Credit crunch pushes cross-border watchdogs high on EU agenda

Europe lacks credible means to manage a cross-border banking crisis, warns

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As shockwaves from the US sub-prime turmoil continue to reverberate around the globe, market confidence in Europeans' ability to handle a financial crisis on this scale is in doubt. Severe lapses in the regulation of banks – notably in Germany and Britain – damaged the credibility of national systems of supervision. And the European Union remains ill-equipped to handle cross-border crises sparked by increasingly interdependent EU banks and by complex patterns of international investment. At least there was one silver lining to the cloud: the European Central Bank proved willing and able to pump enormous amounts of liquidity into money markets from the very beginning of the crisis in August 2007.

But when the dust eventually settles, it is very unlikely that Europe will return to financial market regulation as usual. How different things looked in October 2006 when the City of London celebrated the 20th anniversary of its "Big Bang" liberalisation of securities trading. Back then, many people working in Europe's financial markets and public institutions felt they had good reason to be satisfied with progress to date. Some verged on the complacent, expecting Wall Street to decline and London to dominate a global 24-hour financial market on which the sun never set. Brussels had been busy during these 20 years, too. EU financial integration policies began in earnest in the 1980s, and the Commission and Council made great strides in financial sector reform. Among the milestones were the decisions in 1986-88 to suppress all restrictions on cross-border capital flows, and the launch in 1999 of an ambitious legislative action plan on financial services. The euro was introduced without a hitch and quickly became the world's second currency behind the dollar. The euro's resounding success defied the doomsayers who had prophesied that the EU could never become a stable currency zone.

Perhaps less conspicuous, the EU's decision to adopt International Financial Reporting Standards (IFRS) in 2000-2002 triggered an extraordinary move towards the global harmonisation of accounting rules. Meanwhile, the Commission's steadfast defence of competition in the banking sector – particularly in Portugal, Germany, Italy and Poland – ended an era of protectionism in the guise of prudential control; this helped to spur cross-border financial integration to an extent unprecedented in developed economies.

With hindsight, it is clear that all these achievements came about during a period of remarkable stability in Europe's financial markets. Even during the 1992-93 dark days of the European Monetary System, Europe looked like a safe haven in an unsettled financial world. Many countries outside the European Community suffered banking crises, including close neighbours Norway, Sweden, Finland and Turkey, plus many eastern European nations during their transition from communism. In contrast, the most serious failures for banks inside the EC in the 1990s – including BCCI, Crédit Lyonnais and Barings – had only a limited fiscal cost and a negligible impact on economic growth. Later there were scandals over corporate governance in Asia and then in the US, notably after the dotcom bubble burst in 2000-01 and the accounting debacles at Enron, WorldCom and others became public. But these events only encouraged Europeans to think that the "old continent" had somehow preserved higher standards than its peers.

Such fair-weather conditions on European markets meant it had been plain sailing for Europe's financial regulators. The subprime storm ended all that and now the EU is, for the first time, really in

troubled waters. It is far too early to draw conclusions from the situation but, from a public policy point of view, three points can already be made.

First, the European Central Bank proved itself to be an efficient lender of last resort to Europe's financial system. When in early August 2007 the asset-backed commercial paper market started to freeze, the ECB was quick to react and continued to intervene as long as the inter-bank market needed support. The ECB defied criticism that it is unwieldy and bureaucratic, and demonstrated it could act boldly and decisively in the face of market upheavals. Banks in the eurozone and beyond all benefited. In contrast, the Bank of England's reluctance to provide liquidity – because of concerns about "moral hazard" – proved to be a poor choice.

Second, national banking supervision in Europe fell seriously short of requirement and the overall credibility of the system is now in question. In Germany, the authorities have been deplorably tolerant of commercial banks' involvement in complex "asset-backed commercial paper" investments, which were kept off their balance sheets via so-called conduit operations in Ireland.

Even if the three German banks that were most stricken by the credit crunch – Sachsen LB, IKB and WestLB – had technically complied with capital adequacy requirements, their "conduits" represented very high risk factors at around 30%, 20% and 13% of their total assets respectively. Much stronger supervisory responses were needed in these circumstances. In Britain, the Northern Rock meltdown highlighted problems between the three public bodies responsible for financial stability: the Treasury, the Financial Services Authority and the Bank of England. Some commentators, including the Financial Times and The Economist, said the whole tripartite system introduced in 1997 was at fault. In France, the rescue in November 2007 of CIFG, a US-based "mono-line" insurer, by two cooperative banking networks – Caisses d'Epargnes and Banques Populaires – cast doubt on the risk management abilities of their joint subsidiary Natixis.

Overall, it is clear that efficient bank supervision cannot be taken for granted. Extensive soul-searching, public debate and, eventually, reform will be needed in all EU member states where deficiencies have become evident. Policy changes may have to include tougher rules on financial firms to disclose their exposure to risks, not only to official supervisors but also to the public.

The third and final lesson that can be learned from the current financial turmoil concerns a long-standing but increasingly urgent problem. Europe lacks credible arrangements for the management of cross-border banking crises. Until recently, most banks focused on their country of origin, so risks largely arose under their national system of supervision. Now Europeans banks have dramatically expanded their operations across the EU. Ten years ago, non-domestic assets were barely one-sixth of the total European assets of the EU's largest banks; today the proportion has grown to one-third. By contrast, the proportion of assets held outside the EU is almost unchanged. Cross-border mergers and acquisitions are likely to continue apace once the current market turbulence is over. This degree of interdependence significantly increases the likelihood of a major cross-border banking crisis. Both financial theory nd past experience show that such crises cannot be effectively managed by scattered national regulators who face conflicting pressures. Without a framework for more centralised supervision of a limited number of major international banks, the cost of a future cross-border crisis involving one of them is likely to be larger than Europe's economy can afford.

There are therefore very good reasons to put discussion about new EU-level prudential institutions high on the policy agenda. The exact arrangements will have to be decided, but they must allow quicker and better-informed decision-making. A system built on a strictly limited mandate could be both more efficient and less controversial than some all-encompassing single financial regulator. No doubt there will be difficult political and technical issues to resolve, but the current credit chaos has generated a fresh feeling of urgency. Even Britain, an enduring opponent of EU institutions for financial regulation, may decide that its own interests as Europe's financial hub would be better served by reform, rather than today's ill-adapted cross-border supervision.

As Walter Bagehot, the Victorian editor of The Economist, once famously said, "Money will not manage itself". The private sector cannot act alone; it needs support from well-adapted public institutions. An up-to-date system of EU supervision is now more crucial than ever if Europe's financial system is going to serve its proper purpose.

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