Economic Governance in the Eurozone and the EU: Drawing lessons from the crisis

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Reforming Regulation and Supervision in Europe: Five (Missing?) Lessons from the Financial Crisis

Financial regulation and supervision must change. Everybody agrees about that. But how? Both in the EU and the US reform proposals have been outlined. In order to be effective, such proposals should heed the lessons of the financial crisis, especially when it comes to the design of rules. Generally speaking, the financial crisis taught us that at the root of it all, in addition to monetary policy having been expansionary for too long, there was bad regulation, which caused two intertwined deficits: an information deficit and a behavioral deficit (i.e. different types of misalignment of incentives). In order not to risk making the same errors all over again, five main reforms should be implemented.

1) **Accounting**: The first pillar of a good reform is constituted by the necessity of having common accounting rules. The financial crisis found a potent fuel in the fact that in various institutional contexts banks were allowed to develop over-the-counter assets that are off their balance sheet, which have catalyzed uncertainty over the distribution of risk. To this day, there is the need to understand what in banks' balance sheets need to be overturned, also in some European countries, although it creates further friction in terms of the harmonization of rules. In general, the differentiation of accounting rules can give rise to regulatory arbitrage, thereby distorting international competition. It also distorts the criteria on which oversight is based. On this issue, the US is not moving, and the only concrete measures have been about putting off the moment when

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things will have to be taken care of. Europe has not done anything when it comes accounting norms, either.

2) **Missing Markets**: The second pillar is the necessity of defining regulated markets for any significant financial transaction, starting with markets for derivatives. Financial innovation has enabled banks and firms to create *ad hoc* bilateral contracts to manage or take on the most diverse forms of financial risk. So-called derivative contracts have experienced formidable growth. In the aggregate, their theoretical value has reached a size which is ten times as large as the more established currency markets. The diffusion of bilateral derivatives has had an undesirable aggregate effect: it created uncertainty over the production and the distribution of risk among the various industries and countries.

Information deficits and doubts over the solvency of counterparts fed off one the other in a vicious spiral. Regulated markets for derivatives must be created: risk-management instruments must be standardized, in order to improve information and enable the creation of compensation houses which can guarantee the trustworthiness of exchanges. The proposals for the creation of regulated markets for derivatives – put forward both in the United States and the Europe Union – have their opponents. It's those banks and companies which underline the risks of standardization in terms of effectiveness and efficiency of transactions.

The subject has only been timidly addressed by the Obama proposal, in partial way and using the prohibitionist approach *à la* Volcker. Also in Europe, there's the risk for the prohibitionist approached to be applied: it suffices to look at recent German measures forbidding naked shortselling.

3) **Prudential Regulation**: The third pillar concerns the reform of prudential regulation, which must include not only those who must be controlled, but how to control, to avoid that rules augment, rather than correct, distortions that then morph into crises. Distortions involve incentives that make banks become to big or too important from the point of systemic risk, and encourage procyclical conduct as well. On one side capital coefficients need to be revised. On the other, it is necessary to widen the spectrum of indicators, with at least the introduction of liquidity coefficients. But also revision in the quality and quantity of prudential requirements has its discontents, in general in the banking sector, and on specific aspects, with opposing fronts cutting across countries and banks of different types. The debate over the so-called Basel 3 does not seem to have reduced uncertainty about the future, thus increasing the risk of credit rationing, among other things.

Lastly, there are fourth and fifth pillars linked to the architecture of financial supervision and the role of the central bank, which have been addressed – a rather unsatisfactory way in my opinion – in both the Obama proposal and the European Commission proposal. To these last two aspects I therefore devote closer attention.

4) **Regulatory Architecture**: the fourth pillar is represented by the number and design of oversight authorities.

How do you monitor and oversee constantly fluctuating markets that are ever more complex and cross-linked? The general formula for good oversight is always the same: to have accurate, updated, and complete information. But it's the application of the classic formula that is problematic today. Until not many years ago, in markets that were essentially segmented – bank, stock exchange, insurance – and static, taking "snaphots" of banks and intermediaries from time to time was enough. Now to have a complete and updated information outlook, there needs to be highly skilled human capital, capable of 360-degree monitoring of the whole financial industry. Hence the progressive tendency to change regulatory architectures in ways which display a dominant feature: consolidation.

