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IS EUROPE READY FOR A MAJOR BANKING CRISIS?

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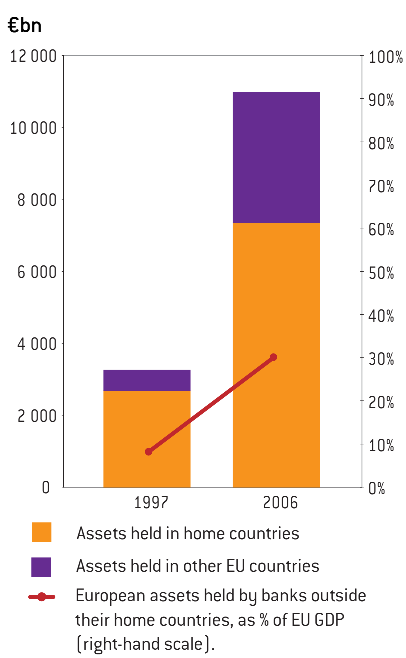
SUMMARY Europe's banks have long been slow to integrate across borders, but this is changing fast. **'Pan-European banks', whose activities span several EU countries, are rapidly emerging,** and are likely to enhance the overall contribution of financial services to economic growth. **Meanwhile, financial stability arrangements, notably banking supervision, remain nationally anchored.** This creates significant risks in the event of a crisis involving a pan-European bank. Faulty cross-border co-ordination and diverging national views could seriously hamper the ability of the authorities to respond speedily and effectively to an unfolding financial crisis.

Aggregate European assets of the EU's 15 largest listed banks



Source: Bruegel estimates based on company information.

POLICY CHALLENGE

Recent turmoil in credit markets underscores the importance of proper management of financial crises. The emergence of pan-European banks requires a reform of Europe's financial stability arrangements, in which the guiding principle should be the minimisation of potential collective crisis costs to Europeans. Important elements of the financial stability framework can no longer best be organised through voluntary coordination among national authorities. A two-tier framework, including new EU-level arrangements and institutions focused on pan-European banks, would address this situation while being consistent with the subsidiarity principle. Given the significant technical and political obstacles, strong commitment at the highest level will be required to make meaningful progress.

EUROPE'S banking sector is one of its biggest industries. Banks represent almost a quarter of the aggregate market capitalisation of Europe's 100 largest listed companies, and form by far the largest sector by this measure of value (Table 1). They are the backbone of the financial sector, which ensures the connection between providers and users of capital, and is a crucial enabler of corporate expansion or restructuring and household consumption and investment. A growing body of evidence indicates that financial development is essential to economic growth[1]. Financial integration can be a major driver of financial development and offers direct economic benefits, permitting economies of scale and greater risk-sharing between countries, and allowing capital to be allocated across borders to the most productive uses[2].

Table 1: Banking, a major European industry

Industry	No. in top 100 European listed companies	% Europe's top 100 total market capitalisation
Banks	**22**	**24%**
Oil, gas & mining	11	17%
Manufacturing & business services	20	15%
Consumer products & services	14	11%
Energy & water utilities	10	10%
Life sciences	6	9%
Telecoms & media	9	8%
Insurance	8	6%
Total	**100**	**100%**

Source: Bruegel estimates based on FT global 500 ranking, end-June 2007 (www.ft.com).
N.B.: This table includes only listed firms, and does not take into account important European players such as savings and cooperative banks or Germany's Landesbanken. However, a 2006 study by McKinsey indicates that including non-listed entities in the list of Europe's 30 largest banks would increase their cumulated value by only 13 percent: see *Financial Times*, 'FT Non-Public 150', 14 December 2006.

Banks are heavily regulated, and one major reason for this is systemic risk. Banks' balance sheets are highly leveraged and strongly tied together. If one bank defaults, it can impact the whole sector. Furthermore, trust in the financial system is a crucial public good that justifies public intervention, including banking regulation and supervision, and the provision of collective insurance of bank deposits. Past systemic banking crises, most dramatically those of the 1930s, showed the dire consequences of a collapse of public trust. Therefore, governments, central banks and specialised agencies have a mandate to monitor and minimise risk in the financial system, including through taking early corrective action toward financial institutions and by supplying markets with liquidity when needed (crisis prevention); making sure that banking crises, if and when they occur, do not result in widespread financial devastation (crisis management); and handling the aftermath of such crises by allowing the orderly exit of failed institutions and adequate protection of banking clients (crisis resolution), a process that history suggests often implies the use of taxpayers' money.

