

European issues

n°246

3rd July 2012**Dominique Perrut**

PhD Economics, Banking Consultant in
Paris, Associate Researcher at the Uni-
versity of Angers (Granem).

Financial Regulation after the “subprime” crisis: what has been learned and what reforms made?

Summary :

The financial crisis that started in 2007 revealed that monetary policy had to include the goal of financial stability and that institutions, whose problems were likely to spread to the entire financial system, had to be identified and supervised. It also showed that in a context, in which traditional financial crisis management doctrines and methods were changing, it was necessary to introduce new regulations and resolution mechanisms to limit moral hazard and the collective cost of support measures. Several global reforms have been undertaken in the area of financial regulation. In the European Union these notably include changes to legislation, the creation of a new supervisory structure and a transposition of new international standards. The paper brings an assessment of these reforms.

INTRODUCTION

The first global financial crisis which began in 2007 brought severe discredit on all the Authorities, both national and global, responsible for foreseeing, controlling and managing financial changes. In response to the severe disruption of the system, the agenda defined by the Group of Twenty (G20) has led to reforms aimed at providing a new regulatory framework in order to improve financial stability[1];

These ongoing reforms outline a new organization, which could be called the Global and Integrated Prudential Model. Such a model is based on the one hand on global rules defined by international standard setters and, on the other, on the integration between the different parts of the prudential organization, mostly between macro and micro-prudential levels. This integration will be realized together with the implementation of new tools.

This paper will take into account, first, the lessons to be learned from the crisis; and, second, the new prudential framework in progress at the global level. Then, it will examine how, in this context, a new prudential organization is being set-up in Europe. Last, this paper will offer an assessment of the strengths and the

weaknesses of this EU framework. We shall see that the implementation of such a reform faces obstacles both inside the EU (with harmonization problems) and outside it (with the worldwide regulatory competition between areas, mostly from the United States).

1 – The lessons learned from the crisis and post-crisis reform

1-1 – What lessons have been learned from the crisis?

Numerous recent debates have been aimed at throwing light on the causes of the recent crisis and on the consequences of its management. Thus a sort of consensus has emerged, which can be summarized around four chief points.

a – Monetary policy has to include a financial stability goal.

For three decades Central Banks have adopted the so-called inflation-targeted policies aimed at stabilizing retail prices. Such policies were based on the belief that retail price stability would ensure the financial system's stability [Borio, 2011]. On the contrary, experience has shown that in a liberalized financial system, retail price stability may well go hand in hand with strong increases in asset prices (real estate or stock

1. Washington (October 2008)
and London G20 (April 2008)
Summits

markets). Such bubbles were often the consequence of excess in credit growth, resulting from generous liquidity provision at low rates by central banks [Aglietta, 2010; Blanchard & al., 2010; Eichengreen & al., 2011; Goodhart, 2010-2.]

These monetarist-inspired policies were not in line with liberalized economies. Indeed, given the increased function of asset markets, which are fluctuating by nature, liberalized economies have become intrinsically unstable. Thus, throughout the so-called period of Great Moderation, monetary stability went together with financial crises. Such a diagnosis has led nowadays to a new approach to Central Bank monetary policy in order to take into account financial stability. Regarding this new goal, we are bound to wonder what kind of instrument could be used to attain it. Indeed interest rate setting by central banks, which is nowadays almost the single anti-inflation tool, would not be efficient to counteract excessive credit growth [Goodhart, 2010-2.] Moreover, according to the Tinbergen rule, it seems difficult to try to achieve two different objectives with the same tool. A risk of conflict between the two goals would appear in such a case. For these reasons, a consensus now exists to achieve the financial stability goal through specific instruments.

The response brought by global standard setters, namely the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS), has consisted in creating a new tool (capital buffers) with a macro-prudential goal in the new banking framework (the so-called Basel III standard). This new tool is considered to have a countercyclical effect to mitigate excessive credit raises and their consequences, namely inflation in asset prices.

b- The institutions presenting a major systemic risk have to be identified and supervised.

Prolific literature has recently addressed the question of systemic risk [EC, 2009; ECB, 2009; Galati & Moessner, 2011; IMF, 2009-2.] Systemic risk can be briefly described as "the risk of widespread disruptions to the provision of financial services that have serious consequences for economy at large" [FSB, 2011-2.] The very existence of Systemically Important Financial

Institutions (SIFIs) can be seen as a chief cause of such a risk. Usually, these institutions, mostly banks, were detected on the basis of a single criterion, namely their size, measured according to the total amount of their balance-sheet. The 2007-2009 financial crisis revealed that two other factors could increase systemic risk. These factors consist, on the one hand, of liquidity problems of banks, which are related with situations of excessive indebtedness (the latter being measured by the leverage ratio); and, on the other, of off-balance-sheet relations between banks, especially through credit insurance mechanisms, such as credit default swaps (CDS) [FSB, 2011-1; BCBS, 2011-2.]

