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# The Reform of Financial Regulation in Europe

## Introduction

The question of financial regulation within the European Union has acquired over recent months a new salience and urgency. As a result of the near-collapse in 2008 of the European banking system, the next twelve months are likely to see important steps by the European Union towards more integrated and mutually constraining forms of financial regulation within the Union. Over the fifty years of its existence, the Union's major integrative steps have usually been accomplished in pragmatic response to external events or internal crisis. The manifest severity of the current economic and financial crisis has finally engendered, at a later date than might have been expected, serious debate about the desirability of integrated European regulation for integrated European financial markets. Given the central role played by British banks in the destabilization of the European financial system over the past two years, this topic should be one of particular interest to British audiences.

Far from demonstrating the excessive integrative zeal for which they are sometimes criticised in the United Kingdom, the European Union's leaders have throughout the past ten years period fought shy of integrated regulatory systems for their increasingly integrated financial institutions. Encouraged by these same governments, national banking groups throughout the European Union have however pursued in the past decade a vigorous pattern of national and European consolidation, which seems likely to continue. 70% of Europe's bank deposits are currently held by Europe's 40 largest banks. It needed however the collapse of the US subprime mortgage market to make spectacularly evident the degree of European regulatory inadequacy in the financial sector and the sector's consequent high vulnerability to external events.

The present European discussion of financial regulation cannot be divorced from the global discussion of these issues. The recommendations of the Geithner report and the conclusions of the G20 Summits form an important backdrop to the European consideration of these matters. Nevertheless, there is an increasing awareness in the European Union that the problems and possibilities of the European financial system are intimately related to the governance of the European single market and that it behoves the European Union to review its own problems by its own deliberative mechanisms, rather than await guidance from others. The Union's governments seem notably disinclined to wait for a global financial Godot as an excuse for delaying the development of a new European regulatory and supervisory regime for financial services. Three documents have appeared in the first half of this year which form the backbone of the current European debate on financial regulation, the Turner Review, the de Larosière report and a Communication from the European Commission. The last of these documents in particular will represent the formal basis on which the European Union will discuss financial regulatory issues over the coming months. The description and analysis of its recommendations will constitute the great bulk of the following contribution to the debate. The current report is deliberately couched in terms of general analysis and will be succeeded later in the year by another report from the Federal Trust, which will consider in more detail specific technical, supervisory and regulatory arrangements.

## The Turner Review

When published in London in March of this year, the report of the Chairman of the Financial Services Authority, Lord Turner, was widely acclaimed for its detailed and comprehensive review of possible future changes to the regulation of the British financial sector. In general, the report advocates a more integrated approach towards financial regulatory procedures. It calls above all for regulation that properly recognizes the real risks in which financial service providers engage, depending upon their specific activities and not upon traditional designation. The report draws particular attention to the role of cross-border banks and the need for co-operation on a global scale to regulate these bodies. Accurate risk assessment can and should, in Lord Turner's view, be promoted by extending macroprudential analysis at the international level, and ensuring better communication between British regulators and international assessors.

Much of Lord Turner's overall analysis and many of his detailed policy prescriptions would be widely shared within continental Europe. They anticipate indeed much that is contained in the de Larosière report and the Commission's Communication. There is, however, an important difference between the political and intellectual world inhabited by Lord Turner and that of Mr. de Larosière. While the Turner Review and the de Larosière report substantially agree on what needs to be done, they differ on who should be responsible for making sure that it is done on a continuing basis. The Turner Review's basic conclusion is that the City of London should be regulated in London, an argument well encapsulated in a phrase attributed to Lord Turner by the Financial

Times, that "we either need more Europe or less Europe." Lord Turner seems to take it for granted that "more Europe" will be in this context uncongenial to the British government and probably to the City as well. There is some reason to believe that his assessment of British governmental attitudes at least is an accurate one, both in relation to the present British administration and a fortiori to its likely successor.

Over the past decades, the United Kingdom has been one of the European Union's member states most resistant to European regulation in the sphere of financial services. Even in the 1970s, the British government was strikingly ill-disposed to the harmonization of European banking law. The traditional reluctance of British governments to countenance centralised sovereignty-pooling has combined with a well-advertised view of Mr. Brown in earlier years that the British economy, and in particular its financial services sector, benefited from "lighter" regulation than that favoured by the United Kingdom's partners in the European Union. It is far from clear how far the present financial and economic crises may have induced Mr. Brown and his colleagues to change their views of these issues, whether at the European or the domestic level. There is on the one hand considerable public support in the United Kingdom for the general proposition that British regulation of its financial services has been excessively lax in recent years and that the tripartite system introduced by Mr. Brown as Chancellor of the Exchequer in 1997 has failed. The British government will not wish to show itself insensitive to this widespread public perception. On the other hand, the British government probably continues to believe that there is a danger to the pre-eminent position of the City of London in excessive or inappropriate European regulation of its activities. There is certainly some, if not necessarily universal support in the City of London for such fears.