Table 2: The relative parochialism of Europe's banking industry

Sectoral breakdown of Europe's top 100 listed companies	Average internationalisation rate*	Average Europeanisation rate**
Life sciences	91%	84%
Consumer products & services	84%	74%
Manufacturing & business services	80%	66%
Oil, gas & mining	70%	57%
Insurance	66%	53%
Energy & water utilities	46%	31%
Banking	**44%**	**27%**
Telecoms & media	36%	24%
Average all sectors	*62%*	*49%*

Each company in the top 100 is allocated a 'headquarters zone', depending on the location of its main operational headquarters, among the following: Nordic, UK & Ireland, Benelux, Germany, Switzerland, France, Spain & Portugal, Italy. * Internationalisation rate = sales outside the headquarters zone/total sales.
** Europeanisation rate = European sales outside the headquarters zone/total European sales.
Source: Based on Nicolas Véron, *Farewell National Champions*, Bruegel Policy Brief 2006/04, June 2006.

1. THE ACCELERATING INTEGRATION OF EUROPE'S BANKING SYSTEM

Europe benefits from London's world-class wholesale capital market and has many world-class financial services firms. But its banking industry has long been – and still is – remarkably fragmented. European financial services firms represent a respectable 36 percent of the aggregate value of companies in the FT global 500 ranking of the world's largest listed corporations. But the only

[1] See Ross Levine, 'Finance and Growth: Theory and Evidence', in *Handbook of Economic Growth*, edited by Philippe Aghion and Steven Durlauf, Elsevier Science (2005).

[2] See chapter 2 of Jörg Decressin, Hamid Faruqee and Wim Fonteyne (eds), *Integrating Europe's Financial Markets*, International Monetary Fund (September 2007).

European player in the financial sector's worldwide top 10 is HSBC – which, incidentally, was incorporated in Hong Kong until 1994, and whose activity is mostly outside the EU. In no other broad sector are so few European companies represented at the top. Furthermore, as Table 2 illustrates, Europe's banks are more concentrated on their 'home' market than any other industry save telecoms and media – a segment in which most companies (eight out of eleven) were national monopolies only a few years ago but are now internationalising rapidly. These features may exact a high price on the performance of the financial system and the economy as a whole. Financial services (excluding insurance) accounted for half the gap in productivity growth between the euro area and the US between 1996 and 2003[3]. Europe's banks also seem to be both less profitable than their US counterparts, and less prone to take risk in lending to certain types of local borrowers, with the possible consequence of more difficult funding for high-growth, capital-hungry innovative companies[4].

However, cross-border banking integration is gaining momentum and changing this picture rapidly. A first wave of consolidation, in the 1990s and early 2000s, had predominantly involved banks within the same country or in neighbouring countries. Emilio Botín, chairman of Grupo Santander, expressed a collective mood when writing that *'it will be some time before Europe is sufficiently integrated and the many barriers – regulatory, fiscal and cultural – that impede the functioning of the single market are overcome. Many would still regard as unacceptable the takeover of a large local bank by a foreign institution. [...] I doubt [cross-border deals] would create value for shareholders'*[5]. But a few months later, Santander successfully acquired Abbey in the UK, initiating a new series of landmark cross-border deals which includes UniCredit's purchase of HVB (2005) and the ongoing battle for ABN Amro, in which Santander is a contender. Table 3 illustrates the speed with which the distribution of the assets of Europe's main banks has evolved towards more geographical diversification inside the EU, while the share of assets outside the EU has remained stable at roughly a quarter of the total.

