation is presently shared throughout the European policymaking community, including by some earlier advocates of a light-touch approach or a minimalist regulatory stance, such as the UK Financial Services Authority. Charlie McCreevy, European Commissioner for the Internal
Market and Services and thus in charge of the financial regulation portfolio from late 2004 to early 2010, exemplified a similar shift from a hands-off regulatory stance during much of his term to an assertive one throughout 2009.

- The crisis has questioned the framework that had been put in place to manage cross-border bank stability issues, based on voluntary cooperation among national authorities under non-binding memorandums of understanding, pledges to share information, and the creation of supervisory “colleges”. These mechanisms, which had been given prominent status in EU financial stability initiatives before the crisis, were seen as largely ineffective in the real-life conditions of September and October 2008, when member states acted either alone in the relationship with banks within their jurisdiction, or in an ad hoc manner in a few key cross-border cases such as Fortis and Dexia (Pisani-Ferry & Sapir, 2010).

- The EU treatment of retail branches, which under the currently applicable banking directive are supervised by home country authorities and whose deposits are guaranteed by home country deposit insurance, has come under question especially in the wake of the Icelandic case. The Turner Review (FSA, 2009) unambiguously called for reform of these arrangements and for more scope for host-country authority over retail branches.

- In general, the EU policymaking framework has been found both wanting and resilient in its reaction to the crisis. Apart from its competition policy duties, the European Commission has exerted limited leadership in the management of the banking crisis, and often seemed to be watching from the sidelines including at crucial moments such as the first half of October 2008. Early legislative efforts tended to focus on peripheral issues and to appear driven by political rather than policy considerations, such as the EU regulation on rating agencies (EC 1060/2009, September 2009) or the legislation on hedge funds and private equity (AIFM directive), still in discussion at the time of writing. Conversely, the above mentioned meeting of October 12, 2008 in Paris showcased a remarkable unity of purpose from EU member states and had major effect in halting the markets’ downward spiral. The EU Council’s endorsement of the Larosière report’s proposals in June 2009 showed unprecedented unanimity to build instruments for financial supervision at EU level, a move that had been vetoed many times before by some member states, primarily the UK. Similarly, EU action (together with the IMF and EBRD) has helped forestall damaging contagion in Central and Eastern Europe. Thus, the crisis so far has given the lie both to observers who would see the EU as adequately equipped to deal with major executive challenges, and to those who deem it essentially irrelevant as power and legitimacy remain primarily anchored at the national level.

Impact on EU banking market trends

The extent to which the EU banking crisis should be considered essentially past, or yet unresolved, is a matter of controversy. On the face of it, most European banks have returned to profitability at the time of writing, and display acceptable capital ratios. However, widespread doubts remain about the overall extent of future write-downs (IMF, 2009). Significant swathes of the EU banking system, such as Spain’s savings banks (cajas) and Germany’s regional banks (Landesbanken) do not generally have high standards of financial disclosure and are suspected of being weakly capitalized in the face of probable future losses. EU authorities have been signally reticent to assess systemically important banks’ financial situation on a public and comparable basis (a process often described as “triage”), the way US authorities published detailed “stress test” results for 19 large financial institutions in May 2009. Specifically, the Committee of European Banking Supervisors (CEBS) did report on a coordinated stress testing of the EU’s major banks by national supervisory authorities in the second half of 2009, but with no public disclosure of any detailed results beyond the affirmation that the banks’ current level of capital was deemed sufficient.

As a consequence, some analysts predict that the European banking system will remain in a state of prolonged fragility unless decisive joint action is endeavored by a critical mass of EU member states to undertake triage and restructure those banks whose current undercapitalization makes them unviable commercially (Posen & Véron, 2009). At the time of writing, the uncertainty about the future fiscal position of several member states, illustrated by the market volatility affecting Greece in the early months of 2010, creates further doubts about the capital strength of Western banks that hold significant amounts of EU and euro-area sovereign debt or have significant operations in the corresponding countries.

Equally controversial and yet to be answered is the question whether the EU is undergoing financial fragmentation as a result of the wave of state intervention in the banking sector that was triggered by the panic of September-October 2008. The European Commission (2009b) has found evidence that financial integration has taken a step backwards in 2008, but it is too early to determine whether this shift, which mirrors a comparable dynamic at global level (see for example McKinsey Global Institute, 2009), is temporary or permanent.

The fate of Fortis, a major bank and insurance group formed by successive mergers of mainly Belgian and Dutch financial institutions since 1990, is illustrative of that ambiguity. In late September 2008, public authorities from Belgium, the Netherlands and Luxembourg concluded that Fortis could not be expected to meet
future obligations given its deteriorating balance sheet and the difficult market conditions. They decided to recapitalize its operations in each of the three countries on a national basis, and a few days later the Netherlands moved unilaterally to fully nationalize the Dutch component, thus reversing the cross-border integration that Fortis had embodied, both before 2007 and through its acquisition announced that year of the Benelux operations of ABN Amro. However, Fortis’ banking operations in Belgium and Luxembourg were subsequently acquired by Paris-based BNP Paribas, one of the largest-ever cross-border combinations in EU banking history. Thus, the Fortis saga since 2007 presents cases of both reversal of cross-border banking integration, and further cross-border consolidation.

