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Reforming Regulation and Supervision in Europe: Five Missing Lessons from the Financial Crisis

There is general agreement that financial regulation and supervision must be improved. But are the proposed reforms adequate to the task? What criteria should they fulfil in order to be effective?

Financial reform proposals have been outlined both in the EU and the USA. In order to be effective, such proposals should heed the lessons of the financial crisis, especially when it comes to the design of rules. Generally speaking, the financial crisis has taught us that at the root of it all, in addition to monetary policy's having been expansionary for too long, there was poor regulation, which caused two intertwined deficits: an information deficit and a behavioural deficit. In order not to risk making the same errors all over again, reforms in five main fields should be implemented:

- accounting
- market regulation
- prudential regulation
- regulatory architecture
- central banking.

Accounting

The first pillar of good reform is constituted by the necessity of having common accounting rules. The financial crisis found a potent fuel in the fact that in various institutional contexts banks were allowed to develop over-the-counter assets that were off their balance sheet, which catalysed uncertainty over the distribution of risk. To this day, there is a need to understand what sheets need to be overhauled in banks' balances, also in some European countries, although this creates further friction in terms of the harmonisation of rules. In general, the differentiation of accounting rules can give rise to regulatory arbitrage, thereby distorting international competition. It also distorts the criteria on which oversight is based. On this issue, the USA is not moving, and the only concrete measures have concerned putting off the moment when things will have to be taken care of. Europe has not done anything when it comes to accounting norms, either. The accounting split remains, and it is a crucial threat to the whole effort to effectively reform international financial regulation.

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Market Regulation

The second pillar is the necessity of defining regulated markets for any significant financial transaction, starting with markets for derivatives. Financial innovation has enabled banks and firms to create ad hoc bilateral contracts to manage or take on the most diverse forms of financial risk. So-called derivative contracts have experienced formidable growth. In the aggregate, their theoretical value has reached a size ten times as large as the more established currency markets. The diffusion of bilateral derivatives has had an undesirable aggregate effect: it has created uncertainty concerning the production and distribution of risk among the various industries and countries.

Information deficits and doubts about the solvency of counterparties fed off one another in a vicious spiral. Regulated markets for derivatives must be created. Risk-management instruments must be standardised in order to improve information and enable the creation of compensation houses which can guarantee the trustworthiness of exchanges. The proposals for the creation of regulated markets for derivatives – put forward in both the United States and the Europe Union – have their opponents: those banks and companies which emphasise the risks of standardisation in terms of the effectiveness and efficiency of transactions.

The subject has only been timidly addressed by the Obama proposal. The concrete rules have been postponed, with large exemptions for non-financial companies, which can avoid using clearing houses to trade derivatives. European policymakers are taking the same path in the name of harmonisation, which could more correctly be called competition in laxity. Both the US and the European lawmakers succumbed to pressure from lobbies. Furthermore, the winners also seem to be the regulators, who gained new discretionary powers. In this field the new legislation gave the small but very active in lobbying Commodity Futures Trading Commission (CFTC) new authority to dictate the future of derivatives markets. The Securities and Exchange

Commission (SEC) also gained new derivatives powers. In Europe there is the same risk of the prohibitionist approach being applied: it suffices to look at the recent German measures forbidding naked short selling.

Prudential Regulation

The third pillar concerns the reform of prudential regulation, which must include not only those who must be controlled, but also guidelines on how to exercise control in such a way as to prevent rules from augmenting, rather than correcting, distortions that then morph into crises. Distortions involve incentives that make banks become too big or too important from the point of view of systemic risk and encourage procyclical conduct. On the one hand, capital coefficients need to be revised. On the other, it is necessary to widen the spectrum of indicators, including at a minimum the introduction of liquidity coefficients. But revision in the quality and quantity of prudential requirements also has its discontents, in general in the banking sector as well as with regard to specific aspects, with opposing fronts cutting across countries and banks of different types. Finding a compromise means a lessening of the overhaul severity as well as a long-term implementation. Capital and liquidity packages will be softer than the industry feared, further evidence suggesting that policymakers are bowing to the lobbyists' pressure.

The fourth and fifth pillars are linked to the architecture of financial supervision and the role of the central bank, which have been addressed – in a rather unsatisfactory way in my view – in both the Obama proposal and the European Commission proposal. I therefore devote closer attention to these last two aspects.

Regulatory Architecture

The fourth pillar is represented by the number and design of the oversight authorities.

How do you monitor and oversee constantly fluctuating markets that are ever more complex and cross-linked? The general formula for good oversight is always the same: to have accurate, up-to-date and complete information. But the application of the classic formula is problematic today. Until just a few years ago, in markets that were essentially segmented – banks, stock exchanges, insurance – and static, taking "snaphots" of banks and intermediaries from time to time was enough. Now to have a complete and up-to-date information outlook, there needs to be highly skilled human capital capable of 360-degree monitoring of the whole financial industry. Hence the progressive tendency to change regulatory architectures in ways which display a dominant feature: consolidation.