It was observed during the crisis that liquidity problems and off-balance-sheet relations were acting as dangerous channels leading to quick and wide propagation of financial shocks. The unrestrained development of complex securitization was based on products such as CDOs and ABCPs, which appear as mere financial innovation concentrates[2]. Thus, through the securitization process we could observe that the worldwide financial system, chiefly European banks, ensured the financing of the north-American residential real estate bubble.

Among SIFIs, the FSB has isolated a sub-category called global-SIFIs (G-SIFIs). These institutions are such that "their distress or failure would cause significant dislocation in the global financial system and adverse economic consequences across a range of countries" [FSB, 2011-1.] In order to identify Global Systemically Important Banks (G-SIBs), a study has been carried-out by the BCBS in cooperation with the FSB. This work led to detecting a set of 29 banking groups defined as G-SIBs. A combination of criteria was defined for such a selection, including, in addition to the size, new significant features such as interconnectedness, global cross jurisdictional activity, complexity and the lack of readily available substitutes [FSB, 2011-3.]

c - The role of the lender of last resort has undergone some major change

The notion of Lender of Last Resort (LLR) appeared two centuries ago in economic literature, but this concept

2. CDO : Collateralized-Debt-Obligations ; ABCP : Asset-Backed Commercial Paper.

has never received a clear-cut definition [Ugolini, 2011.] However, it can be agreed that, in its classical meaning, the LLR function is that of the Central Bank when it provides emergency liquidities, according to Thornton-Bagehot's well-established rules, to a distressed bank facing a liquidity problem but which is not insolvent [Thornton, 1802; Bagehot, 1873; Humprey, 1989.] This kind of operation is aimed at avoiding a banking failure which could be contagious and therefore create damage to the financial system as a whole. We cannot fail to observe that for 25 years, in each of the OECD banking crises following the liberalization process, Authorities have rescued insolvent institutions. Such policies were adopted according to the well-known principle Too Big to Fail (TBTF). Indeed, it was agreed that, given their size, big financial entities could bring about, should they meet a failure, a severe disruption or even a collapse of the banking system.

As a consequence, the classical model was replaced by a new prudential scheme about thirty years ago. We call it the Hierarchical Prudential Model (HPM). It is based on two chief features: on the one hand, the constructive ambiguity principle (when the Central Bank adopts a discretionary, or ambiguous, attitude towards distressed banking situations); and, on the other, safety nets (comprising both supervision, which includes prudential rules and surveillance, and solidarity and guarantee schemes [Humphrey, 1992; Gardener, 1992; Perrut, 2009.]

During the 2007-2009 financial crisis, the TBTF principle was set up as an intangible rule by G7 decision-makers, in October 2008, when they solemnly declared their commitment to avoid any failure of systemically important institutions [G7, 2008.]

As a result of such developments, three major changes can be observed in the LLR function. First, a doctrinal change occurred, for the major principles of the prudential doctrine were clearly put aside (both the “Let insolvent institutions fail”, of the classical model, or the “constructive ambiguity” principle in the HPM). Second, a diversification among authorities acting as LLR could be observed. Indeed, task-sharing took place between States, which chiefly guaranteed recapitalization ope-

rations, and Central banks, which provided banks with liquidity. Third, the toolkit used to conduct anti-crises operations was widened to new instruments. As for the States, operations expanded henceforth from capital furniture to guarantees, including bad banks (or defeasance structures); as for the Central Banks, interventions included unlimited long-term liquidity provisions and sovereign debt purchases[3]; moreover major Central Banks signed unlimited currency swap agreements with each other [ECB, 2011-1; EC, 2009-2], which outline a kind of International LLR function.

d – A crisis management framework designed to avoid moral hazard and to protect the tax payer is necessary. A huge moral hazard problem and considerable collective costs can be observed, as consequences of the decision-making to deal with the recent crisis.

The solemn declaration of the G7 leaders mentioned above led to important actions to rescue insolvent institutions and therefore to big amounts of capital furniture in order to fill the equity gap in distressed institutions. The very nature of such operations led to the commitment of States rather than of Central Banks.

Such bail-out operations brought two major consequences. First, a situation of considerably increased moral hazard appears as a direct consequence of the crisis management. Indeed, all systemic institutions could from now on consider themselves as protected against a failure given their size, whatever their misbehaviour. Such an improper situation creates a stimulus for new excessive risk-taking policies.

Considerable collective costs are to be seen as a second effect of the anti-crisis policy. According to the EU Commission, approved State aid in the EU in favour of the financial sector amount to 4.100 billion €, of which about 2.000 were actually employed in 2008 and 2009. IMF sources state that EU bank losses reached a global amount of 1.000 billion € and 8% of the EU GDP between 2007 and 2010 [EC, 2011.] Thus, the emergency crisis management led to huge collective costs in order to refloat the financial sector. Therefore, the set-up of management and resolution regimes for financial institutions is to be seen as a priority among

3. About the toolkit used in the EU, see ECB Annual reports and Monthly bulletins.

the ongoing reforms in order to preserve the economy, to avoid moral hazard and to protect taxpayers.

