Financial Times, 7 September 2007

Europe must get ready for a banking crisis

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Last month's evaporation of liquidity was a vivid manifestation of the suddenness of finan- cial crises, which no longer stop at national borders. It also provided a reminder of the purpose of banking supervision, which is first and foremost about preventing and managing market disruption.

Serious banking crises are infrequent events, but if not adequately dealt with they can threaten the very economic and social fabric of our polities. Since the 18th century, an elaborate policy framework has evolved to address the prospect of bank failures. Its rules and institutions are still based on the principle of national sovereignty.

A purely national prudential framework may be appropriate for countries with a very large internal banking market, such as the US, Japan and China. But privatisation and European Union competition policy have led the banking markets of the mid-sized nations of Europe to become strongly interconnected. Even in retail banking, the cross-border dimension has recently become too large to ignore.

Consider Europe's 15 largest listed banks. Less than a decade ago, their aggregate assets in home countries were five times those in other European countries. Now the ratio is two to one, and dwindling fast. Large European banks are "europeanising" much faster than they expand in overseas markets. Simultaneously, they seek synergies by centralising risk management and other main functions. Banks such as Deutsche Bank, Santander and UniCredit have become pan-European and more are likely to follow.

There are many aspects of financial regulation for which there is no contradiction between national sovereignty and cross-border corporate expansion. Consumer protection can continue to be provided by mutually incompatible national rules, even if at the cost of hampering financial integration. Systemic risk management is different. Any crisis scenario involving a bank with large cross-border operations indicates that the incentives for national authorities to ring-fence local assets and shift liabilities abroad would overcome the intent to co-operate. National authorities are accountable to national constituencies, and properly so. Entrusting them with supervisory powers on behalf of citizens from other countries works for routine technical tasks, but not when big issues of collective welfare are at stake. Indeed, in the existing precedents of defaults involving banks with a significant cross-border dimension, such as BCCI in 1990-91, a failure of co-operation be-tween national agencies contributed to heavy losses to creditors and investors.

Both economic theory and available evidence thus suggest management of international banking crises by national agencies has no chance of minimising the collective cost to Europeans. Soft co-ordination devices such as non-binding memorandums of understanding, co-ordination within the Committee of European Banking Supervisors or other committee or collegial workings cannot change this hard truth. Swift moves and quick availability of information is what counts most in crises. They are best managed when decision-making is concentrated, as illustrated by the US Federal Reserve's handling of LTCM in 1998.

The challenge to financial stability posed by pan-European banks would be best addressed with a two-tier framework, with new institutions at EU level performing the tasks that national entities can no longer carry out. The mandate should be tightly restricted to discourage "mission creep" and focused on a limited number of institutions with large cross-border operations within the EU. National prudential frameworks should be kept for all other banks. A two-tier set-up would also facilitate co-operation with non-European authorities, a big concern in the current era of financial globalisation. Political leaders have come to the conclusion that the safety of air travel, drugs and food requires the creation of EU agencies. Last month's liquidity crisis should help them overcome institutional inertia and do the same for the supervision of pan-European banks.

In 2000-01, EU governments wondered whether supranational financial regulation was required to build a single financial market. They decided it was not, and were probably right at the time. But now the context is different. Pan-European banks have become a reality. At some point in the future, some of them will inevitably be hit by crises. Europe must prepare for this and only a true pooling of supervisory responsibility can credibly do the job.

The writer, research fellow at Bruegel, is author of Is Europe Ready for a Major Banking Crisis? (www.bruegel.org)