**Banking Nationalism and the European Crisis**

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The European financial crisis is almost six years old. By now, it has too many strands to be reduced to a one-dimensional narrative. It is also part of a wider international sequence of financial turmoil. Its early phases were sparked by the US property market downturn and loss of confidence in US mortgage-based securities in mid-2007, and later by the shockwaves following the collapse of Lehman Brothers in September 2008. Inside Europe, different drivers of the crisis have been identified, including inadequate fiscal policies, structural rigidities and low productivity performance, and regional macroeconomic imbalances.

Today I want to focus on one such driver which, in my reading, has been a central connecting thread of the crisis and bears some uniquely European characteristics. I am referring to the mismatch between, on the one hand, financial market integration, which is very much about banking as banks dominate credit intermediation in Europe; and, on the other hand, the fragmented nature of banking policy in Europe, which until now has remained principally in the hands of national authorities. This mismatch between market structures and institutional arrangements has resulted in a powerful and often under-recognized impact on the propensity of national authorities to view the competition among banks in Europe as a proxy for a competition among member states and their respective national interests, and to act accordingly in the execution of their banking policies and especially in bank supervision.

This attitude can be labelled "banking nationalism" by analogy with "economic nationalism," an expression which has become commonly used to refer to government supporting or protecting domestic corporate actors perceived as "national champions," or undermining foreign such actors seen as champions of competing national interests, usually in contexts which involve an element of cross-border economic competition. Banking nationalism is often more potent than other forms of economic nationalism, because of the dense webs of relationships between banking sectors and governments. These include (but are not limited to) explicit guarantees of segments of banks' activities and banking regulation to protect financial stability, as well as the role of banks in financing the national economy in general, and government operations in particular.

These webs of relationships, and banking nationalism itself, are by no means unique to Europe. While they are never identical from one country to another, they exist in all developed and emerging economies. What is unique to the European Union is their coexistence with a legal framework that bans financial barriers between member states and creates a seamlessly integrated supranational financial market, at least in principle—developments earlier this year in Cyprus having shown that the abolition of national financial borders is less absolute and irreversible than had been previously assumed by many.

In my analysis, the mismatch between European market integration and national banking policy and the resulting impact of banking nationalism have played a central role both in the buildup of financial risk in Europe prior to the crisis, and in the inability to resolve this crisis so far. I will conclude by briefly reflecting on the current initiatives to chart a path towards European banking union.

**The Run-up to the Crisis**

Before the crisis, banking nationalism and its interaction with the drive towards a single financial market should be assigned a significant, though not exclusive, share of responsibility in two developments that have greatly contributed to the fragility of the European financial system. The first of these is the excessive buildup of leverage in European banks, and the second is the comparatively stunted growth of non-bank finance.

As is well known, the "abolition of obstacles to freedom of movement for capital" across borders in Europe was included as one of the missions of the European Community in the 1957 Treaty of Rome, alongside parallel freedoms for persons and services, and the elimination of customs duties and creation of a single market for goods. But that treaty's chapter on capital also provided for considerable prudential exceptions. Until the late 1980s, Community policies to integrate Europe's financial markets had remained comparatively timid, and financial systems had remained predominantly national.

The late 1980s and 1990s brought four changes which radically transformed this context and materialized the promise of a single financial market. First, a 1988 directive mandated the abolition of capital controls. Second, the Maastricht Treaty enshrined this obligation in primary legislation, and further paved the way for the creation of the euro which came into existence in 1999. Third, the ex-communist candidate countries for EU membership in Central and Eastern Europe gradually privatized most of their financial institutions, and in most cases accepted their purchase by Western European banking groups; cross-border bank consolidation also gathered pace inside Western Europe, particularly at the subregional level, such as in the Benelux and in Scandinavia. Fourth, from 1999 onwards the European Commission developed a more assertive competition policy to prevent member states from erecting barriers against such cross-border banking consolidation or otherwise distorting the European market, e.g., though the provision of state guarantees to selected banks. These steps brought Europe much closer to a united banking and financial market, and created the perception of an unstoppable trend towards cross-border integration.

