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Europe's World

Has Europe failed in its combat against the financial crisis?

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Abstract

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Has Europe failed in its combat against the financial crisis?

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The financial crisis has hit hard Europe, as well as other parts of the western world. Europe's has responded to the crisis in a different way from the US and often criticism is heard about the weakness of the European response, the absence of real answers to the causes of the crisis, and the late awakening of Europe to its destructive force.

The response formulated to the crisis is deeply rooted in the way the different societies consider their role: Europe's answer, formulated within the context of the cooperation of 27 member states is bound to be different from the US where one single decision making centre, the Federal authorities, are able to formulate one single policy. This difference has certain advantages: it allows the different states to follow different schemes for re-establishing confidence, whereby the more successful ones will counterbalances the others. If one follows one single scheme, and that fails, the consequences are likely to be more detrimental. But is belongs to the paradoxes of history, that the US where traditionally there has been a strong repulsion for any form of state intervention, has massively intervened in the financial sector, while Europe was more hesitant at least initially, although ultimately the amounts involved are not that much different.

Often the criticism is addressed to the European Commission that it did not come forward with an overarching plan, and that it stood by from the sidelines. One should however keep in mind the structure of the European Union, and of its decision making bodies. The Commission has a certain but limited discretionary budget, that would not have allowed any substantial action. Fiscal support for financial institutions is a sovereign function and requires direct access to taxpayers' money. None of the European bodies enjoy that privilege: only the member states can raise taxes, and this in a unilateral way. At the Paris meeting, this message came through very clearly, when the decision was adopted that measures would be taken by each state, according to its own economic needs and legal system while keeping the other states informed. Competitive actions should be excluded. One could also wonder how the Commission, as guardian of the Treaty and especially of its provisions on state aid, could have reasonably granted financial support to these banks. If Europe failed to adequately support its banks, than it is the Member states that failed.

And the latter is not the case: there has been no bankruptcy of a major financial institution in Europe, unfortunately only of subsidiaries of American firms. National authorities have been quite effective to avoid widespread panic and with massive input of public means have been able to avert the financial Armageddon, that was looming after the US decision to let Lehman fail.

It is clear that financial support will weigh on the budget of many states for a long time, but at least, the losses are not fatal, they can be carried forward to better times. Deeper is the damage caused to the so-called real economy: here the suffering is immediate, as people will have lost their job and their income. And the effects trickle through to the entire economy, hitting the financial sector a second time. Social security systems may be able to alleviate the gravest concerns, at least if the crisis would not last too long.

The criticism that Europe has missed the train is therefore not justified, as one should take into account all factors. But that does not mean that the crisis can be taken lightly and that necessary reforms should not be adopted.

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[1] The author is presently chairman of the Committee of European Securities Supervisors. This paper is written in a personal capacity

The crisis has also taught us some imported lessons. First and foremost, we were not prepared to face this almost fatal meltdown. As the BIS wrote in its 2008 Annual report "no one thought that the financial system could collapse". The warning systems had not worked, the belief in the efficient market lead to a collectively passive attitude, and rare were the states that had sufficient expertise and processes in place to deal with a massive crisis as the present. It is sometimes stated with some cynicism that some states, that had been confronted with a severe crisis – by the way: also in the real estate sector – in the early 90s were better armed: the lessons were learned, the mechanisms well known, and not yet forgotten!

In the meantime, work is being undertaken to remedy this state of affairs, along with the short-term rescue measures. A few of these reforms may be mentioned here.

One of the most visible weaknesses of the present financial system has been the weak surveillance of macro risks. If supervisors adequately followed most of the financial activities, the overall unbalances – of which there were many-, were left to market forces. The huge built-up of credit and leverage, the unregulated and opaque part of the financial business, the amazing practices in some real estate markets are a few of these macro risks that, although identified, were considered less risky than e.g. the developments in the hedge fund sector that were often referred as the prime risk factor. In the future, analysis and monitoring of these so-called systemic risks will be addressed: in the US the Financial Services Oversight Council and in fact the Federal Reserve will be put in charge of following up on systemic risks, in Europe the European Systemic Risk Board will be in charge of exercising macro-prudential oversight of the financial system within the European Union. A bridge between these two strong national pillars will have to be built: the IMF and the Financial Stability Board, recently created by the G.20, could undertake this function.

