The Challenge of Europe's Effort at Financial Redesign

By Nicolas Veron

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Even as it struggles to deal with Greece's problems, the European Union is undertaking another vital effort – overhauling its framework for financial regulation, including establishment of the first EU-level financial supervisory authorities. The outcome of the European legislative process is uncertain, but it will have a decisive impact on the shape of Europe's financial system.

The legislation under consideration by the European Parliament would create three new EU agencies to oversee banks, insurers, and securities and markets respectively. Unlike the committees they would replace, these agencies would have a formal decision-making process and binding powers on individual cases, making them in effect the world's first supranational financial supervisors. In addition, a European Systemic Risk Board, mostly coordinated by the European Central Bank, would monitor major financial risks and issue recommendations to address them.

These proposals, based on a February 2009 report by a task force led by French former central banker Jacques de Larosière at the request of the European Commission's president, received unanimous political backing at a summit of EU leaders in June last year. Their backing was truly remarkable, given the intensity with which some member states – most conspicuously the United Kingdom, but also Germany, Spain and others – had resisted similar attempts in previous years.

The importance of a breakthrough in this area cannot be overestimated. The EU aims to build a single financial market, but finance cannot develop without effective supervision. Entrusting the task to 27 different national authorities, with a track record of protecting local players or attempting to control them, creates constant pressure towards fragmentation. The existence of an EU level of financial supervision is a necessary, though not sufficient, condition for sustainable market integration.

Unsurprisingly, the proposed design is a compromise, and is vulnerable to legitimate criticism. Under the current version, adopted by member states last December, the new authorities' powers are limited. Their rulemaking would be subject to approval by the European Commission. The proposed governance is problematic, consisting of supervisory boards in which the full-time chair has no vote, all but guaranteeing that only parochial national standpoints are represented. A clause that their decisions should not have fiscal impact on member states is seen by some as a portent of future paralysis. The division between banking, insurance and securities into separate authorities arguably overlooks the strong interdependencies among these segments.

Much of the discussion is now about the powers granted to the new authorities. In the current version, they would mostly act as arbiters between national watchdogs in case of disagreement, depending on the circumstances. The only players unambiguously subjected to EU-level supervision would be credit rating agencies, a small if important category. Some European parliamentarians understandably want to extend the authorities' mandate -- for example, by making the European banking authority directly supervise pan-European banks.

But at least equally important is how good their decision-making will be. The current measures, though crucial, are not the end of the game: if the new bodies start with limited responsibilities but carry them out effectively and competently, they will gain trust and support from most stakeholders. Only from such a basis could they be granted, over time, the more sweeping powers needed to ensure the sustainability of an integrated EU financial system. Trying to achieve such a goal in one move is not politically realistic, and not sufficiently cognizant of the crucial role of such confidence-building.

From this perspective, the focus of the parliamentarians should be on improving the authorities' hastily designed governance, possibly by expanding their boards to individuals who would represent a European-wide interest as opposed to national views, as at the European Central Bank, and perhaps by pooling national representatives into multi-country constituencies to reduce the boards' size, as at the International Monetary Fund. Locating all three agencies in the same city, as European parliamentarians have suggested, would also lead to better performance.

The timetable could determine the outcome. Assuming the Conservatives win the UK election in May, this issue will be their first major European discussion. Their Euro-skeptic base is unsympathetic to delegating responsibility to the EU in an area as important to the UK economy as financial services. If the discussion is only about the new agencies' powers, the European Parliament and the future British government may find themselves on a collision course. If it is about governance and effectiveness, a common ground may be found.

The stakes are high. If the attempt to create a more integrated supervisory framework founders, markets could lose faith in the prospects of pan-European banks, and encourage them to retreat to their original home market. Such a result could pose a bigger potential setback for European economic integration than anything that has happened in the crisis so far. The EU cannot afford failure in this reform.

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