## The de Larosière report

As already noted, the report which the former Governor of the Banque de France, Mr. de Larosière, prepared for and presented to the European Commission in the earlier months of this year, substantially overlaps with the topics covered by the Turner report. Mr. de Larosière's report focuses on extending the regulatory and supervisory role within Europe, the strengthening of macroeconomic financial levers and methods of analysis to control financial policy and the liquidity of the markets. The supervisory role envisaged seeks in particular to harmonise sanctions and ensure that national measures adhere to the principles of the single market. The issue of remuneration and pegging bonuses to long term achievements is to be supervised for instance at a European level as a means of standardising basic principles and incentives. It is precisely on this question of supervision at the European Union level that the de Larosière report most significantly differs from Lord Turner's thinking. The de Larosière report provides a comprehensive framework for installing a new supervisory body within Europe, which would leave "national supervisors........fully responsible for day-to-day supervision of firms," but conducting their business under the tutelage of a proposed new body, the European System of Financial Supervisors (ESFS.) This new supranational authority would build on existing structures, pooling individuals from the national supervisory structures into three committees, charged respectively with the European-wide supervision of banking, of insurance and pensions and of securities. In parallel, a European Systemic Risk Council (ESRC) would be set up, with a technical membership, to take on the task of analysing Europe's macroeconomic conditions and facilitate the flow of information and analysis to national supervisors. If the Council concluded that national or European policies had important implications for the global financial system, the Council would approach and work with the International Monetary Fund to ensure the greatest possible sharing of information, analysis and policy co-ordination.

In his recommendations, Mr. de Larosière has clearly sought to avoid the criticism that he is advocating European centralization for centralization's sake. He has stressed in articles and speeches that the day to day supervision of financial actors will take place at the national level. The supervisory powers of the new bodies he proposes will initially be limited, although he clearly envisages that these powers will in the medium term be enhanced. The precise procedure whereby this enhancement will occur and its exact scope are left, probably deliberately, vague by the de Larosière report. As often in European regulatory matters, the report has had to strike a delicate balance between those who are hostile in principle to centralised European regulation and those eager to move rapidly and publicly towards such regulation.

In the absence of a Treaty change, the arrangements proposed by Mr. de Larosière will need to be agreed by all Member States. Significantly, the de Larosière report considered the possibility that not all states might wish to participate in the proposed new system and commented in paragraph 190 that "*The Group hopes that all Member States will aspire to these changes. If not, a variable geometry approach based on the mechanisms of Enhanced Cooperation or an inter-governmental agreement provided for in the Treaty may be required".*

## The Commission Communication

In its Communication of 27th May, 2009, the Commission reviews and analyses, generally positively, all the elements of the de Larosière report. Its clear tactical approach is to seek to gain wide agreement on general and institutional principles first, recognizing that not all details of the new system can or should be definitively agreed at the outset. As with the de Larosière report, the Commission's Communication sets at the heart of its proposals the European Systemic Risk Council and the European System of Financial Supervisors (ESFS.) In important ways, it develops and refines the models for these two new bodies set out in the de Larosière Report.

### *European Systemic Risk Council (ESRC)*

The Commission Communication takes from the de Larosière report the concept of this Council as a body issuing analysis and recommendations rather than an executive authority. All financial sectors will fall within the remit of the Council and its membership should be, in the Commission's view, limited to Central Bank governors and senior supervisors from the Member States acting as alternates. It will meet under the chairmanship of the President of the

European Central Bank. The Chair of the Economic and Financial Committee would be the sole ministerial participant in the Council's meetings, and then only as an observer. The Council will act by a simple majority of its voting members. The Commission's obvious hope is that the technical expertise and political independence of this new body will give an authority to its recommendations, warning and analysis which it will be difficult for governments and other financial actors to ignore. If the ESRC cannot legally compel action by those to whom it addresses itself, the Commission hopes the Council will able to exercise moral and political pressure which will force its interlocutors to "act or explain." Although it is not entirely clear from the Communication how far the work and reporting of the Council should take place in public, it would presumably be in the Council's interest for its warnings and recommendations to be as widely available to public and commentators as possible.