Both in the US and in Europe, other major institutional reforms are being discussed. It appeared from the crisis that the present supervisory architecture presents some significant weaknesses. In the US, a serious concern addresses, apart from the systemic issues, the need to better coordinate the action of the different supervisory agencies. The abovementioned Council is planned to contribute to this aim. Moreover, a new supervisory body will be created, in charge of consumer protection, in fact mostly dealing with the protection of the consumer lending, both consumer and mortgage credit. But other features remain unchanged: insurance supervision will remain in the hands of the 50 states, the demarcation line between SEC and CFTC will be clarified, without more, while the numerous agencies in charge of banking supervision will remain, leading to overlap, lacunae and regulatory arbitrage.

In Europe, the specific federalist structure of the Union will also shape the reforms: actual supervision of financial institution will remain in the hands of local, state supervisors, as only these may call on the necessary fiscal support. But where no such support is likely to come into play, some form of centralisation at the European level could take place. This is the case for rulemaking, where apart from the present directives and regulations, more detailed recommendations and standards will become legally binding, thereby contributing not only to better integration of the market but to contribute to the "level playing field" without which Europe will not have an integrated financial market. In addition stronger mechanisms to enforce the application of the common rules by national supervisors will be introduced, also allowing disputes between supervisors –occurring essentially in a cross border context – to be definitely settled. These functions will henceforth be centralised at the European level, in the hands of the existing so-called Level 3 Committees, acting in the fields of banking, insurance and securities. In the future, CESR, the Committee in charge of securities, will become a European "authority" with said rulemaking and enforcement powers, and furthermore in charge of direct supervision for the Credit Rating Agencies. The banking and insurance committee will be strengthened along the same lines.

This new approach has been outlined in the de Larosière Report, approach that is now endorsed by the Commission, the Economic and Financial Council and finally by the European Council of Head of States and Governments. This approach has been outlined in a model for a European System of

Financial Supervision (ESFS). The plan is due for discussion in Council and parliament starting in October, the authorities being operational from 2011 on. The European scheme is likely to evolve over time, by strengthen the coordination role of the future authorities, but it seems unlikely that even over time, all supervisory functions will be centralised into one, super European financial supervisor.

Several other reforms are under way or have already been implemented. The capital requirements Directive for banks is being strengthened in several respects, e.g. by increasing the amount of required capital, or by obliging securitising banks to keep some of the securitised assets in their portfolio, and hence aligning risks. Very important is the change of insurance prudential regulation, called “Solvency II”, whereby a total new approach to risk management will be introduced in the securities sector. Further to be mentioned is the introduction of a stricter regime for credit agencies, and – more controversial - for hedge funds and private equity funds. But many other aspects will call for further regulatory action: short selling and management remuneration are two of the most conspicuous ones.

Among the more sticky points is the way to protect depositors of banks or other systemic financial institutions in case of failure. Deposit guarantee systems have been operational for many years, but their protection is too limited and does not offer a clear cross border picture. A Europe-wide system has been advocated, but raises serious difficulties. Even more important is the question of “fiscal support” or “burden sharing”: in case of collapse of a systemic institution with activities in several states, which states will be footing the bill? And what with the non- EU activities? Up to now, states have not been able to agree on an ex ante solution, although the present crisis indicated that ex post answers have been given. Member states have been able to agree on some procedures, and should be able to progress on outlining detailed methodologies, with agreeing ex post to a fixed key. Further work and discussion as qnecessary on these points.

To conclude: it seems a little bit short to state that Europe has not responded to the challenges of the present crisis. It has done it in its own way, within its own institutional and legal framework, taking into account the division of powers between the Union and the member States. More efficiency can only be obtained by moving this dividing line towards the Union. But this raises obstacles in terms of sovereignty that states are willing to overcome – but only to a certain extent. Suite au prochain numéro !

Financial Law Institute

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