1-2 - Reforms in progress

An ongoing set of reforms is orchestrated by the G20 and the FSB⁴. Two main components of this agenda consist of a new set of banking standards, the so-called Basel III framework, which is to be seen as the chief tool aimed at preventing a new financial crisis, and a set of guidelines for resolution regimes for financial institutions.

In conjunction with these global responses, each country or area has initiated a recasting of its legislative framework for financial activities. Thus, within the set of recommendations from the FSB regarding macro-prudential supervision, systemic risk observatories have been set-up in the USA, the UK, China; as well as in the EU as a whole [FSB, 2011-1]; Reforms can also be observed concerning micro-prudential supervision, in Europe and in the USA where, within the 2010 Dodd-Frank reform, the organization, which is currently somewhat bureaucratic is to be redefined, especially regarding the supervisory task-sharing between authorities.

a – New Banking Standards.

According to capital ratio standards, banks are required to keep an amount of capital as a percentage of their exposures, risk-weighted with several methods. The Basel III framework, still in progress, will be implemented by banks between 2013 and 2019. The existing micro-prudential tool (the capital ratio) will be dramatically strengthened. A macro-prudential overlay will be added through capital buffers and new tools, entirely different from capital ratio, namely liquidity ratios [BCBS, 2011-1&2; BCBS, 2010.]

Regarding the micro-prudential level, the strengthening of the prior Basel II framework (recently changed into Basel 2.5) comprises:

- A raise in minimum capital requirements with better quality;
- A wider risk coverage;

- A new tool called leverage ratio, non-risk based and including off-balance-sheet exposures; such an instrument aims to restrict bank indebtedness; it establishes a strict limit for total exposures; the latter are required to remain under the level of core capital multiplied by 33.

In order to counteract both moral hazard and systemic risk, the macro-prudential overlay, which is entirely new, comprises, in respect of capital requirements:

- A countercyclical buffer in order to limit excessive credit growth; this tool will be monitored (between 0% and 2.5% of the exposures) by the supervisors;
- An additional capital buffer for Systemically Important Banks (SIBs), varying from 1% to 2.5% (or even 3.5 %) of the exposures; such an additional loss absorbency capacity for these banks is aimed at reducing systemic risk and, should a failure occur, limiting its effects on collective costs.

Moreover, two liquidity ratios (a short term one and a long-term structural ratio) will be created with a worldwide harmonization. Such tools are aimed at avoiding new liquidity crises like the chronic ones we have been faced with since 2007.

Finally, for major SIBs, the new capital ratio would represent capital requirements twice higher (from 8% nowadays to 15.5% and even 16.5%) in proportion to their exposures. In addition, the latter would be subject to a severe redefinition and put under a closer oversight from supervisors whose discretionary powers would be extended.

b – Towards the creation of a crisis management and resolution mechanism

During the recent crisis, Authorities could not fail to ascertain the lack of a resolution process for individual failures. Such a lack compelled administrations to undertake emergency actions, which led to a moral hazard problem and to losses for the taxpayers. A resolution regime for financial institutions is aimed at avoiding the triggering of a systemic crisis when a bank failure occurs, at protecting the taxpayer and at

⁴. The Financial Stability Board was set up in April 2009 by the G20 summit. The FSB took over from the Financial Stability Forum created in 1999 by the G7

following the proper hierarchy between the creditors. The FSB recently published a set of principles in order to guide the national resolution regimes which are to be established. FSB guidelines call for jurisdiction to adopt several measures [FSB, 2011-4]:

- Designation of a resolution authority to resolve insolvent institutions;

- Definition of specific principles for cross-border groups;

- Frames for recovery and resolution plans concerning SIFIs.

Several countries have already planned measures regarding these issues. The EU Commission, for its part, published a communication in 2010 entitled “A European framework for crisis management in the financial sector”, and made a legislative proposal, June 2012 [EC, 2010-1.]

1-3 – A new financial regulatory and supervisory model

The boost given by the 2008 G20 agenda and the take-over by the coordination of international institutions outlines a new organization to ensure a sounder financial system. We would qualify such an architecture as the Global and Integrated Prudential Model. Indeed, such a framework is founded on two main features. On the one hand, the authorities’ determination to respond to financial globalization has led to a global regulation, which should be adopted in all the countries. On the other hand, the acknowledgment of systemic risk and moral hazard calls for an integrated prudential policy. This forthcoming organization thus appears as a third generation prudential model, following the 19th century Thornton-Bagehot classical model and the post-WW2 Hierarchical Prudential Model, as mentioned before.

- A new framework defined at the global level. The 2008 G20 programme (Washington Summit) for a global reform of the financial system is based on several principles: promoting sound regulation and financial market integrity; reinforcing international cooperation;

reforming international financial institutions [G20, 2008.]

This action-based programme was entrusted to the FSB whose task is to ensure, together with the IMF, the coordination of regulators and standard setters. The latter comprise:

- sector-oriented regulators (banking: Bank for International Settlements, BIS, Basel Committee on Banking Supervision, BCBS; insurance: International Association of Insurance Supervisors, IAIS; security markets: International Association of Securities Commission, IOSCO);

- standard setters with broader focus (International Accounting Standard Board, IASB, and US Financial Accounting Standard Board, FASB, regarding accounting standards) and international organizations (World Bank and OECD).

