EUROPE


Why Europe must create a strong financial watchdog

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by Bernhard Speyer / Norbert Walter

The financial crisis has raised serious doubts about the effectiveness of Europe's efforts to address its fragmented national systems of financial regulation. Deutsche Bank's ***Norbert Walter*** *and* ***Bernhard Speyer*** *argue for the setting-up of a pan-European financial supervisor with real clout, and warn that if EU governments fail to summon up enough political courage, the economic cost will be very high*

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The financial crisis that has now engulfed the global economy is raising tough questions. Not surprisingly, many of these relate to the economic and financial aspects of the crisis and these issues inevitably comprise the main policy focus at present. But what will be the longer-term implications of the crisis for financial markets and their future regulation?

Europeans, not least in France, have already begun to proclaim that the EU will eventually emerge as a winner from this crisis. They claim the so-called Anglo-Saxon model of capitalism has failed and that the EU can take the lead in reshaping the world's financial architecture. European leadership of that sort is certainly feasible, but for now the reality still looks very different.

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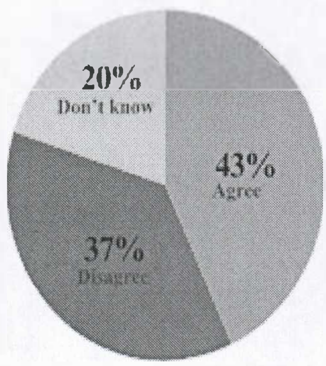
Europeans refuse to be downhearted

Despite the general economic gloom, Europeans appear reasonably positive about their ability to cope on the domestic front. A Eurobarometer survey in the final quarter of 2008 found that well over half (57%) of those interviewed judged the financial situation in their household to be "rather good". An additional 7% said it was "very good" and only 2% said it was "very bad". Having a job obviously helped: 56% said their employment situation was either very good or rather good. However, this seemed to be a very personal assessment. When asked about employment nationally there was less confidence: only 28% judged it to be good, with a similar score (29%) for their country's economy.

Just under three-quarters (71%) judged the world economy to be rather bad or very bad. The European economy, however, was not seen to be in quite such a desperate state, with a third of respondents saying it was in good shape.

Although 2007's "feel good" factor has lessened or vanished, loyalty to the EU remains strong. In 25 of its 27 member states, a majority said membership was a good thing, with that average of 53% being a percentage point higher compared to Spring 2008. The Eurobarometer report suggested that the survey showed "an emergence of a new pattern in European public opinion towards the EU".

DOES THE EU HELP TO PROTECT US FROM THE NEGATIVE EFFECTS OF GLOBALISATION?



Eurobarometer 2008

The initial agreement amongst eurozone members – and subsequently amongst all EU member states – on the common elements for their banking sector's rescue packages, represented a major breakthrough. It was also urgently needed. But it is also worth recalling that the EU countries only managed to present that common front after earlier measures by individual nations had in fact exacerbated the crisis. The Dublin government's guarantee for deposits held only at Irish banks was merely the most blatant example.

While EU member states have agreed on the core principles for their national rescue packages, it is worth remembering that between countries the details differ markedly, and that is a recipe for longer-term competitive distortions. More fundamentally still, the failure of several cross-border financial groups has also raised significant doubts about the viability of Europe's current structure of financial supervision. Essentially, the present approach has failed to provide an effective system of on-going prudential supervision for financial firms and a suitable structure for effective crisis management. Nor are the current arrangements doing much to help preserve the EU's single market for financial services.

Against this background, the EU has reached a fork in the road. Either the financial crisis will finally provide an impetus for building a pan-European financial supervision structure that helps to support the political objective of building a single market for financial services – or the progress achieved so far in building that single market will begin to unravel and the EU will move backwards into a collection of fragmented national financial markets.

For many years, academics, international organisations (including the IMF), and many market practitioners, have pointed to the deficiencies of Europe's current supervisory structure. To its credit, the European Parliament has been increasingly responsive to these calls. By contrast, the European Commission – fearing political opposition from the member states – and, even more so, member states have largely turned a blind eye to this challenge. As a result any progress on this front has been haphazard and piecemeal.

It is true that, with the establishment of the Lamfalussy process, there is now greater emphasis on encouraging coherence amongst Europe's national supervisory bodies. It is also true that with the establishment of the so-called level 3 committees – Committee of European Banking Supervisors (CEBS), Committee of European Securities Regulators (CESR) and Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) – supervisory cooperation amongst EU regulators has improved, even though this cooperation is merely based on intergovernmental cooperation. But any improvements to Europe's system of supervision that may have emerged from these measures have so far been minimal and, as the financial crisis has now demonstrated, wholly insufficient.

