Axel Wieandt

Unfinished Business

Putting European Banking (and Europe) Back on Track

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With 41 figures

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Without the continued support of my family this book would not have been possible.

Königstein i Ts, April 2017 *Axel Wieandt*

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Prologue

"I believe that banking institutions are more dangerous to our liberties than standing armies. If the American people ever allow private banks to control the issue of their currency, first by inflation, then by deflation, the banks and corporations that will grow up around [the banks] will deprive the people of all property until their children wake-up homeless on the continent their fathers conquered. The issuing power should be taken from the banks and restored to the people, to whom it properly belongs."

attributed to Thomas Jefferson, 3rd president of the USA

"Thus, our national circulating medium is now at the mercy of loan transactions of banks; and our thousands of checking banks are, in effect, so many irresponsible private mints. What makes the trouble is the fact that the bank lends not money but merely a promise to furnish money on demand – money it does not possess." [1]

Irving Fisher, American economist, (1935)

This spring, I am again teaching a class on "European Banking and the Financial Crisis" in the Master of Finance Program of WHU – Otto Beisheim School of Management, my alma mater. Most of the students in my class were not even born when I graduated from WHU in 1990. They are part of the post-crisis generation. A generation that has not yet experienced a banking crisis. Not that I wish that they experience one. On the contrary.

The reason why I have been teaching a class on banking in the Great Financial Crisis is because I want the next generation to understand what has happened, how it has happened, why it has happened, and what can be done to prevent it from happening again. But they must also understand that it could happen again. A financial crisis is like an organizational failure, only on a larger scale. That is exactly what a financial crisis is! Nobody wants it to happen. Nevertheless, it may still happen. My students need to understand that it is easy to explain the Great Financial Crisis with the benefit of hindsight. And they need to acknowledge that it could happen again.

I have written the book for all of them, the next generation that will, hopefully,

1 See Fisher (1935), Chapter 1: Introduction.

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contribute to finishing the business, to help putting European banking and Europe back on track.

As I am preparing for class, I find an old article from the Financial Times, dated 29th September, 2008. Lehman Brothers was collapsing and the tsunami of the Great Financial Crisis was reaching the very core of Europe; it was hitting Germany:

"Hypo Real Estate bailed out by German peers

Germany's financial sector was in turmoil on Monday after Hypo Real Estate, one of its biggest lenders, had to be rescued by other banks and the government to solve a €50bn ($72bn, £40bn) liquidity crisis.

Shares in HRE plunged more than 70 per cent, and other banking stocks nosedived after the intervention, the most serious sign of strain in Germany's financial sector since the collapse of Lehman Brothers aggravated the global credit crisis this month.

HRE, one of Europe's biggest commercial property and public sector lenders, was handed a €35bn liquidity lifeline by other German private sector banks, the Bundesbank and the European Central Bank. The lender is also selling €15bn of assets to cover its liquidity shortfall.

The rescue is likely to lead to a sale of assets from HRE's €400bn balance sheet. Peer Steinbrück, Germany's finance minister, said HRE's remaining businesses would be placed in a special purpose vehicle for an orderly wind-down. But people close to HRE rejected the suggestion.

The government and a consortium of German banks will underwrite €35bn of credit guarantees for HRE, with the banks standing for a 60 per cent share of an initial €14bn guarantee. The government will provide the remainder of the first-loss piece and a further €21bn guarantee, meaning the state's exposure could rise to more than €26bn.

The urgent bail-out was agreed in the early hours of yesterday with Mr Steinbrück and Angela Merkel, German chancellor, in telephone contact with bankers and officials meeting in Frankfurt. A finance ministry official said: "We are walking on the edge – this is really serious. We don't know what will happen tomorrow."

HRE is one of Germany's most prominent financial companies and one of the 30 companies in the Dax index, which fell 4.2 per cent. The rescue was organised after HRE's inability to refinance short-term borrowing within Depfa, its Dublin-based subsidiary that lends to the public sector. HRE admitted it faced "extremely challenging conditions on the international money markets".

Bafin, Germany's financial regulator, and the Bundesbank said the package of short and mid-term financing would ensure the viability of the company.

Only a few months ago, JC Flowers, the private equity investor, led funds investing €1.1bn in HRE, buying almost 24.9 per cent of the bank for €22.50 a share.

Shares in HRE had fallen 74 per cent to €3.52 by the close in Frankfurt.