Further integration is likely, perhaps at an accelerating pace. Barriers to foreign investment in banking are falling, not least

Table 3: Europe's largest banks are crossing borders

Europe's 15 largest listed banks (by decreasing order of market value)	Home country	Assets in home country (1997)	Assets in the rest of Europe (1997)	Assets in home country (2006)	Assets in the rest of Europe (2006)
HSBC	UK	35%	4%	27%	12%
RBS	UK	81%	1%	68%	7%
Santander	ES	55%	8%	26%	58%
BNP Paribas	FR	53% (a)	19% (a)	58%	20%
ING (b)	NL	55%	11%	23%	16%
UniCredit	IT	77% (c)	17% (c)	26%	70%
Barclays	UK	71%	8%	41%	20%
ABN Amro	NL	38%	15%	29%	43%
Intesa Sanpaolo	IT	70% (a)	15% (a)	84%	8%
BBVA	ES	85% (d)	3% (d)	61%	9%
Société Générale (b)	FR	80%	7%	54%	27%
Deutsche Bank	DE	32%	35%	18%	47%
HBOS	UK	83% (e)	8% (e)	85%	9%
Crédit Agricole	FR	88%	3%	77%	13%
Lloyds TSB	UK	86%	5%	95%	2%
Average (unweighted)		**66%**	**11%**	**51%**	**24%**
Average (asset-weighted)		**60%**	**13%**	**48%**	**24%**

Source: Bruegel estimates based on company information. Notes: (a) 1999 (1997 data unavailable); (b) breakdown by income (asset data unavailable for 1997); (c) Credito Italiano; (d) Banco Bilbao Vizcaya; (e) Bank of Scotland.

[3] *Integrating Europe's Financial Market*, chapter 2, box 2.1 (see note 2).

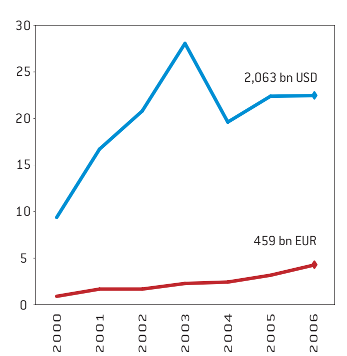
[4] *Integrating Europe's Financial Market*, chapter 4 (see note 2).

[5] Emilio Botin, 'The most profitable course for Europe's banks', *Financial Times*, 22 January 2004.

thanks to the European Commission's vigorous defence of a competitive internal market, in successive cases involving Portugal (1999), Germany (2004), Italy (2005) and Poland (2006). At the same time, new financial products, especially asset-backed securities, have developed in Europe at a rapid pace, as illustrated by Figure 1. In spite of recent credit market turmoil, the growth of European securitisation is unlikely to be halted, as this financial technique brings genuine risk-management efficiency gains. This trend and other technological developments provide additional incentives for banks to seek economies of scale and centrally manage operations that take place in different countries. As a result, there will be a growing number of banks whose activities are not predominantly taking place in one single country. These are called 'pan-European banks' in the rest of this text, even though some may not have a presence in all European countries.

Cross-border banking integration could bring important economic benefits. Pan-European banks provide a link between national financial systems and the highly efficient wholesale capital markets of London and smaller European hubs, as well as global capital markets. This has the potential to bring more dynamic financial development and a quicker spread of financial innovation, facilitate access to credit for consumers and entrepreneurial firms, and ultimately improve the ability of Europe's financial system to foster growth.

Figure 1: Securitisation issuance in Europe and the US (in % of GDP)



Source: SIFMA and Eurostat. US data exclude CDO and other collateral, which are included in European data. A change of SIFMA's methodology for European data occurred in 2005.

2. NATIONAL FINANCIAL STABILITY ARRANGEMENTS ARE ILL-ADAPTED TO PAN-EUROPEAN BANKS

While pan-European banks are emerging, Europe's financial stability arrangements remain grounded at the national level. They now run the risk of lagging behind market developments.