Beyond that particular case, the extent to which state intervention has led large European banks to redirect liquidity and credit towards their home country is not yet clear. In principle, state aid provided by national governments to ensure financial stability cannot be used to distort the internal market, and the European Commission appears to have been particularly vigilant on this front. In practice, however, and somewhat unsurprisingly, there have been reports of national authorities yielding on domestic banks to expand their lending at home as a counterpart to public support measures.

It is likely that the restructuring of the EU banking industry as a consequence of the crisis has barely begun, and that it will be affected both by strategies adopted by member states to sell the stakes they acquired (or may acquire in the near future) in failing banking groups, and by the level of write-downs still to come in the rest of the banking system. Only when this wave of restructuring is completed, which is unlikely to be before several years from now, will it be possible to make an unquestionable assessment of whether the crisis has halted, prolonged or accelerated the earlier trend towards cross-border banking integration.

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Expected policy developments

Similarly, it is likely that the most important policy changes resulting from the ongoing financial crises and affecting the banking sector remain to come, though some legislation has already been enacted both at national and EU level.

Part of the corresponding policy agenda echoes the regulatory debates in the United States, as have unfolded around the discussion of a financial reform act in Congress since at least June 2009, when the Obama administration published a comprehensive reform blueprint (Department of the Treasury, 2009). This includes the possible regulation of derivatives currently traded “over the counter” (OTC), special resolution regimes enabling more effective handling of failing banks at national level (with a range of different situations: Italy has had such legislation for a long time, and several other countries such as the UK, Sweden and Belgium have introduced it in the wake of the crisis), and a possible increase in the taxation of financial firms with the intent of dampening the existing incentives for excessive risk-taking (thus, both the UK and France have introduced a temporary tax on traders’ bonuses, and various other tax proposals have been adopted or floated in countries including Sweden, Germany and the UK). The policy agenda is also partly driven by established global bodies such as the Basel Committee, which in December 2009 issued an extensive set of reform proposals including a tightening of the definition of regulatory capital and tentative options to introduce countercyclical buffers in future capital regulation (Basel Committee on Banking Supervision, 2009).

However, the unique extent of financial integration in the EU gives particular prominence to cross-border issues, which have tended to dominate the agenda to the extent that key aspects of the US policy discussion, such as the crucial question whether banks have become “too big to fail”, are comparatively under debated so far in the EU (Schinasi, 2009). Given the prominence of the concern for cross-border aspects, it is understandable that the main thrust of reform so far has focused on the creation of new institutions that may be able to effectively implement future financial policy initiatives at EU level. Thus, the already mentioned Larosière Report of February 2009 (European Commission, 2009a) is largely about institutional overhaul, and the corresponding legislation to create the European Systemic Risk Board and transform the Lamfalussy Level-3 committees into actual European Supervisory Authorities is at the centre of EU-level financial policymaking initiatives at the time of writing.

If this legislative discussion succeeds in creating a robust institutional infrastructure, it will provide a firmer basis than has existed so far for the establishment of a credible framework for cross-border crisis management, itself a condition for the sustainability of cross-border banking integration in the EU. The corresponding debates, however, have barely started (European Commission, 2010). Especially important, in the light of the Icelandic crisis and other developments which have put a question mark on the viability of the current home-host arrangements for banking branches, will be the question whether the competitive position of a bank in the EU may be increasingly seen as dependent on the fiscal capacity of its home country, which would be inherently contradictory with the
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The notion of a level playing field within the EU single market. In this view, large banks based in small or fiscally fragile countries would be viewed as “too big to save” rather than “too big to fail” (as, in effect, were the large Icelandic banks in October 2008) and would thus find themselves at a comparative disadvantage to their competitors based in larger or fiscally more robust countries.

Obviously, the constant rejection so far by many member states of advances towards fiscal federalism at EU level compounds the difficulty of creating a credible EU prudential framework, as it essentially makes any cross-border crisis management scenario critically dependent on an unpredictable ad hoc negotiation among member states on burden sharing, in the assumption that an expense of public money would be seen as necessary. One key question in the current environment is thus whether international financial integration can be seen as durably compatible with unmitigated national fiscal sovereignty, and this question is exacerbated in the EU context given the high level of already existing integration (Pauly, 2009).

Whether the current sovereign debt market developments affecting Greece and other EU countries, including the landmark statement of euro area leaders on March 25, may radically modify the EU political context from this standpoint, remains undetermined at the time of writing.

Bibliographical references


Notes

1. Namely, a European Securities and Markets Authority (ESMA) to replace the Committee of European Securities Regulators (CESR); a European Banking Authority (EBA) to replace the Committee of European Bank Supervisors (CEBS), and a European Insurance and Occupational Pensions Authority (EIOPA) to replace the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS).


3. For instance, major UK banks, unlike Northern Rock, had access to ECB liquidity as early as August 2007 through their euro area subsidiaries.

4. While not a member of the EU, Iceland belongs to the European Economic Area (EEA). Therefore, the EU banking directives also apply to home-host relationships involving it bilaterally with EU countries.