Regarding the level of consolidation of supervision structures, it's easy to observe that both the US and the EU have major gaps to fill. The lag of the United States in this respect is particularly striking. The oversight architecture – which has gradually come into being since the 1920s – is the most emblematic case of the model with multiple authorities. Firstly, since the US has a federal structure, the system of controls works on two levels: at the state level, so that in each of the 50 states there are controls on banking, trading and insurance, and at the federal level, which is in turn characterized by ten oversight authorities or so.

One could have expected that the progress toward a single US financial market – taken with remarkable decision and speed – would have been accompanied by a similar rationalization of the system of regulation and supervision. No such thing. The effect of such a model? The multiple-authorities model suffers adverse consequences, both ex ante and ex post, from the growing integration of the markets. Ex ante, the plurality of authorities can paradoxically increase gaps in oversight, and make forms of regulatory arbitrage more probable. So preventing crises becomes harder.

Ex post – after the crisis has occurred – the multiple-authorities model gives rise to the offloading of responsibility. In other words, nobody can answer the question: "Whose fault was this?". Every controller either blames others over responsibility, or talks about exogenous, imponderable factors. Let's add the fact that US politicians have always liked to have multiple authorities. If you throw into the mix the tale of "competition in regulation" – the idea according to which competing authorities increase the quality of regulation – you can see how a system of power and money flow, in which politicians and bureaucrats can thrive, was built at the federal and state levels.

Is the Obama plan a real change with respect to this? Absolutely not. There is talk of instituting a Consumer Financial Protection Agency, which would be an independent federal agency protecting small investors. And there is the proposal of instituting a new coordinating entity, the Financial Services Oversight Council, which would assemble all financial supervisors, with the aim of ascertaining systemic risks. To coordinate regulatory action in the insurance industry, there is the proposal to create an *ad hoc* office – the Office of National Insurance – within the Treasury Department. The model with multiple authorities could end up being maintained, and perhaps even shored up.

Similar judgment should be reserved for the proposal formulated by the European Commission. The projected reform does not create any incentives to move toward the reduction in the number of control authorities. Actual European supervision – the so-called micro oversight – would be shared

by three authorities – for banking, trading, insurance – following the obsolete criterion of sector-by-sector market oversight. Such principle does have an advantage, though. It is liked a lot by national politicians and national oversight authorities, because it helps maintain positions of power both at the national and European levels. Hence the tendency toward the consolidation of oversight authorities seems to have come to a halt and always for the same reason: the dynamics of rules is strongly influenced by a political calculation, rather than an economic one, of costs and benefits.

5) **Central Banking**: Finally, the fifth pillar concerns the relations between central banking and financial oversight.

In terms of regulatory architecture, the most interesting innovation to have taken place in Europe over the last decade is the split between responsibility for monetary policy and responsibility for financial supervision, assigning each function to a different regulatory actor. Today, if we look at EU countries we can see that almost half of them – 13 of 27, have unified financial and banking oversight in the hands of a single authority. Also, the diffusion of this new model of supervision has been rapid, if one considers that the first country adopting it was the UK in 1998. Monopoly over supervision has gone hand in hand with the specialization of authorities: only in three cases – Ireland, Czech Republic and Slovakia – this single supervisor is the central bank. One should also note that these three countries are members of the Economic and Monetary Union (EMU), so that their control over monetary policy has been delegated to the ECB in Frankfurt.

The joint trend linking consolidation and specialization is precisely confirmed by looking at EMU members: eight of seventeen countries have consolidated – including also Holland, which has reduced to two the number of its authorities – while only in four cases the consolidation process has benefited central banks, which have become “specialized” in the policy of financial oversight. The few recent empirical analyses also give backing to the decision of reducing the number of financial authorities, and to not entrusting the central bank with monopoly over supervision.