The sea change of market environment prompted banks to position themselves for what most thought was an inevitable incoming consolidation wave. To achieve this, banks sought size, and found it mainly through domestic acquisitions and financial leverage. In a different context, supervisors might have prevented these strategies. Authorities might have frowned on domestic consolidation which not only distracted bank executives from their risk-management duties, but also led to dangerously high levels of market concentration at least in some European member states. On the contrary, the creation of large national banking champions was viewed positively in most cases, as it made it more likely that domestic banks would act as acquirers rather than targets in future cross-border consolidations.

In a similar spirit, many supervisors saw it as justified that domestic banks should be given further leeway to leverage their capital base in order to pursue their acquisition strategies or other forms of expansion. In this light, the active promotion by most European supervisors and by the European Union itself of the Basel II international capital accord, whose negotiation spanned the late 1990s and early 2000s, and which, to an extent, relaxed the capital and leverage constraints on banks, should come as no surprise, in contrast to the more cautious attitude of the United States. The general attitude appeared, at least implicitly, for supervisors to tolerate high levels of leverage as a necessary price to pay so that domestic banks would end up as winners in the pan-European race for prominence. The acceleration of cross-border bank mergers in the early 2000s, after the European Commission had started more assertively removing policy obstacles against inward acquisitions, could only have reinforced this attitude. Thus, banking nationalism played a significant role in the great expansion of European banks' leverage in the 1990s and especially the 2000s.

A related but separate issue in the run-up to the crisis is the relative lack of development of non-bank financing of the European economy, including high-yield bond issuance, loan securitization, and intermediation by non-bank financial firms (other than insurers). Banking nationalism is far from the only factor here, but it is likely to have played a role as regulators, at least in some countries, may have felt that a significant expansion of non-bank finance could negatively affect the competitive position of "their" national banking champions. For example, several EU member states have maintained regulations that exclusively limit the provision of some financial services, such as leasing to credit institutions, to no obvious prudential avail, but with the effect of limiting the potential for growth of non-bank financial intermediaries. Still another related issue is the near-absence in several member states of large institutional investors other than those directly linked to banking or insurance groups, partly because pension systems are organized on a pay-as-you-go basis and partly because large segments of the investment industry are operated by the asset-management arms of larger financial conglomerates.

The dominance of Europe's financial systems by banks is a potential source of concern for two main reasons, respectively related to growth and financial stability. A diverse financial system offers more financing options to borrowers and especially fast-growing companies. Private equity investors are familiar with the fact that banks are not always the best financiers for risky ventures that can offer little or no tangible collateral. In particular, the shift of advanced economies from manufacturing to services and to increasingly knowledge-based dynamics of value creation suggests a trend towards a decrease of banks' share of external financing of growth companies. Investments in technology, training, marketing, or process innovation typically involve the hiring of skilled employees rather than the purchase of tangible assets that can be pledged as collateral to a bank lender.

The financial stability aspect, as illustrated in the crisis, is due to the fact that non-bank finance can, at least to an extent, take the baton from banks when they are forced to deleverage following a systemic shock. This played a large role in the United States in 2009 and later years, as the negative economic impact of bank restructuring was largely offset by other forms of financing, which contributed to mitigate the risk of serious credit scarcity. By contrast, if, as in Europe now (or as in East and Southeast Asia in the 1990s), non-bank finance is barely developed, then bank deleveraging can trigger a downward spiral of credit constraints, economic stagnation, and further pressure on banks' balance sheets. In other terms, financial system diversity can result in better resilience, particularly in advanced economies.

