Rules of the game

In the first of five articles by FW experts on the scope of the anticipated upheaval in regulation of the financial system, **Nicolas Véron** explains how the EU missed the boat in seizing leadership of the policy debate at a time when the US was poorly placed to set the pace

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Financial regulation as we knew it has been a casualty of the financial crisis. Though much of the blame has been placed on the private sector since dramatic events started to unfold in August 2007, an embarrassing string of regulatory and supervisory failures has also been revealed. Thus, the case for reform has become overwhelming, not only from a political standpoint but also as a matter of substance. Quite simply, the financial stability framework has not prevented major disruption in the system. It needs an overhaul, not just a few fixes at the edges.

That there were deep flaws in the framework is not entirely news. BCCI, in 1991, had demonstrated its inability to address cross-border bank insolvencies, and LTCM, in 1998, made it clear that the failure of a financial firm could have systemic impact even if it was outside the scope of banking and insurance regulation. But for all their perceived importance, neither of these was traumatic enough to force a fundamental reassessment.

By contrast, it is the continuation of the regulatory *status quo* that now appears least likely and this puts a premium on leadership in financial reform. Whichever jurisdiction is first seen as adequately addressing the flaws will frame developments, not only domestically but in other jurisdictions as well.

In financial matters, the US has often enjoyed global leadership, at least since the 1930s when innovations such as deposit insurance, securities regulation and accounting standards were introduced by the Roosevelt administration and later emulated in developed countries. However, when the recent crisis started, the potential for US leadership was at a historic low. The Bush administration was impaired by policy failures and a drubbing in the mid-term elections of late-2006. It was seen as hopelessly captured by private interests. And, not coincidentally, the financial crisis had originated in the US.

It seemed a perfect moment for Europe to lead in shaping the global regulatory response, if only by default. Arguably, this happened, when the demonstration of unity on 12 October 2008 by governments in the euro area and by the UK topped the downward spiral of a marketplace that had been traumatised by the nationalisation of Fannie Mae and Freddie Mac, the failure of Lehman Brothers, the rushed bail-out of AIG, the initial rejection of TARP legislation by the US Congress and the rapid destabilisation of the European banking sector.

However, this one-time European success did not translate into the regulatory discussion. One indication is the repeated failure of European attempts to impose a regulatory agenda on international partners. The G20 summit of November 2008 in Washington established a new format for high-level global discussion, but little else. Likewise, the London summit in April 2009 was preceded by sabre-rattling – for different reasons on the part of France, Germany and the UK – about the need for the US to accept tighter discipline for its financial industry. But its most prominent decisions were on largely unrelated matters such as the strengthening of the IMF and the fight against tax evasion in unco-operative tax havens.

The key reason for Europe's failure to assert leadership in the regulatory discussion is, quite simply, that it did not have a model to propose to the rest of the world – a fact that is itself a direct consequence of Europe's political and financial divisions.

In financial matters, the EU can be imagined as being composed of a busy port, namely the City of London, serving a vast and rich hinterland, the euro area, which itself serves a less developed but more rapidly growing territory. The latter is central and eastern Europe – in this oversimplified view, Scandinavia could be considered as having a financial life of its own and Switzerland is a distinct case which lies outside the EU.

The port (the City) and the hinterland (the euro area) are mutually interdependent: the euro area needs the City for access to the international foreland, notably global institutional investors; the City drives a lot of its business from wholesale operations of continental financial firms. But in matters of politics and policy, they follow largely diverging paths, London being naturally friendlier to open trade, finance and the conspicuous accumulation of wealth than the generally more corporatist-minded polities across the Channel.

In the decade preceding the crisis, this tension was resolved by the shared objective of financial market integration, an aim that combined a compelling economic rationale and a sponsor in the form of the European Commission.

The Commission itself relied on at least two powerful policy levers: competition policy, through which it forbade member states from using prudential arguments to block cross-border mergers (*pace* Italy's central bank governor Antonio Fazio in 2005); and internal market policy, which took the form of an activist programme to dismantle regulatory barriers to cross-border integration, namely the Financial Services Action Plan (FSAP) outlined by Mario Monti in 1999 and mostly rolled out by his successor, Frits Bolkestein, up to 2004. In more recent years, the objectives of "better regulation" and "focus on implementation", both often interpreted as "no new regulation" by Charlie McCreevy, internal market commissioner, resulted in the near-absence of EU regulatory initiatives beyond completing the remaining bits of the FSAP, namely the Capital Requirements Directive for banks and its insurance equivalent, Solvency 2.

> The fact that Europe did not have a model to propose springs from its political and financial divisions

But when the crisis put regulatory effectiveness back at the centre of the discussion, this political equilibrium was rendered unsustainable. The Commission, itself facing upcoming renewal, quickly shifted rhetorical gears and started referring at every occasion to the need for tougher standards; it also chose to focus its regulatory work on issues of supposedly significant political resonance but limited practical impact, such as public registration and monitoring of credit rating agencies. But no shared regulatory vision could be built quickly between the continent, where the crisis was generally blamed on Anglo-Saxon foreigners in spite of glaring domestic failures of risk management and public supervision, and the UK. It was there that its effects were most violently felt (among larger EU countries at least) but where the imperative to retain competitiveness in a worldwide competition for wholesale financial activity has so far largely prevented a dramatic regulatory shift, as was recently illustrated by the FSA's U-turn on compensation.

