Europe Gets Closer to Recapitalizing Banks

Nicolas Véron welcomes the move toward recognition of the weakness of European banks but questions whether leaders are moving quickly enough.

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Steve Weisman: After months of talking about recapitalizing European banks, there appears to be some movement toward that objective. Nicolas Véron has been writing about this subject and following it closely. Nicolas, what have the banks agreed to do?

Nicolas Véron: At this point, they haven't agreed to do anything. There's still a lot of discussion about what will happen, and what may be forced on to banks. But, as you said, the good news is that European policy makers now are no longer in denial that they have to do something in the banking front. At the same time, they have to do something of course on the sovereign debt front, which has been much more visible since the beginning of this crisis a year and a half ago. This is very new, and it probably has been caused by many factors. But it's a big change, because there was no willingness to act on the banks until as recently as ten days ago, two weeks ago.

Steve Weisman: What caused the change?

Nicolas Véron: What caused the change I think is the continuing deterioration of the market conditions in Europe, especially as regarding intra-bank lending. It's become very difficult to separate the banking crisis from the sovereign debt crisis in Europe, because the two sort of feed each other in different ways in different countries. If you look at Greece or Italy, it's the sovereign crisis that is triggering distrust in the banking system. If you look at Spain, it's perhaps the other way around. But they do feed each other.

I think there have been two dates that are important in the timetable: one was the annual meeting of the IMF and the World Bank in late September; that's a normal gathering at this time of the year, where all the world leading economic policy makers get together in Washington, D.C. And I think the European leaders were taken aback by the level of concern they could see from non-European finance ministers and central bank governors; not only the US, but also emerging countries. Basically, the entire rest of the world telling them, "Now you have to act, and it's now, it's not in three months' time, because we are very concerned." And, they didn't expect something as stark.

Steve Weisman: They got this word from Treasury Secretary Tim Geithner, but you're saying that when they realized that he was carrying the news of general consensus around the world, they took it more seriously?

Nicolas Véron: I think they certainly took Secretary Geithner seriously. But when you have basically the entire non-European world taking this position that something has to be done quickly, particularly on the banking sector, it has, let's say, even more impact. The second date is the summit in Cannes, of course, because France has this presidency of the G20, [and] may not have a great lot to show for it, frankly. So the one thing that the French government wants to avoid is the Cannes summit being in the moment of complete turmoil in Europe. So that's a big motivation for him.

Steve Weisman: For President [Nicolas] Sarkozy?

Nicolas Véron: For President Sarkozy. It's a good commitment device right there. There is really a moment when he, and certainly other European leaders who don't want the French G20 presidency to be seen in the world as being a failure. So that's a commitment device for them to find a solution also before that date. Or at least it have acted as such. In a way, it's perhaps ironic that the main purpose of the G20 this year will have been to provide a deadline for Europeans to get their act together. But, if it is so, it means that the G20 has value added after all.

Steve Weisman: That summit is in November, is that right?

Nicolas Véron: That's in early November, and there will be a European summit before then in the second half of October.

Steve Weisman: What's the attitude of the French banks? How much in denial are they, still?

Nicolas Véron: The argument in the French banking sector and in other countries as well, as you rightly point out, has been to say, "Well, it's not our fault; there's a sovereign discussion, but if you assume the sovereign crisis is resolved, there is no problem of undercapitalization of the banking sector, and therefore the priority should be to address the sovereign crisis."

Steve Weisman: So they're saying, "You address the sovereign crisis first, decide how much enforced haircuts are going to brought about for Greece, and then we'll worry about recapitalization?

Nicolas Véron: Not even that, because if the sovereign crisis is addressed, and if you refinance Greece and maybe one or two other smaller countries, the main point being to restore the credit of especially Spain and Italy, then it is true that there is not an obvious problem of undercapitalization of the European banking system as a whole. There might be some banks that need more capital, but it's not systemic.

So the banks do have a point, which is if there wasn't an inability of the European leaders to address their sovereign crisis, they would not need to raise more capital. The problem is, that's not the world we live in. The European leaders are unable to address the sovereign crisis and to restore trust in their ability for decision-making, and in that context, then we need more capital in the banks, because they don't have enough buffers to address the worries of the marketplace. So perhaps they're innocent victims in this, and you could say that, but the situation is, the capital cushions are just too small.

Steve Weisman: Where are they going to get the capital?

Nicolas Véron: That's a big question, and there are different ways to look at it. Policy makers say they will favor capital sources that come from arm's length investors from the private sector, not to expend too much taxpayers' money. Now, are European policy makers really ready to accept any source of capital? Will they accept, for example, private equity funds taking big stakes in banks which need a lot of capital? Will they accept sovereign wealth funds to take stakes in banks? I mean, there is a report of a group of investors from Qatar wanting to make an investment in Dexia's Luxembourg subsidiaries. That would be an important signal that this money is welcome. But so far that's not the signal that European policy makers have necessarily given. So, the extent of the private sector to fill the capital gap depends on how open you are about which investors are welcome to invest in the banks. And this I think is largely still a question mark, because we haven't gotten into the concrete. Apart from a few cases, we haven't got into the concrete work of who pays for what.