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Stocks of banks with substantial property exposure were also savaged, with Commerzbank and Deutsche Postbank falling 23 per cent.

A failure of HRE could also have had repercussions for Germany's important market in ultra-safe covered bonds, or Pfandbriefe. HRE is an important issuer of such bonds."[2]

The article brings back memories from those dark days. I was head of Corporate Development at Deutsche Bank at the time, and had spent most of my career with the German lender. Our Corporate Development team was responsible for strategic transactions. We had been working on the Postbank deal for some time. After the announcement of the acquisition of a 29.75 percent stake in Postbank on 12th September, 2008, I had hoped for a quieter autumn. The Great Financial Crisis and the HRE situation, however, did not leave a lot of breathing space. Before I knew it, I would be in Munich. With HRE. As CEO. In the eye of the storm, where we were fighting the tsunami, stabilizing, restructuring and ultimately nationalizing the group.

Since then, almost 9 years have elapsed. And the banks in Germany are still raising capital and restructuring. The situation has improved: significantly improved, no doubt, but is has taken a long time to make progress. And more effort, significant effort, is needed to put European banking back on track.

The state of affairs in European banking reflects the situation of Europe, the political disunion and looming Brexit, the ECB's extraordinary monetary policy with ultralow interest rates and Quantitative Easing (QE) and the structural crisis in Europe. It also reflects the geopolitical situation. In fact, the banks are like a mirror, in which we can see reflections of both the past, and the expectations for the future. Let us a take a closer look and face up to the realities. Putting the situation in context and beginning to ask questions is a first step.

An important step.

This book is my attempt at making a first step.

2 See Financial Times (2009).

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Chapter 1: Unfinished business – an introduction

"There are deep fault lines in the global economy, fault lines that have developed because in an integrated economy and in an integrated world, what is best for an individual actor is not always best for the system. Responsibility for some of the more serious fault lines lies not in economics but in politics. Unfortunately, we did not know where all these fault lines ran until the crisis exposed them."[3]

Raghuram G Rajan, economist and 23rd Governor of the Bank of India, (2010)

"As he (Sir George Blunden) put it, since a country's banking system was central to the management of its economy, its supervision would inevitably be a jealously guarded national prerogative."[4]

David McKittrik, Ulster-born journalist, Obituary of Sir George Blunden in The Independent, (2012)

In 2017, a decade after the outbreak of the Great Financial Crisis in the US subprime mortgage market, Europe's banks (and Europe) are still off track. Profitability and returns on equity are depressed, balance sheets continue to shrink and in some countries, such as in Italy, banks continue to be an acute threat to financial and political stability. Despite recent progress, and extraordinary monetary policy measures, the Continent of Europe continues to be held hostage by three interrelated crises: a chronic economic growth crisis; a peripheral sovereign debt crisis; and a lingering banking crisis, which, together, are all feeding into a political crisis:[5]

(1) *Economic growth crisis:* as measured by Gross Domestic Product (GDP), the European Union (EU) only regained its 2007 output level in the first quarter of 2016. This economic performance is in sharp contrast to the US, which had already regained 2007 GDP levels by 2011. At the time of writing, the US is over 10 percentage points ahead in terms of GDP growth since the crisis.

3 See Rajan (2010), p 4–5.
4 See David McKittrik's (2012) obituary of Sir George Blunden, former Deputy Governor of the Bank of England, and first Chairman of the Basel Committee on Banking Supervision (BCBS).
5 Compare Shambaugh (2012) for an in-depth analysis of the Euro's three interlocking crises.

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Moreover, the US is also ahead in terms of employment: the unemployment rate there has fallen below 5 percent, with labor market participation on the rise. The unemployment rate in the EU, however, is still well above 10 percent: in some countries in the periphery it is still above 20 percent, and yet still higher at the younger end of the employment scale in countries like Greece, Portugal and Spain. This weak growth performance negatively impacts sovereign and bank solvencies, via lower tax revenues and rising borrower defaults respectively.[6]

(2) *Sovereign debt crisis:* sovereign debt levels are still elevated after almost a decade of economic stand-still, and have reached a level of 90 percent of GDP in the Eurozone. While this is still below the level of the US, where public debt has topped 100 percent in the wake of the Great Financial Crisis, the lower Eurozone average masks much higher sovereign debt levels in the southern periphery of the continent. Public debt in countries like Greece, Italy and Portugal is only sustainable in the current environment of ultra-low, negative interest rates. And austerity measures, imposed to improve the fiscal position of the indebted sovereigns, have further reduced growth.