### *European System of Financial Supervisors (ESFS)*

In its discussion of the proposed European System of Financial Supervisors, the Commission Communication takes as its starting-point the proposition that "the EU cannot remain in the situation where there is no mechanism to ensure...best possible supervisory decisions for cross-border institutions..." The ESFS, made up of three European Supervisory Authorities, for banking, insurance and pensions and securities, should, in the Commission's view, fill this gap. These new Supervisory Authorities would replace the existing Committees of Supervisors, which in the Commission's view have "reached the limits of what can be done with their present status." The enhanced powers of the new Supervisory Authorities are a natural consequence of this analysis.

The proposed Supervisory Authorities would have, according to the Commission Communication, shared and mutually reinforcing responsibilities, with legal powers going well beyond those of the Committees of Supervisors. In order to improve the supervision of cross-border institutions, they would be charged with developing a single set of harmonised rules for the European Union including binding technical standards and interpretative guidelines on authorization and supervision carried out at the national level. Where disputes arise between national authorities, the European Authorities would be responsible for mediation and conciliation. Where these fail, the European Authorities "should, through a decision, settle the matter". In case of "manifest breach of Community law... the Authorities could be empowered to adopt decisions directly applicable to financial institutions..." The Authorities would have full supervisory powers for certain entities with a pan-European reach , including credit rating agencies. The Authorities would co-ordinate crisis management and could have the power to adopt emergency decisions on such matters as short-selling. Voting when the Authorities were adopting a decision would be by Qualified Majority Voting for technical rules, but decisions on the application of existing laws should be a simple majority of "one person, one vote"

## Commentary

Of the two new bodies envisaged the ESRC is the less innovative. It clearly represents some extension of the reciprocal right of the European Union's member states to scrutinize the domestic economic policies of their neighbours. But this process of reciprocal monitoring has in any case been developing for decades, at the global level through IMF surveillance and OECD reports, and at the European level through the EU's Broad Economic Policy Guidelines and the Convergence Reports as part of the Stability and Growth Pact commitments. In so far as the recommendations of the Systemic Risk Council's proposals carry weight and persuade governments to pursue revised policies, it will not be because the Council is the beneficiary of shared national sovereignties, but because of the force and authority of its recommendations, recommendations which in general the Council can be expected to publicize widely and vigorously. The Council may well emerge as an important actor in European and global financial affairs, but its principal weapon will be moral suasion rather than its formal legal powers.

The integrative impact of the proposed System of Financial Supervisors is considerably more direct. The precise details of the remit for the new Supervisory Authorities will require painstaking negotiation at the European level, but the new Authorities will in any event acquire and exercise important new legal powers. Implementation of the new system will inevitably imply in its turn a range of domestic legislation to conform to the new harmonised arrangements. To ensure such conformity, the Commission's Communication makes provision for empowering the new Authorities to adopt "directly applicable decisions" in the case of "manifest breach of Community law." Breaches of the kind would no doubt be rare, but the proposed right of the new Authorities to act directly and on their own responsibility is a significant extension of centralized decision-making.

## Conclusions

The European Commission's Communication set for the installation of the Union's new system of financial regulation and supervision an ambitious deadline of 2010, in contrast to Mr. de Larosière's suggested date of 2012. The Commission argues, reasonably, that in adopting this fast track for decision-making the Union will be fulfilling its obligations to the G20 process and setting an example of international leadership. It would be admirable if such a timetable could be achieved, but it must be doubtful whether the Union can meet this demanding deadline for the complete implementation of the new system. The issues involved are wide-ranging, highly technical and likely to be controversial in their details. It may be that certain elements of the package, such as the inauguration of the European Systemic Risk Council, can be secured at a relatively early date, while more contentious and complicated elements will need to be adopted at a more measured pace. The vital question of arrangements for burden-sharing, for instance, between "home" and "host" governments in relation to defaulting cross-border entities, will be a central building-block of the new system, but is likely to require long and patient negotiation before a workable balance can be achieved between the rights and responsibilities of the potentially interested parties. The absence of a strong central fiscal authority, such as that which exists in the United States is undoubtedly a complicating factor in this context, but with goodwill and commitment from the

member states, an acceptable balance of rights and responsibilities should certainly be achievable in the medium term.