In response to the crisis, the European Commission and the member states have indicated that they will use the upcoming revision of the Capital Requirements Directive (CRD) to make some amendments to the existing supervisory structure. These proposals are essentially aimed at establishing supervisory colleges for all cross-border groups and at strengthening the role of the consolidated supervisor. But unfortunately even these minor improvements appear to be too much for the majority of member states to digest. If the fate of the similarly designed Solvency II proposal is any guide - it met with opposition after proposals to strengthen the role of the consolidated supervisor alarmed a number of member states - then the analogous provisions in the CRD may never see the light of day.

This situation cannot continue. If Europe is serious about building an integrated market, then it must be ready to build a supervisory structure that is commensurate. As an interim first step, the revision of the CRD must be used to strengthen the role of consolidated supervisors. To support this, supervisory colleges must become more than mere talking shops, which is so far what they often are. Instead, they need to deliver a full operational integration of supervision designed to deliver greater financial stability, greater efficiency, better quality - and at a lower cost for financial firms. A single group-wide supervisory process is required that is based upon close cooperation and, ideally, a joint work approach in supervisory colleges that cuts across individual supervisory agencies.

To make this happen, however, it will be necessary for consolidated supervisors to have the final say and also the power to act. So a legal review may also be necessary to ensure that the decisions of a consolidated supervisor are legally binding for all of a financial firm's operations in the European Economic Area. This may require some form of European administrative act to ensure that integrated supervision has the appropriate legal clout.

We will also need to ensure that setting-up supervisory colleges and strengthening the role of consolidated supervisors doesn't exacerbate the inconsistencies of approach between national supervisors. For this, centralised governance is needed in the form of a stronger role for the Level 3 committees to ensure competitive neutrality as well as an equality of approach amongst the colleges. An annual review mechanism should be established, into which financial groups should be allowed to provide input.

As a second step, we need to build a truly pan-European system of financial supervision. A European System of Financial Supervision (ESFS), modelled on the European System of Central Banks, would comprise a new EU-level institution - a European Financial Services Authority. This would supervise those systemically relevant financial institutions that operate on a pan-European basis, and it would be the final authority for interpreting and implementing EU financial market rules whenever there is a conflict between national regulators. Small and domestically-oriented institutions should continue to be supervised by member states' national authorities, acting on the basis of common rules and subject to the final say of the pan-European supervisor. Such a European supervsisor would collaborate closely with the European Central Bank, which has an important role in the area of macroprudential supervision.

Only this sort of comprehensive, supranational approach can overcome Europe's present supervisory deficiencies, and only such a system can be competitively neutral and institutionally stable. What's more, from a political perspective the ESFS system - even though difficult to agree on in the first place - would have one significant advantage over the regime of lead supervisors. While smaller countries would essentially lose direct supervisory authority under the latter system, they would regain influence in the running of a pan-European structure. Creating a pan-European system of financial supervision would thus bear some resemblance to the way European monetary policy developed. Small countries that had passively followed German monetary policy prior to EMU, managed to regain a voice in setting monetary policy as a result of the creation of EMU.

It is also worth bearing in mind that developing an appropriate European institutional structure for financial supervision is not just a European issue. Political foot-dragging on this vital matter risks damaging the EU's international standing. There can be no doubt that Europe's obvious inability to deal effectively with the failure of large cross-border financial institutions, and the fall-out from the ensuing systemic crisis, has already damaged the reputation of the EU's financial markets.

Yet many decisionmakers in the EU are still not sufficiently aware of the international dimension, even though Europe collectively represents the second largest financial market in the world and, for this reason alone, has a responsibility for maintaining global stability and security. Moreover, both in competition and cooperation with third countries - whether it is the U.S. or upcoming financial centres - Europe must be able to demonstrate convincingly that it has world-class regulation and supervision right across the EU. Otherwise, Europe's negotiating power and it trustworthiness as a partner risk being seriously undermined.

In building this sort of new supervisory structure, Europe needs pragmatism and vision. Vision without pragmatism will not be enough, while pragmatism without vision lacks direction. The High Level Group appointed by European Commission President José Manuel Barroso and chaired by Jacques de Larosière will hopefully deliver the blueprints for this. Yet even if it does, the EU's legislators must still find the political will to act, and act quickly.

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Deutsche Bank.

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Re:Why Europe must create a strong financial watchdog

Bernhard Speyer and Norbert Walter's support for the creation of a strong pan-European financial supervisor "with real clout" is not shared by the European Association of Public Banks as its members are in generally regionally oriented. By the way such a suggestion was already publicly rejected by Commissioner McCreevy.

Apart from the fact that a pan-European financial supervisor is not in a position to supervise adequately and under consideration of their regional importance all banks in 27 Member States, there is not even a rudimentary legal basis to establish such a single European supervisor.

Before proceeding in this direction, the harmonisation or even unification of the 27 banking supervision laws, the administrative laws, insolvency laws and legal protection has to be accomplished.

Even the suggestion to introduce a separate obligatory supervisory regime exclusively for the 42 cross-border institutions in Europe causes heavy concerns. That would impl y that cross-border groups are treated differently compared to nationally active institutions thereby disregarding the principle of equal prudential treatment.