(3) *Banking crisis:* the profitability of European banks is still anemic. At the end of the 3rd quarter of 2015, Eurozone banks reported a 5.7 percent annualized return on equity (RoE), up from 3.4 percent in 2010, but still below their cost of capital.[7] As a consequence, valuations of Eurozone bank stocks are still depressed: in many instances, well below tangible book value. The weakness of the banks in Europe is simultaneously both cause and symptom of the European economic and political crisis. And the weakness of the banks still weighs heavily on the sovereigns, particularly those on the periphery, where slow growth is preventing a recovery of public finances and non-performing loans (NPLs) continue to burden banks' balance sheets.

(4) *Political crisis:* the European project has taken a significant step backwards with the 2016 Brexit vote across the Channel. In addition, in the wake of the election of Donald Trump as president of the USA, populism is on the rise on the continent. EU exit forces are gaining momentum in a number of EU regions and member states, emphasizing the urgency of overcoming the economic and financial crisis in Europe.

Two fundamental questions follow from this diagnosis: in what ways, and to what extent, does the recovery of the European economy depend on the health of

6 Compare ECB (2015a), in particular slide 4 for an analysis of the post 2007 output gap in Euroland.

7 Compare DB Research (2013) for a detailed comparison of US and European bank performance.

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the banking sector? And why then, almost ten years after the Great Financial Crisis, have we not yet finished the business of putting the banks back on track? Let us look at both of these questions and, subsequently, outline in what ways this book attempts to contribute to the public discussion on banking and banking policies in Europe. Ultimately, and this is the core proposition of this book, we need to repair European banking if we want to get Europe economically, financially and politically back on track.

Why does banking matter? The importance of banks in the European economy

Europe, unlike the US, is not one state, but a union of 28 independent countries. Of these, 19 countries belong to the Eurozone. However, the EU and US economies are comparable in size. The US economy comprises 321 million inhabitants and, as of 2015, has a GDP of USD 18 trillion. The EU economy has a GDP of USD 16.3 trillion and, as of 2015, 510 million inhabitants. The Eurozone (EU-19) economy alone has a 2015 GDP of USD 11.6 trillion with 339 million inhabitants.[8]

Banks perform an important role in the economy. Essentially, they provide for, and channel, financing into longer term investments.[9] This role can, to a certain degree, also be performed by financial markets. But, this role is primarily performed by banks in Europe, unlike in the US. Banks are at the heart of the economic and financial system of Europe. Households in the Eurozone own significantly fewer financial assets than in the UK or in the US, and they hold a much larger portion of their assets in bank deposits and insurance and pension funds. US households, on the other hand, have significantly more exposure to financial markets and have relatively few assets with banks.[10] In many European countries, the economy is characterized by small and medium sized enterprises (SMEs). Unlike larger corporates, they do not have ready access to financial markets and must rely solely on the banks for external financing.

There is not one single banking system but many different banking systems in Europe. Total banking assets in the Eurozone were 270 percent of GDP in 2015[11], in some individual member states even higher, with some individual bank

8 Compare World Bank (2015).
9 The traditional model of banking as Intermediation of Loanable Funds (ILF) has been recently superseded by a description of the role of banks as Financing through Money Creation (FMC). See Jakab and Krumhof (2015) for a detailed analysis of intermediation and financing models of banking.
10 Compare Allen et al. (2012).
11 See ECB (2016).

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balance sheets of more than 50 percent of national GDP. For example, Deutsche Bank's balance sheet of USD 1.75 trillion in 2015[12] was equal to 52 percent of German GDP. This contrasts with the US, where total bank assets amount to just 87 percent of GDP[13], and the largest banks are much smaller relative to overall GDP (eg, J.P. Morgan's balance sheet of USD 2.4 trillion[14] in 2015 equaled 13 percent of US GDP). In total, as of 2015, there are over 7,100 credit institutions (of which 4,700 are in the Eurozone) and close to 1,000 foreign branches in the EU (thereof 700 in the Eurozone).[15] The EU credit institutions still have over 200,000 physical branches, many of which are expected to close over the next few years. The banking market is still fragmented in many countries and characterized by overcapacities.