Much headway has certainly been made in giving national financial stability arrangements a European orientation. The European Commission's 1999 Financial Services Action Plan put in place a largely harmonised set of financial regulations. The so-called Lamfalussy framework for financial rule-making complemented this with a structure intended to implement these regulations consistently and adapt them over time, while reinforcing market consultation. In the banking sector, it brings together all European banking supervisors and relevant agencies within the Committee of European Banking Supervisors (CEBS), established in 2004. To improve cross-border cooperation between existing national agencies, an extensive network of bilateral 'memorandums of understanding' (MoUs) has been built since the late 1980s, complemented more recently with multilateral MoUs on information sharing during a crisis and on specific banking groups. But the interlocking of many national sources of authority has also created complexity and blurred the lines of responsibility for supervision and crisis management. CEBS is an advisory body, with no decision-making powers. The MoUs are non-binding, and their effectiveness has yet to be tested by a crisis. The European Central Bank (ECB), established in 1998, has no supervisory mandate and, apart from its responsibility for open-market operations, its only financial stability task is a monitoring role, supported by the ECB's Banking Supervision Committee.

'The interlocking of many national authorities has blurred the lines of responsibility.'

The prudential framework for pan-European banks has become a maze of national authorities (51 are members of CEBS alone), EU-level committees (no fewer than nine) and bilateral arrangements (some 80 recently mentioned by European Commissioner Charlie McCreevy)[6]. Prudential fragmentation imposes costs on the financial system. One recent study estimates that the resulting absence of scale economies adds 15 percent to the cost of Europe's banking supervision[7]. Additional costs are created as banks need to cope with different requirements and reporting systems in each country.

But these supervisory costs are of

[6] Keynote address at the conference on EU supervisory arrangements in Brussels, 26 June 2007 (www.europa.eu).

[7] Martin Schüler and Friedrich Heinemann, *The Costs of Supervisory Fragmentation in Europe*, ZEW Discussion Paper No. 05-01 (2005).

secondary importance compared to the risks related to an inadequate response to major crises. No national or European authority presently has routine access to supervisory information on all pan-European banks, and in-depth knowledge of their developments. EU countries' existing tools are no longer adequate to contain the impact of financial crises in ways that minimise collective costs and avoid 'moral hazard' (ie precedents that encourage imprudent behaviour by financial players, including banks).

The effects of financial integration are most advanced in the countries that joined the EU in 2004 and 2007, in which the banking system is dominated by foreign-headquartered institutions (Figure 2). Elsewhere, the influence of non-domestic banks is also increasing as cross-border activity gathers pace. As banks increasingly centralise key business functions such as risk, liquidity and asset-liability management, local branches or subsidiaries become less independent from the rest of the group. As a consequence, national authorities increasingly lose leverage over the main banks in their jurisdictions, and their ability to deal with financial crisis situations on a national basis is diminished.

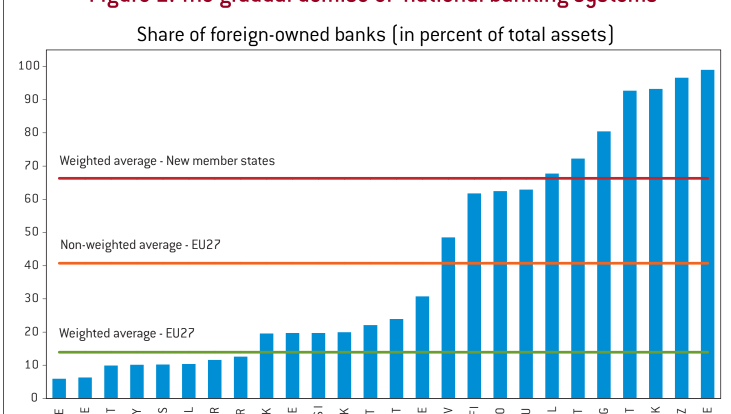
If problems emerge in a pan-European bank, there are no agreed rules on early intervention and remedial action. Because of different interests or a different assessment of risks, different national authorities may have different priorities, the more so as the crisis becomes acute. Speed, crucial in handling crises, might be hampered by coordination difficulties, compounded by the lack of agreement between countries on the role (if any) public funding should play in crisis resolution, and on the division of tasks between supervisors in 'home' (headquarters) and 'host' (local) jurisdictions. At every step, agreement may take so long to reach that it might be overtaken by events on the ground, with consequent increases in the cost of any remedies.

'In crisis situations, national priorities will be incompatible with minimisation of the overall collective cost.'