But why in recent years has the trend not been in favor of handing the monopoly over regulatory policy to the actor already having monopoly over monetary policy? The explanation is simple: the disadvantages have outweighed the advantages. Those who favor the coupling of the two policy monopolies within the central bank object that there are significant benefits in terms of information. But there are other ways to improve information flows, beyond such coupling.

On the other hand, the coupling of the supervision function with the monetary function poses certain dangers. There is the risk of distorting the behavior of financial intermediaries, by augmenting their propensity to risk. When the controller is the same actor that can save you by printing money, the controlled are amenable to think that bailouts will be more forthcoming, precisely because the controller does not want to lose face.

There is a further risk in terms of central bank behavior, which can turn into an all-powerful bureaucracy, with related consequences. The fact that some central bankers seem to like this solution does not decrease such risk, quite the opposite. Lastly, all the previous unknown quantities increase in number, if the propensity is high within the political system to influence the central bank for its own ends.

Thus, the coupling of financial supervision and monetary policy tends not to keep banks, the central bank and the political system at arm's length from each other, with all the consequent risks. These risks are more relevant today, if one thinks how much tighter the relations between these agents have become in the wake of the financial crisis. Both regulatory policy and monetary policy must be managed by independent authorities: independent from banks, governments, and their own bureaucratic appetites.

The regulatory architecture of central banks should ensure that the government of money be not subjected to either the vagaries of the electoral cycle or political ideology. The expressions "independence" and "accountability" have entered everyday language, but they need to be given more significant meaning. How to guarantee the correct perimeter – in the interest of citizens – of the triangle of power linking the central bank to banks and the political system, if two of the corners are already so close to each other?

The project for reforming the EU's structure of oversight has been welcomed as a decisive step forward in the construction of a more robust architecture for the defense of financial stability. But is it really so?

In order to formulate a judgment on the proposal, we need to be clear about the final destination in the process of the construction of European financial supervision. If the final objective is to achieve a single European market for capital and banks, then the objective of financial stability must be accorded the same status hitherto granted to monetary stability.

The European Monetary Union and then the ECB were born out of the awareness that monetary stability was a public good that needed to be provided to all European citizens, irrespective of their nationality. Confidence in the new currency of daily use had to be developed. In order to have a single European financial market, every European must place trust in the reliability of asset and credit markets.

Confidence in markets depends a lot from the credibility of those governing them. To have credible governance of supervision in Europe, there are at least three necessary conditions that must be met: we must arrive at a European Financial Authority (EFA), independent both from governments and financial intermediaries, and separate from the European Central Bank. With respect to these three conditions, the reform plan of the European Commission does not seem persuasive.

Firstly, if you want to govern financial markets, you must understand them first: if I wanted to build a single European financial market, I'd want the tendency to be toward a single authority in charge of defending European financial stability. All recent experience – including the latest episodes of the financial crisis – has taught us the number of regulators must be reduced as much as possible. If markets tend to be without barriers, the more the controllers are the larger is the risk for information to be fragmented (you don't know who knows what), and responsibility to be opaque (you don't know whose fault it is). Thus, the tendency must be toward a single EFA.

But as seen previously, the reform proposal does not create the incentive to move in this direction. Secondly, the future EFA will have to be indifferent both to the preferences of governments and controlled intermediaries that will try to influence its decisions. The regulator is credible if citizens can bank on the fact that its choices, both in ordinary times and in times of emergency, will not be

affected by special interests. The concepts of independence and accountability that Europe has already applied to the ECB, must be rethought to ensure autonomy in the oversight of banks and markets. But the issues of independence and accountability are barely present in reform plans. This makes such proposals very appealing to those politicians and banks who would like supervision to be pliable and subject to political influence.

Finally, EFA and ECB should be two distinct entities: monetary stability and financial stability are interconnected objectives, but they are different from one another, so it's better for each to be presided by a different authority, designing strong forms of coordination, but which occur among equals.

The present reform proposal instead seems functional to giving the ECB a hierarchically dominant role in the new regulatory architecture, thus ending up reducing the distance between the conduct of monetary policy and the conduct of financial oversight. The distinction between micro and macro supervision is still weak on the theoretical level, and its actual institutional functioning remains to be defined. My suspicion is very strong that that we are going in the wrong direction.