It is thus remarkable, in retrospect, how little attention was paid by most European policymakers to the need to diversify their financial system away from its dependence on banks and to lay down the infrastructure for further development of securities markets and alternative forms of financial intermediation. The "Lisbon Agenda," the ill-starred EU initiative to promote competitiveness-enhancing structural reform, left financial policy entirely untouched: of the 24 "integrated guidelines for growth and jobs" endorsed by the European Council in mid-2005, not a single one is about financial sector policy. And to the extent that there were concerns about financial stability in Europe before mid-2007, they tended to be directed primarily against emerging forms of finance such as private equity and hedge funds (eventually resulting in the EU Alternative Investment Fund Managers Directive), rather than focused on the buildup of risk in the banking system that was happening at that time.

From a political economy perspective, the ability of banking nationalism to drive policy choices, consciously or not, was helped by the absence of a coalition of countervailing interests that could have pulled policymakers in a different direction. Incumbent large corporate issuers gained both from intra-country bank consolidation, which created large banks able and incentivized to serve their financing needs, and from the creation of the euro, which strengthened their access to a large and liquid bond market for blue chips. Most family firms are inherently wary of the transparency requirements that come with most non-bank financing options, and many of them prefer not to grow rather than submitting themselves to the corresponding disciplines. Investor voices are largely muted by the scarcity of autonomous institutional investors in much of Europe and by a relative lack of financial literacy in much of Europe's saving public: Thus, the interest that savers would have in the opportunities provided by a more diverse financial system has generally not been actively promoted in policy debates. High-growth firms in Europe, alas, are too few to form a powerful political constituency. Last but not least, the complacency associated with the misguided belief in the "Great Moderation" resulted in an insufficient attention of financial supervisors to systemic risk.

**The Financial Crisis and Policy Responses**

After the initial turbulence in credit markets started in July and August 2007, and even more so after the turmoil following Lehman Brothers' collapse in September 2008, banking nationalism has pervaded most European financial policy responses to the crisis, to an extent that has often been under-recognized by observers and commentators. At least seven interrelated strands can be identified in this respect: bailouts; forbearance; regulatory laxity; lack of cooperation in crisis management; discouragement of inward acquisitions; ring-fencing; and an ad hoc response to the emergence of sovereign credit risk in the euro area. As a detailed analysis vastly exceeds the scope of these remarks, only a cursory review can be presented here.

First: bailouts. At least in the first four years of the crisis, EU governments have fully compensated senior creditors, junior creditors (in almost all cases), and often even shareholders of failing banks, starting with Germany's in the case of IKB in late July 2007. Financial stability considerations have evidently played a large part in this generosity on behalf of domestic taxpayers. However, banking nationalism has certainly played a role too. In many cases, national policymakers appear to have acted out of a concern that domestic banks should not be disadvantaged in their own access to credit by the perception that their creditors might suffer a loss in a scenario of failure. This is likely to have led them to go farther in terms of bailout of private creditors or state guarantees, including for smaller banks whose systemic relevance was debatable, than would have been necessary from an exclusive stability perspective. The counterexample here is Denmark, where the regulatory legacy of the early-1990s crisis forced the imposition of losses on creditors and even unsecured depositors of two banks in 2011. This happened without triggering systemic contagion, but other Danish banks complained vocally about the competitive disadvantage this created for them vis-à-vis European peers.