If a bank's insolvency becomes a realistic scenario, minds will focus on the possible public cost of crisis resolution, which has been a factor in past crises, and countries will act to minimise losses to their own citizens. They may seek advantage by withholding information or otherwise delaying cooperation. Host countries may try to 'ring-fence' subsidiaries or branches and limit their operational freedom, to prevent higher-quality assets from leaving the country or additional liabilities being imposed on the local level. In doing so, they may compound difficulties and prevent solutions at the group level. Conversely, home authorities may be unwilling to spend their taxpayers' money for the benefit of depositors in host countries, or lack the capacity to do so. Depositors may have to face the consequences of decisions made by foreign authorities, who are not accountable to them and will be naturally suspected of being primarily concerned about their own citizens' interests.

The economic literature on 'mechanism design' suggests that in such situations, national priorities will be incompatible with minimisation of the overall collective cost[8]. In such dire events, non-binding supervisory MoUs or voluntary mediation mechanisms (as recommended by the 'Francq report' of February 2006[9]) may not have much impact when weighed against the potency of national mandates. Crises are known to require concentration of responsibility, but in the absence of clear *ex ante* cross-border arrangements, it is unlikely that any authority, national or European,

Figure 2: The gradual demise of 'national banking systems'



Source: ECB, Banking Sector Stability 2005, based on 2004 data (www.ecb.int).

[8] Jerry Green and Jean-Jacques Laffont, *Incentives in Public Decision Making*, North-Holland (1979).

[9] *Financial Services Committee Report on Financial Supervision* (23 February 2006).

could emerge as an 'honest broker' to represent the common interest. As Louis Pauly from the University of Toronto put it recently, *'the belief that financial institutions and national regulators will voluntarily and automatically collaborate to an adequate extent in the face of a financial panic and in the absence of central coordination seems a classic example of wishful thinking. Where is the historical evidence that could justify it?'* Neither the Economic and Financial Committee, which brings together the EU's finance ministries, nor the ECB, nor the Commission are likely to prove able to *'provide the necessary services of multilateral coordination and political buffering'*[10]. As a result, significant and unnecessary losses of taxpayers' money would be likely, and this money may be spent in ways that create moral hazard among Europe's banks.

No real precedent exists for a major cross-border banking failure, except perhaps the unhappy experience in 1991 when BCCI was closed down in London. Nonetheless, recent turmoil in credit markets has reminded the European public of the permanent possibility of financial crises, and of the inability of national borders to keep them at bay. Financial innovation and global integration not only distribute default risk – which, all things equal, tends to strengthen the system – but also create new risks of their own, including those linked to the increase in common exposures across systems, which could make crises even more severe when they occur. As the examples listed in Table 4 illustrate, recent banking crises in the developed world have often resulted in major damage, both in terms of direct fiscal costs related to managing the crisis and loss of economic activity (the numbers remain high under any valuation methodology). More remote memories, including those of the 1930s in Europe and the United States, underscore the fact that disruption in the financial system, if not properly managed, has severe social and political as well as economic consequences.

What they said about Europe's current stability arrangements

'The present institutional setup in Europe regarding crisis prevention (and potentially also crisis management) looks to me, to put it mildly, sub-optimal.'
Alexandre Lamfalussy, 2nd Pierre Werner Lecture delivered at the Central bank of Luxembourg, 26 October 2004 (www.bcl.lu).

'Generally, the framework for financial supervision in the EU remains highly fragmented and overregulated, and therefore inefficient and ineffective.'
European Financial Services Round Table, *On the Lead Supervisor Model and the Future of Financial Supervision in the EU*, June 2005 (www.efr.be) .

'The current networks of national supervisors, the supervisory arrangements, and the non-legally binding memoranda of understanding may not be sufficient to face a major crisis caused by a failure of markets or important cross-border financial groups.'
European Parliament, motion of 8 May 2006 (www.europarl.europa.eu).

'These [Lamfalussy Level 3] Committees must demonstrate progress on [supervisory] convergence quickly and convincingly. This means a change of mentality as well as working methods. This is not easy. Bureaucracy and bureaucrats defend the status quo long past the time when the quo has lost its status! Progress in this area is urgently needed.'
Charlie McCreevy, European Commissioner for the Internal Market, 26 June 2007 (see note 6).