A new feature in this regulatory workshop is to be found in the will expressed from now on by some regulators (Basel Committee, IASB) to expand their standard setting status to that of supervisor of the complete and harmonized implementation of their standards. Such policy is aimed at avoiding, on the one hand, situations of unfair competition between the countries and, on the other, the loss of credibility in standards, should their enforcement be disordered.

Thus, the Basel Committee expressed its will to ensure the follow-up of the implementation of its framework, as it appears clearly in a recent comparative report on the implementation timetable among countries or jurisdictions for Basel standards [BCBS, 2011-1].

- An integrated prudential organization. Integration is indeed a new feature of the new prudential organization. This appears, first, in the setting-up of coordination between micro and macro-prudential supervision. Integration between these two levels is required by the new banking standards, which will entrust Central Banks (whose function is, inter alia, to look after money and credit) with the task of implementing macro-prudential measures such as the level of countercyclical

buffers. A closer cooperation between Central Banks and supervisors will be necessary in this regard in order to make the transmission of such decisions to individual banks effective. EU supervisory reform will give us an example of such integration.

Second, prudential policy is henceforth to be seen as a complete cycle, including several steps linked together:

- preventive action. This level is based upon precocious risk detection, which is the task of systemic risk observatories, and strengthened prudential rules (mostly within Basel III reform); monetary policy probably should also contribute to deal with excessive raises in asset prices;

- crisis management. Crisis, when they occur are to be faced by several players, namely, Central Banks and States (whenever a LLR function is required), and micro-supervisors to manage individual distressed situations;

- crisis resolution. Resolution frameworks are aimed at dealing with the failure of institutions in order to avoid systemic risk, to spare collective costs and to comply properly with the hierarchy of the rights between creditors.

If we do understand the logic and direction of this new prudential model it is impossible not to wonder about the limits to and dangers facing present developments. On the one hand the desire to complete the G20's programme is probably not shared with equal intensity by all countries. From this point of view, the slowness in the finalisation of the Dodd-Frank reform may lead to a situation in which national regulations will be competing, thereby impeding any global reform. On the other hand the new banking rules (Basel III) may lead to a number of adverse effects. These dangers, which we now have to consider carefully, may involve

- the economy's funding conditions (could there be a slowing in lending? an increase in its cost? discrimination between companies, to the detriment of SME's which create jobs?);
- the danger of the recovery of a shadow banking system, although measures are being

prepared in order to counter this; - a possible crowding out effect against the industrial sector for the collation of fresh capital on the financial markets, which apart from the States, will be solicited large scale by the banks over the next decade. Finally we might wonder whether systemic overloading will really be effective against moral hazard.

2 – The EU's financial regulatory and supervisory framework

This second part of this paper will examine the EU prudential framework in progress, along with the global reform, and will discuss a few points concerning this reform.

2-1 – Financial regulatory and supervisory reform

Let us recall first that several EU institutional bodies were involved, during autumn 2008, in dealing with the direct consequences of the crisis:

- decisions taken by intergovernmental meetings (European Council, Ecofin, Eurogroup), in coordination with international meetings (mostly G7 and G20);

- legislative or regulatory actions from the institutional community "triangle" (European parliament, Council, Commission) ;

- Eurosystem actions, mostly aimed at providing banks with liquidity.

Then, the EU undertook a recasting of both its supervisory and its legislative frame for financial activities. This reform should be completed by the end of 2012 [EC, 2010-2; Perrut, 2011.]

a –The 2010 EU Supervisory Reform

The revision of EU supervisory institutions was adopted in October 2010, and consists of:

- The creation of a macro-prudential oversight body;

- The set-up of three sector-oriented authorities, taking over from the so-called Lamfalussy supervisory Committees.

Both levels (macro and micro-prudential) are expected to cooperate through cross-representations and a Joint Committee.

Entrusted with the macro-prudential oversight of the EU financial system, the European Systemic Risk Board's main objective is to prevent and mitigate systemic risks. In this regard the ESRB must collect the information needed for its action, identify systemic risk, issue warnings and recommend measures when threats have been detected [EU, 2010]. The president of the ESRB is the ECB president. Its Steering Committee comprises 14 members, including 7 ECB members and the 3 presidents of micro-prudential authorities. The General Board includes in addition the governors of the 27 national central banks. The ECB provides a secretariat and thereby “analytical, statistical, logistical and administrative support to the ESRB”. Last, the ESRB does not have a legal personality.

The micro-prudential supervisory level, called the European system of financial supervisors (EFSF), which includes the ESRB, works as a decentralized network. While national supervisors carry-out their day-to-day operations, and supervisory colleges ensure the surveillance of cross-border groups, the 3 new European sector-oriented Authorities (taking over the prior 3 Committees) are entrusted with the tasks of coordinating the implementation of European supervisory standards and ensuring a strong cooperation between national supervisors. Established since the beginning of 2011, these new bodies (European Banking Authority, EBA; European Securities and Markets Authority, ESMA; European Insurance and Occupational Pensions Authority, EIOPA) comprise chiefly the 27 representatives of the national public bodies entrusted with supervisory functions.