In 2011, bank credit to the private sector reached 136 percent of GDP in the EU (27)[16], compared with 55 percent of GDP for the US.[17] Corporate bond and stock market capitalizations amounted to only 15 percent and 43 percent respectively in the EU (27), as opposed to 35 percent and 104 percent respectively for the US.[18] The EU (27) averages, however, mask great differences among the EU member states. Bijlsma and Zwart (2013) recently analyzed the financial systems of the EU member states along 23 different dimensions, including the size of the banking system, household deposits, credit to non-financial firms, market capitalization of listed firms, and bank profitability, to name just a few.[19] Their analysis has enabled them to classify the EU countries into four categories:

(1) *The market-based countries:* the Netherlands, UK, Belgium, France, Finland and Sweden; these countries are closer to the US than other EU member states.

(2) *The bank-based countries:* Austria, Denmark, Germany, Greece, Italy, Portugal, and Spain; these countries resemble Japan more closely, as far as their financial system is concerned.

(3) *The Eastern European countries:* Bulgaria, Czech Republic, Estonia, Hungary, Lithuania, Poland, Romania, Slovakia, and Slovenia; these countries accessed the EU relatively recently and are still in at an earlier stage of their

12 Compare Deutsche Bank (2015), Balance Sheet Data. Balance Sheet size converted with 1.08 USD/EUR.

13 See FDIC (2015).

14 Compare J.P. Morgan Chase & Co. (2015).

15 See ECB (2016).

16 Croatia only became a member of the EU in 2013.

17 Compare Bijlsma and Zwart (2013), Appendix B, Table B.1, p 41: Bank credit to the private sector as a fraction of GDP, drawing on IMF financial statistics and World Bank data.

18 Compare Bijlsma and Zwart (2013), Appendix B, Table B.3, p43: Corporate Bonds as a percentage of GDP, drawing on BIS data: and Appendix B, Table B.6, p 46: Stock market capitalization as fraction of GDP, drawing on World Bank data.

19 Compare Bijlsma and Zwart (2013).

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economic and financial development. Therefore, they have, in overall terms, smaller financial systems.[20] They are also typically more reliant on bank financing, as financial market development tends to follow economic development.

(4) *The outlier countries:* Ireland, Cyprus, Malta and Luxembourg; they have large banking sectors that function as important financial hubs in the EU and extend a sizeable amount of cross-border credit.

European banks today are more international than their US counterparts. In addition, the introduction of the Euro facilitated cross-border banking within the Eurozone. In fact, since the negotiations of the Maastricht treaty in the late 1980s and early 1990s, the European banking system has changed along several dimensions:[21]

(1) *Rising leverage:* the lending activity of Eurozone banks increased significantly. A sizeable portion of this lending was short-term cross-border interbank lending, ultimately fueling the expansion of bank lending, and bolstering the development of a real-estate bubble in several countries of the European periphery. Another aspect of this rising leverage was the build-up of commercial real estate exposures.[22] The implementation of the Basel framework in Europe created special incentives for the build-up of sovereign and collateralized real-estate exposures. In particular, the expansion in sovereign debt was, practically, neither constrained by any regulatory equity buffer nor by any large exposure limits.

(2) *Globalization:* the European banks, particularly the respective national champions, significantly expanded their global activities and began to push into investment banking and capital markets businesses. They raised large amounts of short-term funding in the US money markets, and became significant lenders and buyers of securitizations in the US market, impacting domestic credit conditions and contributing to the rise of the (subprime mortgage) housing bubble.[23]

(3) *Increasing complexity:* banking has become more complex, and has evolved beyond the simple channeling of savings and the provision of financing to firms, households and governments. Interbank funding, both unsecured and secured (via the Repurchase Agreement or Repo markets) had been growing significantly in the run-up to the Great Financial Crisis. Intermediation chains have lengthened as a consequence of the rise of securitization tech-

20 Croatia only accessed the EU in 2013 and is therefore not part of the Bijlsma and Zwart study.
21 See Brunnermeier et al. (2016), chapter 9, pp 157–159.
22 See Antoniades (2015).
23 See Shin (2011) regarding the global banking glut impacting US credit conditions.

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nology and off-balance sheet vehicles[24] and the number of transactions has increased. All in all, the European banking system has evolved from a set of largely self-contained national banking systems to a globally integrated and interconnected web of funding and financing arrangements.