'Do the present legal frameworks provide authorities with the necessary tools for supervising cross-border banking groups in an efficient way? And do the authorities themselves have arrangements in place to produce comprehensive assessments of the operations and the risks of these groups? Under the prevailing regulatory structures I am afraid that the answers to both of these questions are likely to be no.'
Stefan Ingves, Governor of Sweden's central bank, speech at the Reserve Bank of Australia, 21 August 2007 (www.riksbank.com).

3. A TWO-TIER FINANCIAL STABILITY FRAMEWORK

Given the deficiencies of the status quo and the potentially severe impact of crises involving pan-European banks, an overhaul of Europe's financial stability arrangements is overdue. Arrangements are needed that deliver solutions to crises that minimise crisis-induced collective losses at the European level – while remaining compatible with continued financial development, including financial integration and innovation.

Handling crises involving pan-European banks efficiently and effectively is only possible when supervisory information can travel across borders confidentially but freely; efficient structures are in place that allow quick decisions involving multiple countries and agencies; sufficient operational flexibility is possible to deal with the unique nature of each crisis; all involved decision-makers share common basic views on how to proceed; and individual and institutional incentives are sufficiently aligned for decisions to serve the collective interest.

Relying on increasingly complex arrangements for voluntary cooperation among national financial stability frameworks is unlikely to deliver on these requirements,

[10] Louis Pauly, *Political Authority and Global Finance: Crisis Prevention in Europe and Beyond*, Global Economic Governance Working Paper WP 2007/34, Oxford University (May 2007).

Table 4: The high cost of banking crises

Country	Period	Fiscal cost as % of GDP	Output dip as % of GDP
Australia	1989-92	1.9%	-
Finland	1991-94	11.0%	23.1%
France	1994-95	0.7%	-
Japan	1992-	20.0%	27.7%
New Zealand	1987-90	1.0%	18.5%
Norway	1987-93	8.0%	19.6%
South Korea	1997-	26.5%	16.5%
Sweden	1991-94	4.0%	6.5%
United States	1981-91	3.2%	5.4%

Source: Patrick Honohan and Daniela Klingebiel, 'The Fiscal Cost Implications of an Accommodating Approach to Banking Crises', *Journal of Banking & Finance* 27, 2003, pp. 1539-1560 (www.sciencedirect.com).

because of the practical coordination difficulties and more fundamentally because the interests of the decision makers involved are not aligned. Actions intended to minimise collective costs are only likely to be on offer when cooperation is no longer simply voluntary, but a core part of the mandate.

It does not follow that all financial stability functions need to be EU-wide. Indeed, the subsidiarity principle and the differences in the risks of cross-border externalities present in the banking system suggest a two-tier setup, in which functions are fulfilled either at the EU level or at the national level, depending on where this can best be done given the objectives outlined above. Some functions related to cross-border crisis management ought to be organised at least in part at the EU level, such a way that key decision-makers are responsible for the common best interest, and held accountable for safeguarding it. In addition, combining effective and collective-cost-minimising crisis management with the objective of allowing pan-European banks to operate freely across borders argues in favour of an EU-level regulatory and supervisory (prudential) regime for these banks. Such a European prudential regime should be effectively focused on pan-European banks, a small subsample of Europe's 8,000-odd banks. The European System of Central Banks has calculated that just 16 groups account for one third of EU banking assets. These groups hold on average 38 percent of their EU assets outside their home countries[11]. For nationally-oriented banks, including most cooperative, public and savings banks, the benefits offered by proximity argue for a decentralised prudential approach based on national supervision.

'The subsidiarity principle suggests a two-tier setup.'

A European prudential regime can best be established at the level of the entire EU rather than the euro area, because the EU offers an appropriate framework of law and democratic accountability and almost all pan-European banks have significant activities in London that cannot be isolated from their euro area operations. It should be based on a single rules book and entail EU-level responsibility over some supervisory functions, which could be transferred either to one or several new or existing agencies. To eliminate current information asymmetries with respect to pan-European banks, supervisory information would need to be centralised, with appropriate arrangements to allow the circulation of confidential data.