Regarding the level of consolidation of the supervision structures, it is easy to observe that both the USA and the EU have major gaps to fill. The delay of the United States in this respect is particularly striking. The oversight architecture – which has gradually come into being since the 1920s – is the most emblematic case of the model with multiple authorities. Since the USA has a federal structure, the system of controls works on two levels: at the state level, so that there are controls on banking, trading and insurance in each of the 50 states, and at the federal level, which is in turn characterised by ten or so oversight authorities.

One could have expected that the progress toward a single US financial market – taken with remarkable decision and speed – would have been accompanied by a similar rationalisation of the system of regulation and supervision, but no such thing occured. What is the effect of such a model? The multiple-authorities model suffers, both *ex ante* and *ex post*, from the growing integration of the markets. *Ex ante*, the plurality of authorities can paradoxically increase gaps in oversight and make forms of regulatory arbitrage more probable. So preventing crises becomes harder.

Ex post – after the crisis has occurred – the multiple-authorities model gives rise to the offloading of responsibility. In other words, nobody can answer the question, "Whose fault was this?" Every controller either blames others or talks about exogenous, imponderable factors. Let's add the fact that US politicians have always liked to have multiple authorities. If you throw into the mix the tale of "competition in regulation" – the idea that competing authorities increase the quality of regulation – you can see how a system of flowing power and money, in which politicians and bureaucrats can thrive, was built at the federal and state levels.

Is the new US legislation a real change with respect to this? No. The law establishes a Consumer Financial Protection Agency, which will be an independent federal agency inside the Federal Reserve aimed at protecting small investors. A new coordinating entity, the Financial Services Oversight Council, which is to assemble all financial supervisors with the aim of ascertaining systemic risks, will also be established. To coordinate regulatory action in the insurance industry, there is the proposal to create an ad hoc office – the Office of National Insurance – within the Treasury Department. The model with multiple authorities could end up being maintained, and perhaps even reinforced. Gaps in oversight are still evident. The US lawmakers ignored the supervisory problem represented by Fannie Mae and Freddie Mac, the two large government-sponsored mortgage finance companies, which so far have absorbed $145 billion in government bailouts. In other words, the US law missed its chance to simplify the supervisory patch-

work. Furthermore, the Dodd-Frank Act gives even more discretion to the same regulators who failed to foresee and prevent the financial crisis.

A similar judgment should be reserved for the proposal formulated by the European Commission. The projected reform does not create any incentive to move toward a reduction of the number of control authorities. Actual European supervision – the so-called micro oversight – would be shared by three authorities (for banking, trading and insurance) following the obsolete criterion of sector-by-sector market oversight. This principle does have an advantage, though. It is supported by national politicians and national oversight authorities because it helps maintain their positions of power at both the national and the European level. Hence the tendency toward the consolidation of oversight authorities seems to have come to a halt and always for the same reason: the reshaping of rules is strongly influenced by a political calculation of costs and benefits rather than an economic one.

Central Banking

Finally, the fifth pillar concerns the relations between central banking and financial oversight.

In terms of regulatory architecture, the most interesting innovation to have taken place in Europe over the last decade is the split between responsibility for monetary policy and responsibility for financial supervision, with each function being assigned to a different regulatory actor. Today, if we look at EU countries we can see that almost half of them – 13 out of 27 – have unified financial and banking oversight in the hands of a single authority. Also, the diffusion of this new model of supervision has been rapid, considering that the first country to adopt it was the UK in 1998. Monopoly on supervision has gone hand in hand with the specialisation of authorities: in only three cases – Ireland, the Czech Republic and Slovakia – is this single supervisor the central bank. One should also note that these three countries are members of the Economic and Monetary Union (EMU), so that their control over monetary policy has been delegated to the ECB in Frankfurt.

The joint trend linking consolidation and specialisation is confirmed by looking at the EMU members: eight of seventeen countries have consolidated – including Holland, which has reduced the number of its authorities to two – while in only four cases has the consolidation process benefited central banks, which have become "specialised" in the policy of financial oversight. The few recent empirical analyses also give backing to the decision to reduce the number of financial authorities and not to entrust the central bank with a monopoly on supervision.

But why has the trend in recent years not been in favour of handing the monopoly on regulatory policy to the actor who already has a monopoly on monetary policy? The explanation is simple: the disadvantages have outweighed the advantages. Those who favour the coupling of the two policy monopolies within the central bank object that there are significant benefits in terms of information. But there are other ways to improve information flows beyond such a coupling.

On the other hand, the coupling of the supervision function with the monetary function poses certain dangers. There is the risk of distorting the behaviour of financial intermediaries by augmenting their propensity to take risks. When the controller is the same actor that can save you by printing money, the controlled firms are inclined to think that bailouts are more likely to be forthcoming. The reason is simple: the controller does not want to lose reputation.

