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Financial Crisis, Banking Union
and New Financial Regulation
Oplæg d. 27.05. 2013

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Why Did it Take so Long to Develop European Regulation/Supervision?

Presentation by
Niels Thygesen*

At Kraka conference on ”Financial Crisis, Banking Union and New Financial Regulation”, Copenhagen, 27 May 2013

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* Professer (emeritus) of Economics, University of Copenhagen

Why so little effort at EU regulation/supervision of finance?

- Banking was until recently a largely national industry in the EU (financial market integration was ahead)
- The macroprudential/systemic perspective was missing (though there were warnings from app. 1980)
- Institutional complications in the balance between national, regional (EU) and global authorities and in finding a role for the central banks

Two motives for international cooperation

- Spill-over effects are sufficiently important
- A need to learn from each other's national experience to develop best practice

The second is always present, but barely strong enough to drive international cooperation towards major common efforts

The first two decades of EU cooperation illustrate the problems

- A ”contact group” of national regulators/supervisors was set up as an informal body in 1972- UK and Denmark participated from the start
- From the start under pressure to include the European Commission and to expand geographically to the remaining G10 countries (US, Canada, Japan)
- The Basel Committee (BCBS) was set up in 1975 and served by the BIS – and the Central Banks joined.

Three individual cases of failures/holes in national supervision

- Herstatt insolvency 1974 – the German regulator closed the bank in US business hours, imposing major losses on US creditors
- Banco Ambrosiano, home in Italy but with major activity through unregulated holding company in Luxembourg, was closed in 1982– a spectacular, but very exceptional lapse in regulation, according to the BCBS chairman – but it inspired the ”Concordat” on the division of work between home and host authorities

- It was repeated, though only in 1991, nine years later, in the case of BCCI, based in London, but with a global network and imaginative use of loopholes in the "Concordat" – including a holding company in Luxembourg

All three cases involved a single banking group with links beyond the EU – and beyond the G10 for the last two – but with only limited links to systemic issues

Global coordination agreed in Stockholm 1996

Surprising inattention to systemic issues, since even the three individual cases mentioned had links to the Eurocurrency markets and the evolution in these markets – which provided an escape valve from national regulators – had been monitored by the G10 since 1968

Initially the Eurocurrency markets were regarded with concern by the authorities on both sides of the Atlantic, but after the transition to flexible exchange rates and the need to recycle the surpluses of the oil exporters via these markets, attitudes became more tolerant

Transition of the BCBS from exchange of information to standard setter

Despite the dramatic nature of the Latin American debt crisis from 1982 there were no global initiatives to improve systemic stability in Basel or elsewhere

But, as bank regulation firmed up later in the 1980's the BCBS responded with new capital requirements
– "Basel I" – in 1988 to assure a "level playing field", aimed not least at Japanese bank competitors who operated with very low levels of capital

Efforts concentrated on convergence of national rules for capital adequacy ratios on a consolidated basis, and relying on risk-weighted assets – but the US continued to advocate an unweighted ”leverage ratio” as a backstop

Could such a major effort be made on the basis only of the ”soft law” produced by an informal standard setting committee such as the BCBS?

No, support from governments, the EU and central banks would be required, on the European side an EU rule book

Preparing the Maastricht Treaty

- Intellectually bank (and other financial) regulation was an issue that transcended European authorities
- Several countries were building up unified national supervisory bodies – FSAs – for banks, markets and insurance by 1990, e.g. Denmark
- Most central banks were moving further from regulatory or supervisory tasks nationally, Bank of England was the main exception (and that lasted only until 1997)

Discussions in the Delors Committee

While a classic, arguably the most important, role of a central bank was to preserve financial stability, that role had, by the late 1980s, been eclipsed by the responsibility for monetary/price stability, the inflation-targeting regime

As that responsibility, strongly encouraged by monetary theory, became more rules-based and more closely identified with central bank independence (of both the political authorities and the financial sector), financial stability moved further down the CB agenda, particularly in the EU

In the absence of urgent or likely systemic concerns, and with supervision of individual financial institutions at best regarded as a tedious activity, but a potentially dangerous one for central bank independence

Asking for involvement of the future European System of Central Banks and its main arm, the ECB, in EU financial supervision was seen by the central bankers as ”a bridge too far” -

and ”macroprudential” tasks remained below the radar

So, just a short reference in the Delors Report (art. 32) : ”The system (ESCB) would participate in the coordination of banking supervision of the supervisory authorities”

This formulation was retained in the Maastricht Treaty (art. 105), but possible additional prudential authority for the ECB was mentioned (now art.127,6 in the Lisbon Treaty), if ECOFIN were to decide so unanimously

Recalling the 1988-91 discussions, this is an amazingly tenuous basis for centralizing substantial supervisory powers in the EU – but it avoided a Treaty revision

Let me recall that when Maastricht was agreed

- Financial stability was not obviously in danger in Europe
- Individual banking problems had been few over the past two decades (as outlined above)
- Europe had, to a considerable extent, “outsourced” financial standard-setting to the BCBS (where Europe had a major, even excessive, presence)
- The central bankers did not wish to touch financial supervision – and the political authorities agreed
- Capital movements had only recently been fully liberalized, the Euro was seven years into the future, and the EMS was holding up well (until September 1992)

Events in the 1990s did not change much in this complacent climate

- The Asian financial crisis of 1997-98, though some of its roots were in overlending by western institutions, did not register – ”we are different”
- Nor did the EU pay much attention to the experience in the Nordic – Finland, Sweden, Norway – financial crises of the early 1990s, though they were interesting from a systemic perspective (excessive credit creation and liberalization of capital flows in a boom), and have some similarities to the recent crisis in the EU periphery

Three important steps towards an EU responsibility for supervision

- The Financial Services Action Plan (FSAP), launched 1998 by Commissioner Mario Monti
- The recognition by the Lamfalussy group of wise men in 2001 that decision–making on regulation/supervision of financial markets was severely deficient – ”Comitology”
- The de Larosiere Report of 2009 (during the crisis) proposed a European Systemic Risk Board (ESRB) in the ECB and three EU supervisory authorities for banks, markets and insurance; all started early 2011

Lamfalussy (2001) ”threatened” use of art. 127,6 after five years, if the coordination of national supervisors in the implementation of common rules did not work well

De Larosiere (2009) went as far as they interpreted the Treaty to allow in setting up the still advisory ESRB and the upgrading of the three Lamfalussy Committees, but they did not go as far as proposing a Single Supervisor

By 2010-11 a banking union with the three elements of a single supervisor, a single resolution mechanism and – possibly for the long term – a common deposit insurance mechanism was seen as essential for stabilizing EMU

This would take me well into Graham Bishop's theme so let me just end by noting that only the first of these steps is foreseen in the Treaty – and barely so, in my view

Hence, for quite some time banking union beyond the SSM will have to operate in a more decentralized, though obviously closely coordinated, way than originally announced by the European Council (June 2012)

For the longer term the main element of progress relative to the slowness of the EU regulatory/supervisory process prior to the recent crisis is that macroprudential perspectives have become prominent and accepted as a natural extension of central banking responsibilities

Despite a promising start, challenges to the new framework remain

- At the micro level, some observers, mainly in the UK, claim that the three European supervisory authorities create legal uncertainty by going beyond the principle of national responsibility for implementing common rules

- At the macro level there are, despite major efforts to separate monetary policy-making and supervisory authority inside the ECB, serious concerns, particularly in Germany, about the continuing ability of the ECB to balance its mandate to assure price stability with its new wider responsibilities as a prudential watchdog