(4) *Explicit and implicit government guarantees:* after 2001, the German state-sponsored "Landesbanken" aggressively increased their state-guaranteed bond issuance and invested these cheap funds into US subprime mortgage securities. Subprime mortgages are characterized by poor credit histories and high interest rates. The Landesbanken were taking advantage of a transition agreement that the German government had negotiated with the EU Commission. This transition agreement allowed them to issue state-guaranteed bonds until July, 2005 with a maximum maturity up to the end of 2015. Bonds issued after July 2005 were no longer eligible for state guarantees, in line with European competition law.[25] Not only the Landesbanken, but also the largest banking groups in the Eurozone benefited from implicit government guarantees: they were obviously considered "too-big-to-fail". Rating agencies and financial markets would assume that these banks would be bailed out by their respective sovereigns, significantly lowering the cost of funding and driving the build-up of leverage in these institutions.[26]

These developments made the European banking system more vulnerable to the fall-out from the US subprime mortgage crisis, and fueled the build-up of a real-estate bubble in certain countries in the periphery. In other words, they created hidden vulnerabilities too, that only became apparent when the crisis was hitting – and by then it was far too late.

What did go wrong in the Great Financial Crisis? – Getting Europe's Banks (and Europe) back on track

The Great Financial Crisis of 2007–2009 emanated from the US subprime mortgage market and spread to Europe via securitizations bought and sold by banks and other institutions. As a consequence, the interbank markets were hit by turbulence, as the delinquencies of US subprime mortgages began to increase. The interbank markets ultimately came to a complete stop in the after-

24 See Adrian and Shin (2010) for an analysis of the changing nature of financial intermediation leading up to the Great Financial Crisis.

25 Compare BMF (2002).

26 See for example Schich and Kim (2012) for evidence on the value of implicit government guarantees.

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math of the Lehman failure in the fall of 2008. Central Banks on both sides of the Atlantic were forced to come to the rescue, as lenders and market-makers of last resort. The Federal Reserve Bank (Fed) and the European Central Bank (ECB) put in place a swap facility to ensure access to US dollar (USD) funding for European banks, which had been relying extensively on roll-over funding in the US money markets. At the institutional level, the first response was increased coordination among supervisory agencies.

Whereas the US opted for swift recapitalization of its banking system the European response was characterized by protracted forbearance. Unlike in the US, where the top banks were virtually forced to take government recapitalization money, the European banks had to apply for state aid on an individual basis, and to both their national governments and the EU Commission. The latter had to sanction this financial support and negotiate compensatory measures with the national governments. Between 2007 and 2009, the US spent 74 percent of its GDP on bailing out the financial services industry, including the banks. The UK 86 percent of its GDP, whereas the Eurozone spent only 18 percent of its GDP.[27] Policy coordination and sequencing in the US was better, with stress-testing conducted to determine whether the banks could repay government money soon or later. With the solvency of the banking system restored, QE could then reach the economy faster via the bank lending channel. In addition, QE in the US was supported by fiscal stimulus. In the Eurozone, however, the banking system was never properly recapitalized and, consequently, monetary stimulus could not work as well as in the US. In fact, the need to keep interest rates "lower for longer" to reflate the European economy comes at a significant cost, as sub-zero interest rates erode both deposit gathering and lending franchise values. Stress testing of banks' regulatory capital without a fiscal back-stop in place added to the uncertainty, rather than rebuilding stability, as the 2009 stress testing did in the US.

With the outbreak of the so-called "Euro" Crisis (a sovereign debt crisis on the EU periphery) the crisis became existential in Europe. It started in Greece and quickly affected Italy, Ireland, Portugal, Spain and Cyprus, all of which, with the exception of Italy, had to be bailed out by the EU, its member states and the International Monetary Fund (IMF). Greece, in actual fact, received three bailout packages, the second one with Private Sector Involvement (PSI), which "bailed in" banks and other institutional investors still holding Greek sovereign bonds at that stage. Several important fault-lines had existed under the surface since the launch of the Euro, notably (1) weak public finances due to a lack of

27 Compare Figure 1.2 in Huertas (2014), p 12, based on the December, 2009 Financial Stability Report of the Bank of England (2009a), Figure 1: Public sector interventions during the financial crisis, p 6.

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budgetary discipline, (2) divergence in financial cycles (boom in the periphery and sluggish growth in the core)[28], (3) diverging competitiveness evidenced by growing current account balances in the periphery, and increasing surpluses in countries like Germany and the Netherlands, and (4) the negative feedback loop of sovereign funding problems associated with the banking sector, as the latter had large holdings of sovereign debt on its balance sheet. Losses in the banking system in Ireland, Greece and Cyprus were so high that they ultimately forced the governments in those countries to ask their European partners for help.