Second: forbearance. It is now apparent that in many cases involving most EU member states (at least most of those which are home to significant banking groups' headquarters), national supervisory authorities were aware of banks' problems and chose not to disclose them to EU institutions, other national authorities, or the public. Perhaps the most egregious, but far from unique, examples are those of bank collapses that happened shortly after the publication of results of pan-European "stress tests" in 2010 and 2011, in which the same banks had been given a clean bill of health. The financial jargon calls "supervisory forbearance" the propensity of national supervisors to refrain from forcing public disclosure of losses by banks, in the hope that better future market conditions or other factors that may improve the bank's fortunes would lead to a reversal of those losses and bring the bank back to financial health. Notable past examples of supervisory forbearance include US savings and loan supervisors in the 1980s, French authorities overseeing Crédit Lyonnais in 1992–93, and Japanese banking authorities following the market downturn of the early 1990s and until 2002. As these examples illustrate, forbearance is often associated with supervisory failures with a significant economic, fiscal, and reputational cost. As with bailouts, supervisory forbearance in the European Union since 2007 may have been partly motivated by financial stability concerns, but also partly by the notion that disclosing one's domestic bank problems, while other member states did not, may have put the national champions at a competitive disadvantage (or conversely, that hiding domestic losses while other countries were more transparent would favour domestic actors in the cross-border competitive game). Needless to say, such ideas are typically promoted through various channels by the banks themselves. This created the conditions for a race to the bottom, in which more market integration begets more supervisory forbearance, and fewer incentives to resolve the crisis.

Third: regulatory laxity. This is directly related to supervisory forbearance and designates the tendency to water down regulatory requirements, including capital standards and disclosure requirements, to allow weak banks to avoid recapitalization or restructuring. One example is when EU pressure forced the International Accounting Standards Board to create retroactive exemptions to its standard on financial instruments accounting, known as IAS 39, in an emergency procedure that violated its due process in mid-October 2008. Another relevant example is the deviation from the letter and spirit of the Basel III international accord in its recent transposition into EU legislation (known as the Capital Requirements Regulation, or CRR), specifically as regards the definition of capital, with the result that some European banks which would be considered undercapitalized under a strict application of Basel III will be deemed compliant with CRR.

Fourth: lack of cooperation in crisis management. Concern for national banking champions created disincentives for EU member states to adopt joint approaches to address the crisis. In this respect, the landmark meeting of heads of state and government of euro area countries and the United Kingdom, at the Elysée Palace in Paris on October 12, 2008, both marked a high point of togetherness among EU countries, and planted the seeds of future adverse developments. In this meeting, leaders agreed on a joint approach for crisis management, modelled on measures announced a few days earlier by the United Kingdom and consisting of a combination of enhanced liquidity support, state guarantees of bank liabilities, and public recapitalizations, mostly through hybrid instruments. In the short term, this show of unity allowed market participants to regain confidence, and marked the end of the most disorderly phase of the crisis. But the decision involved each country dealing with its own banks in a separate manner, with no central steering, opening the way for the combination of forbearance and regulatory laxity which ultimately prevented a proper crisis resolution.

Fifth: discouragement of inward acquisitions. The openness of the European market for corporate control, including cross-border bank mergers and acquisitions, is vigorously policed by the European Commission, so that national policymakers must refrain from public statements of a policy that would restrict possibilities of foreign banks acquiring domestic players. Nevertheless, there are clear indications that, at least in the first half-decade of the crisis, member states have favoured national buyers (or nationalizations) over purchases from other countries, in several instances when a domestic bank could no longer sustain its independence (the most significant exception being the acquisition of Fortis Belgium by BNP Paribas). A revealing instance is when the revelation of an embarrassing trading loss made Société Générale appear fragile in early 2008, and the French Prime Minister rushed to declare that Société Générale would in any case “remain a major French bank,” which was widely understood as a signal that if the bank should be sold (a scenario which eventually did not materialize), the acquirer should be another French bank.

Sixth: national ring-fencing. It is well known in the financial community that supervisory authorities in numerous EU member states have exerted what the financial jargon delicately refers to as “moral suasion” to nudge locally operating banks towards prioritizing the country in their internal capital and funding allocation decisions—even though such policies are typically not made public, as they would run the risk of being deemed in breach of those member states’ commitments under the European treaties. (The exception here is the imposition of capital controls in Cyprus, which has been explicitly endorsed at the European level as an extraordinary measure.) This has happened in countries experiencing current-account deficits, but also in countries in surplus. In such cases, and more generally in all policies that are referred to under the imprecise label of “financial repression,” banking nationalism is less a driver than an enabler: the perception, and often the reality, is that such moral suasion is more effective when applied to a domestic bank than to the domestic banking arm of a foreign-based group. In other terms, the perception that government can, and may need to, leverage their influence over domestic banks for objectives deemed of national interest, even if the same objectives are incompatible with the wider European interest, is a powerful motivator of banking nationalism.