More important in this context, however, than the achievement of any particular deadline for the complete setting up of the new regulatory system is the underlying political question of the real commitment or otherwise of the European Union's member states, and particularly those with large financial sectors, to the realization in the foreseeable future of a European system of financial regulation and supervision recognizably similar to that proposed by Mr. de Larosière and developed further by the European Commission. The European Council of March, 2009 agreed that the de Larosière proposals should be "the basis" for future progress in this area. Later comments from European heads of state and government such as Mr. Sarkozy and Mrs. Merkel show no sign of emerging reservations or hesitation on their part. With the possible exception of the United Kingdom, there seems little reason to doubt that the political and administrative commitment of the European Union's member states to making a reality of the de Larosière and Commission proposals will be followed by constructive negotiations conducted with goodwill and designed to solve problems rather than use them as an excuse for procrastination. The overwhelming likelihood must be that in the foreseeable future a European financial supervisory and regulatory system very much along the lines of the de Larosière proposals will be put in place. With something very near to unanimity, Europe's leaders believe that the events of 2008 showed beyond doubt the need for a European system of regulation for the European banks which are today so prominent a feature of the European single market; that this system of regulation will need to be very similar to the de Larosière and Commission proposals; and that avoidable risks have been run in the past with the savings and deposits of the European Union's citizens by the Union's failure to draw the necessary regulatory consequences from the otherwise wholly beneficial development of a European-wide financial sector. For these European leaders, the question of Lord Turner about whether more or less Europe is needed admits of only one answer, that more European regulation is necessary as a concomitant of the more European financial sector that we already have and are likely to see deepened over the coming years.

It remains to be seen on which side of this argument the United Kingdom, still the most important financial market of the European Union, will finally come down. The UK did propose an alternative approach to that of the de Larosière report in early March. The specifically British approach which underlay this alternative, that of an inter-governmental agreement rather than the use of the "Community method" implied by the de Larosière report, recalled to many observers the abortive British "hard ECU" plan of the 1980s, which was rendered irrelevant by the Treaty of Maastricht in 1991. Twenty years later, in mid-March, 2009, Mr. Brown found himself as British Prime Minister potentially isolated at the European Council and agreed to the statement from all EU heads of Government that the de Larosière report would be "the basis" for moving forward. Since the meeting of the European Council, differing opinions within the City and the British government have been expressed, with familiar reservations surfacing about the general desirability of centralised European decision-making and its likely specific consequences for the City. Political volatility in Westminster has proved a difficult background for the establishing of a clear British position on these issues, although the City Minister, Lord Myners, has expressed to the House of Commons European Scrutiny Committee concern at the proposed role of the Supervisory Authorities as binding mediators. This domestic volatility, however, will not dispense the British Prime Minister, representing the United Kingdom at the European Council of 18th-19th June, from the need to express a view on the proposed administrative and legislative programme to follow up the Commission's Communication. .

The British government will need to reflect carefully on this matter. To many of Mr. Brown's colleagues in the Council, the current debate about financial regulation in the European Union represents a potential watershed in Britain's relationship with the rest of the European Union. It would seem to a number of Britain's partners perverse, even dishonest for the United Kingdom to dispute the force of the case made for more centralized European regulation by the damage which has already been done, and still continues to be done, to Europe's savers, investors and pensioners by the financial crisis of 2008 in which the "nationally-regulated" City of London played so large a role. Some among these neighbours might well regard such an attitude as calling into question Britain's whole commitment to the European single market, be it in financial services or more broadly. It was not by chance that Mr. de Larosière evoked the possibility of a European Union of "variable geometry" in financial services. Despite its current pre-eminence in the European provision of financial services, the City's position is not so strong and unchallenged that it could afford to face any such outcome with equanimity. At a time moreover when all the Union's member states are in heavy deficit on their public finances (in some cases, massively so), no national government can afford to have question marks over its domestic financial system such as would inevitably arise were the City to exclude itself or be excluded by the British government from the European Union's central supervisory and regulatory system.

A frequent consequence of the European Union's consensual and complex decision-making system is that national governments are able to find between themselves compromises and transitional arrangements that obviate or at least soften the need for otherwise painful choices by governments in a minority within the Union. It is not evident that any such compromises can be found to save the United Kingdom from the need over the coming months to decide whether it wishes to be a full member of the European financial regulatory system or whether it believes that it is better to remain outside. This decision will not merely be important in itself for a major sector of the British economy. It will say a great deal more generally about Britain's future role within the European Union.

**Sir Brian Unwin**

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