The slow recovery of the European economy relative to the US after the Great Financial Crisis raises the question to what extent this is caused by the difference in financial systems. Recent work by Allard and Blavy (2011) of the IMF, finds supporting evidence for a faster recovery of market-based economies as opposed to bank-based economies.[29] In fact, the comparative advantage of market-based economies in recovery is amplified when comparing strongly market-based economies with those which are strongly bank-based. To a certain degree, however, the superiority of market-based economies in recovery is due to higher employment and product market flexibility. Intuitively, market values for tradeable securities adjust faster than loan loss provisions (LLPs) can be booked. Market prices can fall off the chart on a screen in milliseconds, as market participants react to news on unexpected losses with sell-orders, whereas banks, at least to date, are only required by international accounting standards to book provisions for loan losses they have actually incurred.[30] Loan losses cannot be hidden in the market, but they can be on a bank's balance sheets for a long time.

The circumstances of the European banks today are characterized by multiple challenges and uncertainties, notably (1) the ongoing wave of regulatory changes and increased requirements for solvency capital, (2) low interest rates/flat yield curves pushing the deposit and lending franchise values into negative territory, (3) broken reputations and skyrocketing costs of misconduct, (4) elevated levels of non-performing loans (NPLs) and non-core legacy assets, as well as (5) growing investment requirements to make a successful transition into the digital world. These challenges are reflected in the valuation discount to book, making recapitalizations difficult.

Getting the banks back on track is key. What has been done so far and what needs to be done to finish the business? Let us look at an outline for this book.

28 Compare de Haan et al. (2015).
29 Compare Allard and Blavy (2011), WP/11/213.
30 This will change with the introduction of IFRS 9 which will require banks to recognize impairment losses over the full life time more quickly.

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Finishing the business – an outline for this book

This book is aimed at the well-informed and interested public as well as bankers, regulators, supervisors, politicians and academics. As we obviously have not yet managed to get the banks bank on track in Europe, we need to take the debate to the next level and come up with specific suggestions. This will involve taking an historical perspective and looking at the evolution of the banking system, both from a macro-economic as well as a micro, bank-management standpoint. The book refers to the most recent academic research on the issues at hand, putting the findings into perspective through the eyes of an "insider". The general tone of the discussion is investigative – trying to identify the underlying root causes and uncover hidden fault lines. Getting the European banks and Europe back on track is as much about asking the right questions as it is about providing guidance and making actionable suggestions.

The book is divided into a total of fourteen chapters, including this introduction, and falls into five parts:

Part I – Where we started from: the starting point for this book in *Chapter 2: Europe's banking landscape* is a brief description of the evolution of the European banking landscape prior to the Great Financial Crisis. The chapter traces the evolution and integration of European banking since the Second Banking Directive of 1989, through to the launch of the common Eurozone currency a decade later. *Chapter 3: Banking – from the bottom up* – complements this description with a fundamental analysis of the economics of banking and banks. Specifically, this chapter attempts to answer the questions of why we need banks, how banks earn money, and how they create value for their shareholders. *Chapter 4: Banks' specialness – and the need for regulation and supervision* builds on this analysis by examining the specialness of banks resulting from their transformation of readily-available, liquid deposits into long-term, illiquid loans to the economy. This transformation creates an inherent vulnerability to panic and runs on banks, because the withdrawal of deposits is subject to a serial service constraint and the liquidation of loans is costly. Bank runs are socially wasteful: the resulting need for regulation, supervision and safety nets is the topic of chapter 4. This chapter tries to answer the questions of why we need to regulate and supervise banks (instead of just relying on market discipline), how we can prevent socially wasteful bank runs and contagion across the financial system, and how much regulation and what safety nets are really needed.

Part II – European banking and finance in less troublesome times: on the basis of the foundations laid in Part I, chapters 5 and 6 set out to trace European policy-making with regards to integration of financial markets and banking services. *Chapter 5: Re-engineering of European Banking* analyzes the most important steps towards financial and monetary integration, in particular, the

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First (1977) and Second European Banking Directives (1989), the Financial Services Action Plan (FSAP) (1999), and the implementation of the international Basel regulatory framework in the European Union. Financial and banking integration further accelerated with the launch of the common currency in 1999. Banking in the monetary union is therefore the topic of *Chapter 6: One market, one money – (too) many banking systems.* However, while monetary policy was unified and wholesale money markets were beginning to integrate, banking politics and supervision remained a national prerogative. This created a critical fault line that few appreciated in less troublesome times and which only became apparent in the burgeoning financial crisis.