In contrast with the ESRB, these authorities have legal personalities. They are independent from political powers but are nevertheless expected to report to them. Moreover, these new bodies have binding powers on financial institutions. However, as we shall see, these powers can only be applied in a few cases and according to complex proceedings.

Their mandate, which is extremely wide, can be summarized around two quite distinct axes:

- Elaborating a single set of rules and principles, that is to say a common supervisory culture;
- Solving conflicts regarding individual cross-border institutions (controlled by supervisory colleges).

b – The change of the legislative framework.

According to a well-known “spill-over effect”, the launching of the euro, in 1999, gave a fresh boost for completing the single market of financial services with two programmes: first, the Financial Services Action Plan (1999-2004) which produced 39 legal measures, and, second, the Financial Services Policy (2005-2010); [EC, 2005.]

From 2008 on, the crisis required emergency responses, which were followed-up by the will to reform the legislative framework for financial activities. This programme was to be completed before the end of 2011, in order to ensure a transposition in all EU member states in 2012. This plan is founded on three principles [EC, 2010-2; EC, 2011-1].

- Enhanced transparency. This part includes: a regulation concerning credit rating agencies (CRAs), adopted in 2009; a legislative proposal on derivative markets (already published) and the improvement of the Markets in Financial Instruments Directive (MiFID), whose proposal is under discussion by the legal system.
- Enhanced resilience and stability of the financial sector. This section comprises chiefly two points: first, a legislative proposal, published June 2012, in order to set up a complete set of tools for the prevention and resolution of failing banks; second, proposals for the revision of the Capital Requirement Directive (CRD IV), published in July 2011 (a directive and a regulation), in order to take into account the Basel III framework.
- Protection of the consumer. Regarding this issue, measures have been taken on short selling and credit default swaps; moreover, the revision of guarantee schemes (concerning depositors, investors and insu-

rance policy holders) has been completed or is in progress.

2-2 – An assessment of the reforms and issues raised.

Let us examine, first, several issues raised by legal changes in the EU, then, questions related to supervision and, last, problems that the harmonization process has to deal with.

a – Legislative reforms: some improvements made, but weaknesses and questions remain.

In the close aftermath of the strong impulse given to the single market of financial services, in 1999, the European Council and Ecofin ordered a study on the regulation of European security markets. Published in 2001, Lamfalussy's report sets out a devastating criticism of the legal European system. Indeed, the paper regrets deeply the lack of basic common rules and doubts whether the existing legislative system would be able to produce such a corpus. It reads: “the current regulatory system is not working”. Moreover, the criticism turns into a flame-thrower to attack such a system, arguing that it is feeble and slow while technology changes at a fast pace. As a consequence, new EU laws are already out-of-date when implemented. Last but not least, the diagnosis underlines the lack of any control from the EU to ensure an effective and consistent implementation of rules in all the Member States [Committee of Wise Men, 2001]. The core proposal of the report consists in associating regulatory and supervisory committees in the legislative process. Such recommendations led to the setting up (between 2002 and 2004) of sector-oriented committees (for security markets, banking and insurance).

These committees bring together national supervisory and regulatory bodies. They are aimed at improving the rules and, on the authority of legislative institutions, defining implementation measures.

The goal of improving the quality of legislative work has been reasserted in the Financial Services Policy programme (2005-2010) with a formula: “better law-making”. Several means such as: the law recasting technique (making laws more simple, legible and up-

to-date), impact assessments (cost-benefits studies), open consultations and controls for the effective application of community rules, were used to reach such an objective [EC, 2005.]

Recently, a Smart Regulation principle was presented in a communication of the EC. According to this paper, the whole regulatory “policy cycle” must be taken into account “from the design of a piece of legislation to implementation, enforcement, evaluation and revision”. [E.C., 2010.]

After such attempts, we cannot fail to question the quality and the effectiveness of EU rules. As to the improvements, we can observe that the intensive legal work carried-out by the EU in the field of financial services since 1999 is aimed at providing the continent with a modern set of rules, consistent and constantly updated. In addition, legislative responses to address the crisis have been fast and effective, with the ambition of taking over immediate measures to ensure a whole framework for financial security. The recasting technique offers clearer and more legible rules. Follow-ups are frequently conducted. Before the proposals, synthetic green papers presenting clear questions are provided for wide consultation by all the players (E.C. 2012).

Nevertheless, weaknesses and questions remain. During the “Lamfalussy process review”, in 2007, remarks were made about the lack of sufficient delegation of power from the legal system to the committees, while it was the very purpose of the “comitology” reform [ECB, 2007.] However, we can observe that henceforth the chief directives frequently go together with delegation for implementation measures.

