Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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Deep Gloom over Europe, Foreboding for United States*

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The Institute of International Finance (IIF), managed by my classmate and former Treasury Department colleague, Charles Dallara, just finished another successful spring conference in Copenhagen, Demark, a beautiful city and country far from the looming financial crisis encroaching upon much of the rest of Europe. Not surprisingly, the prospects of a looming financial crisis in Europe cast a deep gloom over the entire 3-day conference of private sector participants and public officials. More importantly, the potential for a European financial crisis has obvious repercussions for the U.S. financial system and economy, as Federal Reserve Board Chairman Ben Bernanke told Congress that same week. Consequently, policy-makers and regulators in both Europe and the United States would be well advised to get ahead of the curve — sooner rather than later.

This article is based on my observations from the conference and experience in a variety of crisis countries. First, I offer my reflections and their implications on some critical issues affecting the European economy and banking industry. Then, I will move to equally important implications for our own financial reform efforts.

Gloom over Europe

European Economy. First, it is clear that the crisis brewing is real, coming on top of a weak European economy, with some exceptions like Scandinavia, for example. An IIF panel of the three financial ministers from Denmark, Sweden, and Norway presented a compelling case and were living proof of three countries, which had their own banking and debt crises in the early 1990s. All three took swift action to fix their weakened banking and fiscal systems, and now enjoy real economy growth and strong banking

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systems, which in turn allows them to focus on their own national competitiveness in the face of a challenging global economy.

Broader Europe is facing zero growth in 2012, with recession likely if a real financial crisis erupts. The monetary union (Euro) is strained to the potential breaking point, with increasing fragmentation of financial markets, a dramatic decrease in cross-border lending and inter-bank lending, and increasing ring-fencing by national regulators to protect their national financial systems at all costs. The "liquidity union" (European Central Bank, or ECB) has been responsive, but, like many other central banks including the Federal Reserve, it too is reaching a point where further easing is reaching a point of diminishing returns and potential futility. The new European Stabilization Mechanism (ESM) becomes fully effective July 1, with adequate resources for now, but will likely need more resources in the future. What also makes this potential crisis different from others I have witnessed around the world is the highly correlated risk of both a sovereign debt crisis (or crises) and a banking crisis (or crises) occurring simultaneously. This situation is complicated by the fact that Europe lacks a fiscal union, a real political union, and a "banking union." More on that last point in a moment.

Second, tension over both a banking solution and debt solution in Greece is rising in the run up to the June 17 elections. Everyone is concerned about the potential impact, not just on the outcome, but what that may entail not only for depositor and investor confidence but also EU-wide financial stability. At dinner one night, former Greek Prime Minister Lucas Papademos, who started his career as a Federal Reserve economist, talked about a "vortex of self-destruction" if the Greeks don't get their collective act together soon. If Greece goes into its own crisis for whatever reasons, a full blown crisis in neighboring Cyprus and perhaps Hungary is likely not far behind.

If that happens, many participants at the conference pondered the contagion implications for a weakened Spain, which is experiencing is own version of the U.S. S&L crisis, but on a much larger scale. Spain's sovereign debt was downgraded three notches the day that the conference concluded, and the IMF confirmed the need for a minimum €40 billion to back-stop the Spanish banking system. The minimum bid appears now to be €100 billion just for the banking system. And if both Greece and Spain spin out of control, for example, experiencing depositor and creditor runs, then many observers wondered about the fate of other weakened economies and their banking systems (e.g., Italy and Portugal).

Third, and perhaps most disturbing, there does not appear to be any clear, comprehensive game plan on the table to manage either the deep gloom or a potential financial crisis. Nor are there quick fixes or silver bullets.

The Prime Minister of Denmark, Her Excellency Helle Thorning-Schmidt, who also is the rotating President of the Council for European Union for the next month, made a compelling case for the preparatory steps taken already, but gave little indication about further much-needed steps going forward. No one I spoke to at the conference from either the public or private sector knew anything about the kind of scenario planning and contingency planning you might expect in a crisis. Most doubted there was much of it going on at all.

To the contrary, consistent with other crisis countries in which I have worked, there still appears to be a level of denial and hopeful belief in "muddling through" the mess. This is typical, but misguided and unfortunate, especially at what appears to be a critical juncture in the coming weeks leading to the next in a string of inconclusive EU summits. The next G20 Leaders Summit in Mexico this summer also is likely to be another critical inflection point as well for the global response to the EU debt and banking crises.

European Banking System. Three brief observations on the banking system in Europe.

First, the European banking system, while obviously stressed from a market perspective, needs to be carefully segmented for any real analysis. That is beyond the scope of this article, but the relative strength of the Scandinavian countries and others like Germany, must be carefully compared and contrasted with others like Greece and Spain. Even within national banking systems, there are relative strengths like the two major Spanish banks — BBVA and Santander — that are relatively well capitalized and still profitable (more on that below), compared and contrasted with the regional "cajas" or savings banks heavily concentrated in underwater real estate loans and assets, much like our S&L crisis. There are islands of calm amidst the gale winds, but keen observers rightly worry about the contagion effects from the bad parts of a financial system to the good parts.

Second, there were two contrasting panels on the need for a European "banking union." This is still a squishy term of art, but most speakers seemed to ascribe at least three features in common: an EU-wide supervisory regime; an EU deposit guarantee scheme; and a resolution facility across Europe to manage failing banks similar to the old U.S. Resolution Trust Corporation (RTC). One panel talked about the need for such a banking union in the long term and in the context of protracted treaty negotiations and ratification that is typical in Europe. European Commissioner for Internal Markets and Services Michel Barnier acknowledged the need for such a union — in the longer term.