There is a further risk in terms of central bank behaviour, which can turn into an all-powerful bureaucracy with the related consequences. The fact that some central bankers seem to like this solution does not decrease this risk – indeed, quite the opposite. Lastly, all the previously unknown quantities increase in number if the propensity within the political system to influence the central bank for its own ends is high.

Thus, the coupling of financial supervision and monetary policy tends to fail at keeping banks, the central bank and the political system at arm's length from one another, with all the consequent risks. These risks are more relevant today if it is considered how much tighter the relations between these agents have become in the wake of the financial crisis. Both regulatory policy and monetary policy must be managed by independent authorities – independent from banks, governments and their own bureaucratic appetites.

The regulatory architecture of central banks should ensure that the governance of money is subjected to neither the vagaries of the electoral cycle nor political ideology. The expressions "independence" and "accountability" have entered everyday language, but they need to be given more significant meaning. How can the correct perimeter of the triangle of power linking the central bank to banks and the political system be guaranteed in the interest of citizens, if two of the corners are already so close to each other?

Conclusions

The project for reforming the EU's oversight structure has been welcomed as a decisive step forward in the construction of a more robust architecture for the defence of financial stability. But is it really so?

In order to formulate a judgment on the proposal, we need to be clear about the final destination in the process of the construction of European financial supervision. If the final objective is to achieve a single European market for capital and banks, then the objective of financial stability must be accorded the same status hitherto granted to monetary stability.

The European Monetary Union and then the ECB were born out of the awareness that monetary stability was a public good that needed to be provided to all European citizens, irrespective of their nationality. Confidence in the new currency of daily use had to be developed. In order to have a single European financial market, every European must place trust in the reliability of asset and credit markets.

Confidence in markets depends a great deal on the credibility of those governing them. To have credible governance of supervision in Europe, there are at least three necessary conditions that must be met: we must create a European Financial Authority (EFA) that is independent of both governments and financial intermediaries, and separate from the European Central Bank. With respect to these three conditions, the reform plan of the European Commission does not seem persuasive.

Firstly, to govern financial markets, one must first understand them: if I wanted to build a single European financial market, I'd want the tendency to be toward a single authority in charge of defending European financial stability. All recent experience – including the latest episodes of the financial crisis – has taught us that the number of regulators must be reduced as much as possible. If markets tend to be without barriers, then the more controllers there are, the larger is the risk of information being fragmented (you don't know who knows what) and responsibility being opaque (you don't know whose fault it is). Thus, the tendency must be toward a single EFA. But as we have shown above, the reform proposal does not create an incentive to move in this direction.

Secondly, the future EFA will have to be indifferent both to the preferences of governments and of controlled intermediaries that will try to influence its decisions. The regulator will be seen as credible if citizens can bank on the fact that its choices, both in ordinary times and in times of emergency, will not be affected by special interests. The concepts of independence and accountability that Europe has already applied to the ECB must be rethought to ensure autonomy in the oversight of banks and markets. But the issues of independence and accountability are barely present in the reform plans. This makes these proposals very appealing to those politicians and banks who would like supervision to be pliable and subject to political influence.

Finally, EFA and ECB should be two distinct entities: monetary stability and financial stability are interconnected objectives, but they are different from one another, so it is better for each to be presided over by a different authority. The EFA and ECB should design strong forms of coordination between equals.

The present reform proposal, however, seems to be giving the ECB a hierarchically dominant role in the new regulatory architecture, thus ultimately reducing the distance between the conduct of monetary policy and the conduct of financial oversight. Also, national policymakers have moved to finalise reforms of the central bank involvement in supervision at both the international and national levels. In 2008 the German grand coalition government expressed its willingness to dismantle the unique financial supervisor (BaFin) in favour of the Bundesbank. In June 2010 the UK government unveiled a reform of the bank supervisory system aimed at consolidating power within the Bank of England. The key functions of the Financial Services Authority will be moved into the Bank of England, which will become the Prudential Regulatory Authority. Finally in the summer of 2010 the Irish Financial Services Regulatory Authority was legally merged with the central bank.

The distinction between micro and macro supervision is still weak at the theoretical level, and its actual institutional functioning remains undefined. Therefore the risk of moving the central bank regimes in the wrong direction seems to be very high.

To summarise: policymakers seem to ignore the lessons from the financial crisis in reforming the architectures of financial regulation and supervision. Why? Usually the policymakers explicitly justified the regulatory reorganisation by referring to the emerging needs in their financial and economic structures, especially after the financial crisis. It is evidently the tendency among policymakers to allude to developments in their financial markets to justify their actions.

However, the finding of crucial missing lessons from the financial crisis suggests a different interpretation. We have to explore the political economy view in analysing the behaviour of governments and lawmakers. The policymakers are politicians: politicians are held accountable in elections for how well they have pleased the voters. All politicians are career-oriented agents motivated by the goal of pleasing the voters in order to win the elections. The only main difference among the various types of politicians concerns which voters they wish to please in the first place. A country by country and region by region political cost and benefit analysis is the only way to discover the real drivers of the (unsatisfactory) overhaul of financial regulation and supervision.