Seventh: ad hoc responses to sovereign crisis developments. On this, the impact of banking nationalism has been particularly visible when the perception was that the sovereign crisis was limited to comparatively small “periphery” countries, including Greece and Ireland. In the case of Greece, following the revelation of larger fiscal deficits than previously thought in late 2009, the concern was that a rapid restructuring would particularly impact banks in several EU member states that had built material cross-border exposures to Greek sovereign credit risk. It appears likely that this concern contributed significantly to the absence of rapid restructuring action, which was recently criticized with hindsight by the International Monetary Fund as a major shortcoming of European crisis response (the participation of private-sector creditors was eventually forced in March 2012, after banks from most EU countries outside Greece had significantly reduced their exposure). In the case of Ireland, assistance was provided in November 2010 on the condition that all senior creditors be made whole, ostensibly against the wishes of the then Irish government which desired to save its taxpayers' money by "burning the bondholders." Here again, banking nationalism is impossible to entirely disentangle from financial stability concerns. Nevertheless, it is likely that some member states were specifically motivated to prevent a tightening of interbank credit conditions that may have resulted from a more aggressive restructuring of Irish banks, and could have put some of their domestic players at a competitive disadvantage.

Clearly, banking nationalism has not been the only factor or driver of the European crisis. The point here is to identify its impact on the behaviour of national regulatory and supervisory authorities. This summary review suggests a significant impact, with mostly negative consequences for Europe in terms of financial fragility, "zombification" of the banking system, and credit scarcity for viable borrowers.

**Recent Developments and Outlook**

Since 2010 the crisis has become more complex. Unemployment has reached dramatic levels in many EU countries, transforming the political context. Fiscal difficulties have put into question the very architecture of the euro area, and have led to the adoption of unprecedented European surveillance and intervention instruments. In mid-2011, the risk perception has moved from the smaller countries of the periphery to Spain and Italy, two large sovereign issuers, and also briefly to French banks. Leaders of EU member states, or at least the euro area, have eventually converged on the acknowledgment that the bank-sovereign vicious circle had to be addressed, and in late June 2012 made what appears to be an irrevocable (if still very incomplete) decision to move towards banking union, which on the face of it should imply a farewell to banking nationalism. In the meantime, the European public has grown less tolerant of public bailouts, and policymakers have shifted, rhetorically and in some cases also practically, towards the advocacy of more systematic "bail-in" of private-sector creditors in bank restructurings.

At the same time, and compared with the situation just before the crisis in mid-2007, market integration has gone sharply backwards. Fragmentation of the EU financial system, specifically in the euro area, has moved from being a risk to being an observable trend. Thus, the mismatch between an integrated market and a fragmented policy environment, which underlies the unique features and impact of banking nationalism in Europe, is being eroded from both sides—less market integration, and more policy integration promised by banking union.

Which one of these contradictory trends will eventually predominate is hard to predict at this point. On the face of developments in the last 12 months, it appears that the willingness of European member states to hang together is stronger than their reluctance to pool responsibilities, decisions, and resources. If it is carried through, banking union is bound to lead to a gradual attrition of banking nationalism, which in turn would have a profound impact on financial structures in Europe, and is likely to unlock a transformation of Europe's financial system that could make it both more diverse and more resilient. But this is a huge if. The completion of banking union is inevitably dependent on a much broader agenda of economic, fiscal, and political union in Europe. Whatever the outcome, there is little doubt that this crisis will be transformational for Europe’s financial system, its underlying structures, and the attitudes of European policymakers to banks.