# After The Storm: The Future Face of Europe's Financial System

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<u>(These remarks are the personal views of author and should not be taken as reflecting the views of any organisation with which he is associated)</u>

1. The subject of my remarks today will concern a new institutional structure for the governance of Europe's financial system. I will focus my remarks on the Report of the Larosière Group and the Turner Review.

2. I make no apology for concentrating on institutional issues. Because institutions shape decisions and create culture. The wrong institutional structure is likely to give rise to wrong decisions. The right institutional structure can never guarantee good decisions, but it can make them more likely.

3. Let me begin at the beginning? What are the fundamental causes of the current crisis?

4. The Larosière Group and the Turner Review agree here. The Turner Review states

   > *At the core of the crisis lay an interplay between macro-imbalances …and financial market developments and innovations…"*

5. The Larosière Group points to an "*environment of plentiful liquidity and low returns*" caused

   > *…by the accumulation of huge global imbalances. The credit expansion in the US was financed by massive capital inflows from the major emerging countries with external surpluses, notably*

*China. By pegging their currencies to the dollar, China and other economies such as Saudi Arabia in practice imported loose US monetary policy, thus allowing global imbalances to build up. Current account surpluses in these countries were recycled into US government securities and other lower-risk assets, depressing their yields and encouraging other investors to search for higher yields from more risky assets*[1]*…*

Europe and Japan had some role in this episode but in essence the Larosière Group are right.

6. Unless we can prevent disruptive economic imbalances, sooner or later we will find ourselves visited by another storm

7. Hitherto, the guiding philosophy of policy makers in the G7 countries has been – keep your own economy healthy and all will be alright. There was insufficient realization that the imbalances, the spill overs were stoking up the credit conditions that gave rise to the present storm.

8. For the future, we need effective machinery for international economic and financial cooperation if we are to avoid the financial storm that we are now experiencing.

9. Of course, we should introduce measures for macro-prudential supervision which are recommended in the Report.. But even the toughest macro-prudential rules would not have saved the global financial system from the excesses of the liquidity glut of the latest era of good feelings. Macro-prudential supervision has to work *in support* of policies for sustainable global economic balances, not in substitute for such policies.

10. But back to the Larosière Group's recommendations for European institutional reform as it affects global decision making. They recommend

[1] The de Larosiẻre Report, Chapter 1, paragraphs 9 and 10

*…that a coherent EU representation in the new global economic and financial architecture be organised.*

*In the context of a more ambitious institutional reform, this could imply a consolidation of the EU's representation in the IMF and other multilateral fora.*[2]

11. These mild words conceal a minefield. Together with three colleagues, I wrote a Report a few years ago that explained why.[3] Effective international economic cooperation requires

    - ✓ The creation of a G4 as the forum for international financial and economic cooperation, with membership drawn from the four economic power blocs that have effectively created the global imbalances – the USA, Japan, China and Europe
    - ✓ The strengthening of the institutional structure of the International Monetary Fund.

12. Both recommendations pose great political challenges for the European Union.

    - ✓ In the first case – the creation of a G4 – who is to come from Europe? Certainly, the President of the European Central Bank, but who else? The President of ECOFIN, a European Commissioner, the President of the Eurogroup, the Finance Ministers of the larger member states? And what is the of the European ministerial representative to speak on, let alone to make informal commitments on economic policy?
    - ✓ In the second case –strengthening the institutional structure of the International Monetary Fund –will require to use the words of the Larosière Group, "…*a consolidation of the EU's representation in the IMF and other multilateral fora".* In other words, fewer Executive Directors, fewer votes in international economic fora and fewer European Ministers speaking for Europe.

[2] Ibid, paragraph 256

[3] International Economic and Financial Cooperation: New Issues, New Actors, New Responses. Kenen, Shafer, Wicks and Wyplosz, Geneva Reports on the World Economy 6

13. To some these changes may sound trivial. But make no mistake about it. They go to the heart of national sovereignty and national prestige. They pit big member state against medium and small member states.

14. They are essential if the European Union is to play an effective role in the management of global imbalances. New arrangements for representing the European Union in the international economic bodies must be a feature in the future face of Europe's financial system.

15. Let me now come to some of the particular recommendations in the Report of the de Larosière Group.

16. Most of the recommendations of the Larosière Group and of the Turner Review concerning regulatory and supervisory reforms are admirable and should be implemented as quickly as possible. My doubts relate to the Group's recommendations for institutional reform.

17. **First,** the core of the Report's proposals is the establishment of two new institutions, the European Systemic Risk Council (ESRC) and the European System of Financial Supervisors (ESFS) with the Economic and Financial Committee (EFC) of ECOFIN having some sort of coordinating role.

18. The objectives are admirable. But the machinery proposed is immensely cumbersome. On my rough count, the ESRC would have 33 members, each of the three Authorities constituting the ESFS would have at least 27 members and the EFC has over fifty members.

19. Admittedly some of the members of these various bodies are the same, but decision making in such complex machinery will inevitably be tortuous, subject to opaque compromises and turf battles. Nor is this machinery suited to discussion of some immensely market sensitive issues which may involve particular firms. I am doubtful whether this machinery meets the test set by the Group,

> *It must be clear to everyone who should act and according to which timetable.*[4]

[4] Report, Paragraph 182

As an aside, let me add that the voting arrangements for the ESFS and the ESRC – simple, qualified or whatever majority – are unclear. So too is the compatibility of the institutional proposals with the Treaty.