Steve Weisman: In the United States in 2008-9, some banks did turn to the Middle East and to Asia for help, and there wasn't too much of a negative reaction. What about the citizens of Europe?

Nicolas Véron: I think it's about the citizens, but it's also about political systems and the way they relate to banking systems. So, it's not just about public opinion, even though that does play a part. Let's say that, in the past, European countries have taken very different attitudes to foreign investment, including investment from other European countries in their banking systems.

Steve Weisman: Sure.

Nicolas Véron: If you look at Central and Eastern European countries, they have accepted in many cases entire banking systems being taken over by foreigners, usually banking groups from Western Europe, but also American groups; GE, Citi, and others. In Western Europe, there are a few countries that have had this attitude. Belgium, for example, being an exception. Well, now Belgium has nationalized Belgian operations of Dexia, but probably with the intent to sell them to some investor down the line. But they have accepted, for example, BNP Paribas taking over the banking operations of Fortis, which is very big banking operation. Similarly, Finland has accepted foreign acquisitions of big parts of its banking industry by fellow Scandinavians from Sweden and Denmark, but still, not Finnish groups.

But if you look at France, Italy, Germany, Spain, the biggest core European countries, even the Netherlands to an extent, they've been very reluctant to let foreign groups, even from Europe, take over large banks, including in the last few years. So, we don't know how these attitudes may change. It depends on the intensity of the crisis, of course. Even Spain, which has a big banking problem to solve, so far has tried as much as possible to address it through intra-country consolidation, and not by putting these assets on the block for purchase by foreign investors, even from the rest of Europe. It's really about the Europeans' mental map of the world, that still feels that Europe is a special place that is somehow above neighbors. I don't think there is mental preparedness in many policy circles for having what Europeans typically ask from other countries, which is being open to investment from investors that can provide guarantees of soundness fit and proper. But European banks have purchased a lot of assets in the US, in Latin America, in Asia, in Africa. The question is, are Europeans ready to have investors from those different parts of the world take over their banks? I think this is the big cultural, psychological, political challenge for Europe, because they have not yet adjusted to this change in the global economic map.

Steve Weisman: Let me ask finally a question about the role of the ECB [European Central Bank] and the European Financial Stability Facility in any of these recapitalizations, or in the sovereign debt problems. Has this evolved at all in the last few weeks?

Nicolas Véron: The current state of the discussion seems to be that, to the extent that public money would be needed, beyond private investors that we just discussed, the request for public money should be met primarily by the individual member states. If they don't have the capacity, then the European Financial Stability Facility would be there to help and provide loans that would finance this public intervention. I think in a way, a lot of the discussion understandably is focused on where does the money come from. But more important is how centralized the process of assessment of which banks need how much capital might be. If you look at the stress test in 2010, in 2011, that's how it's been, the big problem. We had a process which was largely in the hands of national supervisors, and frankly, they didn't do it the same way in different countries. If you have a harder process, a more binding process now, which results in a much larger number of banks being asked to recapitalize –

Steve Weisman: And that seems in the offing.

Nicolas Véron: And that seems in the offing. Then you need something that provides better guarantees of fairness, because otherwise, you will have banks from countries where the supervisor is harsh, saying, "Well, I don't need to raise that much capital, and my neighbor in the neighboring country where the supervisor [is] more forebearant, here is the bank in the neighboring country which does need more capital, and it's not asked for it." So, you need a sense of fairness, and I'm not sure if the current process really guarantees it. I'm quite concerned about this, because if we end up in a process where some banks are asked to raise capital they don't need, and other banks are weak links in the system and need a lot more capital, but are not asked to raise it, we'll have a problem. Remember that Dexia had a very high capital ratio at the outcome of the latest stress test, which after all, are only a month and a half to two months and a half old. So you need to have an assessment process that provides better guarantees than we have had so far of accuracy and fairness in assessment. I'm quite concerned about this in the next steps.

Steve Weisman: Are we in a better place now than we were in a month ago?

Nicolas Véron: If you look at the European policy in response to the crisis, it has always been headed in the right direction. It just hasn't been quick enough and forceful enough, and I'm afraid we're still in that framework at this point. So, I think it's a very good thing that banking issues are now being discussed and addressed, as a core element of the crisis, in contrast with the denial that policy makers were in still a couple of weeks ago. I think it's also a good step that Germany is now openly calling for treaty changes to be one of the things that we need down the line. So they recognize that the EU doesn't have only a crisis management problem, but a more structural-institutional problem, which actually explains a lot of the crisis management inadequacies. This is very good news. They are just the start, and it's not clear that we will have decisions that really make a difference in a time frame which is short enough to avoid further contagion. There is still no room certainly for complacency.

Steve Weisman: Thank you, Nicolas.

Nicolas Véron: Thanks to you, Steve.