In distinct contrast, the other panel talked about the need for a banking union in a matter of weeks and months, which while likely helpful is also equally unrealistic given the climate in Europe. The current reality simply gets in the way: an EU-wide deposit insurance scheme realistically means, for example, German taxpayers backing Spanish depositors; my German friends with whom I spoke privately assured me that was impossible in the near-term.

Third, there were two relative bright spots at an excellent but otherwise dispiriting conference. The first was a panel on improving risk governance. All panelists, including a senior official from the Federal Reserve Bank of New York, admitted there had been much progress made by banks in the wake of the last crisis, but clearly still more work to improve risk governance is required in the future. No new rules are required or anticipated, but banks, especially large globally active banks, should expect more intense supervisory intrusion and probing into their corporate governance risk practices (and related executive compensation practices) than in the past. For more guidance, the IIF's 2011 report, *Implementing Robust Risk Appetite Frameworks to Strengthen Financial Institutions*, and the 2012 Group of Thirty (G30) report, *Toward Effective Governance of Financial Institutions*, are two excellent starting points for those who want to both ensure their own best practices and also get ahead of their regulators.

The second point that every policy-maker needs to contemplate and understand came from the panel of senior banking executives from the U.S., Canada, Europe, and Japan. The panel was focused on changing bank business models in the wake of the crisis and subsequent policy reforms, but a critical point relevant to financial stability was stressed by all four executives.

Back to Spain: the fact that the two largest banks in Spain — BBVA and Santander — are well capitalized and relatively well positioned today is heavily a reflection that each is a large, globally diversified, universal bank — with earnings streams and customers all over the world. These facts — size, scale, global customer reach, diversification, strong capital and management — are directly responsible for each bank weathering the Spanish "banking" storm, which as noted above is largely concentrated in the smaller S&L-like cajas. Financial stability in Spain, therefore, is actually enhanced by the continuing presence of these two financial institutions, when other smaller domestically banks are struggling to survive and in some cases failing. All policy-makers and regulators need to take note of this real-time experiment we are observing across the ocean.

Implications for the United States

Allow me to reverse course, and start now with what I see as implications for the U.S. financial system and economy based on what I see happening both in Europe and here at home. It is the confluence of potential financial crisis and likely economic chaos that drive me to the firm belief that we need far more transformational, radical policy responses. Here goes.

U.S. Banking System. First, given the high potential for a financial crisis and ensuing recession in Europe, we ought to stop and think about the impact of the myriad of sweeping regulatory reforms underway here and their expected impact on our own economy as well as the global economy, which otherwise is slowing by as much as half a percentage point of GDP. We need a "time out" — a moratorium on all future U.S. rulemaking — until we better understand the full economic impact of the 400 Dodd-Frank Act rules on our own economy.

In light of the financial mess in Europe, we can do this precisely because today our banks are better capitalized and more liquid than ever, even though many are still deleveraging their balance sheets, which in turn will have its own economic impact. Most banks that survived the crisis took these steps to bolster capital and strengthen liquidity reserves well in advance of the U.S. version of Basel III capital and liquidity rules even being proposed, which just happened while I was at the conference.

During the moratorium, we can pause and better analyze more comprehensively the real benefits and costs of 400 new rules. We may discover that some we need for prudential reasons, but others could be delayed or reversed upon further analysis of the costs, benefits, and unintended consequences. Even though I am sure he would not support such a delay in capital rules, Stefan Ingves, Chairman of the Executive Board and Governor of Riksbank (the Swedish central bank) and current Chairman of the Basel Committee, made the point when he told the audience he saw little value in resolution planning for "gone concerns" by well capitalized banks, preferring instead that banks focus on recovery planning to remain "going concerns." That's at least a start.

Second, repeal the Volcker rule, with all the market and economic uncertainty surrounding it, now. At this critical economic juncture, we need strong U.S. financial institutions that can make markets and meet the capital market needs of their customers to support needed economic growth. If we don't, then we will only cede these activities to foreign banks or less regulated parts of our financial system (the so-called "shadow banking" system). If policy-makers are concerned with pure proprietary trading as a principal activity for banks, then those activities can be moved into separately capitalized legal entities, with more intelligent supervision and greater transparency than is envisioned in the current proposed rule. Otherwise, we jeopardize the ability to make markets and serve customers at precisely the wrong time in a weak economic recovery under threatening, negative headwinds.

Third, to ensure greater market certainty for the ability of financial institutions to serve their retail customers, we need to address the governance and powers of the new Consumer Financial Protection Board (CFPB). Without a doubt, all consumers deserve to be protected in their dealings with financial institutions, just as financial institutions need to ensure that they put their customers' best interests first in their dealings with them.

That said, there are two simple fixes to the CFPB that would ensure better governance and more market certainty at a time of growing economic uncertainty. First, replace the single director with a more balanced board similar to the FDIC, Federal Reserve, SEC, and CFTC. Second, clarify that the CFPB cannot arbitrarily set or fix prices for retail consumer products and services. A simple amendment stating that competitive, market-based fees are not "abusive practices" and that the CFPB has no power to set or influence prices beyond normal market-based forces should do the trick.

Conclusion

In sum, time is running out, and none of us can confidently predict exactly how the next shock wave from Europe or from within the United States will impact our financial system and economy. We simply can't afford that risk.

With Europe teetering, we no longer have the luxury of tinkering at the fringe. Now is the time for radical, transformative thinking about our most pressing policy issues, which threaten our own national economic self-interest. We all need to acknowledge that we have reached an undeniable inflection point in our economic and financial history, and then take the bold actions necessary to secure our economic and financial future, not just for us, but for the generations that follow.

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