Europe and the US: A Tale of Two Financial Crises

Nicolas Véron

Originally published in French in *La Tribune*, 7 April 2008

Where is the epicentre? Since last August the crisis has seemed to ping-pong from one side of the Atlantic to the other.

Last summer, the first banks to fail were in Europe: IKB and Sachsen LB in Germany, then Northern Rock in the UK. But other European banks seemed to resist the shock.

In autumn Wall Street giants started wobbling, chiefly Citi, Merrill Lynch and the US operations of UBS. But the welcome arrival of the sovereign wealth funds has helped keep their heads above water for the time being.

Subsequently Societe Generale put the spotlight back onto the old continent. But since it completed a capital increase, Jerome Kerviel has been all but forgotten outside France. Then in mid-March, the last-minute public bail-out of Bear Stearns has cranked up tension in the US and left Europe looking almost immune by comparison.

No wonder many people are non-plussed.

The risks and the fall-out are considerable on both sides of the water, but they are not identical. In the US the residential property market is undergoing a major reverse, which is affecting the whole country. The economy has probably entered a recession, and a wave of corporate bankruptcies is likely.

The economic environment in Europe has also deteriorated, but not to the same extent. Moreover, the way mortgage lending is regulated and conducted in Europe provides more protection for the banking system.

If the market value of a US property dips below the amount of the outstanding mortgage, the homeowner can often settle the matter by giving back the keys to the bank. In Europe, the bank would have recourse over his or her other assets and sources of income.

But over the last eight months the European banking system has nevertheless proved to have an unsuspected and worryingly soft underbelly.

Serious gaps in risk management have appeared at all levels.

In the banks themselves: German public banks have exposed a large part of their balance sheet to risks which they seem not to have properly understood. Societe Generale revealed major gaps in its internal controls.

In public authorities: Germany's financial regulator was unable or unwilling to deal early enough with the off-balance sheet risk of IKB, Sachsen LB and WestLB. The Bank of England made a serious misjudgment by failing to supply liquidity to UK banks, thus precipitating the fall of Northern Rock.

Finally, in the market as a whole: public trust in European banks' financial statements is generally lower than it is in the US. In spite of theological battles about fair value, this is not much the fault of the accounting standards themselves, but of a lack of discipline and consistency in implementing them, which is compounded in Europe by the fragmentation of supervisory authorities. This was illustrated when Societe Generale chose to book the 'Kerviel loss' to 2007 rather than 2008, interpreting IFRS standards in a way which was endorsed by France's securities regulator but remains controversial.

Above all, Europe suffers from a gaping hole in its financial supervision. Large European banks have increasingly ventured beyond their home base during the last few years, with cross-border mergers such as Santander-Abbey, UniCredit-HVB, BNP Paribas-BNL or the dismantling of ABN-Amro. But the supervisory framework remains essentially based on national authority.

As a result, the most systemically important banks are the also those whose supervision is most problematic. Granted, there is also a debate in the US about the respective responsibilities of regulatory authorities. But Americans have had a national banking charter since 1864, and federal banking supervisors since 1933.

In a nutshell, the economic environment remains benign in Europe compared with the US, but our banking and financial system appears more fragile. In the current volatile climate, the probability that this fragility could turn into disaster has increased.

The two financial crises, on each side of the Atlantic, are linked and develop in parallel. But they call for different policy responses. The US is facing a large-scale disruption which is likely to require radical policy initiatives in the short term.

In Europe, the problems are more structural in nature and do not lend themselves to a quick fix. The challenges here are about financial risk management, credible supervision, reliable transparency and proper internal controls in banks.

Meeting these challenges is bound to be a lengthy process. But it needs to start now.

The author is a research fellow at Bruegel (n.veron@bruegel.org).