The 2004 Market in Financial Instruments Directive (MiFID), implemented at the end of 2007, raises a number of questions. Indeed, the MiFID is to be seen as the hard core of the financial market regulation, whose infrastructures are subject to extremely fast technological change. Reports from market observers state that numerous advanced technologies are used by players, namely investment banks, in order to circumvent the rules, thus create glaring disparities

between investors [Vauplane, 2011]. One cannot help wondering about the reasons for such unfair practices. Do they proceed from unclear, imprecise rules or from the lack of a proper supervision?

Last, is there effective control of national implementation of EU regulation, in order to ensure a consistent set of rules throughout Europe? Eleven years after Lamfalussy's report, such a question should be seriously documented.

b – The supervisory reform: a complex organization, numerous tasks, limited binding powers.

Like several large countries (USA, UK, China, inter alia), the EU as a whole has created a macro-prudential oversight body, the ESRB. This body, which has no binding powers or legal personality, depends entirely on the ECB for its technical and administrative support. According to reports published before it was set up, this body was expected to derive its influence from its reputation [High Level Group, 2009.] However, given the dependency of the ESRB on the ECB and the ECBS (within the Steering Committee and the General Council, respectively), we are bound to consider that such a body will be mostly a place for exchange and consultation, especially between the ECB and the ECBS, on the one hand, and micro-prudential authorities, on the other.

In contrast to the ESRB, the new micro-prudential authorities already have a history because they took over prior supervisory committees that were set up almost ten years ago in the aftermath of Lamfalussy's report. Several attempts have been made to strengthen these bodies, in order to allow them to cope with the enlargement of their mandate. They have been entrusted with powers a little more binding (such as the so-called approach “comply or explain”, which compels an institution to justify itself if it does not comply with a prescription).

Before being upgraded to Authorities, it was considered that these sector-oriented committees were mainly acting as “informal mediators” [CEPS, 2009.] Moreover, the increase in the number of bodies and committees (4 Lamfalussy's committees and 3 Authorities, hence-

forward), which create risks of overlapping, is to be mentioned (for instance, between European Banking Authority and ECB's Banking Surveillance Committee). The recent upgrading of the supervisory committees into Authorities provides these bodies with extended capacities, owing to their legal personality and binding powers. However, two limits are to be noted. On the one hand, the decision-making process will remain difficult because of the collegiate governance. On the other hand, binding procedures that could be undertaken against a financial institution or a national authority (the latter being represented within the new EU Authorities) are complex and, obviously, somewhat tricky.

The specialization of these bodies according to each financial sector (banking, insurance, security markets) has been discussed. Indeed, one might wonder if choosing a single supervisor for all financial businesses would not have been a better solution. However, such a specialization can be seen as preferable, given the specific features of each business, namely concerning rules, national organization and even the very nature of risks (by contrast with insurance, banks have to address systemic risk).

In order to cope with the supervision of cross-border banking groups, especially when crises occur, the EBA is supported by two tools, as mentioned, supervisory colleges and memoranda of understanding. Supervisory Colleges (there are about 120 SC in the whole EU) bring together, for each cross-border banking group, the authority of the home country (where the registered office of the group is established), which is the lead supervisor, and authorities of all the host countries (where subsidiaries or branches are situated). According to field testimonies, hostile situations can be observed in those colleges, between host and home supervisors. Moreover, several reports have pointed out the lack of effectiveness of supervisory colleges to deal with crises of cross-border banking group such as Dexia or Fortis [Pisani-Ferry & Sapir, 2009.]

European memoranda of understanding (either multi-lateral or bilateral) are signed between authorities of banking supervision, central banks and finance minis-

tries in order to offer guidelines for financial crises situations. It appears that such agreements were not helpful during the recent crisis [E.C. 2010-4]

In addition, new Authorities are entrusted with the task of improving the legislative process, owing to their field experience, especially regarding the definition of implementation measures foreseen in the directives. They are also expected to promote a common supervisory culture and practice in order to ensure a consistent implementation of EU rules. A common basis of this kind for supervision is needed to avoid regulatory competition. This is what is at stake in the harmonization policy, which faces several obstacles.

c – Challenges in the EU harmonization policy and regulatory competition: the case of Basel III standard.

Let us recall that according to a constant policy, the EU single market is founded on two related movements: a liberalization policy and a process of harmonization. The latter is aimed at ensuring the safety of the financial system, at avoiding competition in laxity and protecting the consumer. We have to observe that banking standards of the Basel Committee mainly concern international banks and have no legal power. By contrast, according to the EU harmonization policy, Basel Committee rules are enforced through EU laws and become compulsory for all EU banks. The implementation of such a policy raises obstacles.

- Transatlantic challenges. The Basel Committee recently published, as mentioned before, a follow-up report on the implementation of its standards throughout the world. As for Basel 2.5 framework (published in 2009), the report shows that the EU set its deadline at the end of 2011 for the enforcement in all Member States. According to available information, EU countries could comply with this timetable, whereas in the USA, proposals for regulations were still under discussion and still not yet published in October 2011 [BCBS 2011-1.] Such a situation obviously leads to unfair competition between the two areas. As a consequence, it creates a strong incentive upon European players to slowdown the process of implementation or lowering the rules. A kind of regulatory competition concerning the accounting standards could already be observed in 2008.