From our point of view the model of a "college of supervisors" which is also currently discussed is the right answer to the claim of the standardisation of banking supervision in Europe.

By HenningSchoppmann on *2/9/2009 4:33:38 PM*
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Re:Why Europe must create a strong financial watchdog

It is in the interests of all to find consistent approaches to supervising financial groups operating in a multitude of jurisdictions. T he European Banking Federation (EBF) has contributed a list of concrete proposals to the European Commission's High Level Expert Group on Supervision led by Jacques de Larosière.

The aim of the EBF is the creation of a single financial market. This should be supported ultimately by a pan-European financial supervisory framework. With this in mind, the EBF proposes that in any future pan-European framework the prudential supervision of each institution be consistent across countries and that it should be proportionate to the degree of systemic risk.

Pending the creation of a pan-European framework, the existing supervisory str uctures need to be enhanced. Naturally, supervisors have in essence a central role to play. They are key to reducing regulatory duplication and in consistency. Furthermore, colleges of supervisors are the appropriate structure to enhance supervision of large complex financial institutions. Their functioning should be improved by giving the home supervisor the final say when consensus cannot be reached among the members of the college.

The Committee of European Banking Supervisors (CEBS); the Committee of European Insurance and Occupational Pensions Supervisors (CEIOPS) and the Committee of European Securities Regulators (CESR) should be strengthened and, moreover be better empowered and resourced.

By GuidoRavoet on *2/10/2009 3:42:19 PM*
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A call for an ECB supervisory board of colleges

In general I very much agree on the proposals brought forward Mr Walter and Mr Speyer. The cross-border European banks need more accurate supervision and it follows that a common market for financial services requires some sort of common control mechanism. I agree that the Level 3 committees ought to have a stronger role. Further, the supervision should be modelled on the present ECB structure - a common authority for the big banks where the domestic supervisory authorities sits on th e board. That would give us the operational capacity we lack today whilst guaranteeing that smaller Member States, such as my home country Sweden, are not overrun when decisions are taken.

Moreover, supervising hedge funds should be made a priority but not to the extent that they are regulated out of the market. It is fully reasonable that these are put under the same surveillance as the banks since they have become real power-brokers on the financial markets. The supervisory board of colleges, if such an institution was to be put in place, should therefore follow them closely thus securing the stability of the market in a manner which unfortunately has been lacking under the present regime.

By OlleSchmidt on *2/12/2009 12:12:27 PM*

Re:Why Europe must create a strong financial watchdog

The article provides a good overview of the challenges associated with the current supervisory framework in Europe as exposed by the crisis. I especially share their view that Europe's inability to coordinate its actions during the crisis better may have already damaged the reputation of its financial markets.

In describing the possible solutions to the deficiencies of the framework, the authors appear to cover both banking supervision and securities markets. While I do not in principle disagree with the broad thrust of their suggestions in relation to banking supervision, Europe's securities exchanges believe that there is no need for a structural change in the securities field that would replace the decentralised framework with a centralised one.

Nonetheless, certain improvements are needed. FESE recently urged the High level Group appointed by the European Commission to consider the following improvements to the supervisory framework for securities markets:

- CESR should be endowed with a clearer mandate, an increased and more independent budget and a decision-making procedure that leads to clearer decisions. The possibility of turning CESR into a Community agency – and therefore endowing it with its own legal personality - could be explored. CESR should be bolder in its focus on enforcement by initiating Level 3 work in all areas that pose a problem for the Single Market and by reaching clear agreements among its members. CESR should have the resources to tackle technical and complex subjects.
- The European colleges that exist for multi-jurisdictional exchanges should be made more effective, especially through: a clearer division of labour via delegation of tasks (or designation of a lead supervisor) and more regulatory harmonisation / Level 3 co-ordination to minimise areas of divergence. Moreover, the principle of subsidiarity applies to colleges as well: A multi-jurisdictional college should not become an additional layer, but simply a mechanism for a coherent approach among the various national authorities involved.
- To boost the EU's role vis-à-vis 3rd countries, the greater cohesion of enforcement in Europe should be accompanied by establishing a clear regulatory and supervisory regime for 3rd country issuers and institutions. Moreover, the Level 3 committees should be allowed a stronger role at the international level. In addition to building its capability for information needed for effective oversight of markets, CESR should rebuild confidence in markets through a greater focus on investor protection. Consultations should reflect the full spectrum of diverse interests of the securities value chain including in particular issuers, shareholders, an d investors of different sizes. Consideration should be given to a whistleblower regime similar to the suspicious transaction disclosure rule under the Market Abuse Directive.

There is an overlap between our proposals and those of the authors with regard to the need improve the effectiveness of the Level 3 committees in ensuring supervisory convergence, the functioning of the colleges of supervisors, and the need to have a more effective role for Europe on the international front.

By JudithHardt on *2/12/2009 8:20:12 PM*

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