To help ensure collective crisis cost minimisation, a European prudential regime should be accompanied by a single set of pre-crisis sanctions and tools and specific, harmonised arrangements for deposit insurance. Bankruptcy procedures tailored to the characteristics of pan-European banks might also need to be considered. Because overall cost minimisation often tends to be to at least one party's disadvantage, it is likely to require countries to commit to sharing the costs of crisis resolution. If well handled ahead of time, this need not prompt moral hazard[12]. Any EU-level arrangements should provide the clear prospect for failing banks to disappear as legal entities, so as to curtail moral hazard and strengthen banks' incentives to manage savings carefully[13].

An important and difficult question is determining to whom exactly a European prudential regime should apply. Filtering banks on the basis of specific thresholds of geographical risk diversification and/or size may be overly rigid and distort competition. Making adhesion to a European regime voluntary carries both the potential benefits and risks of regulatory competition, and there is no guarantee that all pan-European

[11] Jean-Claude Trichet, keynote speech at the first CEBS conference in London, 9 May 2007 (www.ecb.int).

[12] Charles Goodhart and Dirk Schoenmaker, *Burden Sharing in a Banking Crisis in Europe*, LSE Financial Markets Group Special Paper Series No.164 (March 2006).

[13] *Integrating Europe's Financial Markets*, chapter 10 (see note 2).

banks would join[14]. A combination of both approaches could also be considered.

An EU-level approach for pan-European banks would facilitate coordination with non-European supervisors in the event of a crisis that extends beyond the EU's borders, something financial globalisation makes ever more likely. It would increase Europe's influence in international discussions on banking. It would reduce compliance and opportunity costs for pan-European banks. It would level the playing field on which pan-European banks compete, whatever their country of incorporation, and may accelerate the ongoing convergence of national-level banking regulation. It could hamper the protectionist bent of national policies[15]. And it would probably contribute to an acceleration of European financial integration, with positive growth and competitiveness impact. These 'side effects' would not be negligible.

'Given the magnitude of the challenges, an evolutionary approach is unlikely to deliver.'

Discussions about pooling decision-making and building new institutions that defend Europe's collective interest raise many legitimate concerns. These include the desire to keep institutions close to citizens and market players; the need for effective accountability, especially as crisis management may lead to using taxpayers' money; the risks of mission creep and unchecked overregulation; and the risk that new institutions may be difficult to reform if they prove inadequate. Also, there is a natural desire to maintain the mandate of existing national institutions and related jobs – not to mention other possible obstacles to reform such as turf protection, regulatory capture, and institutional inertia. The European regime should rely on extensive delegation of operational tasks to national agencies; and arrangements on the funding, governance and public accountability of EU-level organisations to be involved in it will be crucial for creating trust and legitimacy. Under current arrangements, EU citizens are subject to decisions of foreign authorities that are not at all accountable to them. The two-tier framework would thus restore accountability in an area where it is currently not provided.

Given the magnitude of the challenges, an 'evolutionary' approach, based on consensus-building among national agencies, is unlikely to deliver. Political commitment at the highest level will be needed, as has been the case for previous major European reforms. The severe potential impact of inadequate management of potential pan-European banking crises justifies a high degree of engagement by principals.

Until recently, it was acceptable to downplay the importance of cross-border prudential issues, but the recent and likely future rise of pan-European banks changes the situation. If a major banking crisis, triggered by events inside or outside the EU, catches Europe unprepared, the risk would be an extraordinarily costly outcome, possible regulatory overreaction and the rushed adoption of poorly prepared reforms. Seen in its wider context, swift and proactive adaptation of financial stability arrangements in response to the emergence of pan-European banks is in the interest of all market participants.

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[14] A discussion of the related policy choices can be found in Martin Cihák and Jörg Decressin, *The Case for a European Banking Charter*, IMF Working Paper WP/07/173 (2007).

[15] On this aspect see Adam Posen, 'Liberalism Needs Central Power', *Financial Times*, 4 July 2007.

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