Under the pressure of professionals, the EU agreed to lower its rules, in order to bring them into line with those of the USA.

- European harmonization challenges. In contrast with Basel I rules (1988), which were purely quantitative, recent banking standards (Basel II, 2.5 and III) are founded on two qualitative features: the intensive use of internal-rating-based models and the discretionary powers entrusted to the supervisors.

Internal-rating-based models, indeed, are complex constructions with specific organizational features, questions related to perimeters of operations and choices to be made as to the several optional methods. For their part, discretionary decisions from supervisors would be extended with Basel III rules, allowing them to require complementary amounts of capital to individual institutions.

Therefore, regarding both the agreement by supervisors for internal-rating-based models and their discretionary powers, it is crucial to ensure a consistent and homogenous supervisory process in order to avoid any competition in laxity.

Addressing such an issue, which both the Basel Committee and EU bodies consider as essential, will be a challenging task for the new EBA. Insurance and security markets authorities will have to face similar tasks.

- EU institutional challenges. The EU prudential reform is aimed inter alia, at enforcing Basel III frame, as mentioned before. The new EU supervisory organization leads to task-sharing between the ECB and the new authorities. We cannot help to wonder how such coordination will be managed in a system which remains complex and swarming.

CONCLUSION

Aimed at addressing the first global financial crisis with a global regulatory reform, the G20 agenda outlines a new prudential architecture, which is global and integrated. Such a goal is ambitious. Henceforth, international coordination is operative and at work, but questions remain. Is there the same strong will in all countries to ensure a complete achievement of the G20 programme? What could be the perverse effects of the new rules?

As for the EU, which very quickly carried out an important recasting of its legal frame, the continent will henceforth have to face two obstacles. One is outside the EU and results from the risk of regulatory competition from large countries, chiefly the USA. The other is inside the EU and is the result of the complex organization of the legal and supervisory system. We are bound to wonder if the challenge of creating a set of harmonized rules and practices in all the countries can be met without improving such an institutional framework.

This second obstacle covers all of sensitive issues in the debate over Banking Union, the definite shape of which still has to be defined. Leaders should soon be able to move on to a new stage in the integration of anti-crisis measures. This phase will be marked by the introduction of a European Supervisory body that has extended powers, of a coordinated system to resolve crises and a European deposit guarantee scheme, for transna-

tional banks. The recent European Stability Mechanism may be mobilised together with these last two instruments.

Two challenges lie ahead, the redefinition of world standards and the European financial reform. These post-crisis programmes aim to bring the liberalized financial system in line with social and economic needs. It seems that EU citizens have a compelling duty to watch developments in these two areas very carefully.

Dominique Perrut

PhD Economics, Banking Consultant in Paris, Associate
Researcher at the University of Angers (Granem).

REFERENCES

Aglietta M., 2011, « La rénovation de la politique monétaire », Complément A, in Banques centrales et stabilité financière, Rapport du CAE;

Bagehot W., 1873, Lombard Street: A Description of the Money Market, London: H.S. King; reprinted, Homewood, III:Richard D. Irwin, 1962.

Basel Committee on Banking Supervision, 2011, “Progress report on Basel III implementation”, October.

Basel Committee on Banking Supervision, 2011, “Basel III: A global regulatory framework for more resilient banks and banking systems”, revised version June.

Basel Committee on Banking Supervision, 2011, “Global systemically important banks: Assessment methodology and the additional loss absorbency requirement, June.

Basel Committee on Banking Supervision, 2010, “Basel III: International framework for liquidity risk measurement, standards and monitoring, December 2010.

Blanchard O.J., G. Dell’Ariccia et P. Mauro (2010) : « Rethinking Macroeconomic Policy », IMF Staff Position Note, n° 10/03, 12 February.

Borio C., 2011, “Central banking post-crisis: What compass for uncharted Waters?”, BIS Working Paper, n° 353, September.

Borio C. & Drehmann M., (2009): « Towards an Operational Framework for Financial Stability: ‘Fuzzy’ Measurement and its Consequences », BIS Working Paper, n° 284.

Brunnermeier M., A. Crocket, C. Goodhart, A. Persaud et H. Shin, 2009, « The Fundamental Principles of Financial Regulation », Geneva Reports on the World Economy, CEPR, n° 11, January.

Center for European Policy Studies, 2008, Concrete Steps towards More Integrated Financial Oversight, The EU’s Policy Response to the Crisis.

Committee of Wise Men on the Regulation of European Securities Markets, 2001, Final Report, Chaired by A.

Lamfalussy, Brussels, February 15.

Davis E. P. and Karim D., 2009, "Macro-prudential regulation, the missing policy pillar", keynote address at the 6th Euroframe Conference, London, June;

Eichengreen B. and Alii, 2011, "Rethinking Central Banking", Brookings Institution, Washington.

European Central Bank, 2011, "The ECB's non-standard measures: impact and phasing-out", Monthly Bulletin, July.

European Central Bank, 2011, "The new EU framework for financial crisis management and resolution", Monthly Bulletin, July.

European Central Bank, 2011, Financial Integration in Europe, May.

