Rethinking Europe's Financial Regulation, in London

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The drama, dripping with *Schadenfreude*, which played out two weeks ago might have been entitled 'the inconvenience of being independent'. Mervyn King, Governor of the Bank of England, has overestimated his ability to maintain an unyielding stand in the midst of credit turmoil. Unlike the US Federal Reserve and the European Central Bank (ECB), he refused to pump liquidity into the banking system and stated on 12 September that : 'the provision of such liquidity support (…) encourages excessive risk-taking and sows the seeds of a future financial crisis'. This was textbook application of the economic theory of moral hazard, whereby helping sinners in distress only acts as an incentive to sin again. But a few days later the queues forming outside the branches of the embattled Northern Rock bank obliged him to make a dramatic U-turn and go well beyond what the ECB had done, by accepting mortgage debt as collateral. Theory had hit the wall of reality.

It is not only the personal credibility of Mervyn King which is in tatters after this debacle. Following the failure of BCCI (1991) and Barings (1995), the shortcomings in UK financial regulation had in 1997 led Tony Blair and Gordon Brown, newly installed in power, to reshuffle the cards. The underlying principle was the independence of the Bank of England to set interest rates, while banking supervision and market regulation were entrusted to the newly created Financial Services Authority (FSA). The Bank, the FSA and the Treasury were together to manage financial crises. This 'tripartite' approach, originating in Scandinavia in the 1990s, subsequently inspired other countries to do likewise, Germany being one in 2002. However, Northern Rock was its first true test and the failure cannot be laid exclusively at the door of Governor King. In a hard-hitting editorial ten days ago, the *Financial Times* summed up the mood of many observers when it concluded that this division of responsibilities had proved itself 'unworkable', and that 'the tripartite approach will have to be reconsidered as will banking supervision more generally.'

Reform of financial regulation is thus the order of the day in London, and is bound to stir a national debate in the UK. But over the last ten years European financial markets have integrated at a dramatic pace, a development of which the City has been both an agent and a beneficiary. With the increasing complexity and interdependence of financial operations, it has become harder to ensure the coherence of the regulatory architecture. National and European regulation and supervision should be complementary, but the reluctance of member states has so far thwarted attempts to create a European level of authority, even where the need for one is flagrant, such as for supervising pan-European banks or enforcing international accounting standards. The 1997 UK reform sought to bolster the independence of monetary policy by separating it from day-to-day supervision of the financial sector. But the Northern Rock episode confirms the close link between financial stability and monetary policy, especially at times of crisis.

In fact, there is no ideal model, and the circumstances are different for each country and vary over time. France, Spain and Italy have kept banking supervision under the control of the central bank. The Netherlands has carved out conduct-of-business regulation and entrusted it to a separate agency. France has been spared the banking accidents of the last few weeks but should not allow itself to become complacent. The French regulatory system remains highly fragmented. It must adapt to the growing internationalisation of the big banking groups, and to the increasing interpenetration of retail banking, investment banking and insurance. One should hope that the ongoing debate in London is not conducted in isolation but is linked to complementary reforms in Brussels and in other European capitals. It should be conducted with the European interest in mind – which, as the past decade has shown, is in no sense incompatible with the interest of the City.

Continental European stakeholders should play an active role in the forthcoming debate in London, while respecting UK sovereignty. The recast of British financial regulation cannot be separated from a more general rethink of the European setup.

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