20. **Second,** the guiding principle of the Report's proposal for the European System of Financial Supervisors (ESFS) is that it should be "a decentralised network"[5]. I do not believe that such a system will meet the Report's own benchmark

> *Supervision must ensure that all supervised entities are subject to a high minimum set of core standards. When carrying-out their duties, supervisors should not favour a particular institution, or type of institution, to the detriment of others[6].*

21. In this era of "national champions", the national home supervisor will remain under immense domestic pressure to favour the local institution over the foreign. And in an Authority made up of fellow national supervisors, the likelihood of an Authority overruling a fellow supervisor, except in the most egregious case, must not be high, especially if the supervisor comes from one of the larger member states.

22. The Group quote figures that suggest that the four largest Eurozone states have the lowest penetration of foreign banks into their markets.[7] I do not see the Group's proposals stimulating much change.

23. **Third,** the Report's emphasis on decentralised supervision will give an incentive supervisors to press firms to establish local subsidiaries, rather than to work cross border through branches. Why? Because the domestic supervisor will want more control and will press for local business to be done through subsidiaries rather than through branches. And once created, the tendency will be for the subsidiary's home supervisor to seek to ring fence the subsidiary's assets, for example to prevent the up-streaming of liquidity. For reasons that I can easily understand that is an important theme of the Turner Review with

[5] Larosiere Report, Recommendation 18
[6] Larosiere Report, Paragraph 150
[7] Larosiere Report, Annex 3, Figure 1

its call for "…strongly capitalised local subsidiaries…"[8] and its bias against branches.

24. The result – the financial industry will not be able to fulfil its economic raison d'être of the efficient allocation of capital. The Single Market will be weakened as national supervisors focus on financial stability in their home markets. Moreover, the efficiency of the European financial market place for financial services will fall compared to the that of the United States. Because a Balkanised European market place will be handicapped in competing with the scale of the US market. That matters – because a less efficient European capital market will lead to a less efficient European economy.

25. **Fourth**, supervising large complex financial institutions requires an ability to distil an enormous amount of detailed and highly technical information into a coherent picture of individual firms' risk positions, to assess that picture against global market developments and to judge the viability of firms in various market scenarios. Supervision requires experience, not experience just in length of service but experience in dealing with a variety of complex cases.

26. In this context, the Report says

> *…it considers that the supervisory experience of the crisis points to the need for well staffed, experienced and well trained supervisors in all Member States,…*[9]

27. I agree, but I have doubts about those last four words, "*in all Member States".* Over half of the member states have headquartered in their home state large complex financial institutions. It will be very difficult for the national supervisors however talented to gather sufficient experience if their attention is concentrated on a limited number of national cases.

28. **Fifth**, the Group argue, and rightly so, that

[8] Turner Report, Action 26
[9] Larosiere Report, Paragraph 155

> *Poor supervisory organisation or unduly intrusive supervisory rules and practices will translate into costs for the financial sector and, in turn, for customers, taxpayers and the wider economy. Therefore supervision should be carried-out as effectively as possible and at the lowest possible cost*[10]*.*

29. I have already argued that working through subsidiaries, rather than through branches, increases firms' costs. Servicing colleges is expensive and the establishment of the ESRC and ESFS would provide two further interlocutors for large complex financial institutions. Those working in their firms' regulatory and public affairs departments will not be short of work.

30. **Sixth**, an effective system of supervision requires teeth – sanctions which the supervised believe are capable of biting.

> *In the event of the national supervisor failing to respond to this [an Authority's] ruling, a series of graduated sanctions could be applied, including fines and the launch by the Commission of infringement procedures. In exceptional circumstances, where serious issues of financial stability are at stake, the Authorities should be able on a temporary basis to acquire the duties which the national supervisor is failing to discharge.*[11]

31. In theory, such a regime is possible. But it has a whiff of the sanctions regime under the excessive budgets deficit procedure. Hardly an encouraging precedent.

32. These, I believe, are serious doubts of whether the Group's proposals will in practice bring meets its objectives.

33. So we have a dilemma here, elegantly summed up by Lord Turner as follows

> *Sounder arrangements require either increased national powers, implying a less open single market, or a greater degree of European integration. A mix of both seems appropriate: the extent to which more national powers are required will depend on how effective 'more Europe' options can be*[12]*.*

34. There is an echo of this dilemma – more Europe or less Europe – in the section of the Larosière Report headed, "Reviewing and Possibly Strengthening the European System Of Financial Supervision". In this

[10] Report, Paragraph, 135
[11] Report, Paragraph 208 iv
[12] Turner Review, page 101

section the report's authors answer the question, 'What do we do if the Report's central recommendations for institutional change do not meet their objectives?"

35. Their answer is set out in Recommendation 24, which states

*The functioning of the ESFS should be reviewed no later than 3 years after its entry into force. In the light of this review, the following additional reforms might be considered:*

> - *Moving towards a system which would rely on only two Authorities: the first Authority would be responsible for banking and insurance prudential issues as well as for any other issue relevant for financial stability; the second Authority would be responsible for conduct of business and market issues;*
> - *Granting the Authorities with wider regulatory powers of horizontal application;*
> - *Examining the case for wider supervisory duties at the EU level.*[13]

36. In other words, they indicate a roadmap, in properly tentative terms for strengthening the system if the recommendations in their Report do not meet their objectives.

37. I believe that it would be prudent to give some intensive study to the approaches hinted at in Lord Turner's ""more Europe" options" and in the Larosière Group's Recommendation 24 though I would add to their list of matters to consider

> *Fiscal implications of moving supervisory duties to the EU level.*

38. Thank you.

[13] Larosière Group Recommendation 24