European Central Bank, 2009, Financial Stability Review, December.

European Central Bank, 2008, "Developments in the EU arrangements for financial stability", Monthly Bulletin, April.

European Central Bank, 2007, "Review of the Lamfalussy framework - Eurosystem contribution", November 2007 ;

European Commission, 2012, Green paper: shadow banking, COM (2012) 102 final.

European Commission, 2011, Regulating financial services for sustainable growth, A progress report.

European Commission, 2011, Press release on CRD IV, July 23.

European Commission, 2010, An EU Framework for crisis Management in the Financial Sector, COM (2010) 579 final.

European Commission, 2010, Regulating financial services for sustainable growth, Communication, COM(2010) 301 final.

European Commission, 2010, Smart Regulation in the EU, Communication, COM(2010) 543 final.

European Commission, 2010, Communication: Towards a Single Market Act, COM(2010) 608 final.

European Commission, 2009, European Financial Integration Report 2009, Commission Staff working Document, SEC (2009) 1702 final.

European Commission, 2009, Economic Crisis in Europe : Causes, Consequences and Responses, European Economy 7, Economic and Financial Affairs;

European Commission, White paper: Financial Services Policy 2005-2010, Brussels, 2005;

European Union, 2010, Regulation (EU) n° 1092/2010, establishing a ERSB.

Financial Stability Board, 2011, Overview of progress in the Implementation Recommendations for Strengthening Financial Stability, Report to G20 leaders, November 4.

Financial Stability Board, 2011, Macroprudential policy tools and framework, October 27.

Financial Stability Board, 2011, Reducing the moral hazard posed by systemically important institutions, October 20.

Financial Stability Board, 2011, Key Attributes of Effective Resolution Regimes for Financial Institutions, October.

G7, 2008, Leaders' Statement, Washington, October 10.

G20, 2008, Declaration, Summit on Financial Markets and the World Economy, Washington, November 15.

G20, 2009, Leaders' Statement, London Summit, April 2.

- Galati G. & Moessner R., 2011, Macroprudential policy – a literature review, BIS Working Papers n° 337, February.
- Gardener E. P. M., 1992, “Banking Supervision”, in The new Palgrave Dictionary of Money and Finance, Ed. Newman P., Milgate M., Eatwell J.
- Goodhart Ch. A. E., 2010-1, “The changing role of central banks”, BIS Working Papers, n° 326, November;
- Goodhart Ch. A. E., 2010-2, «La surveillance macro-prudentielle», complément B, in Banques centrales et stabilité financière, Rapport du CAE ;
- High-level Group on Financial Supervision in the EU, 2009, Report, Chaired by J. de Larosière, February.
- Humphrey T. M., 1989, “Lender of Last Resort : the Concept in History”, Federal Reserve Bank of Richmond Review 75, March-April : 8-16;
- Humphrey T. M., 1992, “Lender of Last Resort”, in The new Palgrave Dictionary of Money and Finance, Ed. Newman P., Milgate M., Eatwell J.
- IMF, 2009, “Assessing the Systemic Implications of Financial Linkages”, chapter 2 in Global Financial Stability Report, April.
- IMF, 2009, “Detecting Systemic Risk”, chapter 3 in Global Financial Stability Report, April.
- Kindleberger C. P., 1989, Manias, Panics and Crashes : A History of Financial Crises, Basics Books.
- Perrut D., 2009, “Evaluating the European management of the financial crisis : Which regulatory and supervisory model should be adopted?” Communication at the 6th Euroframe Conference
- Perrut D., 2010, “Do the new financial regulations for the European Union offer good responses to the current crisis and forthcoming challenges?” Communication at the 7th Euroframe Conference.
- Perrut D., 2012, “Quelle banque centrale pour l’Europe de demain? », www.atlantico.fr, Janvier.
- Perrut D., 2012, “Financial regulation after the subprime crisis: lessons and reforms”, Robert Schuman Foundation, Policy paper;
- Pisani-Ferry J. & Sapir A., 2009, Banking crisis Management in the EU: An Interim Assessment, Bruegel.
- Schinasi G. J. & Truman E. M., 2010, “Reform of the Global Financial Architecture”, Peterson Institute for International Economics, Working Paper, September.
- Thornton H., 1802, An Inquiry into the Effects of the paper credit in Great Britain, F. H. Hayek ed., Mac Kelley, 1802, (1978).
- Ugolini S., 2011, “What do we really know about the long-term evolution of central banking ?” Norges Bank Working Papers, 15;
- Vauplane H. de, 2011, “Révision de la directive MIF?”, Revue Banque, Février.

You can read all of our publications on our site:
www.robert-schuman.eu

Publishing Director: Pascale JOANNIN

THE FONDATION ROBERT SCHUMAN, created in 1991 and acknowledged by State decree in 1992, is the main French research centre on Europe. It develops research on the European Union and its policies and promotes the content of these in France , Europe and abroad. It encourages, enriches and stimulates European debate thanks to its research, publications and the organisation of conferences. The Foundation is presided over by Mr. Jean-Dominique Giuliani.