While developments in the UK remain uncertain, this division was enough to prevent elaboration of a framework at a time when Europe could have made itself heard. By the time a compromise approach started to emerge, with the delivery of the Larosière Report in late-February, Barack Obama had been inaugurated as US president and the opportunity for the EU to frame the discussion was ending.

Where do we stand now in the debate on how to regulate financial firms? On 17 June, the Obama administration published a plan now being discussed in Congress. The central proposal is to define a category of systemically important financial firms, irrespective of their legal or regulatory status – in the plan's jargon, "Tier 1 Financial Holding Companies". The criteria for such designation would be elaborated by a Treasury-chaired committee but the actual regulation would be exercised by the Federal Reserve.

Correspondingly, the separation between financial firms and other economic actors would be made tighter, so that the Fed's supervisory scope would not unduly extend to non-financial companies. In spite of the Larosière Report's recommendation to "extend appropriate regulation, in a proportionate manner, to all firms or entities conducting financial activities of a potentially systemic nature, even if they have no direct dealings with the public at large", the EU has no specific comparable proposal, as it retains the logic of having separate regulatory frameworks for separate categories of financial firms such as banks, insurance companies, hedge funds, etc. Simultaneously, the US plan attempts to address the challenge posed by "too-big-to-fail" institutions by proposing that "the prudential standards for Tier 1 FHCs – including capital, liquidity and risk management standards – should be stricter and more conservative than those applicable to other financial firms to account for the greater risks that their potential failure would impose on the financial system". This is an endeavour also without equivalent in the European discussion.

The US plan drives the discussion a big step forward by articulating not only what should be done but also who among the many US financial authorities should do what. By contrast, because of severe constraints of consensus-building, the regulatory section in the Larosière Report could only make general recommendations without assigning them to specific players. This creates a new set of controversies in the US debate, most crucially perhaps about whether the vastly expanded supervisory powers of the Fed over an array of financial firms would be compatible with its core monetary policy mission.

How such questions are to be addressed will be decided largely by the congressional debate and may differ in significant ways from the administration's initial blueprint. But overall, the US policy discussion now has a lead on the most difficult regulatory issues raised by the crisis, and it appears likely that whatever key choices are made across the Atlantic will be broadly replicated in the EU. For example, if the Fed (or another federal agency) is effectively granted supervisory authority over any systemically important financial firm, whatever its legal status, or if US legislation effectively imposes more stringent regulatory standards on large financial firms than on smaller ones, it is to be expected that the EU will eventually introduce comparable measures. Whether this will be positive or negative for the EU will depend on the criteria envisaged for such an assessment, and may be too early to predict as it will depend on the details of the corresponding rulemaking.

On one issue, however, the EU remains naturally the most exposed and also the most likely jurisdiction to devise new solutions, namely how to meet the institutional challenges created by cross-border financial integration. In this, the EU is once again placed at the cutting edge of supranational institution-building, as it was with the creation 10 years ago of the ECB, whose action during the crisis has been generally praised. As previously argued, the underlying consensus driving EU policy during the decade preceding the crisis was to prioritise financial integration over any other considerations, including prudential ones, to eschew intractable policy differences, especially between Britain and the continent. But as the crisis has shattered this consensus, it also has opened a space for introducing ways to manage cross-border financial integration with matching, i.e. supranational, policy instruments.

The US plan drives the debate forward by articulating not only what should be done but who does what

From this perspective, the decisions made by the European Council on 18 and 19 June, immediately after the announcement of the US regulatory reform plan, may be seen as of key significance – even though too many details are still missing to make a reliable assessment.

Specifically, the agreement to transform the three Lamfalussy Level 3 Committees, currently advisory bodies to the Commission, into full-fledged supervisory authorities (respectively on banking, insurance, and securities) with binding decision-making powers and the ability to supervise directly some market participants (for example, credit rating agencies), appears to overcome a bottleneck. This had prevented creation of any EU-level financial authority separate from the Commission and the ECB, even where the need for such players had become overwhelming (for example, consistent enforcement of international Financial Reporting Standards).

The safeguard provision added by the Council, that decisions made by such authorities should not impinge on member states' fiscal sovereignty, does not impair the significance of this step if it is confirmed by corresponding legislation, for which the Commission is expected to release a draft early in the autumn. To be sure, in the short term there is every reason to doubt that these European supervisory authorities will have much impact, as their tasks are likely to be severely limited, their budget paltry, and their governance too tilted towards compromise among member states, not to mention problematic overlaps of the three authorities between themselves and with the Commission or ECB.

But these shortcomings can be corrected and there is a distinct possibility that the Council in June has created the initial basis for the empowered supervisory institutions the EU needs to sustain and deepen its financial integration over the long term. Needless to add, the stakes for the UK in this debate are high: making compromises on national supervisory sovereignty is difficult, painful and perilous but the downside risk of EU financial fragmentation would be even worse for London as the continent's financial hub.

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