Part III – Crisis hitting and multiplying: Chapters 7 and 8 analyze the Great Financial Crisis and its impact on European banking. *Chapter 7: From "turbulences" to the Great Financial Crisis* traces the origins of the Great Financial Crisis back to the US subprime crisis. It raises the important question of why this Crisis was able to seriously affect European banks, and identifies the interbank market as the key transmission channel of turbulences across the Atlantic. *Chapter 8: Mopping up – containing the crisis* compares the crisis response in the US with the crisis response in Europe. The case studies of the Lehman failure and the AIG bail-out on the US side and the HRE bail-out in Germany on the European side provide the background for this comparison. The crisis response in Europe was characterized by a lack of both speed and policy coordination.

Part IV – Crisis becoming existential: just as the crisis is coming under control in the US in 2010, it is suddenly becoming existential in Europe. *Chapter 9: Early lessons drawn: shackled by principles?* analyzes the early lessons drawn in Europe, particularly the de Larosière report[31] of 2009, which led to increased coordination, but not to the much-needed integration of banking, capital markets and insurance supervision in Europe – at least, not yet. It also takes a closer look at the nexus between sovereigns and banks. This nexus turned into a spiral of doom not only in Greece, Ireland, Portugal, Spain but also in Cyprus. The resulting "Euro" crisis is the topic of *Chapter 10: Then come Greece and Ireland: "unnecessary, undesirable, and unlikely"*. The main focus of this chapter is on the Greek and Irish sovereign debt crises.

Part V – Finishing the business, in a principled way: chapters 11, 12, 13, and 14 are devoted to finishing the business of putting the banks back on track in a principled way. Europe clearly needs to improve the institutional crisis management framework and move beyond a time-consuming and incomplete national policy coordination. *Chapter 11: Centralization of financial policies – If Greece (or Ireland) were Texas,* is devoted to the need for centralization of banking policies in a monetary union. It compares the Texas banking crisis in the

31 Compare European Commission (2009a).

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US with the recent Greek and Irish banking crises and draws important lessons for the European banking system by looking at the evolution of the US banking system. *Chapter 12: Blueprints, optimal policies to choose from* takes us back to the drawing board and analyzes the shortcomings of the current Basel framework, which is at the heart of international banking regulation. It draws important lessons from the bank and sovereign (creditor) bail-outs between 2008 and 2014, and looks at the issues of state aid, competition policy and bank resolution schemes. In particular, it sheds light on the issue of moral hazard and the link between liability and accountability. It critically discusses the need for further structural reforms, especially the question of separation of investment banking from retail banking. *Chapter 13: Banking union –realm of the possible*, finally, is devoted to an in-depth assessment of the current state of play in the implementation of Banking Union. Last, but not least, the discussion is elevated to the level of the overall architecture of the European Union in *Chapter 14: The larger context – how much political union European Monetary Union (EMU) needs.* This chapter concludes the book by trying get at the fundamental question of how much more political union is ultimately necessary in a monetary union, in order to achieve sustainable growth and financial stability in Europe.

In summary

The banking system in Europe is large relative to the size of the economy and characterized by universal banking, and a significant number of systemically relevant, globally active national champions. Banks perform a vital role for the economy. Their leverage and deposit funding makes them inherently vulnerable to bank runs. Hence there is a need for safety nets in the form of supervision, a lender of last resort facility, and deposit insurance. In the run-up to the Great Financial Crisis, European policy makers were pushing towards more financial and monetary integration, culminating in the creation of the single Eurozone currency at the turn of the millennium. Monetary integration and a naive and inconsistent implementation of Basel II capital rules allowed for an increase in sovereign debt and a significant build-up of bank leverage, and made the European banking system vulnerable to the US subprime crisis. Since then, Europe has been held hostage by three overlapping crises, a banking crisis, a sovereign debt crisis, and an economic growth crisis. Resolving these crises means putting the banks back on track: this requires a centralization of banking policies and a careful recalibration of rules and regulations. Europe needs to (re-) establish a clear link between liability and accountability to contain the moral hazard created by multiple safety nets and reinforced by bank rescue measures in the aftermath of the crisis.

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